A Comparative Analysis of the South African and Australian General Tax Avoidance Enactments

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24. **W P Keighery Pty Ltd v FCT** (1957) 7 AITR 107.

25. **W T Ramsay Ltd v IRC** (1981) 11 ATR 752.

ABBREVIATIONS

ITAA	**:**	**Australian Income Tax Assessment Act of 1936.**

CHAPTER 1: GENERAL INTRODUCTION

From a tax planning perspective it is important to take note of the general trend of the developments in anti-tax avoidance provisions and the manner in which they are interpreted by the Supreme Court.

From an international perspective it is important to take cognizance of the fact that internationally, a flurry of tax avoidance provisions are being promulgated to curtail the increasing efforts of taxpayers to avoid the effect of harsh tax measures being taken by different authorities.

It is extremely useful to study the basic approach and philosophy of various International tax structures as a result of the fact that one tends to find that where a specific tax approach reveals a similarity to another approach it is possible to pre-empt and predict the development of that specific tax approach by a Government, especially where such tax approach lags behind the approach of another Government, if it can be established that the approach of such Governments rest upon the same principles.

For the purposes of this study an examination of the Australian tax system was undertaken after it was found that the South African and Australian tax systems displayed remarkable similarities in dealing with efforts to evade an existing tax liability. Both of the systems utilise general tax avoidance statutes as a defence against tax avoidance.

The general South African anti-tax avoidance provisions can be found in s 103(1) of the **Income Tax Act.**[1] This section is aimed at an anticipated liability for tax and not at an existing liability.[2]

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1. Section 103(1) **Income Tax Act 58 of 1962 (as amended).**
2. **CIR v King** 1947(2) SA 196 A.

Most Revenue legislation has provisions which are intended to prevent the avoidance of tax in circumstances where arrangements comply with the literal meaning of the law, but taxpayers exploit inconsistencies and anomalies in the operation of that law. In Australia the general section dealing with the avoidance of tax was formerly s 260 of the **Income Tax Assessment ACT of** 1936 (as amended).

The attack upon tax avoidance by specific legislation really commenced in Australia in it's modern form in 1964 following the recommendations of the Ligertwood Committee.[3] However, it was in the 1970's, particularly in the latter part of that decade that tax avoidance became widespread. As a result of such avoidance, amendments were effected to overcome the weaknesses of s 260 of the **ITAA**, more particularly Part IV A.[4]

The purpose of the study is to effect a comparison between the principles as applied in terms of s 260 and Pt IV A of the **ITAA** on the one hand and the principles as applicable in terms of s 103 of the **Income Tax Act 58** of 1962 (as amended) on the other hand. An analysis shall be made of the Australian case law and the South African case law insofar as it is applicable to general tax avoidance.

For the purposes of this study the statutory enactments dealing with specific forms of tax avoidance shall be avoided insofar as possible.

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3. **Australian Tax Handbook** p 1309.

4. Part IV A of the **Australian Income Tax Assessment Act of 1936.**

CHAPTER 2: A COMPARISON BETWEEN THE RESPECTIVE STATUTORY ENACTMENTS

2.1 Section 103 of the Income Tax Act 58 of 1962 (as amended)

Section 103 (1) directs that where any transaction, operation or scheme (whether entered into or carried out before or after the commencement of the aforementioned act and including a transaction, operation or scheme involving the alienation of property) has been entered into or carried out, the Commissioner shall determine the liability for any tax, duty or levy imposed by the **Income Tax Act 58 of 1962** 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 of tax, duty or levy if he is satisfied that the following conditions are present:

(a) the transaction, operation or scheme, has the effect of avoiding or postponing liability for any tax, duty or levy imposed by the **Income Tax Act 58 of 1962** or any previous **Income Tax Act;**

(b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out it;

(i) that it was entered into or carried out-

(aa) 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; and

(bb) in any other case, 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 one 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 one in question; and

(c) the transaction, operation or scheme was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.[5]

The above section was introduced as a replacement of s 90 of **Act 31 of 1941** (as substituted by S 17 of **Act 78 of 1959)** to afford the Commissioner wider powers to attack the actions of taxpayers avoiding tax.

