# TAXATION OF TRUSTS: QUO VADIS?

## A DISCUSSION OF CHANGES TO THE TAXATION OF TRUSTS IN THE CONTEXT OF CURRENT LAW



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## CONTENTS:


| | | Page no. |
|---|---|---|
| 1. | Introduction | 1 |
| 2. | Definitions | 1 - 2 |
| 3. | Liability for Taxation in Trusts | 3 |
| 3.1 | The Conduit Principle | 3 |
| 3.2 | Section 25B(1) | 3 - 4 |
| 3.3 | Section 25B(2) | 5 |
| 3.4 | Section 25B(3) | 5 |
| 4. | Liability of the Donor | 6 |
| 4.1 | Trust Income Deemed to be Donor's Income - Section 7(3) and Section 7(4) | 6 - 8 |
| 4.2 | Trust Income Deemed to be Donor's Income - Section 7(5) | 8 - 11 |
| 5. | Benefits of Utilisation of a Trust | 11 - 12 |
| 5.1 | Business Trusts | 12 |
| 5.1.1 | Limited liability | 12 |
| 5.1.2 | Flexibility | 12 |
| 5.1.3 | Tax Rate | 13 |
| 5.1.4 | Losses | 13 |
| 6. | Margo Commission | 13 - 16 |
| 7. | 1998 Budget Review | 16 |
| 8. | 1998 Amendments | 17 - 18 |
| 8.1 | The effect of the new amendments on trusts | 19 |
| 8.1.1 | Income Splitting | 19 |
| 8.1.2 | Inter vivos trusts : Flat tax rate and assessed losses | 19 - 20 |
| 8.1.3 | The Effect on the Conduit Principle | 20 - 21 |
| 8.1.4 | Vesting Trusts | 21 - 22 |
| 9. | Wealth Tax | 22 - 28 |
| 10. | Conclusion | 29 |

# 1. INTRODUCTION:

The aim of this dissertation is to discuss the general context of the taxation of trusts in South Africa, highlighting areas of uncertainties. The above is then viewed in the context of the recent changes to such taxation, in particular with regard to what have become known as 'business trusts'. Further, the proposals regarding the future taxation of capital gains in trusts, and the effectiveness of such taxes, are considered.

The aim of the above is to arrive at a conclusion as to the question - are trusts still useful in the context of arranging one's affairs in a tax effective manner?

# 2. DEFINITIONS:

A trust is defined in the Trust Property Control Act 57 of 1988 as "an arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed:

a) To another person, the trustee, in whole or in part to be administered or disposed of according to the provisions of the trust instrument for the benefit of a person or class of persons designated in the trust instrument or for the achievement of the object stated in a trust instrument; or

b) To the beneficiaries designated in a trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument."

Trusts have been utilized for quite some time for the purposes of carrying on a business. Van der Westhuizen(1) defines a business trust as any trust primarily used for the carrying on of a business or profit. A distinction is further made between that of private and public trading trusts. Public trading trusts are governed by the Unit Trusts Control Act 54 of 1981 and are trusts in terms of which the public are invited to contribute to a trust fund in exchange for which the public will receive proof, usually in the form of a certificate of his / her pro rata transferable share in the unit trust funds. However, it is in the main difficult to provide an all-encompassing definition of a trading trust. A variety of inter vivos and discretionary trusts make provision for certain business features which complicate any attempt at a pithy definition.

In a trust, a person (the "settlor" or "donor") transfers certain property to a trustee on terms which oblige the latter to administer the property for the benefit of a third person (the "beneficiary") who has a right against the trustee to enforce the trustee's obligations(2).

A trust is defined in Section 1 of the Income Tax Act 58 of 1962 (the "Act") "as any trust fund consisting of cash or other assets which are administered or controlled by a person acting in a fiduciary capacity, where such person was appointed under a Deed of Trust or by agreement or under a Will of a deceased person".

A trust may be created in one of the following manners:
1. during the life of the settlor or donor - inter vivos trust;
2. on death - testamentary trust;
3. by statute.

At common law, a trust does not have a separate legal persona. However, in terms of the Trust Property Control Act, trust property does not form part of the personal estate of the trustee(3). The Income Tax Act defines a "person" to include that of a trust. Notwithstanding the above, neither an inter vivos nor the testamentary trust possesses legal personality(4).

The administration of a trust is largely laid down by the Trust Property Control Act.

Trusts - Latest Developments - Seminar for continuing legal education - 1998.
Thorne and Mollenaar MMO v Receiver of Revenue, Cape Town 1976 (2) SA (c) SATC1.
Section 12 of the Trust Property Control Act 57 of 1988.
COR vs MacNellie's Estate 1991 3 SA 833(a) at 840.

## 3. LIABILITY FOR TAXATION IN RESPECT OF TRUSTS:

Having established that the trust is a "person" for the purposes of the Act, the following question to be answered is who bears the burden of payment of tax in respect of trusts. This burden falls on either the donor, the trustee (in his capacity as a representative tax payer) or the beneficiary. It is at this stage where the interpretation of the provisions of the Act become vital. It is, furthermore, important to attempt, as will be done later, to establish the effect on the various provisions of the Act on the stated of intention of the legislature in respect of taxation of trusts.

## 3.1 THE CONDUIT PRINCIPLE:

Section 25(B) of the Act envisages two situations where a beneficiary will be liable for the payment of tax in respect of taxable income. The situations are reflected in Sections 25(B)(1) and (2) of the Act respectively.

## 3.2 SECTION 25(B)(1):

Section 25(B)(1) states that any income received by or accrued to or in favour of any person in his capacity as the trustee of a trust, shall, subject to the provisions of Section 7, to the extent to which such income has been derived for the immediate or future benefit of any beneficiary with a vested right to such income be deemed to be income which has accrued to such beneficiary, and to the extent to which such income is not so derived is deemed to be income which has accrued to such trust fund. Silke(5) states (correctly, it is submitted) that the deemed-income rule established by Section 25(B) does no more than codify the application of the principles of accrual to income to and through a trust.

(5) Silke on South African Income Tax: Loose Leaf: at 12 - 26.

In effect, the trustee, in such circumstances, is a mere conduit pipe by means of which the income in conveyed to the beneficiary who is legally entitled to it. The conduit pipe principle was upheld as part of our law by the then Appellate Division in Armstrong vs CIR(6).

Consequently if, for instance, the income flowing into the trust constitutes dividends, such income will not be taxable in the hands of the beneficiary in terms of Section 10(1)(k) of the Act. SIR vs Rosen(7) supports the principle of the conduit pipe espoused in Armstrong provided that the income accrues to the beneficiary in the same year of assessment as accrued to the trust.

As stated in Rosen obiter:

> *"It suffices to say that the trust deed may itself entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit pipe for passing them on to the beneficiary, that in his hands their source as dividends can no longer be identified or they otherwise lose their character and identity as dividends, and that the beneficiary is thus entitled to receive mere trust income in contradistinction to the benefit of the dividend rights ....."*
>
> *"Thus, a trust deed may endow a trustee with the discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think (but express no firm view), that the dividends might then lose their identity and character as dividends so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit pipe had turned itself off at the relevant time."* (8)

This issue is further complicated when one has recourse to the published intentions of the legislature in respect of changes to the taxation of trusts, as will be discussed later.

6) 1971 (1) SA (A) 32 SATC249.
7) At 190.
8) 1938 AD343 10(10) SATC1.

## 3.3 SECTION 25(B)(2):

Section 25(B)(2) provides that if a beneficiary has acquired a vested right to any income referred to in sub-Section 1 in consequence of the exercise by the trustee of a discretion vested in him in terms of the trust deed, will, or agreement, the income so vested shall for the purposes of sub-Section (1) be deemed to have been derived for the benefit of such beneficiary.

The case of Dempers vs SIR(9) has held that accumulated income which has been capitalized and added to the trust fund retains its essential character, and hence the problem of double taxation, namely in the hands of the trust as well as later on the subsequent in the hands of the beneficiary has been removed.

## 3.4 SECTION 25(B)(3):

Section 25(B)(3) provides that any deduction or allowance which may be made under the provisions of the Act in the determination of the taxable income derived by way of any income referred to in sub-section (1) shall, to the extent to which such income is under the provisions of that sub-section deemed to be income which has accrued to a beneficiary or to the trust fund, be deemed to be a deduction or allowance which may be made in the determination of taxable income derived by such beneficiary or trust fund as the case may be. In essence, this Section has allowed trusts, in particular business trusts, to carry any assessed losses through to beneficiaries, permitting them to deduct such assessed losses from their income from other sources, provided the beneficiaries had a vested interest in the income.

(9) 1977 (3) SA 410(A).

## 4. LIABILITY OF THE DONOR:

In order to prevent Section 25(B) being utilized by a taxpayer as donor disposing or dissipating his income-producing property in favour of other parties (usually family members) so as to divert income from himself and accordingly reduce his tax liability, the provisions of Section 7 of the Act have been effected. These Sections are important tax-avoidance measures and their effect is that, under certain circumstances, income that is subject to a trust, will be taxed in the hands of the donor and not in the hands of the trustee or the beneficiaries. These provisions are by reason of their application relevant to the liability for income of an inter vivos as opposed to a testamentary trust.

## 4.1 TRUST INCOME DEEMED TO BE DONOR'S INCOME - SECTION 7(3) AND (4):

Section 7(3) of the Act provides that income shall be deemed to have been received by the parent of a minor child, if by reason of any donation, settlement or other disposition made by that parent of the child:

1. 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; or

2. it has been accumulated for the benefit of that child.

The phrase "donation, settlement or other disposition" has been closely analysed by the Courts over the years. This phrase has been interpreted to exclude any commercial transactions or transactions made for due consideration. If the nature of the transaction is partially gratuitous and partially commercial, apportionment may be possible.

In Joss vs SIR(10),on the facts the Court distinguished between two transactions, the first being the disposition of shares at a proper value and the second being a loan which was interest-free. The Court held that, although there were two dispositions, only the latter fell within the meaning of Section 7(3), the first being a commercial transaction.

(10) 1980 (1) SA 674(T).

This approach was followed in the matter of CIR vs Berholdt(11). However, in the matter of Barnard vs COT(12) the Court used intention as the dominant test. The leading case in this area is that of Ovenstone vs SIR(13) in which the taxpayer took up shares offered to him at a discounted rate for his children, two of whom were minors. To enable his children to take up their shares, he lent each of them the required amount at the equivalent rate of interest charged to him by the bank for taking such loans. It was intended that the loans would be repaid together with such interest from the dividends received on the shares. The loans were, however, made to the children without security since the children had no assets of their own. The taxpayer evidenced this by saying that the loans amounted to "a family affair". The Commissioner assessed the taxpayer on the dividends accruing to the minors reduced by interest paid by the loans.

