AN ANALYSIS OF THE ANTI-AVOIDANCE PROVISION SECTION 103 OF THE SOUTH AFRICAN INCOME TAX ACT 58 OF 1962

BY

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Opinions expressed in this work and conclusions arrived at, are those of the author.

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INTRODUCTION

"It is trite law that His Majesty's subjects are free if they can, to make their own arrangements so that their cases may fall outside the scope of the Taxing Acts. They incur no legal penalties and strictly speaking, no moral censure if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them."[1]

However, the South African Income Tax Act 58 of 1962 contains a general anti avoidance section, as well as specific anti avoidance sections. The legislature, having observed the growing industry of avoidance, enacted the law to counter tax avoidance. Therefore, the purpose of this dissertation is to analyse the law in question and see how the courts interpret the law in order to enforce anti tax avoidance provisions.

To motivate this objective, this dissertation will be divided into three parts. Firstly, dealing with general anti-tax avoidance section 103, secondly, specific anti-avoidance sections and finally, interpretation of fiscal legislation will be looked at.

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[1]Viscount Summer in Leven v IRC at 227

Where tax cases are analysed it must be kept in mind that the burden of tax is imposed by Parliament in the form of Income Tax Act, while it is the courts that apply these laws. The task of the courts has accordingly been described by Lord Templeman in the case of **Ensign Tankers (Leasing) Ltd v Stokes.**[2]

"The task of the courts is to construe documents and analyse facts and to ensure that the taxpayer does not pay too little tax or too much tax, but the amount of tax which is consistent with the true effect in law of the taxpayer's activities. Neither the taxpayer nor the Crown should be deprived of the fiscal consequences of the taxpayer's activities properly analysed".

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[2][1992] 2 All ER 275 et 236

PART I

THE GENERAL ANTI- AVOIDANCE PROVISION SECTION 103

The anti- avoidance provision, section(s) 103 has three substantive provisions. The first, the general provision of section 103(1) is focused on transactions and arrangements that have the effect of avoiding, postponing or reducing income tax. The second provision section 103(2) deals with utilization of assessed losses for the purposes of tax avoidance and lastly, the third provision section 103(5) deals with dividend and interest swops. However, this provision is a specific anti avoidance provision and will be discussed in part II of this work. For purposes of this part, I propose to deal with section 103(1) and section 103(2) separately, thereby starting with section 103(1).

1.1 SECTION 103(1)

Section 103(1) reads: Whenever the commissioner is satisfied that any transaction, operation or scheme, (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property):-

a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof, and

b) having regard to the circumstances under which the transaction, operation or scheme 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; or has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction operation or scheme in question, and

c) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, duty or levy (whether imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of such liability, the Commissioner shall determine the liability for any tax, duty or levy imposed by this

Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such a manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.

Section 103(1) has four requirements. These requirements have been summarized by Ogilvie Thompson CJ in **SIR v Geustyn, Forsyth and Joubert** as follows.[3]

He stated that to warrant a determination by the Secretary of liability for tax in terms of section 103(1) it must be established that:

a) transaction, operation or scheme entered into or carried out,

b) which has the effect of avoiding or postponing liability for tax on income or reducing the amount thereof, and which

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[3]1971 (3) SA 567 at 571-2

c) in the opinion of the secretary, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out:-

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,

ii) has created rights or obligations which would not normally be created between persons dealing at arm´s length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question, and that

d) the avoidance, postponement or reduction of the amount of such liability was in the opinion of the secretary, the sole or one of the main purposes of the transaction, operation or scheme.

In terms of subsection 4(a), once it is proved that the transaction, operation or scheme in issue would result in the avoidance, postponement or reduction of tax, it is, until the contrary is proved presumed that the sole

purpose, or one of the main purposes of the transaction, operation or scheme was the avoidance, postponement or reduction of tax. Subject to this presumption, all the four requisites listed above must, however, co-exist in order to justify the secretary in invoking section 103(1) of the Act.[4] If one of the above requirements is missing the taxpayer can be held to be successful in avoiding tax. These requirements will be dealt with as follows:-

a) Transaction, operation or scheme

The first element requires that a transaction, operation or scheme was entered into or carried out. Prior to the present anti tax avoidance, section 90 provided for "transaction or operation", without the word "scheme"[5]. Section 90 was later substituted by section 20 Act No 55 of 1946, which enacted the word "scheme". The word scheme includes transaction and operations. As will be revealed in the discussion below in the case of **Meyeworitz v CIR**[6], in practice it is difficult to identify a series of transactions or operations opposite to a scheme.

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[4]Ovenstone v SIR 1980 (2) SA 721 at 730

[5]Section 90 of Act 31 of 1941.

[6]1963(3) SA 863

The facts of the case are as follows. The taxpayer and two others had formed a company to produce a magazine (The Taxpayer). The company later sold its right for a nominal sum to a partnership. Instead of the taxpayer, a trust for the taxpayer's minor children was a partner in this partnership. The taxpayer continued to render editorial services for a small remuneration. It was held that the taxpayer avoided tax on the income of the trust. The income produce was the sole product of the taxpayer's labour.

In this case the distinction between a "series of transactions" and a "scheme" was of relevance. The transactions in themselves were sound as each of them on their own did not amount to tax avoidance. Only when one looked at the series of transactions as a scheme the whole picture resulted in tax avoidance. The taxpayer's counsel submitted that a scheme may consist of a series of transactions, nevertheless the transactions must be connected in the sense of being part of a pre conceived plan.[7] He further argued that this connection between the transaction was lacking in the taxpayer's case. Beyer JA who delivered the judgment opposed to this

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[7]ibid at 871

line of argument, on the grounds that the word "scheme" is a wide term and that there can be little doubt that if it is sufficiently wide to cover a series of transactions such as those mentioned in the present case.

Also the case of **CIR v Louw**[8] raises an important issue, of whether the "lapse of time" could be a total interruption between different steps at a series of transactions. The facts of the case are briefly as follows. A firm of consulting engineers, of which the taxpayer was a member decided to incorporate the practise and the partnership business was sold to a newly formed company. Subsequent loans were made to the directors and which were interest free. The Commissioner argued that the lending of moneys to directors was an integral part of the original scheme to incorporate the partnership. It was held by Corbett JA that the loans to the directors created independent transaction.[8] The granting of the loans was neither an integral part of the incorporation nor necessary for the formation of the company. The lapse of time is no total interruption as long as

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[8]1983(3) SA p551

[8]ibid at 572

there is sufficient unity between the ultimate step and what had gone before. Only when this unity is lacking each transaction must be looked at its own and each is capable of being hit by section 103. This unity was lacking in Louw's case.

The new anti- tax avoidance provision, following the recommendation of the Margo Commission[10] may be of guidance in this case. The new anti-avoidance provision section 73 of the Value Added Tax Act of 1991 embodies a definition of the word "scheme". Sub-section (2) of section 73 reads as follows:-

For the purposes of this section -
"scheme" includes any transaction, operation, scheme or understanding (whether enforceable or not) including all steps and transactions by which it is carried into effect.

The transaction or operation, or scheme must have been entered into or carried out. It is important to establish the purpose or intention of the taxpayer when the scheme is formulated. In

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[10]Commission of Inquiry into the tax structure of the Republic of South Africa Para 27.28

Ovenstone v SIR[11] the question of purpose was raised and the taxpayer failed to discharge the burden of proving that the avoidance of tax at that time was not his main purpose. The background to this decision, is that, the taxpayer claimed that section 103(1) was not applicable in his case in that he did not have tax avoidance as a purpose or as one of his purpose. At the time when the scheme was decided upon he would have no purpose of saving income tax since none was payable, and it was that scheme which was ultimately implemented. Held by Trollip JA,[12],

> "although the taxpayer's original scheme had not involved the avoidance of income tax and although this scheme had not been abandoned, the avoidance of tax, in consequence of the change in the law, had either become an additional purpose at the time of implementation of the scheme or, at any rate, the taxpayer had failed to discharge the burden of proving that the avoidance of tax at that time was not one of his main purposes."