In terms of s 103 (4)(a), once it is proved that the transaction, operation or scheme in issue would result in the avoidance, postponement or reduction of tax, it is, until the contrary is proved, presumed that the sole purpose, or one of the main purposes of the transaction, operation or scheme, was the avoidance, postponement or reduction of tax.[6]

Subject to this presumption, all of the prerequisites listed above must, however, co-exist in order to justify the Commissioner invoking s 103(1) of the Act.[7]

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5. Section 103 of the **Income Tax Act 58 of 1962.**

6. Section 103(4)(a) of the **Income Tax Act 58 of 1962.**

7. **SIR v Geustyn, Forsyth and Joubert** 1971(3) SA 567(A).

2.2 Section 260 of the Australian Income Tax Assessment Act of 1936 (as amended)

In Australia the general section dealing with the avoidance of tax was formerly s 260 of the **ITAA.** Section 260 is still applicable with regards to transactions entered into or carried out or commenced before 27 May 1981.[8]

Section 260 of the **ITAA** formerly provided the capacity for the Commissioner to attack arrangements which he considered were conducted for the purpose of avoiding tax. In the 1970's and early 1980's it was found that the effectiveness of this section against sophisticated tax schemes was substantially reduced with the result that Part IV A **of the Australian Income Tax Assessment Act of 1936** (SS 177 A to 177 G inclusive) was introduced which afforded greater flexibility to the Commissioner in his attacks upon tax avoidance schemes.[9] The amending act at the same time amended s 260 by providing in s 260(1)(2) that it does not apply to contracts, agreements or arrangements made or entered into after 27 May 1981. The new legislation contained in Part IV A applies to all such situations on or after 28 May 1981 in particular. The new legislation can apply to unilateral schemes and the Commissioner is authorised to reconstruct a set of facts where the new legislation is found to be operative.[10]

As a result of the fact that s 260 is still applicable to contracts or arrangements concluded or entered into before 27 May 1981 and as a result of the fact that many of the principles which are applied in the interpretation of s 177 have been formulated during the period that s 260 applied, it is important to deal with s 260 and s 177 simultaneously.

The text of s 260(1) of the **Income Tax Assessment Act of 1936** reads as follows:

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8. Section 260(1) of the **Australian Income Tax Assessment Act of 1936.**
9. **Australian Tax Practice** p 4325
10. **Australian Tax Practice** p 4326

260(1) Defeating, evading, avoiding etc taxes

Every contract, agreement or arrangement made or entered into orally or in writing, whether before or after the commencement of this act, shall insofar as it has or purports to have the purpose or effect of in any way directly or indirectly -

(a) Altering the incidence of any income tax;

(b) Relieving any person from liability to pay any income tax or make any return;

(c) Defeating, evading or avoiding any duty or liability imposed on any person by this Act; or

(d) Preventing the operation of this Act in any respect,

be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

Section 260(2) of the **Australian Income Tax Assessment Act 1936** read as follows:

260(2) Scope of application

This Section does not apply to any contract, agreement or arrangement made or entered into after 27 May 1981.

As a result of the fact that s 260 was formulated in relatively simple form the consequence of a literal construction was that it was applicable to virtually every transaction into which a taxpayer entered. It became necessary, therefore, to interpret the Section restrictively. The restrictive interpretations of s 260 become so dramatic that eventually the section was considered to be almost useless against tax avoidance schemes.[11]

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11. **Australian Tax Handbook** p 1309.

The main difficulties in s 260 appeared to be the following:

1. Section 260 of the **ITAA** was an annihilating section which did not permit reconstruction of facts by the Commissioner. If the arrangement, when ignored, did not disclose a set of taxable facts then the provision was of no effect.[12]

2. The **Income Tax Assessment Act of 1936** allows a taxpayer to choose between being taxed as a sole trader, a partnership, a trust or a company. To exercise his choice in terms of the aforementioned categories will not necessarily result in an application of s 260 of the **ITAA** even if the tax payable as a result of that choice is less than if the taxpayer had chosen another form of business. The courts however interpreted s 260 of the **ITAA** so restrictively that the judicially formulated principle as it emerged in the 1960's and 1970's went much further than this. In one case a Company was able to avoid the former "undistributed profits tax" by a scheme involving the issuing of redeemable preference shares which resulted in the Company being a public Company for tax purposes.[13] In another interesting decision a university student obtained the benefits of income averaging by becoming a unit holder in a Unit Trust.[14] The ratio in both cases was that the taxpayer was simply electing between choices available under the **Income Tax Assessment Act of 1936** and that therefore s 260 did not apply.

In other matters various deficiencies and anomalies in s 260 of the **ITAA** were referred to although these appear to have taken little part in actual decisions. It was generally held that s 260 of the **ITAA** required more than one party to the arrangement in order to fall within it's terms.