In finding for the Commissioner, the Court accepted that the phrase "donation, settlement or other disposition" denotes the disposal of property other than by means of a commercial transaction and that any wholly gratuitous disposition is covered by the Section.

The Court took the matter further in finding that, if there was an appreciable amount in gratuitousness as well as a commercial element, apportionment in effect was possible.

The second phrase "by reason of" as is maintained in Section 7(3) has also been the subject of some litigation. In CIR vs. Kohler(14) it was held that a causal nexus or a sine qua non between the donation and the income is required, otherwise the income is not received by reason of the donation. However, in CIR vs. Widan(15), the Court took a broader view finding that "by reason of" should be interpreted as referring to the approximate and not the remote cause. Although the judgment in this matter discussed extensively the decision in Kohler's case, it did not expressly overturn it. However, it would be difficult to come to any other conclusion regarding its result.

1962 (3) SA 748(A).
1959 (2) SA 713(FC), 22 SATC326.
1980 (2) SA 721(A), 42 SATC55.
1949 (4) SA 1022.
1955 (1) SA 226 (A), 19SATC341.

Section 7(4) prevents the evasion of Section 7(3) by means of the intervention of a third party. Income is deemed to be income of the parent where the parent makes a donation or gives some other consideration in favour of a third party who then makes a donation in favour of the parent's minor child.

## 4.2 TRUST INCOME TO BE DEEMED DONOR'S INCOME - SECTION 7(5):

Section 7(5) provides that, if any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether imposed by himself or anybody else, that some or all of the beneficiaries shall not receive the income thereof until the happening of some event, whether fixed or contingent, so much of any income from the donation, settlement or other disposition as would, but for such stipulation or condition, be received by or accrue to the beneficiaries shall, until the happening of the event or the death of that person, whichever occurs first, be deemed to be income of that person.

This Section requires two conditions for its operation:

a. there must be a stipulation or condition, the effect of which is that the beneficiaries shall not receive the income until the happening of an event; and

b. but for the stipulation, the income would be received by or accrued to the beneficiaries.

The income at issue is taxable in the hands of the donor, only if both conditions operate. On the death of the donor, Section 7(5) ceases to apply and trust income will be taxed in the hands of the beneficiaries or the trustee. Central to Section 7(5) is the concept of an "event", which may include, for example the marriage or attainment of a particular age by the beneficiary.

The first issue arising from Section 7(5) is whether the exercise of a discretion of a trust in terms of the trust deed constitutes an event. This matter remains undecided by our Courts(16).

In Estate Dempers vs. SIR(17), the taxpayer argued that "event" constituted a single, once-and-for-all occurrence after which the beneficiary received the income. If the exercising of discretion amounted to an event, the following circumstances could arise, namely income which accrued to a trust during the year of assessment would be deemed to be the donor's even if, later in the year, the trustee decided to distribute that income to the beneficiaries.

Furthermore, if the trustee exercised his discretion not to distribute income to the beneficiaries, the "event" would have nevertheless occurred and the donor's liability for tax under Section 7(5) would cease. Corbett J A, as he then was, conceded that the above arguments "were forceful" but found that it was unnecessary to decide on the correctness thereof.

The second question arising from Section 7(5) is whether the right of the beneficiary needs to amount to a vested right in order for the provision to apply. In Estate Dempers, the Court found that a vested right per se was not required. Rather, Section 7(5) involves a hypothetical, notional inquiry which cannot be directed solely to questions such as whether the beneficiary's right to income is vested or contingent. The question should be formulated in terms of whether in the absence of the stipulation withholding trust income, the income would have been received by or have accrued to the beneficiary. The Court states:

> *"In answering this question, regard must be had to the terms of the instrument generally, the donor's general benevolent intention as evinced 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 has a vested right to the income would ... be an important factor but would not be the sole touchstone."* (18)

(16) See ITC 775 (1953) 19SATC31, ITC 1033 (1959) 26SATC73, Hewlett vs. CIR 1944 NBD 263, 13SATC58.
(17) 1977 (3) SA410 (A).

Applying this approach to the trust deed, the Court found that the beneficiary was dominantly the object of the donor's bounty and that this overriding intent to benefit the donee was not detracted from, in any substantial way, by the substitution in his issue in the event of his predeceasing the termination of the trust, or by the power conferred upon the trustees to benefit charitable institutions. In the result, the Court held that, but for the stipulation withholding income, the accumulated income would have accrued to or been received by the beneficiary, and accordingly Section 7(5) applied to such accumulated income.

Emslie et al(19) query the effectiveness of the above judgment stating that the question whether the Dempers case might have been decided differently had there been a class of beneficiaries and not only one discretionary beneficiary whom it was clear was the intended beneficiary "could be seen as placing a question mark over the general application of the decision"(20). Silke supports the view that, for the purposes of Section 7(5), it is immaterial whether beneficiary has or has not vested right to trust income(21). Once again, there are special Court decisions which contradict each other on this issue(22).

Williams(23) points out that revenue's practice with regard to the above is that the Commissioner will not tax the donor under the Section on income which the trustee in the exercise of his discretion has paid out in the year in which it accrued. Although this practice is quite possibly incorrect, the fact that it is favourable to the donor has prevented the Courts from finally deciding on this issue.

The finding in the Dempers case also nullifies any possibility of double taxation in that it makes plain that where income is deemed to be the donor's under Section 7(5), its subsequent distribution to the beneficiaries does not attract tax in the hands of such beneficiaries. Once the income has been deemed to be the donor's, it is so deemed for all time and there is no room for finding that subsequently it accrued to the beneficiaries as income.

(18) Supra at 426.
(19) Emslie Davis Hutton - Income Tax Cases Materials 1994.
(20) Supra at 1070.
(21) Supra at 12.20.
(22) See for instance ITC 775 (1953) 19SATC314 and ITC 823 (1956) 21SATC77.
(23) Income Tax in South Africa Law and Practice - Butterworths.

Meyerowitz & Spiro(24) summarize the position in regard to Section 7(5) as follows:

*"1. If, in the trust deed, there is a provision that the right to receive may, under powers retained by the person by whom the right is conferred, be revoked or conferred on a different beneficiary, that is a stipulation which falls inside Section 7(5);*

*2. where a stipulation such as in 1 exists, so much of the income which in consequence of the donation could have been received by accrued to the beneficiary, shall be deemed to be the income of the person by whom the right is conferred, so long as he retains those powers;*

*3. current income actually paid by the trustee during any year of assessment to a beneficiary will not be deemed to be income of the donor in terms of Section 7(5);*

*4. any income deemed to be that of the donor will not constitute income in the hands of the beneficiary when ultimately paid to him, whether paid out of accumulated income or capital."*

If the beneficiaries are minor children of the donor, the donor will be taxed under Section 7(3) or (4) if Section 7(5) is not applicable. The donor is entitled to recover from the trustee of the trust so much of the tax as is payable by the donor in terms of Section 7(5).

## 5. BENEFITS OF THE UTILISATION OF A TRUST:

As the legislation regarding the taxation of trusts stands at present, there are numerous benefits for the use of trusts for business and income tax avoidance purposes.

(24) Supra at 571.

For example, trusts are a perfect device for income-splitting, in terms of which the marginal tax rate at which the income is ultimately taxed is reduced, estate planning purposes, and for channelling losses incurred as a result of the deduction of expenditure and allowances via the trusts to the beneficiaries, who then set off these losses against their income. For the purposes of this seminar, it is intended to discuss two aspects, namely the use of business trusts and the issue of a capital tax in some form or another.

## 5.1 BUSINESS TRUSTS:

Trusts have become a popular tool for the purposes of carrying on businesses. The advantages of utilizing a trust for such purposes include the following:

### 5.1.1. Limited liability:

Whilst the trust at common law is not considered a legal persona, the trust's assets nevertheless are separated from those of the trustee in terms of the Trust Property Control Act and as such, liability of debts incurred by any person through the utilization of the vehicle of the trust, can only be recovered against the assets of the trust itself, and not the trustees in their personal capacities or any other party.

### 5.1.2. Flexibility:

Whilst the trust enjoys the protection of a company or close corporation, it is not subject to the strict rules imposed particularly on companies. There is no requirement to retain capital reserves or to comply with the numerous requirements of the Companies Act 61 of 1973.

5.1.3 Tax-Rate:

The income of trusts is currently taxed on the same basis as that of a person in terms of the Act. This level of taxation is clearly advantageous in comparison to a company or close corporation, in particular when regard is had to the effect of secondary taxation on companies. (See changes to Act in 1998 below).

5.1.4 Losses:

Trusts allow for the channelling of losses through to the beneficiaries, in line with the case of individuals and partnerships. Of course, companies and close corporations do not enjoy this benefit. (See changes to act in 1998 below).

## 6. MARGO COMMISSION

As long ago as 1986, the Margo Commission(25) discussed the question of business trusts in some detail. The Commission sought to distinguish between business or trading trusts and what could be termed common-law trusts.

As regards the latter, the Commission recommended that the conduit-pipe principle, in that the identity of the income which accrues to a beneficiary retain its nature and is taxable in the hands of the beneficiary, remains. Income which is either not paid to the beneficiary or does not vest in such beneficiary at the end of the relevant tax year, would then be taxable at the maximum marginal rate applicable to individuals.

As regards business trusts, these ought to be dealt with on the same basis as companies.