In **Meyerowitz v CIR**, supra it was held that even

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[11]1980 (2) SA 721

[12]ibid

though certain steps might be taken without the purpose of avoiding tax, if such steps are later employed in a tax avoidance scheme they are nevertheless vulnerable to attack under section 103(1).

In order to arrive at the conclusion whether the scheme was entered into or carried out, surrounding circumstances must be taken into consideration; as was the position in **Hicklin v CIR**[13]. In that case the taxpayer was one of a number of shareholders of a company. In 1975 the shareholders entered into a deed of sale with a public company, in terms of which they sold their shares for an amount equal to the company's reserves, and less certain amounts. The other terms and conditions of the deed of sale were of the nature usually found in a deed of sale shares. Shareholders acquired assets from the company. They had to repay their loan accounts to the company on the effective date, namely when the public company was to receive transfer of the shares and pay the purchase price. The secretary invoked section 103(1) of the Act to tax the original shareholders on the company's distributable profit which accrued to the public company by way of

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[13]1980(1) SA 481

dividend. It was held, considering the surrounding circumstances, that there was nothing abnormal in the transactions between the sellers and Ryan Nigel (Public co), either in the manner or means by which the transaction was entered into or carried out, or in the rights or obligations created, and therefore section 103(1) was not applicable. Trollip[14], submits that the question whether or not the scheme in question is hit by the provisions must be answered by reference to the effect and purpose of the scheme and the circumstances surrounding it at the time it is implemented or carried out, and not at the time it was formulated ie. conceived, decided or agreed upon, or otherwise evolved. His submission is to the effect that "entered into" does not mean "formulated". Because of its context, he is of the opinion that it has a connotation of implementation that is similar to "carried out".

Taking the observation by Trollip in Hicklin- judgment one has to consider the circumstances of the case. This criterion caused a lot of controversy as it makes normality requirement

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[14]Emslie Davis Hutton: Income Tax Cases and Material 1995 p35

abnormal. It is logically inconsistent to apply an objective test by looking at rights and obligations created at arm's length and then to take the peculiar facts of a scheme into account.

b) The transaction, operation or scheme, must have the effect of avoiding, postponing or reducing liability for tax, duty or levy imposed by the Act or any previous Income Tax Act. Pertaining to this condition, it was held in **Smith v CIR**[15] that "avoiding liability" within the meaning of the section is to get out of the way of, to escape or prevent an anticipated liability. It follows from this judgment that the alienation of any asset, or any other transaction, operation or scheme, by or involving the taxpayer by which income, which otherwise would have accrued to the taxpayer, accrues to another can be regarded as having the effect of avoiding, postponing or reducing liability to tax, although the taxpayer has no right to and will receive no benefit from the income.[16] The facts of this case are as follows. The taxpayer transferred his shares to a company and created a series of companies of which he was the controller.

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[15]1964(1) SA 324

[16]Meyerowitz and Spiro - Income Tax 1616

But for the transaction dividends would have accrued to him and not to the company and as it was common cause that the transaction was both abnormal and had the purpose of avoiding tax, he was held taxable on the dividend.

For the purpose of reducing tax, the case of **Commissioner of Taxes v Ferera**[17] is the authority. Shortly in the Ferera case the taxpayer formed a company, P, solely to avoid death duties and not to avoid the payment of tax on undistributed profits or to reduce the shareholder's liability for super tax. P acquired the taxpayer's shares in three trading companies. It was, in the years in question, a usual practice for companies generally to distribute two-thirds of their profits and retain one-third in order to avoid payment of tax on undistributed profits and to reduce the liability of the shareholders for super tax. Subsequent to its incorporation, P used to achieve this result. The Commissioner invoking section 91 of the Rhodesian Income Tax Act, ignored the retention of its profits by P and assessed the taxpayer as though he had received a share of the profits as dividends accruing to him and his wife in respect of their

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[17]1976(2) SA 653

shares in P. The taxpayer having appealed successfully to the General Division of the High Court, on appeal by the Commissioner to the Appellate Division, held, avoiding, postponing or reducing liability for tax was not in itself a business or trade since it was in no way concerned with earning income but only with the incidence of tax income. From the facts, it appears that it was not disputed that one-third of the profits of P were retained so as to reduce the liability of shareholders to super tax. P was operated in such a way as to prevent this part of its profits from accruing to the shareholders.

Considering the element of reduction of liability to tax, it is submitted that the assessments were rightly hit by the provision of section 90 now section 103. Existence of income is clearly explained in the case of **CIR v King**[18] as an anticipated liability for tax and not an existing liability. There is a real distinction between the case of one who so orders his affairs that he has no income which would expose him to liability for income tax, and that of one who so orders his affairs that he escapes from liability for taxation

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[18]1947 (2) SA 196

which he ought to pay upon income which in reality is his. In King's case where the decision implied that the taxpayer properly arranged his affairs in order to avoid tax, Watermeyer held that section 90 referred to anticipated liability for tax, either in respect set a current tax year or in respect of future years, and not an existing liability for tax.

In Hicklin's case supra it was decided that the taxpayer ought to be liable to the revenue authority and no one else. The liability he is avoiding or reducing must be the asset of the revenue. Three of the four requirements of section 103(1), all of which had to be satisfied before it could be invoked, were found to be present: there was a transaction, it had the effect of avoiding liability for tax on income, and the taxpayer had not discharged the burden of proving that it had not been entered solely or mainly for the purpose of avoiding tax.

It is now a settled law that liability refers to "anticipated liability". The Courts have approved this conclusion for numerous times.[18] Uncertainty

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[18]Smith v CIR 1964(1) SA 323 at 333

nevertheless arises to the extent of the anticipated liability. The courts in Hicklin-judgment supra have refused to draw an exact line at demarcation. David Clegg[20] submits that "some vague remote possibility" is referring to the time of the future receipt or accrued and not to the existence of liability per se. Then, coming to the element of avoiding liability a detailed analysis of the element can be found in the Australian case of **Newton v COT.**[21] The counsel for the taxpayer submitted that, in section 260(i), the words "liability imposed on any person" meant a liability which had already accrued, and that "avoid" meant displace. He concluded that in order to avoid liability for tax, it must be an arrangement which sought to displace a liability which had already come home to a taxpayer in respect of income which had already been received by him. The court disagreed with the counsel and came to the following interpretation of "avoiding liability"[22].

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[20]D.J.M Clegg: Section 103(1) - "Freedom of Choice" 1 SATJ (1986) 224 at 226

[21]Newton and others v Commissioner of Taxation of the Common Wealth of Australia (1958) 2 A LL ER 75 et

[22]ibid at 763

" ..... the word "avoid" is used in its ordinary sense - in the sense which a person said to avoid something which is about to happen to him. He takes steps to get out of way of it. It is this meaning of "avoid" which gives the clue to the meaning of liability imposed". To "avoid liability imposed" on you means to take steps to get out of the reach of a liability which is about to fall on you."

In **Smith v CIR**, supra, this interpretation of the words "avoid liability" was confirmed by Steyn CJ[23]. He made reference to the Australian case and further supports this interpretation with the Afrikaans version of section 103(1)[24]. The Afrikaans rendering of the phrase is:
"wat die uitwerking het dat dit aanspreeklikheid vir die betaling van 'n belasting op inkomste vermy". The ordinary meaning of "vermy" is "ontwyk" or "voorkom".

Our legislation has not yet attended the definition of liability. A different approach has been taken in New Zealand. The equivalent to our general anti-avoidance provision in New Zealand is section 99 of

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[23]1964(1) SA 324 et 333

[24]See the Afrikaans texts of section 103

the Income Tax Act 1976. In subsection (1) "liability is defined": For the purpose of this section ....." liability includes a potential or prospective liability in respect of future income.

e) Solely or mainly for "purposes" of avoiding any tax administered by the Commissioner of inland revenue.

