PIERCING THE CORPORATE VEIL

A REVIEW OF THE CONCEPT; AND CONSIDERATION OF ITS RELEVANCE IN SOUTH AFRICAN TAX LAW

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SYNOPSIS

The main objective of this research is to ascertain the degree to which the concept of the corporate veil is relevant in South African Tax Law.

The first part of the paper is introductory in nature and is devoted to reviewing the concept from a company law perspective. Part I thus focuses on the following areas:

- limited liability - rationale for; history and development, and implications
- disregarding the company's separate personality
- literature survey pertaining to the United Kingdom, Australia, United States and South Africa.

In concluding part I, it is submitted that the dicta of Lord Halsbury in the Salomon case has stood the test of time and still represents the law today.

Part II deals with the application of the concept in South African and selected overseas tax cases. It has been found most relevant in relation to the determination of a company's intention and in tax avoidance cases.

In addition, part II focuses on specific aspects of gross income and deductible expenditure, as well as some related topics.

In many instances, the corporate veil concept is linked to the debate of substance versus form. Over time, it seems that "substance" has gained ground at the expense of "form", particularly in tax avoidance scenarios.

In conclusion, it is submitted that the concept is relevant in the tax law context and needs to be considered by tax practitioners dealing with both large and small companies.

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The Company as a Separate Legal Entity

" The company is at law a different person altogether from the subscribers to the memorandum; and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them".

(Lord MacNaughten: Salomon v Salmon and Company Limited: [1817] AC22 at page 51)

However, at page 33 Lord Halsbury stated:

" If there was ***no fraud and no agency,*** *and if the company was a* ***real one and not a fiction or a myth,*** *every one of the grounds upon which it is sought to support the judgement is disposed of".*

It appears that Lord Halsbury clearly defined the bounds of recognition of the principle of separate legal personality, and that unfortunately these basic exceptions have become less clear over time.

Assuming that "fiction and myth" may be seen as a subset of agency (which is often but not always the case), two basic exceptions were identified, namely:

1. Fraud, and
2. agency.

But stepping back briefly, it is necessary to define the corporate veil.

The corporate veil has the effect of separating the company on the one hand, from the members, directors and officers on the other hand.

Larkin, [82] paraphrasing Dr Benadie, notes that the concept of the separate corporate entity should not be seen as an end, but rather as a means to an end, the end being the encouragement of business and investment. Therefore, the concept would not be served by attributing excessive weight to it, or by applying it too rigidly, where such application was never intended.

The question of degree is particularly important, ie where does one draw the line between respecting the separate corporate entity, and the demands of equity?

Are considerations of equity adequate grounds to pierce the veil? Dr Benadie,[82] in his inaugural address as Professor of Mercantile Law at the University of South Africa, seemed to think so, in certain cases.

However, in Botha v Van Niekerk,[3] it was stated that:

> *" Mere equity, at its best a reasonably unmanageable horse, is not sufficient".*

It was felt that in addition to equity considerations, there had to be other pressing factors present to sway the court in favour of piercing the veil.

Brief History of Limited Liability

In the United Kingdom, the Joint Stock Companies Act of 1844 represented one of the significant milestones in the development of modern Company Law. However, the act made no provision for the limitation of members personal liability.

In practice however, a different picture emerged. It appears that de facto limited liability was being achieved by many members by virtue of express provisions to that

effect in each contract entered into by the company, (on a basis similar to the procedure applicable to present day insurance contracts). In addition, there was support from many for the concept of limited liability to become part of the Company Law Statute.

Statutory recognition of limited liability was finally achieved in Great Britain in the Limited Liability Act of 1855, which provided for the limited liability of members, provided certain conditions were met, primarily the use of the word "Limited" after the company's name which was intended to advise all parties dealing with the company as to the risk they were running. This Act was in force for only a short time, and was then incorporated into the Joint Stock Companies Act of 1856.

In terms of the 1856 Act, limited liability was automatically achieved once all registration formalities had been complied with.

To various commentators at the time, the incorporation of limited liability into the general enabling Act did not in reality represent a major step, as many members already enjoyed limited liability in practice, by virtue of the express stipulations in company contracts referred to earlier.

Probably the most significant reason for limited liability is specifically referred to by Gower[(109)] at page 47:

> *" Nevertheless, it is clear that without the legislative intervention limited liability could never have been attained in a satisfactory and clear cut fashion, and that it was this intervention which finally established companies as the major instrument in economic development".*

In the South African Companies Act, statutory reference to limited liability seems to be restricted to section 49 which indicates that public companies having a share capital are required to use the word "Limited" as the last word of their names and private companies having a share capital are required to use the words "(Proprietary) Limited".

Rationale for Limited Liability

The main reasons for the existence of limited liability are as follows:

1) Facilitates and encourages business and general economic development - - particularly in so far as large public companies having many members are concerned.

   Were it not for limited liability, individual investors would need to undertake far more extensive research into the nature of the company as well as the other members. This would result in a significant loss of efficiency.

2) Allows parties (members and creditors) the freedom to allocate risk between them.

Implications of the Separateness of the Company - the Corporate Veil

Although separate corporate personality was one of the consequences of incorporation, in terms of the Joint Stock Companies Act of 1844, it took 53 years before an English Court fully addressed the implications of the separateness.

Salomon's case (supra) clearly established that the company is an entity separate from the members, and is not automatically their agent nor the trustee for their property. The recognition of the separate entity of the company has a number of implications:

1) Acts of the Company

   People are required to act on behalf of the company. The Board of directors would be the body of persons to be given authority to act for the company, which authority is usually delegated to individual directors. Members, qua member are not permitted to act on behalf of the company.

2) Limited Liability of Members

Gower[(109)] at page 88 writes that:

> *" It follows from the fact that a corporation is a separate person, that its members are not as such liable for its debts".*

3) Company property

The company owns its property in its own name and members have no proportional right or interest thereto. However, on liquidation, the residue of property which remains after all liabilities have been settled, vests in the members.

4) Contracts

Rights and obligations are acquired by the company as a result of its entering into contracts.

5) Estates of Members

The fortunes or misfortunes of members have no bearing on the existence of the company. For example, the sequestration of a member's estate will not affect the company at all, whereas it would result in the dissolution of a partnership of which the person was a partner.

Equally, the death of a member does not affect the company, its shares are simply transferred to another party (perpetual succession).

6) Profits of Company

As is the case in respect of other company property, members have no right to receive company profits until they are declared as dividends.

7) Transferrable Shares

The free flow of investment is facilitated by virtue of transferrable shares. Transferrable shares would not be possible, were it not for the separateness of the company.

8) Borrowing

In many cases, a company may be able to provide a lender with greater security, by virtue of its separate property. Gower[(109)], at page 96 refers to a "floating charge", equivalent to a general notarial bond in South Africa.

9) Contracts between the Company and its Members or Directors

As the company is a separate entity, it is free to enter into contracts with members or directors, something which is not possible for an unincorporated entity or partnership.

Disregarding the Separate Personality of the Company - Extent/Degree of Piercing

Under certain circumstances, courts will not have regard to the separate personality/ existence of the company. Such circumstances may be defined by Statute or based on Common Law principles. Although this paper will focus primarily on common law principles; for completeness various examples of Statutory piercings of the corporate veil are illustrated in annexure 1.

Various writers as well as the courts have noted that different degrees of piercing are possible.

Gower[(109)] for example, refers to the "veil" of incorporation and also to a "curtain", at page 109:

> *" Normally, however, third parties are neither bound nor entitled to look behind such information, as the law provides shall be made public; in addition to the veil of incorporation, there is something in the nature of a curtain formed by the company/public file, and what goes on behind it is concealed from the public gaze".*

Gower seems to envisage a two tier arrangement, ie:

i)	The curtain -	is qualitatively less significant and relates to availability of information about the company - what information must be made available and what need not be. That which need not be made available, is "behind the curtain".
ii)	The corporate veil -	is the more significant concept and relates to the separate legal personality of the company, which if disregarded, renders members liable for the company's obligations.

Ottolenghi[(87)] sees four piercing categories:

i) Peeping behind the veil

This offends least against the company's separate personality and is merely an attempt to obtain information about the company or its controllers.

The Daimler[51] case is an example of this concept, where after investigation the company was categorized as an enemy alien.

In the South African context (Botha v Van Niekerk)[3], a distinction was drawn between:

i) Piercing the veil in the strict sense. This results in someone other than the company being held liable for its debts, and would relate to the existence of an "unconscionable injustice".

ii) Something falling qualitatively short of the above. This would encompass a mere enquiry in order to obtain information about the company or its controllers and is exactly the scenario termed "Peeping" by Ottolenghi[87].

ii) Penetrating the Veil

In this category, members are held responsible for acts of the company. Examples of this category are:

- Personal liability of members of a public company where membership falls below the specified minimum.

- Attribution, in terms of United Kingdom Taxation Law, to "participators" of "close companies", a share of income not distributed by the company.

iii) Extending the Veil

The situation envisaged here is where the veil of various companies in a group is lifted and then drawn over the group as a whole. An example of this is group financial statements where separate companies in a group are

disregarded and treated as a single economic entity.

iv) Ignoring the Veil

Qualitatively the most severe category, where the courts completely disregard the separate existence of the company. This is likely in cases of gross abuse of the company or where the company is used to defeat creditors or circumvent laws. A typical example of this was the case of United States v Milwaukee Refrigerator Transit Company[59] where Judge Sanborn stated, at page 255:

> *" If any general rule can be laid down in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."*

Literature Review

United Kingdom

(1) C M Schmitthoff in his article "Salomon in the Shadow"[85], made various important points:

1) That for many years following the Salomon[39] decision, exaggerated weight was placed on the concept of the separateness of the company, and what could be achieved by members as a result.

This view appears consistent with that of Benadie, referred to earlier (page 2), who sees the separate corporate entity merely as a means to an end

and not an end in itself.

2) That over time, Company Law theory has advanced with the needs and development of society from the "economic liberalism" and "legal formalism" to the more modern view of companies as merely forms of business enterprise within the community.

Quoting Schmitthoff:

> *" It is in consonance with the modern theory of enterprise to treat the company as an economic unit in the business structure of society rather than an absolute equivalent to a natural person".*

He seems generally in favour of a "substance over form" approach.

3) Identified two categories where the corporate veil has been disregarded by the courts:

- Agency, and
- abuse of the corporate form.

4) The Salomon principle should not be seen as the most important principle of modern company law, but merely, as one of the fundamentally important principles in its development.

(2) J P Lowry[(88)], in contrast, commenting in the British Business Law Journal on the case of Creasey v Breachwood Motors Ltd, expressed reservations in relation to the circumstances under which the court had lifted the veil. It was held that a judgement in favour of an employee of a dissolved company, could be satisfied from the assets of a company into which the original business had been transferred, as the members and directors had acted in disregard of their duties to the dissolved company and to creditors, particulary the ex-employee.

Lowry writes that:

> *" The problem that can naturally arise from this approach is the uncertainty which it casts over the safety of incorporation. The use of policy to erode established legal principle is not necessary to be welcomed".*

Clearly, the shield of incorporation will, and should only protect those with bona fide motives. It would seem equitable for the veil to be pierced where the corporate form is being used as a mere device to attempt to evade legal obligations.

Australia

Gallagher & Ziegler[(99)] view the traditional categories used to describe piercing decisions as subsets of one overriding category, namely the "prevention of injustice".

In discussing why exceptions to the separate entity principle need to exist, they refer to an article by Pickering where the two primary causes of exceptions are stated:

1) A company, by its nature cannot be treated like a natural person, ie it is not capable of committing delict or a crime requiring proof of mens rea unless regard is had to the intentions of the members/directors.

2) Strict application of the separate entity principle may lead to unjust results.

They make the point that the general tendency of Australian courts has been to uphold the veil unless hard pressed not to. Reference is made to the British decisions favouring a single economic entity approach in group situations (Smith, Stone and Knight Ltd v Birmingham Corporation[(45)] and *DHN Food Distributors Ltd v London Borough of Tower Hamlets*[(38)]) and the fact that this approach has not found favour in Australian courts, which have leaned in favour of the stricter approach as laid down in *Woolfson v Strathclyde Regional Council*[(46)] *and Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd and Others*[(47)].

Other areas where the separate entity approach has been strictly upheld relate to:

1) Taxation Law - *Federal Coke Co Ltd v FCT*[71], and
2) the takeover code - *NCSC v Industrial Equity Ltd*

An interesting difference of interpretation is that while Gallagher and Ziegler feel that courts are more likely to lift the veil on an agency basis where the principal is a holding company (body corporate), the empirical study by Thompson[96] in respect of American experience indicates the opposite; ie a greater tendency to lift the veil where the principal is a natural person.

Gallagher and Ziegler feel that the above should be the position as the holding/ subsidiary company relationship provides greater scope for the misuse of limited liability and the resulting injustice.

United States

(1) Professor RB Thompson[96], writing in the Cornell Law Review presented the results of extensive empirical research into the subject of piercing the corporate veil in the United States.

Aspects of the data researched are as follows:

1) Number of reported cases reviewed - 1583,
2) Period - pre 1930 to 1985,
3) Factors observed from the cases included, inter alia;

- whether or not the veil was pierced
- year
- court
- which jurisdiction's law was applied

- number of members
- nature of members - natural or artificial persons
- substance of the claim for piercing relief, contract, delict, criminal or statutory.

The article highlights the following points:

1) In the United States, piercing the corporate veil is one of the most litigated areas of corporate law.

2) Many commentators criticise the use of metaphorical terminology by judges, claiming that such language provides little insight into the nature of factors considered. Judge Cardozo in the case of *Berkey v Third Avenue Ry* (1926)[(66)] said that this part of the law is:

   " enveloped in the mists of metaphor"

   However, that being said, it also appeared that commentators believed that courts were, on the whole, arriving at correct/equitable decisions.

   Thompson notes that:

   "Much of the legal scholarship in this area reflects scholars efforts to reveal the decisional structure beneath the verbal shabbiness of the law's facade".

3) Decisions tend to be very case-specific with little in the way of general principles/standards being enunciated by the courts. It appears that courts wish to leave the question reasonably open-ended as attempts to circumscribe the situations leading to veil piercing may only invite abuse.

It seems that American courts see the concept of limited liability as a rebuttable presumption.

4) Most common law piercing theories as well as those embodied in Statute tend to be geared toward dealing with contractual problems. It is therefore likely that applying these theories or principles to delictual, criminal or statutory situations may be awkward or cumbersome.

5) The findings of the research, inter alia, were as follows:

a) Listed public companies v other types of company.

Piercing was only successful in respect of unlisted companies. Piercing was not successfully achieved in any publicly held listed company, with the single exception of *Anderson v Abbot*[(67)] which may be distinguished as falling under the ambit of the Banks Act.

Thompson interprets this as being indicative of the different role that limited liability plays in listed public companies in contrast to unlisted, public or private companies (close corporations).

Thompson, at page 1047 notes that:

" *Limited liability performs the additonal function in larger corporations of facilitating the transferability of shares and making possible organized securities markets with the increased liquidity and diversification benefits that these markets make possible.*"

and goes on:

" *The total absence of piercing in public corporations permits a stronger positive statement for those corporations: 'the market-*

related benefits of limited liability are sufficient to prevail over all possible claims of those who have claims against the public corporation and cannot collect from its assets.'"

b) Trend over time

Courts pierced the veil in approximately 40% of all reported cases. This percentage has remained stable over time, varying between 40,8% in respect of all pre - 1960 cases and decreasing to 38,6% in respect of cases reported during the 1980's.

c) Number of members (natural persons)

It was evident that the fewer the members, the greater was the court's propensity to pierce the veil:

	Percent pierced
- more than 3 members	35
- 2 or 3 members	46
- 1 member	50

d) Nature of members - natural v juristic persons.

Contrary to the views held by many writers (including Gallagher & Ziegler - page 11), it was found that courts were more likely to pierce where the members were natural persons (43%), than when they were other companies (37%).

e) Nature of the claim

	Number of cases	Percent pierced
Contract	779	42
Statutory	552	40
Delict	226	31
Criminal	15	67

The contrast between contractual and delictual scenarios goes against what many felt the position would/should be. It is a common argument that the likelihood of piercing is greater in delictual situations, as the claimant did not choose to contract with the company, as would be the case in the contractual scenario. Therefore, the claimant, due to his lack of knowledge of the company, is entitled to greater protection. This view was not supported by the empirical results.