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12. The above interpretation was handed down in a number of decisions:
Rowdell (Pty) Ltd v FCT (1963) 9 AITR 177; **FCT v Kareena Hospitals** (Pty) Ltd (1979) 10 ATR 535; **Cecil Bros (Pty) Ltd v FCT** (1964) 9 AITR 246.

13. **W P Keighery (Pty) Ltd v FCT** (1957) 7 AITR 107.

14. **Cridland v FCT** (1978) 8 ATR 196.

A unilaterally designed and applied scheme did not attract the application of s 260 of the **ITAA.** It was also suggested at the time of the introduction of Part IV A that s 260 was deficient in the sense that it did not allow an enquiry into the actual motives of the parties entering into the scheme.[15]

As a result of the above the provisions of the Part IV A came into effect on 27 May 1981 effectively terminating the application of s 260 to contracts, agreements or arrangements made or entered into after the aforementioned date.

2.3. Section 177A - 177G of the Australian Income Tax Act of 1936 (as amended)

Part IV A comprises s 177A to s 177G. There are a number of pre-requisites which must be satisfied before Pt IV A will apply:

1. There must be a "scheme";
2. A "tax benefit" must be acquired as a result of that scheme;
3. The Scheme must have been entered into or carried out or commenced to be carried out after 27 may 1981;
4. After consideration of the factors as set out in s 177D (b) it must be the conclusion of the Commissioner that a party to the scheme intended into it or carried it out with the dominant purpose of enabling a taxpayer or taxpayers to obtain a tax benefit in connection with the scheme.[16]

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15. **Australian Tax Handbook**, p 1310

16. Part IV A of the **Income Tax Assessment Act of 1936.**

The mechanics of the legislation is such that it only comes in operation after it has been established that no other provision of the **ITAA** applies to limit the deduction or increase the assessable income of the specific taxpayer.[17] However, it has been positively established that the Commissioner may only apply the provisions of s 177F of the **ITAA** once the criteria as stated above has been satisfied.[18]

Section 177F provides the Commissioner with the mechanism to deny the tax benefit after specifically conducting a reconstruction of the scheme to determine the true intention of the party or parties.[19]

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17. Section 177 B of the **Income Tax Assessment Act of 1936.**

18. **AAT Case 5219** (1989) 20 ATR 2777.

19. Section 177 F of the **Income Tax Assessment Act of 1936.**

CHAPTER 3: A COMPARISON BETWEEN THE RESPECTIVE COURTS' APPROACH TO RELATED CONCEPTS

3.1 Sham Transactions

Strictly speaking sham transactions cannot be regarded as tax avoidance.[20] The reason for the aforegoing lies within the distinction between tax avoidance and tax evasion.[21] Furthermore, a transaction devised for the purpose of evading a prohibition under an Act or avoiding liability for taxation imposed by it can, as a result the intention of the parties and as a result of the structure of the transaction be classed as **in fraudem legis.**[22] Generally speaking the Court has the power in terms of the Common Law to strip away the form of the transaction under consideration and extract the substance to disclose the true intention of the parties.[23]

However, it is sometimes possible for a court to apply either the Common Law or s 103(1) of the **Income Tax Act 58 of 1962.**[24]

The approach of the Australian Supreme Court is to distinguish between the operation of general or specific anti-avoidance provisions and the rules of sham. In a number of decisions the Court found it unnecessary to apply general or specific anti-avoidance provisions as a result of the fact that a specific transaction was regarded as a facade or a pretence.[25]

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20. Silke, **Income Tax Reporter** 1979 Vol 36 p 10.
21. ibid.
22. ibid.
23. ibid.
24. Silke, **Income Tax Reporter 1979** Vol 36, p 10.
25. **AAT Case 11,** 125(1996) 33 ATR 1140; **AAT Case 10;** 796(1996) 32 ATR 1168.

In the **Rosen Family Trust** case the Court found that it is not necessary to apply anti-avoidance provisions to sham transactions. A sham cannot be regarded as a real transaction and if something is found to be a sham it can merely be disregarded and it is not necessary to strike down the transaction in the manner in which anti-avoidance provisions might be considered to operate.[26]

The general approach of the Courts seem to be that Part IV A of the **ITAA** is not applicable and therefore reconstruction is not necessary. As a result of the fact that the transaction can be regarded as a sham transaction no reconstruction is possible. The Australian Courts have dealt with the question which arises where the application of s 260 and s 177 of the **ITAA** on the one hand and the doctrines of sham on the other hand are both possible.[27]

In a recent South African decision in the matter of **Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue**[28] the Appellate Division specifically faced the situation where both the application of the Common Law principles of sham and the application of Section 103 were possible.

