

SIMULATED TRANSACTIONS AND THE FRAUS LEGIS DOCTRINE

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*This article deals with the doctrine of substance over form in so far as it relates to committing fraud on the law (or the doctrine of *fraus legis*), and the connected question of when a transaction can be said to be simulated. These three doctrinal concepts are inter-linked and their interstices will be explored with reference to the case law. The aim is to shed light particularly on the last issue — simulated transactions — and to answer the question whether dishonesty remains a requirement for a finding that a transaction is simulated. This enquiry is prompted by dicta in the recent case of *NWK* which tend to suggest that in certain circumstances a transaction might be deemed to be simulated even in the absence of fraud.*

I INTRODUCTION

Although Lady Justice is usually depicted with a blindfold to portray her impartiality, this visual metaphor should not be interpreted as a wilful closing of her eyes to the true state of affairs or, in a commercial context, to the true nature of a given transaction. Indeed, when parties to a transaction attempt to avoid the provisions of a statute or peremptory law by disguising the true nature of their transaction, they are said to act ‘in fraud of the law’ (in *fraudem legis*); and once the situation is detected, the court will strip away the disguise and have regard to the true substance of the transaction rather than its outward form. The law relating to simulated transactions thus implicates two related doctrines: the doctrine of *fraus legis*, and the doctrine of ‘substance over form’. What is the relationship between these doctrines? And are they limited in their scope of application to simulated transactions? Can a transaction honestly entered into by the parties ever be regarded as a ‘sham’ or simulation, or be in *fraudem legis*? These are questions raised by the recent decision of the Supreme Court of Appeal in *Commissioner for the South African Revenue Service v NWK Ltd*,¹ and which we wish to examine in this article.

II IMPORTANT CONCEPTS

For the sake of clarity, we will attempt at the outset a definition of certain key concepts necessary for an understanding of the relevant case law.

‘*Fraus legis*’ refers to an act done in fraud of the law in one of the following ways: first, by disguising one’s transaction in order to avoid the law; secondly, by structuring one’s transaction so as to defeat the spirit (or purpose),

¹ 2011 (2) SA 67 (SCA).

although not the letter, of the law;² or, thirdly, doing indirectly what one is not permitted by law to do directly.³ All three of the above scenarios involve attempts at evasion of the law, but the difficulty with this concept is that one may clearly arrange one's affairs so as to remain outside of the scope of a particular law.⁴ Whether one is successful in such an 'arrangement' will depend on the interpretation of the law in question. (A particular question here is to what extent one may have regard to the 'spirit' or purpose of the law.⁵) In addition to interpreting the law, one must furthermore interpret the transaction to determine whether it falls within or without the statute or law. Here one must have regard to substance over form, since *fraus legis* is a branch of this doctrine.

'Substance over form' refers to the idea of a court stripping away the outward appearance or label given to a transaction to reveal its true nature. This may either be because the transaction is a 'sham' (synonyms include 'disguised' or 'simulated'), in which case the court should strip away the disguise and have regard to the true nature of the transaction; or there may be no attempt to disguise the transaction: the parties may have inadvertently (or when acting on advice in a complex legal transaction⁶) applied a false label to their transaction. In the second case no dishonesty is required, but a court should nevertheless treat the transaction according to its true nature.

In a 'simulated transaction' the authenticity of the intention expressed by the parties to that transaction is called into question. For example the parties refer to a transaction as a lease, but did they genuinely intend to create a contract of lease or to give effect to the lease in accordance with its tenor?⁷ This concept of *intention* to effect a particular type of transaction should be distinguished from the parties' *motive* or *purpose* in concluding the transaction. The question of purpose goes to lawfulness, rather than genuineness of intention. Here one must ask: why did the parties enter into the lease? If both parties had an unlawful purpose in mind, the transaction fails for illegality, not simulation. (For example: if the purpose of the lease of a truck is to smuggle marijuana into the country.) In this vein the distinction drawn by Nienaber JA in *Hippo Quarries (Tvl) Pty Ltd v Eardley*,⁸ in the context of an alleged simulated cession, bears repeating:

'Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if

² *Dadoo v Krugersdorp Municipal Council* 1920 AD 530.

³ *Collins v Minister of the Interior & another* 1957 (1) SA 552 (A).

⁴ A clear statement of this rule can be found in *Etf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue* 1996 (3) SA 942 (A) at 951A–B.

⁵ Compare the approach of De Villiers JA with those of Innes and Solomon JJA in *Dadoo* supra note 2.

⁶ See *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2005] 1 AC 684 (HL).

⁷ See, for example, *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A).

⁸ 1992 (1) SA 867 (A).

their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.⁹

Finally one must ask here whether there can be such a thing as an honest simulation? It should be noted that for simulation it is the *intention* with which a transaction is concluded which is not genuine. This is clear because one may have a genuine intention to hire the truck to smuggle marijuana; the transaction fails here because it is unlawful, not because it is simulated. For a simulated transaction there must be a deliberate element of disguise, which would of necessity entail *dolus*.¹⁰ Thus there can be no such thing as an ‘honest’ simulation.

III TRANSACTIONS IN FRAUDEM LEGIS

If one traverses the law reports for historic cases involving the above concepts one cannot help but be impressed by the ancient pedigree of this doctrine: the judgment of Innes CJ in *Dadoo v Krugersdorp Municipal Council* cites three key passages from the *Corpus Iuris Civilis* dealing with the doctrine of *fraus legis*.¹¹ All deal with the central idea that a statute may be transgressed not merely by doing that which the statute expressly forbids, but also that which its purpose forbids by implication.¹² Thus the doctrine of *fraus legis* becomes entwined with questions of statutory interpretation, as well as the more obvious issues of fraud by the defendant. One also needs to ask, given the broad phrasing of the concept of *fraus legis* in the texts of the *Corpus Iuris*, whether *fraus legis* can only be perpetrated by means of a simulated transaction, or whether any act, or series of actions taken together, which contravenes the spirit of the law can be labelled as ‘fraudulent’ in this manner. This is the question with which the Appellate Division was squarely faced in *Dadoo*’s case.

