Simulated transactions from a common–law perspective and whether this doctrine is still relevant in respect to the application of the current anti-avoidance rules

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DECLARATION

I, Martin Fredericks, hereby declare that this dissertation is my own, unaided work. It is being submitted in partial fulfilment of the prerequisites of the degree of Master of Philosophy in Tax Law at the University of Cape Town. It has not been submitted before for any degree or examination at any other University.

ABSTRACT

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ABBREVIATIONS USED IN THS DOCUMENT

TERM/CONCEPT	SHALL MEAN
GAAR	General Anti- Avoidance Rule
IT ACT	Income Tax Act 58 of 1962
SARS	South African Revenue Service
TA ACT	Tax Administration Act 28 of 2011
AD	Appellate Division
SCA	Supreme Court of Appeal
UK	United Kingdom

CHAPTER 1 - INTRODUCTION

1.1 Introduction

"Tax- gatherers dislike people who get the better of them. They see themselves as the custodians of the fiscal morals of the nation. Tax avoiders, they say, are bad citizens who dodge the column and put part of their burden on to others. While the small fry get up to minor tricks, the big employ specialists to launch tax avoidance rackets on a scale which makes bank robbers envious. The picture is one of the hapless tax-gatherer constantly following his astute quarry through a revolving door and never coming out in front. The tax avoider keeps one move ahead and all the complicated anti-avoidance legislation fails to stop him. In desperation the tax-gatherer is driven to the conclusion that to administer and construe the Income Tax and Finance Acts are not enough. He must have the power to search the taxpayer's conscience and compel him to bare his soul. Was he up to something? To protest innocence is not enough: there must be proof of it"[1]

1.2 The scope of the simulation doctrine

Common-law doctrines try to nullify some forms of tax evasion without the need to invoke statutory anti-avoidance provisions, for example GAAR. The first inquiry where a suspicion arises to tax-gatherers that a tax scheme is improper is whether it falls foul of common-law principles- Is the taxpayer involved in a 'sham' or disguised arrangement?

The tax-gatherers will have the following common-law principles at his disposal as established by our judicial decisions:

1. Substance prevails over form – The substance of a transaction is determined by the 'legal rights' of the parties as distinct from 'mere nomenclature'. Some foreign authorities, however regard the parties'

[1] Taxes, the journal of the Inland Revenue Staff Federation, England January 1978

'legal right' as constituting the 'form' of a transaction and the 'economic consequences as the 'substance'[2].

2. A taxpayer is entitled to arrange his affairs so as to minimise his tax liability as explicated in the Duke of Westminister[3] case, whereas, "Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".

3. The choice principle - where a taxpayer could achieve his objectives in different ways. In this instance our common law explicitly recognises the taxpayer's right to adopt the course of action that is fiscally advantageous to him. Giving judgement in the NWK[4] case, Lewis JA illustrates this notion in as much that 'It is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible'.

4. Does the GAAR supersede the choice principle or vice versa? There seems to be only one judicially satisfactory way of determining whether, in any given fiscal scenario, the choice principle outplays the GAAR, and that is to ask whether the choice exercised by the taxpayer was one in which the legislation explicitly or implicitly allows it or not. If the answer is affirmative, the GAAR is not applicable and the choice principle prevails – In the Conhage[5] case the SCA said that "Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achievable in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax'.

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[2] Coleman J, Tax Avoidance Law in New Zealand, CCH New Zealand Ltd (2009) at 1 and authorities there cited.

[3] IRC v Duke of Westminister (1936) AC 1 at 19.

[4] C:SARS v NWK Ltd 2011 (2) SA 67 (SCA).

[5] CIR v Conhage (Pty) Ltd (4) SA 1149 (SCA) at para [1].

The choice principle is subject to the caveat that the taxpayer cannot achieve this by way of a simulated or disguised transaction. In the Michau v Maize board[6], Scott said that 'What [taxpayers] may not be done is to conceal the true nature of their transaction or, in the words of Innes JA in Zandberg's case….."call it by name, or give it a shape, intended not to express but to disguise its true nature". In such an event a court will strip off its ostensible form and give effect to what the transaction really is.' This principle was restated by the NWK case (supra) where Lewis JA said, "But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not….'

These common-law principles will be put under the spotlight.

1.3 The purpose of the dissertation

The purpose of this paper is to analyse the common-law principles pertaining to simulated transactions in an effort to protect our tax base and to expose unlawful tax evasion. This paper highlights what is currently regarded as a 'simulation' and how South Africa compares to international practices. I have divided my discussion into five parts, viz:

1. Analysis of the requirements for an effective tax system;
2. Discussion of common-law principles;
3. Simulated transactions from a common law perspective,
4. International case law on simulated transactions; and
5. Relevance of common-law principles to the current GAAR.

1.4 Methodology

This research has been conducted by studying and discussing various sources of literature, the writings of experts in the field and in particular case law which led to the development of the simulation principle. The approach in this study will also be analytical and comparative. I will draw comparisons between permissible and impermissible tax

[6] 2003 (6) SA 459 (SCA) at 464 B-C 66 SATC 288.

avoidance. I will discuss the common-law principles, analyse the current GAAR, look at common principles employed on the international arena and then look at the applications.

1.5 Overview of chapters

Chapter 2: This chapter will look at three important definitions that will be used throughout the other chapters.

Chapter 3: Comprises a general discussion of tax avoidance, tax evasion, effective tax systems and aggressive tax planning. I have incorporated discussion around methods of corporate tax avoidance which I believe is relevant to this research topic. The tax reporting has been included because of the current developments on international exchange of tax information.

Chapter 4: In this chapter I discuss how the current common-law principles were developed by our legal system from a 'simulated transaction' perspective.

Chapter 5: In this chapter I looked at international case law on simulated transactions.

Chapter 6: Overview of our current GAAR and a brief discussion on the interaction with our common-law encounters.

Chapter 7: Conclusion to this dissertation.

CHAPTER 2 - TERMS USED IN THIS RESEARCH PAPER

2.1 Arm's length transactions

Trollip JA in Hicklin[7] case describes the arm's length principle as follows: 'It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.'

In respect of the valuation of property in a claim for compensation for expropriated land, King J defined arm's length transactions as follows in Opera House (Grand Parade) Restaurant (Pty) Ltd v Cape Town Municipality[8]:

'...sales in the open market by a willing seller to a willing buyer ...'

In a tax appeal relating to the taxation a forsaken interest on the unpaid price of the shares sold to trusts, Froneman AJA held in the Woulidge case[9] that:

'A notional commercial arms' length transaction on interest would assume a lender who would insist on payment of the interest he charges and a borrower able to pay that interest'.

2.2 Sham transactions

In Sharment (Pty) Ltd v Official Trustee in Bankruptcy[10] (Australian case), after reviewing the authorities on the concept of a sham, Lockhart J made the following dictum that:—

'A sham is ... for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is

[7] Hicklin v CIR 1980 (1) SA 481 (A)

[8] 1989(2) SA 670 (C) at 681

[9] 2002(1) SA 68 (SCA) at para 12

[10] Sharment Pty Ltd v Official Trustee in Bankruptcy (1988) 18 FCR 449 the Australian Federal Court

something which is false or deceptive and the High Court went on to say that: —

'Important to this description is the idea that the parties do not intend to give effect to the legal arrangements set out in their apparent agreement, understood only according to its terms. In Australia, this has become essential to the notion of sham, which contemplates a disparity between the ostensible and the real intentions of the parties. The courts must therefore test the intentions of parties, as expressed in documentation, against their own testimony on the subject (if any) and the available objective evidence tending to show what that intention really was.'

The concept of a sham was further refined by Diplock in Snook v London and West Riding Investment Ltd case[11] where he said that:

'If it has any meaning in law, [sham] means acts done or documents executed by the parties to the sham which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. ... [F]or acts or documents to be a sham, with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a shammer affect the rights of a party whom he deceived'.

2.3 Reportable Arrangements and Arrangements

Section 34 of the Tax Administration Act (TA Act) defined as 'reportable arrangement' to be an arrangement as referred to in section 35(1) or 35(2) that is not an excluded 'arrangement referred to in section 36.

An 'arrangement' means any transaction, operation, scheme, agreement or understanding whether enforceable or not.

An arrangement is reportable if it contains certain features stipulated in the legislation or if it is listed in a public notice issued by the Commissioner. Certain arrangements are, however, not reportable despite meeting the criteria if they constitute an excluded arrangement as set out in the TA Act or it they are listed as an excluded arrangement in a public notice by the Commissioner.

The Commissioner for the South African Revenue Service (SARS) issued a public notice in the Government Gazette on 16 March 2015,

[11] Snook v London and West Riding Investments Ltd [1967] 2 QB 786 at 802

listing reportable arrangements and excluded arrangements for purposes of the reportable arrangement provisions of the Tax Administration Act. The public notice is effective from the 16 March 2015.

The notice includes as reportable transactions relating to:

- Hybrid equity and hybrid debt instruments
- Company share buy-back coupled with new issues of shares
- SA residents making contributions to foreign trusts in which they are beneficiaries
- The acquisition of companies with assessed losses in excess of R50 million;
- Participants in foreign cell captive insurers[12]

It is important to note that in the latest notice the excluded arrangement where the tax benefit was the main or one of the main benefits of the arrangements has been removed. This exclusion provided relief from the obligation to report where the tax benefit associated with the arrangement was ancillary to any other benefits with the result that many transactions undertaken for purely commercial purposes were not reportable. The removal of this exclusion resulted in many transactions that are of no concern from a tax perspective that may be considered reportable.

In terms of section 212 of the TA Act, a person who fails to disclose the information in respect of a reportable arrangement is liable to a penalty for each month that the failure continues limited to 12 months. The amount of the penalty may be doubled or even tripled, depending on the amount of the anticipated tax benefit realised by the participant[13].

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[12] Cell captive insurer - Cell Captives are entities consisting of a core and an indefinite number of cell entities which are kept legally separate from each other. Each cell has dedicated assets and liabilities ascribed to it, and the assets of an individual cell cannot be used to meet the liabilities of any other cell. A core cell company may also have non-core assets, which may be made available to meet liabilities that cannot be attributed to another single cell. Depending on the specific structure and operation of the core cell company, it can create and issue cell shares with respect to any of the cells. There may be a common board of directors for all cells or cells may have their own unique board

[13] '**participant**', in relation to an 'arrangement', means (a) a promoter; or (b) a person who is directly or indirectly will derived or assumes that the person will derive a 'tax benefit' or 'financial benefit' by virtue of the arrangement; [section 34 of the TA Act]

2.4 Conclusion

We can draw the inferences that the term *arm's length transaction* means a transaction in which the parties involved act independently of each other. Also, in such a case, the mechanics of the transaction are handled as if the transaction takes place between strangers. Sometimes the transaction is conducted by a mutually agreed upon third party, to ensure that one of the principal parties does not influence the other.

A transaction, operation or scheme will be characterised as a 'sham' if some of the following elements are present:

(i) Something that is intended to be mistaken for something else or that is not really what it purports to be viz., spurious imitations, a counterfeit, a disguise or a false front;
(ii) All the parties to the agreement must have a common intention that the acts or documents are not there to create legal rights and obligations other than what is implied.
(iii) The real intentions of the parties are sometimes obscured by the insertion of a sub-agreement within the main agreement.
(iv) The courts must test the intention of the parties as expressed in the documents against their own testimony to show what that intention really was.

CHAPTER 3 - DISCUSSION OF AN EFFECTIVE TAX SYSTEM, TAX AVOIDANCE, TAX EVASION AND AGGRESSIVE TAX PLANNING

3.1 Introduction

Taxation as we know it today is a comparatively recent phenomenon, a natural concomitant of the growth of the administrative state. Tax is an everyday reality of life and there is scarcely an economic act devoid of tax consequences.

Tax avoidance has been a challenge to most tax authorities in both developing and developed countries. The effort to combat tax avoidance by tax authorities includes amongst other things general anti-avoidance rules, specific anti-avoidance rules like section 7 and reporting procedures in the South African IT Act.

It is clear that tax avoidance is a tax activity or behaviour that is legal. It is often referred to in words that reflect the negative view taken by tax authorities in most countries. It is my contention that tax avoidance is synonymous to 'aggressive tax planning'. In South Africa, it is referred to as 'impermissible or abusive tax avoidance'. In New Zealand and the United Kingdom it is referred to as 'unacceptable tax avoidance"[14].

Countries around the world have traditionally treated tax planning as a legitimate practice. Over time, tax planner's structures have become increasingly sophisticated. Tax planners developed various jurisdictions and effectively, shifted taxable profits towards states with beneficial tax regimes. These practices to reduce tax liabilities through legal arrangements are contradictory to the intention of domestic law.

Aggressive tax planning takes advantage of the technicalities of a tax system (normally happened with new legislation) or mismatches between two or more tax systems with exclusive purpose of reducing

[14] Evans, 2006:1

tax liability. Tax authorities find it challenging to protect their tax base from erosion through aggressive tax planning[15].

3.2 Three elements of an effective tax system

"Taxation provides governments with the funds needed to invest in development, alleviate poverty and deliver public services. It offers an antidote to aid dependence in developing countries and provides fiscal reliance and sustainability that is needed to promote growth. Tax System Design is also closely linked to domestic and international investment decisions that become inclusive in terms of transparency and fairness. Strengthening domestic resource mobilisation is not just a question of raising revenue; it is also about designing a tax system that promotes inclusiveness, encourages good governance that matches the views of society on appropriate income and wealth inequalities and promotes social justice".[16]

In 2013 a Fiscal Commission Working Group appointed by The Scottish Government published a comprehensive report on Principles for a modern and effective tax system. On page 51 – 74 the report set out the objectives, principles and methods of taxation.

Five objectives of taxation

1. Funding government
2. Redistribution;
3. Macroeconomic stabilisation;
4. Behaviour changes;
5. Growth and competitiveness;

Four principles of taxation

1. Simplicity;
2. Neutrality;
3. Stability;

[15] The European Commission of aggressive tax planning- 6.12.2012

[16] Supporting the Development of more effective tax systems -A report to the G-20 development working group by the IMF, OECD, UN and World bank (2011);

4. Flexibility;

Three broad methods of taxation

1. Income (Corporate, Individuals);
2. Wealth (CGT);
3. Consumption/expenditure

The objectives, principles and methods are all linked. In applying the principles to the difference methods of taxation or structure of taxation should allow any country to meet the objectives of taxation in the most effective and efficient manner.

Wealth and property taxes (Donation tax, CGT and Estate Duty) can be economically efficient and effective in a growth orientated tax system, and can be used to redistribute resources across society. However, they may not be so apt at raising large sums of revenue as the tax base tends to be relatively limited.

These trade-offs highlight the importance of considering the entire system when analysing taxation. It is also important to consider related government spending such as in welfare where the spill-overs between taxation are significant. It is vital to ensure that, in all these areas, clear principles are established and followed to ensure the objectives are met in the most efficient manner.

3.2.1 Objectives of taxation

The central objective of taxation is to fund government services. However, taxation can also be used as a tool to influence behaviours to meet public policy objectives.

3.2.2 The Principles of Taxation[17]

To meet the objectives of taxation in the most efficient and effective manner, it is important to consider the principles of a good taxation system.

Adam Smith famously set out three maxims with regard to taxes in the *Wealth of Nations*, first published in 1776: burden proportionate to the ability to pay;

1. certainty;
2. convenience; and,
3. efficiency of collection

The Mirrlees Review[18] set out what matters when formulating the objectives of a tax system:

(a) Welfare and economic efficiency – the negative effects of the tax system on welfare and economic efficiency should be minimised;
(b) Administration and compliance costs – all things equal, a system that costs less to operate is preferable;
(c) Fairness other than in the distributional sense – for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;
(d) Transparency – a tax system that people can understand is preferable to one that taxes by 'stealth'.

Based on the two Mirrlees Review and the Fiscal Commission Working Group inferences can be drawn that a tax system that is simple, neutral and stable is best placed to meet these objectives.

[17] A comprehensive report on Principles for a modern and effective tax systems – Fiscal Commission Working Group appointed by The Scottish Government published in 2013,

[18] Reforming the Tax system for 21st Century: The Mirrlees Review (10 November 2010)

3.2.2.1 Simplicity

A simple tax system is one in which tax rules and obligations are well known, easily understood, and where liability is clear. With a simple tax system, taxpayers can anticipate in advance and factor into their decision making, with minimal burden and uncertainty, the tax consequences of an action.