Firstly it is important to distinguish between effect and purpose so as to satisfy this requirement. "Purpose" as used in Section 103(1) is used in the sense at that intention with which the transaction was entered into and not with the effect of the transaction, that is while the transaction may have the effect of avoiding tax it does not follow that the purpose of entering into the transaction was to avoid, postpone, or reduce liability for tax. The purpose or intention of any particular transaction is a matter of fact.[25] The facts of **SIR v Geustin** [26] were briefly as follows:

A partnership carried on by three taxpayers as consulting engineers had been converted into an

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[25]Sir v Geustyn Forsyth & Joubert 1971(3) SA 567 et 576

[26]ibid 567

unlimited company of which they were the sole shareholders and directors. The appellant (SIR) had invoked section 103(1) of the Income Tax Act and had allocated the whole of the company's taxable income to the three shareholders thus reflecting that the company had lodged an objection of which that objection was overruled, but on an appeal to the Special Income Tax Court had held that the circumstances of the case did not rightly fall within the ambit of section 103 and consequently set the assessment aside. In an appeal under section 86(1) (b) of the Act, it was held, that the transaction entered into by the three taxpayers was not abnormal within section 103(1) of the Act. Held further, that the transaction entered into by the three taxpayers was not abnormal within section 103(1) of the Act. Held further that the finding of the special Income Tax Court that tax avoidance had not been a factor which had been taken into consideration by the partners in deciding to practice as an unlimited company was a finding on a question of fact. It is important for the purposes of discussing the finding of this case to refer to Ogilvie Thompson CJ's judgment[27].

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[27]ibid 576 - 577

"As indicated earlier in this judgment, there existed various reasons, quite unrelated to the incidence of tax in favour of converting the partnership into a company. The special court's finding that tax avoidance was not a factor which was taken into consideration by the partners in deciding to practice as an unlimited company was a finding on a question of fact."

The test used to determine the purpose of the scheme is a subjective approach. The evidence of the progenitor of the scheme as to why it was carried out is of necessity.[28] For section 103 to apply tax avoidance must be the sole or main purpose. It must be the dominant purpose. The evidence of the taxpayer is of prime importance, but the court is not bound to accept what a witness says in evidence, even under oath.[29] In determining the purpose of a transaction Nicholas J held in ITC 1307 that despite the distinction between effect and purpose the effect of a scheme might be of guidance.[30]

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[28]Sir v Gallagher 1978(2) SA p 464

[29](1979) 42 SATC at 154

[30]ITC 1307 (1979) 42 SATC 147 at 150

"And although the subsection distinguishes between the 'effect' and the 'purpose' of a scheme, the effect of the scheme is of course not necessarily irrelevant to this part of the enquiry - the effect may in some circumstances tend to show what purpose the taxpayer had in mind. The outcome in Gallagher or ITC 1307 cases called for an amendment of section 103(1). In Gallagher, the taxpayer had entered into a scheme with the sole intention to save estate duty. The purpose clause of section 103(1) at that time covered only transactions which were entered into for the sole or main purpose of avoiding income tax. Since the taxpayer could prove that his purpose was not to save income tax but estate duty the anti-avoidence provision was no longer applicable. It is then my submission that Gallagher's case would now be covered by the amended section 103(1). The consequences of the amendment was that other laws administered by the Commissioner besides the Income Tax Act are the Estate Duty, the Value Added Act, the Stamp Duties Act, the Sales Tax Act, the Transfer Duty Act and the Marketable Securities Act, were to be covered by the administration of the Commissioner.[31] Secondly the word "sole or main" purpose were displaced by

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[31]Meyerowitz and Spiro op it 1614 (A)

"solely or mainly".

The first anti-avoidance provision, section 90 of Act 31 of 1901, only spoke of the "purpose". The first major change in wording came with the second amendment of section 90. The words "the purpose" were replaced with "the sole and main purpose". The present wording "solely or mainly" was introduced with section 14 of Act No 101 of 1978 in response to the **Sir v Gallagher** as mentioned above. The wording "solely or mainly" is narrower than "sole and main" purpose. The exact meaning of these two words in the context of section 103(1) is not quite clear. It was held in **SBI v Lourens Erasmus (Eiendoms) BPK**[32] that "mainly" lays down a purely quantative standard of more than 50% and the use of the alternative "solely" does not derogate from there. This interpretation, it was contended would make the word "solely" superflous and meaningless. The above interpretation would disrespect the cardinal rule of interpretation, that statute should be interpreted and construed in such a way that, if it can be prevented, no clause, sentence or word shall super flous, void or

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[32]1966 (4) SA 434 at 442

insignificant[33]. Meyeworitz presumes that the word "solely" should prevent an argument that where the sole purpose is tax avoidance it cannot be termed a main purpose[34]. Consequently the word "solely" is redundant since it is enough that the purpose is mainly tax avoidance. It is submitted that the change in wording lightened the taxpayer's burden in discharging the onus[35].

d) Normality requirement

The requirement of normality is the crux of the anti - avoidance provision. Only if a transaction, operation or scheme is abnormal will it be hit by section 103, presuming that all the other elements are also fulfilled.

When considering the normality of the rights or obligations so created or of the means or manner so employed, due regard had to be paid to the surrounding circumstances. Section 103(1) itself postulates that, what might be normal because of the presence of circumstances surrounding the entering

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[33]Loewenstein v COT 1956 (4) SA 766 at 770

[34]Meyerowitz and Spiro op.cit 1618

[35](1978) 27 The Taxpayer 111 at 112 - 3

into or carrying out of an agreement in one case might be abnormal agreement of the same nature in another case because of the absence of such circumstances.[36]

The requirement of normality has got two aspects that is (i) means or manner by which agreement is entered into. (ii) right or obligations between parties not being normal. Hicklin's case deals with the awkward question of what constitutes abnormality in context of the wording of section 103(1) in relation to a scheme. It does not necessarily follow that, because a transaction, operation or scheme was aimed at and had the effect of avoiding an anticipated liability for tax, it is hit by the provisions of section 103(1). These provisions are inapplicable if that transaction falls within the limits of normality of means, manner, right, and obligations prescribed by section 103(1)(i) and (ii). The means by which and the manner in which the transaction, operation or scheme has been entered into or carried out, and the rights and obligations created thereby, have to be examined. If the means and manner are those normally employed in entering into or carrying out a transaction,

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

operation or scheme of the same nature, and if the rights and obligations created are those which would normally be created under such a transaction, operation or scheme, between persons dealing at arms length, the section would not apply, even if, of set purpose, a liability for income tax is being avoided or postponed or the amount thereof reduced.[37] In terms of section 103(1), the abnormality of means, manner rights or obligations, is a matter of the opinion of the Commissioner, but in terms of SS(2) his decision is subject to objection and appeal. In **Smith v CIR**[38], Schreiner JA remarked as follows:

"The section is designed to meet the Commissioner's objections to the creation of abnormal or unnatural situations, to the detriment of fiscus".

Now normally and naturally the owner of an income producing asset receives the income and the labourer receives the reward of his labour. Any departure from this order of things, if done with the object of prejudicing the fiscus is the subject of legitimate objection by the Commissioner, which is met by the machinery of the section. It is

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[37]Clegg DMJ: Tax Law Through the Cases 1991 P550 - 551

[38]1964(1) SA p324

submitted that in such cases alone, it can be said that the Commissioner is seeking to tax the taxpayer on what is "in reality his income". To use the expression employed by the Chief Justice, it is in reality his income because it should have accrued to him and it can only be said that it should have accrued to him if it was the fruit of his capital or his labour or both.' The normality requirement has been introduced to overcome absurdities and unsatisfactory results as shown in King's case supra.