Dadoo involved an 1885 statute which prohibited ‘Asiatics’ from owning immovable property within the Transvaal. Two stands within the borders of Krugersdorp Municipality had nevertheless been transferred to Dadoo Ltd, a company controlled by one Mohamed Dadoo through his majority shareholding. Dadoo was classified as a ‘British Indian’ by the laws of the time. (The remaining shares were held by Dindar, also an ‘Indian’.) Dadoo Ltd

⁹ *Ibid* at 877C–E.

¹⁰ This *dolus* may exist simply in the fact that the parties did not intend their transaction to have *inter partes* the legal effect which it tends to convey to the outside world.

¹¹ *Dadoo* *supra* note 2 at 544. The passages of the *Corpus Iuris Civilis* cited are: *D* 1.3.29; *D* 1.3.30; *C* 1.14.5.

¹² These passages can be summarised by reference to the extract from the *Digest* which was cited in translation in *Dadoo*: ‘A man who does what a statute forbids, transgresses the statute; a man who contravenes the intention of a statute, without disobeying the actual words, commits a fraud on it’ *D* 1.3.29.

leased these stands to Dadoo in his personal capacity. On one of them he carried on a business as a general dealer and on the other he and his family resided. When the Dadoo family was absent from South Africa, the premises were occupied by the manager of the business, who was also classified as 'Indian'. The Krugersdorp Municipality sought to set aside the transfer of the property to Dadoo Ltd in this case.

In the court of first instance the municipality was successful. On appeal, three judgments were delivered. Innes CJ and Solomon JA found for Dadoo. De Villiers JA dissented. Innes CJ began his judgment by questioning the scope of the doctrine of *fraus legis* — did the 'intent or spirit' of the law operate beyond the express enactment, giving rise to two enactments: one express and one implied?¹³ Or was a narrower construction to be placed upon this doctrine so that it should be limited to simulated transactions aimed at avoiding the operation of a particular statute?¹⁴ Innes CJ decided, after analysis of the various examples posed in the *Corpus Iuris*, that the Roman texts point only toward simulated transactions being in *fraudem legis*.¹⁵

In reaching this conclusion Innes CJ also noted that it was perfectly legitimate deliberately to keep outside of the prohibition of a statute.¹⁶ If an evasion was used fraudulently to conceal a transaction which was prohibited by disguising it as one which was not, this would be in *fraudem legis*. Innes CJ assumed an intention on the part of Dadoo to avoid the operation of the relevant statute, yet this, he held, was not enough to decide the case.¹⁷ In other words, Dadoo's conduct constituted an honest attempt to keep within the letter of the law. Since there was no disguise covering the transaction in this case, the question left unanswered was whether the spirit of the law had been contravened. With regard to the statute, Innes CJ found that it had intended to prohibit 'Asiatics' from owning land in the Transvaal and the fact that this might be effected through the medium of a company had not occurred to the Legislature.¹⁸ A company was a legal persona separate from its shareholders, hence an intention on the part of the Legislature to outlaw this type of transaction could not be inferred and Dadoo was free to continue in occupation of the land.¹⁹ This reading of the statute was described as a restrictive one, which Innes CJ felt was appropriate for statutes which interfered with elementary rights.²⁰

The concurring judgment of Solomon JA²¹ likewise held that a strict construction should be placed on a statute limiting fundamental rights, and that allowing a court to decide that a *casus omissus* could be supplied if this

¹³ *Dadoo* supra note 2 at 543–4.

¹⁴ *Ibid* at 544.

¹⁵ *Ibid* at 546–7.

¹⁶ *Ibid* at 548.

¹⁷ *Ibid*.

¹⁸ *Ibid* at 549.

¹⁹ *Ibid* at 550–2.

²⁰ *Ibid* at 552.

²¹ Maasdorp and Juta JJA concurring.

was in accord with the intention behind the statute was not permitted by South African law.²²

De Villiers JA saw the *fraus legis* rule in a different light. For him the texts in the *Corpus Iuris* indicated that one could act in *fraudem legis* simply by contravening the spirit of the law.²³ Thus a contravention of the deemed intention of the legislature is prohibited in the same way as a contravention of the express meaning of a statute.²⁴ Hence a judge could not adhere simply to the words of a statute, but should attempt to ascertain its purpose.²⁵ The law was as much contravened by transferring the land to a company owned by 'Indian' shareholders as it would be by transferring it to these 'Indians' as individuals, since the intention of the Transvaal Legislature had been to prohibit 'Asiatics' from owning immovable property.²⁶ Hence the transfer was null and void.²⁷

It is apparent that the divergence in the judgments rested on a distinction as to the scope of the *fraus legis* doctrine. The majority clearly favoured an approach outlawing only fraudulently-disguised transactions, while De Villiers JA opted for a broader view prohibiting any transaction contrary to the deemed intention of the legislature, whether there had been any disguise or not.²⁸ All the judges concur, however, that where a transaction is in *fraudem legis* the court will give effect to the true nature of the transaction.^{29,30}

Subsequent commentators have argued that this decision was a victory based on a common-law bill of rights and is an example of value-coherent statutory interpretation.³¹ The question of the proper approach to the interpretation of statutes is of course not entirely the same as the question of the proper approach to the interpretation of a particular transaction. Indeed,

²² *Dadoo* supra note 2 at 558.

²³ *Ibid* at 564.

²⁴ *Ibid* at 564–5.

²⁵ *Ibid* at 565.

²⁶ *Ibid* at 566.

²⁷ *Ibid*.