Simple tax systems improve transparency – and in turn political and administrative accountability. Easily understood systems minimise the burden to both taxpayers and the exchequer of administration and compliance.

A simple system is also fairer, in that it boosts accessibility. It also improves the integrity of the system by minimising the requirement for time and money to be spent on tax specialists to calculate or avoid tax burden.

3.2.2.2 Neutrality

The principle of neutrality aims to ensure that decisions should be made on merit, rather than on the basis of tax consequences. All taxes result in behaviour changes and distortions.

The neutrality of a tax system can be thought of in two ways. Firstly, in considering the effect of taxation relative to completely untaxed markets, and secondly in terms of the impact and consequences of different taxes relative to each other.

3.2.2.3 Stability

The stability and predictability of the tax system relates both to the stability of revenues which governments raise through taxation, and the stability of tax rules which face individuals and businesses.

A key aim of any tax system should be to ensure that the revenue stream from taxation should be relatively predictable at

least to the extent that it meets a minimum level, in order to facilitate forward planning.

3.3 Tax Avoidance verses Tax Evasion

Tax evasion refers to illegal activities deliberately undertaken by a taxpayer to free himself from a tax burden. Tax avoidance, on the other hand, usually denotes a situation in which the taxpayer has arranged his affairs in a perfectly legal manner, with the result that he has either reduced his income or that he has no income on which tax is payable.[19]

Tax evasion, including the evasion of tax through the use of simulated transactions, is a criminal offence and is subject to severe penalties as well as being subject to a fine, imprisonment or both in terms of the Act.

Section 235 (1) of the TA Act[20] cautions those with intent to evade or to assist another person to evade tax or to obtain an undue refund under a tax Act is guilty of an offence and, upon conviction, is subject to fine or to imprisonment for a period not exceeding five years. Section 235(2) states that any person who makes a statement as per subsection (1) must, unless reasonable grounds exist of ignorance of the falsity of the statement was due to negligence, be regarded as guilty of the offence as stipulated in same subsection.

In Australia, the Ralph Review of Business Taxation has characterized 'tax avoidance" as "misuse or abuse of the law" that "is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by Parliament but also includes the

[19] K Jordaan, A Koekemoer, M Stiglingh, L van Schalkwyk, M Wassermann, *Silke: South African Income Tax* (2011) at section 25.1

[20] Tax Administration Act no.28 of 2011 [This Act has been updated to Government Gazette 35491 dated 4 July, 2012]

manipulation of the law and a focus on form and legal effect rather than substance'[21]

The OECD similarly defines "tax avoidance" somewhat awkwardly, as 'an arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that the arrangement could be strictly legal if it is in contradiction with the intent of the law it purports for follow"[22]

Lord Templeman provided another definition in the Challenge Corporation case:

'Income tax is avoided and the tax advantage in derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in the tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtained a reduction in his liability to tax as if he had'[23].

In the King case[24], Chief Judge Watermeyer states that 'there is a real distinction between the case of one who so ordered his affairs that he had no income which would expose him to liability for income tax, and that one who ordered his affairs in such a way that he escaped from liability for taxation which he ought to pay upon the income which in reality was his. Similarly there was a distinction between reducing the amount of tax from what it would have been had the transaction not been entered into and reducing the amount of tax from what it ought to have been in the tax year under consideration'

In Lord Vestey's Executors v IRC[25]-United Kingdom (UK) case- Discretionary beneficiaries resident in the UK- The trust accumulated income –payments to the beneficiaries. The question before the courts

[21] Australia, Final Report of the review of Business Taxation, a Tax System Redesigned

[22] OECD , International Tax Terms…op. cit. n4

[23] CIR v Challenge Corporation Ltd [1987] AC 155

[24] CIR v King 1947 (2) SA 196 (A) at 208

[25] Lord Vestey's Executors v IRC [1949] ALL ER 1108;

was whether “income” becomes the tax liability of the beneficiaries. Lord Norman made the following dictum -“Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to stretch the language of the statute in order to subject to tax people of whom they disapproved.

In the Duke of Westminster[26] case the Duke’s gardener was paid weekly, but to reduce tax, his solicitors drew up a deed in which it was said that the earnings were not really wages, but were an annual payment payable by weekly instalments. The court held in order to determine what the true nature of these payments were, one has to look at the deed. Lord Tomlin made the following dictum ‘it is said that in revenue cases there is a doctrine that the Court may ignore the legal position and regard what is called ‘the substance of the matter’, and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wage, and that therefore while he is so serving, the annuity must be treated as salary or wages.

Lord Tomlin than made the following historical dictum- ‘every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax’

This so called doctrine of ‘the substance’ seems to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the tax liability is not legally claimable and whatever the substance of the arrangement may have been, their fiscal or tax effect has to be in accordance with the legal rights and tax obligations they created.

[26] IRC v Duke of Westminster (1936) AC 1 at 19

Section 103(1) of the Income Tax Act lays down a set of interlocking criteria which determine whether a particular tax avoidance "scheme" falls foul of the section. If the answer is affirmative, the Commissioner is empowered to ignore the scheme for tax purposes or to take such action as is necessary to nullify the tax benefit. Section 103 applies only to schemes in which the taxpayer entered into a transaction "solely or mainly for the purpose of obtaining a tax benefit". This is a subjective test, in other words, the court is required to look into the taxpayers mind (as best it can) and determine whether he had such a sole or main purpose. [Supra- Hicklin case][27]

In the **Hicklin Case**[28] the court made the following observation when it perused the application of section 103(1) and in the words of Judge Trollop: "It is true of course that the shareholders could be repaid their loans by declaring Reklame's reserves and assets as dividends, thereby incurring the ensuing tax liability. But they were not obliged to do so. They were perfectly entitled to try to avoid such tax liability by adopting some other legitimate course."

There are however limits on the degree to which a taxpayer can reduce his/her tax burden. As stated by Hefer JA in the ***Conhage case***[29]: 'Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract or attracts less tax. But when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the Court will give effect to the true

[27] Section 103(1) was amended after the judgement in Gallager's case to encompass the situation where transaction, operation or scheme is entered in to or carried out solely or mainly for the purpose of avoiding, postponing or reducing liability for the payment of tax, duty. Levy under any law administered by the Commissioner.

[28] Hicklin v SIR 1980 (1) SA 481 (A)

[29] CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd) 1999 (4) SA 1149 (SCA), 61 SATC 391 at 1

nature and substance of the transaction and will not be deceived by its form'

There is a vast difference between the tax implications of a tax avoidance transaction and a tax evasion transaction. A tax avoidance transaction creates legal rights and obligations in accordance with the contract and the taxpayer is allowed to arrange his affairs in such a way that he is liable for the least amount of tax on that transaction. The taxpayer would be perfectly entitled to minimise his tax burden in this manner, as has been confirmed in our courts in the various judgements noted above.

The Commissioner for the South African Revenue Services (hereafter 'SARS') would then have to evaluate whether the transaction entered into by the taxpayer falls foul of the statutory general anti avoidance provisions contained within the Income Tax Act. The Commissioner would not be able to use the common law to tax the transaction, and the transaction would only be taxed if the Commissioner deems it to be an impermissible avoidance arrangement.

During April 2006 SARS released an Interim report in response to the Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act based on comments released through the media and subsequently to SARS. The purpose of the Discussion Paper was to spark a healthy and vigorous debate over this important and often emotionally charged topic. The public comments have focused upon the following areas:

1. The distinction drawn between evasion, impermissible avoidance and aggressive tax planning;
2. The introduction of objective factors under the Abnormal Requirements, together with a new presumption of abnormality;
3. The proposed change to the Purpose Requirements;
4. The application of section 103 to steps within a larger transaction;
5. The use of the section "in the alternative", together with related administrative concerns;

6. The need to coordinate the introduction of a stronger GAAR with the phase –in of the new Advance Tax Ruling System (ATR system);
7. The need for broader income tax reform;
8. The use of additional specific anti-avoidance rules in lieu of a stronger section 103;
9. The proposed penalties for promoters and for the substantial understatement of income by taxpayers.

On 14 May 2013 the Commissioner of SARS tabled SARS strategic plan 2013/14- 2017/18 and the 2013/14 SARS Annual Performance Plan addressed the standing committee of finance. In these reports the Commissioner addressed the global tax environments and made the following remarks:

'…the challenging global and domestic economic environment in which we find ourselves and which continue to place pressure on us and the other revenue authorities around the world to meet the fiscal demands of our countries. These economic conditions of subdued growth are further exacerbated from a revenue collection perspective by the proliferation of sophisticated tax avoidance and evasion schemes which rob countries of their rightful share of tax.'

Oxfam International mentioned at the World Economic Forum on Africa held in Cape Town during the first week of May 2013 estimated that illicit financial outflows from Africa in the form of tax evasion and trade mispricing by extractive industries were estimated at $200 billion each year.

The tax evasion is an illegal offence resulting in severe penalties and possible imprisonment. It involves the usage of fraud or deceitfulness to reduce a tax liability through the non-disclosure of income and overstatements.[30] It has always been referred to as 'illegal

[30] Hauxham, K & Haupt, P (2007), Notes on South African Income Tax, Cape Town: Hedron, At 350

arrangements through or by means of which the true tax liability is hidden or ignored.[31]

Typically, tax evasion schemes involve an individual or corporation misrepresenting their taxable income to the South African Revenue Service or tax authority. Misrepresentation may take the form of underreporting income, inflating deductions, or hiding money and its interest altogether in offshore accounts.

Individuals involved in illegal enterprises often engage in tax evasion because reporting their true personal income tax would serve as an admission of guilt and could result in criminal charges. Individuals who try to report these earnings as income from legitimate sources can face money laundering charges.[32]

In a budget speech delivered in Parliament on 18 March 1985, the South African Minister of Finance made the following statement: "It is regrettably true that there are those who consciously and willingly evade taxation and those who cynically manipulate tax avoidance to such an extent that it cannot be construed as anything but evasion of taxation"

3.4 Aggressive Tax Planning

Countries around the world have traditionally treated aggressive tax planning as a legitimate practice. Over time, however, the tax planning structures have become ever-more sophisticated. They develop across various jurisdictions and effectively, shift taxable profits towards states with beneficial tax regimes. A key characteristic of the practices in question is that they reduce tax liability through strictly legal arrangements which however contradict the intent of the law.

Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. Tax authorities

[31] OECD, International Tax Terms for the participants in the OECD programme of Corporation with Non-OECD Economies,

[32] Tax evasion – Legal information Institute- Cornell University

find it difficult to protect their national tax bases from the so called base erosion through aggressive tax planning, despite numerous efforts. Anti-avoidance provisions in this area are often not fully effective, especially due to the cross border dimensions of many tax planning structures and the increase mobility of capital and persons.

In the foreword of the HM Treasury report dated March 2014, that the International cooperation is the only way to tackle the challenges of tax avoidance in the global economy. The widespread adoption of new and powerful information technologies and the growth of the digital economy have expanded the opportunities for companies to trade and grow and revolutionise how companies operate. The sophisticated digital marketplace with the increasing global average spending has creating new challenges when it comes to make sure multinational enterprises are paying their fair share of tax. Aggressive tax planning by some digital businesses has given them an unfair advantage over their competitors. There is currently real concerns over how certain digital businesses engage in aggressive tax planning and the impact that this has on their counterparts- particularly small, domestic business which do not have the opportunity to arrange their tax affairs in this way.

One of the remedies is to develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures drawing on the experiences of countries that have disclosure regimes. One area of focus will be how to capture international tax avoidance schemes in such rules.

Based erosion and profit shifting (BEPS)[33] refers to tax planning strategies that exploit gaps in the architecture of the international tax system to artificially shift profits to places where there is little or no economic activity or taxation.

The addressing of base erosion and profit shifting is a key priority for governments around the globe. In 2013, OECD and G20 countries,

[33] OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15

working together on an equal footing, adopted a 15-point Action Plan to address BEPS. Beyond securing revenues by realigning taxation with economic activities and value creation, the OECD/G20 BEPS Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. A key focus of this work is to eliminate double non-taxation. However in doing so, new rules should not result in double taxation, unwarranted compliance burdens or restrictions to legitimate cross-border activity.

3.5 Methods of Corporate Tax Avoidance

3.5.1 Artificial profit shifting from a high to a low tax jurisdiction

If a company can shift profits to a low-tax jurisdiction from a high-tax one, its tax will be reduced without affecting other aspects of the company. The tax differences also affect real economic activity which in turn affects revenues. Since South Africa taxes all income earned within its borders as well as imposing a residual tax on income earned abroad by South African residents as define in section 1 of the IT Act, tax avoidance relates both to SA parent companies shifting profits abroad to low-tax jurisdictions and the shifting of profits out of South Africa by foreign parents to SA subsidiaries. In the case of U.S. multinationals, one study suggested that about half the difference between profitability in low-tax and high-tax countries, which could arise from artificial income shifting, was due to transfers of intellectual property (or intangibles) and most of the rest through the allocation of debt.[34]

3.5.2 Allocation of Debt and Earnings Stripping

One method of shifting profits from a high-tax jurisdiction to a low-tax one is to borrow more in the high-tax jurisdiction and less in the low-

[34] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Locations," *National Tax Journal*, vol. 56, March 2003, Part II, pp. 221-242.

tax one. This shifting of debt can be achieved without changing the overall debt exposure of the company. A more specific practice is referred to as earnings stripping, where either is associated with related companies or unrelated debt is not subject to tax by the recipient.

In the commercial world, a company is said to be thinly capitalised when it has more debt than equity, and many thin cap cases boil down to a company with more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons.

Many South African companies with foreign parent companies receive financial assistance in the form of loans. South Africa introduced thin capitalisation rules in 1995. The SARS Commissioner was empowered under the rules to have regard to the financial assistance provided, by scrutinising the transaction in question. Interest paid or payable on the financial assistance was disallowed if the funding was considered excessive having regard to the lender's fixed capital in the borrower. The Commissioner's views on what was considered 'excessive' were initially contained in a practice note (Practice Note No. 2 of 1996), which has been repealed and only applies to companies' years of assessment commencing before 1 April 2012.

For companies' years of assessment commencing after 1 April 2012, thin capitalisation is dealt with under the general transfer pricing provisions contained in the Income Tax Act (section 31(2)). Under the current law a taxpayer is required to determine what amounts it would have been able to borrow in the open market, and under what terms and conditions, and at what price. The arm's length principle is applied to financial assistance in the same way as it is applied to any other transaction,

SARS has removed the safe harbour provisions and has stated that it will adopt a risk-based approach in selecting potential thin capitalisation cases for audit. Dicta of Mr Badenhorst of

PricewaterhouseCoopers- “Organisations need to review their existing financing and business arrangements to assess the potential implication of the rules and must carefully consider any current or proposed financial assistance to ensure compliance with the regime,’.

3.5.3 Transfer Pricing

The second major way that company can shift profits from high-tax to low-tax jurisdictions is through the pricing of goods and services sold between affiliates or subsidiaries. To properly reflect income, prices of goods and services sold by related companies should be the same as the prices that would be paid by unrelated parties. By lowering the price of goods and services sold by parents and affiliates in high-tax jurisdictions and raising the price of purchases, income can be shifted.

An important and growing issue of transfer pricing is with the transfers to rights to intellectual property, or intangibles. If a patent developed in the South Africa is licensed to an affiliate in a low-tax country income will be shifted if the royalty or other payment is lower than the true value of the license. For many goods there are similar products sold or other methods (such as cost plus (a mark-up) that can be used to determine whether prices are set appropriately. Intangibles, such as new inventions or new drugs tend not to be comparable, as it is very difficult to determine the royalty that would be paid in an arms-length price. Therefore, intangibles represent particular problems for policing transfer pricing.

3.6 Tax reporting- Going Global

SARS has extended its ability to query, interrogate and find out about our tax matters. What isn’t so well known is that these powers are rapidly extending across the globe. South Africa has signed multilateral and bilateral taxation agreements with over 90 nations (and counting). This is part of a global trend as countries seek to

maximize the tax revenues due to them by fighting tax evasion and avoidance across international borders.[35]

In terms of section 46(1) of the Tax Administration Act[36], SARS can gather relevant information from taxpayers to ensure compliance. It can also obtain information from third parties. It can compel third parties who owe a taxpayer (or who hold assets for a taxpayer) to pay SARS for tax liabilities unpaid by the taxpayer. SARS can aggressively pursue legal avenues to recover tax liabilities.