The inherent problem that faced the Margo Commission, however, was the difficulty in differentiating between business and common-law trusts. The Margo Commission, in this regard, states the following(26):

(25) Margo Commission Report 1986: paragraphs 11.47 - 11.62.
(26) At paragraph 11.60

"Insofar as the features of a business trust are concerned, it is instructive to point out the following:

a. Crane and Bronberg on Partnership distinguish between a business trust and what they call a common-law trust in that in the latter, there is a gratuitous transfer by one person to a trustee for the benefit of another and the trust is more concerned with investment than with business operations.

b. The beneficiaries of business trusts often hold transferable certificates which are issued and transferred in the same manner as shares in a company.

c. The trustees often have the right to fill their own vacancies, and there is delegated centralized management.

d. In the United States, the Internal Revenue Code has certain provisions relating to the business trust. In this regard, Henn states:

*"A troublesome problem under the Internal Revenue Code is distinguishing an ordinary trust from an organization technically cast in the trust form but having the corporate characteristics of an 'association' and, therefore, taxable as a corporation."*

e. United States Treasury Regulation 301.7701/4A provides as follows:

*"Generally speaking, an arrangement will be treated as a trust 'under the Internal Revenue Code' if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise with the conduct of business for profit."*

f. Robert D Flanagan describes the business trust as follows:

*"A business or 'Massachusetts' trust is a trust utilized as an attractive vehicle through which to conduct operations of a manufacturing, service, investment or other type of business."*

g. H B Chemside says:

> *"In a number of representative cases, the Courts have observed or commented upon the features which distinguish the 'Massachusetts' or business trust from the ordinary or private trust.*
>
> *One such distinction is functional: the business trust is devised to increase business or profit, whereas the traditional trust is designed to conserve the protected property. Another distinction lies in the manner in which the trust relationship is created: investors in a business trust enter into a voluntary, consensual and contractual relationship whereas the beneficiaries of a traditional private trust take their interests by gifts from the donor or settlor."*

The Margo Commission then defines a business trust(27) in a similar manner as Van der Westhuizen(28), namely as one which in the opinion of the Commissioner, is used for carrying on business for profit, including the owning and letting of property for profit. Trusts designed simply to protect and conserve assets would fall outside this provision. A trust should be deemed to be a business trust where:

a. the interest of a beneficiary is transferable;

b. the beneficiaries and trustees establish their association by voluntary, consensual and contractual means, excluding mere acceptance of a benefit stipulated between a settlor and trustee.

It would seem, with respect, that the Margo Commission raised the problem of the definition of business trusts, but did not deal with same in any authoritative manner. Although the Commission's Report was approved, no legislation ensued apparently in view of the difficulty of making the discretion between a business and other type of trust.

(27) (27) At 11.62.
(28) Supra.

There are inherent problems in distinguishing between private trusts established for other purposes such as financial planning reasons, charitable reasons and institutional reasons. It is also not clear as to what the position would be in the event of one trust conducting various activities including some business activities as well as other asset-protection activities. Would apportionment apply? Furthermore, it is submitted that the splitting and / or combining or various trusts which deal with asset protection and commercial business activities, could be manipulated to render the Receiver's position extremely difficult in attempting to define a trust as that of a business trust.

## 7. 1998 BUDGET REVIEW:

The income tax proposals contained in the 1998 Budget Review and announced by the Minister of Finance in the budget speech of 11 March 1998, do not differentiate between business trusts and common-law trusts. Nor is there, to date, any indication of a distinction between testamentary and inter vivos trusts. The taxation proposals are stated as follows(29) :

*"3. That the rates of normal tax payable in respect of the taxable income of any trust (other than a special trust) in respect of the taxable income referred to in paragraph 1(a) and year of assessment ending 28 February 1999, shall be an amount of tax calculated in accordance with table below:*

| TAXABLE INCOME | RATES OF TAX |
|---|---|
| Where the taxable income - | |
| does not exceed R100 000,00 | 35% of each R1 of the taxable income |
| exceeds R100 000,00 | R35 000,00 plus 45% of the amount by which the taxable income exceeds R100 000,00 |

29) Annexure to Budget Review of 1998.

*"...7. For the purposes of - (a) paragraph 3, 'a special trust' means a trust created solely for the benefit of a person who suffers from:*

*1. any mental illness 'as defined in Section 1 of the Mental Health Act, 1973' (Act 18 of 1973); or*

*2. any serious physical disability where such illness or disability incapacitates such person from earning sufficient income to maintain himself / herself."*

It is not stated as to how the proposal of the amendment of Section 25(B) is to be enacted or if it is to be repealed in its entirety. In the 1998 Budget Review(30), the proposal is that losses of the trust may for tax purposes not be allowed to flow through to the beneficiaries, but that they be retained in the trust, to be carried forward to the following tax year and set off against the income of the trust in the following year, in respect of all new trusts created from 11 March 1998 and existing trusts with effect from years of assessment commencing on or after 01 January 1999.

## 8. 1998 AMENDMENT

Section 25B of the Act has been amended in accordance with the proposals in the Budget Review by the insertion of the following:

*"4. Notwithstanding the provisions of subsection (3), any deduction or allowance contemplated in that subsection which is deemed to be made in the determination of the taxable income of a beneficiary of a trust during any year of assessment shall be limited to the income which is deemed to be income which has accrued to such beneficiary in terms of subsection (1) during such year of assessment.*

(30) See annexure C: Summary of Tax Proposals.

5. *The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the income contemplated in that subsection, shall be deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during such year of assessment : Provided that the sum of such deductions and allowances shall be limited to the taxable income of such trust during such year of assessment as calculated before allowing any deduction or allowance under this subsection.*

6. *The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the income contemplated in subsection (4) of such beneficiary and the taxable income of such trust contemplated in subsection (5), shall for the purpose of subsection (3) be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived from by such beneficiary by way of income referred to in subsection (1) during the immediately succeeding year of assessment."*

The 1998 Budget Review furnishes two reasons for the above proposed changes, namely to prevent income-splitting in terms of which the marginal tax rate at which the income is ultimately taxed is reduced, and for channelling losses incurred as a result of the deduction of expenditure and allowances via the trust to the beneficiaries who then set off these losses against the income. The Budget Review(31) further states that the utilization of such losses for tax purposes is popular in the structuring of financing transactions. A beneficiary moreover has the added advantage of not being held liable for payment by a creditor of the trust, while at the same time enjoying the advantage of deduction of the loss.

Furthermore, the ownership and management of trust property normally vests in the trustee and tax allowances are usually only granted to the owner of the property. The Budget Review states that the above amount to "two initial steps in reforming the taxation of trusts"(32) and that the whole question of trusts is to be investigated.

(31) Chapter 9.20.
(32) Supra at 920.

## 8.1 THE EFFECT OF THE NEW AMENDMENTS ON TRUSTS:

### 8.1.1 Income Splitting:

It is submitted that the above proposals will not in any marked way prevent the splitting of income amongst beneficiaries. Trustees will still be able to direct income to beneficiaries and enjoy the benefits of the resulting lower tax rate, provided the income vests in the beneficiaries.

### 8.1.2 Inter vivos Trusts: flat tax rate and assessed losses

There is no suggestion in either the Budget Review or in the Minister of Finance's speech that the prevention of assessed losses will be limited to business or trade trusts and this is not dealt with in the amendments.

It would seem that the position, accordingly, is that any trust in which either the trustee does not exercise his discretion in the tax year in which the income is received by paying same to the beneficiaries, or that the beneficiaries have a vested interest in the income will be affected by the prevention of the assessed loss (and indeed the flat rates of taxation).

The Legislature has, accordingly, to date not accepted the Margo Commission's proposals regarding categorization of trusts into business and other trusts and applying separate taxation principles in respect of each trust. Instead, it would seem that a blanket amendment is the order of the day.

It is stating the obvious when reflecting that not all trusts, in terms of which a beneficiary has a vested right, amount to business trusts. A fortiori, not all trusts are used for the purpose of structuring finance transactions. Other trusts, including trusts with a charitable purpose, trusts created as a result of the immaturity of beneficiaries and so on will be affected by the amendments. This does not accord with the stated purpose of the Legislature.

This is somewhat surprising considering the attitude of the Katz Commission(33). In the context of discussing capital transfer tax, the Katz Commission states:

(33) Fourth Interim Report of the Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa. At paragraph 10.7 and 10.8.

"10.7a. *If planners wish to use a trust to carry on their business activities as opposed to using a more conventional business form, then they must accept all the consequences of doing so; and*

b. *In any event, there is no cogent commercial reason why business activities should be conducted through the vehicle of a trust as opposed to other conventional vehicles such as companies and close corporations. In fact, very often a trust is selected for the purposes of conducting business activities so as to avoid the company law obligations, such as the maintenance of capital provisions, which would attach to conducting business activities in a company and also to achieve a more favourable tax dispensation than would have applied had the business activities in question been conducted through a company.*

Business trust.

*10.8 The Commission can find no adequate justification for exempting trading trusts from the capital transfer provisions, bearing in mind that trading trusts are usually used to avoid compliance with normal company law and tax provisions that would otherwise have applied. Even if trading trusts were not subjected to the capital tax transfer provisions, there are cogent arguments that would require trading trusts to be subject to the company law and tax regimes applicable to conventional companies."*

It is illuminating that the Katz Commission has carried forward the argument of the Margo Commission in respect of business trusts, albeit in a context of discussing a wealth or capital transfer tax. In this context, the blanket proposals by the Legislature seem to be that more surprising and do not, with respect, seem to have been sufficiently considered.

8.1.3 <u>The Effect on the Conduit Principle:</u>

A fundamental legal difficulty arises, in the writer's submission, with regard to a vesting trust. According to precedent and Section 25(B), in a vesting trust the beneficiaries acquire a firm right to the income of the trust.

Accordingly, the income is never deemed to be that of the trust's income for income tax purposes. The difficulty that arises is that if a loss occurs during a tax year, according to the new rulings, this loss cannot be carried through to the beneficiaries, i.e. the conduit principle would not apply. According to the amendment, such assessed loss would then remain in the trust, to be deducted against income of the trust in future years. However, in following years, any income will deemed to be income of the beneficiaries and not of the trust. Accordingly, it will not be possible for the assessed loss to be deducted against such income. It is the writer's submission that this is more problematic than at first blush for it fundamentally alters the conduit principle. As such, it raises doubt regarding the entire precedent involved in the conduit pipe principle. Surely the legislature has not considered this position sufficiently.

8.1.4 Vesting Trusts:

Although an assessed loss will not be carried through to the beneficiary, who has a vested interest in such income, i.e. it makes no difference for the purposes for assessed loss as to whether the beneficiary has a vested or contingent interest in the income of the trust, nevertheless, this issue becomes important in the context of whether the flat rates of taxation, or the rates applicable to individuals will apply to such income.

Although discussed in the context of a beneficiary having a vested right in the trust capital and not trust income, the issue in the matter of Hilda Holt Will Trust vs. CIR(34) is important. In this case, an annuity which was inflation index linked was to be paid to a certain Ms Walker and the capital was to devolve upon a number of charitable and educational institutions on the death of Ms Walker. In terms of the trust deed, the trustees were obliged to utilize capital, if necessary, in order to ensure that such annuity was payable to Ms Walker.