The **Ladysmith case** is significant in the sense that the Court did not invoke the principles or provisions of s 103(1) of the **Act** but rather used the principles of the Common Law. Had the Court attempted to invoke s 103(1) the four pre-conditions as discussed above would,

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26. **Rosen Family Trust v FCT** (1987) 10 of 28.

27. **AAT Case 10**, 796 (1996) 32 ATR 1168.

28. **Erf 3183/1 Ladysmith Pty Ltd and Another** v CIR 1996(3) SA 942.

in terms of the Section, have had to be fulfilled. Under the provisions of s 103(1) it is only after it's requirements have been fulfilled that the form, substance or legal effect of the transactions may be wholly or partly ignored.

It is submitted that in the **Ladysmith** case the four pre-requisites would have been satisfied as a result of the fact that the transaction or scheme in question was entered into or carried out in a means which would not normally be used in the carrying out of such a transaction or scheme and that rights and obligations had been created, which would not normally be created between persons acting at arm's length.

It is clear that, per definition, a transaction tainted in terms of s 103(1) can also be regarded in specific circumstances as a sham transaction. The reason for this contention is based upon the fact that a transaction that is concluded on terms other than "at arm's length" creates rights and duties which, per definition, are not what they purport to be.

However one would be safe to conclude that both the South African and Australian Courts are at pains to keep the two remedies separate to enable the unhindered application of the Common Law principles available to them.

From an Australian perspective it has been specifically stated that where an agreement, contract or arrangement is regarded as a sham, s 260 has no application, because it fails for its own lack of legal efficacy. Consequently it is no defence against the operation of s 260 to argue, for example, that a contract or agreement is valid and at Law has its purported effect.[29] In the matter of **Jaques v FCT** Isaacs J stated the following:

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29. **Australian Tax Practice,** p 4326.

> "that the transaction is a reality is no reason for the non-application of the Section. On the contrary, if the transaction were not real and effective apart from the Section, that Section would be unnecessary. A sham transaction is inherently worthless and needs no enactment to nullify"[30]

In the above matter it was also found that if the documents evidencing the transaction have not been acted upon or if they have been entered into for the purpose of concealing the real nature of the transaction, they may be avoided without recourse to s 260 of the **ITAA.**

The Australian Courts have dealt with the issue which arises where a specific matter reflects facts that indicate the possibility of a sham but the facts were constructed in such a matter that s 260 was also possibly applicable. In the matter of **Glenfield Estate (Pty) Ltd v FCT**[31] the court held that a particular clause in a Deed was a sham clause but the arrangements effected by the underlying facts were not a sham. In this matter the Court did not hesitate to find that although a sham clause was present in the particular Deed that s 260 applied and not the Australian Common Law principles of sham.[31]

A further interesting aspect which were dealt with by the Australian Courts within a tax context was whether a sham detracted from the contractual duties where more than one party were involved. In the matter of **Snook v London West Riding Investments Ltd,**[32] an English decision, Diplock LJ indicated the following which were accepted in the matter of **Cranstown v FCT**[33].

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30. **Jaques v FCT** (1924) 34 CLR 328 of 358.

31. **Glenfield Estate (Pty) Ltd v FCT** (1987) 18 ATR 792.

32. **Snook v London West Riding Investments Ltd** [1967] 1ALL ER 518 at 528.

33. **Cranstown v FCT** (1984) 15 ATR 1278.

> "One thing I think, however, is clear in legal principle, morality and the authorities... that for an act or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto was to have a common intention that the Acts or documents are not to create the legal rights and obligations which they give the appearance of creating."

The unexpressed intentions of a "shammer" does not effect the rights of a party who he deceived. There was an express finding in the above case that the Defendants were not parties to the alleged "sham".

According to the Australian Law it is clear thus that where a party to a sham transaction is unaware of the sham element there is no detraction from his rights to claim in terms of the Civil Law notwithstanding the nullifying effect from a tax perspective on the tax consequences of the sham.

3.2 Transaction, operation or scheme

It has previously been stated that the first requirement to be satisfied before the Commissioner can apply the remedy under s 103 is that a transaction, operation or scheme has been entered into or carried out.[34]

Under s 260(1) of the **Australian Income Tax Act of 1936** the initiating action is a contract, agreement or arrangement made or entered into orally or in writing.