Previously information requests across jurisdictions were upon request on the bank affairs of a specific client. By signing the multilateral and bilateral agreements, SARS is seeking to be able to operate globally as it does within South Africa's borders. These agreements thus include for example –

1. Routine exchange of information on taxpayers,
2. Examining taxpayer affairs in these foreign countries,
3. Freezing of taxpayer assets in these countries and
4. Getting the assistance of foreign courts to collect tax debts owed to SARS

More than 90 jurisdictions have adopted the universally agreed standard for the automatic exchange of information.

The US adopted (become law) commonly known as the Foreign Account Tax Compliance Act (FATCA) in March 2010. FATCA targets tax non-compliance by U.S. taxpayers with foreign accounts. It focuses on reporting U.S. foreign financial accounts and offshore assets. Also tackling foreign financial institutions about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest. The main objective of FATCA is the reporting of foreign financial assets with the aim of withholding as the cost of not reporting.

[35] Logista Chartered Accountants (SA) –Snippets and new desk- 14 October 2014
[36] Tax Administration Act no.28 of 2011

The Organization for Economic Co-operation and Development (OECD), of which South Africa has only observer status, has launched its own initiatives with regards to global standards for automatic exchange of information. On 21 July 2014 the OECD took an important step towards greater transparency by putting an end to banking secrecy by releasing a full version of a new global standard for exchange of information between jurisdictions.

The Global Forum on Transparency and Exchange of Information, consisted of OECD countries and jurisdictions, has become the world's largest tax organization comprising of more than 127 jurisdictions and countries. Through an in-depth peer review process, the restructured Global Forum monitors that its members fully implement the standard of transparency and exchange of information they have committed to implement.

Tax authorities must continue and even intensify the management of multinationals' tax compliance and challenge their tax planning arrangements where those amount to avoidance or otherwise push the boundaries of acceptable legal interpretations. It is imperative that global tax authorities further develop their relationships.[37]

3.7 Conclusion

The statement by the Minister of Finance in the 1985 budget speech show a general misunderstanding of the distinction between tax avoidance and tax evasion. A tax evasion scheme is by definition illegitimate. If the cynical manipulation includes fraud or misrepresentation, or non-disclosure of facts, it constitutes tax evasion and not tax avoidance.

A person's tax liability for the payment of tax is defined in the Act: The Act casts the tax net, but as far as the taxpayer keeps outside that net he is free from the liability for the payment for the payment of tax. This

[37] International physical association SA – Cape Town 4th August 2015, Held at the office of Webber Wenzel – Part B – Financial Institutions, the new and extended information providers to revenues authorities (exchange of information, tax reporting, risk or opportunity?)

means that a person is entirely free to arrange his affairs so as to pay the least tax, because the legislature has been forced from time to time to take steps against tax avoidance and this way ensure that the tax authorities obtains adequate revenue.

CHAPTER 4 – DISCUSSION OF SHAM TRANSACTION FROM A CUSTOM PERSPECTIVE

4.1 What is a sham transaction?

The business dictionary describes sham transactions as 'transactions that serves no business purpose or provides no economic benefit but is entered into for deception, such as to escape a tax liability'.

The US legal society gives a sham transaction a legal state that a 'sham transaction is a business transaction that is entered into for the sake of avoiding tax'. Since the 1930's, the courts have used what is known as "the sham transaction doctrine" to invalidate deals designed solely to skirt income taxes. The question whether or not a transaction is a sham is primarily a factual one, one in which the taxpayer bears the burden of proof in the abatement process. Some courts apply a two-prong test.

The first prong of the inquiry examines whether the transaction has economic substance other than the creation of a tax benefit, which has been labelled the "objective" economic substance test.

The second prong examines whether the transaction was motivated by any business purpose other than obtaining a tax benefit, which has been labelled the "subjective" business purpose test.

Other courts have rejected a rigid two-step analysis, using traditional sham analysis, that is, whether the transaction had any practical economic effects other than the creation of income tax losses.

The Cornell University Law School define sham transaction as "a transaction that is unlawful or illusory. Illusory transactions that exist on paper but have no tangible consequences may be voided in court, especially if used as a tax shelter or other deceptive device."

The word 'sham' is often used in judgements without explanation, as though it's meaning was self-evident and as though the legal consequences of a transaction being a 'sham' are clears. Both of these assumptions are unwarranted. The criteria for a 'sham', the

precise meaning of the word, and the legal consequences of a transaction being so characterised by a court of law, are far from self-evident.

4.2 Common-Law Principles

4.2.1 Common-law counters to tax evasion

Common-law principles nullify some forms of tax evasion without the need to invoke statutory anti-avoidance provisions. The first inquiry where a suspicion arises that a tax scheme is improper is whether it falls foul of common law principles, that is to say, whether it involves a sham or disguised transaction. The strength of the common law is that it finds expression in terms of broad principles; by contrast, the reach of a statute is limited by the particular words in which it is couched. The following are accepted common law principles in this regard, as established by judicial decisions over decades. These principles do not have clearly defined boundaries and that the tendency exists to duplicate the common law principles.

4.2.2 Substance prevails over form

One of the most common forms of tax avoidance is where the parties to a contract attempt to disguise its true nature in order to qualify for a tax benefit that would not be available if the true contract between them were revealed.

When looking at the nature of a simulated agreement it was not disputed that the courts will not give effect to a simulated transaction. The locus classicus in this regard is the judgement of Innes CJ in the Zandberg case[38] where he said that –

"Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what

[38] Zandberg v Van Zyl 1910 AD 302 at 309

they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), *the parties to a transaction endeavour to conceal its real character*. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. But the words of the rule indicate its limitations. The Court must be satisfied that *there is a real intention, definitely ascertainable, which differs from the simulated intention.* For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than what it purports to be.'

This is a dictum that has been affirmed many times in our courts. In reported judgements, there have been numerous occasions where SARS has attempted to deny a taxpayer a claimed tax benefit on the grounds that the transaction in question is not what it purports to be, but is a "disguised" or "simulated" transaction and that the real transaction entered into between the parties does not give rise to the claimed tax benefit.

The Randles, Brother & Hudson case[39] [1941] in which the 'issue was 'settling' on the basis of passing of ownership' the court looked at "disguised transactions' from a slightly different perspective or angle.

4.2.2.1 Synopsis of the facts of the Randles case:

Randles was a fabric importer which sold the material on to another company which made shirts and pajamas. If Randles acquired a certificate showing that this pyjama manufacturer had become the owner, then they were entitled to pay a lower customs duty. So, Randles sold the pajamas to this company,

[39] Commissioner of Customs and Excise v Randles, Brother & Hudson, Ltd 1941 AD 349

the company made the pajamas, after which Randles purchased the material back.

The Commissioner of Customs and Excise then sued Randles for the outstanding customs duty.

The issue in the present case was whether ownership had passed in a consignment of imported cloth on the basis of a purported sale to a clothing manufacturer by the importer under an agreement which provided for the resale to the importer for the price paid plus the costs of production. The agreement was manifestly a device to avoid the payment of import duties by the defendant. Form the point of view of property law it is clear that the parties intended to transfer ownership but that the simulated sale was probably not the true basis on which they wanted to do so.

The majority in the appellate division essentially adopted the abstract form of conveyance by ruling that ownership had transferred even in the absence of a valid underlying contractual agreement.

Watermeyer JA makes reference to the Dadoo Ltd[40] case [1920] and acknowledges the discussion of following two legal principles.

"Firstly, the law has to be construed to ascertain what kind of transaction is forbidden or taxed in as much as the transaction has to be interpreted to ascertain whether it is a transaction of the kind which is forbidden or taxed. As to the interpretation of the law, the ordinary recognized principles of statutory interpretation are applied in order to determine what it is that is forbidden or taxed, and in this connection 'the spirit of the law does not operate beyond the limitation of its language, as pointed out by Inness CJ". Then Watermeyer JA make the follow judgmental obiter "… but when it comes to the

[40] Dadoo Ltd v Krugersdorp Municipality Council 1920 AD 530 at 547;

interpreting the transaction a difficulty sometimes arises because the parties for some reason endeavored to conceal the real nature of the transaction between them." The court then gave substance to the passage above from Judge Inness JA in Zandberg case by stating 'the method of solving it in words which I shall not attempt to improve upon'

Watermeyer JA said that "Ownership of movable property does not in our law pass by the making of a contract. It passes when delivery of possession is given accompanied by an intention on the part of the transferor to transfer ownership and on the part of the transferee to receive it. ....". "…The form of the contract between the parties does not, therefore, determine whether a delivery in pursuance of it passes ownership, but the form is not a negligible factor from which no inference can be drawn. On the contrary it has considerable value because, if the parties put their contract in the form of a sale on credit, a strong inference can be drawn that they intended a delivery in pursuance of that contract to transfer ownership, whereas if they put their contract in the form of a locatio operis, an equally strong inference to the contrary can be drawn." [p 398].

In 1996, in the matter of Erf 3183/1 Ladysmith case41 the Supreme Court of Appeal held that a series of transactions were a sham, on the basis that the parties did not intend that they have effect according to their tenor, and that effect should therefore be given to what their intention really was, a clause in a head lease entitled the lessee (a tax-exempt entity), in its discretion, to erect buildings on the leased property.

4.2.2.2 Synopsis of the Erf 3183/1 Ladysmith facts:

During 1983 the directors of Pioneer Seed Company (Pty) Ltd [Pioneer] and its subsidiary, Pioneer Seed Holding (Pty) Ltd

[41] Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR [1996] (58 SATC 229)

[Holding], decided to establish a furniture factory which would be operated by Pioneer. The taxpayers, which were both wholly owned subsidiaries of Holdings, each acquired a piece of land.

During 1984 eight separate but inter-related written agreements comprising two practically identical sets of four contracts were simultaneously concluded, a set relating to each taxpayer. In essence the agreements set up the following structure: an independent pension fund hired the land from the taxpayer; in terms of the lease the lessee was entitled at its expense to erect such building and other improvements on the land as it determined; the building becomes the property of the lessor; the lessee having no claim against the lessor for compensation.

A sub-lease was then entered into between Pioneer and the pension fund for the same period as the initial lease. This sub-lease provided that the pension fund would erect the building to be occupied by Pioneer, and for which Pioneer was required to pay a monthly rental and a premium on completion of the building.

A building contract was entered into between a pension fund and a building contractor for the construction of a building on each piece of land. The final agreement provided that the pension fund's liabilities to the taxpayer, in respect of rent due had to be discharged from the rent accruing to it from the sub-lessee under the sub-lease.

The Commissioner assessed the taxpayer to tax on the basis that the erection of the factory brought about an accrual of income under para (h) of the definition 'gross income' of the IT Act.

Para (h) of the definition of 'gross income' reads as follows:

"in the case of any person to whom, in terms of any agreement relating to the grant to any other person of the right of use or

occupation of land or buildings, or by virtue of the cession of any rights under any such agreement, there has accrued in any such year or period the right to have improvements effected on the land or to the buildings by any other person—"

The taxpayer objected to the assessment on the ground that there was no such agreement because their lessee, the pension fund, was not in terms of the lease agreement obliged to effect improvements to the land. They based their argument on the following two well- known legal principals. The first one expounded in the Duke of Westminister's case supra which was recognized for example in Dadoo Ltd. and others case supra which permitted parties to arrange their affairs so as to remain outside the provisions of a particular statute. It must be noted that in every case in which this principle is invoked, it is the Court to decide whether the party concerned has succeeded in achieving that result. The outcome may depend entirely on the facts as were experienced in the Elandsheuwel Farming case[42] or on the application of the law to the facts as in the Hartzenberg case[43] and second legal principle "…. Courts of law will not be deceived by the form of a transaction; it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance." (per Wessels ACJ in Kilburn v Estate Kilburn 1931 AD 501 at 507.)

The question before the court was whether the contracting parties actually intended that each agreement would, inter partes, have effect according to its tenor. The court said that the two mentioned legal principals can be applied in the same case provided that each of them is confined to its recognized bounds ['restrictions'], hence the two legal principles do not conflict.

[42] Elandsheuwel Farming (Edms) Bpk v SBI 1978 (1) SA 101 (A) at 113 F-H
[43] SIR v Hartzenberg 1996 (1) SA 405 (A), 28 SATC 94;

In the Relier case[44] the Supreme Court of Appeal rejected a rather optimistic appeal that would have required the Court to distinguish the facts of that case from those in Erf 3183/1 Ladysmith case supra which, Harms JA stated at 6, had 'held that parties cannot arrange their affairs through or with the aid of simulated transactions…and effect will be given to unexpressed arrangements and tacit understanding.' As the parties' intentions were such that the agreement could not be taken at face value, the Court was entitled to examine the actual provisions of para (h) of the definition of 'gross income' in section 11(g) were applicable. In the Relier case the Court confirmed the approach to the facts and legal issues (which were almost identical) in Erf 3183/1 Ladysmith, and again the Court found that by virtue of an unexpected agreement or tacit understanding the taxpayer in that case had the right to have improvements effected as contemplated in paragraph (h) of the definition of "gross income" of the IT Act.

SARS attempted to apply these principles in the Conhage case[45] in which the company required finance for its business operations raised the necessary finance through a sale and lease back transaction, in which it sold certain of its assets to a financial institution and then leased these back. This transaction was selected by the taxpayer as the preferred transaction because, in addition to raising the required cash, it offered substantial tax saving in comparison with a conventional loan. The assets to be sold were valued and, following conclusion of the agreement of sale and lease back, legal delivery of the assets to the financier was affected. SARS sought to set aside the transactions as a sham, asserting that the real intention was a loan of money and not a sale and leaseback. The Supreme Court of Appeal found that the un-contradicted evidence was

[44] Relier (Pty) Ltd v CIR 60 SATC 1, 1997 (5) JTR 119;

[45] CIR v Conhage (Pty) Ltd (formarly Tycon (Pty) Ltd) [1999] (61 SATC 391)

that the parties intended to enter into and implemented the agreement of sale and lease back. In effect, the contracts were genuine.

4.2.2.3 Synopsis of the Conhage case:

Taxpayer entering into two sets of agreements with bank and in form each set comprised a sale and leaseback of some of its manufacturing plant and equipment. As the issue was the true nature and substance of the agreement, the Commissioner's contention being that they were not what they purported to be and should be construed as giving rise to a loan rather than a sale and leaseback, although he accepted that the parties had not acted in fraudem legis (in fraud of the law) by deliberately disguising their transactions.

The taxpayer appealed successfully to the Special Court, which held that the sale and leaseback agreements were genuine. SARS took the case on appeal to the Supreme Court of Appeal.

The court held that a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner and within the bounds of any anti-avoidance provisions in the relevant tax legislation. The same commercial result can be achieved in different ways; the reduced tax result will be a byproduct. The Courts will give effect to the true nature and substance of the transaction and will not be deceived by its form (Erf 3183/1 Ladysmith case supra)

The true nature of the agreement:

The Court pointed out that 'true nature' of a transaction will prevail where the parties enter into an agreement in the honest belief that they will achieve a particular purpose by doing so, but do not actually intend to have effect according to its meaning (Nedcor Bank Ltd v ABSA Ltd 1998 (2) SA 830 (W). In

McAdams case[46] the real transaction was found to be a loan even though the parties had deliberately cast their agreement in the form of a sale in the bona fide belief that it provided security to the 'purchaser'. The Court said that in even in such a case, the agreement is plainly a simulation, and it may be a dishonest simulation depending on what use the parties' want to make of it.

4.3 The operation of the plus valet principle

The South African common law principle encapsulated in the maxim plus quod agitur quam quod simulate concipitur means 'what is actually done is more important than which seems to have been done'. This has been understood to allow courts to champion the legal substance of the transaction over the form in which it is presented if the nature of such a transaction is in dispute. In the context of tax planning, parties to a transaction may, for example, simulate a transaction to resemble, in form, a lease, when the transaction actually achieves a sale. The tax consequences of sale and leases differ and if such a transaction is brought before a court, application of the principle will ensure that the parties are taxed according to the legal consequences of the sale the transaction effects in substance, instead of the lease consequences that the transaction purports to have in its form.