The issue that arose was whether the awards to the charitable institutions amounted to a vested or contingent right. The Court looked at the facts of the case, and having regard to the considerable size of the estate in relation to the relatively minor annuity, the Court found that it was a remote possibility that the testatrix had considered the use of capital necessary to supplement the annuity(35).

(34) 1992 (4) SA661 (A) 55SATC1.
(35) Supra At 666.

The overriding intention of the testatrix could not have been to give Ms Walker a vested interest in the trust capital in that her rights could not be equated to those of a fideicommissum residui. The Court supported the view that the fact that the annuitant was entitled to have her annuity supplemented from capital did not make her a fiduciary. Furthermore, the fact that the annuitant could receive capital and as a result reduce the value of the capital could not have the effect of postponing the vesting of the residue in the ultimate beneficiary.

This case is important in its reflection of the "extension of the vesting principle" to include the situation where the final amount due may be uncertain. In view of the new legislation in particular, it is submitted that there will possibly be a scrambling to amend trust deeds to ensure that beneficiaries have vested interests in the income of such trusts.

## 9. WEALTH TAX:

The Katz Commission(36) in principle supports the idea of a wealth tax. Such a wealth tax is particularly relevant to trusts, as these are the most commonly used vehicles for increasing asset value i.e. capital which is currently non-taxable. The idea is supported on the basis that a wealth tax would promote vertical and horizontal equity(37). The Katz Commission goes on to say:

*"It is established that there is a huge disparity of incomes and assets between the various groups in South Africa. There is significant concentration of wealth in the hands of relatively few people ...*

*The actual and perceived redistributive effects on the tax systems are nonetheless important, particularly in the current circumstances in South Africa. In the Commission's view, the contribution which a wealth tax can make to the overall fairness of the tax system should not be underestimated...*

(36) See in general the Fourth Interim Report of the Commission Enquiry into Certain Aspects of Tax Structure of South Africa.

(37) Supra paragraph 1.4.

*Another factor in favour of wealth taxes ... is that capital contributes to a person's ability to pay taxes, and consequently offers a further base to levy tax."* (38)

These comments have been criticised in that it has been argued that the premise of the Katz Commission lies in that the accumulation of wealth is a "bad thing in itself"(39). If there is a great disparity between the few and the many, wealth should be taken from the few and redistributed to the many in one form or another(40). The criticism is taken further when it is stated that "this reasoning, we suggest, is an assault upon the capitalist system as such, because the system can lead and has lead to concentration of wealth in a few, but by no means necessarily to the detriment of the many".

Whilst it is certainly not the purpose of this dissertation to discuss the advantages and disadvantages of a capitalist system, it would seem to the writer that in trying to effect such principles, the Commission enters a realm of raising more difficulties than providing solutions.

The Commission immediately recognizes those problems associated with implementing a wealth tax of some sort. As such, the Commission immediately discards an annual, or once off wealth tax in favour of a capital transfer tax. This is despite the fact that the Commission acknowledges the problems with capital transfer taxes to include the following(41):

> *"a. Capital transfer taxes are prone to be extremely complex;*
>
> *b. The complexities referred to above result in problems of administration and high cost of collection;*
>
> *c. Anti-avoidance measures in addition to having to comply with equitable principles, must be designed so as to result in taxation of transactions that should be subject to the relevant taxes but, on the other hand, must endeavour not to include within a tax net transactions that have legitimate commercial and other justifications;*

(38) Supra paragraph 1.5.
(39) See Taxpayer 1997 (46) page 67.
(40) Supra at page 67.
(41) Supra paragraph 1.7.

*d. Capital transfer taxes have a notoriously low yield, that is, revenue collected minus costs of collection; and*

*e. Regrettably a worldwide phenomenon of capital transfer taxes is that it gives rise to an unproductive estate planning industry."*

Capital transfer taxes, or broadly wealth taxes, are criticized from the point of view that in general accumulations of wealth contain elements of savings of income. The result of a tax on wealth, therefore, amounts to an effective double taxation, once in the income accrued to the taxpayer and the second time on the accumulation(42).

In effect, there are currently several forms of wealth taxes applicable, including donations tax and estate duty. It is further submitted that transfer duty also constitutes a wealth tax.

In view of various factors, including effectively utilizing the resources of the South African Revenue Services, avoiding unnecessary complexity and attempting to attain vertical and horizontal equity in the tax system, the Katz Commission recommends that donations tax and estate duty remain as they currently stand, namely a rate of 25% of the value of such estate or donation, with a rebate of R25 000,00 per annum per donor rebate in respect of donations, and a R1 000 000,00 rebate in respect of estate duty. Naturally, all assets bequeathed to a surviving spouse of the deceased are not subject to estate duty.

Within the context of retaining such duties, the Katz Commission concentrates its attention on generation-skipping trusts(43). Generation-skipping trusts are considered to be trusts which acquire assets from the planner on the basis that the assets so acquired will be held by the trusts for a period extending beyond one generation.

This could be taken further to the creation of trusts in terms of which assets are held indefinitely on the basis that allocations of capital and income will be made to the children of the various generations. These inter-generational transfers of capital usually take place on a basis that does not attract liability to pay tax.

(42) The Taxpayer 1997 (46) page 67.
(43) Supra paragraph 10.

The Commission considers the imposition of two taxes, namely:

1. Based on periodic valuations of the assets; and

2. Distributions of capital from a trust to the beneficiaries.

With regard to the question of periodic valuations of the assets of a trust, the Commission identifies two criticisms of the imposition of such tax, namely:

a. The complexity of legislation that could be necessary to achieve the objective of subjecting the trust to capital transfer tax; and

b. The appropriateness of subjecting commercial trusts as opposed to family planning trusts to capital transfer tax.(44)

As regards (a), the Commission in essence says that it is possible, although it is the duty of the South African Revenue Services to draft such legislation, and not that of the Commission. As regards (b), the Commission in effect finds that commercial business trusts should not be utilized in any event(45).

The Commission's findings are as follows(46):

*"It is, therefore, the recommendation of the Commission that trusts be subjected to the capital transfer tax provisions on the basis that, at periodic levels, the net assets of the trust will be valued and subjected to capital transfer tax at the rate applicable to inter vivos donations and assets without any rebates. The frequency of the period must be a matter determined by Government and it should ordinarily reflect a single generation and any period within the range of 25 to 30 years would be appropriate."*

The Commission finds that there should be a transition period for existing trusts to adapt to such legislation, alternatively, that provision is made for existing trusts to be wound up without the imposition of such capital gains taxes. The recommendation is that trusts should be taxed on the same lines as in an individual, in that if it accumulates income earned by it after the imposition of tax and thereafter distributes the capital, it should be in the same position as would be applicable to an inter vivos donation.

(44) See paragraph 10.5.
(45) See paragraphs 10.8 and 10.9.
(46) See paragraph 10.9.

*"As regards the periodic valuation for capital transfer tax purposes, amounts accumulated and retained but not distributed should be subjected to the same treatment as all other assets of the trusts during a periodic valuation for capital transfer purposes"*(47).

The Commission realizes that the above position will be problematic in respect of vested rights of beneficiaries to the income of a trust. The Commission suggests that it is incorporated in the definition of a "distribution" - this will ensure that a vested right is subject to tax on distribution and not to the generation-skipping tax.

The Commission is consistently met with the problem of how to deal with double taxation. Problems highlighted include the following:

1. Testamentary trust - estate duty has already been paid;

2. Inter vivos trust - donations tax may already have been paid on establishment of such trust, or later;

3. Vesting trust - cannot be incorporated in the capital transfer tax as the tax payable will be such on distribution to the beneficiaries with vested rights;

4. What happens in a situation where there are successive vestings?

It is submitted that a further problem with generation-skipping tax is inflation - it could have a significant effect on asset growth in a trust. If, as the Commission recommends, the further or the second-generation tax is only effective on the asset growth on the trust, to be equitable, the amount upon which the original tax was paid (whether in the form of donation, estate duty or an original assessment in terms of the generation-skipping rules) should be adjusted by inflation to reflect the fact that the asset growth then taxable is a real and tangible asset growth.

(47) See paragraph 10.12.

Otherwise, as (it is submitted is often the case in divorces), there is in fact little or no real asset growth after the original amount is adjusted to reflect the effects of inflation (in terms of the Consumer Price Index). If such an adjustment is not incorporated in the legislation, it is submitted that such a taxation is artificial in that it quite obviously leads to inequitable results. Indeed, if for instance the inflationary figures of the 1980's were to arise again, the generation-skipping tax without an inflationary adjustment would make the entire effect of the taxation essentially a double taxation.

The Commission also raises the problem(48) of where a family utilizes the purposes of a holding company instead of a trust in order to protect the asset accumulation.

In terms of this process, a founder's assets are sold to the family holding the company in consideration for a loan account or preference shares. The ordinary shareholders would include the founder's children and grandchildren. After the death of the founder, the children and grandchildren effect the liquidation of such founding holding companies.

The founder retains control by use of preference shares in terms of which the founder enjoys multiple votes for control purposes. The answer to this is that in terms of the existing law, this would be part of the estate of the founder and accordingly be liable to estate duty.

Further recommendations of the Katz Commission include the fact that legislation preventing interest-free loans and preference shares would be ineffective and is not recommended.

The Portfolio Committee on Finance, of Parliament(49), has evaluated the Katz Commission Report and has received responses from various bodies. The Committee agreed that there should be no immediate changes to existing donations tax and estate duty taxes.

However, concerns were raised as to whether the levels of such taxation were not too high with a relatively minor yield. According to the Committee(50), capital transfer taxes contributed just over 0.1% of total revenue prior to the 1994 election.

(48) See paragraph 10.14.
(49) See Taxpayer 1997 (46) page 66.
(50) Supra page 5

This increased around the election to approximately 0.2% but since then has reverted back to its previous level of just over 0.1%. This has not changed despite the increase of the rate of 15% to 25% during the 1996 - 1997 fiscal year. It is accordingly felt that the tax rate of 25% is well beyond the rate that would deliver maximum yield. The contribution of capital transfer taxes to total revenue is not substantial and this must be measured against the administrative costs involved in collecting same.

Furthermore, as these rates were at such a high level, it contributed to avoidance behaviour. This should be seen in the light of the fact that the Commission does not recommend that any further tax avoidance legislation be adopted at present.