²⁸ In a recent judgment, a unanimous Supreme Court of Appeal approved a modernised approach to the interpretation of statutes, which recognises that there is no such thing as the intention of the legislature: a court should rather ask what the words of the statute mean when read in context (i.e. including the purpose of the legislation). See *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) paras 19–26, per Wallis JA.

²⁹ *Dadoo* supra note 2 at 548, 560 and 566.

³⁰ It is worth noting that the case had historic interest only as the legislature had intervened to extend the prohibition on people of colour owning or occupying land in certain areas to companies controlled by such people (see the concluding paragraph of the judgment of Solomon JA in *Dadoo* *ibid* at 562). Thus it could be argued that, given the fact that the interpretative exercise forced on the Appellate Division was now a moot point, it is possible that this was seen merely as an attempt to set out the law on interpretation of statutes.

³¹ Etienne Mureinik 'Administrative law in South Africa' (1986) 103 *SALJ* 615 at 624–6; G E Devenish *Interpretation of Statutes* (1992) 44.

these posit separate steps: one needs first to determine the ambit of a statute through interpretation (ie in *Dadoo's* case the extent of the prohibition) and then move to an examination of the transaction to determine whether it falls within or without that prohibition.³²

In another case involving legislation which attempted to limit fundamental rights, the Appellate Division was less successful in protecting the rights of the appellant. In *Collins v Minister of the Interior & another*,³³ counsel for the appellant tried to argue that the (implied) spirit of a statute had been transgressed, although the defendant had formally complied with the letter of the law. This case represents one in a series during the constitutional crisis South Africa experienced during the 1950s.³⁴ The apartheid government wanted 'coloured' voters removed from the Cape voters' roll. Due to an entrenchment provision in the South Africa Act of 1909 (which was the constitutional authority of the day) the government needed a certain majority in a joint sitting of both houses of Parliament. Since it did not enjoy this majority, the government expanded the number of seats in the Senate to ensure that it did. The expansion of the Senate was within the government's powers, but the purpose of this measure was clearly to achieve an unlawful end, namely the circumvention of the entrenched clauses in the Constitution. The *Collins* case concerned the validity of this reconstituting of the Senate in order to amend the South Africa Act.

The case was heard before eleven judges of the Appellate Division. The majority of nine judges (per Centlivres CJ) gave a decision in favour of the executive. A separate concurring judgment was given by Steyn JA (as he then was). The sole voice of dissent was that of Schreiner JA, who had previously shown himself to be a strong proponent of the purposive interpretation of statutes.³⁵ Schreiner JA held that the protection offered to 'coloured' voters by certain sections of the South Africa Act could only be amended by legislation which conformed to the amendment requirements of that Act in substance as well as form.³⁶ Thus, although taken separately, the Act

³² Compare (from an English law perspective) *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* supra note 6 at para 32: 'The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description.'

³³ 1957 (1) SA 552 (A).

³⁴ A good source on this crisis and the trilogy of Appellate Division cases discussed here can be found in Christopher Forsyth *In Danger for their Talents: A Study of the Appellate Division of the Supreme Court of South Africa 1950 — 1980* (1985) 61–74. A brief account is also given at outset of the judgment in *Collins* itself.

³⁵ See *Jaga v Dönges* 1950 (4) SA 653 (A) at 662G–663A (again this was a dissenting judgment). Even before the advent of the constitutional era and s 39(2) of the final Constitution, this dictum enjoyed strong support in later cases such as *UCT v Cape Bar Council* 1988 (4) SA 903 (A).

³⁶ *Collins* supra note 33 at 572G–H.

reconstituting the Senate and the passing of the amendment Act by this reconstituted Senate were legal as a matter of form, their substance required that these two legislative steps be read together. Schreiner JA used this technique to discern an indirect ‘motive’ behind the ostensible purpose of each separate piece of legislation.³⁷ This led him to the conclusion that the ad hoc reconstitution of the Senate was an attempt to do by indirect means what could not be done directly. Hence the South Africa Act had not been validly amended.³⁸

Schreiner JA’s inference of a tacit or indirect intention on the part of the legislature was thus essentially a finding that the legislative scheme in question was in substance invalid despite its seemingly legitimate outward form. The apartheid government was indirectly in fraud of the entrenched provisions.

IV SIMULATED TRANSACTIONS

The discussion of simulated transactions will begin with the lucid analysis of Hefer JA in *Erf 3183/1 Ladysmith (Pty) Ltd & another v Commissioner for Inland Revenue*.³⁹ Here the Judge of Appeal set out two distinct principles. The first of these is that a party may arrange his affairs to stay outside the provisions of a particular statute. This necessitates an interpretation of the parameters of the statute in question. One might ask here whether the meaning of a statutory provision is limited to its plain meaning, or whether these limits are broader so that the provision also extends to its spirit or purpose.⁴⁰ This question arises from the differences in approach suggested by the various judges in *Dadoo* (Hefer JA cites the judgment of Innes CJ). The second principle is that a court will not be deceived by the form of a transaction, but will delve into its true substance.⁴¹ This is a question of interpretation of the transaction or contract itself to see whether it falls within the statutory provision. Substance over form dictates that the true intention of the parties must be determinative here, rather than any disguised intention.

As Hefer JA notes, a court becomes involved in examining the substance of a transaction when determining whether the provisions of a particular statute have been legitimately avoided.⁴² In determining whether a transaction had been simulated, Hefer JA confirmed the tests which had been laid down in *Zandberg v Van Zyl*⁴³ and *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd*.⁴⁴

³⁷ Ibid at 577A–B.

³⁸ Ibid at 581E–F.

³⁹ Supra note 4.

⁴⁰ Note the discussion of Wallis JA in *Natal Joint Municipal Pension Fund* supra note 28 paras 17–26.