The fact that the number of contract cases (779) so heavily outweigh the number of delictual cases (226), seem to confirm R Clark's[110] point that the most common piercing problems arise from "fraudulent transfers" and similar contract related claims.

f) Reasons given for piercing.

Table 1 below illustrates the reasons given for piercing.

Category	Number of Cases in which factor mentioned	Number of Piercing Results	Number of No-Piercing Results	Percentage Pierced
Instrumentality	75	73	2	97.33
Alter Ego	181	173	8	95.58
Misrepresentation	169	159	10	94.08
Agency	52	48	4	92.31
Dummy	78	70	8	89.74
Lack of Substantive Separation	141	120	21	85.11
Intertwining	63	54	9	85.71
Undercapitalization	120	88	32	73.33
Informalities	151	101	50	66.89
Domination & Control	551	314	237	56.99
Overlap:				
Officers	174	87	87	50.00
Directors	152	66	86	43.42
Owners	101	49	52	48.51
Office	68	40	28	58.82
Business Activity	43	35	8	81.40
Employees	52	36	16	69.23
Managment	43	28	15	65.12
Other	169	118	51	69.82
Total Overlap	812	459	343	56.53

The following may be noted:

- there is no apparent reference to "abuse of the corporate form" or "fraud".

- the research also focused on which factors, by their absence, were important. Misrepresentation was the factor most often mentioned, as not being present.

(2) R Clarke[110] notes that courts often overlook the issue of "fraudulent conveyances", when dealing with piercing cases, particularly those involving agency. The concept of fraudulent conveyance may be likened to the type of dispositions in fraud of creditors in the South African context.

He writes, at page 72:

> *" Many of these cases are triggered by behaviour that would invoke fraudulent conveyance law. Nevertheless, courts typically ignore the relationships between that body of law and the attempts to pierce".*

Reference is made to the case of *Bartel v Home Owners Co-operative Inc*, where creditors alleged that a subsidiary company had sold homes to members of its holding company at cost (ie no profit). Although this could be seen as conduct in fraud of outside creditors of the subsidiary, the issue was not dealt with in the judgement.

A further aspect, noted in American cases dealing with company liquidations, is the application of the "Deep Rock Doctrine" (first applied in the case of Taylor v Standard Gas and Electric Co)[64]. Application of the doctrine involves two steps:

1) Examining the relationship between a company and its controlling shareholder, natural or juristic, to ascertain whether de facto agency exists.

2) If de facto agency exists, the claims of the controlling shareholder are subordinated in favour of other creditors.

This approach is also referred to as equitable subordination. The controlling shareholders' claim is not refuted, it is merely paid (assets permitting) after the claims of "external" creditors.

South Africa

A Domanski[(81)], in a 1986 article published in the South African Law Journal, examined the South African position at the time.

As with many other writers, he criticised the use of the "categorization" approach to piercing decisions, indicating that such categories would not always yield an equitable result. In support of this contention he cited two cases, *Yanu-Yanu Co Ltd v Nbewe and Nbewe (Malawi)*[(80)] and *R v Hammersmith and Fulham London Borough Council, ex parte People Before Profit Ltd (United Kingdom)*[(53)].

In the Malawi case, the veil was not pierced whereas in the UK case it was. The common denominator linking these two cases is that in each one, it was the members desire that the veil should be pierced to achieve what appeared to be an equitable result.

The point is well made by Domanski that neither the numerous categories proposed by some writers, nor the simple "agency"or "abuse of the corporate form" proposed by Schmitthoff appear to be capable of application in either case. The reason for lifting the veil in the UK decision, is quoted by Domanski as:

"commonsense must prevail and one must look at the realities".

However, it should be noted that such cases, where the members wish the veil to be lifted, and there is no misconduct, appear to be the exception to the rule in so far as

piercing decisions are concerned, as in most cases members want the veil to be strictly upheld.

Using Domanski's logic, it is therefore important to realize that traditional veil piercing theories are founded in cases where in the main, the members wished to uphold the veil.

Thompson's empirical research(supra) in relation to the United States indicates a low rate of piercing the veil (13%) when the applicant is a member. He states, on page 1057:

> *" The corporation itself seldom is successful in arguing self-piercing . Courts tell participants that they chose the form of enterprise and that they are stuck with it in bad times as well as in good".*

However, it is felt that although Domanski is correct in saying that Schmitthoff's simplified categories of "agency" and "abuse of the corporate form" will not be applicable to all piercing cases, they are likely to be applicable in the vast majority.

Domanski then refers to the decision of the Louisiana Supreme Court in *Glazer v Commission on Ethics for Public Employees*[58] where the ratio was that the test for piercing the corporate veil should be a balancing of:

> *" the policies behind recognition of a separate corporate existence against the policies justifying piercing".*

Domanski is of the opinion that a test of this nature, which consists of broad principles is likely to lead to more coherent and equitable decisions in piercing cases. He also noted that the traditional "categories" could be used to support the application of this "balancing test".

Thompson, as well as other writers have made the point that overseas courts have

tended to decide piercing cases on a case-by-case basis, seemingly being unwilling to circumscribe the circumstances which would lead to piercing.

The "balancing" test put forward in the Glazer case would seem to be robust enough not to unduly limit a court's discretion, while at the same time not assisting corporate planners who wish to define a particular ambit for the piercing tests, simply to be able to avoid them.

In the Glazer case, the court had to balance the following policies:

In favour of recognising the separateness of the corporation	In favour of piercing the veil
1. the separateness of the assets and liabilities of the members and the corporation.	1. support the Code of Ethics applicable to all public employees.
2. the limitation of members liability to creditors of the corporation.	2. maintain public confidence in the integrity of government officials.
3. the encouragement of investment and business.	3. maintain the respect of the majority of government officials who abide by the code.
4. the freedom given to parties to allocate the risks of doing business between them.	

The issues underlying recognising the separateness of the corporation will always be the same whereas the issues in favour of piercing will always differ.

Dennis J, in the Glazer case also noted that the separateness of the corporation need not be totally disregarded in all cases, but that partial piercing may achieve the desired result. In other words, quoting Dennis, J:

> *" (partial piercing)... may result in recognition of separate corporate identity for some purposes, ie insulation of shareholders from liability, and a disallowance of the separate corporate entity privilege for others".*

(2) Larkin[82], in a 1989 article published in the SA Mercantile Law Journal raised a number of interesting points.

He referred to the case of Botha v Van Niekerk[3] and discussed the question of the degree of piercing. The judgement differentiated between:

a) Piercing the veil in the true sense, and
b) something which falls qualitatively short of true piercing.

It is suggested that merely ascertaining information about the members of a company eg their race - Dadoo's case[8] does not constitute a true piercing (see also Ottolenghi - page 7)

Statutory piercing of the veil is also provided for in terms of the Close Corporations Act, where necessitated as a result of "gross abuse of the juristic personality". Following Dodoo's case (which upheld the veil), statutory piercing was provided for in terms of various Group Areas related legislation.

Also discussed, is the apparently more liberal approach to piercing, as espoused by Dr Benade(supra), ie the possibility of piercing the veil on the basis of equity alone.

There exist various strong counter-arguments to this concept. Firstly, in Botha v Van Niekerk, it is stated that *" ... equity, at its best a reasonably unmanageable horse, is not sufficient"*. Various British writers have also indicated that "equity" or the "interest of justice" are terms too broad to justify sacrificing the corporate privilege.

In the Dadoo[8] case, the court although refusing to pierce the veil did refer to the concept of substance over form. Clearly, this is often likely to be an important consideration in possible piercing situations - ie whether or not the transaction is a real commercial one, or merely a cloak for some other motive.

Larkin's final point is that it is important not to overemphasise the importance of the separateness of the company. Using Dr Benade's expression, the (separate) entity concept is merely a means to an end, and not an end in itself.

The Traditional "Categorization" Approach to Piercing and Other Tests

Many different categories and types of analysis have been applied in different parts of the world, but it is felt that the vast majority of decisions may conveniently be divided into two groups:

1) agency; and
2) fraud or abuse of separate corporate personality.

This view conforms to that of CM Schmitthoff expressed in his article "Saloman in the Shadow"[(85)].

Many judges and commentators have criticised the use of metaphorical language in piercing cases but one wonders whether this is not merely the result of the court's determination to see justice served even when the facts of the case do not fit any existing theory.

Professor Thompson[(96)] writes that:

> *" Despite this barrage of negative reviews, many believe that beneath this layer of unhelpful language courts are getting it right".*

He goes on to quote Elvis Latty who observed:

> *" that in spite of conflicting and misleading dicta the judicial hunch usually carries through to a correct decision".*

Gower[109], commenting on the decision in Adams v Cape Industries states:

> " *It is to be hoped that the Lords will be afforded another opportunity of reviewing the law in this field. Having invented the "facade" test it behoves the Lords to tell us what it means".*

Other frequently criticised factors are the lack of detailed analysis and the shortage of far-reaching standards which may prove useful in deciding future cases.

Domanski(supra), notes an important point in his article in the SALJ, when he refers to the case of People before Profit[53], and asks how the decision to pierce the veil in that case could be reconciled to the agency or fraud/abuse formulation referred to earlier. The point made is that neither agency nor fraud/abuse were present and yet the veil was lifted. The reason seems to be that the twin tests of agency or fraud/abuse would only be applicable in respect of applications to pierce the veil by those outside the corporation (outsiders).

Where the application to pierce the veil is made by members, directors or officers (insiders), these tests are unlikely to be helpful.

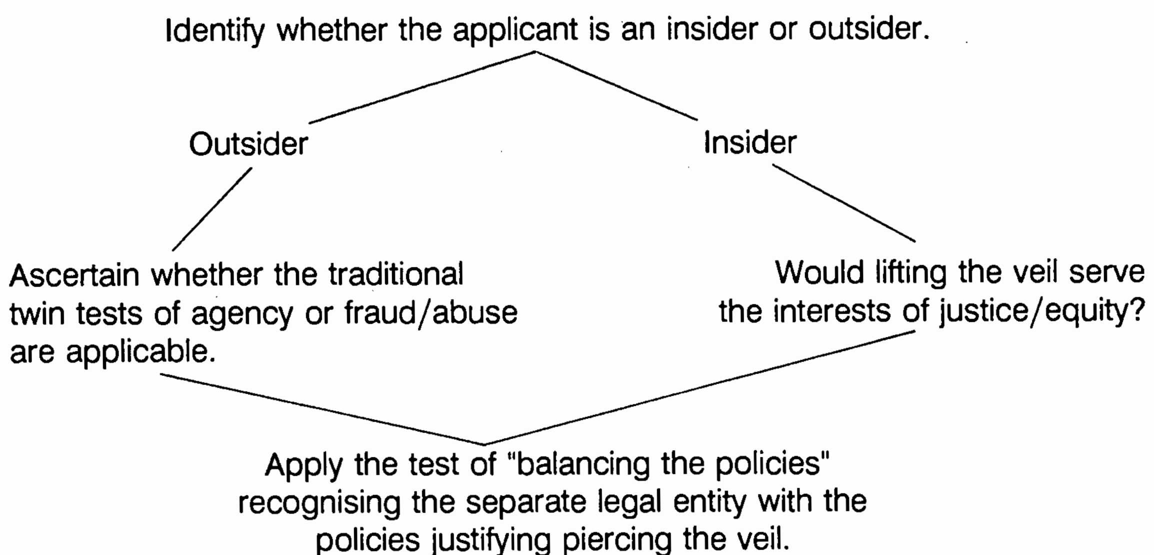
There do not seem to be many cases involving insider or self-piercing and courts generally seem unsympathetic in such situations. The reason presumably being that members cannot *"have their cake and eat it too".*

The following are examples of insider piercing:

Case	Circumstances
1. R v Hammersmith and Fulham London Borough Council, ex parte People Before Profit Ltd[53]	Locus standi of the company which had been incorporated during the course of legal proceedings.
2. Yanu-Yanu Co Ltd v Mbewe and Mbewe[80]	Locus standi in relation to maintaining legal proceedings.
3. Smith, Stone and Knight v Birmingham Corporation[45]	Expropriation of subsidiary's property. Holding company claimed compensation.
4. DHN Ltd v Tower Hamlets[38]	As in 3.

Having reviewed a number of these cases, it is easy to see why the categorization approach is popular. It is natural to try to organise the decisions into some logical groupings. However, as I found personally, it is no easy task.

It is suggested that the following procedure be adopted when faced by possible piercing questions:



Conclusion

Many texts refer to the "privilege" of limited liability. The inference being that in order for a member or other party to continue to enjoy insulation from liability, a certain standard of conduct is required.

However, it is felt to be generally accepted that one of the strong motivating factors in incorporating a business is often the insulation from liability. In other words, seen from the opposite point of view to that referred to above, by incorporating, the member submits to additional regulations, administration and publicity, in return for which he enjoys limited liability.

It makes sound commercial sense to accept the least risk when doing business, particulary in those parts of the world which are litigation prone. Delictual actions in the United States, for example, often result in large damages awards, which would have to be satisfied from the private assets of a person conducting an unincorporated business. The *Walkowsky v Carlton*[(60)] case is an excellent example of how an American taxi operator successfully limited his potential delictual liability by using a number of companies which each owned one or two taxis.

In terms of inroads being made into the sanctity of the corporate veil, the greatest number, in terms of case law, have been made in the United States. A sizeable body of case law has evolved, as evidenced by Professor Thompson's empirical study[(96)]. Whether or not the greater number of decisions has brought greater clarity to the issue seems to be debateable. In Britain, greater inroads have been made via statute, rather than in terms of case law. Gower[(109)] at page 134 states:

> " *Hence, while statutory inroads into the corporate entity principle continue to increase, those by the judiciary have contracted".*

After almost 100 years, it seems that the words of Lord Halsbury in Salomon's case(supra) have stood the test of time:

> " *If there was no* ***fraud*** *and* ***no agency*** *and if the company was a* ***real one*** *and* ***not a fiction or a myth****, every one of the grounds upon which it is sought to support the judgement is disposed of*".

The Corporate Veil - Its Implications in the Context of Tax Law

Introduction

The objective of this part of the dissertation is to extract both:

a) Specific points, and where possible
b) general principles

in relation to the relevance of the corporate veil in a tax law context. The research encompasses a literature review of journal articles as well as a review of reported cases. South African cases as far back as *Ochberg v CIR* (1931)[33] were reviewed. In addition, selected, more recent Australian, Canadian and United Kingdom cases were also reviewed. As much as one would like to be able to extract general principles, this is particularly difficult. Each case has to decided on its own facts. On page 12, I referred to comments made by Professor RB Thompson[96] which tend to indicate that this branch of the law, like that applicable to insider trading or directors fiduciary duties has intentionally been kept unspecific by the courts who do not wish to circumscribe the ambit of lifting the veil as this may invite abuse.

Thompson's empirical study reveals some interesting statistics:

- Overall rate of piercing the veil in the reported cases reviewed 40%

- Overall rate of piercing when the case arose in a statutory context 40%

- Differences within the statutory context:

  - Tax law 31%
  - employees compensation 13%

- environmental 83%
- bankruptcy 47%

One would have expected a lower rate of piercing in a tax law context, as most taxing statutes presume that the company is a separate taxable entity.

In his article *"Income Taxation and Legal Entities"* Professor WA Klein[97] attempts to demonstrate, by reference to different forms of business organisation, the inverse relationship between:

a) the closeness/proximity of the owner of the business to "his" income, and

b) the tendency for the business organisation to be recognised as a separate legal entity.

He contrasts the recognition accorded different business forms, inter alia:

1) sole proprietorship 3) trust

2) partnership 4) company

To emphasise that companies are artificial persons, is trite, however, in grappling with the concept of a company's intention; in the context of the corporate veil, has led to my reviewing this often covered ground. A company's intention has to be imputed from natural persons, and its acts effected by natural persons. The question thus arises:

Does the ascertainment of a company's intention constitute a piercing of the veil?

I will attempt to answer this question. In this part of the dissertation, the following areas will be addressed:

a) Intention of the company,

b) tax avoidance,

c) specific aspects of gross income and deductible expenditure, and

d) other related topics.