## 10. CONCLUSION:

It is clear that trusts are not as attractive as vehicles for purposes of tax and estate duty avoidance as in the past, and will become less so in the future. Whilst the Legislature was unable to distinguish business trusts from other forms of trusts, in its attempt to discourage the use of business trusts with the imposition of flat rates of taxation and the assessed losses being passed through to the beneficiary, all other trusts have been, unintentionally it is submitted, drastically affected by such changes. Quite clearly, the amendments will have significant consequences on the precedent regarding the conduit principle and this highlights the question of vesting of beneficiaries's rights. It would seem that the legislature has not thought these amendments through clearly - it has lead one magazine(51) to comment:

*"It's the old story of the fiscus wielding a sledgehammer to remedy an avoidance technique, when a scalpel would have been more appropriate."*

The Katz Commission has turned its attention to capital transfer taxation of inter-generational trusts as well as on distributions to beneficiaries. With questions of double taxation, the effect of inflation and different forms of trusts all being incorporated into such legislation, it is submitted that, no matter how such a tax is legislated, there will be ample room for much querying, tax planning and indeed litigation. This should be seen in the context of what the contribution of such tax will yield as well opposed to administration costs incurred in recovering such taxes. It is all very well arguing that, in principle, such taxes are a good idea. However, one wonders what the point would be if such a taxation will not yield significant benefit to the fiscus, whilst at the same time allowing for more scope for tax planning. It is submitted that such legislation will be too complicated to draft, too difficult to apply and too easy to avoid to make it effective.

The writer, for one, awaits new developments in the taxation of trusts with interest.

(51) See Financial Mail March 13, 1998, at page 13.

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# ANALYSIS OF SECTION 103(1)
## with particular reference to the 'abnormality' requirement

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## CONTENTS:


| | | Page no. |
|---|---|---|
| 1. | Introduction | 1 |
| 2. | Development of the anti-avoidance provision | 1 - 5 |
| 3. | Purpose | 5 - 6 |
| 4. | Normality | 6 |
| 4.1 | Position prior to 1996 Amendment | 6 |
| 4.1.1 | Arm's Length Requirement | 6 - 9 |
| 4.1.2 | Abnormal manner requirement | 9 - 12 |
| 4.2 | The Amended Section | 12 - 14 |
| 5. | Australia - Anti-Avoidance Position | 14 -18 |
| 6. | The English 'Substance over Form' Doctrine | 18 - 19 |
| 7. | Application of Substance over Form to Section 103 | 20 - 21 |
| 8. | Conclusion | 22 |

# 1. INTRODUCTION

The war between the taxpayer and the South African Revenue Service ("The Commissioner") comprises fluid, non-stop battles on various fronts. An interesting point of conflict is that of the general anti-avoidance provision contained in Section 103(1) of the Income Tax Act No. 58 of 1962 ("The Act").

While each party can, and does, draw support from numerous dicta from local and international Judgments to claim the moral high ground *(1)* , in the end it is the requirements laid down in Section 103(1), and the way such requirements have been interpreted, that will point to the outcome of an attempt by The Commissioner to invoke the provisions of Section 103(1). Over the years this provision has been amended at the instance of the Commissioner, in an attempt to broaden its net and improve its effectiveness. The last of such amendments was effected in July 1996 *(2)* . In effecting such an amendment, the legislature has deemed it fit to tamper significantly with what is known as the "normality requirement". With reference to recent case law, interpretation of the provisions of the section as well as briefly exploring the position in other countries, in particular the United Kingdom and Australia, this paper attempts to measure the efficacy of Section 103 in its amended form.

# 2. DEVELOPMENT OF THE ANTI-AVOIDANCE PROVISION

In 1941, the precursor to Section 103 was enacted in the following form:

> *"Section 90. Whenever the Commissioner is satisfied that any transaction or operation has been entered into or carried out for the purpose of avoiding liability for the payment of any tax imposed by this Act, or reducing the amount of any such tax, any liability for any such tax, and the amount thereof, may be determined, and the payment of the tax chargeable may be required and enforced, as if the transaction or operation had not been entered into or carried out."*

The matter of CIR v King *(3)* reflected the shortcomings of the wording of Section 90, in that the Court effectively sanctioned the most common used devices of income tax avoidance, namely that of alienating an income-producing asset. The fact that such alienation took place between the taxpayer and his daughter particularly irked the Commissioner.

*(1)* *See for instance Duke of Westminster v IRC 1934 S1 TLR 467, 19 TC 490 at S20 and Meyerowitz - Income Tax 1997, 1998 at B29.1*

*(2)* *The amendments were introduced in the 1996 Act.*

*(3)* *1947(2)SA 196(A), 14 SATC 184..*

Working from the premise that numerous instances of a taxpayer reducing his liability for tax, "for example, a man can sell investments which produce income subject to tax and in their place make no investments at all, or he can spend the proceeds in buying a house to live in ..." *(4)* could not possibly be covered by the provisions of Section 90, Watermeyer C J sought to distinguish two scenarios, namely:

(1) where a taxpayer orders his affairs in such a way as that he has no income, or a reduced income, exposed to tax liability, and

(2) where a taxpayer orders his affairs that he escapes or reduces his liability to taxation on "which he ought to pay upon which is in reality his" *(5)*.

The words "avoiding liability" and "reducing the amount" ought to be interpreted in terms of the second scenario. Schreiner J A, in a concurring Judgment, elucidated the difficulty that Watermeyer C J was having with such concepts, by emphasising the difference in the above two scenarios in the context of the normality of such a transaction. He states:

> *"The Section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer's affairs which will result in him getting less income; it is designed to meet the Commissioner's objections to the creation of abnormal or unnatural situations to the detriment of the 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. In such cases, and in my view, 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 of his labour or of both." (6) (my emphasis)*

This interpretation of the Section was effectively utilised by the Commissioner in Meyerowitz v CIR *(7)* in which the taxpayer went to significant lengths to divest himself of receiving the income from an income-producing asset (a text-book) and from the rewards of his labour (editing a publication).

*(4)* *Supra at page 208.*
*(5)* *Supra at page 210.*
*(6)* *Supra at page 215.*
*(7)* *1963(3)SA 863(A).*

As a result of the limitations imposed in the Judgment in the King case, a new avoidance Section was enacted, incorporating, inter alia, the scenario of alienation of property, and formally recognising the normality requirement as stated by Schreiner J A. The new Section incorporated in 1959 and falling as Section 103(1) after the consolidation of the act in 1962 (and the 1978 amendment pursuant to SIR v Gallagher), reads as follows:

*"103(1) Wherever 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 reducing the amount thereof; and*

*(b) 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 entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question, or*

*(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*

*(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 or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of the 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 manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction."*

In terms of this section, all requirements had to be in place in order for the Commissioner to successfully invoke its provisions, namely:

1. There is a transaction, operation or scheme;

2. which has the effect of avoiding, postponing or reducing a tax liability;

3. is carried out in an abnormal manner;

4. and has as its sole or main purpose the avoiding, postponement or reduction of a tax liability.

Over the years, the Commissioner achieved only partial success in invoking Section 103. In an attempt to bolster the position of the Commissioner with effect from July 1996, the legislature amended Section 103 by means of Act 36 of 1996 (with the amendments highlighted) which now reads, as follows:

*"103(1) Wherever 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 reducing the amount thereof; and*

*(b) 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 at -*

*(aa) <u>in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit</u>; and*

*(bb) <u>in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item ( aa )</u>, 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*

*(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*

*(c) was entered into or carried out solely or mainly for the purposes of a tax benefit,*

*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 manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction."*

"Tax benefit" is defined in Section 103(7) as including "any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner".

As is apparent, the amended Section affects only the third requirement, namely that of "normality". The other requirements have not been affected, and I intend dealing briefly with the fourth requirement, namely purpose, before turning to normality.

## 3. PURPOSE

The test to be applied in determining purpose is subjective as opposed to an objective test when regard is had to the "effect" requirement *(9)*.

Meyerowitz *(10)* argues correctly, it is submitted, that "solely or mainly" implies at the least a dominant purpose.

Both the matters of Sir v Geustyn, Forsyth and Joubert *(11)* and CIR v Louw *(12)* involved the incorporation of engineering partnerships. In the former Ogilvie Thompson C J stated "the intention or purpose with which any transaction is entered into is a question of fact" *(13)* and the Court a quo had found that there were various reasons for incorporation, including the advantages of continuing as a legal entity in the event of the death or retirement of one of previous partners. In the later case, the then Appellate Division found that, at the time of incorporation, there was no sole or main purpose to avoid, reduce or postpone tax liabilities, instead the purpose was to provide legal persona continuity to facilitate association with foreign consortiums as well as long term undertakings.

*(8) 1978(2)SA 463, where the taxpayer successfully argued that his purpose was to save estate duty and not income tax. The Section was consequently broadened to include "the payment of any tax, duty or levy (whether imposed by this or any previous Income Tax Act or other law administered by the Commissioner) ..."*

*(9) Sir v Gallagher (supra) at 48.*

*(10) Meyerowitz on Income Tax 1997, 1998, at 29.8.*

*(11) 1971(3)SA 567(A).*

*(12) 1983(3)SA 551(A).*

*(13) At SATC 122.*

However, in Louw, the erstwhile partners, at a later stage, began borrowing substantial amounts from the company, allowing their loan accounts to go into debit. These were financed by the company's surplus cash. The shareholders, as employees were claiming far smaller salaries than was the case while acting as a partnership. The balance of their income (being the majority of their income) was being received by way of the aforesaid loans, which were unsecured and in terms of which no interest repayments were laid down. Corbett J A, as he then was, held that the loans were unlikely ever to be called up and the purpose requirement was satisfied in respect of the loan. Likewise, in Ovenstone v SIR *(14)*, the taxpayer's purpose was originally to avoid estate duty (which would have succeeded in nullifying the purpose requirement, the facts having arisen before the 1978 amendment). However, there was a delay in implementing his scheme of approximately 3 years. His scheme involved selling certain shares to a trust to avoid estate duty. The dividends at the time of proposing the scheme were not taxable in the hands of the taxpayer as some were held in the then South West Africa. The Act was eventually changed, in terms of which the aforesaid dividends would become taxable in the hands of the taxpayer, and just prior thereto the scheme was finally hurriedly put into place. Trollip J A in a unanimous decision held that the taxpayer's purpose had changed as a consequence of the change in the law and that an additional purpose of avoiding tax had arisen thus falling into the purpose requirement of Section 103.