In terms of s 177 as incorporated in Part IV A one of the elements which must be satisfied before Part IV A will apply, is that there must be a scheme.[35] The term "scheme" is an essential part of this legislation and is defined in s 177A(1) to mean "any agreement, arrangement, understanding, promise or undertaking" whether

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34. Section 103(1) of the **Income Tax Act 58 of 1962.**

35. Section 177 A(1) of the **Australian Income Tax Assessment Act of 1936.**

legally enforceable or not which is entered into by a taxpayer. Section 177A(3) contemplates the possibility of a uni-lateral scheme being one entered into by the taxpayer on his or her own.

In the South African context the expression "transaction, operation or scheme" has not received much attention. The reason for this is probably based in the fact that the phrase "transaction, operation or scheme" extends the ambit of the Act quite wide with the result that further attention or definition might not be reasonably required.

In the Australian context there has been an extensive effort to define and clarify the definition of the words "scheme" and "arrangement". As was previously stated the terms "scheme" is an essential part of the legislation and has been defined in s 177A(1). The reason for this extensive effort is based in the fact that s 260[36] did not make provision for reconstruction of an agreement where the Commissioner decides to ignore the "scheme" or "arrangement". In **Cecil Bross (Pty) Ltd v FCT**[37] the Court found that where properties were agreed to be let at less than the true economic rent, there may be circumstances in which s 260 of the **ITAA** can be successfully invoked so as to render the agreement void, but there is no power in s 260 of the **ITAA** by which the actual rent can be raised to the economic rent so as to tax the Lessor on that basis. It was necessary that the arrangement, when ignored, disclosed a set of taxable facts otherwise the provision was of no effect.[38]

In the South African context the ambit of the words "transaction, operation or scheme" becomes important if one takes into account the wide powers of the Commissioner as set out in s 103(1). Section 103(1) specifically directs that where

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36. Section 260(1) of the **Australian Income Tax Assessment Act of 1936.**

37. **Cecil Bros (Pty) Ltd v FCT** (1964) 9 AITR 246.

38. **Rowdall (Pty) Ltd v FCT** (1963) 9 AITR 177.

any transaction, operation or scheme (whether entered into or carried out before or after the commencement of the Act and including a transaction, operation or scheme involving the alienation of property) has been entered into or carried out, the Commissioner shall determine the liability for any tax, duty or levy imposed by the Income Tax Act as if the transaction, operation or scheme, had not been entered into or carried out in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution resulting from the avoidance, postponement or reduction of tax, duty or levy if he is satisfied that certain listed conditions are present.[39]

Furthermore, s 103(1) dictates that where the conditions of the sections are present, the Act requires the Commissioner to tax in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of the avoidance, postponement or reduction of liability for tax.

Deciding what a "transaction, operation or scheme" entails becomes important where there is more than one transaction, operation or scheme involved. The importance of clarifying what a transaction, operation or scheme entails is the result of the fact that it becomes important for the Commissioner to analyse the transaction, operation or scheme when exercising his discretion in "such manner as in the circumstances of the case he deems appropriate".

The lack of Case Law on this issue also has certain implications from a tax planning perspective, making it difficult to predict which transactions, operations or schemes might fall prey to the wording of s 130(1).

From a South African perspective, however, the South African Appellate Division in the matter of **Meyerowitz v CIR**[40], found that s 130(1), since it's amendment in 1959

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39. Section 103(1) of the **Income Tax Act 58 of 1962.**

40. **Meyerowitz v CIR** 1963(3) SA 863(A

was couched in far wider terms than it's Australian counterpart. The court specifically stated that not only is the Commissioner entitled to determine the liability to tax "as if the transaction, operation or scheme had not been entered into or carried out", but he may also, since the amendment, do so "in such manner as the circumstances he deems appropriate." The court specifically mentioned the case of **Newton and Others v Commissioner of Taxation on the Commonwealth of Australia**[41] and stated that Section 90 confers additional powers on the Commissioner.

3.2.1 "Annihilate and reconstruct"

As previously stated, s 260 of the **ITAA** has been interpreted by the Courts as an "annihilating" provision containing no power to rectify an arrangement. The provisions of s 177(f) now specifically provides for reconstruction with the result that this previous difficulty has been overcome.[42]

An analysis of the South African approach reveals a similar construction.