⁴¹ *Erf 3183/1 Ladysmith* supra note 4 at 950I–951D.

⁴² Ibid at 952B.

⁴³ 1910 AD 302.

⁴⁴ 1941 AD 369.

In *Zandberg*, Innes J stated that when faced with an alleged simulated transaction, ‘the court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention’,⁴⁵ in order to render such transaction ineffectual. This inquiry is one of fact.⁴⁶ This passage was cited in *Randles* too, with the gloss (per Watermeyer JA) that a disguised transaction ‘is a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world’.⁴⁷ This necessitates some ‘unexpressed agreement or tacit understanding’ between the parties.⁴⁸

Viewed in this light it is clear that a faked (ie dishonest, or fraudulent) intention is required to label a contract a simulated transaction. This inquiry into the subjective intention of the parties is a question of fact (as noted above) and the onus of establishing a faked intention lies on the party alleging this.⁴⁹ (The position is different in tax cases, however, where the onus rests on the taxpayer when contesting the assessment of the fiscus.⁵⁰) Such intention may also be inferred on the facts, since the burden of proof which has to be met is only one of a preponderance of probabilities.⁵¹

In *Ef 3183/1 Ladysmith*, a holding company, Pioneer Seed Company (Pty) Ltd, wished to establish a furniture factory. It obtained land which was registered in the name of two subsidiaries in its group. In order to claim a deduction from income tax, Pioneer wished to structure the transaction so that it leased the premises on which the factory produced income. This was achieved by an elaborate scheme which interposed a third party as lessee between the holding company lessor and the subsidiary sub-lessee.

All of the lease agreements involving Pioneer, the subsidiaries and the third party were signed at the same time by the same parties, thus knowledge of the entire scheme, and its intention to disguise the true nature of the transaction, was the inference drawn by Hefer JA.⁵² Counsel for the appellant had argued that the parties in question had actually intended the agreements to have effect according to their tenor and this was the end of the matter, since effect must be given to the agreements as intended. The Judge of Appeal disagreed:

‘This is plainly not so. That the parties did indeed deliberately cast their arrangement in the form mentioned, must of course be accepted; that, after all, is what they had been advised to do. The real question is, however, whether

⁴⁵ *Zandberg* supra note 43 at 309.

⁴⁶ *Ibid.*

⁴⁷ *Randles* supra note 44 at 395–6.

⁴⁸ *Ibid* at 396.

⁴⁹ *Vasco Dry Cleaners v Twycross* supra note 7 at 615H–616A.

⁵⁰ Section 102 of the Tax Administration Act 28 of 2011; *Ef 3183/1 Ladysmith* supra note 4 at 953C–E.

⁵¹ *Ef 3183/1 Ladysmith* *ibid* at 956A–E.

⁵² *Ibid* at 953F–G.

they actually intended that each agreement would *inter partes* have effect according to its tenor. If not, effect must be given to what the transaction really is.⁵³

The conclusion reached by Hefer JA was that the provisions of the contracts in question bore ‘the stamp of simulation’ and a purpose of concealing what the parties truly intended could be inferred.⁵⁴ Hence the appellants had not escaped liability for tax.⁵⁵ Although the motive or purpose of avoiding tax was permissible, the transaction by which it was effected was not genuine, since there was no true intention in actual fact to create the rights its provisions purported to create.

The decision in *Erf 3183/1 Ladysmith* reveals a further interesting point: it demonstrates that a simulated transaction may be a composite one, consisting of several separate contracts. Viewed alone these would not be problematic, but viewed as a composite whole, the transaction falls within the scope of the legislation.⁵⁶ In this light the reasoning is not far removed from that of Schreiner JA in *Collins*, although this case was not cited in *Erf 3183/1 Ladysmith*, probably due to the difference in context.

(a) *Honest simulation?*

A source of much confusion within the discourse on simulated transactions is the appropriate treatment of a case where the parties to a particular transaction have a genuine intention to structure their deal so as legitimately to avoid the legislation in question, yet the attempt fails, so that the transaction has to be treated in line with its true substance. With regard to simulated transactions, as we have seen, one may legitimately *avoid* the law in question: if the intention of the parties to effect a particular transaction is honest, it is hard to argue that they have the requisite element of *dolus* (a ‘tacit agreement’)⁵⁷ to render their transaction simulated. The question to be discussed under this heading (and the following part IV(b)) is thus whether a court may rule a transaction to be simulated without relying on a finding as to the subjective intention of the parties.

The classic case of ‘honest simulation’ was *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd.*⁵⁸ The defendants in that case were importers, who brought material into South Africa to be made into shirts and pyjamas by a separate manufacturing company. Initially, this took place in terms of a contract of service, under which the manufacturers were required to ‘cut, make and trim’ the material to the required specifications. Once manufactured, these items of clothing were then sold by the importers in the

⁵³ Ibid at 953B–C.

⁵⁴ Ibid at 956E–F.

⁵⁵ Ibid at 956F–G.

⁵⁶ Compare *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* supra note 6 para 36.

⁵⁷ *Randles* supra note 44 at 396.

⁵⁸ Supra note 44.

ordinary course of their business. Prior to 1936, this importing of material was subject to a customs rebate allowed to manufacturers of certain types of clothing. In that year, the regulations were changed, so that the manufacturers now had to import the material themselves to obtain the rebate, or source their raw materials locally. The defendants wrote to the Commissioner of Customs and were advised that the only way they could continue to enjoy the customs rebate was if they sold the goods in question to the manufacturers. This sale could not be bogus, however, meaning that ownership in the goods needed to pass to the manufacturers.

The defendant importers thus altered their contract with the manufacturers so that instead of being required to 'cut, make and trim' the fabric into clothing, the fabric was passed to them in full ownership. Thus the contract of service became a contract of sale with the sales price generally being the same price which the importers had paid for the goods. Once manufactured, the clothing would be resold to the importers at the same price at which they had paid for it, plus an additional charge for the cost of producing the clothing. The Commissioner alleged that this was a bogus sales contract and sought the customs duty from the importers.