Intention of the Company

The first question to be answered is, why is the ascertainment of a company's intention a relevant tax issue? The reason is that the intention of the company (or natural person in other instances), may be decisive of the tax treatment of income or expenditure. Probably the most common area is that relating to the disposal of assets and the decision as to whether the proceeds are of a capital or revenue nature. Intention is also important in deciding on the deductibility of certain types of expenditure and losses.

A well-known statement by Centlivres CJ *(CIR v Richmond Estates (Pty) Ltd 1956 AD 20 SATC 355)*:

> *"A company is an artificial person with no body to kick and no soul to damn and the only way of ascertaining its intention is to find out what its directors acting as such intended. Their formal acts in the form of resolutions constitute evidence as to the intentions of the company of which they are directors ..."*

Intention is a human characteristic. An artificial person cannot be endowed with an intention; an intention may only be imputed to such person. All acts of a company, in pursuance of such imputed intention are effected by natural persons. Therefore, in ascertaining the "intention" of the company one is left with no choice but to focus on natural persons. The issue of course is upon **which** person(s) does one focus.

In terms of the articles of most companies, the power to manage the affairs of the company is entrusted to the Board of Directors. Bearing in mind the concept of the division of powers between the Board of Directors and the members, it is the Board who generally have the exclusive power to direct and manage the company's affairs. Should they not do so to the satisfaction of the members, the members may terminate their employment but may not interfere in the management decision making. Therefore it is the aggregate intention of the Board of Directors which will be imputed

to represent the "intention" of the company. This may be ascertained from board resolutions/oral evidence of the directors and conduct of the company.

Seen from the perspective of members, the point was clearly made in *Ochberg v CIR*[33] that the company is separate and distinct from, and must not be confused with the members. It may therefore be said that generally, the intention of members will not be relevant in determining the "intention" of the company.

Having said this, it should be noted that courts have not allowed themselves to be unduly restricted in the determination of a company's intention, where the circumstances required a more pragmatic approach. In various reported cases, where it was obvious that the company's affairs were not being directed by the Board of Directors, the courts have identified who in fact is in ***effective control.***

Such effective control has been found to reside in various places, inter alia:

1) A management committee, made up of senior management of the company - *SIR v The Trust Bank*[26]

In this case Counsel for the Secretary tried to limit the method by which the court could establish the taxpayer's intention. Botha JA rejected such narrow reasoning and stated at page 105:

" Counsel for the appellant, ... submitted that, with certain immaterial exceptions not relevant in this case, 'the only way of ascertaining its (a company's) intention is to find out what its directors acting as such intended' and that (again with immaterial exceptions not relevant in this case) the only way to find out what a company's directors acting as such intended is from their formal acts'"

And continued at page 106:

" In an enquiry as to the intention with which a transaction was entered into for

the purpose of the law relating to income tax, a court of law is not concerned with that kind of subjective state of mind required for the purposes of the criminal law, but rather with the purpose for which the transaction was entered into .... Why that purpose cannot, in the case of a company, be proved, inter alia, by evidence as to the state of mind or intention of the persons in effective control of the affairs of the company is not clear, and the exclusion of such evidence would in my view be insupportable in law. While such evidence will, therefore, always be admissible, the weight thereof must necessarily depend upon the circumstances."

2) An investment committee, who established the policy of dealing with the company's investments - *African Life Investment Corporation (Pty) Ltd v SIR, 1969 AD 31 SATC 163.*

3) The controller(s) of "dummy/puppet" directors

4) The Board of Directors of a parent company - *ITC 1236*

Insofar as reference should be had to the intention of **members**, Silke[107] at page 53 states:

" It would appear then, that in circumstances where a shareholder effectively controls a company not merely through his power to replace the directorate but directly, an exception may arise to the rule that the intention of a company will be determined without reference to the intention or activities of its shareholders".

Such circumstances were addressed by the courts in the following instances:

1) "One-man company" - where one person holds all the shares and is the sole director - *CIR v Richmond Estates (Pty) Ltd,(supra),*

2) "main shareholder - who is the author of all the (company's) decisions" -

ITC 1238 1975 37 SATC 283,

3) where a member is said to be the "architect" of the activities of the company - *John Bell & Co (Pty) Ltd v SIR 1976 AD 38 SATC 87.*

It is felt that each of the above situations falls within Silke's exception referred to above.
It may be noted that in *ITC 1238*, it was further stated that in such circumstances, it would not be unreasonable for a court to have regard to the member's private activities, where these are similar to the activities of the company.

Two further cases where the courts reached different decisions should also be reviewed.

In the case of *Tati Company Ltd V COT*, heard in the Court of Appeal in Botswana, (1974 37 SATC 68)it was held that the intention of members, qua member, were not relevant in ascertaining the company's "intention", however their intention qua director was a relevant factor.

This idea of divisible intention in relation to the same person(s) acting in two capacities (viz as member and director) was developed by Corbett JA in a dissenting minority judgement in the case of *Elandsheuwel Farming (Edms) Bpk v SBI*[(23)].

The case dealt with the disposal of what had previously been farming land, by a company, following closely after a change in shareholding. The new sharholders were well known land speculators. It was held by three to two that the advent of the new shareholders had led to a change of the company's intention viz a viz the land, ie from holding as a capital asset to disposing of as part of its stock in trade.

Corbett JA, delivered the dissenting minority judgement in which he made various important points.

He stated, at page 184:

> " *The next series of findings by the court a quo relates to the advent of De Villiers and his co-shareholders (for convenience of reference I shall call them 'the De Villiers group') in November 1969. It would appear that they all became directors of the appellant company.* ***It is consequently in their collective will as directors that the purpose and intent of the company should be sought.***"

At page 185 - 186:

> " *What emerges clearly from these passages, in my view, is that, despite what is stated in paragraph (3) above, the court a quo* ***failed properly to distinguish between the intentions of the De Villiers group in acquiring their shares in the appellant company and the intention manifested*** *by them as directors, in the conduct of the affairs of the company. ...*
>
> *But, in any event,* ***it is not from their point of view but from the point of view of the appellant company*** *that the existence or otherwise of a profit-making scheme must be adjudged. And from the company's stand-point all that happened was that the change in shareholding which occurred on 11 November 1969, and the resultant reconstitution of the board of directors, led to a decision to market and sell a capital asset, viz the property. This, as I shall show later, can also hardly be construed as a profit-making scheme.*
>
> *Having regard to this analysis it seems to me, with respect,* ***that the court a quo erred and indeed misdirected itself when it (i) in effect merged the activities and intentions of the De Villiers group in their personal capacities and the activities and intentions of the company,*** *under the direction of the De Villiers group; and (ii) by reason thereof, took into account irrelevant facts and circumstances in dealing with the question as to whether the company had engaged upon a profit-making scheme."*

With respect, I am unable to agree with Corbett JA. Since the directors and members were the same people, it seems to me to be somewhat artificial to suggest that they may have had different (opposite) intentions qua member and qua director in relation to the same property.

In the later case of SIR v Rile Investments, Corbett himself noted that a change of shareholding may result in a change of the company's intention. He stated at page 141:

> *" account must be taken of changes in shareholding which cause control of the company to pass into new hands since the advent of new controllers may bring about a change in the intentions of the company."*

Whether or not a single person is able to have different (opposite) intentions in relation to the same property, when acting in different capacities, is, I think, open to question.

Nicholas AJA, at page 151 of the majority judgement in *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*[(14)] said:

> *" It is suggested that when dealing with the matter as chairman and managing director of Pick 'n Pay, his purpose was solely a business one, although it was the same donation to the same charity. I cannot accept that. A man does not change his mind when he changes his hat".*

In an article entitled "Is Generosity a Bar to Tax Deductibility?" (SALJ), T Emslie, analyses the Pick 'n Pay Wholesalers case from a different perspective and concludes that the minority judgement (may be) preferable.

The point made by Emslie is that in order to obtain greater precision, the concept of intention may be viewed as having two constituent elements, namely:

1) purpose, and 2) effect

At page 218, he states:

> *"There was certainly sufficient evidence, it is submitted, to discharge the onus of proving that, while the respondent did envisage a philanthropic* ***effect*** *its* ***purpose*** *in making the donations in question was solely to enhance its business image".*

At 219:

> *" It is clear from both judgements in the Pick 'n Pay case that the distinction between the purpose or objective of an expenditure and its effect is of critical importance. It is the former which must be untainted by any non-business motive, however secondary or incidental. On the other hand, the existence of a non-business effect is no obstacle to a deduction as long as the abovementioned purpose remains pure".*

In determining a company's intention, reference should also be made to the objects clause stated in its Memorandum of Incorporation. In certain cases this may be helpful, but in many the objects clause is widely framed and not of much real assistance.

In reviewing the different judgements, I have found it useful to group them into what I have termed "narrow" and "pragmatic". What is meant by pragmatic is a judgement which appears to take greater account of the surrounding circumstances and their bearing upon the point of at issue.

NARROW	PRAGMATIC
1. Tati Company Ltd v COT	1. ICT 1238
2. Elandsheuwel Farming (Edms) Bpk v SBI - the minority judgements of Corbett JA and Kotze JA	2. SIR v Rile Investments (Pty) Ltd(22)
	3. Elandsheuwel Farming (Edms) Bpk v SBI - the majority judgement
3. CIR v Malcomes Properties (Isando) (Pty) Ltd[11]	

Therefore in determining the "intention" of the company the courts will generally focus on the Board of Directors. However, where the Board is not in reality directing the business of the company, the court will attribute the intention of those who are in effective control, to represent that of the company.

In concluding this section, what then is the answer to the question posed in the introduction, namely:

Does the ascertainment of a company's "intention" constitute a piercing of the veil?

The answer, I believe, to borrow the words of Flemming J, in *Botha v Van Niekerk*[3], is that such ascertainment does not represent a piercing in the strict, or true sense, but represents something falling qualitatively short of that. Clearly, such ascertainment would also not fall within the ambit of the traditional categories of agency or fraud/abuse.

Tax Avoidance

The use of separate corporate entities in a tax avoidance context is fairly common. However, not surprisingly there seems to exist somewhat less respect for the separate corporate form in such circumstances. Various statutory and common law tests exist in regard to alleged tax avoidance situations. In South Africa the twin tests of the "normality" of the:

(i) Means or manner in which the transaction was carried out, and

(ii) the rights or obligations which were created as a result thereof

need to be reviewed by the court (section 103(1)). One would suppose that these tests would be used to compare what had been undertaken to what was commercially realistic between parties acting at arms-length. The efficiency of the tests appear however to be significantly diminished by virtue of the following wording:

" having regard to the circumstances" and

" (i) was entered into or carried out by means or in a 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".**

The use of these words, it is submitted, poses two problems in applying the normality tests:

a) It presupposes some "normal" or "acceptable" objective benchmark method for carrying out such a transaction, and

b) it seems to imply an iterative type of test, whereby the bona fides of the scheme is to be judged against itself.

In the United States, the commercial reality of transactions is reviewed in terms of what is called the "business activity" test. This common law test has its origins in the cases of *Gregory v Helvering*[65] and Nelson v Commissioner[68]. In terms of the test, the court will ascertain whether the company was formed for a legitimate business purpose other than solely the avoidance of tax. This concept of legitimate purpose is also embodied in section 103(1)(c) and 103(4)(a).

In tax avoidance situations, one would expect that courts, in applying the legislation or common law tests, would not take a narrow view of the circumstances.

To quote Botha JA, at page 334 of the *Glen Anil v SIR*[25] case:

> *" Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefore or to the incidence thereof, but rather to schemes designed for the avoidance of liability therefor. 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. The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation".*

Although none of the well known South African tax avoidance cases deal with a direct lifting or an attempted lifting of the corporate veil; in the light of the above statement, it is felt that such a lifting could quite conceivably take place, where a court felt that it was justified by the circumstances - in order to "suppress the mischief".

In the South African context, a number of cases have touched on the concept of the separateness of the company.

HICKLIN v SIR 1979 [19]

The secretary attempted to subject to tax in the shareholder's hands (Hicklin) a pro-rata share of the distributable reserves of a company. Hicklin and his co-shareholders had avoided liability for personal tax on dividends by arranging to borrow the distributable profits on loan account, rather than receiving taxable dividends. In holding in favour of the taxpayer, the following comments were made by the court:

At page 192 of the judgement:

> " *As to requirement (b) [now (a)] of S103(1), did the RN agreement, have the effect of avoiding, liability for any tax on income? 'Liability' there means that* ***of the taxpayer concerned,*** *in this case the appellant. The liability for income tax on Reklame's distributable profits would and could only attach to appellant and his co-shareholders* ***if and when they caused Reklame to declare them as dividends".***

Thus, the Commissioner from a strategic point of view, is bound/limited to challenge only the person who has allegedly avoided tax. This issue as to who the Revenue authorities should challenge is well illustrated in the Australian case of *Federal Coke and Coal Company*[71] (page 62) where the court, in holding for taxpayer seems to imply that the Revenue challenged the wrong party.

The point was also made that no liability existed (insofar as the taxpayer was concerned) until such time as dividends were declared. As no dividends were ever declared and the shares in the company subsequently disposed of, no liability could attach to the shareholder.

At page 194:

> " In regard to the effect and purpose of the RN agreement the Special Court

proceeded on the basis that **'the distributable profits were in reality the income of the shareholders'.** Similarly, respondent's counsel contended that by entering into and implementing the RN agreement, appellant and his co-shareholders **in reality received the distributable profits of Reklame, even though they had not been declared as dividends. ...**

In my view that approach by the Special Court and counsel was wrong, at any rate at this stage of the inquiry. The former's approach erred because **it ignored the factors that Reklame had its own juristic personality, separate and distinct from its shareholders** and that in law therefore its distributable profits did not belong to the shareholders until declared as dividends. And counsel's argument wrongly ignored the form, substance, and legal effect of the loans to the shareholders and the RN agreement. After all, the loans and RN agreement were not simulated or sham transactions. On the contrary, they were genuine and bona fide. Now at the stage when one is still inquiring whether or not the requirements of section 103(1) have been fulfilled, none of those factors can be ignored; they must duly accorded their full legal effect. It is only if and when the requirements of section 103(1) are all fulfilled that the form, substance, or legal effect of those factors may be wholly or partly ignored. For then, in accordance with section 103(1), the appellant's liability for tax must be determined either 'as if the transaction, operation or scheme had not been entered into or carried out' or 'in such manner as in the circumstances of the case' is deemed appropriate for preventing the avoidance of the tax liability. But until that stage of the inquiry is reached - and as will presently emerge it will in the present case not be reached - it must be **premised that Reklame's distributable profits belong to it and not to its shareholders;** that the shareholders in fact did not receive them; that they were subsequently declared by Ryan Nigel as dividends to itself; that under the RN agreement the shareholders received the money from Ryan Nigel as the purchase price for the sale of their shares; and that they used the money to liquidate their loan indebtedness to Reklame".

The point made by Trollip JA, is that until such time as **all** the requirements of section

103(1) have been shown to be present, there is no warrant for ignoring the form, substance and legal effect of any transaction or relationship unless such transaction or relationship is plainly a sham.

To my mind this attitude would seem to make the Commissioner's task extremely difficult, as it may conceivably be exactly those relationships which Trollip JA insists must be respected - that need to be disregarded to lay bare the true scheme. Taxpayers may obviously be comforted in this respect, which seems to present somewhat of a "chicken and egg" predicament.

CIR v OCEAN MANUFACTURING 1990[12]

The Commissioner challenged the set off of an assessed loss of a subsidiary of one of the parties to an agreement against the gross income of the other party to the agreement. Following the conclusion of what was referred to as the "merger" or "main" agreement between The Brick and Potteries Company Ltd (B&P) and Ocean Manufacturing (Pty) Ltd (Ocean), the profitable business operations of Ocean were transferred into an assessed loss subsidiary of B&P. This took place in terms of what was referred to as the "transfer" agreement.