The mere intent to avoid taxes, no matter how deliberate or ingenious, does not make the situation susceptible to attack via the application of the common law principles.[47] Before a court can find that a transaction is simulated, it must be satisfied that there is some unexpressed

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[46] McAdams v Fiander's Trustee & Bell No 1919 AD 207 at 223-224

[47] This is stressed by all the leading cases. See *Michau v Maize Board* 2003 (6) SA 459 (SCA) 464A–C. See also Nereus L Joubert 'Assetbased financing, contracts of purchase and sale, and simulated transactions' (1992) 109 *SALJ* at 707–711:

'. . .the mere fact that a specific type of contract is concluded in order to circumvent the legal rules or principles applicable to another type of contract is not indicative of simulation.

agreement or tacit understanding between the parties or, as it has been put, a 'real intention', definitely ascertainable, which differs from the simulated intention.[48]

The principles relating to simulated transactions do not mean that a court is empowered to disregard a transaction's legal characterization and look instead at what is achieved from an economic point of view. In our law there is no doctrine of economic equivalence.[49] On the contrary, it is generally recognised that different economic results may be achieved with different types of agreements.[50] Our tax courts accept that –

'if a person is liable to tax in a specified set of circumstances, he must not be held liable in different though analogous circumstances merely for the reason that it appears logically to be right that because he is liable in the one case he should also be liable in the other.'[51]

4.4 Accounting Issues

On the accounting issues, the Court apparently considered that the legal substance of an agreement is not the same as its economic or commercial substance. The Court made the telling point that the

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[48] *Zandberg v Van Zyl* 1910 AD 302–309; *Registrateur van Aandelebeurse v Aldum h/a Onecor Group & ander besighede* 2002 (2) SA 767 (A) at 773.

[49] See RC Williams *Income Tax in South Africa – Law and Practice* Juta & Co Ltd 1994 at 14. This principle does not apply universally. In many countries the general domestic law or a judicially developed anti-avoidance doctrine may be applied, in certain circumstances, in order to tax a set of events based on their economic effect rather than their legal nature. Sometimes this result may even be achieved via a straightforward application of the principles governing the interpretation of fiscal legislation. This is important in the present context because it may influence the question whether a domestic court confronted with the situation may be said to have the power of recharacterising the facts (as opposed to merely disregarding simulations and establishing the true underlying facts).

[50] See Nereus L Joubert 'Assetbased financing, contracts of purchase and sale, and simulated transactions' (1992) 109 SALJ 707 710. For an example in relation to the law of negotiable instruments, see *Tucker v Ginsburg* 1962 (2) SA 58 (T)

[51] *Badenhorst & others v CIR* (1955) 20 SATC 39 at 49.

approach of the accountant is different to that of the Court. The purpose of the accountant is to give a fair reflection of a financial state, whereas the Courts purpose is to establish the true agreement on which to base a liability of tax. It cited with approval the dictum of Corbett CJ in the Felix Schuh case[52]

'… the court is concerned with deductions permitted in terms of the Act and not with debits or other provisions made in the taxpayers accounts, even though these may be regarded as prudent and proper from an accounting point of view.'

In financial accounting we measure and report for business transactions and other events on the economic impact of an event instead of its legal form. This translates into the substance-over-form principle. This principle is critical for reliable financial reporting. It is particularly relevant in case of revenue recognition, sale and purchase agreements.

4.5 Tax cases after the introduction of the new GAAR

Tax cases in recent years have evoked as much interest as the recent case of CSARS v NWK[53], in which the Supreme Court of Appeal expanded the accepted interpretation to the legal doctrine of substance over form.

4.5.1 Synopsis of the NWK case:

NWK entered into this series of complicated, interlinked and in certain aspects self-cancelling commercial transactions with First National Bank (FNB). The effect of the structured series of transactions was that the amount of interest deducted, economically included the capital amount of the loan intended to be advanced by FNB to NWK.

SARS raised additional assessments on the basis that the agreement concluded between NWK, FNB and its subsidiary did not reflect the true substance of the transaction. SARS argued that if affect is given to the true intention of the parties, the parties entered into a loan

[52] CIR v Felix Schuh (Pty) Ltd [1994](56 SATC 57)

[53] Commissioner for the South African Revenue Service v NWK Ltd 2011(2) SA 67 (SCA)

agreement, and that the amount of this loan and resultant interest would be substantially lower than the amounts claimed. SARS also contended that some of the transactions had no commercial substance and these were only entered into with the intention to disguise the true nature and amount of the loan transaction intended by the parties. SARS also argued that the purpose of entering into this series of transactions was to obtain a tax benefit by way of increased interest deductions, by disguising the true nature of the transaction. In the alternative SARS contended that the series of transactions constituted a tax avoidance scheme contemplated by section 103(1) of the Income Tax Act.

NWK argued that the contracts concluded between NWA, FNB and its subsidiary were performed in accordance with the terms of the agreements and as such, based on an interpretation of previous case law, the doctrine of substance over form could not be invoked.

The appeals court, in considering the matter, confirmed that there was nothing wrong in principle with entering into the arrangements that are tax effective, but inferred that there was something wrong with dressing up or disguising a transaction to make it appear to be something that it is not, especially if it has the purpose of tax evasion and avoidance of tax.

In assessing whether the transaction in point was simulated, the court held that the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with the terms. The test should go further and require an examination of the commercial sense of and reasons for the transaction, of its real substance and purpose. If the purpose is only to achieve an objective that allows the availing of tax benefit it will be regarded as being simulated. The appeals court also held that the mere fact that the parties perform in terms of the agreement does not show that it is not simulated as “the charade performance” was generally meant to give credence to the simulation of transaction.

Based on the previous interpretations of case law, substance over form challenges by SARS were traditionally difficult to prove in transactions where agreements were implemented in accordance with their form. The NWK judgement has increased SARS's ability to attack transactions in terms of the substance over the form.

Effectively the NWK case brings together the 'substance over form doctrine' with the general anti-avoidance rules set out in the Income Tax Act, which allow courts to disregard transactions where the sole or main purpose is tax avoidance. Following the court decision it seemed that any transaction that achieved tax avoidance could be disregarded. This created a minefield for tax planners who had previously understood the law to be very different.

4.5.2 Classification of the NWK (supra) as per the Roshcon case (supra)

In the Roshcon (Pty) Ltd54 case [2014] the Supreme Court of Appeal ('SCA') in an unanimous judgement clarified the issues caused by its previous decision in the NWK case; Roshcon (Pty) Ltd was not a tax case. In this case the appeal centred on the fact of supplier and floor plan agreements relating to the sale of trucks, with a reservation of ownership to a finance house as security until the trucks were fully paid for by the purchaser. On the assumption that NWK had transformed our law in regard to simulated transactions, counsel contended that the agreements in question were a disguise or simulation, amounting in fact to a pledge of the trucks without delivery of possession as required by law. In rejecting this argument, the SCA took great care to reaffirm the well-established principles relating to simulations, and to explain its previous comments in NWK.

4.5.2.1 Synopsis of the Roshcon case

Roshcon (Pty) Ltd ('Roshcon') was granted a contract in early September 2008, which required it to purchase five trucks which

[54] Roshcon (Pty) Ltd v Anchor Auto Body Builders CC (49/13) [2014] ZASCA 40 (31 March 2014)

were to be fitted with specialized cranes to modify the trucks to suit the particular project. Roshcon ordered the five trucks from Toit's. Toit's in turn ordered the trucks from Nissan Diesel. This transaction was financed by Wesbank. Nissan Diesel supplied the vehicles under a **'supplier agreement'** it had concluded with Wesbank in terms of which it sold and Wesbank purchased and paid for the vehicles that authorised Nissan dealers, such as Toit's, wanted for their customers. Toit's had a separate 'floor plan agreement' with Wesbank in terms of which Wesbank provided finance to Toit's for the acquisition of motor vehicles. The vehicles purchased by Wesbank from Nissan Diesel would be delivered directly to Toit's or to such person as Toit's may from time to time direct.

Clause 6.1 of the '**supplier agreement'** reads as follows:

'6.1 It is recorded that it is the express purpose of this agreement to ensure that ownership in and to the vehicles shall pass to and remain vested in Wesbank until such time as payment has been received therefore from the relevant authorised dealer.'

Whereas Clause 8.1 of the 'floor plan agreement' reads as follows:

'8.1 The sale of the goods is made on the suspensive condition that, until payment of the selling price be made by the Dealer in full in terms of the relevant invoice with interest thereon as shall from time to time be stipulated by the Bank and all other amounts, if any, due in terms of or in connection with the agreement, the ownership in the goods shall not pass to the Dealer but shall be and remain with the Bank, and nothing herein contained nor any act or omission of the Bank shall be deemed to vest ownership in the goods in the Dealer until such payment shall have been made'.

The five trucks were delivered to Anchor on Toit's' instructions to have modifications undertaken to the sub-frames and load bodies to enable cranes to be fitted to the trucks. On 19 November 2008 two

trucks were delivered to Roshcon having been modified. The other three trucks would be delivered on 21 November 2008. A handover sheet for the two trucks was signed by the representatives of Roshcon and Anchor. On 21 November 2008, Roshcon took delivery of the remaining three trucks, though it did not physically remove them, but only signed the handover sheet. There was apparently a technical misunderstanding which required the trucks to be modified further, in that the outrigger supports for the cranes would not fit in the trucks as modified, so that they would require further modification. This resulted in a further delay in the payment process by Roshcon to Toit's. On 28 November 2008 the documentation constituting proof of delivery, was handed over to Roshcon and Roshcon effected payment for all five trucks to Toit's. However, Anchor was not prepared to release the three trucks because Toit's had not paid for the modifications. Then Roshcon paid for the work done by Anchor, but by then Toit's had gone into liquidation, and Anchor refused to release the trucks on the instructions of Wesbank, which claimed ownership of the trucks as Toit's had not yet paid for them.

Roshcon contended: that the **supplier agreement** and the **floor plan agreement** were a disguise or simulation. It alleged that the floor plan agreement was a loan against the security of the trucks without Wesbank having to take possession thereof, thereby securing an advantage which the law would otherwise not allow.

Wesbank contended: that the onus of proving a simulated agreement rested on Roshcon and that Roshcon has failed to discharge such onus. Wesbank regarded this transaction as a simple arm's length agreement between a manufacturer which wished to sell its products and a bank which wanted to make money by financing transactions of this nature. Toit's on the other hand, a reputable dealer that was in the business of selling vehicles, including Nissan trucks, wanted to sell vehicles to its customers, but required finance. Wesbank further contended that this procedure is employed by most

financial institutions in South Africa today in effecting asset based finance with the proviso to reserve ownership as security to protect itself.

The court a quo found:

'In my view there were sound reasons for the parties to structure their transactions in the way they did, and the agreements make *commercial sense*. A dealer needs vehicles to sell but doesn't have the money to pay for the vehicles. He will be able to pay for the vehicles when he sells them but needs finance in the interim. The financial institution (bank) agrees to provide the finance but requires security. Security in the form of a pledge is impractical because, for it to be effective, the bank has to be in possession of the vehicles. But the dealer needs to be in possession in order to offer the vehicle for sale to its customers. The supplier agreement and the floor plan agreement provide the bank with the security which it requires and enables the dealer to offer the vehicle for sale to its customers. Should the dealer dispose of a vehicle without first paying the bank, the bank will be entitled to vindicate the vehicle from whoever is in possession thereof.'

The court then made the following observation:

(a) For a court to declare a transaction a simulation it does not have to look at any particular legislation but has to look at the facts of each particular case- The court made reference to the dictum of Inness J in the Zandberg case which state: 'The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down. Perezius (Ad. Cod., 4.22.2) remarks that these simulations may be detected by considering the facts leading up to the contract, and by taking account of any unusual provision embodied in it: of its real substance and purpose'.

(b) The fundamental issue therefore is whether the parties actually intended that the agreement that they had entered into should have effect in accordance with its terms. Wesbank, Nissan Diesel and

Toit's did not have a secret understanding between them, nor has Roshcon shown anything of that nature. In determining whether a transaction is simulated, a crucial and often decisive question is whether the parties to the contract intended to give effect to it according to its tenor (see Michau v Maize Board 2003 (6) SA 459 (SCA) para 4).

(c) It is common cause that one of the most common forms of tax avoidance is where the parties to a contract attempt to disguise its true nature in order to qualify for a tax benefit that would not be available if the true contract between them were revealed. Our courts require no statutory powers to ignore pretence of this kind, and the law will always give effect to the real transaction between the parties. (See Zandberg (supra) at 309).

Judge Wallis JA clarified the perceived misconception regarding the proper approach to simulated transaction as per the NWK case supra.

The foundation of our law in regards to simulated transaction is in the classic statement of Inness J in the Zandberg case:

'Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is: not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur –meaning -the real intention carries more weight than a

fraudulent pretence. But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.'

1.1 The law allows people to arrange their contractual or business affairs to obtain for themselves a different arrangement that would not permit or avoid a prohibition that could be imposed. This principle was laid down in Dadoo case supra where judge Inness CJ said:

'… Parties may genuinely arrange their transactions so as to remain outside [a statute's] provisions. Such a procedure is, in the nature of things, perfectly legitimate.'

1.2 The above two principles are basically the same. Whether a particular transaction is a simulated transaction is therefore a question of its genuineness. If it is genuine the court will give effect to it and, if not, the court will give effect to the underlying transaction that it conceals. The genuineness will depend on a consideration of all the facts and circumstances surrounding the transaction.

2. The analysis by Lewis JA of the transactions in *NWK* clearly demonstrated that a range of unrealistic and self-cancelling features had been added to a straightforward loan. They served *no commercial purpose*, were based on no realistic valuation of the different elements of the transaction and were included *solely to disguise the nature of the loan* and inflate the deductions that NWK could make against its taxable income. In those circumstances the

courts stripped away the unrealistic elements in order to disclose the *true underlying transaction*.

3. The problem dealt with in *NWK* was the contention that, irrespective of the *unreality* of most of the elements of the arrangement under scrutiny, provided the *parties intended to take all the steps provided for in the contractual documents*, in other words to jump through the contractual hoops as a matter of form, the court could not find that the transaction was simulated. That is what Lewis JA was dealing with, in para 55 of her judgment, when she said:

'In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties' structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the *commercial sense of the transaction*: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.'

3.1 The notion that *NWK* transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines *the transaction as a whole*, *including all surrounding circumstances*, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated.

In the **Bosch[55] case** SARS's argument as alternative what the contract took was different than its substance, and that the deferred delivery mechanism was a simulation.

4.5.2.2 Synopsis of the Bosch case:

The appellants were employees of the Foschini group of companies and participants in an employee's share incentive scheme run by that group. The appellants were assessed by SARS for income tax in respect of the share received in respect of the scheme.

The type of scheme was what is referred to as a 'deferred delivery scheme'. What this means is that the employees were granted options to purchase shares, which they have to exercise within 21 days. Once the option to purchase was exercised, delivery and payment in respect of the shares were delayed and would take place in three tranches[56], each two years apart. Before the delivery and payment for the share the following restrictions were placed on the shares:

1. Employees could not dispose of or encumber the shares;
2. Employees were not entitled to dividends;
3. No voting rights attached to the shares.

The risk and benefits did not pass to the employees until delivery and payment in full for the shares. The scheme was also subject to a 'stop loss provision' with the proviso that the employee could sell their shares back to the employer if the share price fell below the consideration that was payable on delivery of the shares. Furthermore, the employees were also obliged to sell their shares back to the employer for the same consideration payable on delivery if they terminated their services for any reason other than sequestration, death, superannuation or ill health.

SARS raised the arguments that the scheme was a simulated transaction and that there was *no real unconditional* sale at the time of

[55] CSARS v Bosch [2014] ZASCA 171 (19 November 2014)

[56] A: "Tranche" is actually a French word meaning "slice" or "portion". In the world of investing, it is used to describe a security that can be split up into smaller pieces'

the exercise of the option, but that the parties actually intended that the sale be subject to the suspensive condition *that the employees remain employed* until the date of delivery and payment.

SARS relied on the NWK case (supra) which states the following: Lewis JA's dictum in *Commissioner for the South African Revenue Services v NWK Ltd*, where it was stated at par [55]:*"If the purpose of the transaction is only to achieve an object that allows the evasion of tax…then it will be regarded as simulated."*

The court then took the opportunity to analyse the NWK judgement.