## 4. NORMALITY

### 4.1 Position prior to 1996 Amendment

#### 4.1.1 Arm's Length Requirement

Trollip J A in Hicklin v SIR *(15)* in delivering the unanimous Judgment laid down the approach to the normality requirement by stating that the first step in the enquiry is to determine whether or not the parties are acting at arm's length as envisaged in Section 103(1)(b)(ii). He states:

> *"When the transaction, operation or scheme is an agreement ... it is important, I think, to determine first whether it was one concluded 'at arm's length'. That is the criterion postulated in Section 103(1)(b)(ii). For 'dealing at arm's length' is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost advantage out of the transaction for himself. Indeed, in the Afrikaans text the corresponding phrase is 'die uiterste voorwaardes beding'. Hence in an 'at arm's length' agreement, the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by Section 103(1)(b)(ii)."* *(16)*

*(14)* *1980(1)SA 721(A).*
*(15)* *1980(1) SA 481(A).*
*(16)* *Supra at 195.*

In ITC 1518 *(17)* it became obvious to the Court that the scheme had created rights not normally created between persons dealing at arm's length. In this matter, two brothers who were directors of farming companies owned by their family trusts, contrived to appoint the trusts as managers of the farming companies, and route what they called managerial services remuneration from the companies to the trusts which then distributed that income to their children as beneficiaries, thereby reducing the tax obligation of the brothers by drawing smaller director's fees. Such dealings clearly failed the arm's length test and the scheme was found to be abnormal.

The arm's length requirement, however, is not completely clear where parties, who are prima facie not acting at arm's length, e.g. a father his son, or two companies with identical shareholders. Silke addresses this difficulty by raising the question "How can a transaction be required to be 'at arm's length' having regard to circumstances that are anything but at arm's length?" *(18)* Meyerowitz also states "Is this fact [that the parties are not at arm's length] one of the circumstances to which regard must be had in determining the normality of the transaction?" *(19)* The wording of the old Section *(20)* requires that (b)(ii) must be read in the context of (b) i.e. "having regard to the circumstances under which the transaction (etc.) was entered into or carried out ... has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, of the nature of the operation or scheme in question" (my emphasis). Must the scheme create rights or obligations not at arm's length when considered in the context of such schemes which are patently not at arm's length i.e. is it different to the context of such schemes not being at arm's length?

This in essence was the issue raised in Geustyn's case. Clearly the erstwhile partners were not prima facie at arm's length when incorporating and becoming identical directors. Ogilvie Thompson C J, however, considered the scheme in question in the context of other schemes of engineering partnerships being incorporated. The Court states *(21)*:

> *"The criterion of 'persons dealing at arm's length' mentioned in Section 103(1)(ii) is, however, not ..... of application in a case such as the present. For the Section enjoins the application of that criteria in relation to a transaction, operation or scheme 'of the nature of the transaction, operation or scheme in question'. Yet the Court is in the present case ex hypothesi concerned with partners who have, in circumstances outlined above, made over their practice, not to an independent third party with whom they would ordinarily deal 'at arm's length', but to an unlimited company of which they are the sole shareholders and directors and whereof they have full and complete control."*

*(17)* *(1989) S4 SATC 113.*
*(18)* *Silke on South African Income Tax Volume III - Alwyn de Koker - Butterworths looseleaf at 19.29.*
*(19)* *Meyerowitz Supra at 29.8.*
*(20)* *and, it is submitted, the new Section.*
*(21)* *Supra at 574.*

Whilst postulating the above position, however, Ogilvie Thompson C J refuses to carry this argument through, stating *(22)*: "However, inasmuch as it is not essential for the decision of this case to pronounce upon this particular aspect of the matter (which was not exhaustively argued before us) I prefer to express no conclusion on the point", and promptly assumes in favour of the Commissioner, that the scheme was abnormal.

In Louw's case, the above point was considered in some detail by Corbett J A, as he then was, in the unanimous Judgment of the Appellate Division. The Commissioner argued that the arm's length requirement had not been satisfied in respect of the rights and obligations created under the scheme. The Commissioner alluded to the following features in support of its argument, namely:

( a ) that the assets of the partnership, including its goodwill, were sold to the company on credit without the requirement of payment of interest;

( b ) that the balance of the purchase price was only payable as the company was placed into a position to make payment;

( c ) the conclusion of service contracts between the company and its shareholders; and

( d ) the lending on large sums of money to the shareholders free of interest and without any definite conditions of repayment.

Regarding ( a ), Corbett J A held that the parties had little choice as there was limited capital and that they intended to pay the purchase price out of profits which it in fact did. The Court states:

> *"Since the sellers were the persons mainly instrumental in earning these profits and were in complete control over the company, it was a perfectly sound and businesslike arrangement. It was not an arrangement that would not normally have been created by persons dealing at arm's length in this type of transaction."* *(23)* (my emphasis)

Corbett J A applied the same logic in dealing with items ( b ) and ( c ). Corbett J A later looks at ( d ) in the context of a change of purpose by the parties. In discussing Geustyn, Corbett J A states:

> *"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 were 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 of the nature of the transaction, operation or scheme in question ...'".*

*(22)* *Supra at 575.*
*(23)* *Supra at 574.*

> ***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. 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 parties; 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."*** *(24)*

It is accordingly submitted that the "arm's length" requirement is fairly difficult to satisfy in that effectively the rights and obligations created have to be abnormal in the context of schemes of a similar nature.

### 4.1.2 Abnormal manner requirement

After dealing with the first step as looking at the arm's length requirement (as quoted above), Trollip J A in Hicklin's case states that the second step in the normality enquiry is as follows *(25)*:

> *"The next observation is that, when considering the normality of the rights or obligations so created or the means or manner so employed, due regard has to be paid to the surrounding circumstances, Section 103(1) itself postulates that. 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. The last observation is that the problem of normality of such matters is mainly a factual one."*

In ITC 1178, the then Section 50(f), exempted a company from the undistributed profits tax if the amount of the company's reserves did not exceed R100 000,00, was at issue. The directors of company A formed a new company B when A's profits reached R100 000,00. B then took over the business of A, with the effect that B was now free to accrue further reserves of undistributed profits without invoking tax obligations. Corbett J, as he then was, found that the scheme was abnormal, the facts reflecting that the scheme was not carried out by means or in a manner in which would not normally be employed. Such factors included: there was no business agreement entered into between A and B; after the sale, the business was conducted from the same premises, with the same equipment, under the same staff and directors, using the same hired plant and machinery; there was no payment to A by B for the business.

*(24)* *Supra at 574.*
*(25)* *Supra at 195.*

The facts in Hicklin involved the taxpayer as one of the shareholders of a virtually dormant company, Recklane, which had assets effectively consisting of its loans to its shareholders in proportion to their shareholding. The company also had distributable and non-distributable reserves. A public company, Ryan Nigel (RN), in which none of the shareholders of Recklane had any interest, purchased the shares of Recklane. The purchase price was an amount equal to the company's reserves less:

1. 10% of its distributable reserves;
2. 1% stamp duty on the share transfers;
3. an amount equal to the loan levy, the purchaser undertaking to pay an equal sum to the sellers when the levy matured.

The sellers, including the taxpayer, warranted that at the effective date the company's only assets, apart from the levy, would be the loan accounts, which they ensured by acquiring all the assets of the company resulting in a proportionate increase in their loan accounts. They had to repay their loan accounts on the effective date. Thereafter, RN completed its dividend-stripping operation. The effect of the agreement was that the sellers, including the taxpayer, obtained the full value of their shares without incurring any tax liability. The issue, when the matter reached the AD hinged simply on the normality requirement, all three other requirements of Section 103 being found to be in existence.

The Commissioner argued *(26)* that the shareholders caused Recklane to lend them, before and at the time of cleaning Recklane of its assets and liabilities for the sale of its shares, the whole of the distributable profits. The purchase price was used to liquidate these loans. "So in effect and reality", said Counsel, "the shareholders received those distributable profits." *(27)* Trollip J A refused to pierce the corporate veil. He further agreed that the parties are entitled to arrange their affairs in the most tax effective manner, when he states:

> *"It is true, of course, that the shareholders could have repaid their loans by declaring Recklane's reserves and assets as dividends, thereby incurring the ensuing tax liability. But they were not obliged to do that. They were perfectly entitled to try to avoid such tax liability by adapting some other legitimate course."* *(28)*

Trollip J A found on the facts that the parties were indeed acting at arm's length. Then, upon his own test formulated, as quoted above, on looking at all the surrounding circumstances, there were no abnormal rights or obligations resulting from the scheme. He states:

*Supra at 494.*
*Supra at 494.*
*Supra at 494.*

> *"It seems an eminently reasonable consideration for the shareholders to have to pay in order to be rid of the stubborn, 'untidy', dormant Recklane, their loan indebtedness to it, and their anticipated substantial tax liability, and for Ryan Nigel to receive a reward for fulfilling its part of the bargain."* (29)

The main issue which seems to have turned the point was that the parties were acting at arm's length, and that all the circumstances merely pointed to each party effecting their purpose in the most tax efficient manner.

In an as yet unreported Judgment in the matter of Tycon (30), Kroon J looked both at sham transactions as well as Section 103(1) [considered in fact prior to Section 23D and Section 23G being implemented (31)]. The facts were as follows:

The taxpayer, in order to raise finance, entered into a sale and leaseback arrangement with a financial institution. The sale agreement was made subject to the suspensive condition that the seller and buyer entered into a lease agreement. The assets were sold at market value. A term of the lease agreement was that if the Commissioner did not accept the purchase price as the basis on which a depreciation allowance might be claimed, the rental would be adjusted upwards to compensate the financial institution. The parties avoided the common difficulty involved with attempting to pledge the assets (which is invalid in our law unless the pledgee takes possession of the assets, an effect which nullifies the whole point of a 'pledge' in such circumstances), by carefully attending on the factory, and in the presence of an attorney, delivery took place by way of constitution possession, which exercise was recorded by the attorney in a notarial certificate.

The Court rejected the Commissioner's main argument that the agreement was a sham. For good measure, it also accepted the argument regarding onus that, in view of the general onus on the taxpayer in Section 82 of the Act, the effect of the presumption contained in Section 103(4) is to shift the onus to prove the requirements of Section 103(1) back on the Commissioner. It remains to be seen as to whether the Supreme Court of Appeal will accept this.