Nicholas AJA, at page 161 stated:

> " The main argument advanced in this court by Mr Swersky on behalf of Model Homes (the assessed loss subsidiary) was this: He conceded that 'as a matter of legal form' there were two agreements - the merger agreement and the transfer agreement. Model Homes was not a party to the merger agreement, in the negotiation of which the parties were at arm's length and engaged in hard bargaining. 'In legal form' Model Homes was a party to the transfer agreement, **but as it was a wholly-owned subsidiary of B&P, it had 'no independent mind, interest or purposes; it was formally carrying out what had already been agreed in substance between the parties to the merger agreement'.** The

transfer of the business to Model Homes, though 'in legal form' an agreement between Model Homes and Ocean, was 'in commercial reality an implementation of an arrangement between Finansbank, B&P and Ocean and was nothing more than an integral component of the merger of interest which had been provided for in the main agreement'. He submitted that 'there was, effectively, from an economic and business point of view, only one transaction'.

I am at a loss to understand all this. The word *agreement* as used in section 103(2) connotes a contract, that is an agreement which is legally binding and enforceable between the parties. Any implication that an agreement 'in legal form' is something less than or different from such an agreement, is to be rejected".

Swersky SC was in reality arguing for "self-piercing", ie that the court should regard Model Homes as acting as agent for its parent B&P, in putting the "merger" agreement into effect. Three principles emerge:

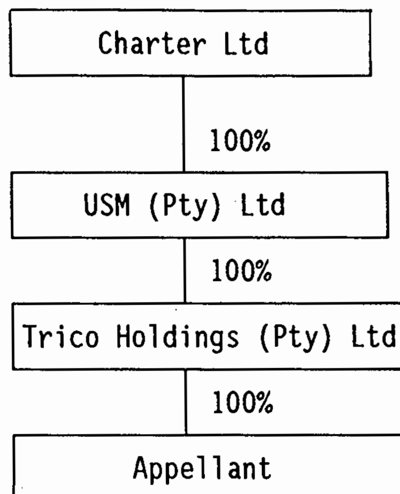
1) Courts will have regard to the actual agreements concluded unless they are plainly sham in nature.

2) A parent/subsidiary relationship does not automatically imply a principal/agent relationship.

3) "Self-piercing" requests by taxpayers have an extremely low probability of acceptance by courts - as having formed the separate entity, the taxpayer must "live with the consequences".

Glen Anil Development Corproation Ltd v SIR 1975[25]

The Secretary challenged the set-off of existing assessed losses by the taxpayer against profits from township development in terms of section 103(2). The shareholding structure was as follows:



It was argued on behalf of the taxpayer that the Secretary was precluded from invoking Section 103(2) **as the change in shareholding had to occur in the same company that attempted to utilise the assessed loss**. In this case, the change of shareholding occurred in Charter and not in the taxpayer.

The ratio of the judgement as expressed by Botha JA at page 336 was that:

> *" The appellant company was clearly **affected by the agreement** (in respect of the change of shareholding in Charter) of 10 March 1966, as the Special Court found. I come to the conclusion, therefore that the Secretary was in the circumstances in law entitled to invoke the provisions of section 103(2)".*

Thus, it was not necessary that any change to the **taxpayer's** shareholding had occurred - it was sufficient that an **agreement** had **affected** the taxpayer.

Botha JA also rejected the argument that the change of shareholding and the utilization of the assessed loss had to occur in the same company before the Secretary could invoke section 103(2). He stated, at page 335:

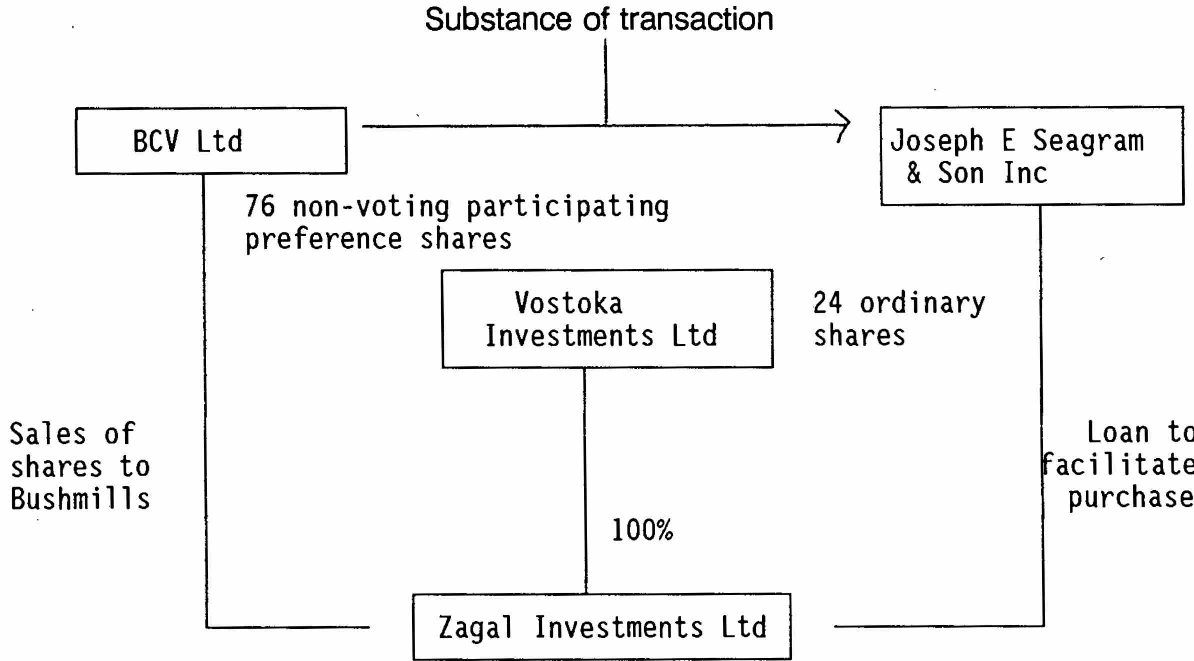
"It is so unlikely that the legislature could have intended, by the mere substitution in 1959 of the words 'that company' for the words 'any company' where they appeared for the second time in that section, to have narrowed the field within which the Secretary could have invoked the provisions of the new section 90(1)(b), by excluding from it an attempted tax avoidance by agreement, that it can be ignored as a possible object of the legislature."

In the United Kingdom attempts to avoid Capital Gains Tax (CGT) have led to the use of separate corporate entities in various ways.

Burman (HM Inspector of Taxes) vs Hedges and Butler Ltd 1978[57]

The issue at stake was whether the profit on disposal of the shares of a company (Bushmills) should attract CGT. A company in one group wished to sell the shares to a company in an unrelated group. Such a transaction would, under normal circumstances, attract CGT - being a disposal to a third party.

In order to avoid CGT, the parties entered into the following scheme:



Steps:

1) Vostoka was incorporated with the following capital structure: £

- total share capital 100

Divided into:

a) 76 non-voting, participating preference shares entitled to a maximum of £76 on liquidation - allotted to BCV Ltd (it is critical to realize that the nature of these shares caused Vostoka to be regarded, for tax purposes as part of the BC Group). 76

b) 24 ordinary shares carrying all the rights to vote and the entitlement to the balance on liquidation after the participating preference shares - allotted to Seagrams 24

100

2) Zagal was incorporated as a wholly owned subsidiary of Vostoka.

3) BCV Ltd then disposed of the Bushmills shares to Zagal, CGT was not payable as the disposal was "inter-group".

Zagal was able to purchase the shares as a result of a loan by Seagrams.

4) Vostaka was then liquidated. As holders of the participating preference shares, BCV received £76, Seagrams as holders of the ordinary shares received the balance of Vostoka's assets, ie. the shares in Zagal which owned the Bushmills shares sold to it by BCV.

In effect, what had been achieved was that Seagrams, indirectly (via Zagal) controlled Bushmills and BCV had avoided CGT.

Revenue's main contention was that Vostaka had acted as agent for BCV and Zagal had likewise acted for Seagrams. Thus, in substance the real transaction/disposal was one between BCV and Seagrams, ie not inter-group and therefore did attract CGT.

The comments of Walton J may be noted, at page 513-514:

> " This suggestion (that Zagal was from the first acting as a nominee or agent for Seagram), appears to me wholly without foundation in fact, and in any view, whilst of course there is no reason at all why a subsidiary company (like anybody else, but doubtless, just because it is a subsidiary company, with rather a greater degree of likelihood) should not be an agent or nominee for its parent company, **whether or not it is in fact such as a pure question of fact** to be determined by a consideration ... of the whole of the facts of the case, of the relationship between the parties and the **documents and engagements which each of them has entered into".**

Walton J continued at 514 I:

> *" The parent/subsidiary relationship is fundamentally different from a principal/agent relationship and we think it would be wrong to make an assumption that a company in Zagal's position is acting as agent for a company in Seagram's position simply because Seagram is quite patently able to tell it what it should do and how it should act - and that is all that the evidence points to here. Our conclusion, therefore, is that Zeagal was not at the relevant time agent or nominee for Seagram when it took the transfer of the Bushmills shares and accordingly there was a disposal of assets from one member of the group (BCV) to another (Zagal)."*

and again at 516B:

" Although Mr Millett, by way of what I might perhaps call a pre-emptive strike, disclaimed any intention of relying upon the ***now well and truly exploded doctrine of the substance of the transaction,*** *this was, in effect, precisely what he was attempting to do in his argument.*

It is felt that the following points should be noted in regard to this decision:

1) the relationship between a holding company and its subsidiary **may** be one of principal and agent, but this cannot be assumed in all cases merely as a result of the relationship. The facts of each case will indicate whether such a relationship exists.

2) Walton J rejected the notion of the "doctrine of the substance" of the transaction.

3) As in Hicklin's[19] case, Walton J insisted that the actual "documents" and "engagements" entered into by the parties be given effect to.

Having thus illustrated the type of scheme the taxpayer would consider to avoid CGT, it must be noted that the fairly narrow approach of the Chancery Division, has been significantly changed. This followed the decision of the House of Lords in *WT Ramsay Ltd v CIR*[55].

The Ramsay case, referred to in a number of subsequent decisions, adopted a far more pragmatic approach to the totality of the facts and it involved delving into the real crux of the matter. The disdain with which Walton J referred to the "substance of the transaction" was rejected by the House of Lords who indicated that they wished to ascertain the "true position".

To quote Lord Diplock from the subsequent case of *CIR v Burmah Oil Company Ltd*[56] at 214 D:

" It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end)..."

At 215 F, he notes:

" I agree with Lord Fraser of Tullybelton that the approach to tax avoidance schemes of this character sanctioned by Ramsay entitles your Lordships to ignore the intermediate circular book entries and to look at the end result,..."

In applying the concept of the "substance of the transaction" or what we would call substance over form, the House of Lords disregarded the interpositioning of a separate Isle of Man company, where its sole purpose was the avoidance of CGT. The House lifted the veil and held that the Isle of Man company,in effect was the agent of its members. (Furniss (H.M. Inspector off Taxes) v Dawson 1984[54]

It may therefore be concluded that in so far as CGT avoidance schemes are concerned in the United Kingdom, courts are likely to apply the concept of substance over form.

A Canadian case dealing with alleged tax avoidance using a separate company as a vehicle was also reviewed.

Natural Retreats of Nova Scotia Ltd v Minister of National Revenue 1979[75]

This case involved an attempt by Revenue to apply the Canadian equivalent of section 103, namely section 245(1), in disallowing commissions, fees and interest paid by the appellant to its wholly owned Bermudan subsidiary (Vacatia Ltd). The appellant contended that the Bermudan subsidiary was a "real" company involved in marketing

and selling the appellant's Canadian property. The reason for its formation in Bermuda was to attract business from wealthy holiday-makers vacationing there. It was held by the tax review board that the Bermudan subsidiary was in fact the agent of the appellant and therefore the deductions claimed by the appellant were not allowable.

The President of the Board, Guy Tremblay noted, at page 2496 that what has to be asked (in relation to the acceptance of the subsidiary as a separate persona) is:

> *" Is the transaction (including incorporation of Vacatia Ltd and division of profits) a sham or a bona fide commercial one and consequently with significant business purposes?"*
>
> *" In other words, who, in the present case was really carrying on the business? Vacatia Ltd or Natural Retreats of Nota Scotia Ltd?"*

In answering the question, Tremblay referred to the United Kingdom case, of *Smith, Stone and Knight Ltd v Lord Mayor, Alderman and Citizens of the City of Birmingham*[45], in which Atkinson J noted various enquiries which could be made. Summarized, they are:

1) Were the profits of the subsidiary treated by the parent as its own?

2) Were those in effective control of the subsidiary appointed by the parent?

3) Did the subsidiary really control its own operations, with an element of independence from its parent?

4) Was the subsidiary's every move controlled by the parent?

In applying the above tests, the Board came to the conclusion that Vacatia Ltd was in reality the agent of the appellant.

In the course of the judgement, various earlier cases were cited. In relation to the recognition of a separate legal entity, the case of *Dominion Bridge Company Ltd v MNR [1975]*[77] is of interest.

Briefly stated, the facts of the case were that a Canadian steel manufacturing company incorporated a wholly-owned subsidiary in the Bahamas. The ostensible purpose of this subsidiary was that it would source all the appellant's foreign steel requirements. Extreme care was taken to give an appearance of independence to the operation of the subsidiary. The appellant was the subsidiary's only customer and it chose to pay the subsidiary a higher price for steel on-supplied than the Canadian market price for similar imported steel.

Revenue reassessed the appellant, disallowing portion of the cost of purchases from the subsidiary (as being excessive) as well as other amounts paid to the subsidiary, on the basis that the subsidiary was in reality carrying on the appellant's business and not an independent trade.

The appellant company appealed on the basis that its subsidiary was a separate legal entity.

In dismissing the appeal, it was stated that:

> *" The Minister had correctly added back the sham expenses claimed by the plaintiff.* ***The Plaintiff was in fact carrying on its own business under the guise of a subsidiary,*** *which had no bona fide operations pertaining to the off-shore steel. The pervasive control of every step of the subsidiary's activities by plaintiff's vice-president prevented any freedom of action on the part of the subsidiary. Incorporation and the alleged operations of the subsidiary were a sham. From a formalistic view, the profits were those of the plaintiff because the subsidiary was only a puppet.* ***The relationship between them was so close as to make them a single entity.*** *In reality, the off-shore steel purchasing department of the plaintiff was transferred off-shore and incorporated off-shore, but supervision and control*

remained the same as if there had been no other legal entity involved. What the plaintiff was claiming as expenses was in fact income in its hands. By paying excessive prices for the off-shore steel, the plaintiff was intending to keep in a tax-free country a part of its profits which could always be repatriated into Canada tax-free. The paramount objective of the exercise was the avoidance of tax."

In concluding this section on tax avoidance, it is appropriate to attempt to distil some general principles from the earlier discussions. The following may be noted:

1) In the earlier cases reviewed (1970's to mid 1980's) it seems that courts in South Africa and in the United Kingdom adopted a fairly narrow, formalistic approach in tax avoidance cases,

2) it is submitted that this has changed and the current thinking is that the true intentions and real objectives of the parties have to be ascertained,

3) having said this, it could be anticipated that the concept of substance over form would prevail, and

4) to the extent that a separate legal entity existed "in name only" and not in commercial reality - it's separate existence would not be accepted.

It is felt that this "commercial reality" approach would be applicable in other countries, such as the United States, Canada and Australia.

SPECIFIC ASPECTS OF GROSS INCOME AND DEDUCTIBLE EXPENDITURE

1. GROSS INCOME

In the South African context, as mentioned earlier, the most prevalent topic to which

the concept of the corporate veil is applicable is that of the intention of a corporate entity in relation to the disposal of its property. In deciding whether the proceeds on disposal should be regarded as being of a capital or revenue nature, courts traditionally have regard to:

a) The original intention (if applicable) of the company at acquisition of the property,

b) whether there have been any subsequent changes of (or formation of) intention, and

c) the intention with which the company disposed of the property.

As discussed earlier, it is often imperative to ascertain from what person or group of persons the company's "intention" should be imputed. For simplicity, I have grouped various cases of this nature together under the general heading of "realization cases".