In **Hicklin v SIR**[38] three observations are made by Trollip JA with regard to section 103(i) and (ii) of the Act. The first observation is that the inquiry about the normality of a transaction which is an agreement should start with the arm's length criterion. It is assumed that parties dealing at arm's length try to achieve the upmost possible advantage out of a transaction for themselves. Because each party knows what is best for itself the rights and obligations created will be regarded as normal. The parties, in Hicklin, when entering that agreement both sides manifestly dealt with each other at arm's length. Neither Reklame nor its

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[38] 1980 (1) SA 481

shareholders, as directors or otherwise, were associated with or interested in Ryan Nigel (Public Company). Nor the latter hold any sway over them. It was also Ryan Nigel who drew up the agreement and tendered it to them as an offer to purchase their shares on an accept-it-or reject-it basis. It was part of Ryan Nigel's business to purchase the shares of companies with capital and distributable reserves, and this offer was made in the ordinary course of the business. To the shareholders the advent of Ryan Nigel's with its offer was the deus ex machina for solving their problem of having to keep the "untidy", domant Reklame in existence. All these confirm that both sides dealt with one another at arm's length. The agreement obliged the shareholders to divest themselves of their shares and control of Reklame. Against that Ryan Nigel had to pay them the purchase price. Those reciprocal obligations were, of course, normal incidents of such a contract of sale.

The next observation is that, when considering the normality of the rights or obligations so created or of the means so employed, due regard has to be paid to the surrounding circumstances. As already pointed out section 103(1) itself postulates this.

Thus what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. As to this observation it is submitted that there was nothing about the means or manner of entering into the RN agreement. But respondent's counsel concentrated on the means or manner of carrying it out, which he contended, was abnormal in certain respects.

The last observation is that the problem of normality or abnormality in such matters is merely a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards by means of the expert or other evidence adduced thereanent by either party. It is unnecessary to decide what happens if at the end of the day, because of the lack of its knowledge or such evidence, the court cannot resolve the problem.

Then going back to the question of arm's length, it is important to note Corbett J's judgment in the case of **Cir v Louw**[40]. The court dealt with the

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[40] 1983(3) SA 551(A)

conversion of a partnership into a limited company. After having quoted the passage from Ogilvie Thompson CJ, Corbett JA continued[41].

> In such a case should the court, in applying the "normality yardstick, take account of the special relationship between the erstwhile partners and the company which they have formed, or ignore it and apply the yardstick as though the company was a stranger? I do not see how the court can ignore this special relationship and yet give proper effect to the concluding words of section 103(1)ii, viz "under a transaction, operation or scheme in question".

For it is of the very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as its shareholders and directors the self-same partners and will be controlled by them. Those are the realities of the situation!

Corbett JA then goes on to argue that despite the fact that there was an identity of persons involved - the former partners now being the sole shareholder

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[41]ibid at 574

of the company - there was still an arm's length transaction.

> "Moreover it must be borne in mind that in a case such as the present the transaction is a multipartite one to which all the partners and the company are partners; and each partner contracts both with the company and his fellow partners and seeks to extract from the transaction the best possible advantage for himself".

It is my submission that this is not concrete. The reason there being, a party is at arm's length with one another if he is away from close contact or familiarity. Where parties stand in an ongoing relationship with each other they are no longer at arm's length. Partners in partnership that is subsequently converted into a company are in an ongoing relationship and are therefore not in an arm's length position. At the end however the case is decided correctly, as even persons not dealing at arm's length can still enter into 'normal bona fide business transactions.

1.2 SECTION 103(2)

Section 103(2) provides

> "Whenever the Commissioner is satisfied that any agreement affecting any company or any change in the shareholding in any company or in the members interested in any company which is a close corporation, as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment, has at any time before or after the commencement of the Income Tax Act of 1946, been entered into or effected by any person solely or mainly for the purposes of utilising any assessed loss incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof, the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed".

This section, specifically restricts the right of set-off of an assessed loss under certain circumstances. It forms part of the so-called "anti-avoidance provision of the Act. This section

grants the Commissioner for Inland Revenue certain powers in relation to the set-off of assessed losses incurred by a taxpayer in certain circumstances described in the section. The section is colloquially described as aimed at preventing trafficking in assessed loses, and can be of fundamental importance when transactions involving corporate reorganisations are being planned.[42]

The section is fairly widely worded, and has in its various forms come before courts on a number of companies currently have assessed losses, and the possible use as to which these may be put for tax purposes has raised again the question of the interpretation of this section. In order for this section to be applicable, the Commissioner must be satisfied as to the following:

a) An agreement affecting any company or any change in the shareholding in any company or in the member's interest in any close corporation has been entered into or has taken place.

b) As a direct or indirect result of that agreement or change in shareholding or members' interest, income has been received by or has

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[42](1987) 36 The Taxpayer p226

accrued to the company in question during the relevant year of assessment. These requirements will be discussed separately below.

a(i) Although the section applies in the alternative it is in the practice the change in shareholding which is more common [43].

The enquiry whether or not a change in shareholding has taken place is a factual one[44]. The transaction referred to the agreement affecting any company, or the change in shareholding or members' interest in any company. The generally accepted interpretation is, since the words "affecting any company" are extremely wide, they would include all agreements of any sort affecting the company, whether or not such agreements have any effect upon the shareholding of the company. The words "any company" have been replaced by the words "that company". This change in wording created an

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[43] De Koker, AP & Urquhart Vol 1, para 26 - 23 110

[44] ITC 1123 (1969) 31 SATC 48 at 52

principle was enunciated in ITC 1123 (1968) 31 SATC 48. In ITC 1123 a company which had previously been engaged in manufacture become unable to pay its debt and went into liquidation. The liquidators disposed of all the movable assets and only the immovable property remained. An entrepreneur acquired the company with its assessed loss and revived the business. The new income produced fell into two categories.

a) Income received from connected companies and,

b) Income produced by transactions with outside parties.

The appellant submitted that the set-off of the income from connected companies was correctly disallowed, as this income was diverted to the company by the entrepreneur for other companies controlled by him in order to avoid tax. Trollip J submits that

'That section was intended to apply where income was diverted from another person to

a company in order to avoid liability for tax on the part of that is clear from its very language. But its wording is wide and there is no warrant of limiting its application to such cases.'

The New Urban Properties case[47] deals with the question of fatal interruption. The taxpayer in this matter, was a land-dealing company whose only assets had been sold in execution, leaving it a dormant empty shell with an assessed loss of $767 709. The shares, together with certain convertible notes issued by the company were then acquired by new shareholders.

Beyers JA, in delivering the judgment of the Court, at 27 SATC 180:

The new shareholders had not previously had shares in the taxpayer company. Their purpose in now acquiring shares therein was plain. They were the owners of five other land-dealing companies, and bought a controlling interest in the taxpayer

[47] 1966 (1) SA p 215

company because of its large assessed loss. They hoped to channel income from their own companies into the taxpayer company, with the object of setting off against the assessed loss, thereby avoiding tax which that income would otherwise attract. There was no trading by the taxpayer company in the first half of the 1959 fiscal year, that is to say, before the change in shareholding. The company was dormant and it is difficult to imagine, in view of its enormous deficit and complete lack of funds, how it could have traded, or indeed at any future date.

The crux of the judgment is therefore that, when a company is hopelessly insolvent and could not, without the activities or financial support introduced by new shareholders, earn any income at all, section 103(2) fatally interrupts the recognition of any income as that of the company and therefore, by necessary implication, interrupts the carrying on of trade in so far as the set - off of a balance of assessed loss in terms of

section 20 is concerned. Clegg[48] submits that, being an Appellate Division judgment it must now be a settled law.

However, there is, with respect, a certain inconsistency arising out of this reasoning, for one must consider whether any subsequent losses incurred by the company in its new activities can themselves give rise to any balance of assessed loss to be sett off against future profits from those some activities. The effect of the judgment would seem to be that for purpose of section 20 the company does not carry on trade at all so far as its new activities are concerned, and it is difficult to see how within the scheme of the decision they can constitute "trade" for purposes of later years' losses. In practice, Inland Revenue does not appear to deny the accumulation of losses commencing after the date of a change in shareholding or an agreement that has been undertaken under section 103(2). The fatal interruption is similar

[48]Clegg op.cit p375

to a company which did not carry on trade in a particular year.[48] It follows that if the company doesn't earn any untainted income its assessed loss is irretrievably lost.