Regarding Section 103(1), Kroon J found, predictably, that the first two requirements were present, and the issue turned on both the normality and purpose requirements. In respect of normality, the starting point was that the parties were indeed acting at arm's length. On the authority of Hicklin, this meant that the premise was that the scheme was more likely to be normal than abnormal. Thereafter, the Court looked at the surrounding circumstances and found that the special relationship between the parties had to be taken into account. The fact that the transactions were finance transactions and that the taxpayer had a solid credit rating were important. Importantly, the Court found that the fact that sale and leaseback agreements were frequently entered into should be

(29) *Supra at 496.*
(30) *See article of Olivier: "Sale and leaseback", De Rebus October 1997 691.*
(31) *Section 23D and Section 23G would nullify the tax advantage of this type of scheme.*

> "a factor to be thrown into the melting pot as constituting a pointer to the normality of the transaction." *(32)*

Once again, when the normality requirement was tested against the background of similar schemes, the Court accepted that the scheme was not abnormal. Kroon J also found that the purpose requirement had not been satisfied.

## 4.2 THE AMENDED SECTION

The amendments to Section 103(1) introduce a division between a scheme in a business context and any other scheme. This division results from the recommendation of the Katz Commission that a business test be introduced to the section *(33)*. There is now a split between a scheme in a business context and schemes not of a business nature. For "schemes in the context of business", the Commissioner may act when such were entered into or carried out "in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit" [Section 103(1)(b)(I)(aa)]. For other schemes, the test of abnormality has not varied from the test applicable under the old section *(34)*.

The test for the schemes in the context of business is whether the manner in which they would be carried out would not normally be employed 'for bona fide business purposes' other than the obtaining of a 'tax benefit'. The legislature has deleted the words "by means" probably in the belief that such wording does not add to the meaning of the section.

It has been pointed out *(35)* that the fact that there is no definition of the term "in the context of business" may lead to practical difficulties in establishing which schemes fall into business context category. For instance, in what circumstances will a loan to a relative amount to a scheme in the context of business.

The next logical question is to ask whether the amendment has extended the applicability of the section, and, if so, the range of such extension.

It is submitted that the section remains a difficult one to interpret and apply. The added test reads fully as follows: "having regard to the circumstances ..... in the context of business was entered into or carried out ..... in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit". Williams *(36)* argues that the above entails both a subjective and objective test. He states:

*(32)* *Supra at 693.*
*(33)* *The Taxpayer Volume 45 1996 at 113..*
*(34)* *Income Tax Reporter Volume 35 Part 6 page 251.*
*(35)* *Income Tax Reporter Supra at 252.*
*(36)* *R C Williams "The 1996 Amendments to the General Anti-Avoidance Section of the Income Tax Act" 1996 SALJ.*

> *"Two points about this form of words are significant. First, the criterion centres not just on the substance of the transaction itself, that is to say on the terms of the transaction, but on the 'manner' in which it was entered into, which seems to widen the enquiry. Second, the section does not say that the enquiry is into whether the transaction 'was not entered into ..... for bona fide business purposes', but is expressed in the subjunctive, the operative phrase being 'would not normally be employed for bona fide purposes, other than the obtaining of a tax benefit'. I believe, therefore, that the section does not mandate an enquiry into whether or not the particular taxpayer entered into the particular transaction for bona fide purposes, but that it necessitates an enquiry into a hypothetical situation: whether the manner in which the transaction was entered into 'would not normally be employed' for bona fide business purposes'. This raises the question: 'Would not normally be employed by whom? By the particular taxpayer? By business people generally?' In my view, the latter is the intended meaning."* (37)

The writer respectfully disagrees with Williams. The purpose requirement invokes a subjective test and the normality requirement an objective test. The initial clause states "having regard to the circumstances". This is clearly a subjective notion, but it is also all encompassing. One, therefore, it is submitted, looks at what would be normally employed for bona fide business purposes in the context of the subjective circumstances of the particular scheme. Williams' first point regarding the use of the word "manner" does not take the point further and certainly does not widen the enquiry. If so, from what premise is the enquiry widened and what is the expanded enquiry? What word ought the legislature to have used? Williams' second point, namely that if the test was purely subjective it would have read "was entered into" can also be questioned on the basis that such wording would mean that the enquiry would simply amount to a different way of stating the purpose enquiry in Section 103(1)( c ) and as such would be redundant.

Williams almost concedes that his interpretation would amount to a nullification of the principle that "every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it would otherwise be". (38)

In attempting to avoid such a conclusion, he in fact contradicts his original argument and states that the subjective circumstances of the scheme must be seen in the context of objective bona fide business schemes of such a type. He states:

(37) *Supra at 667.*
(38) *Lord Tomlin in Commissioner of Inland Revenue v Duke of Westminster (1936) AC (HL) at 19.*
(39) *Supra at 682.*

> *"Can these subjective and objective criteria be applied simultaneously? I think there is only one interpretation that reconciles them: the Court must first take recognisance of the particular taxpayer and then ask whether, in those circumstances, the generality of taxpayers would normally have entered into the given transaction, or entered into it in the given manner, for bona fide business purposes other than the obtaining of a tax benefit. If the answer is no, they would not have, then - irrespective of whether it was the business purpose that attracted that particular taxpayer - Section 103(1) will be applicable."* (40) (my emphasis)

Williams' argument has moved from testing the subjective circumstances against an objective hypothetical enquiry, to (almost) looking at the subjective manner in the context of a bona fide business purpose in the context of the taxpayer's particular circumstances. This interpretation, it is submitted, in actual fact implies that the effect of the amendment is not significant. In general, all that is required is that there are 'bona fide' business purposes for the scheme 'other than obtaining a tax benefit'. The only instances that Williams gives as examples under which a scheme would previously have escaped Section 103 but now fall under the auspices of the Section are Erf 3183/I Ladysmith (Pty) Ltd and another v Commissioner for Inland Revenue, a rather extreme case, as well as, in his submission the matter of ITC 1603 (41) where the taxpayer, an attorney, structured his borrowing for the purposes of financing his practice not initially in a tax effective manner, but later changed as an afterthought to a scheme in terms of which the borrowing was made against the bond over his wife's immovable property.

It may be useful to consider the application of the 'business purpose test' in the context of the English 'Substance over Form' doctrine. See below.

It would seem, therefore, that the scope of the amendments are fairly limited. As the amendments only apply to schemes entered into after 02 July 1996, it remains to be seen as to how the judiciary will in fact interpret the amendments.

## 5. AUSTRALIA - ANTI-AVOIDANCE POSITION

Australia has a general anti-avoidance provision in the form of PART IV A of the Income Tax Assessment Act 1936, in particular Section 177. The material provisions of the section read as follows:

*"Section 177A(1) ..... 'scheme' means*

> *(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and*

(40) *1996(3) SA 942(A).*
(41) *(1996) 58 SATC 212.*

*(b)* *any scheme, plan, proposal, action, course of action or course of conduct.*

*Section 177A(5)* *A reference in this part to a scheme ..... being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme ..... being entered into or carried out by the person for two or more purposes of which that particular purpose is the dominant purpose.*

**[Section 177C - defines a tax benefit]**

*Section 177D .....*

*(a)* *a taxpayer has obtained ..... a tax benefit in connection with the scheme; and*

*(b)* *having regard to:*

*(i)* *the manner in which the scheme was entered into or carried out;*

*(ii)* *the form and substance of the scheme;*

*(iii)* *the time at which the scheme was entered into and the length of the period during which the scheme was carried out;*

*(iv)* *the result in relation to the operation of this Act that, but for this part, would be achieved by the scheme;*

*(v)* *any change in the financial position of the relevant taxpayer that has resulted, will result or may reasonably be expected to result, from the scheme;*

*(vi)* *any change in the financial position of any person who has, or has had, any connection (whether of a business family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;*

*(vii)* *any other consequence from the relevant taxpayer, or for any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and*

> *(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi);*
>
> *it would be concluded that the person, or one of the persons, who entered into or carried out the scheme ..... did so in fact for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme ..... "*

Harris et al *(42)* argue that analysis of the various conceptual bases of anti-avoidance jurisprudence leads to remarkably similar formulations of the circumstances which will be regarded as unacceptable tax-avoidance. Such common elements are:

1. The taxpayer has departed from the ordinary means of achieving the objective of the transaction sought to be taxed;

2. In so doing the taxpayer has obtained a tax advantage which is not appropriate to the economic reality of his position; and

3. The taxpayer intended that result by structuring the transaction in that way.

In Australia, Part IV operates where, as a result of a scheme allowing the conclusion that the dominant purpose of one participant was the obtaining by a taxpayer of a prescribed tax benefit, and the taxpayer obtaining such a tax benefit.

It is an essential ingredient that the scheme entered into has a dominant purpose which enables a taxpayer to obtain a tax benefit. Whether the dominant purpose of an arrangement is tax avoidance will be determined by the tests set out in paragraph b of Section 177D. It is for the Commissioner to examine a scheme and place the emphasis in respect of the tests set out in (b) where it appears to be appropriate. *(43)*

*(42)* ***Harris, Russell & Blissenden: Part IV A - Schemes to reduce Income Tax - General Commenting ..... at 4068 4.4.***

*(43)* ***Supra at 4068.35.***

In the matter of Peabody *(44)* , the question of "dominant purpose" and "scheme" was considered in detail. The facts were that a company, TEP, was the trustee of the Peabody Family Trust (the Trust). The taxpayer and her husband were the only directors of TEP. TEP held 62% of the shares in the Puzzelonic Group of companies. A certain Mr Kleinschmidt owned the rest. Mr Peabody made plans to publicly float Puzzelonic. Kleinschmidt agreed to sell his shares to Peabody interests. It was estimated that the public float would net 24 million dollars and it was believed that commercial difficulties might arise if the prospectus disclosed the fact that the price of the shares offered to the public was well in excess of the price paid to Kleinschmidt. To circumvent this problem, TEP acquired a shelf company to acquire the Kleinschmidt shares, thereafter each of the companies in the Puzzelonic group declared dividends which were paid to the shelf company and passed special resolutions converting the Kleinschmidt shares from ordinary shares to preference shares. The total effect of these transactions were that the Kleinschmidt shares, which previously had a value of at least 8.6 million dollars, became preference shares with a total value of less than 500 dollars, while the trust's interest increased from 62% to 100% without any change in the number of shares it held. The flotation went ahead successfully.