1.1 CAPITAL AND REVENUE

1.1.1 REALIZATION OF COMPANY PROPERTY

The cases reviewed, and grouped under this heading are:

1)	Lace Proprietary Mines Ltd v CIR[32]	1938
2)	CIR v Richmond Estates(supra)	1956
3)	African Life Investment Corporation (Pty) Ltd v SIR(supra)	1969
4)	SIR v Trust Bank[26]	1975
5)	Berea West Estates (Pty) Ltd v SIR[24]	1976
6)	SIR v Rile Investments (Pty) Ltd[22]	1978
7)	Elandsheuwel Farming (Edms) Bpk v SBI[23]	1978
8)	ITC 1299[20]	1979

9)	Constantia Heights (Pty) Ltd v SI[21]	1979
10)	ITC 1238(supra)	1980
11)	ITC 1406[15]	1985
12)	CIR v Malcomess Properties (Isando) (Pty) Ltd[11]	1991
13)	GRE Insurance Ltd v FCT[73]	1992

To a large degree, these decisions are relevant in relation to the establishment of the company's "intention" which has been addressed earlier (page 30). Other points made, in these cases pertinent to the corporate veil will now be discussed.

Lace Proprietary Mines Ltd v CIR 1938[32]

One of the questions to be addressed in relation to the issue of the appellant's "intention" viz and viz the mineral rights disposed of, was its general dealings with such rights.

Counsel for the taxpayer tried to argue that the company was in fact involved in exploiting other similar rights (ie dealing with the rights in a "revenue" manner) **by virtue of holding shares in a separate mining company**. It had acquired these shares in exchange for the cession to the other company of the mineral rights.

Stratford CJ rejected this line of reasoning that the activities of a company in which the taxpayer merely held shares could be imputed to the taxpayer. He stated on page 360-361:

> *".... it is argued that the effect of holding shares in that company was to make the appellant company a partner in the working company; in other words that the operations of the buying company were the operations of the appellant company pro tanto to its holding of shares. I disagree entirely that this is the proper legal light in which to look at this transaction. The disposal to the Vlakfontein Company*

was simply a sale to another legal persona and in law it matters not whether the appellant company by means of its large shareholding retained control of it or not."

Thus, it would appear that a shareholder (whether natural or artificial person) will not be classified/characterized in any way by virtue merely of holding shares in a particular type of company.

Berea West Estates (Pty) Ltd v SIR 1976[24]

Counsel for the secretary raised the point, at page 48 that the court was obliged to differentiate between two things:

a) The motive (of the beneficiaries) leading to the formation of the company, and

b) the intention of the company itself.

Bearing in mind earlier discussion on the question of intention, one can see the flaw in counsel's argument, in this instance. In this case the beneficiaries formed the company and became shareholders and directors, thus it is unlikely (but not impossible) for the "intention" of the company to differ from that of its beneficiaries/members/directors.

Holmes JA, in rejecting counsel's argument indicated that a court is not "blinkered" and takes into consideration "all the circumstances"

CIR v Malcomess Properties (Isando) (Pty) Ltd 1991[11]

The court rejected the Commissioner's contentions that:

a) Malbak should be regarded as trading in property for profit, and

b) as one of its subsidiaries (Rushton) acquired the shares of the taxpayer on 23/8/1976 and the taxpayers' property was disposed of on 27/8/1976,

c) the profit on disposal realised by the taxpayer should be taxable.

Nicholas AJA, in delivering the judgement of the court made various observations.

At page 163:

> *" That sale was, it is true one facet of the entire scheme - but Malcomess (Isando) was not a party to that scheme. Malcomess Properties and Malbak operated at* ***arm's length."***

At page 164:

> *" ... Malbak's intention or purpose in embarking upon it (the scheme) has no bearing on the question whether the taxpayer continued to hold the Isando property as a capital asset. It was argued however that Malbak's intention to make a profit was attributable to the taxpayer because* ***its controlling mind at that point in time was in fact the Malbak Group, which through Rushton, was in control of the taxpayer at the time the property was sold."***

At page 165:

> *" Counsel for the appellant submitted that on 23 August 1976 Malbak acquired all the issued shares in Malcomess (Isando) and so acquired control of the company; and that the advent of the new controllers brought about a change in its intentions. He said that at the time the property was sold on 27 August 1976, Malbak 'already had executive control of the taxpayer'* ***and it was the intention of Malbak which determined the intentions of the taxpayer in entering into the transaction."***

In rejecting the Secretary's contention Nicholas stated that:

1) The acquisition by Rushton (the Malbak subsidiary) of the shares in Malcomess (Isando) on 23/8/1976 was **conditional** upon the sale and leaseback being concluded. It could therefore not be said that Malbak had in fact acquired control as the transaction was subject to a condition precedent.

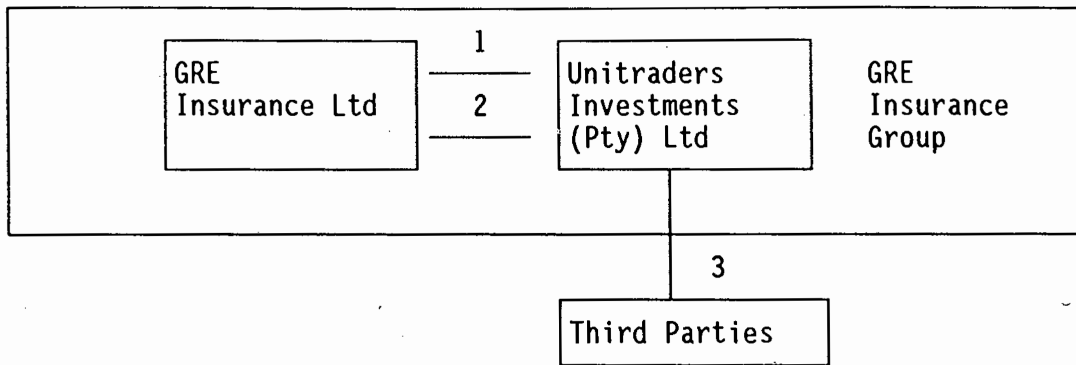
2) Secondly, Nicholas contrasted a controlling interest with "de facto" day-to-day control and noted that whilst in nominal terms Malbak did acquire control (subject to the condition precedent), it was not yet in reality in effective control of the taxpayer's operations.

It may also be observed that the profit-making intention of Malbak was imputed to its subsidiary Rushton Properties Ltd. No comment was made in relation to this and it must be assumed that all the parties were in agreement that Rushton was acting as agent for Malbak.

It may be noted in comparing the Malcomess decision to that in Elandsheuwel Farming, that each case will be decided on its own facts. Although there were certain similarities between the facts of the two cases, the courts arrived at opposite decisions.

GRE Insurance Ltd v FCT 1992(73)

In this recent Australian Federal Court case, the fact that separate legal entities were involved came back to "haunt" the taxpayer. Diagrammatically reflected, the parties involved were:



In transaction 1) GRE purchased all the shares of Unitraders with the purpose of selling its equity portfolio to Unitraders at a later date. The reason for this was that as GRE was expecting to enter a period when it would have no taxable income, it would lose the benefit of certain tax relief in respect of dividend income. It was intended that Unitraders (which was likely to have taxable income) could utilize the tax relief provisions.

In transaction 2), GRE sold its equity portfolio to Unitraders and the amount owing was left outstanding on loan account. In terms of this transactoin GRE realized a profit on sale.

In transaction 3), Unitraders sold some of the equities it had purchased from GRE, to third parties during the course of its ordinary business operations. Again profits were realized.

The Commissioner contended that the profits realized in transactions 2) and 3) should **both** be subject to tax. The taxpayer argued that neither profit, ie realized by transaction 2) or 3) was taxable. In respect of transaction 2), the taxpayer contended that:

a) The profit was not realized in terms of the ordinary course of business,

b) that it was a "special event" of a structural kind in the reorganisation of the business,

c) that the reorganisation was related to the capital structure of the group.

In respect of transaction 3), the taxpayer contended that the investments were intended to be held as long-term capital assets and that their realization was of a capital nature.

The court held in favour of the Commissioner, and the profits realized on both transactions were taxed. It thus appears that from the group's point of view the profit that would have been subjected to tax on disposal by GRE to a third party had Unitraders not been interposed, was split into two stages; with part being realised on the disposal to Unitraders and the balance on disposal by Unitraders to third parties. In other words, there was no double taxation of the same profits, but tax was merely payable earlier than it would otherwise have been in respect of the disposals.

Although it was not referred to in the judgement, possibly GRE was attempting to "camouflage" part of the ultimate (taxable) profits it expected to realize by interposing Unitraders.

In the course of the judgement, various comments pertaining to the separateness of the different companies were made:

At page 92-93:

> *" **The group treated GRE and Unitraders as one.** Unitraders had no separate premises or staff of its own but paid annual management fees to GRE".*
>
> ***The trial judge considered that the activities of Unitraders were to be treated as separate from the insurance business.** His Honour held:*

" In the present case Unitraders was a separate entity. It did not carry on the business of an insurer and was not licensed to do so. Its assets were not required by its parent to meet statutory solvency ratios or any other requirements under the Insurance Act.

In our respectful opinion, however, ***the activities of Unitraders were an integral part of the insurance business conducted by GRE.*** *Although the equities were held by the wholly owned subsidiary rather than by GRE directly, the equities indirectly formed part of the funds representing the insurance reserves and part of the circulating capital of the business....*

As the reason for holding the equities in Unitraders rather than GRE was to enhance the profits, the after tax profits, of the insurance business, we are unable to regard the activities of Unitraders as being other than an integral part of the insurance business, whose profits were by this technique increased.

The interposition of the wholly owned subsidiary between GRE and the portfolio of equities was not a capital transaction *such as was under consideration by Kitto J in the National Bank of Australia case.*

It is true that the sales from GRE to Unitraders were not ordinary transactions in that the shares remained within the group. The equities were not sold by GRE to Unitraders because it was a prudent time to dispose of or realise the investments. Nevertheless, profits were made on the sales of assets that formed part of the circulating capital capital in the sense we have described. ...

In the present case, Unitraders was introduced into the affairs of GRE solely to ensure that the benefit of the section 46 rebate would not be lost in the event that underwriting losses brought GRE to the position that it had no taxable income. ***Unitraders was a separate entity from GRE but its activities reflected, indeed formed part of, the overall business in which GRE was engaged."***

It is felt that the following statements may be made in the context of this judgement:

1) It is unlikely that the character (capital/revenue) of proceeds on disposal of assets can be altered by interposing a wholly-owned subsidiary company, (although see Federal Coke Co below).

2) In attempting to maximise the tax relief available to a group as a whole, care must be taken not to "create" profits that would otherwise not materialise.

1.1.2 COMPENSATION RECEIVED

Federal Coke Co Pty Ltd v FCT 1977[71]

The decision facing the court in this case was whether the receipt of compensation by a subsidiary, related to the variation of a contract between its parent and a third party, was of a revenue or capital nature.

The parent company, Bellambi Coal Co Ltd (Bellambi), had entered into a contract to supply coke to a French manufacturer, Le Nickel. Subsequently, the contract was varied to the prejudice of Bellambi which resulted in the payment of compensation by Le Nickel.

Bellambi had various coke producing subsidiaries, of which Federal was one. Due to the pressure of environmental legislation, these subsidiaries were, at the time of these occurrences, under threat of closure.

Initially, Le Nickel tendered payment of the agreed compensation to Bellambi. Bellambi having taken tax advice, declined to accept the payment and arranged for an amended agreement to be entered into with Le Nickel, in terms of which payment would be made to Federal, **ostensibly in compensation for the closure of its business operations.**

The Commissioner attempted to tax the compensation received by Federal as being of a revenue nature (loss of profits). Federal contended that the nature of the receipt was capital as it related to the permanent discontinuance of its business.

The Federal Court held in favour of the taxpayer, reversing the decision of the court a quo.

The following comments were made in relation to the effect of the separateness of Federal.

In the judgement of Bowen CJ, at pages 526 - 530:

"But Bellambi refused to accept the sum of $500,000. Eventually a like sum with adjustments was paid by Le Nickel to Federal in accordance with the deed of 22 March 1972. ***Had an assessment then been raised against Bellambi,*** *it might perhaps have been argued that the $500,000 had accrued due to Bellambi as income and had been paid by Le Nickel to a subsidiary of Bellambi in accordance with the order and directions of Bellambi. ....*

In the result, none of these bases of assessment were adopted by the Commissioner. ***He assessed Federal upon the receipts so that the question for determination by the Court is not what would have been the character of the receipts in the hands of Bellambi, but what, for the purposes of income tax, is the character of the receipts in the hands of Federal".*** *(526-20).*

" Certainly the deed was not attacked as a sham or by reference to section 260. Undoubtedly the payments were made pursuant to the deed. But Counsel for the Commissioner challenged the correctness of the recitals and submitted that ***the Court should look to the whole of the circumstances.*** *I agree that the Court is not bound to restrict itself to the deed and is not bound by the terms of the deed in characterising the payments to Federal."*

" When the arrangements between Bellambi and Le Nickel were altered, as appears from the deed of 22 March 1972, ***the decision that the payment should be made to Federal seems to have been largely for the purpose of avoiding income tax".*** *(527-20)*

" ***His Honour appears to have considered that he could approach the characterisation of the receipts in the hands of the taxpayer by treating them as if they were received by Bellambi or the Bellambi group. One may have some sympathy with an approach of this kind.*** *However, in taxation matters, the Court is obliged to have regard to the actual facts and not to their equivalents. In cases where it is appropriate the Court may apply a statutory provision such as section 260 to get rid of a contract, agreement or arrangement and deal with the case in disregard of that element, but, where there is no statutory warrant for doing so, the Court cannot disregard certain of the facts or rearrange the facts or decide the case according to its view of the substance of the matter. It is not legitimate to disregard the separateness of different corporate entities or to decide liability to tax upon the basis of the substantial economic or business character of what was done.*

" ***Indeed, it appears to me that the starting point of this argument for the Commissioner is wrong.*** *When one is considering the character of an amount received by a taxpayer, the enquiry must start with the question: what is the character of the receipt in the hands of the taxpayer? It appears to me to be wrong to ask: what would have been the character of the amounts had they been received by Bellambi? and then to pose the question: has their character been changed by the fact they were paid to Federal? ...*

" It then becomes less than decisive to observe that, in their origin, and if they had been received by Bellambi, they may have been of an income character. Each receipt in the hands of Federal is broadly in the nature of a gift, being a sum received without consideration." (529-10)

" It does not appear to me that the motive of Bellambi of avoiding tax, whatever view one may take of that motive, when taken into consideration with all the circumstances of the case can alter the position so as to lead to a conclusion that the receipts in the hands of Federal bore the character of income and not of capital.

At page 538-20 Nimmo J stated as follows:

" Counsel for the Commissioner argued that there were special considerations in this case based upon the relationship between Bellambi and Federal, viz, that of a ***parent company and its wholly-owned subsidiary..... I cannot accept this argument. As the law stands in Australia today, Federal is a separate and independent entity - Slutzkin v Federal Commissioner of Taxation (1976) 7 ATR 166 - and for that reason the fact that it is a wholly-owned subsidiary of Bellambi cannot operate to give the payments it received from Le Nickel a character they would not otherwise have.***

As the Commissioner elected to tax Federal and not Bellambi in respect of the two instalments, possible application of the provisions of sections 19 and 260 of the Income Tax Assessment Act 1936 was not argued before us.

The following observations may be made in relation to this decision:

1) Both Bowen CJ and Nimmo J seemed to imply that the Commissioner challenged the wrong party, on weak grounds. They seem to suggest that a better case could perhaps have been made by challenging Bellambi on the basis of tax avoidance. However, as a Commissioner "chose his weapons", so he had to abide by the consequences.

2) The character of a receipt must be judged from the perspective of the taxpayer in question, and no one else.

3) A court is bound to take cognizance of actual documents and related evidence - it cannot merely "ride roughshod" through the party's formal acts and apply an economic entity approach.

4) Taking cognizance of the period when this decision was handed down (viz late 1970's), the prevalent judicial thinking at the time seemed to be fairly narrow and formalistic ("form over substance"). The decision in *Burman v Hedges and Butler* (referred to on page 46) handed down at approximately the same time could also with respect, perhaps be construed as rather narrow and formalistic.

   Considering the significant shift in judicial emphasis demonstrated by the Ramsay case (page 49), it is felt that were this case heard in the Australian Federal Court today, a different decision may be arrived at.

1.1.3 RECEIPT BY A DIRECTOR OF "EMOLUMENTS" FOR OTHER SERVICES

Harmel v Wright 1974[91]

A Sumption, writing in the British Tax Review, commented on this case.