To overcome this problem, from a tax planning point of view it is suggested by Broomberg that the target company is left in possession of some pre-existing assets which are capable of generating "untainted" income[50]. This income can then be regarded as an "insurance policy" in order to escape the consequences of a successful attack of the commissioner under section 103(2) and consequently keep the assessed loss alive.

c) The agreement or change in shareholding or member's interests was entered into or effected solely or mainly for the purpose of utilising any assessed loss or any balance of assessed loss incurred by the

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[48]SA Bazaars (Pty)Ltd v CIR 1952(A) SA 505 et 510 - 511.

[50]Broomberg Tax Strategy 2nd Ed 1983 at 219

company, in order to avoid liability on the part of that company or any other person for the payment of any tax, or to reduce the amount of such tax payment.

The point in issue is whether the agreement had been entered into solely or mainly for the purpose of utilizing any assessed loss in order to avoid liability for the payment of tax. The element of purpose must be read together with sub-section (4) of section 103. The subsection presumes that the sole or main purpose of utilising an assessed loss is to avoid tax.

In terms of section 103(4) of the Act, any decision by the Commissioner in terms of section 103(2) is subject to objection and appeal. Section 103(4) in addition provides that when in proceedings relating to such an objection and appeal it is proved that the agreement, change in shareholding or member's interests in question would result in the avoidance or postponement of liability for payment of

any tax, duty or levy imposed by the Act or any other law administered by the Commissioner; or in the reduction of such tax, duty or levy it is presumed until the contrary is proved that the agreement or change in shareholding or member's interest was entered into or effected solely or mainly for the purposes of utilising the assessed loss or balance of assessed loss in question in order to avoid, reduce or postpone the relevant tax liability.

Once it is shown to the satisfaction of the Commissioner that the arrangement or change in shareholding would result in tax avoidance it is up to the taxpayer to discharge the onus which is placed upon him in terms of section 103(4)(b). For analysing the purpose - element one has to look at the intention of the taxpayer at the time of entering into the agreement. Thus the test to be applied is a subjective one. Where the dominant motive is one other than the avoidance of tax, the section will not apply.

Once the above three requirements are met, the Commissioner must disallow the set off of the assessed loss or balance of assessed loss in question is lost but merely that it may not be set off against the income referred. The Commissioner may only utilize the remedy afforded to him by the section if satisfied as to the requirements set out above. Clegg[51] is of the view that the "purpose" requirement, is on the face of it the simplest. The determination of the sole or main purpose of an individual or juristic person in entering into a transaction is one of fact, and conceptually therefore fairly simple determined.

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[51]Clegg op.cit p227

PART II

SPECIFIC ANTI AVOIDANCE PROVISIONS

There are various specific anti- avoidance provisions contained in the Act, but this part will only deal with the following sections i) section 103(5), ii) section 7(1) - 7(6), iii) section 8(5) and section 9 and section 9A.

2.1 SECTION 103(5)

This sub-section deals with the swopping of dividends and interests. It is focused on the cession of interest income in exchange for receiving dividend income. It reads as follows:

5(a) Where under any transaction operation or scheme any taxpayer has ceded his right to receive any amount of interest in exchange for any amount of dividends, and in consequence of such cession the taxpayer's liability for normal tax, as determined before applying the provisions of this subsection, has been reduced or extinguished, the Commissioner shall determine the liability for normal tax of the taxpayer and any other party to the transaction, operation or scheme as if such cession had not been effected.

b) Paragraph (a) shall be deemed to have come into operation on 22 December 1988 and shall

(i) to any transaction, operation or scheme concluded on or after that date, and

(ii) to any transaction, operation or scheme concluded before that date, if the taxpayer is at liberty to terminate the operation of such transaction, operation or scheme without incurring liability for damages, compensation or similar relief.

The special anti- avoidance provision is deemed to have come into operation on 22 December 1988. Thus all relevant transaction on or after this date will fall foul of this sub-section. Furthermore, will this section apply in respect of accruals before this date where the taxpayer can terminate the scheme without incurring any liability, three conditions have to be met in order for section 103(5) to apply:

a) the taxpayer has ceded his right to receive any amount of interest in exchange for any amount of dividends

b) the cession has taken place under any transaction, operation or scheme, and

c) in consequence of the cession the liability of the taxpayer for normal tax, determined before applying this section, has been reduced or extinguished.

This special anti-avoidance provision has been enacted to attack a certain form of tax avoidance where the parties involved in the scheme were companies and insurers. The scheme only functioned as a result of peculiar features with regard to the participants of the scheme.

On the side of the company it is the fact that it is not liable for the dividend income but for interest income. The peculiar feature of the insurer is that his investment income is immaterial for tax purposes and that its rate of tax is lower than that of companies. By the dividend interest swop the company was able to reduce its tax liability for taxable interest income. The insurer shared a certain portion of the tax saved as "bonus" for his trouble. As the section came retrospectively into effect it immediately put a stop to the dividend - interest swops.[52].

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[52](1989) 38 The Taxpayer 1 at 2; "Voiding Tax Avoidance". Another Press Release

2.2 PROVISIONS OF SECTION 7

This section is mainly designed for anti-avoidance provision. The following subsections will be dealt with as follows 7(1) and (2), 7(3) and (4), 7(5) and (6) separately.

a) SECTION 7(1) AND (2)

Both subsections (1) and (2) deal with income for married persons. They deem the other spouse's income to have accrued to the other spouse.

Section 7(1) reads:

Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalized by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalized or otherwise dealt with in his name or on his behalf, and complete statement of all such income shall be included by any person in the returns rendered by him under this Act.

Section 7(2) deems any income received by or accrued to any person married with or without community of property to be income accrued to such person's spouse (hereinafter referred to as the donor). In terms of section 7(2)(a) income is deemed to have accrued to the donor if such income was derived by the recipient in consequences of a donation, settlement or other disposition by the donor, and the sole or main purpose of such a donation or settlement was the reduction, postponement or avoidance of the donor's liability for any tax, levy or duty which but for such a donation, would have been payable to the Commissioner.

For married couple's income to have accrued to each other, it is important that such income cannot be seen as a donation, but should rather be seen as non independent income arising from trade. "Trade includes every profession, trade, business, employment, calling, occupation or venture including the letting of any property and the use of or the grant of permission, to use any patent design trademark or any other property which in the opinion of the Commissioner is of similar nature".

Thus a spouse's income derived as a result of "trade" will not generally be deemed to be part of the other spouse's income.

SECTION 7(3) AND 7(4)

Section 7(3) reads:

Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation settlement or other disposition made by the parent of the child:-

a) it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child.

b) it has been accumulated for the benefit of that child.

Section 7(4) reads:

Any income received by or accrued to or in favour of any minor child of any person, by reason of any donation, settlement or other disposition made by any other person, shall be deemed to be the income of the parent of such minor child, if such parent or his spouse has

made a donation, settlement or any other disposition or given some other consideration in favour directly or indirectly of the said other person or his family.

For the purpose of this sub-section, the word "child" means any person who is under the age of twenty one years and is unmarried and includes any such person who is lawfully adopted, is illegitimate or is a step child.

In **Barnett v Commissioner of Taxes**[53] it was held that if any deed of donation or settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom the right is conferred, be revoked or conferred upon another, so much of any income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers.

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[53] 1959 (2) SA 716

This approach was qualified in the case of **Ovenstone v SIR**[54] . Briefly, the facts were as follows - the taxpayer took up some shares for himself and placed the others with his four children, two of whom were minors, and the group engineer of the company. To enable them to take up the shares he lent each of them the required amount of money at the same rate of interest that the bank charged him for borrowing the money which he used to make the loans. It was envisaged that the loans with interest would be repaid out of the dividends received on the shares. The loans were made to the children without security, since the children had no assets of their own. The secretary assessed the taxpayer on the dividends accruing to the minors on the shares, reduced by the interest paid by them on the loans. He purpotted to do so under section 7(3) which provided that income was deemed to accrue to the parent of a minor child if by reason of any donation, settlement or other disposition made by that parent it had accrued to the minor. The taxpayer claimed that section 7(3) did not apply because there was no

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[54]1980(2) SA 721 at 1081

"donation, settlement or other disposition" by him by reason of which dividends had accrued to his minor children.