The majority in this case quoted the same passage from *Zandberg* as referred to above and added the important gloss (also discussed above) that in order for a transaction to be simulated there must be an 'unexpressed agreement or tacit understanding' between the parties to the contract.⁵⁹ Both the concurring majority judgments stressed that South Africa recognises an abstract system of transfer, so that for ownership in movable property to pass, only the relevant intention on the part of both parties was required. The contract was not essential for the transfer of ownership.⁶⁰ Watermeyer JA was very particular that a contract cannot be a sham unless it is dishonest and that the evidence did not point toward that conclusion in this case.⁶¹ On the facts, the importers had been honest and as ownership in the material had passed to the manufacturers, customs liability had been validly avoided.⁶²

For the minority, De Wet CJ focused on the authenticity of the transactions between the importer and the manufacturer: if there was no genuine sales agreement, then there could be no intention to pass ownership on either side.⁶³ Although the Chief Justice also found that there had been an honest intention on the part of the defendant manufacturers to comply with the regulations, in many respects he felt their sales contract was bogus.⁶⁴ Hence the conclusion of De Wet CJ was that there was no desire or intention to purchase the materials on the part of the manufacturers; all they wanted

⁵⁹ *Ibid* at 394–6.

⁶⁰ *Ibid* at 398.

⁶¹ *Ibid* at 401–2.

⁶² *Ibid* at 406.

⁶³ *Ibid* at 380–1.

⁶⁴ *Ibid* at 383–4.

was the contract to cut, make and trim.⁶⁵ Thus the appeal of the Commissioner should be allowed.⁶⁶

On the specific point of the honesty of the parties to the transaction, both De Wet CJ and Watermeyer JA agreed that the parties had honestly attempted to comply with the regulations. The difference lay in the fact that De Wet CJ believed that despite such honesty, the transfer of ownership could not have been the real intention of the parties.⁶⁷ This seems to be an illogical result, since, with respect, the Chief Justice finds the transaction to be simulated despite the good faith attempt of the parties to create a sale and resale with attendant transfer of ownership. Perhaps De Wet CJ viewed the substance of the transaction as different to its form, even in the absence of simulation. Possibly it was for this reason that the honesty of the parties to the transaction was decisive for the majority. In the words of Watermeyer JA:

‘Whenever an act is voluntarily done with the expectation that a consequence will follow, that consequence is intended. . . . So when a person makes an agreement thinking that he is buying, he intends to buy, and it is difficult to see how he can think that he has the intention to buy without having it.’⁶⁸

In another case bearing certain similarities to *Randles*, Hoexter AJA (for a unanimous Appellate Division) left open the question whether in a case involving an alleged simulated sale, an honest intention of the parties thereto could defeat the inference that the agreement was a sale rather than a pledge. Thus in *Vasco Dry Cleaners v Twycross*,⁶⁹ one Duff had purchased a dry cleaning business. Duff needed R4 700 to settle the outstanding amount on his equipment, which had been bought on hire purchase. His brother-in-law, Twycross, was prepared to furnish this amount, but wanted security. A special notarial bond would not have served their purpose in those days⁷⁰ and nor would a pledge, since Duff would have had to surrender possession of the equipment. Hence they settled on a sale and a resale of the equipment between them, with a reservation of ownership in favour of Twycross in the resale. All of this occurred without the equipment leaving the premises from which Duff conducted business. Duff then proceeded to sell the equipment and the business to a third party. Twycross attempted to vindicate his ‘property’ and to attack the sale to the third party. This required proof that ownership had indeed passed to Twycross.

The trial court had noted that in a case where constructive delivery was alleged, a court must examine such delivery carefully to determine the factual

⁶⁵ Ibid at 389.

⁶⁶ Ibid.

⁶⁷ Ibid at 383.

⁶⁸ Ibid at 399.

⁶⁹ Supra note 7. A similar case is *Bank Windhoek Bpk v Rajie* 1994 (1) SA 115 (A) — see particularly the judgment of Nienaber JA.

⁷⁰ Since the Security by Means of Movable Property Act 57 of 1993 only came into effect in 1993.

accuracy of the allegation.⁷¹ Hoexter AJA took a different approach: he viewed the inquiry rather as to whether the agreement between Twycross and Duff was one of sale or pledge.⁷² Thus Hoexter AJA viewed the inquiry as being not whether Duff had sold the equipment to Twycross, who had then resold it back to him; but rather that Twycross had advanced money to Duff against security of the equipment, which had occurred by means of a (possessionless) pledge. The allegation was thus of a simulated sale.⁷³

The onus therefore lay on Twycross to prove that there had been a genuine sale and resale between himself and Duff.⁷⁴ Hoexter AJA went on to discuss the relevant case law, including *Randles*, with particular emphasis on the intention of the parties to these alleged simulated transactions.⁷⁵ Since the court noted that Twycross was an honest and forthright witness, it left open the ‘interesting’ question whether the sale could be found to be simulated if the plaintiff had honestly intended to acquire ownership in the equipment.⁷⁶ (Whether dishonesty was a requirement for a simulated transaction had been the difference between the approaches of De Wet CJ and Watermeyer JA in *Randles*.)⁷⁷ The confirmation of either of the conflicting approaches in *Randles* was deemed unnecessary, however, since Hoexter AJA found that Twycross had not met the burden of proof in establishing that he had the requisite intention to acquire ownership of the dry-cleaning equipment.⁷⁸ Thus ownership had never passed to Twycross and it was unnecessary to establish simulation in the transactions to which he was party.