The issue to be decided was the nature of receipts by the taxpayer in the United Kingdom. The taxpayer received the emoluments in question from two South African companies. These emoluments were then used to subscribe for shares in a South African company called Artemis. Artemis then loaned the money to a second South African company called Lodestar which lent it to the taxpayer in the United Kingdom.

Counsel for the taxpayer contented that what was received in the United Kingdom was a loan (capital) rather than taxable emoluments.

Templeman J disagreed and (although denying it) clearly lifted the corporate veil in order to:

"keep one's eye on the emoluments, on the original sum of £25 000, and see what happens to it".

Sumption, in respectfully disagreeing with the ratio of Templeman, states at page 51:

" Parliament can declare that loans shall be deemed to be income as indeed it did in section 478 and, indirectly section 451 of the Income and Corporation Taxes Act 1970. ***Judges cannot".***

In concluding, Sumption refers to a particular taxing provision within the ambit of which the "emoluments" fell to be taxed. Thus he reasoned, the correct conclusion was reached, albeit it for the wrong reason.

1.2 RECEIPTS BY A COMPANY WHICH WOULD BE EXEMPT IN THE MEMBERS HANDS

Kinookimaw Beach Assoc. v Board of Revenue Commissioners 1978[89]

The above Canadian case addressed this issue.

The basic facts were that land which had been set aside for use as an Indian reserve, was to be developed by various Indian tribes. As part of the plan the seven tribes decided to incorporate a company to undertake the development.

The problem which was subsequently discovered, was that had the tribes acted as partners or in terms of any arrangement other than an incorporated entity, all proceeds from the development would have been exempt from tax in terms of a specific provision.

The question before the court was whether or not it was entitled to lift the veil of the company, in order to grant the desired exemption.

During the judgement (at page 753), the general circumstances in terms of which other Canadian courts had lifted the veil, were noted:

1) One company is the agent of another,

2) one company acts as a cloak for the actions of another,

3) one company is so extensively controlled by another that in reality they constitute one common unit,

4) for the just and equitable enforcement of a tax law.

It could perhaps be felt that 1), 2) and 3) could all fall under the single heading of agency.

The ratio of the court a quo was that if a court could lift the veil to prevent taxpayers avoiding tax, it was **just and equitable** that it could also lift the veil to grant the benefit of an exemption where this was aimed at a particular group of persons.

The decision of the court a quo was reversed on appeal. In upholding the separateness of the company, it was stated at page 88:

"that the autonomous and independent existence of the corporate structure must be accepted and respected, unless it can be shown that such structure is being deliberately used to defeat the intent and purpose of a particular law or is intended to or does convey a false picture of independence between one or more corporate entities ..."

At page 89:

" If it is decided that the best way to achieve certain objectives is by forming a company, then should it not also follow that fiscal benefits or disadvantages should be assessed accordingly."

It is felt that two principles may be drawn from this decision:

1) A court is unlikely to accept "self-piercing" by the company itself, in order to avail itself of tax benefits. If a separate entity is established in error, the taxpayer will have to bear the consequences.

2) It is unlikely that a court will lift the veil to reduce the burden on a company - while it may well lift the veil where it is felt that tax has been avoided.

1.3 SOURCE OF INCOME

TRANSVAAL ASSOCIATED HIDE & SKIN MERCHANTS v COT, BOTSWANA 1967[28]

The issue for decision in this case related to the determination of the source of the taxpayer's income from the sale of hides. Various activities were undertaken in Botswana and others in South Africa. The ratio of the judgement was that the dominant activities (dominant originating cause) were in Botswana and the source of the taxpayer's income was thus Botswana.

The facts are very simply stated but demonstrate the type of problem that may be encountered when the activities of a single company are conducted in different countries. Obviously, the impact of a double-tax agreement, where applicable, would need to be taken into consideration.

It is submitted however than once a taxpayer's business operations in another

country become significant, it is likely to be best to incorporate a separate legal entity in the foreign country. In addition to the tax aspects, various other issues may be addressed:

1) From a tax point of view, the establishment of a separate legal entity ensures the integrity of the taxpayer's earnings to an extent not otherwise possible where business is carried on in terms of an unincorporated structure. Within reason, the taxpayer is able to dictate the source of income. In addition, intercompany expenditure is also more likely to be accepted.

2) to a degree, international profit shifting can be managed via transfer pricing. Certain countries have specific legislation to curb transfer pricing abuse (eg. Division 13 in Australia). From a practical point of view however, it may well be extremely difficult for the Revenue to disprove a taxpayer's contention that a particular transfer price is in fact reasonable.

3) non-tax consideration would include:

   a) Limitation of liability in the foreign country,

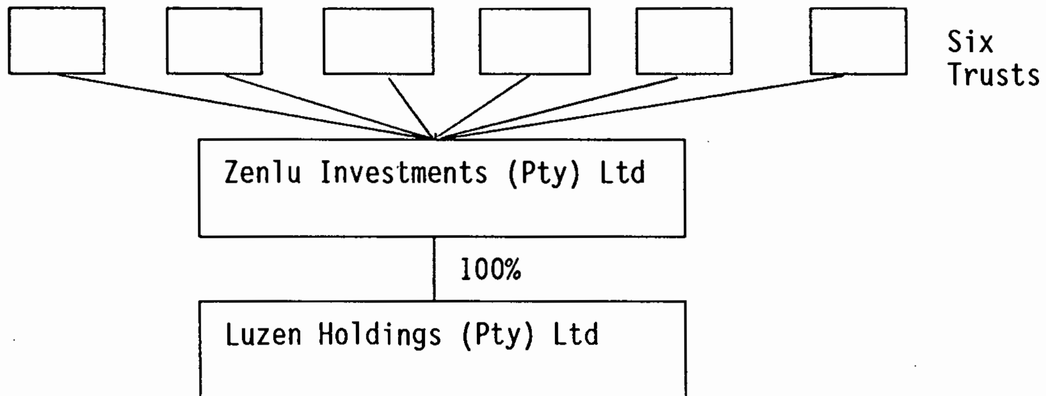
   b) reflecting commitment to undertaking business in the foreign country, and

   c) trade practices or legislative provisions.

1.4 WHICH PARTY SHOULD BE TAXED ON THE INCOME?

CIR V BEROLD 1962[29]

This case dealt with dividend income received by six trusts and who should be liable for tax thereon. The following structure was in place:



The Commissioner contended that the "effective cause" of dividends being received by the trusts, was the continuing interest-free loan made by the taxpayer to Luzen in respect of assets which it had purchased from him.

In finding in favour of the Commissioner, the court lifted the veil of both Zenlu and Luzen in order to ascertain the originating or effective cause of the income being earned. As Templeman did in Harmel v Wright (page 66), so Hoexter JA in this case "kept" his eye on the benefits which flowed from the non-charging of interest by the taxpayer.

The following statements are relevant:

At page 730, P Schock Q.C., for the Commissioner stated that:

" To determine the 'effective cause', the real substance, and not merely the form, of the transaction must be looked to."

Hoexter JA, at pages 736-737:

" I have already pointed out that, although in form the dividend in question is derived from Zenlu, in fact it is derived from the taxpayer's donation, and the

Court should not allow the forms of the company law to cancel the effective casual connection between the taxpayer's donation and the income accumulated for the benefit of the children."

Thus, it is clear that even though this case was heard in 1962, the court was, under the circumstances, quite prepared to lift the veil of the two companies in order to ascertain the effective cause of the income accruing to the trusts.

It is interesting that if one were to compare this case to cases dealing with section 103, at approximately the same time, one would probably find, in general, a narrower and more formalistic approach being applied in the context of alleged tax avoidance.

Paul F White v Minister of National Revenue 1979[79]

The issue for decision related to who, in fact, was carrying on the opticians business - Mr White or a company in which he owned all the shares, (Palmak Ltd). In assessing the taxpayer, the MNR reduced the taxable income of the company and increased that of to the taxpayer in his personal capacity. The MNR was satisfied that certain income did in fact accrue to the company in relation to management services provided.

The Tax Review Board held in favour of the MNR and Dubrule Q.C. stated, at page 2070:

" There is no doubt that Palmak was a legally incorporated company. However, unlike the corporation in the Cameron case, the persons who dealt with the optometrist business had no idea they were dealing with Palmak, if they were. As far as the business was concerned, the customers of the business - the patients of the optometrist business - had no knowledge of Palmak or its existence; its name appeared nowhere, it was not listed in the telephone book,

and the invoice and the receipts for payment for all services were in the name of the appellant".

Thus, where a legally incorporated company exists, it may still be disregarded by the courts where it is in fact disregarded by those in effective control of its operations.

RALPH J SAZIO v MINISTER OF NATIONAL REVENUE 1969[76]

The taxpayer in this case had, amongst other business activities, been rendering soccer coaching services to a professional football club in an employee capacity. When he subsequently incorporated a company and become its sole member and director, it was decided that the company should in fact render the soccer coaching services to the club, instead of the taxpayer. The MNR contended that in reality the income in respect of the provision of coaching services was that of the taxpayer and not that of the company.

In holding in favour of the taxpayer, the Tax Review Board stated that:

" The amounts involved in the appeal were not income of the appellant. The company formed by him was a properly constituted legal entity and could legitimately carry on the objects described in its charter. Unlike in Kindree v MNR (64 DTC 5248) where the rendering of services was restricted to natural persons under the general tenor of the Medical Act and the code of ethics of the medical profession, there was no such restriction imposed in this case. A company must, from its very nature, act through natural persons. The fact that it may have been formed to serve the interests of a particular person did not necessarily mean that a principal agent relationship was established between that person and the company. The company in this case was fully competent to engage in football coaching activities, and the agreements entered into in connection with these activities were bona fide commercial transactions."

1.5 DEEMED INCOME - INTEREST

Massey Ferguson Ltd v Minister of National Revenue 1974[78]

The above case dealt with an interest-free loan by the appellant to a wholly owned (Canadian) group finance company which then "on-lent" the funds to its (the finance company's) wholly owned American subsidiary. The MNR detected that the funds had been transferred directly from the appellant to the American company and therefore attempted to tax the appellant in respect of deemed interest resulting from an interest-free loan to a non-resident company. It was further contended that the accounting entries processed in the books of the Canadian finance company were a sham, merely intended to link it to a transaction to which in reality, it was not a party, in order that the taxpayer would avoid being taxed on the deemed interest.

The Federal court of appeal rejected the MNR's contention that the interposition of the finance company (wholly owned subsidiary of the appellant) was a sham. The court upheld the separate entity status of the finance company and confirmed that by virtue of its ongoing activities, there was no reason to deny that it was a party to the loan.

2. EXPENDITURE AND LOSSES

2.1 CAPITAL v REVENUE

2.1.1. RENT PAID

LITTLEWOODS MAIL ORDER STORES LTD v IRC 1969[48]

The IRC's challenged the deductibility of rent paid by Littlewoods. The background to the challenge may be summarised as follows:

a) Originally, Littlewoods leased its business premises from a non-taxable friendly society (Oddfellows), for £23 444 p.a. in terms of a 99 year lease (88 years unexpired at the time),

b) in 1958 an agreement was concluded, in terms of which:

   i) A wholly owned subsidiary of the taxpayer (Fork Manufacturing Company Ltd) acquired freehold title to the property in return for leasing it to the original freeholders (Oddfellows), for a nominal rental of £6 p.a. for 22 years,

   ii) Oddfellows entered into a sub-lease with Littlewoods for 22 years at the increased rental of £42 450 p.a.

Thus in effect what had been achieved was the substitution of a 22 year lease and freehold title thereafter for the unexpired portion (88 years) of a 99 year lease (without freehold title).

The IRC's contended that the differences between the new rental of £42 450 p.a. and the original rental of £23 444, viz £19 006 represented capital expenditure to acquire the freehold title to the property and was therefore not deductible. The fact that the freehold title would belong to a separate legal entity (the Fork Manufacturing Company Ltd) and not the taxpayer was considered to be of no consequence by the IRC's as the Fork Manufacturing Company Ltd was a wholly-owned subsidiary of the taxpayer. Counsel for the taxpayer argued that the fact that freehold title vested in a separate legal entity made all the difference, as the taxpayer could not be said to have acquired a capital asset.

The court of appeal held in favour of Revenue - thus in effect treating the two separate legal entities as one.

At page 860E, Lord Denning MR stated:

" *Counsel for the taxpayers said that the interposition of the Fork company made all the difference, albeit it was a wholly-owned subsidiary of the taxpayers. He said that the Fork company was to be regarded as a separate and independent entity, just as if its shares were owned by someone quite unconnected with the taxpayers. In that case the freehold of Jubilee House would be acquired by the Fork company. The taxpayers would have acquired no capital asset at all. They would be able to deduct the whole £42,450 a year.*

I cannot accept this argument. I decline to treat the Fork company as a separate and independent entity. ***The doctrine laid down in Salomon v Salomon & Co, Ltd has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil.*** *They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit. I think that we should look at the Fork company and see it as it really is - the wholly-owned subsidiary of the taxpayers.* ***It is the creature, the puppet, of the taxpayers in point of fact; and it should be so regarded in point of law.*** *The basic fact here is that the taxpayers, through their wholly-owned subsidiary, have acquired a capital asset - the freehold of Jubilee House; and they have acquired it by paying an extra £19,006 a year."*

The court's order was that the original rental £23,444 p.a. be allowed as a deduction and the additional amount of £19,006 not be allowed, as being of a capital nature (apportionment).

It is submitted that section 23(g) could be interpreted similarly.

2.1.2. LOSSES ON IRRECOVERABLE LOANS

ITC 1321 1980[17]

The taxpayer, together with 3 associates wished to acquire certain agricultural land which they intended to develop together. As the legislation at the time prohibited the registration of such land in the name of more than 1 party, a number of companies were formed to expedite the venture. These companies were funded mainly by shareholders loans and had only nominal share capital.

When disposing of his shares and loan account in one of the companies, the proceeds realized was lower than the aggregate value of the shares and the loan. The taxpayer attempted to deduct the full loss, including the loss related to the irrecoverability of the loan.

The taxpayer contended that his interest/investment in the company was represented by the aggregate of the shares and the loan which were irrevocably linked. In addition, he argued that given that he was forced by legislation to form a legal entity which he did not desire, he should be taxed as if he had undertaken the transaction in his own name and not through the company ("self-piercing").

The court held in favour of the Commissioner. Milne J, delivering his judgement, at page 271 refers to correspondence from the taxpayer to the Commissioner:

" ... 'If, however, we as a group of individuals, had been legally able to purchase the properties at D, in our own personal names (ie as a partnership) we would have had a situation whereby all funds advanced to purchase the properties (plus subsequent advances for running expenses etc) would have been deducted from the realisation prices of such properties to arrive at a profit or loss on the sale of the individual properties, and such profit or loss would have been

taxed or allowed respectively in the hands of the individual partners'.

No doubt that is correct. He then goes on:

*' **Thus if one lifts the corporate veil,** one would have a situation whereby the losses would be allowed in full and this case would not have arisen'"*

And at page 272 notes that:

" It is however, not possible to ignore the existence of the companies. The true position, in fact and in law, is that the appellant lent the company money in order to enable the company to acquire immovable property, and to assist the company with the running expenses incurred in respect of that immovable property. **The company was carrying on the business of selling land for profit, not the appellant**. Furthermore, the appellant concedes that he is not a moneylender, and once the true position is, as it is in the view of the court, that this is simply a loan to a company, which has not been recovered in full, this is a loss of fixed capital."

BURMAN v CIR 1991[9]

The principle at stake in this case was similar to that in ITC 1321 - could it be said that a member's (trading) interest/investment in a company consisted of both shares and loans.

Goldstone JA, delivered the majority judgement of the court, again in favour of the Commissioner.

At page 78, he referred to the view of the accountant member of the special court:

" The accountant member, on the other hand, did not accept that there was a dichotomy between the shares and the loan accounts. He considered that Burman's trading stock comprised the shares and the loan accounts together.

The narrow issue to be decided in this appeal is which view was correct."