Trollip JA held, in the circumstances there was strong element of bounty in the loans to the children. Such loans were therefore partly gratuitous and partly for consideration, and finally held that the Secretary's assessment was correct.

In **Kohler v CIR**[55], it was held that it was not all the income of a minor which was deemed for tax purposes to be that of his taxpayer parent: the minor's income derived from other sources (for example interest upon a money legacy received from other relative, or his own earnings) were separately taxable. In casu, it appeared that the taxpayer had so ordered his affairs so as to successfully avoid taxation. The sole question was whether, on a proper construction of section 7(3) it was "by reason of" the donation made by the taxpayer that the sums which were received by or accrued to his minor children or were deemed to have been so

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[55]1949(4) SA 1022

received or accrued. Murray J held that, if permitted by a parent to exercise his own discretion in enjoying the fruits of a donation, and there would be nothing, beyond such income, which could be included in the parent's income. It was finally resolved that although the original donation may have been a causa sine qua non it was not the causa "by reason of which" the amounts in issue were derived by the minors. Murray J took the view that the section should be strictly interpreted and that it was only the proximate causa and not the remote causa which should be considered. It was then finally held "though the original donation may have been a causa sine qua non it was not the cause by reason of which the amounts in issue come to the minors"[56].

In **Joss v SIR**[57] a taxpayer sold dividend producing shares to a company in which his minor daughter and a trust owned shares, in return for a loan which was interest free. The company declared dividends to the daughter and

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[56]ibid at 1028

[57]1980(1) SA 674

the trust, the amount of the said dividend being less than it would have had the company paid interest on the loan. The court held that the portion of the dividends that the company would have paid the interest had on the loan be charged in the taxpayer's income.

It is of importance to note the approach in the case of **Widan v CIR**[58] against that of Kohler supra. The approach in Widan's case widened the test which had been adopted in Kohler's [58] case. Murray J took the view that the section should be interpreted strictly and that it was only the proximate cause and not the remote cause which should be considered. The legal causation approach adopted by the court in Kohler's case has been replaced by factual causation which was adopted in Widan's case, thereby enlarging the ambit of the section. Widan adopted that the precise meaning of "by reason of" was opined by Centlivres CJ that there has to be some causal relation between the donation and the income in question, and that it was important to look at

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[58]1955(1) SA 226

[58]Kohler op cit 1028

the real effective cause of the receipt or accrual of the income.

SECTION 7(5)

Section 7(5) reads:

If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition, be received by or accrued to or in favour of the beneficiaries, shall until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person.

The provisions of section 7(5) are fully explored in the case of **Estate Dempers v SIR**[80]. The taxpayer created a trust which he declared to have done out of love and affection for his grandson (the donee) for whom he was desirous of making provision. Clause 17 of the deed originally gave the trustee discretion to pay annual income to the donee (or charities) and directed them to capitalise all income not paid out during the year. In 1973 clause 17 was substituted by a new clause which provided that the trustees might use the income for the benefit of the donee and or his issue. Clause 18 provided that one third of the trust fund (which included accumulated income) was to be paid to him when he attained the age 25 years, one half of the balance was to be paid to him when he attained the age of 35 years.

If the donee should die before reaching the age of 34 years, his issue were to be substituted for him as beneficiaries in respect of whatever then remained of the trust fund. During the 1970 to 1973 years of assessment certain small sums of income were paid out by the trustees and the balance was accumulated. The Secretary

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[80] 1977(3) SA 410

included the accumulated income in the taxpayer's assessments for 1970 to 1973 as deemed income under section 9(5) of the Income Tax Ordinance of South Africa, the then equivalent of section 7(5) of the Income Tax Act.

The taxpayer objected and appealed to the special Court on the ground that section 9(5) did not apply since:

a) the exercise of a trustee's discretion was not an "event" falling within the scope of the section, and because the trustee could pay out the income there was no stipulation that the donee should not receive the income until the happening of an event, and

b) the donee did not have a vested right to the income and therefore it could not be said that, but for the stipulation (if there was none), the income would have accrued to or been received by the donee.

Corbett JA held that the provision that the capital plus accumulated income was to be paid to the donee when he attained the respective ages constituted a stipulation that the income was not to be received until the happening of events. And having regard to the aspects of the case, it was clear that the donee was dominantly the object of the donor's bounty and that consequently, but for the stipulation, the income would have accrued to or have been received by the donee.

It is observed that the Court was confronted with an argument as to whether the exercise by a trustee of a discretionary power constituted an event for the purposes of (the equivalent of) section 7(5).[61]. Corbett JA, acknowledging that there was "undoubtedly some force" in the argument that a discretionary power did not constitute an event for the purpose of section 7(2), was not however required to pronounce upon the correctness of such argument. The court also dealt with the question of whether section 7(5) applied only

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[61]Emslie, Davis, Hutton: Income Tax Cases and Materials 1995 p1069 - 70

where there was a vested right to accumulated income. The court found that vesting was not a sine qua non to the application of this section. In this regard, Corbett JA said that the question which the Court had to ask itself was whether, in the absence of the stipulation withholding trust income, the income would have been received by or accrued to the beneficiary.

In answering this question regard was to be had to the terms of the instrument generally, the donor's general benevolent intention as envinced by the terms of the instrument, and all the relevant circumstances. In this inquiry the fact that in terms of the instrument as a whole the beneficiary had a vested right to the income would be an important factor, but it was not the sole touchstone. The question whether the case might have been decided differently had there been a class of beneficiaries and not only one discretionary beneficiary could be seen as placing a question mark over the general application of the decision.

SECTION 7(6)

Section 7(6) reads

If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom that right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers.

Broomberg[82] submits that section 7(6) is a pure loop-hole-stopper, to prevent what could possibly be regarded as a sham transaction in any case. He goes on to argue that if a donor purpots to make a donation to a trust or to some other person, but retains the power to revoke the donation or confer the benefits on some other person, section 7(6) provides that while the donor retains that right, all income that accrues to the donee will be deemed to be a donor's income. In ITC 673 a trust deed left various controls in hands of the donor. The court took the approach, that in the absence of an express provision in the deed, an implied power to revoke the right to receive income was not sufficient to bring the section into play.

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[82] Broomberg op.cit p.212

Silke adopts the view that the section envisages an express cause in a deed or donation that reserves the right of the donor to deprive the donee of the right conferred on him and to transfer this right to income to someone else.

SECTION 8(5)

Section 8(5) reads:

Where any right, to acquire any marketable security is ceded or released by the taxpayer in whole or in part for a consideration which consists of or includes another right to acquire such marketable security or any other marketable security -

a) the second right shall for the purpose of this section not be deemed to be consideration for the cession or release of the first right; and

b) any gain made by the taxpayer by the exercise, cession or release of the second right shall be determined and included in

the taxpayer's income as[63] though such gain had been made by the exercise, cession or release of the first right, and for the purposes of determining such gains, the amount to be deducted under subsection 2(a) or (3). In respect of the amount or value of the consideration given by the taxpayer for the right or the grant of such right, less so much of the amount or value of that consideration as has been offset by any consideration other than the consideration consisting of the second right. The provisions of section 8(5) are designed to prevent tax-avoidance on the part of the lessee by way of the expedient of paying rent for business assets, claiming a deduction in respect thereof, and thereafter applying the rentals paid as part of the purchase price of the asset. Broomberg[64], further submits that this would in effect secure a deduction in respect of the purchase price of a capital asset.

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[63]Silke, Divens and Stein: Silke on South African Income Tax par 12:21

[64]ibid p212

SECTION 9 AND 9A

Section 9A is aimed at countering tax avoidance schemes based on the formation of investment companies in neighbouring countries. In terms of this section, certain investment income of a foreign company is deemed to be income from a source within the Republic in the hands of the shareholders, if such shareholders are ordinarily resident in the Republic or are domestic companies.