The Commissioner argued that there were a series of steps implemented to avoid paying capital gains tax. The taxpayer objected, arguing that there was no scheme, or, that if there was, it was explicable on commercial grounds. In the Federal Court, O'Loughlin J found that there was in fact a scheme in place, and stated, regarding purpose:

> *"Let it be assumed that the scheme did extend to the legitimate purpose of obtaining cheap finance through the issue of redeemable preference shares; that will not save the relevant taxpayer if some other prescribed purpose existed that can be properly be classified as the dominant purpose of the plan."* *(45)*

However, this view was rejected by the Full Federal Court *(46)* which considered that the whole scheme as formulated was entered into or carried out with a dominant commercial purpose, namely the acquisition of the shares from the minority shareholder and the flotation of a public company. The factors that dominated in the scheme, when considered as a whole, were purely commercial.

On appeal, the High Court found that "the fact that relevant purpose under Section 177D may be the purpose of dominant purpose under Section 177A(5) of a person who carries out only part of the scheme is insufficient to enable part of a scheme to be regarded as a scheme on its own." *(47)*

*(44)* ***Peabody v FCT (1992) ATR 58; 92 ATC 4585.***
*(45)* ***Supra at ATR 68.***
*(46)* ***Peabody v FCT (1993) 25 ATR 32; 92 ATC 4104.***
*(47)* ***FCT v Peabody (1994) 28 ATR 344 at 352.***

It would, accordingly, seem that the Court will look at abnormality as espoused in paragraph (b) of Section 177D as one of the tests to establish the dominant (subjective) purpose. Unlike Section 103, not all the requirements have to be present. It could, it is submitted, be similar to the South African scenario, where to put it laconically, if the taxpayer shows a bona fide business purpose (being not tax avoidance), he is "home and dry".

As regards normality, the comment of Lord Denning in Newton's case in respect of the predecessor to PART IV, Section 260, states *(48)*:

> *"In order to bring the arrangements within the section, you must be able to predicate - by looking at the overt acts by which it was implemented - that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section."*

This is an interesting comment when considering, in the South African context, the provision of Section 103(1)(b)(i)(aa). It would seem to support the view that the manner needs to be investigated in the context of similar business schemes.

## 6. THE ENGLISH 'SUBSTANCE OVER FORM' DOCTRINE

Like South African Law *(49)*, both Australian and English Law attack sham transactions. A transaction is a sham where it takes the form of a pretence to the creation of legal relationships which do not in fact exist *(50)*. In English Law, in the matter of W J Ramsey Ltd v IRC *(51)*, Lord Wilberforce and Lord Fraser approved the statement made in Snook v London and West Riding Investments Ltd *(52)* as follows:

> *"Acts done and documents executed by parties to the 'sham' which are intended by them to give to third parties or to the Court the appearance of creating between the parties legal rights and obligations (if any) different from the actual legal rights and obligations (if any) which the parties intend to create."* *(53)*

As against the above, Section 103 is directed at a transaction which is at least genuine in that it reflects the intentions of the parties.

*(48)* *Newton v FCT (1958) 98 CLR 1 at 8.*
*(49)* *See for instance: Glen Anil Development Corporation Ltd v SIR 1975(4) 715(A).*
*(50)* *Harris et al Supra at 4068.4.1.*
*(51)* *(1982) AC 300.*
*(52)* *(1967) 2 QB 786 at 802.*
*(53)* *Supra at 323 and 337.*

In the absence of a general anti-avoidance provision in United Kingdom legislation, the judiciary have developed in its place a series of principles relating to tax avoidance, and have asserted the superiority of such means. Initially, the tax planner was blessed with the oft-quoted principle set out by Lord Tomlin in Duke of Westminster v IRC *(54)*.

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

This comforting dicta was, however, extensively modified in the Ramsey *(55)* and Furniss *56)* matters, which developed a 'substance over form' doctrine. The difficulty in particular with the Duke of Westminster case was stated by Lord Diplock in IRC v Burmah Oil *(57)*.

> *"Lord Tomlin's off-quoted dictum tells us little or nothing as to what methods of ordering one's affairs will be recognised by the Courts as effective to lessen the tax that would attach to them if business transactions were conducted in a straightforward way."*

In Furniss, Lord Fraser says, regarding the Ramsay decision:

> *"The true principle of the decision in Ramsay was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately." (58)*

In essence, the Furniss / Ramsay principle is based on a series of preordained transactions and the insertion of steps which have no commercial purpose other than the avoiding of a liability to tax. Unlike in the sham scenario, all the transactions were actual. Notwithstanding this, if any steps taken in the scheme are inserted merely for tax avoidance purposes, the Court will look at the substance of the agreement, namely to avoid tax.

This differs from the South African notion of sham as reflected in the Ladysmith case as well as Relier v CIR *(59)* in which the test is simply that the scheme is a disguised one which does not reflect the true intention of the parties. The Furniss / Ramsay principle does not require a false appearance to be applicable *(60)*.

*(54) 1934 51 TLR 467, 19 TC 490 at 520.*
*(55) IRC v Ramsay (1981) STC 174.*
*(56) Furniss v Dawson (1984) STC 153.*
*(57) (1982) STC 30 at 32.*
*(58) Supra at 532.*
*(59) Relier (Pty) Ltd v CIR 60 SATC 1.*
*(60) See Derksen 1990 107 SAZJ 416.*

## 7. APPLICATION OF 'SUBSTANCE OVER FORM' TO SECTION 103

The question arises as to whether the English 'substance over form' jurisprudence can and ought to be applied to the interpretation of Section 103(1). This was indeed the approach taken by Tebbutt J in ITC 1606 *(61)* in dealing with the normality requirement. The facts of this case involved a taxpayer company and other companies in a group requiring larger premises from those from which the taxpayer operated. To effect this, the holding company decided to acquire land and build the premises required for the taxpayer's operation. The financing method adopted involved a Close Corporation (H) acquiring and developing the site, and letting the property to the taxpayer for a period of eight years in consideration of a lease premium of R1.5 million plus an annual rental. H borrowed R1.65 million to develop the site and a mortgage bond was passed over the property by the lender, a financial institution, as all the other companies in the group signed sureties in favour of the institution. The taxpayer borrowed from the same institution in order to pay the lease premium to H, which H used to repay the mortgage loan. H sold the property subject to the lease (but without the lease premium) to a dormant company within the group for R502 000,00. H reflected the lease premium and the sale price as income and deducted the cost of acquisition and development of the site. The taxpayer claimed the deduction of the lease premium to the extent provided in Section 11(f) of the Act, namely the amount divided by the number of years contained in the lease. The Commissioner invoked Section 103.

The Court found in favour of the Commissioner. In so doing, Tebbutt J quoted extensively on the English substance over form position. The Court found that tax avoidance was at least a main purpose of the taxpayer. The Court held that the parties were not acting at arm's length. Its main conclusion was that H was intervened into the scheme for no purpose other than tax avoidance. The Court was obviously attracted to the similarity of facts, though in the context of capital gains, in the Furniss and Ramsay matters, namely the intervention of a third entity for no commercial purpose other than to obtain a tax benefit. Tebbutt J states *(62)*:

> *"Alhoewel die mening uitgespreek is dat enige regsbeginsel wat uit die* Furniss-*saak mag voortvloei nie deur ons howe toegepas behoort te word nie (kyk Artikel deur Anton Derksen in August 1990 SA Law Journal bl 416) sê die geleerde skrywer van die gemelde artikel nogtans dat die denkproses in die* Furniss-*saak akkoord gaan met die statutêre anti-belastingvermydings bepalings van die Suid-Afrikaanse Inkomstebelastingwet. Afgesien hiervan is dit ons mening dat gesonde verstand dit voorsê dat waar een van die transaksies in 'n reeks transaksies ingesluit is wat geen kommersiële doel het nie en bloot daar is om 'n belastingvoordeel te probeer kry dit nie as 'n normale transaksie tussen persone, die uiterste voorwaardes beding, beskou kan word nie."*

*(61)* *58 SATC 328.*
*(62)* *See The Taxpayer: May 1998 at 98.*

The English substance over form approach was, however, rejected by Wunsh J in ITC 1666 *(63)* , when he states, in a matter similar to the Ladysmith matter *(64)*:

> *"It is clear that in departing in the Furniss v Dawson case from the previous jurisprudence the House of Lords exercised or came very close to exercising a legislature function ..... It is not the function of our Court to remedy or augment the power of the legislature of to counteract tax avoidance. We do not have the weapons to counteract parliamentary inaction or ineptitude or to avoid parliamentary congestion."*

Wunsh J rather relied on looking at the intention of the parties, holding that a Court could examine whether there was a tacit term which had not been reduced to writing, and this was determined by looking at the facts and circumstances.

It is submitted that there is no need to incorporate the English substance over form doctrine into South African law. Our law is comprehensive in dealing with sham transactions, and as soon as a genuine transaction is effected, there is no reason not to invoke Section 103(1). It needs to be borne in mind that there are difficulties with defining the purpose and limits of the English doctrine. Indeed there have been calls in England for the legislature to provide a statutory general anti-avoidance provision. Oliver *(65)* states that the advantages of a general anti-avoidance provision over the doctrine include that such legislation can identify the transactions within its scope, identify the nature and the tax advantage to be counteracted and the statutory result in terms of tax. The final advantage results in view of the difficulty of the English doctrine in respect of establishing the resultant tax burden.

However, there has been no application of the business purpose test in any case law as yet in South Africa. A fairly convincing argument could be raised to the effect that the application of the business purpose test could amount to a very similar scenario as that reflected in the Dawson / Furniss principle, to the extent that if any step in a scheme has no bona fide business purpose other than avoiding tax, the scheme could well fall foul of Section 103(1). It remains to be seen as to whether this argument will be accepted.

*(63)* *ITC 1611 (1995) 59 SAT 126.*

*(64)* *Supra at 145.*

*(65)* *Recent Tax Problems, 1985, Stephen Oliver QC: "The Ramsay / Dawson Doctrine - The Quest for the Relevant Transaction. Page 1 at 14.*

# 8. CONCLUSION

There has been some difficulty for the Commissioner in applying Section 103(1), in particular in preventing the taxpayer from disproving the normality requirement. The amendments to the legislature brought about in 1996 will, it is submitted, not materially affect the difficulties incurred by the Commissioner. Although the Courts have recently shown a tendency more to rely on labelling transactions as shams, this has not, it is submitted, involved an adoption of the English doctrine of substance over form in applying the normality and purpose requirement. Instead, the Australian anti-avoidance provision is more useful, although purpose dominated, in interpreting Section 103(1).

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