In the NWK case the court was faced with clear simulated transactions as illustrated by the facts. The parties had not created genuine rights and obligations but simulated a loan that was for a larger amount than it actually was, only to allow the taxpayer to get a tax benefit.

Davis J further makes the following important dictum:

'Beyond this finding, there is nothing in the careful judgment of Lewis JA which supports the argument that the reasoning as employed in NWK was intended to alter the settled principles developed over more than a century regarding the determination of a simulated transaction for the purposes of tax.'

The court than goes on to say that the NWK judgement needs to be read within the context of the legal principles on simulation laid down in the following judgements:

1. Commissioner for Customs and Excise v Randles, Brothers and Hudson Ltd 1941 AD 369 - A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.'.[57]

[57] Income tax Cases and Materials by Emslie, Davis, Hutton and Ovivier, page 974, 3rd

2. Zanberg v van Zyl 1910 AD 302 - *Now, as a general rule, the* parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is: not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur –meaning -the real intention carries more weight than a fraudulent pretence .But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.

3. *Erf 3138 / Ladysmith (Pty) Ltd v CIR 1996 (3) SA 942*. - "…. Courts of law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance"

This is so to ensure that "the body of precedent is read coherently rather than NWK as being an unexplained rupture from that of a century of jurisprudence"

Davis J than interprets the test in respect of simulation as laid out in the NWK case as follows:

1. Commercial substance of a transaction needs to be examined – Where the form of a transaction attempts to present a commercial rationale and the sole purpose of the transaction is to avoid tax, then the approach taken by NWK is justified. The court seems to suggest that there must firstly be an agreement that purports to have a *commercial rationale* and secondly, there must in fact be no commercial rationale, such as the one purported, but some other purpose such as tax avoidance before it can be said that there is simulation.
2. The fact that a transaction aims to achieve the avoidance of tax does not as such make it a simulated transaction,

In a separate judgement, Wagly J differed from David J in his interpretation of the NWK case. Wagly J states that the NWK judgement does depart, and dramatically so, from the case law of simulated transactions, however the NWK case does not constitute bindings precedents that lower courts have to follow.

For a judgement to form a binding precedent it must be 'clear and unequivocal, it must explain, be unmistakable and explicit in its rejection of the previous judgements which it seeks to reverse'. The rejection of the previous judgements does not have to express, but must be clear from the reasoning.

4.6 Conclusion

The South African courts have over the years applied the doctrine of simulated transactions which consist of the following:

1. Substance over form – The courts will not be deceived by the form of a transaction; it will remove the corporate veil in which the transaction is wrapped and examine the true nature and substance of the arrangement.

2. The courts acknowledge that every man is entitled to order his affairs via effective tax planning provided this is done within the bounds of the law.

3. It is clear from the dicta of Lewis JA in the NWK case that our common-law implicitly recognises 'the choice principle' namely 'that where a taxpayer could achieve his objectives in different ways, he is entitled to adopt the course of action that is most fiscally advantageous to him.'

4. The simulated transaction – Our courts said that there is nothing wrong with arranging your tax affairs but there is something wrong with dressing up or disguising a transaction in order to achieve a predetermined tax outcome. The courts must be satisfied that there is a real intention, definitely ascertainable, which differs fundamentally from the simulated intention.

5. The simulation doctrine was restated by the SCA in C:SARS v NWK Ltd (supra) where Lewis said the following:
'In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where party's structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.'

6. In Roshcon (Pty) Ltd v Anchor Auto Body Builders CC (supra) Willis JA tries to express the real interpretation of the NWK judgement as follows:

'For those reasons the notion that *NWK* transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated.'

7. The final analysis will be addressed in my conclusion chapter.

CHAPTER 5 - International case law on sham transactions

5.1 English case law

In Bridge v Campbell Discount Co. Ltd (1962) AC 600, Lord Derlin said that:

"… when a court of law finds the words which the parties have used in a written agreement are not genuine, and are not designed to express the real nature of the transaction but for some ulterior purpose to disguise it, the court will go behind the sham front and get at the reality"

This was the position employed by the court decision a decision dated 23 January 2012 -In the Civil Appeal 347/2008 Marfin Popular Bank v Micheal – The full bench of the Cyprus Court, held by a majority that a hire purchase transaction, was a sham and consequently void ab initio[58] and the Appellant bank was not entitled to receive, or collect the funds advanced to the Respondent, pursuant to such sham transaction.

According to the facts of this case, the Bank entered into a hire purchase agreement with the Respondent, which provided for the purchase by the Bank, of certain movable items. The items were delivered to the Respondent for his own use. The obligation of the Respondent was to pay the Bank certain lease instalments and the right of the Respondent to acquire the ownership of the movable goods, when the agreed lease instalments were paid in full.

When the Respondent, failed to meet the agreed timeframe of payments of the leased instalments, the Bank terminated the hire purchase agreement and claimed the balance of the outstanding instalments payable under the contract.

[58] The term avoid ad initio, which means 'to be treated as invalid from the outset'

The respondent pleaded in his defence that the hire purchase agreement was a sham transaction structured by the Bank in order to cover a credit facility. Failure to meet the obligations under the agreement entitles the Bank to acquire shares from the Cyprus Stock Exchange. The movables allegedly covered by the hire purchase agreement did not in reality exist.

The court held, based on the evidence presented, that the hire purchase agreement was a sham transaction.

The concept of a sham in English case law was further redefined by Diplock in Snook v London and West Riding Investment Ltd (1967) 2 QB 786 at 80259, where he said that:

"if it has any meaning in law, [sham] means acts done or documents executed by the parties to the sham which are intended by them to give to third parties, or to the court the appearance of creating between the parties, legal rights and obligations, different from the actual legal rights and obligations (if any), which the parties intend to create... for acts or documents to be a sham, with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a shammer affect the rights of a party whom he deceived..."

The doctrine of sham is attached only where the parties intended to create rights and obligations different from those appearing in their documents. The sham doctrine has been applied by the English courts to lift the corporate veil of a limited liability company in order to declare agreements as void ab initio to determine whether a trust is a sham.

[59] Snook v London and West Riding Investment Ltd (1967) 2 QB 786 at 802

5.2 New Zealand case law

The New Zealand courts have defined “sham” consistently with Diplock LJ’s judgement in Snook (supra). As defined by the New Zealand courts, a sham exists where the parties execute documents, or do acts, so as to mislead third parties as to the true nature of the legal arrangement between the parties. The parties either intended to create different rights and obligations to those recorded in the documents, or to create no legal rights or obligations at all.

In Bateman Television Ltd v Coleridge Finance Co Ltd [1969] NZLR 794 (CA), Turner J held (at 813):

“I think that the occasions on which Courts have set aside the form of a transaction as a "sham" are confined to cases in which, really doing one thing, the parties have resorted to a form which does not fit the facts in order to deceive some third person, often the revenue authorities, into the belief that they were doing something else. Thus where in a lease both parties prescribe a rent in excess of what is really to be paid, so as to deceive those who collect taxes as to the quantum of a deduction to be allowed, this is a sham ….”

To similar effect, in the same decision McCarthy J reiterated Diplock LJ’s judgment in Snook by stating (at 821):

“… whatever else is accepted as being involved in the concept of a sham, one thing is clear in legal principle, morality and authority, namely that for acts or documents to be a sham all the parties thereto must have a common intention that the acts or documents are not to create legal rights and obligations which they give the appearance of creating.”

By contrast, there is no “sham” if the parties intended the document to be legally effective. In Paintin and Nottingham Ltd v Miller Gale and Winter [1971] NZLR 164 (CA), Turner J held (at 175):

“The word "sham" is well on the way to becoming a legal shibboleth; on its mere utterance it seems to be expected that

contracts will wither like one who encounters the gaze of a basilisk. But by a "sham" is meant, in my opinion, no more and no less than an appearance lent by documents or other evidentiary material, concealing the true nature of a transaction, and making it seem something other than what it really is. The word "sham" has no applicability to transactions which are intended to take effect, and do take effect, between the parties thereto according to their tenor ….”

In Marac Finance Ltd v Virtue (1981) 1 NZLR 586 (CA), Richardson J stated (at 588) that a sham could exist at the outset when the documents are created. The documents might be bona fide when created but could later become shams. This could happen when the parties agree to change the terms of their transaction, but decided to leave the original documents unchanged so as to mislead third parties:

“Where the essential genuineness of the documentation is challenged a document may be brushed aside if and to the extent that it is a sham. There are two such situations: (1) where the document does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions; and (2) where the document was bona fide in inception but the parties have departed from their initial agreement and yet have allowed its shadow to mask their new arrangement.”

The Court of Appeal in Official Assignee v Wilson [2007] NZCA 122, [2008] 3 NZLR 45 clarified whether there is a sham depends on the subjective intention of the parties. Robertson and O’Regan JJ held (at [50]):

“An important prior question is whether common intention must be ascertained objectively, as is usual in the construction of commercial documents, or subjectively, in the departure from orthodox norms of construction. Where a sham is alleged, should a Court look behind the objective trust appearance of an alleged

sham so as to ascertain the true nature of the transaction? The answer must be "Yes". Otherwise, the most insidious kinds of shams are those most able to work their mischief. To answer "No" would be to give exaggerated weight to the objective appearance of a transaction. While the objective appearance is the default determinant of a transaction's effect and substance, sham transactions are by definition transactional aberrations, and therefore require departure from the default principles of analysis"

Glazebrook J concurred with Robertson and O'Regan (at [108]):

"In my view, where a sham is alleged, the search is for subjective intent that the transaction is a sham. After all, the whole point of a sham is that it is intended to have an effect other than the effect it would have if looked at objectively…"

The New Zealand and English case law on sham was summarised by the Supreme Court in Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115, [2009] 2 NZLR 289. The Supreme Court stated (at [33]):

"There is no need for us to engage in any extended discussion of what constitutes a sham for present purposes. In essence, a sham is pretence. It is possible to derive the following propositions from the leading authorities. A document will be a sham when it does not evidence the true common intention of the parties. They either intend to create different rights and obligations from those evidenced by the document or they do not intend to create any rights or obligations, whether of the kind evidenced by the document or at all. A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement."

5.3 Australian case law

The Australian courts have defined sham consistently with Snook (supra) and the New Zealand case law. For example, in Eguuscorp (Pty) Ltd v Glengallan Investment (Pty) Ltd [2004] HCA 55, 211 ALR 101, the High Court of Australia held (at [46]):

'Sham" is an expression which has a well-understood legal meaning. It refers to steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences.'

The High Court of Australia cited the Full Federal Court of Australia's decision in Sharman v Official Trustee. In this decision the court cited Dip locks LJ's judgement in Snook (supra) and held (at [454]):

"A "sham" is therefore, for the purposes of Australia law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive."

Again, in the Full Federal Court of Australia decision in Richard Walter Pty Ltd v FCT 96 ATC 4,550, Hill J defined (at 4,562):

"a transaction as being a sham transaction where it involves:

A common intention between the parties to the apparent transaction that it is disguise for some other and real transaction or for no transaction at all."

5.4 Spanish case laws[60]

Article 15 of Spanish General Tax Law set forth a general mechanism for combating tax fraud whose features are very similar to those in the German mechanism. Fraud exist where the performance of taxable event is partially or completely avoided or the taxable income or tax liability is decreased by means of actions or transactions in which the following occurs:

(a) Where, considered individually or collectively, they are manifestly artificial or inappropriate for achieving the result obtained;

(b) Their use does have relevant legal or commercial effects or other than tax savings which would have been obtained by means of usual acts or transactions;

For the Spanish tax administration to be able to declare the acts or transactions to have been performed fraudulently it must be evidenced that the transactions are manifestly artificial or inappropriate for the purpose of achieving the result obtained and that these acts or transactions have not been performed for a valid commercial or legal reason other than obtaining tax savings.

The Spanish law includes two anti-fraud techniques already known in common law as “substance over form” and “business purpose test” which gets applied as in German case law, where the analysis of the other reasons for the transaction is essential for determining whether the form is or is not appropriate for the purpose achieved by the parties. It is not only the tax benefit obtained which determining the existence of abuse or a transaction fraudulently, but the way in which the tax benefit was obtained given the features intrinsic to the transaction.

[60] ‘The burden of proof in tax matters EATLP Conference, May 2011, Athens, Greece. Prepared by: Prof Dr Maria Rodriguez-Bereijo Leon

In Spanish law the presumptive evidence test can be used by the taxpayer by proving that the transaction performed was genuine since grounds exist beyond a tax advantage and the company's purpose is not artificial.

In Case C-106/89, [1990] ECR 1-4135 the court held that Spanish Civil Code provides that contracts have no legal effect if they are without a cause or have an illegal cause and it was argued, on the basis of this provision, that a contract leading to the incorporation of a Spanish company was void, since it lacks cause, was a sham transaction, and was entered into in order to defraud the creditors of another company.

It was therefore claimed that the incorporation of the company was nullity. The Union directive tabled a list of grounds on which the incorporation of a Spanish company was void, as a lack of a legal cause not being one of them[61].

5.5 Conclusion

International court principles of 'sham' transactions:

- The tax treatment of transactions between taxpayers depends on the *legal rights and obligations created by the transaction documents*. However, if satisfied that the documents are "sham", the court disregards them to the extent that they are shams. The court then gives effect to the *true legal arrangement* between the parties and the parties are taxed accordingly.

  The essential characteristic of a sham is pretence. A sham exists where the parties intended the transaction documents to mislead third parties as to the true nature of the relationship between the two parties. The parties intend either to create different rights and obligations to those recorded in the documents, or create no legal rights or obligations at all.

[61] The foundations of European Union Law, TC Hartley, Eight Edition, page 236

- The leading New Zealand authority on sham is Ben Nevis 62(supra). In this decision the Supreme Court reiterated the requirements for sham as set out in Diplock LJ's judgement in Snook (supra). It also described the effect of a sham in the tax law context (at [33]): "A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement. The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities."
- First, the courts determine the legal rights and obligations recorded in the documents. The courts interpret the documents objectively to arrive at the meaning a reasonable person would give them. They may consider evidence of surrounding circumstances at the time the documents were created to ascertain the meaning of the words used, but this evidence cannot be used to contradict or vary the terms of the documents. Evidence of the parties' subjective intentions is not considered at this stage.
- Second, the courts then consider whether there is evidence that the documents are shams. The courts are concerned with the parties' subjective intentions at this stage. To show there is a sham, the courts must be satisfied on the balance of probabilities that the parties did not intend to create the legal rights or obligations recorded in the documents, and it was intended that third parties would be misled by those documents into thinking the parties had created those rights and obligations.

An allegation of sham is serious – it is akin to an allegation of fraud. Consequently, the courts have made clear that an

[62] *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289;

allegation of sham is not to be made lightly and that a high standard of evidence is required to prove it.

- Third, if the court is satisfied the documents are shams, the documents are disregarded to the extent they are shams. A document may be a sham in part and, in such cases, only that part of the document will be disregarded. The true arrangement between the parties (i.e., the legal rights and obligations (if any) they created) is then given effect and the parties taxed accordingly. By contrast, if the court is satisfied that the documents are not shams, the parties are taxed in accordance with the legal rights and obligations created in those documents (except where s BG 1 or another anti-avoidance provision applies).

CHAPTER 6 - The South African approach to curbing impermissible tax avoidance

6.1 Introduction

In the Discussion Paper on Tax Avoidance and Section 103 of the IT Act on 3 November 2005 has sparked a high degree of interest and public comment of the effectiveness of the old Section 103 and the need for a new anti-tax avoidance regime. The public acknowledged that an "appropriate general anti-avoidance regime is a prerequisite for an effective tax system" and have to agree that "taxpayers should support action that is taken to combat impermissible tax avoidance as this will serve to lessen the overall burden on all taxpayers. The public has firmly supported the view that "historical equity in the tax system should be protected in order to advance economic prosperity to redress historical imbalances inherited from our painful past history"

Some of the commentators went so far and admitted that Section 103 was "essentially emasculated" by the Conhage[63] decision and that "for the past five or six years [after the decision] the section has barely been a feature in the tax planning and has ceased to be the deterrent it once was".

The South African tax law contains a number of specific anti-avoidance provisions, amongst others, paragraph (c) of the definition of "gross income" in section 1, section 8E, section 8F and section 9D. These sections will not be dealt with in this paper, as only the general anti-avoidance provisions (GAAR) from a "sham transaction" perspective will be examined and discussed.