In **H v COT**[43] the Court stated the following:

> "The Commissioner may, if he wishes, pull down the whole artificial edifice which has been created by the taxpayer for the purpose of avoiding tax, but if it in the circumstance it is not appropriate, he can pull down part of the edifice and tax on the basis that that part of the edifice had never excited, while at the same time leaving in existence another part of the edifice and accept tax from that part as if that part was illegitimate structure in the taxpayer's business. He can do this provided that the

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41. **Newton and Others v Commissioner of Taxation of the Commonwealth of Australia** 1958 2 ALL ER 759.

42. Section 177F of the **Australian Income Tax Assessment Act of 1936 (as amended).**

43. **H v COT** 1972(2) SA 719 (RAD) 1972 **Taxpayer** 87, 34 SATC 39.

> result is not to subject any portion of the taxpayer's income to double income tax, because were he to do this he would not be acting in a fair and appropriate manner, as this section is not a penal one".

In the above case the scheme involved passing profits through a chain of companies, and what the Commissioner of Taxes did was to "cut the pipe line" with the result, for the purpose of income tax, that the profits did not reach the further companies in the chain as income.

It is clear, that from the approach of the Appellate Division in the case of **Meyerowitz v CIR** (see above) that the Court was at pains to emphasise that the South African general anti-avoidance provisions were not hamstrung in the same manner as the Australian general anti-avoidance provisions, which, before the provisions of Part IV A, did not make provision for rectification.

It is clear that this power to reconstruct is situated in the discretion afforded to the Commissioner in terms of s 103(1). However, pertaining to the ambit of the Commissioner's discretion Emslie, Davis and Hutton say the following regarding the matter of **CIR v Louw**[44]:

> "**Louw's case** is also instructive concerning the powers of the court where s 103(1) is successfully invoked against the taxpayer. Where the manner in which the Commissioner has applied s 103(1) requires adjustment, for example, because only part of a wider course of conduct is found to constitute a scheme which falls foul of the sub-section, it is not for the Court to decide how to tax: This is a matter for the Commissioner. In **casu ins** it was not for the Court to decide how much of the loans should be treated as dividends and how much as a salary, and the matter was remitted to the Commissioner for

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44. **CIR v Louw** 1983(3) SA 551(A) 1983 **Taxpayer** 145, 45 SATC 113.

> decision by him. Importantly, however, Corbett JA pointed out (at 583) that in exercising his discretion to tax in terms of s 103(1): "Naturally, the Commissioner may not have his cake and eat it".[45]

The general approach of the court in the **Newton** case as discussed above was that the section entitles the Commissioner to look at the end result and to ignore all the steps which were taken in pursuance of the avoided arrangement.

In **Smith v CIR** the Commissioner applied s 103(1) in such a manner that he taxed the taxpayer on the basis that, had it not been for the transactions or operations entered into, the dividend would have to come into his hands and he would have been liable to tax.[46]

De Koker provides an apt description of the Commissioner's capability in this regard:[47]

> "Inland Revenue takes the view that, in applying s 103, it is entitled to adjust a taxpayer's liability for tax on the basis either that the transaction did not take place at all or that, while it did take place, it was entered into or carried out in the manner normally employed in carrying out such a transaction and not in the abnormal manner resorted to by the taxpayer. If by the interpretation Inland Revenue considers that it is entitled to impute rights or obligations to a transaction that do not exist in the actual bargain between the parties, for example, to assume a reasonable rate of interest

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45. Emslie, Davis and Hutton **Income Tax Cases and Materials,** The Taxpayer 1995.

46. **Smith v CIR** 1964(1) SA 324 A, 26 SATC 1.

47. De Koker, **Silke on South African Income Tax** 1914 Vol II.

> when none was actually stipulated, it is considered that it misinterprets s 103(1). Inland Revenue nevertheless accepts that it cannot proceed under s 103(1) on the basis that the taxpayer who entered into a certain transaction that resulted in the avoidance or reduction of tax did not enter into that particular transaction but entered into some other transaction that would not have had the result. For example, if a taxpayer may achieve a certain financial result in two different ways, one of which would attract tax and the other not, there will be not abnormal features in either event, there is no ground for the Commissioner to contend that the taxpayer must be subjected to tax on the basis that he followed the method that would have attracted liability for tax."