PART III

INTERPRETATION OF FISCAL LEGISLATION

Firstly it is important to note that the interpretation of fiscal statutes is not characterised by unique rules of construction. Their interpretation is not different to tax law, and are rooted in the general law of interpretation. Secondly, this part will deal with how the courts construe statutes so as to arrive at tax avoidance decisions. More especially, English and South African approach will be the subject of attention.

3.1 ENGLISH APPROACH

"The rule of our law and the English law is a branch of the fundamental doctrine in that the law regards the substance rather than the form of things, and it is an undoubted principle of our law that the provisions of a statute may not be circumvented by contravention of its provisions in an indirect manner[65]". The Rendle case is the authority for the theory of literalism also known as the "plain meaning" approach. Meaning is equated with linguistic or philological meaning only, and hence the interpretation of a statute, the safer course is to observe the literal and grammatical sense of the words

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[65]Watermeyer JA in Commissioner of Customs and Excise v Rendles 1941 AD 369 at 371

employed and leave it to the legislature which is always at hand for the purpose - to amend the law, in case such construction should not carry out its real intention[66].

When a regime employs specific sections only, greater reliance is placed on the courts to interpret the legislation in such a manner as to curb not only the specific practice for which the section was introduced but also variations on the theme introduced by an innovative taxpayer. The United Kingdom provides a good example of such judicial activity. In this connection the leading case in UK on the issue of tax avoidance has been **IRC v Duke of Westminster**[67] . As far as the court's attitude to tax avoidance was concerned the Westminster case laid down a classic test, namely

> "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be"

It took more than forty years for the courts to challenge the Westminster approach to tax avoidance. Then in 1981 in **IRC v Ramsay**[68], Lord Wilberforce laid down four general principles to be applied to tax avoidance

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[66]L.M. du Plessis: The Interpretation of Statutes 1986 p31

[67]F. Mc Farlane & D.M. Davis The Taxpayer vol 36 1987 p4-5

[68][1981] STC 174

schemes:

a) When construing fiscal legislation the courts are not confined to the literal interpretation. The taxpayer will be taxed according to clear statutory words but the Act itself must be placed in the context and the purpose of the Act should be taken into account.

b) The taxpayer can arrange his affairs to reduce his liability to tax. He is still to be taxed according to the legal effect of the transaction into which he has entered. Lord Wilbeforce was here reaffirming the ratio of the Westminster decision.

c) The Commissioner will find as a matter of fact whether the transaction is the genuine one or a sham.

d) If the document or transaction is genuine the court should not look for some underlying substance. One does not look at the transaction distinct from its context. It may be an ingredient of a wider transaction as a whole. When the Commissioners are deciding whether the transaction is a genuine one or a sham they may look at the series of transaction to determine the effect of a series. In other words this constituted a limit imposed by the Ramsay Court

on the Westminster doctrine.

It is submitted that this tougher approach to tax avoidance continued in **IRC v Burmah Oil Co Ltd** and culminated in the now famous case of **Furniss v Dawson**[88]. In Furniss Case the taxpayer owned shares in two family companies (called Opco) and he wanted to sell these shares to WB Co. If he simply sold these shares he was liable for capital gains tax so he incorporated a Company, Greenjacket Company on the Isle of man. Greenjacket Co bought the shares from the taxpayer in exchange for shares in Greenjacket Co. Greenjacket Co sold the Opco shares to WB Co. The money paid for the shares belonged to Greenjacket Co. When the taxpayer transferred the shares to Greenjacket Co. in exchange for shares in that same company; there was capital transfer tax but no capital gains tax because this was classified as a company reconstruction. The base cost for the Greenjacket shares was equal to the base cost of the Opco shares and therefore there was no chargeable gain. The House of Lords disregarded the sale of the shares to Greenjacket on the ground that it was a step inserted without a commercial (business) purpose and
treated the series of transaction as a sale by the taxpayer to WB Co and this liable to capital gains tax.

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[88][1984] 1 ALL ER 530

The House of Lords decision came as a rude shock to those taxpayers who thought that the ratio of Burmah Oil and Ramsay could be restricted to the facts of those cases. The House of Lords was intent on extending the approach adopted in Ramsay and Burmah Oil. Thus it reprimanded the court, a quo in **Furniss v Dawson**, Lord Brightman saying:

> "It is difficult to escape the impression that the High Court and the Court of Appeal were determined at all cost to confine the Ramsay principle to the sort of cancelling arrangement which existed in that case and to resist what they conceived to be a deplorable inroad into the social principles of the Westminster case.

The state of UK tax avoidance law after the House of Lords decision in **Furniss v Dawson** can be summarised as follows:

a) It is still perfectly legal for any taxpayer to order his affairs to reduce his tax liability.

b) A subject is to be taxed only upon the clear words of any Act of Parliament but, in determining what "clear " words are, one is not in the case of the fiscal statute limited and confined to literal

interpretation. One must look to the context and scheme of the relevant Act and its purpose should be considered. This was pointed out by Lord Wilbeforce in Ramsay's case.

c) The Commissioners are to find as a matter of fact whether or not a document or transaction is genuine or sham. If the document is genuine the court cannot go beyond it to find some supposed underlying substance.

d) Not all series of transaction are to be construed within and determined under the Ramsay principle.

3.2 SOUTH AFRICAN APPROACH

In South Africa the approach that is usually chosen is the so called in *intention theory* which, according to Steyn, who calls it the foreign rule of interpretation to which all others are subjected, holds that once it is established what the real intention of the legislature had been, one must give effect to that intention[70]. The intention theory endeavours to ascertain the intention of the lawmaker from a study of the provisions of the enactment in question. Du Plessis contends that

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[70]Steyn L.C Die Uitleg van Wette 4de Uits 1974

this approach, is little more than the theory of literalism in disguise[71].

In so far as South African tax avoidance legislation is concerned, our courts have from time to time adopted a "substance over form approach" or business purpose test. This is clearly illustrated in the interpretation of section 77[72] which the Appellate Division has classified as tax avoidance section. Thus Corbett JA,[73] remarked as follows:

> "In section 9 of the Ordinance, hower (as in the case of corresponding South African legislation), certain limitations are placed upon the right to avoid in this way liability for the payment of tax. One is that a taxpayer cannot avoid such liability if he makes his minor child the beneficiary of the income to be derived from the assets so donated(section 9(3)) nor can he avoid liability by achieving this in an indirect manner through the instrumentality of a third party (section 9(4)). Another limitation is that he does not avoid liability where he retains the right to revoke the right of the beneficiary to receive the income of

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[71]du Plessis op cit p35

[72]Income Tax Act 58 of 1962

[73]Estate Dempers v Sir 1977 (3) SA 410 at 421 c-d

the donated assets or to confer the right of the beneficiary to receive the income of the donated assets or to confer the right upon someone else (section 9(6))".

Another example is the Appellate Division's decision in **CIR v Berold**[74]. The court in interpreting section 7(3) said 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 effective causal connection between the taxpayer's donation, and the income accumulated for the benefit of the children".

However, South African Courts have refused to follow the English approach that is Ramsay-Furniss test in interpreting tax avoidance legislation. The question arises as to whether they will resist the invitation, to do so on the same grounds as the Australian and Canadian Courts, namely that the existence of specific tax avoidance legislation in the South African Income Tax Act dispenses with the need to interpret ordinary tax legislation in a pro- fiscum manner.

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[74]1962(3) SA (A) et 755 e-d

A sign that our courts may not follow their Australian and Canadian counterparts was given in the recent decision in **De Beers Holdings (Pty) Ltd v CIR**[75] in which the Court was required to interpret the statutory definition of trading stock and more significantly, aspects of the general deduction formula and section 23(g) in particular. Section 23(g) provides that "No deductions shall in any case be made in respect of the following matters, namely:..(g) any moneys claimed as a deduction from income derived from trade, which are wholly or exclusively laid out or expanded for the purpose of trade". The question for decision was whether the purchase price of shares bought for R4 158937 and sold for R1 after a dividend stripping operation constituted money solely or exclusively expended for the purposes of trade. Without articulating his premise in similar fashion to the house of Lords in Ramsey and Furniss cases, Corbett JA said: It is true, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and corresponding moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of section 23(g). Such moneys may well be disbursed on grounds of commercial expediency or in order directly to

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[75]1986(1) SA 8

facilitate the carrying on of the taxpayer's trade. Where however normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must in order to satisfy section 23(g), be shown to have been so connected with the pursuit of the taxpayer's trade on ground of commercial expediency or indirect facilitation of the trade, so as to justify the conclusion, that despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for themselves, this will call for an explanation from the taxpayer.