[63] CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391.

South Africa has relied on GAAR since 1941 which was contained in section 103(1) of the IT Act. The current GAAR which will be found in section 80A –L was introduced in 2006[64].

6.2 Brief Overview of the old [GAAR] section 103

Before section 103 may apply, the Commissioner must be satisfied that four elements exist. In the case of a transaction "in the content of business", the requirements may be summarised as follows-

There must be a 'transaction, operation or scheme' (the Scheme Requirement);

The transaction must result in the avoidance, reduction or postponement of a tax (the Tax Effect Requirement);

The transaction must have been entered into or carried out in a manner not normally employed for business purposes, other than obtaining a tax benefit, having regards to the circumstances (the Abnormality requirement);[65]

The transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit (the Purpose Requirement)

A "tax benefit" includes "any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner."[66] Once the

[64] The current GAAR was inserted by s 34(1)*(a)* of the Revenue Laws Amendment Act 20 of 2006.

[65] Outside "the context of business", this Requirement is satisfied by any transaction, operation or scheme entered into or carried out, "by means or in the manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question". Section 103(1) (b)(i)(bb). The Abnormality Requirement also applies to any transaction, operation or scheme that "has created rights or obligations which would not normally be created between person's dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question." Section 103(1)(b)(ii)

[66] Section 103(4)

Tax Effect Requirement is satisfied, a rebuttable presumption arises that the sole and main purpose of the transaction was to obtain a tax benefit.[67]

If a transaction falls within the ambit of section 103, the Commissioner is empowered to determine the liability for tax as if the transaction has not been entered into or carried out, or alternatively, "in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction"

6.2.1 Reason for Change

Section 103 has proven to be inconsistent and, at times, an ineffective deterrent to the increasingly sophisticated forms of impermissible avoidance that certain advisors and financial institutions put forward and some taxpayers are implementing. In addition, it has become clear that the GAAR has not kept up with international developments. Finally, uncertainty has arisen with respect to the application of the GAAR in the alternative due to conflicting Court decisions in this regard.

6.3 Role of GAAR

Richardson P of the New Zealand Court of Appeal has cogently explained the conceptual basis of a GAAR –

'The GAAR is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance

[67] Prior to the 1996 amendment, the Abnormality Requirement required the Commissioner to be satisfied that, having regard to the circumstances under which the transaction was entered into or carried out, the transaction either (1) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or the carrying out the transaction in question, (2) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction of the nature of the transaction in question.

provisions which are directed to particular defined situations, the legislature through [the GAAR] has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.

Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in the business decision making and family property planning; that something more than the existing benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice- as Lord Templeman put it in Challenge at p.562, most tax avoidance involves a charade; and that certainty and predictability are important but not absolute values.[68]

The function of [the GAAR] is to protect the liability for the income tax established under the other provisions of the tax legislation.

It was held in Glen Anil[69] that s103 'does not impose a tax, nor does it relate to the tax imposed by the Act or the liability therefor or to the incidence thereof….It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed. It is important to note that GAAR is not a charging tax provision. While the application of GAAR to impermissible tax avoidance my help to stem the tide of short-term revenue loss, the GAAR itself is not a revenue raising measure. Its main purpose is to protect the tax base established by Parliament and not to expand it. However this protection may in

[68] CIR v BNZ Investments [2002] 1 NZRL 450;

[69] Per Botha JA in Glen Anil Development Corporation Ltd v SIR 1975 (4) SA 715 (A), 37 SATC 319 at 328;

turn provide the necessary and essential foundation for any future tax reform and simplification, particularly in the area of corporate taxes.[70]

6.4 Current GAAR

The new GAAR is inserted in PART IIA of the Chapter III of the Income Tax Act. The GAAR opens by describing what an "impermissible avoidance arrangement" is in Section 80A. The powers that the Commissioner has with respect to an impermissible avoidance arrangement are set out in Section 80B. The remaining provisions expand on these first two provisions and deal with certain procedural issues that arise.

The requirements for an impermissible avoidance arrangement may be summarised very briefly as follows:

Arrangement

+ Tax effect

Avoidance Arrangement

+ Sole or Main purpose Tax Avoidance

+ Tainted Element

= **Impermissible Tax Avoidance**

6.4.1 Section 80L

This section defines 'arrangement', avoidance arrangement', 'impermissible avoidance arrangement', 'party' and 'tax' for use in the GAAR. The definition 'tax benefit' has been deleted by section 77 of Act 7 of 2010.

6.4.1.1 Definition 'arrangement'

Section 80L defines 'arrangement' to means any transaction, operation, scheme, agreement or understanding (whether

[70] Business day (12 April 2005) at page 8

enforceable or not), including all steps, therein or thereof, and includes any of the foregoing involving the alienation of property;'

The definition of an 'arrangement' does, however, serve one useful purpose. It draws attention to the need, on the part of both the Commissioner and the taxpayer, to identify the transaction, operation or scheme, or in which steps or parts of a scheme, the Commissioner has applied the anti-avoidance rules. This will reduce the risk of the misunderstanding that may have cost the taxpayer his appeal in CIR v Louw[71]

The current general avoidance regime, requires of the Commissioner to furnish reasons for his decision to apply the rule, to at least provide the mechanism to enable the parties to ensure that there is clarity as to the matter in issue. This is dealt with in section 80J (1).

Section 80J (1) reads as follows:

'The Commissioner must, prior to determining any liability of a party for tax under section 80B (s*ection 80B deals with the tax consequences of impermissible tax avoidance*), give the party notice that he or she believes that the provisions of this Part may apply in respect of an arrangement and must set out in the notice his or her reasons therefor."

(Italic inserted for clarity only – not part of the section quoted)

Unfortunately, section 80H casts a degree of uncertainty over the disclosure requirement of SARS in respect of the 'arrangement'.

Section 80H reads as follows:

'The Commissioner may apply the provisions of this Part to step in or parts of an arrangement'.

Can the Commissioner do so when the step or part so selected loses it commercial substance when considered in isolation? Does the provision apply when a taxpayer does nothing at all? We need

[71] CIR v Louw 1993 (3) SA 551 (A), 45 SATC 113

judicial exposition as to actual meaning and purpose of section 80H.

6.4.1.2 Tax benefit

The definition of 'tax benefit' as used in section 80A has been deleted by section 77 of the Act 7 of 2010. The new GAAR applies to "impermissible tax avoidance arrangement" as described in section 80A which was entered into with the sole and main purpose to obtain a tax benefit.

The term "tax benefit" as defined in section 1 of the IT Act arises in both the definition of "avoidance arrangement" and in the preamble to section 80A. For GAAR to be invoked, therefore, it must be shown that the arrangement resulted in a tax benefit and that the main purpose of the arrangement was to obtain such benefit.

The question whether a "liability for tax" exists and has been avoided has been considered by the courts on a number of occasions. In **CIR v King**[72], Watermeyer J pointed out that:

'There are many …. ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than in the past, or of freeing himself from taxation on some part of his future income. For example, a man can sell investment which produce income subject to tax and in their place make no investment at all, or he can spend the proceeds in buying a house to live in, or in buying shares which produce no income but increase in value…He may even have conceived such a dislike for the taxation under the Act that he sells all his investments and lives on his capital or gives it away to the poor in order to have to pay such taxation. If he is a professional man he may reduce his fees or work for nothing…He can carry out such operations for the avowed purpose of reducing the amount of tax he has to pay, yet it

[72] CIR v King 1947 (2) SA 196 (A);

cannot be imagined that Parliament intended by the provision of section 90 to do such an absurd thing as to levy a tax upon persons who carry out such operation as if they has not carried them out."

It is considered that the King principle of 'a tax benefit' is still relevant under the new GAAR.

In **Smith v CIR**[73] the court held that: "The ordinary, natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability…."

The court in Smith case found that the arrangement concerned avoided Mr Smith's anticipated liability for tax on the Tellurometer dividends and that there was no need for the income still to be economically Mr Smith's, for GAAR to operate. Determining the existence of a 'tax benefit' therefore typically requires one to identify income which might otherwise have accrued to the tax planner and this is the situation which has faced the courts in most of the reported cases.

6.4.1.3 Sole and main purpose of the arrangement

- **Onus of proof**

Section 80G (1) reads as follows: "An avoidance arrangement is presumed to have been entered into or carried out for the sole and main purpose of obtaining a tax benefit unless the party obtaining a tax benefit proves that, reasonable consideration in light of the relevant facts and circumstances, obtained a tax benefit was not the sole and main purpose of the avoidance arrangement"

Once it has been established that an arrangement exists, section 80G (1) creates a presumption that it was entered into or carried out for the sole or main purpose of obtaining the tax benefit identified. The party obtaining that benefit may rebut that presumption by proving that 'reasonable consideration in the light

[73] CIR v Smith 2002 (6) SA 621 (SCA) 65 SATC 381;

of the relevant facts and circumstances' obtaining a tax benefit was not the sole or main purpose of the avoidable arrangement. The presumption may arise in relation to the entire arrangement or in respect of any step or part thereof and the Act clearly envisage that steps or parts may have purposes different to the whole and/or other steps or parts. It may, therefore, be that an arrangement as a whole has a main business purpose, whereas a subsidiary transactional element thereof has been inserted principally for its tax effectiveness. In such a case, that subsidiary element would fail the main purpose test and then fail to be considered under the further test [later discussed in this dissertation], to determine whether the GAAR can apply.

The South African courts have long-since determined that the purpose test is purely an objective one. What was in the mind of the **taxpayer** who entered into the scheme? In most other countries the courts, in interpreting legislation which referred to the purpose of an arrangement, have come to the opposite conclusion. The principle that has been established in our courts, on the strength on that wording, is that the intention of the taxpayer is irrelevant. The test is purely an objective one. It is considered that the wording of section 80G has probably brought about a profound change in the onus of proof relating to the application of the whole GAAR.

The courts have ruled, onus lay on the Commissioner to prove that the presence of all the requirements for the old section 103(1) applies, subject to the proviso that once the tax avoidance effect of the transaction has been proven by the Commissioner, the onus then shifted to the taxpayer to prove that his main and sole purpose was not tax avoidance.

In the result the courts will presumably now be unable to find anything in the current GAAR to suggest that the provisions of section 102 of the Tax Administration Act have been displaced. The probable consequences are that the courts may hold that

henceforth the onus rests on the taxpayer to prove that at least one of the four requirements for the application of GAAR is missing. As noted above, this presents a profound change to the ones of proof.

As discussed earlier section 80H confirms that the Commissioner may apply the GAAR to steps in or parts of an arrangement and section 80G (2) provides that:

'the purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole."

Presumable the legislator of the new GAAR was out to destroy the principle that has been established by South African courts in Conhage case supra.

In the Conhage **case**[74] the court held the following:

The problem facing the Commissioner in this case was that he had discarded the possibility that the agreements were deliberately disguised. The only other explanation SARS was able to suggest was that the parties might have believed that the formal instruments would gain them the desired tax benefit. The facts showed that the parties had not merely gone through the motions but have every intention of concluding sale and leaseback agreements. Although a sale and leaseback comprises an agreement of sale as well as an agreement of lease, it had to be treated as one combined transaction and all in all the transactions made perfectly good business sense.

The very important principle has been laid down in this case that "a taxpayer is free, within the bounds of the anti-avoidance provisions of the Income Tax Act, to minimise his tax liability. If the same commercial result can be achieved in different ways, he is free to enter in a type of transaction which does not attract tax or attract less tax. When determining whether a taxpayer has

[74] CIR v Conhage (Pty) Ltd (former Tycon (Pty) Ltd;

succeeded in avoiding or reducing tax, a court gives effect to the true nature and substance of the transaction and is not deceived by its mere form"[75]

The effect of the Conhage case was that when a transaction operation or scheme was entered into for an overriding non-tax reason, the Commissioner could not apply section 103(1) to any steps in or part of the transaction, operation or scheme that were tax driven.

The general anti-avoidance rule in Australia has proved to be successful in overcoming this rule. It seems from the wording of section 80G (2) that the legislator has destroyed the principle established in the Conhage case.

The presumption contained in section 80G places a heavy burden of proof on the taxpayer, since the mere assertion by him that his purpose was not the avoidance of tax does not carry a great amount of weight. In order to displace the presumption against him, not only must the taxpayer be able to point to some compelling reasons for the entering into of the arrangement but the court must be convinced that 'reasonable consideration in the light of the relevant facts and circumstances' the tax benefit was not the sole or main purpose. The courts must take an objective view of the facts which includes the *ipse dixit* of the taxpayer in order to determine the actual purpose of the transaction.

6.4.2 Section 80B

This section provides the Commissioner with specific remedies to impermissible tax avoidance, as well as additional general remedies. The current GAAR also introduced a requirement that the Commissioner may make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to a permissible avoidance arrangement.

[75] Income Tax in South Africa, cases & materials, 2nd Edition, RC Williams, page 571

Such compensating adjustments are subject to the normal three-year prescription rules with respect to assessments that have already been issued, since they may result in both additional and reduced assessments.

6.4.3 Section 80A

This section contains the basic statutory structure of the GAAR. In terms of section 80A the GAAR can only be applied to disregard a transaction if three basic elements – and a fourth which can be any of the tainted elements – have been met. The three basic elements that need to be established to determine whether the transaction is in a business context or not are:

- An arrangement;
- A tax benefit; and
- Sole and main purpose of obtaining a tax benefit.

In the context of business, the following are the tainted elements:

- The utilisation of abnormal means or manners which are not used for a *bona fide* business purpose other than to secure a tax benefit;
- The absence of commercial substance;
- The creation of rights and obligations which would not be created in an arm's length arrangement; and
- The misuse or abuse of the provisions of the Income Tax Act.[76]

In the context of other than business the tainted elements:

- The execution of an arrangement by abnormal means or in a manner which would not normally be employed for a *bona fide* purpose, other than secure a tax benefit;

[76] Analysis of misuse and abuse in terms of the South African general anti-avoidance rules: lessons from Canada- Benjamin T Kujinga- page 44 (Section 80A);

- The creation of rights and obligations which would not be created in an arm's length arrangement; and
- The misuse or abuse of the provisions of the Income Tax Act.

The GAAR uses certain indicators to target the so-called 'impermissible avoidance arrangements'. Impermissible avoidance arrangements are tax avoidance arrangements with a sole or main purpose to avoid tax and any one of the various indicators of permissible tax avoidance. These indicators may exist in (a) business context, (b) context other than business, (c) in any other contexts. The word 'and' is crucial because 'a sole and main purpose to obtain a tax benefit' is insufficient as indicator of impermissible tax avoidance. A sole or main purpose to obtain a tax benefit can also be found in permissible tax avoidance transactions because tax is almost always avoided on purpose through aggressive tax planning.

The current GAAR can be contrasted with South Africa's first GAAR in section 90 of the 1941 Act. In its original form, section 90 was literally broad in the sense that it only required tax avoidance purpose to be established in order to strike down a transaction. The court in the King case[77] extensively analysed section 90-GAAR, the court held at page 196 that 'purpose' meant a sole or main purpose, not just incidental purpose.

Section 80A(c)(ii) is crucial to the operation of section 80A since it applies both to situations "in the business" and situations "in a context other than business". Cilliers (2008a:85 -86) therefore indicates that section 80A(c)(ii) can be described as "the heart of section 80A"[78]

[77] Commissioner for Inland Revenue v King 1947 (2) SA 196 AD;

[78] Section 80A(c)(ii) of the Income Tax and the interpretation of tax statutes in South Africa-L van Schalkwyk & B Geldenhuys- pages 173;

6.4.4 Tests in the context of business

The first test in terms of section 80A (a)(i), requires an objective determination whether the arrangement was entered into or carried out, by means or in a manner, which would normally be employed for bona fide business purpose.

The business purpose test in terms of the GAAR is not whether the scheme itself has a commercial purpose, but whether the manner in which the transaction is entered into or carried out in which would normally be used for *bona fide* business purposes other than to obtain a tax benefits.[79]

It is quite possible that a transaction in the context of business- that is, it is submitted, entered into or carried out by the entity which carries on business and in the course of that business- is in fact entered into or carried out expressly and solely to achieve a tax benefit, but that the methodology used in one that would normally be employed for *bona fide* business purpose.