Whereas the majority of the court found the shares and loan accounts divisible, Nicholas AJA disagreed and stated - at page 79 of his minority judgement:

" Even though it is not permanent capital, a member's loan is therefore a contribution to the capital of the company, and in a real, economic sense such loan is a component, together with his shareholding, of the member's interest in the company. Shares and loan accounts go in double harness, and a sale of shares by a shareholder in a private company is usually (one might almost say invariably) accompanied by a sale simul ac semel of any loan account owned by the seller. The reason is self-evident; the seller does not wish to leave his capital lying, unproductively from his point of view, in a company in which he has no interest; and the buyer does not wish to acquire shares in a company whose capital structure is vulnerable to attack by a stranger".

Thus, taking cognizance of the decisions in ITC 1321, and Burman v CIR(supra), it seems clear that a member's trading investment in a company is represented exclusively by shares and would exclude any loan indebtedness due to him by the company. Therefore, any profits or losses upon realization of his loan account will be of a capital nature.

2.1.3 <u>COMPENSATION PAID</u>

NCHANGA CONSOLIDATED COPPER MINES LTD v COT 1962[30]

In this case the reference to the existence of separate legal entities was very much obiter - but still of passing interest. The issue at stake related to the deductibility of compensation paid to a group company which in terms of an agreement had ceased production of copper for one year.

It was held by the court that the payment was in fact deductible as it:

a) Created no enduring benefit, and

b) was more closely linked with the company's income earning operations, than with its income producing structure.

Briggs FJ, at page 480-482 stated:

*" They are not in the strict sense controlled by the Anglo American Corporation of SA Ltd, which I shall call 'Anglo American'. **They are all independent public companies.** But their boards are largely the same as the Anglo American board ....., and it may fairly be said that ties are very close".*

*" It is hardly necessary to say that those present were well aware of their **duty to consider separately and to protect, the interests of each company,** a duty which they were all accustomed to performing".*

> *" It was finally suggested that the **best method in the interest of all three companies** was for Rhokana and Nchanga to produce ..."*

It is interesting to compare this case to the Australian case of Federal Coke Company (page 62). In the Federal case the issue related to the capital or revenue character of income in contrast to this case which focuses on expenditure.

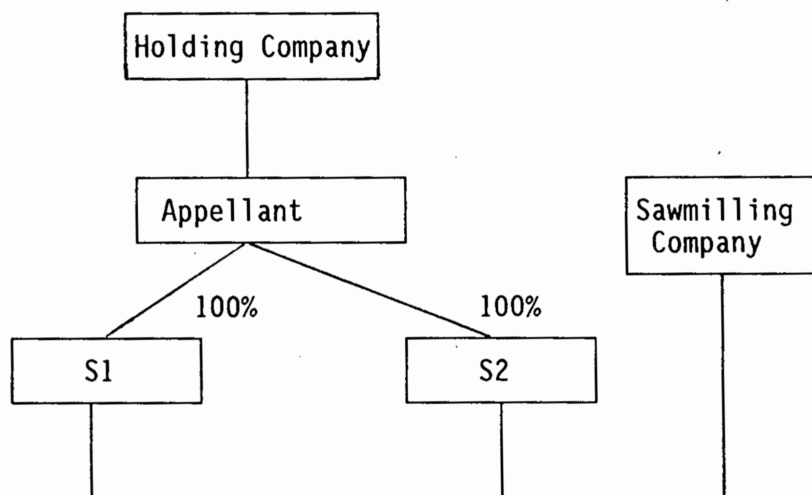
Secondly, the issue of the expenditure benefitting taxpayers other than the appellant did not seem to have been addressed. This could possibly have affected the deductibility of the expenditure, as was held in the Solaglass case - ie not wholly and exclusively for the purposes of trade. However, the appellant could have countered that any benefit to Bancroft was in fact wholly trade related.

2.2 IN THE PRODUCTION OF INCOME

2.2.1 INTEREST PAID

ITC 1124 1968[27]

The parties involved may be diagrammatically presented as follows:



The dispute related to interest paid by the appellant to its holding company on funds advanced to allow it to purchase the shares in two companies (S1 and S2)

which owned timber plantations.

As to the purpose of the transaction, Trollip J stated, at page 55:

> *" On all the evidence we find as a fact that the sole purpose of the appellant company in acquiring and holding the shares in those companies was to **get control of their plantations in order to ensure a supply of timber to the saw-milling company** and that any receipt or accrual of dividends on those shares was to be purely incidental thereto. Consequently, we do not think that the payment of the interest is so linked or identified with dividends on those shares that it must be disallowed on that ground."*

In other words section 23(f) did not preclude the deductibility of the interest. Trollip continued at page 56-57:

> *" We now turn to consider whether the appellant company has proved that the interest was paid in the production of **its** income within the meaning of section 11(a). The test is whether the payment was so closely connected with the appellant company's income earning operations that it would be proper, natural or reasonable to regard it as part of the cost of performing those operations.... Now the income-producing operations of the appellant company were the growing and felling of timber on its own or leased lands, the purchasing of timber from other growers, and the selling of all such timber to the saw-milling company. The purpose of its getting control of the said two private companies through the acquisition of their shares **was not to enable it to procure and resell the latter's timber to the saw-milling company but to cause them to sell their timber direct to the saw-milling company. It is true that a director and the secretary of the appellant company testified that in the business sense the group regarded the plantations of the said two private companies as belonging to the appellant company and the sales of their timber to the saw-milling company as being by the appellant company, but that of course is not the true legal position, which is what we are concerned with in this appeal.** Consequently, the*

appellant company's acquisition of the shares and the payment of interest on the loan that financed it, cannot be regarded as directly connected with any of its abovementioned income-producing operations. At best, the only connection according to the evidence is an indirect one."

The court then went on to suggest examples of the type of relationship between the companies, which, had it existed would have constituted the necessary close link, thereby enabling the expenditure to be deductible:

" We think that more specific evidence was necessary to prove the required close connection; evidence, for example of the effect that the supply of timber by the said two private companies to the saw-milling company had actually had on the sales of timber by the appellant company to the saw-milling company, such as, whether the prices for the appellant company's timber had as a consequence of those supplies been maintained or increased, or whether, if it had not been for such supplies, those prices would have been decreased or the saw-milling company would not have been able to continue buying the appellant company's timber, and so on. ... Be that as it may, all that we need find, as we do, is that, in the absence of any such evidence, the appellant company on whom the onus of proof rested, has not proved that the payment of interest in question was so closely connected with its income-producing operations that it would be proper, natural or reasonable to regard it as part of the cost of such operations."

In terms of the structure it was important to "involve" the appellant company in the sale of timber from the plantation-owning companies to the saw-milling company. For example, the plantation-owning companies could have sold the timber to the appellant who could then have sold to the saw-milling company, or the appellant could have acted as a commission agent in disposing of the plantation-owning companies timber.

The point is, that in order for expenditure to be deductible, it must be closely linked to the income earning operations of the person incurring it - not the income

earning operations of a separate entity.

2.3 WHOLLY AND EXCLUSIVELY FOR TRADE

CIR v PICK 'N PAY WHOLESALERS (PTY) LTD 1987[14]

The issue to be decided in this case related to the deductibility of annual donations to the Urban Foundation, which the respondent claimed under the category of advertising expenditure. The respondent contended that the donations constituted what it called indirect ("soft-core") advertising which demonstrated the company's community spirit and was thus extremely effective. The expenditure was motivated exclusively by trade considerations.

Counsel for the Commissioner contended that as there existed a partly philanthropic purpose it could not be said that the donations were wholly and exclusively for trade.

The majority of the court (3 to 2) found in favour of the Commissioner.

Nicholas AJA, delivered the majority judgement, and stated at page 51:

" Mr Ackerman's involvement in this matter was in a dual capacity. He was a director of the Urban Foundation, and the chairman and managing director of Pick 'n Pay. He was on the side of the donor and also that of the donee. His evidence makes it clear that, sitting at the board table of the Urban Foundation, he saw the donation as a benefaction to the Urban Foundation, while he perceived at the same time that it could provide valuable publicity for Pick 'n Pay. Sitting at the board table of Pick 'n Pay he no doubt saw the operation as an opportunity for indirect publicity, but it was publicity which would be given to a philanthropic action. ***It is suggested that when dealing with the matter as chairman and managing director of Pick 'n Pay, his purpose was solely a business one, although it was the same donation to the same charity. I cannot***

accept that. A man does not change his mind when he changes his hat."

In all the circumstances I am of the opinion that Pick 'n Pay did not show, on the probabilities, ***that in making the donation it did not have a philanthropic purpose as well as a business purpose.***

In delivering the court's minority judgement, Nestadt JA stated at 152-154:

" There will, in these circumstances, only be a dual purpose where there exists a deliberate and independent or distinct secondary motive which inspired the expenditure; as it has been called, a private purpose.

It is not in dispute that an object of respondent in making the donation to the Urban Foundation was, in effect, the purchase of indirect advertising. This was clearly a trade purpose. The narrow, factual question is whether this was its sole or exclusive aim..."

" Mr Ackerman was also found to be a credible witness. Nothing that he said or did detracts, in my view, from the clear effect of Mr Hurst's evidence. ***His intention may be taken as reflecting that of respondent.*** *'Wearing his Urban Foundation hat' he obviously wished to benefit this organisation. In this capacity, therefore, it may be assumed that he acted from motives of philanthropy.* ***But the matter has to be judged from a different point of view, viz, his thinking qua managing director of respondent. Not only can this distinction be made on the facts; it must be made."***

" In other words, in the circumstances under consideration, one has to guard against ***merging Mr Ackerman's activities and intentions in his personal capacity and those in conducting the affairs of respondent."***

" To sum up on this issue. Whatever the subordinate and private or personal objective of Mr Ackerman may have been, from respondent's point of view it

discharged the onus of proving that the donation was actuated purely by commercial motives; its purpose in benefiting the Urban Foundation was not an independent or distinct one; it was purely a means to an end, viz, to acquire indirect advertising in the form of favourable publicity; the latter was, in reality, its sole aim; the expenditure was entirely divorced from, the element of charity for charity's sake. This, in substance, is what the Special court found and, for the reasons stated, I agree with it."

In so far as Nestadt's reliance on the comments of Corbett JA (in the Elandsheuwel case)[(23)] are concerned, it is submitted with respect, that such reliance was misplaced. In the subsequent case of *SIR v Rile Investments (Pty) Ltd*[(22)], Corbett himself appeared to reconsider to a degree, whether a single person can realistically hold opposite intentions in respect of the same issue - while acting in different capacities. Thus, I feel that it may be somewhat artificial to suggest, as Nestadt did, that the respondent's intention should be adjudged from Mr Ackerman's intention qua director of Pick 'n Pay and not qua board member of the Urban Foundation.

However, I must agree with Emslie in so far as he contends (in his article "Is Generosity a Bar to Tax Deductibility?), that the majority did not properly distinguish between two issues:

a) the purpose of the expenditure, and

b) the effect of the expenditure.

This view is consistent with the dicta of Lord Brightman who, in the case of Mallalieu v Drummond [1983], said, at paid 1100 a-d:

" The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure."

An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes. Thus the respondent's board may well have envisaged a philanthropic effect, while at the same time pursuing an exclusively business purpose. As the purpose was in fact wholly and exclusively for trade - the expenditure should in fact have been deductible.

Finally, it seems that the majority of the court accepted Mr Ackerman's intention as representing that of the respondent. Nestadt also, at page 152 states:

" His (Mr Ackerman's) intention may be taken as reflecting that of the respondent".

In correctly determining the intention of a company, one should first ascertain the intention of the board of directors (as a group). Should it be obvious that for some or other reason, the board as a group, are not in effective control of the company's affairs - one would be justified in ascertaining who is in control, and imputing their intention to the company.

With respect, it is felt that both the majority and minority judgements attributed too much weight to the intention of one member of the board - namely Mr Ackerman. Although he held 30% of the company's shares and was its Managing Director, their was no evidence that the board was constituted by "puppet" directors, who merely "danced to his tune". In contrast, in ITC 1406[15], the court refused to accept necessarily, that the intentions of a person holding 50% of the company's shares, should be imputed to the company. There seems to be no evidence of a review of board resolutions or other formal documents which may have assisted in reflecting the aggregate intention of the board. It is thus submitted that had such an attempt been made to ascertain this "aggregate" intention of the respondent's board, additional support would have been found for the deductibility of the expenditure.

SOLAGLASS FINANCE COMPANY (PTY) LTD v CIR 1991[10]

In this case, the Commissioner challenged the appellant's deductions relating to irrecoverable loans incurred in the course of money-lending activities.

It was held in the ITC that in the earlier judgement of the Transvaal Provincial Division - namely *Plate Glass and Shatterprufe Industries (Finance Company) (Pty) Ltd v SIR* 1979 41 SATC 103- the company was held not to be conducting money-lending activities. Thus, unless the company's modus operandi had changed, that decision should still apply.

In relation to the question as to whether the company was in fact conducting money-lending activities, the appellate division unanimously accepted that it was. Therefore, the irrecoverability of the loans represented losses of circulating capital which were deductible in terms of section 11(a).

However, the appellate division then proceed to analyse section 23(g) and found that since its ambit did in fact include both expenditure **and losses**, the section applied and prevented the deductibility of the losses due to the appellant's **dual purpose** in granting the loans.

It is in relation to the issue of the dual purpose that the concept of separate entities is relevant.

Botha JA, delivering the majority judgement in so far as the application of section 23(g) was concerned, stated at pages 26-27:

> " *In my opinion the evidence speaks for itself and in so speaking it proclaims that the appellant's trading activities were geared to the achievement of a dual purpose; furthering the interest of the Group's subsidiaries and thus of the Group itself; and making a profit for the appellant.*

Counsel for the appellant argued to the contrary, on a number of grounds. I proceed to deal with the main points raised in argument. To begin with, it was suggested that, although the appellant company may have been brought into operation for the purpose of promoting the interests of the Group, when once it commenced, and therafter continued, its trading activities, it did so for the ***sole purpose of serving its own interest by earning a profit, and not with a purpose of advancing the Group interests.*** *I see no merit in the suggested dichotomy between the creation of the trading concern and its actual activities. What was aimed at by the former was achieved by the latter. The object of promoting the Group interest, which gave birth to the appellant as a trading entity, did not disappear with the actual carrying on of the business, but was in fact implemented thereby.* ***The appellant was itself a wholly-owned subsidiary within the Group. The controlling mind which brought it into operation also directed its ongoing activities.*** *And the evidence shows that such activities were in fact directed, not only at earning a profit for the appellant, but also at promoting the interests of the Group.*

Then it was argued that the promotion of the Group interests was ***merely a motive of the appellant in carrying on its trade and not a purpose of it.*** *I am unable to perceive any room for applying the distinction between the two concepts to the facts of this case, whatever the line of demarcation between them may be. .... On the evidence, the promotion of the Group interests is an integral part of the very activities carried on by the appellant. It borrows money from subsidiaries in the Group whenever they have a surplus available, irrespective of the needs of the appellant at that time. It lends money to subsidiaries at a reduced rate of interest whenever the interest of the subsidiaries concerned require that to be done,* ***irrespective of the attendant disadvantage of the appellant.*** *In short,* ***the trading activities of the appellant are governed by policy considerations dictated by the interest of the Group.*** *To talk of 'motive' as opposed to 'purpose' in relation to the appellant's furthering of Group interests is to ignore the evidence."*

Friedman AJA, felt that the "result" (benefit to the group) did not constitute a "purpose" in its own right, separate from promoting the appellant's own business.

In regard to Botha's view, the following points may be noted:

1) in ascertaining the intention of the appellant he states that:

> *" The appellant was itself a wholly-owned subsidiary within the Group. The controlling mind which brought it into operation also directed its ongoing activities."*

He thus pierces the veil of the appellant in looking for its true intention, beyond its own broad of directors. He was obviously satisfied that effective control of the appellant's business rested elsewhere than with its own board (eg the board of its holding company).

Thus one may differentiate, in terms of degree, the extent to which the veil is lifted in ascertaining a company's intention. Where such intention is determined from the taxpayers own board, it is felt that the veil is not lifted at all. Where it is determined from the taxpayers shareholders, it is felt that the veil is pierced, but falls qualitatively short of full piercing *(Botha v Van Niekerk)*. Where it is determined by reference to third parties, eg the board of another company, or another individual, it is felt that the veil is fully pierced.