In another Appellate Division case which followed soon after, the situation was slightly different. Again this case turned on the true intention of the parties to a particular transaction, but in this second case the transaction was indeed held to be simulated. Thus in *Skjelbreds Rederi A/S & others v Hartless (Pty) Ltd*,⁷⁹ a peregrinus creditor (Freedom Tramping Enterprises Inc) ceded its claim for payment under a shipping contract to Hartless (Pty) Ltd, an incola, to attach the property of the peregrinus debtor, Skjelbreds, in South Africa. Skjelbreds challenged this cession on the ground that it was simulated and that Hartless was merely the agent or nominee of Freedom Tramping.⁸⁰ The judges of the Appellate Division agreed: the written agreement of cession was not a true reflection of the real agreement between the parties. In truth, the cession merely disguised a contract of mandate between Freedom Tramping and Hartless.⁸¹ The sole reason for the cession agreement was to

⁷¹ *Vasco Dry Cleaners v Twycross* supra note 7 at 614G–H.

⁷² *Ibid* at 615A–G.

⁷³ *Ibid* at 615E–G.

⁷⁴ *Ibid* at 615G–H.

⁷⁵ *Ibid* at 618–20.

⁷⁶ *Ibid* at 620C–E.

⁷⁷ *Ibid* at 619D–620D.

⁷⁸ *Ibid* at 620G–H.

⁷⁹ 1982 (2) SA 710 (A).

⁸⁰ *Ibid* at 727B–H.

⁸¹ *Ibid* at 736A–B.

overcome the legal obstacle Freedom Tramping faced as a peregrinus, namely that it could not attach property in South Africa to found jurisdiction here.⁸² Thus the cession was found to be an ‘empty shell’ to disguise the parties’ true intentions.⁸³ The debtor’s appeal was upheld and the attachment was set aside.⁸⁴

One might legitimately ask of the decision in *Skjelbreds* whether the intention to cede was simulated? There does not seem to be any doubt that the intention to cede and transfer rights by this juristic act was genuine, otherwise the peregrinus creditor could not have achieved its aim. Rather the inquiry should focus on the motive or purpose underlying this transaction, namely to circumvent the laws on jurisdiction. This in itself was arguably against public policy, since it led to the clogging up of South African courts with the claims of peregrini. Thus viewed, the true issue is not simulation, but the lawfulness of the transaction in the first place.

A similar case to *Skjelbreds* is *Hippo Quarries (Tvl) Pty Ltd v Eardley*⁸⁵ (quoted from already in part II above). This case also involved a cession, effected so as to transfer a right of security in favour of the creditor in that case. The defendant surety alleged that this was a simulated cession, intended merely to enable the collection of a debt.⁸⁶ Nienaber JA disagreed: the cession was legitimate and not a disguised mandate, since the companies legitimately intended this and there was no lawful impediment to their transaction.⁸⁷ The absence of a lawful impediment distinguished the *Skjelbreds* case on which counsel for the defendant had relied.⁸⁸ This distinction rested (as has been shown above) on a distinction between ‘intention’ (ie to transfer a debt through cession) and ‘motive’ or ‘purpose’ (ie to secure that debt and enable its collection). In *Hippo Quarries* the intention was clearly genuine and the motive or purpose was clearly lawful, hence the allegation of simulation was misplaced.

Another alleged simulation survived judicial scrutiny in *Commissioner for Inland Revenue v Conhage (Pty) Ltd*.⁸⁹ There the Commissioner sought to disallow a deduction based on a sale and leaseback agreement. The Supreme Court of Appeal held unanimously, however, that the main purpose of the transaction had been to raise capital, which was commercially sound.⁹⁰ Thus although Tycon (Pty) Ltd had sold some of its manufacturing plant and equipment to a bank and was leasing it back, since this equipment was vital for production, it could still legitimately claim a deduction from income in

⁸² Ibid at 733G–H.

⁸³ Ibid at 733G–736B.

⁸⁴ Ibid at 738E–G.

⁸⁵ Supra note 8.

⁸⁶ Ibid at 872F–873E.

⁸⁷ Ibid at 877E–878D.

⁸⁸ Ibid at 875H–876H.

⁸⁹ 1999 (4) SA 1149 (SCA).

⁹⁰ Ibid paras 9 and 15.

respect of the rental paid under this agreement.⁹¹ The question for Hefer JA was whether the parties genuinely intended ownership in the equipment to pass; if they were genuine the transactions were not simulations nor in fraudem legis.⁹² The onus was on Tycon to prove that its intention in concluding these transactions was genuine, and this evidentiary burden was met.⁹³ Thus the transaction was not simulated, and this finding rested on the subjective intention of Tycon, objectively inferred through the good business reasons underlying it. In other words, even a transaction which could under different circumstances have been simulated will not be found to be fraudulent where the business purpose of the transaction is legitimate and the parties have honest intentions to effect it in line with such purpose.

One might ask at this point whether *Conhage* is not similar on its facts to *Vasco Dry Cleaners*? Just like in *Conhage*, the sale and resale in *Vasco Dry Cleaners* was effected for sound business reasons: the first sale was to raise capital for the seller and afford security for the buyer, while the second resale with a reservation of ownership was the only valid way in which the owner of the dry cleaning business could retain the use of his equipment while still affording his brother-in-law security. To analyse this transaction as a disguised pledge misses the point that a pledge would have been useless to the parties in question: a tacit agreement to effect a disguised pledge would not have afforded the necessary security. Hence the allegation of simulation was (with respect) misplaced.