The inferences can be drawn that the business purpose test can be passed without there being any actual business purpose whatsoever. It is therefore a misnomer to make reference to this element of the GAAR as a 'business purpose test'. It is rather a 'bona fide business method test'.

It is interesting to note that the 'business purpose' test was introduced to the old anti-avoidance in 1996 by the provision in the form of section 103(1) (b)(i)(aa). The provision requires that each separate transaction in the scheme must have its own business purpose, or at least contributes some real sense to the overall business purpose of the scheme.

[79] SARS (2010) –Draft Comprehensive Guide to the GAAR; Available on www.sars.gov.za at page 24

In many transactions entered into under the 'old' provision of section 103 this was probably not the situation, and a clear example of where the new business purpose test would operate to the Commissioner's satisfaction is contained in the special court decision given in **ITC 1606**[80].

In **ITC 1606** the court observed that in order to determine the purpose of a particular agreement, it was necessary to look at the subjective intent of the parties at the time the agreement was entered into and that the present transaction was clearly one which led to tax reduction. The central question was whether the transaction was one which would normally be entered into wholly or mainly for the purpose of reducing tax liability. The court was of the view that although the scheme had been made up of three separate steps, each one of which could be seen as genuine, it was clear that they were all parts of one composite transaction and that although there were three entities with independent legal personalities, two of them took part as members of a single company group and the third acted purely as agent for the group in the transaction.

Tebbutt J said: 'Afgesien hiervan is dit ons mening dat gesonde verstand dit voorsê dat waar een van die transaksies in 'n reeks transaksies ingesluit is wat geen kommersiele doel het nie en bloot daar is om 'n belastingvoordeel te probeer kry dit nie as 'n normale transaksie tussen persone, die uiterste voorwaardes beding, beskou kan word nie. ... As daar na die wesenlikheid van die skema in sy geheel gekyk word is dit, onses insiens, nie 'n normale een nie.'

[80] (1995) 58 SATC 328

The court held that s 103(4) raised a rebuttable presumption that where a scheme has had the effect of reducing tax then it has been entered into wholly or mainly for the purpose of reducing tax and the taxpayer had not rebutted that presumption.

6.4.4.1 Bona fide business purpose

The phrase '*bona fide* business purpose' needs to be carefully analysed to establish exactly what the Acts entails. There is no definition of the term 'bona fide' in the IT Act. The terms 'bona fide' probably bears the established judicial interpretation of 'good faith'[81]. Clegg[82] is of the view that the phrase means that the transaction must be real and not imaginary.

A bona fide purchaser is one who purchases property for a valuable consideration that is inducement for entering into a contract and without suspicion of being defrauded or deceived by the seller. He or she has no notice of any defects of the title. A bona fide purchaser pays in good faith full value for the property and, without any fraud, goes into possession.[83]

Beadle CJ in Estate G v Commissioner of Taxes[84] was of the opinion that:

'The sensible approach, I think, is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as carrying on business? The principle features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object, the continuity of the activities concerned, if the acquisition of property is involved, the intention

[81] Javis, J (1996), Things are Seldom What They Scheme, Juta's Business Law, vol4 at 147- 148;

[82] Glegg D, (2002). Business purpose test, Tax Planning Corporate and Personal, vol. 16,

[83] legal-dictionary.thefreedictionary.com

[84] Estate G v Commisioner of Taxes 1964 (2) SA 701 SR 26 SATC 168 at 173 -174

with which the properties as acquired. This list of features does not purport to be exhaustive, nor is any one of these features necessarily decisive, nor is it possible to generalise or state which feature should carry the most weight in determining the problem. Each case must depend on its own particular circumstances'

6.4.4.2 The abnormality test

The first limb of section 80A (a)(i) is posited on 'abnormality'. It requires an objective determination whether the arrangement was entered into or carried out, by means or manner, which would not normally be employed for bona fide business purpose other than obtaining a tax benefit. The legislator attached the qualification 'not normally ….employed for bona fide purpose to both the means ('by means') and the manner ('in a manner') in which the arrangement was entered into or in which it was carried out.

There is no overriding presumption as to abnormality in relation to the provisions of section 80A (a)(i) and it is incumbent on the Commissioner to show that, on the balance of probability that abnormality exists.

The abnormality test does not require that the arrangement under examination should have a primary or substantial business purpose *per se*, but merely that the method employed should be normal in a business context. It is quite possible that a transaction in a business context entered into or carried out by an entity which carries on business and in the course of that business expressly and solely achieves a tax benefit.

The Act does not define what is normal or abnormal for the purpose of establishing whether the manner or means in which a transaction, operation or scheme has been entered into or carried out is normal, or whether the rights and obligations created are those which would normally be created between persons dealing at arm's length.

The courts have in many cases involving tax avoidance been called upon to consider the question of normality and abnormality. These cases are important in giving guidance to those taxpayers and their advisers who are contemplating entering into tax avoidance schemes and who wish to structure the schemes so that there is no element of abnormality which could result in the schemes failing in their tax avoidance purpose.

In **ITC 1496**[85] the court has to consider the appeal of the taxpayer against the decision of the Commissioner to attack the tax avoidance scheme using the provisions of section 103(1) of the IT Act. Melamet J held that there were many abnormal elements present in the scheme[86]. The structure of the partnership was found to be artificial. The division and allocation of the distributors to the scheme into four sub-partnerships which in turn formed the main partnership was held to indicate abnormality in the formation of the alleged partnership. Melamet J dictum to the above indicators:

*"*It is highly unlikely that parties who were total strangers would be willing to enter into business as partners in timber farming with joint and several liabilities. It is all the more so that this would be done without seeing the area, having a meeting with the manager of G and without meeting or corresponding with each other."

'The whole artificial structure relating to the partnerships was necessitated by the need to camouflage investors as partners.'

In **ITC 1606**[87] the court considered whether the provisions of section 103(1) applied to a tax avoidance scheme which was a typical example of the so-called bare dominium scheme. In his

[85] (1990) 53 SATC 229;

[86] At 250-2;

[87] (1995) 58 SATC 328;

judgement, Tebbutt J stated that one of the central questions to be considered was whether the transaction was one which would normally be interred into by persons dealing at arm's length. The court asks the following all important dictums:

'all the surrounding circumstances under which the transaction was entered into must be taken into account. It is a question of fact. There must also, in my opinion, be a distinction drawn between an unusual transaction and an abnormal one. It is in the nature of things that where a taxpayer uses his ingenuity fairly to reduce his liability for tax through a scheme, it will be unusual. The abnormality of the scheme will normally depend on whether it creates rights and obligations which would not normally be treated between the parties to the transaction who are
dealing at arm's length.'

In **Geustyn's**[88] case the court held that where persons incorporate their business and their sole and main purpose for doing so was not the avoidance of tax, section 103 is not applicable, even if the transaction was abnormal.

The **Geustyn's** [**1971**] case:

Three taxpayers have since 1961 practised in partnership as consulting engineers. In 1966 they formed an unlimited liability company. The practice of the partnership was sold to the company. The former partners, now directors, were each employed by the company at an annual salary of R10 000. This resulted in a significant reduction in the tax liability. The Commissioner applied section 103(1) and assessed the individual partners to tax as if the transfer had never been affected.

[88] SIR v Geustyn, Forsyth & Joubert 1971 (3) SA 567 (A)

The Appellate division dismissed the assessment on the basis that section 103(1) expressly requires the Commissioner, in deciding whether the abnormal rights and obligation has been created, have

"*regards to the circumstances under which the transaction, operation or scheme was entered into or carried out."*

According to the Appellate Division the former partners of the partnership and the shareholders of the new company where not acting at arm's length. The existence of interest-free and unsecure loans and the absence of any formal service agreement and so on were not being regarded as being normal features.

The finding of the Special Court that tax avoidance was not the sole or one of the main purposes of the taxpayer was a question of fact and could not be upset on appeal unless it was shown to be a finding which on the evidence could not reasonably has been reached. There was evidence to support the conclusion of the Special Court that tax avoidance was 'not a factor which was taken into consideration,' and the Special Court's conclusion could accordingly not be disturbed.

The absurdity and the implications of this approach seemed to have passed the notice of the Appellate Division. In **Hicklin**[**1980**] case[89] the court was concerned with a dividend- stripping operation. Mr Hicklin was one of a number of shareholders of a company which was virtually dormant; most of its assets consist of loans to its shareholders substantially in proportion to their shareholding. The company had both distributable and non-distributable (capital) reserve, but the shareholders had not intended to declare dividends or liquidate the company.

[89] Hicklin v SIR 1980 (1) SA 481 (A), 41 SATC 179, 1980 Taxpayer 49

In 1975 the shareholders entered into a deed of sale with Ryan Nigel, a public company, in terms of which they sold their shares for an amount equal to the company's reserves less:

(a) 10% of its distributable profits;

(b) 1% stamp duty on the share transfers; and

(c) An amount equal to the loan levy, the purchaser undertaking to pay a like sum to the seller when the levy matured.

In order to achieve this they acquired the other assets of the company which has the effect of increasing their loan account. They had to repay their loan accounts to the company on the effective date, namely when Ryan Nigel was to receive transfer of the shares and pay the purchase price.

The court held as follows:

1. The Special Court had erred in law in finding that the transaction in issue created rights or obligation which could not normally be created between persons dealing at arm's length within the meaning of the section.
2. When considering the normality of the rights and obligations so created or of the means or manner employed, due regards had to pay to the *surrounding circumstances*.
3. The problem of normality or abnormality was *mainly a factual question,* and the Court could resolve it by taking judicial notices of relevant norms and standards or by means of the expert or other evidence adduced by either parties.
4. The court concluded that there was nothing abnormal in the transaction between the sellers and Ryan Nigel, either in the manner or means by which the transaction was entered into or carried out, or in the rights or obligations created.

   The effect of Hicklin and Geustyn are that if regard is indeed had to the circumstances under which the transaction, operation or scheme was entered or carried out, it makes no

difference whether the parties are or are not acting at arm's length, the Commissioner is likely to lose, either way. This can provide another escape route for an avoidance scheme.

6.4.4.3 Commercial substance test

The second test in terms of section 80A (a)(ii) is triggered through a complete or partial lack of 'commercial substance'.

Tests in the context of business:

Section 80A (a)(ii) reads as follows:

(i) [the impermissible arrangement/agreement] … lacks commercial substance, in whole or in part, taking into account **section 80C**.

Section 80C defines 'lack of commercial substance':

(A) An impermissible arrangement lacks commercial substance if:

- the arrangement <u>resulted in</u> a significant tax benefit for a party; but/and
- the arrangement <u>does not have</u> a significant effect upon either the business risks or net cash flow;

(B) The characterises of an avoidance arrangement that are indicative (symbolic) of a lack of commercial substance:

- the legal substance or effect of the avoidance arrangement as a whole is inconsistent or differs significantly from the legal form of the individual steps;
- the presence or inclusion of the following:
  - round trip financing as described in section 80D[90]; or

[90] 1. Transfer of funds between and among the parties;

2. The transfer resulted in directly or indirectly in a tax benefit;

- an accommodating or tax indifferent party as described in section 80E[91]; or

- elements that have the effect of offsetting or cancelling each other;

Section 80C (1) partially explain the characteristics of a transaction that lacks commercial substance. It however does not explain how the comparison between the tax benefits and the effect on the business risks or net cash flows of the *taxpayer* in question should be done. In the absence of South African case law on the concept, it is useful to refer to foreign case law in a country that relied on a closely related, if not identical, concept known as economic substance.

The United States relies on interlinked doctrines such as the economic substance doctrine, the business purpose doctrine, the sham transaction doctrine and the step transaction doctrine to curb impermissible tax avoidance. According to Bankman, the economic substance doctrine is the most important.[92] The

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3. Significant reduce, offset or eliminate any business risk;

[91] Accommodating or tax indifference if the avoidance arrangement resulted in:

No amount subject to normal tax; Significantly offset of any expenditure or loss incurred by either parties to the agreement;

[92] Bankman, 'The economic substance doctrine' (2002) 74 (5) Southern California Law Review 5 at 6, Regards the sham transaction doctrine, the 'sham' was used by the Supreme Court in Lilienthal's Tobacco v United States 97 US 237 (1877). In this case a tobacco seller, wanting to avoid a high tax rate, claimed to have sold tobacco to a broker before the date on which the tax rates were to be increased. However, in reality, the tobacco that had been 'sold' remained on the merchant's premises and within a few days the broker 'sold' the tobacco back to the tobacco seller. The transaction was held to be a 'perfect sham' at 247 and the Supreme Court stated at 270 that the purported sale was 'fictitious'.

economic substance doctrine will be discussed under the international approach to curb impermissible tax avoidance.

Section 80C contains both presumptive and indicative tests whether commercial substance exists.

6.4.4.3.1 Presumptive[93] test

An avoidance arrangement is presumed to lack commercial substance if it would result in a significant tax benefit for a party but has no significant effect upon either business risk or net cash flows of that party. The application of this presumptive test is problematic since there is no indication of what would constitute a 'significant' tax benefit. It is presumed that the tax benefit must be significant in the context of the particular taxpayer's financial affairs in general. The same challenge applies to determining whether there is a 'significant effect' on business risk or net cash flow.

The provisions have the potential to strike down commercial arrangements where the parties have gone out of their way to hedge their commercial risks. In most, but by no means all, such situations the main purpose of the arrangement, and its parts would probably be commercial, thereby providing a defence against the application of GAAR.

6.4.4.3.2 Indicative test

The indicative test included the following:

(a) Legal substance over form of the avoidance arrangement as a whole which differs from the legal form. It is suggested that in context, the word 'legal' qualifies 'substance' but not 'effect'. Thus, the comparison required will be between the legal reality or the commercial effect of the whole on the one hand and the legal form

[93] The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method- definitions.uslegal.com [17 December 2015]

of the individual steps on the other. It will be uncommon if the commercial effect of a series of transactions is remotely similar to the legal form of any one of the traditional elements required to arrive at the end result. The same applies to the legal substance of the whole when compared to the legal form of individual steps.

(b) The draft Comprehensive Guide to the GAAR[94] conceded that the term 'legal substance or effect' have been the subject of much debate and goes on to the say that the word 'effect' includes 'economic, commercial or practical effect'

6.5 Conclusion

Section 80C of the Act was no doubt intended to form the heart of the general anti-avoidance rule. This is in fact, an articulation of the so called economic substance doctrine which forms the basis of the general anti-avoidance rule in many Western countries. In South Africa law, provisions such as the above are peremptory. Neither the Commissioner nor the courts have discretion as to whether the provision should be applied or ignored.

There is also no presumption of misuse or abuse of the provisions of the Act for the purpose of section 80A(c) (ii) and it is submitted that the Commissioner bears the onus of proof hereto. In the case of a lack of commercial substance, however, there are certain presumptive tests contained in section 80C which will shift the onus of disproving that lack of substance onto the shoulders of the taxpayer.

The subparas of section 80A deal with the avoidance of tax in both a business context and in a context other than a business context, however, certain of the tests that will be discussed later apply to both contexts and other only apply to the one or other.

[94] At 6.4.3

CHAPTER 7 - CONCLUSION AND POSSIBLE RECOMMENDATION

7.1 Introduction

What can the general anti-avoidance provisions achieve that is not already adequately facilitated by the existing common law doctrines? Answering this question involves a consideration of two interrelated issues. First, are these common-law principles sufficient to combat tax avoidance? Second, do these provisions seek to achieve a goal that goes beyond that provided by these common-law principles?

In answering the first question I will start by considering each of these common-law principles in turn.

It will be seen that in the taxation context the role of the common-law principles has been significantly impacted upon by the *Duke of Westminister principle.* This refers to the off-cited controversial statement of Lord Tomlin in *The Duke of Westminister* case (supra):

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

In regards to the second question, from the analysis of the GAAR provisions it becomes clear that the statutory provisions have a wider operation than the common-law principles. Notably the statutory provisions are not premised on the prerequisites that are required to enliven the application of the subject common-law principles. Ultimately in regards to the first question it is concluded that when the limiting prerequisites of the operation of the common-law principles are combined with the *Duke of Westminster* principle, the common-law is insufficient to combat tax avoidance. As to the second question, it is concluded that the legislative provisions do

not suffer from the same limitations and they are intended to have a scope beyond these common-law principles.[95]

7.2 Common-law principles

7.2.1 Substance over form

The South African common law formulated the underlying principle that the court only becomes concern with the substance rather than the form of a transaction when it has to decide whether the party concern has succeeded in avoiding the application of a statute by an effective arrangement of his affairs.[96]

The first is the one expounded in The Duke of Westminster's case (supra). This principle was adopted by the minority judgement in CIR v Estate Kohler[97] and confirmed in subsequent judgements. In effect it involves the application of the more general principle, recognised in Dadoo Ltd and Others v Krugersdorp Municipal Council[98] and Van Heerden v Pienaar[99] which permitted parties to arrange their affairs so as to remain outside the provisions of a particular statute. It is for our courts to decide in every case where this principle is invoked whether the parties to the arrangement have succeeded in achieving the intended result.