I submit that the Commissioner is not competent to tax outside the general scope of the **Income Tax Act** 58 of 1962 and that any attempt to tax "in such manner as in the circumstances of the case he deems appropriate" should be within the boundaries of the aforementioned Act. De Koker puts it well when he states:[48]

> "The Commissioner has not the power under s 103(1) to change the nature of a receipt from capital to income and subject the taxpayer to tax as if he had received income. Whichever remedy applies, in order for him to determine liability, it must be manifestly clear that the amount he includes in the taxpayer's assessment and on which he determines liability falls within the general scope of the Act. The Commissioner's power to determine the taxpayer's liability as if the transaction had not been entered

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48. ibid

into or carried out or in such manner as in the circumstances of the case he deems appropriate may be exercised not only in respect of the year of assessment in which the transaction was entered into or carried out but also in respect of all subsequent years of assessment.

3.2.2 "Scheme: in Australian Law

As was previously pointed out, in the South African context the expression "transaction, operation or scheme" has not received much attention. The reason for that is probably based in the fact that the frase "transaction, operation or scheme" extends the ambit of the Act quite wide with the result that further extension or definition might not be reasonably required. However, it can be argued that a further clarification of the phrase "transaction, operation or scheme" might be reasonably required as a result of the fact that s 103(1) is couched in far wider terms than its Australian counter part. One of the major criticism against s 260 was that it was phrased in relatively simple form and if construed literally would have extended to virtually every transaction into which a taxpayer entered. It was, therefore, necessary to read the section down from the literal meaning of the words. The restrictive interpretation became so dramatic that eventually the section was considered to be almost useless against tax avoidance schemes.[49]

It is interesting to to note that the extremely wide ambit of s 260 of the **ITAA** eventually become one of the reasons why s 177 was promulgated.

At present the attitude of the South African courts can be mirrored in the matter of **Glen Anil Development Corp Ltd v SIR**[50] where the court had the following to say regarding the interpretation of Fiscal Statutes:

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49. **Australian Tax Handbook**, p 1309.

50. **Glen Anil Development Corp Ltd v SIR** 1975(4) SA 715(A), 37 SATC 319.

> "In any event I do not understand the rule to be that every provision of a Fiscal Statute, whether it relates to the tax imposed or not, should be construed with due regard to any rules relating to the interpretation of Fiscal legislation. Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefore or to the incidence thereof, but rather to schemes designed for the avoidance of liability. It should, in my view, therefore not be construed as a tax measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed. The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation".

It is clear that the word "scheme" is an essential part of the Australian legislation and has been defined in s 177A(1) of the **ITAA**. The word "scheme" has been used as a substitute for the phrase "every contract, agreement or arrangement" as incorporated in s 260 (1) of the **Australian Income Tax Assessment Act** of 1936.

When analysing the Australian Case Law one comes to the conclusion that the Commissioner would usually not have much difficulty in finding that the taxpayer has entered into a scheme. However, the tendency of the Australian Supreme Court is to subject the Commissioner's finding that the taxpayer has entered into a scheme to some scrutiny. In **Peabody v FCT**[51] the full Federal Court proceeded to hold that the

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51. **Peabody v FCT** (1993) 25 ATR 32.

Commissioner was not competent to isolate one specific step out of a course of action and classify that as a scheme. The court further held that it was the specific scheme which had been identified by the Commissioner which had to be considered by the Court. When the matter was taken on appeal to the High Court in **FCT v Peabody**[52] the full High Court held that, although the Commissioner had described the scheme as encompassing a wide range of transactions, he was entitled to rely on a narrower range as initially identified, provided that the narrower range that the capacity of being defined as a scheme without being devoid of all practical application.

As was previously pointed out the term "scheme" has been drawn into the Australian legislation and has been defined in s 177A(1) to mean any agreement, arrangement, understanding, promise or undertaking, whether legally enforceable or not which is entered into by a taxpayer. Section 177A(3) contemplates the possibility of a unilateral scheme being one entered into by the taxpayer on his or her own.[53] Section 260 required that there must be a "contract, agreement or arrangement"[54]

It is therefore clear that s 177A(1) extended the definition of the phrase "contract, agreement or arrangement" as included in s 260 considerably.

From a South African perspective it is useful to examine the way the Australian Courts interpret the word "scheme" as well as it's subsidiary terms as set out in s 260. The reason for this contention is based upon the fact that there are a number of Australian decisions specifically dealing with the situation where "schemes" comprise of a number of individual transactions and elements.

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52. **FCT v Peabody** (1994) 28 ATR 344.