What the brief synopsis in the foregoing cases should indicate, is that it is well established at appellate level, both in tax cases and in other civil matters, that the subjective intention of the parties to an alleged simulated transaction is usually determinative of their case. If the parties honestly intend the transaction to take a particular form (as in *Randles*) the transaction will not be held to be simulated. Furthermore, if there are sound business purposes underlying the use of that form (as in *Conhage*) this would present a strong indication that the intention of the parties to the transaction is genuine. Thus it would appear that if a transaction is honest, it is not a simulation in the eyes of the law. Such a test makes the subjective intention of the parties to an alleged simulated transaction paramount, with the subjective intention being inferred from objective factors. This test appears to rest on less solid foundations than previously felt, however, following the unanimous decision of the Supreme Court of Appeal in the next case to be discussed, *Commissioner for the Inland Revenue Service v NWK Ltd.*⁹⁴

(b) *NWK and its aftermath*

The facts of *NWK* represent an exercise in creative tax-planning, and will be simplified somewhat here. *NWK*, a public company trading in maize, was

⁹¹ *Ibid* paras 15–17.

⁹² *Ibid* para 4.

⁹³ *Ibid* paras 7–10.

⁹⁴ *Supra* note 1.

offered a finance facility of R50 million by First National Bank ('FNB'), to be repaid with interest over five years. For tax reasons, however, a third party was inserted into the deal as interloper between NWK and FNB, which served no other purpose other than helping to dress up a loan for R50 million as one for nearly R100 million. This allowed NWK to claim a greater deduction from income tax due to the larger amount of interest it would have to pay on a R100 million loan. In truth, however, only R50 million changed hands and the amount claimed as a deduction (R75 million) thus comprised not only of interest but also of capital. As Lewis JA said in her judgment: 'what a charade!'⁹⁵ The Commissioner sought back taxes plus interest and penalties on the basis that this was a simulated transaction designed dishonestly to reduce liability for tax.⁹⁶

The allegation that NWK's transaction was simulated was thus the major issue for decision in this case. Lewis JA (for a unanimous SCA) began her discussion on this point with the usual statement that one may arrange one's affairs to avoid taxation, but that one may not disguise a transaction for the purpose of tax *evasion* or to avoid a peremptory rule of law.⁹⁷ If one did this a court would 'rend aside the veil in which the transaction is wrapped and examine its true nature and substance'.⁹⁸ Lewis JA went on to cite *Zandberg* and *Randles* and came to the conclusion that the case law is not consistent in its treatment of what is meant by a party's 'intention in concluding a contract — what purpose he or she seeks to achieve'.⁹⁹ From there she went on to note the differences in approach of Watermeyer JA and De Wet CJ in *Randles*. What is interesting about Lewis JA's analysis is that she felt that the approach which had subsequently been followed in South African courts was actually that of De Wet CJ.¹⁰⁰

To support her analysis on this point, Lewis JA referred to *Vasco Dry Cleaners* and *Skjelbreds*, arguing that dishonesty had not been an issue in either of these cases, but rather that each involved a transaction 'concluded to achieve a purpose other than that for which it was ostensibly concluded'.¹⁰¹ (The reader should at this point note that this analysis does not draw a distinction between 'purpose' and 'intention', as set out by Nienaber JA in *Hippo Quarries*. This will be discussed further below.) This line of reasoning

⁹⁵ Ibid para 21.

⁹⁶ Ibid paras 34–9.

⁹⁷ Ibid para 42.

⁹⁸ Ibid, citing *Kilburn v Estate Kilburn* 1931 AD 501 at 507.

⁹⁹ Ibid para 45. The reader should notice here that this is an elision of the distinction between 'purpose' and 'intention' neatly drawn by Nienaber JA in *Hippo Quarries* supra note 8.

¹⁰⁰ Lewis JA's convictions supporting this finding were reiterated in an address at the Norton Rose Tax Thesis Competition awards on 11 December 2012, where she stated that she did not understand 'how one can genuinely intend to do something that serves no purpose at all other than to gain a tax advantage' (at 4 of the typed record of her speech on file with the authors).

¹⁰¹ *NWK* supra note 1 para 49.

was then built up to a conclusion that ostensibly involves a new test for simulation:

‘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.’¹⁰²

In support of this conclusion, Lewis JA relied on *Conhage* where the structure of the transactions in question did have sound commercial sense and would hence meet her stipulated test.¹⁰³

The decision in *NWK* has given rise to a great deal of controversy, particularly in tax circles, which resulted in much discussion in academic journals, notably *The Taxpayer*. Broomberg SC argued that Lewis JA had confused the avoidance of tax with the evasion of tax.¹⁰⁴ Broomberg argues that should the term ‘evasion’ be read as ‘avoidance’, then effectively Lewis JA has created a common law anti-avoidance provision, parallel to the statutory provision in the Income Tax Act.¹⁰⁵ This, he argued, was an infringement of the separation of powers and represented an unacceptable departure from precedent.¹⁰⁶ Emslie SC interpreted *NWK* as representing an inference of dishonesty from objective factors.¹⁰⁷ Thus interpreted, the *NWK* decision does indeed rest on a finding of a dishonest intention in the minds of the parties involved and hence, Emslie argues, Lewis JA’s new test, involving an objective examination of the commercial purpose of the transaction, was obiter.¹⁰⁸

Pretorius, a contract scholar, was less critical of the *NWK* judgment. Pretorius seems to support the move towards a more objective determination of party intention, although he does note that Lewis JA’s judgment would in all likelihood cause unease to tax practitioners.¹⁰⁹ It should be noted that this

¹⁰² Ibid para 55.

¹⁰³ Ibid para 54.

¹⁰⁴ Eddie Broomberg SC ‘*NWK* and *Founders Hill*’ (2011) 60 *The Taxpayer* 187 at 197–8. (Broomberg cites para 55 of the *NWK* judgment in support of this argument.)

¹⁰⁵ Ibid at 199–202.

¹⁰⁶ Ibid.

¹⁰⁷ Trevor Emslie SC ‘Simulated transactions — A new approach?’ (2011) 60 *The Taxpayer* 2 at 5–6.

¹⁰⁸ Ibid.