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[95] Tainted elements or nugatory directive? The role of the general anti-avoidance provisions ('GAAR') in fiscal interpretation – Julie Cassidy (Page 322);

[96] Dadoo Ltd v Krugersdorp Municipal Council 1920 AD 530 547, see also CIR v Saner 1927 TPD 162 172;

[97] 1953 (2) SA 584 (A) at 591E- 592H

[98] 1920 AD 530 at 548

[99] 1987(1) SA 96(A) at 107E-F

The CIR v Sunnyside Centre (Pty) Ltd[100] the AD held that 'When a scheme works, no tears are shed for the Commissioner. That is because a taxpayer is entitled to order his affairs so as to pay the minimum of tax. When he arranges them so as to attract more than the minimum he has to grin and bear it.'

The dictum in CIR v Cohage (Pty) Ltd[101] brings the anti-avoidance rules and the application of the common-law principles to a mutual ground when the SCA said that:

'Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in different ways, he may enter into the type of transaction that does not attract less tax.'

In C: SARS v NWK Ltd (supra) Lewis JA said that

'There is, in principle, nothing wrong with arrangements that are tax-effective. But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not.' With this in mind the second principle comes in to play.

'Courts of law will not be deceived by the form of a transaction; it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance' (per Wessels ACJ made in Kilburn v Estate Kilburn[102])

In Erf 3183/1 Ladysmith case [1996] the court makes reference to the taxpayer's real intention by making the following dictum which is striking similar to the Kilburn case (supra):

'Where parties to the agreement do not honestly intend to give effect to it or some of its terms, and have an ascertaining and different 'real agreement', the court will give effect to their real agreement.'

[100] (86/95) [1996] ZASCA 102; 1997 (1) SA 68 (SCA); (20 September 1996)

[101] (1996) 58 SATC 319, AD at 327

[102] AD 501 at 507

In the same case the court looked at the purpose and effect of these two common-law principles and concluded that each of them is confined to its recognised bounds and there is no reason why both of these principles cannot be applied on the case.

7.2.2 The choice principle[103]

The choice principle is anchored in the view that if a taxpayer merely makes a choice between two or more tax liabilities, the anti-avoidance provision could not be intended to take these choices away, thus, the taxpayer was not avoiding tax if he/she made a decision, which attracted less tax. In the C:SARS v NWK case (supra), in the dicta quoted above, it become evident that our common law tacitly recognises the so called choice principle.[104]

In CIR v Conhage (Pty) Ltd (supra) the court made it clear that the choice principle is available to the taxpayer only within the bounds of the anti-avoidance provisions of the Act, in other words, that the statutory anti- avoidance provisions will *pro tanto* override the taxpayer's right to arrange his affairs so as to minimise his tax liability.

The Australian courts have explicitly restricted the choice principle to situations where the tax legislation itself explicitly or impliedly offered the taxpayer the choice in question and the courts have accepted that, in such circumstances, the taxpayer cannot be fiscally penalised for choosing the more tax-effective course of action- even if he himself created the situation that gave rise to that choice. As Barwick CJ said in Mullens v FCT[105]:

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[103] Silke SA anti-avoidance – Chapter 19.3 –Tax avoidance

[104] Silke SA anti-avoidance – Chapter 19.3 –Tax avoidance,

[105] [1976] HCA 47; (1976) 135 CLR 290 at 298. For a critical overview of the influence of Sir Garfield Barwick in this regard, see, see Lehmann, G, 'The Income Tax Judgments of Sir Garfield Barwick' (1983) 9(3) Monash University Law Review 115

'The [High Court of Australia] has made it quite plain in several decisions that a taxpayer is entitled to create a situation into which the Act attaches taxation advantages for the taxpayer. Equally, the taxpayer may cast a transaction into which he intends to enter in a form which is financially advantageous to him under the Act.'

It is to be hoped that our courts, at the first opportunity, confirm that the choice principle in South Africa is applicable only in relation to a choice that is explicitly or tacitly implied by the tax legislation itself, and that where it is so offered, the choice principles prevails over the general anti-avoidance provision that is applicable to the transaction in question.

7.2.3 Simulated transactions

The locus classic on the subject of simulation transactions is no doubt formulated in the Innes J's judgement in Zandberg v van Zyl[106] were the following appears:

'*Not frequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to the transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when the court is ask to decide any rights under such an agreement, it can only so by giving effect to what the transaction really is; not what in form it purports to be….But the words of the rule indicates its limitations. The court must be satisfied that there is real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in the fact mean that the contract shall have effect in accordance with its tenor, that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact,*

[106] 1910 AD 302 at 309

for the right solution of which no general rule can be laid down' (authors underline)

The thrust of the above passage lies in my underlined words that our court will ascertain the real or actual intention of the contracting parties. Remove the veil that conceal or disguised the intention and call it by name.

Clegg and Stretch explain the interplay between the broader "form over substance" approach and the sham doctrine:[107]

"while the legal substance of an agreement will generally be looked to in situations of genuine uncertainty or disagreement as to the nature of a transaction, the sham transaction test is more usually applied in situations where the parties have purposefully disguised the true nature of the transaction between them through the adoption of a form which is at variance with their actual intentions"

When the transaction is a sham it is in *fraudem legis* and the court will look to its substance, not its nominal form.

The principle that substance may prevail over form has been subsequently reaffirmed in a number of important cases[108], including tax cases.

Glegg and Stretch explain that "the legal substance of an agreement is of relevance when its form does not give clear guidance as to the relationship between the parties and this lack of clarity will usually be because the agreement between the parties is poorly or confusingly drafted" In the context of sham doctrine " the legal reality of an agreement – which is an element of the facts which must be established in determining the tax consequences of a transaction or a series of events – may be "… overruled through

[107] D Clegg & R Stretch Income Tax in South Africa (2007) para 2674, quoting in support the passage above from Zandberg v Van Zyl 1910 AD 302 – 309;

[108] See Michau v Maize Board 2003, 6 SA 459 (SCA);

the sham transaction test, where the form does not actually represent the true intention of the parties."

From the above discussions it seems that the prerequisite to the applicability of the sham doctrine has ensured that these common-law principles have had limited application in tax avoidance jurisprudence.

As explained in Commissioner of Customs and Excise v Randle, Brothers & Hudson Ltd[109]

'[a] transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the court according to its tenor, and then the only question is whether, so interpreted. If falls within or without the prohibition or tax.'

In essence a simulation transaction is a dishonest agreement or arrangement as the parties to it do not really intend to create a legal effect. The purpose of the concealment or disguise is too deceived by concealing the real agreement. The parties wish to hide the fact that their real agreement falls within the prohibition or is subject to tax.

A dark cloud was put on this principle by the SCA in C: SARS v NWK (supra) where Lewis JA giving the judgement of the court and said that:

'In my view the test to determine simulation cannot simply be whether there is <u>an intention to give effect to a contract in accordance with its terms</u>. Invariably where parties' structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the

[109] Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd 1941 AD 369-395

terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.'

(Author underline)

In Roshcon (Pty) Ltd v Ancor Auto Body Builders CC (supra) Wallis JA try to defend Lewis J's intention made the following dictum:

'It appears that in some circles this, and particularly the statement that 'If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated', has been understood to condemn as simulated transactions any and all contractual arrangements that enable the parties to avoid tax or the operation of some law seen as adverse to their interests[110]. But that fails to read this sentence in the context of both the particular paragraph in the judgment and the entire discussion of simulated transactions that precedes it. If it meant that whole categories of transactions were to be condemned without more, merely because they were motivated by a desire to avoid tax or the operation of some law, that would be contrary to what Innes J said in *Zandberg v Van Zyl* in the concluding sentence of the passage quoted above, namely that: 'The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.'

[110] Trevor Emslie SC 'Simulated transactions – A new approach?' (2011) 60 The Taxpayer 2 at 56; Eddie Broomberg SC 'NWK and Finders Hall' (2011) 60 The Taxpayer 187 at 1978; C J Pretorius 'Simulated agreements and commercial purpose – Commissioner for the South African Revenue Service v NWK Ltd' (2012) 75 THRHR 688 at 696; Andrew Hutchinson and Dale Hutchinson 'Simulated transactions and the fraus legis doctrine' (2014) 131 SALJ 69.

Willis JA than attempt to clear the air by making the following dictum[111]:

'For those reasons the notion that *NWK* transforms our law in relation to simulated transactions, or requires more of a court faced with the contention that a transaction is simulated then a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated.'

Some commentators have interpreted the NWK judgement as holding that a lack of commercial substance or business sense, as per section 80A of the Tax Act, is indeed a free-standing or self-sufficient measure for determining that an arrangement was 'simulated'. An editorial in the *The Taxpayer*[112]predicts that:

'It is almost certain that the South African Revenue Service ("SARS") will celebrate its victory in NWK by going after the offensive…. With NWK as the new weapon in its armoury"

Not surprising, SARS released a media statement dated 15 December 2010 that it was aware-

'that a number of other taxpayers have entered into simulated transactions, including compulsorily convertible loans similar to the one at issue in the NWK case, with the effect of artificially reducing their tax liabilities. Starting from 15 February 2011 SARS will commence audits of these taxpayers.'

In conclusion I would like to pose the following question and that is where I will leave it. Does the Supreme Court of Appeal judgement

[111] At [37]

[112] 113 2011 (59) The Taxpayer 2010.

in NWK hold the view that a lack of 'commercial substance' or 'business sense' are substantive criteria in their own right that definitively stamp a transaction as being 'simulated' or merely as evidentiary factors to be taken into account in determining whether an ostensible agreement between the parties was, in reality, what it purported to be?

7.3 The legislation: GAAR

In regards to the anti-avoidance provisions in specific the context of Part IIA in the Income Tax Act, it will be seen that these provisions have an intended reach that extends beyond that of the above common-law principles.

Part IIA deals with the notion of an "impermissible avoidance arrangement". Section 80A identifies the following elements of an impermissible avoidance arrangement:

- The sole and main purpose (presumed under section 80G);
- The avoidance arrangement (defined in section 80L);
- Must be to obtain a tax benefit (defined in section 1, definition "tax benefit')
- One or more of the "tainted elements" must exist.[113]

In regards to the "tainted elements" it requires the application of the "abnormality test".

7.3.1 Commercial substance

Section 80A(a)(ii) included an additional "tainted element", namely that the arrangement lacks commercial substance. As this is stated in the alternative, the commercial substance test applies whether or not the arrangement would meet the abnormality test. Section 80C sets out certain factors guiding the conclusion as to commercial substance. Section 80C(2) then sets out a non–exclusive list of

[113] The notion "tainted element" is not expressed in the legislation, but is adopted in the Explanatory Memorandum, Revenue Laws Amendment Bill 2006 page 62.

relevant factors that are indicative of arrangements that lack commercial substance.

While each of these factors ultimately relates to the existence or otherwise of commercial substance, the first indicium most directly relates to the common-law principle that the law has regards to the substance, rather than the form, of things.[114](*plus valet quod agitur quam quad simulate concipiture*). Creating a legal façade that is contrary to the substance of the arrangement, in particular individual steps in a broader arrangement, is a common tool used in tax avoidance schemes.[115]

The traditional common-law 'substance over form' principle has proven to be insufficient to combat many tax avoidance schemes because the underlying agreements are technically valid and thus not normally susceptible to challenge.[116]

Section 80A(c) includes another alternative "tainted element", namely that the avoidance arrangement results directly or indirectly in the misuse or abuse of the provisions of the Act (including the provisions of GAAR). The language of this relates to the common-law principle in *fraudem legis*, albeit that the role of this section remains controversial.[117]

This section 80C(2) draws on the United Kingdom's judicially developed "doctrine of fiscal nullity". This doctrine applies where there is a preordained composite transaction or series of transactions and inserted into this is a step with no commercial

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[114] Dadoo Ltd v Krugersdorp Municipal Council 1920 AD 530 – 547, see also CIR v Saner 1927 TPD 162 -172;

[116] SARS Tax Avoidance and Section 103 of the Income Tax Act, 1962: An Interim Report (2006) n 92.

[117] Tainted elements or nugatory directive? The role of the general anti-avoidance provisions ('GAAR') in fiscal interpretation – Julie Cassidy (page 339 – 342);

business other than tax avoidance.[118] When these two conditions are met, the inserted steps are to be disregarded for fiscal purposes. The court would then look at the end result and how that end result will be taxed will depend upon the terms of the taxing statute that is sought to be applied.[119]

7.3.2 Do these provisions merely embody the common law principles?

"Does section 80A(a)(ii) do nothing more that echo the *plus valet* doctrine? Is it thus a "dead letter"?[120] There are two interrelated responses to these questions. There are responses that the plus valet doctrine does not apply to all cases. There must be the prerequisite factual trigger before in *fraudem legis* and the sham doctrine will come into play. These must be a "real intention, definitely ascertainable, which differs from the simulated intention"[121]and there must be "some unexpressed or tacit understanding between the parties to the agreement which has been deliberately concealed".[122]In the absence of the "cloak" and the intention to deceive, these common-law principles will not come into play and the legal form of the transaction will be accepted. By contrast, neither the commercial substance test in section

[118] Furniss v Dawson [1984] AC 474 -512, More recent cases have rejected this doctrine, asserting it merely exemplified a purposive approach to interpretation;

[119] The Interpretation of Taxation Legislation by courts – A Reflection of the Views of Justice Grahim Hill – John Tretola – Revenue Law Journal Volume 16/ Issue 1, Article 5, page 95;

[120] Cilliers (2008), The Taxpayer 104, See also Cilliers (2008) The Taxpayer 108;

[121] Zanberg v Van Zyl 1910 AD 369-395; Commissioner, SARS v NWK 2011 2 SA 67 (SCA) para 43;

[122]Commissioner of Customs and Excise v Randle, Brothers & Hudson Ltd 1941 AS 369-396

80A(a)(ii), or the ability to compare legal substance and legal form under section 80C(a), are premised by an intention to deceive.

It seems that the GAAR provisions do not suffer from the same prerequisites as the common law. The traditional common-law 'substance over form' doctrine has proven to be insufficient to combat may tax avoidance schemes because the underlying legal agreements are technically valid and thus not normally susceptible to challenges.[123]

7.4 Conclusion

It seems that the GAAR provisions do not suffer from the same prerequisites as the common law. The traditional common-law 'substance over form' doctrine has proven to be insufficient to combat many avoidance schemes because the underlying legal agreements are technically valid and thus not normally susceptible to challenges.

Not all tax avoidance arrangements involve the "disguise" that is required to trigger *in fraudem legis* and the sham doctrine. Modern tax avoidance schemes are more sophisticated than sham and other blatant and calculated attempts to cloak arrangements to make it look different to what it truly is in substance.[124]

When we consider the desirable scope of our common law principle to tax avoidance and evasion, in particular to simulated transactions, given the extensive reach of the statutory anti-avoidance provisions, in particular GAAR, there is no reason for our courts to aggressively expand the role of common-law remedies for tax avoidance. There is no reason for our courts to embrace a 'fiscal nullity' doctrine, such as has become judgement-made law in the UK. Unlike SA, the UK has no statutory GAAR and their courts

[123] SARS Interim Response n 92;

[124] Silke SA anti-avoidance – Chapter 19.3 –Tax avoidance;

have to develop common-law remedies that meet the challenges of modern strategies of tax avoidance.

The decision in NWK (supra) arguably lost sight of the point made by Nicholls of Birkenhead in MacNiven v Mestmoreland Investments Ltd[125] (an UK case) where he said:

'The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case.'

[125] [2003] 1 AC 311, 320 at para 8; quoted with approval in *Barclays Mercantile Business Finance Limited v Mawson* [2004] UKHL 51 at para 32.

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