F. Mac Farlane and D.M. Davis[78] express the view that it is difficult to predict whether De Beer's case heralds a new approach by our highest court to tax avoidance. If followed, it will make tax advice an even more hazardous task. Given the range of general and specific tax avoidance sections in our Act, it does seem somewhat unfair for the Court to create its own doctrine of tax advice. The legislature has not shown a reluctance to introduce legislation to curb tax avoidence practices, the Revenue is armed with a general tax avoidance section

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[78]"Substance overform: a new approach to tax avoidance" 1987 36 The Taxpayer p11

and the basis of the interpretation of tax legislation is the contra fiscum approach. Unless legislation is introduced our courts should follow Australia and Canada and desist from bringing in the Ramsay\Furniss rule via the back door.

Criticisms levelled against South African "intention theory" approach are depicted by Du Plessis[77] as follows:

i) The intention theory serves to reinforce literalism, and this leads to an underestimation of other contextually and structurally relevant aspects of an enactment in the process of its interpretation.

ii) Due to the impossibility of determining expost facto what went on in collective minds of the legislators, the "intention of the legislature" is about a fiction. The interpretation of a statute does not in actual fact necessarily imply a search for the intention of the legislature, but much rather amounts to the ascertainment of the meaning of an enactment by way of employing recognized canons of interpretation.

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[77]du Plessis op cit 36 - 39

iii) The intention theory is a denial of creative role which the judiciary can and ought to pay in interpreting statutes. A judge should not merely be "his master's voice", charged with carrying out legislature's wishes.

iv) A court might, while applying the rules and presumptions of interpretation in a correct and\or "permissible" way, construe an enactment in such a way that the conclusion arrived at is diametrically opposed, to what the legislature had in mind when "forwarding its intention". The impeccably correct or at least a perfectly valid possibility even though it might not in fact reflect the intention of the legislature, that is " what it had in mind".

The last part is well illustrated by quite a number of instances where the previous section 7 of the Abuse Dependence - producing substances and Rehabilitation Centres Act[78] was construed by the Courts. The trading in (section 2(a) and (c)) and the possession of section (2(cb) and (d) certain scheduled dependence producing substances.

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[78]Act 41 of 1971

It is submitted that there is no single theory of interpretation and that different approaches may lead to different outcomes in a particular case. It appears that South African Courts feel obliged to follow the so-called intention theory, which usually means that they consider themselves bound to give effect to the literal meaning of a statute which they tend to equate with such intention. Exception to the South African approach are the Nemojim[78] and Glen Anil cases[80]. They appear to be based on wider, contextual theory. The judgments contain, admittedly, the usual references to the intention of the legislature, but it is submitted, in arriving at what they consider the intention to be, they go beyond the plain meaning of the words, taking into account, in the Nemojim case, the unrealistic result that would flow from a literal approach which would allow the taxpayer to accumulate "fictitious" losses by way of dividend stripping.

In **CIR v Nemojim**, the taxpayer, trading as a dealer in shares, sought to deduct amounts expended in acquiring shares in companies which had large distributable reserves and which distributed those reserves as tax exempt dividends to the taxpayer after distribution of

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[78]1983 (4) SA 935

[80]1975 (4) SA 715

the dividends sold again at a price lower than their purchase price, as the net asset value of the company was, of course, much reduced after distribution of the reserves. The contention was that the difference between the purchase and sale price of the trading stock was a loss of a revenue nature incurred in the production of income[81].

Corbett JA agreed with the taxpayer that the purchaser of shares does not in law purchase the dividend, but went on to say that the issue was not whether he had purchased the dividend, but whether the connection between the expenditure incurred in the purchase of the shares and the receipt of the dividend was sufficiently close to justify the conclusions that the expenditure incurred was partly in the production of the exempt dividends and said".

".....it would be wholly unrealistic to regard the purchase price of the shares as having been expanded solely in the production of the income consisting of the proceeds resulting from the resale of the shares[82] and his concluding remarks were.

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[81]1983 (4) SA 935 et 941 -5

[82]ibid at 953

"It has been said that "there is no equity about a tax". While this may in many instances be a guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer, and from the point of view of the fiscus. And it may be fairly inferred that such a result is in conformity with the intention of the legislature. An acceptance of the case put forward by Nemosim would have the effect of permitting a taxpayer who is carrying on a profitable business to accumulate enormous annual assessed losses, which from a financial and accounting point of view can only be described as fictitious. This could not have been what Parliament intended. It is true that an amendment to the Act may render a scheme of dividend stripping ineffective but I do not consider that this amendment in any way affects the interpretation to be placed on the Act as it was when the assessments under review was made[83]".

In Glen Anil's case it was found that the scheme which appellant entered into was aimed at avoiding tax. Botha

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[83]Emslie, TS Tax Matters: ITC 1427 1988 Derebus 529 et 529

JA held that section 103 of the Act was clearly directed at defecting tax avoidance schemes. It did not impose tax, nor did it relate to the tax imposed by the Act or to the liability thereof or to the incidence thereof, but rather to the schemes designed for the avoidance of liability thereof. It should therefore not be construed as a taxing measure but rather in such a way that it would advance the remedy provided by the section was directed.

CONCLUSION

From the above discussion , it is clear that the aim of section 103 is to defeat tax avoidance schemes. The purpose of this work has been stated supra; that is to see whether the courts succeed in construing section 103, so as to assist the commissioner to arrive at the correct assessment. Before, depicting the achievements of the taxpayer against those of revenue it is important to note the difference between tax avoidance and tax evasion.

Distinction drawn between tax avoidance and tax evasion seems to have no effect in the court's interpretation. Tax avoidance is arranging and ordering of taxpayers's affairs in a legal manner in such that one pay less tax or no tax at all. However tax evasion is about employing illegal means so as to escape the revenue's attention. Meyeworitz submission is that tax avoidance has no penalties and tax evasion is illegal in that it carries heavy fines imposed by the courts. It is my submission that invoking of provisions of section 103 by the Commissioner, boils down to penalties, but in a more polite manner it does not mean that when one is caught in tax avoidance one escapes the sword of the law, the only difference is that the Commissioner enforces the law, whereas with the latter it is the courts function to enforce the law. Moreover with the act of tax avoidance, the scheme remains in

force. Proper assessment by the revenue after invoking of provisions of section 103 amounts to a penalty on the part of the taxpayer. Anti-tax avoidance provisions do in no way remove the guilt on the part of the taxpayer. The taxpayer only escapes if the four requirements discussed supra are not satisfactory. The legislature will soon have the way of closing the loopholes which may be of existence because of non satisfaction of the requirements in question. Every supposed to be taxpayer must pay tax irrespective of how wise he is in arranging his affairs.

The taxpayer's victory against the Commissioners in issues involving the anti-avoidance measure is shown in cases such as **SIR v Geustyn, Forsyth & Joubert, SIR v Callagher and Hicklin v SIR Supra**. However the impact of the last two cases was rapidly neutralised by the legislature. In practice, taxpayers have been relatively successful in defeating the Commissioner in contests based on the application of section 103(2). In some cases the taxpayers were able to satisfy the Court that they were moved by non-tax considerations to take over the company with the assessed loss.

On the other hand, **Glen Anil Development Corporation Ltd v SIR & Ovenstone** cases prove how the courts succeeded in construing section 103 to the advantage of the Commissioner.

The plain fact is that a taxpayer can structure a transaction, operation or scheme which has the effect of avoiding tax, with a reasonable prospect of success in his endeavours.

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