2) Counsel for the taxpayer also appeared to attempt to differentiate between the **purpose** of the appellant and its **motive** ("purpose" and "effect") in so far as the granting of loans was concerned. Such differentiation was rejected.

OTHER AREAS OF TAX LAW WHERE THE SEPARATENESS OF A CORPORATE ENTITY HAS BEEN A RELEVANT FACTOR

1. SELF PIERCING

There have been various cases where the taxpayer itself wishes the veil to be pierced - in order to extricate itself from a set of circumstances not initially envisaged or which are no longer beneficial.

Generally, courts have refused to heed such pleas on the basis that taxpayers are free to choose the "vehicle" which will undertake the activity and they must properly assess all the relevant tax advantages and disadvantages. Examples of cases where this attitude has prevailed are:

- Kinookimaw Beach Association v Board of Review Commissioners (page 67)

- CIR v Ocean Manufacturing (page 42)

- ITC 1321 (page 77)

OCHBERG v CIR 1931[33]

The main issue at stake was whether Ochberg should be taxed on the receipt of additional shares (previously unissued) from a company of which he was already the majority and controlling shareholder.

In holding that such receipt did form part of the taxpayer's income, the court made various remarks relating to the separateness of the company.

De Villiers CJ stated the majority view at page 99-100:

" I entirely agree with the view that the Court may look at the substance of a transaction. But that argument must be employed with judgement, more especially in company law. The law endows a company with a fictitious personality. The wisdom of allowing a person to escape the natural consequences of his commercial sins under the ordinary law, and for his own private purposes virtually to turn himself into a corporation with limited liability may well be open to doubt. But as long as the law allows it the Court has to recognise the position. ***But then too the person himself must abide by that.*** *A company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter.* ***To say that a company sustains a separate persona and yet in the same breath to argue that in substance the person holding all the shares is the company is in attempt to have it both ways, which cannot be allowed."***

De Villiers appeared not to be overly enamoured with the idea of the company as a separate entity at all. However, once formed, the shareholders must accept all the consequence of such separateness.

Roos JA, also part of the majority, delivered a separate judgement and stated at page 106:

" Supposing that someone other than the appellant had entered into precisely the same agreement with the company that the appellant entered into. He would not be able to evade liability for income tax on the amount of £4 893. ***How can appellant avoid such liability merely because he stands in a special position towards the company?"***

Wessels JA, delivering a minority judgement took a different view, at pages 110-113:

" ... and therefore the Courts must be careful to analyse transactions of this nature and to insist on the principle that the individual who controls the private company is not to be regarded as if we were the company. Juridically the controlling individual and the Company itself must be kept apart and distinct, even if he be the sole shareholder. Prima facie, therefore, what the sole shareholder receives from the private company during the year of assessment must be regarded as income flowing to him from the company" ...

" It has also been repeatedly laid down by this Court that when considering whether an amount received by the taxpayer is income or not, we must not merely look at the form of the transaction but at its real nature."

AS WALKER HOLDINGS v MINISTER OF NATIONAL REVENUE 1979[74]

In planning to transfer business assets from a holding company to a subsidiary, the taxpayer was advised at what value the property should be sold to avoid the payment of Capital Gains Tax. For reasons which are not clear from the judgement, the property was sold at market value and the appellant was taxed on the capital gain.

The appellant tried to argue that the issue should be decided on the basis of its intention rather than according to the formal agreement.

This line of argument was rejected by the court which in effect held that the taxpayer must accept the consequences of his actions.

2. "CARRYING ON BUSINESS"

ITC 1501 1989[13]

The question facing the court in this case was whether or not the taxpayer could be said to be:

a) ordinarily resident in South Africa, and/or

b) carrying on business in South Africa.

The Special Court held in favour of the taxpayer in both respects, thus allowing him the benefit of certain tax exemptions. The Commissioner took the question of "ordinary residence" on appeal but the case was dismissed.

The relevance of the corporate veil was made clear in relation to counsel for the Commissioner's argument relating to the "carrying on of business". It was submitted by the Commissioner's counsel that:

1) the taxpayer was a major shareholder and active director of a South African company.

2) the company carried on extensive business, and

3) the taxpayer's intentions qua director of the company represented the intention of the company and it could therefore be concluded that in effect the company was merely carrying on his business.

Howie J, president of the Special Court, stated at pages 326-327:

" The facts are that appellant was a director and majority shareholder of B, and B conducted an extensive business. But however much say appellant had in the policies adopted by B's directorate and however vast the business activities of B, ***the undeniable fact is that the business was nonetheless that of the company, not that of appellant.*** *The mere fact that he held the positions he did, and that his intention,* ***where concurred in by his fellow directors,*** *was the intention of B, did not make the business his.*

As to the implication of what is called the 'corporate veil', it is conceivable that an intending emigrant could form a company and transfer his existing business to that company in order to try to claim the benefit of the exemptions in question, but there seems every reason to think that this manoeuvre would be hit by section 103 of the Act. In any event, this certainly was not the factual position in the present matter. B had existed for some years and there could be no question that the business was ever appellant's asset." ....

" In so far as Mr Cloete sought to content that appellant was carrying on his own business by being a director and majority shareholder of B, the court was not referred to any authority for the proposition that a director and shareholder of a company carries on his own business by reason of the mere fact that he is involved in the carrying on of the company's business. Indeed, such authority as there is runs counter to the acceptability of that proposition. As to a shareholder, ***his investing in the shares of a company does not amount to his carrying on business:*** *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue 1926 AD 444 at 445. In so far as being a director is concerned, in Cain v Butler (1916) 1 KB 759, the question was whether process had been served where the defendant 'carried on business'. The evidence was that he was a director of a company and that service was effected where the company conducted its business. It was considered by the court that, whatever the position might be in the case of a one-man company where all the shares are held by that one person,* ***the mere fact that the defendant in that case was a director of the company concerned did not mean that such directorship constituted his business.*** *With respect, that conclusion appears to be sound.*

Furthermore, the present is not a case of a man who earns his living by being a director of a number of companies. On the evidence, appellant's only directorship was that of B and ***nothing in the evidence shows that he received any remuneration for his services.*** *In fact, he earned his income during the period under consideration from investments. Judged purely on the facts,*

therefore, appellant's actions as director of B did not amount to his carrying on his own business."

The following points should be noted in relation to this judgement:

1) It seems that the taxpayer received no remuneration for services as a director or for managerial services. Had either of such types of remuneration been payable by the company to him, the position in relation to his "carrying on business" may have been different.

2) A person who offers his services as a "professional director" in return for fees, would, in all probability to be held to be carrying on business.

3. FRINGE BENEFITS

ITC 1374 1982 (Z)[16]

The case dealt with the fringe benefit value that should be attributed to the sole member and director of a company who occupied a house owned by the company.

At page 200, Squires J notes:

" The court here, he (counsel for the Commissioner) said, should look behind the corporate veil or else the decision would be reached on an unsound basis."

Squires, in finding in favour of the Commissioner indicated that he did not feel justified in lifting the veil in such a case. However, such action seems to a degree implicit in the judgement.

4. NOMINEE COMPANIES

A nominee company holds legal title to real/personal property which is beneficially owned by another party. The usual reasons for using nominee companies include:

1) anonymity of ownership

2) limited liability

3) estate planning

4) compliance with legal requirements.

LG Bertane, in an article entitled "Tax Problems of the Straw Corporation"[(98)] raises the possibility of the Revenue authorities treating what has been formed as a mere nominee company, as a real taxable entity. At page 11, Bentane writes:

> " *The (Internal Revenue) Service has considerable power to disregard or recognise a purported corporate entity. In fact it has been suggested that the IRS may disregard or recognise the corporate entity at its discretion (see Higgins v Smith 308 US 473). ... Conversely, taxpayers usually cannot complain that corporations of their own creation which may have served their purposes,are shams and should be disregarded."*

Bertane continues, at page 19:

> *" Thus, the Moline test (Moline Properties Inc v Commissioner 319 US 436) as evolved can be summarized as follows:*

" where a corporation engages in business activity, in the ordinary meaning of that term, even if such activity is nominal, its corporate existence will not be disregarded for tax purposes unless its sole activity consists of those ministerial tasks necessary to receive and transfer title."

5. TAXATION OF GROUPS OF COMPANIES[105]

In certain countries, a group of separate legal entities may, under certain circumstances be treated as a single taxable entity.

South Africa

Each separate legal entity is separately assessed. There are no provisions for group taxation. There is one specific fairly minor exception to this rule - section 14 (ID). In terms of this section a wholly-owned ship-owning subsidiary and its holding company can be taxed as a single entity.

United Kingdom

Generally speaking, a company resident in the United Kingdom is subject to tax on its worldwide income and capital gains. As in South Africa, there is no group taxation (ie no combined filing of tax returns for more than one legal entity).

However, trading losses may be transferred between companies in the same group (for this purpose, in order to qualify, the companies must be at least 75% held and be UK resident).

Intergroup transfers of assets are also exempt from Capital Gains Tax. (see *Burman v Hedges and Butler* discussed on page 46)

United States

Certain larger groups (intergroup shareholding of at least 80%) are able to elect to file a consolidated tax return.

Australia

Groups are not able to file consolidated tax returns. However, as in the UK, losses may be transferred between group (100% held) companies.

6. THE CONCEPT OF SHAREHOLDER INTEGRATION

This concept relates to the question of who should be taxed - the company or the member or both. The essential problem is that of double taxation, where company profits are subjected to tax at the corporate level and again in the hands of members when distributed as dividends. At present, dividend income received by both individuals and companies is exempt from tax in South Africa, although this system is regarded by certain commentators as "inherently defective".

The objective of shareholder integration is to eliminate or at least reduce double taxation. Different countries have adopted integration using different methods. There are essentially two methods that can be used:

a) Dividend relief schemes

i) Imputation method - tax paid by the company is treated as withholding tax in relation to distributed income. Only the member is subject to tax on such income.

ii) Dividend paid deduction method - this can take two forms:

- dividends paid are treated as tax deductible

- different rates of tax are applied to distributed and undistributed profits.

b) True integration

In terms of true integration the company is not regarded as a taxable entity. The taxable income of the company is apportioned to the members pro-rata to their shareholdings - irrespective of whether or not such profits are in fact distributed.

An important issue in this regard is the tax treatment of capital gains.

Although to some, such concepts may sound far-fetched, it is interesting to note an article by W Levitt titled "The Apportionment System of Taxing Private Companies" (The Taxpayer, October 1983). In the article Levitt states that:

a) In 1941, what was know as the "apportionment system" was introduced in South Africa in respect of **private companies**. This was an example of true integration - ie company tax was scrapped and shareholders were taxed on the company's taxable income pro-rata to their holdings.

b) The rationale for its introduction at the time, was an attempt to "level the playing fields" from a tax perspective between private companies, partnerships and sole traders.

CONCLUSION

Having reviewed the literature and a number of reported cases, it is submitted that the separation between the members of a company and the company itself is a relevant issue in relation to tax law. As various commentators and judges have pointed out, it is not an easy field in which judicial thinking can be reconciled over time.

It is submitted that courts fully intend to maintain this "open-ended" approach to this field of law, in order not to unnecessarily limit their ability to give effect to the intention and spirit of the legislature.

In many of the reported cases, one can see the court grappling with the form versus the substance of transactions/schemes. It seems in fact that the "substance v form" debate is often particularly relevant when courts are considering lifting the corporate veil. Cases dealing with tax avoidance schemes illustrated this on a number of occasions. In order to expose the real substance of a scheme, courts have on various occasions felt it necessary to lift the veil. From this fairly limited research, it appears that "substance" is gaining the "upper hand" over form - particularly post 1980. Whereas prior to the 1980's courts demonstrated significant resistance in disregarding the legal form of transactions, this approach seems to have "softened" with a more pragmatic, commercially oriented view gaining support. This change of approach was clearly stated by Lord Diplock in the UK Capital Gains Tax avoidance case of *CIR v Burmah Oil* (page 49). The obvious question then is under what circumstances will a court be prepared to disregard the legal form of a transaction(s) in favour of its view of the substance of the matter?

Bowen CJ's comment in the 1977 Australian case of Federal Coke Co (page 62) is of direct relevance:

" However, in taxation matters, the court is obliged to have regard to the actual facts and not to their equivalents. In cases where it is appropriate the court may apply a statutory provision such as section 260 to get rid of a contract, agreement or arrangement, and deal with the case in disregard of that element, but where there is no statutory warrant for doing so, the court cannot disregard certain of the facts or rearrange the facts or decide the case accordingly to its view of the substance of the matter."

From this perspective, a court is bound to decide a case based on the legal form and the actual arrangements entered into by the parties, irrespective of its view of the unspoken intentions of the parties.

By contrast - Lord Scarman's judgement in the 1981 UK case of CIR v Burmah Oil predicate a far more realistic approach, at page 222:

" First, it is of the utmost important that the business community (and others, including their advisors) should appreciate, as my able and learned friend Lord Diplock has emphasised, that Ramsay's case marks a significant change in the approach adopted by his House in its judicial role towards tax avoidance schemes. Secondly, it is now crucial when considering any such scheme **to take the analysis far enough to determine where the profit, gain or loss is really to be found. The 'true position' ...."**

The degree to which courts lift the veil in the tax law context should also be noted. Most instances, to adopt the formulation of the court in Botha v Van Niekerk[3], fall qualitatively short of true piercing.

The following statistics have been extracted from the relevant reported cases reviewed as part of this research.

		No	%
1.	Total number of cases	33	100
	Number of cases in which the veil was not lifted	21	64
	Number of cases in which the veil was lifted in favour of the Revenue authorities	11	33)) 36
	Number of cases in which the veil was lifted in favour of taxpayers	1	) 3)
		33	100

		Total	Veil Lifted	Percentage of cases in which veil lifted
2.	Number of cases reported up to and including 1980	22	7	32%
	Number of cases subsequent to 1980	11	5	45%

It is interesting that the results of this very small sample are similar to the results achieved by Professor Thompson in his empirical study referred to earlier (page 15). He found that in a statutory context, the courts lifted the veil in 40% of cases and in relation specifically to tax law in 31%.

Although no statistical relevance can be attached to these finings, they certainly appear to evidence the change of judicial approach referred to by Lord Scarman.

In general terms the points to be noted by tax practitioners are:

1) In determining the intention of a company - a court will identify the persons in effective control, and will not be restricted necessarily to the board of directors alone.

2) Recent trends indicate that courts are more likely to lift the veil once having ascertained the true intentions of the parties - particularly in tax avoidance situations.

3) Pleas by taxpayers for the court to disregard a separate entity of their own creation have virtually no chance of success.

4) Courts will analyse all the facts in order to determine who the real/true beneficiaries are in terms of a transaction or scheme.

5) Whatever the other circumstances, courts are more likely to recognise a separate entity that undertakes a certain amount of "commercially defensible" business operations.

6) Courts will not automatically attribute a principal/agent relationship to a parent company and its subsidiary - whether such relationship exists is always a question of fact.

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    Cape

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Annexure 1

PIERCING OF THE CORPORATE VEIL IN TERMS OF STATUTE

		PERSONS LIABLE/ EXPOSED
i)	Persons issuing negotiable instruments (cheques, promissory notes, etc) when purporting to act for the company - where the company's name is not properly advertised (section 50(3)).	Directors/ Officers
ii)	Reduction in number of members of a public company below seven, for more than six months (section 66).	Members
iii)	Winding up a company on the "just and equitable ground (section and 344(h)). The court is required to consider the relationship between members.	Members
iv)	Court order in terms of section 252 will generally involve the court lifting the veil to consider the conduct being complained of.	Directors/ Members
v)	Recklessness in carrying on of the company's business (section 424).	Directors/ Members or any other persons
vi)	Criminal liability may attach to the company in terms of the Criminal Procedure Act (section 332) where offences are committed by directors or employees in the course of service to the company.	Company
vii)	Liability of directors and subscribers to the memorandum, in respect of obligations incurred by the company prior to the issuing of a certificate to commence business (section 172).	Directors/ Subscribers
viii)	Group reporting in terms of Generally Accepted Accounting Practice (section 288).	-
ix)	Shareblock companies	Members

In Great Britain, the statutory grounds for piercing are generally similar to those described above.