¹⁰⁹ C-J Pretorius ‘Simulated agreements and commercial purpose — *Commissioner for the South African Revenue Service v NWK Ltd*’ (2012) 75 *THRHR* 688 at 696.

type of response may be indicative of a general trend towards greater objectivity in the interpretation of contracts.¹¹⁰

Despite the possibility of a move towards objective interpretation of contracts, which does not focus on the subjective intention of the parties, this does not change the fact that the test for simulation should continue to rest on the intention of the parties to the transaction. While it is perfectly acceptable to infer subjective intention from objective factors, it seems paradoxical to argue that a transaction may be simulated without the parties to it having a dishonest intention. If there is no direct evidence to confirm the subjective intention of the parties, then this may be derived from objective factors (such as the farcical charade which their transaction presents). There should not be a finding that a transaction is simulated without a direct ruling on whether the intention of the parties was to deceive or disguise.

Lewis JA distinguishes *Hippo Quarries* as being decided on the ‘form’ of the transaction (ie that the intention to cede was genuine), and states that this was in line with what the parties had ‘apparently agreed’.¹¹¹ The neat distinction drawn in *Hippo Quarries* between ‘intention’ and ‘purpose’ is ignored, however. Indeed, the decision in *NWK* elides the ‘purpose’ of a transaction (or the reason why the parties entered into that transaction) and the intention of the parties (genuinely to carry out the juristic acts in question).¹¹² Thus instead of distinguishing between what is lawful (‘purpose’) and what is simulated (the ‘intention’ genuinely to perform a juristic act), these two legs are rolled into one simple objective test. In doing this, an important framework for the analysis of future transactions is lost.

In addition, what is particularly troubling is that the new test for simulation seems to allow for an objective inference of fraud, through allowing courts to make a determination that if a sound commercial purpose for a transaction is lacking, then that transaction must be a sham. If we are to drop the fraud requirement for a transaction to be simulated, then a lot of precedent of heavy weight must be overturned. In addition what seems to be a definitional requirement of simulation or disguise — namely dishonesty — has to be dropped. For this reason the interpretation of Emslie SC that the Supreme Court of Appeal did in fact infer subjective dishonesty in the transactions of the parties to that case makes (with respect) the best sense.

¹¹⁰ Compare Malcolm Wallis ‘What’s in a word? Interpretation through the eyes of ordinary readers’ (2010) 127 *SALJ* 673. Wallis argues for a departure from the traditional approach to ascertaining the subjective intention of the contracting parties towards a contextual approach, which goes broader than the ‘ordinary meaning of words’ and the current restriction on the use of ‘background and surrounding circumstances’. See also *Natal Joint Municipal Pension Fund v Endumeni Municipality* supra note 28 at paras 17–26, where Wallis JA for a unanimous Supreme Court of Appeal held that this objective approach applies to the interpretation of contracts and statutes.

¹¹¹ *NWK* supra note 1 para 50.

¹¹² See in particular paras 45 and 55 of the judgment.

In a final postscript to this development, Davis J, for the majority in *Bosch & another v Commissioner for the South African Revenue Services*,¹¹³ declined to follow the test set out by Lewis JA in *NWK*. Davis J held that without directly overruling established precedent, Lewis JA's new objective test cannot pass muster, since the effect would be to alter 'settled principles developed over more than a century regarding the determination of a simulated transaction for the purposes of tax'.¹¹⁴ Davis J also found that the substance of the alleged simulated transactions in *Bosch* did not differ from their form and hence that *NWK* was distinguishable.¹¹⁵ In a separate concurring judgment, Waglay J also did not doubt that the new test in *NWK* is problematic.¹¹⁶ Waglay J took issue with the framing of this test as being aimed at tax 'evasion' rather than 'avoidance'.¹¹⁷ He held that if 'avoidance' was in fact intended, then Lewis's test did indeed go against the accepted rule.¹¹⁸ Waglay J held that the 'confusion' created by the *NWK* judgment should preclude it from serving as a precedent binding on lower courts.¹¹⁹

V CONCLUSION

The purpose of this contribution was to draw attention to the constitutive elements of a simulated transaction and to highlight the link between this concept and that of *fraus legis*. Cases involving alleged simulation are seldom easy, since by definition the true intention behind such a transaction is disguised. Most of the leading cases were canvassed along the way, with perhaps the most vital being *Randles*. The differences between the judgments in that case highlight the difficulty of the questions it raised — and continues to raise — to this day. The essence of that majority decision, and of almost all the cases discussed herein, barring to some extent *NWK*, was that dishonesty in the form of a 'tacit agreement', at variance with the outward express purpose of the agreement, was required to set aside the alleged simulated transaction. As we have discussed above, the issue this contribution takes with the judgment of Lewis JA in *NWK* is the attempt therein to objectivise fraud out of the test for simulation. While the absence of a sound commercial purpose for a transaction may be a strong indicator of simulation, without a direct inference of dishonesty, it seems incongruent to find a transaction to be fraudulent.

While an objective approach is appropriate to the interpretation of statutes, and most written legal instruments, it must be borne in mind that fraud requires intentional conduct on the part of the perpetrator. In other words, there can be no such thing as an honest simulation. If we are to accept

¹¹³ 2013 (5) SA 130 (WCC) para 78.

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid* para 92.

¹¹⁶ *Ibid* paras 97–106 (per Waglay J).

¹¹⁷ *Ibid* paras 104–105.

¹¹⁸ *Ibid* para 105.

¹¹⁹ *Ibid.*

that the courts can make a finding that a transaction is simulated simply from analysing the juristic acts in question, without ruling on the hidden intention behind those juristic acts, then the distinction between 'purpose' and 'intention' is lost. Those honestly attempting to comply with the requirements of statute law could be deemed fraudulent in the absence of a dishonest state of mind.