53. Section 177A(1) of the **Australian Income Tax Assessment Act of 1936.**

54. Section 260(1) of the **Australian Income Tax Assessment Act of 1936.**

Section 177D of the **Australian Income Tax Assessment Act** of 1936 provides that certain factors are to be considered before it can be determined that a scheme has been entered into. This latter provision also relates to unilateral schemes. Section 177D specifically makes provision for application where the scheme was entered into or carried out in Australia, outside Australia or partly in Australia and partly outside.

Needless to say, the taxpayer must obtain a tax benefit in order for the provision to apply. Section 177D(b) provides eight alternative tests which the Commissioner can apply in deciding whether the scheme was entered into for the purpose of enabling the taxpayer to obtain a tax benefit:[55]

1. The manner in which the scheme was entered into or carried out.[56] This test apparently relates to the background of the scheme and the underlying purpose of the taxpayer in entering into it.[57] This provides an objective method by which the Commissioner may analyse the scheme. Typically one would expect that this test could apply where the Accounting Profession provides a "scheme" to a number of clients to enable them to receive tax benefits.

2. The form and substance of the scheme.[58] The substance of the scheme specifically relates to the eventual effect of the scheme as opposed to the legal form in which the scheme is wrapped.[59]

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55. Section 177D(b) of the **Australian Income Tax Assessment Act of 1936.**

56. ibid

57. **Australian Tax Handbook**, p 1314.

58. Section 117D(b) of the **Australian Income Tax Assessment Act of 1936.**

59 **Australian Tax Handbook**, p 1314.

3. The time at which the scheme was entered into and the period of time during which the scheme was carried out.[60]

4. The result which would be achieved by the scheme.[61]

5. Any change in the financial position of the relevant taxpayer arising out of the scheme.[62]

The Australian Tax Handbook (1997 issue)[63] states the following:

> "This test would relate to the many schemes which have involved paper losses and against which special legislation has been enacted. In these particular cases the financial position of the taxpayer has improved because the expenditure alleged to have been made, which is an allowable deduction, is greater than the actual loss incurred. In many of these schemes the financial position of the taxpayer improved. If, however, a taxpayer incur expenditure which is an allowable deduction or alternatively does not receive assessable income, one would expect the scheme to result in a diminution of the assessable income of the taxpayer entering into that scheme."

6. Any change in the financial position of any other person[64]. The Australian Tax Handbook (1997 issue) describes this test as follows:[65]

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60. Section 177D(b) of the **Australian Income Tax Assessment Act of 1936.**

61. ibid

62. ibid

63. **Australian Tax Handbook**, p 1314.

64. Section 177D(b) of the **Australian Income Tax Assessment Act of 1936.**

65. **Australian Tax Handbook**, p 1314.

"This test relates to any person. The person does not need to have any connection with the taxpayer or a business or family kind, and a professional relationship could result in the Commissioner having the first factor towards establishing the application of Part IV A.[66] The independence of the person who benefits from the scheme vis-a-vis the taxpayer would have some importance because if expenses are incurred and the taxpayer gains no benefit from those expenses, one would normally expect that to be looked upon as a normal business relationship with the deductibility being determined under the normal provisions of the ITAA without the application of Part IV A".

7. Any other consequences for the relevant taxpayer or any other person connected with him.[66]

8. The nature of any connection between the relevant taxpayer and a person contemplated by test no 6.[67]

So far there has not been a lot of Case Law on the abovementioned tests. However, it was held at Federal Court level in **Peabody v FCT**[68] that the eight matters which the Commissioner must take into account under s 177D(b) requires the balancing of the Commercial and Tax elements of the scheme. The High Court on appeal did not need to consider the eight matters in detail. The Federal Court applied Part IV A in a manner that would seldom permit the Commissioner to make a determination under s 177F where the transaction was in every way Commercial although it contained some elements of reducing the tax payable. When analysing the aforementioned case it becomes clear that it is an essential ingredient that the scheme must be one entered into with a dominant purpose, and that the result of such dominant purpose must be

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66. Part IV A of the **Australian Income Tax Assessment Act of 1936.**

67. ibid Section 177D(b).

68. **Peabody v FCT** (1993) 25 ATR 32.

to place the taxpayer in a position where he obtains a tax benefit either alone or together with other parties involved in the scheme. The Court also found that there need not be any correspondence between the tax benefit that has been obtained and the tax benefit sought to be obtained.

In **FCT v Spotless Services Ltd**[69] one finds that an important aspect of the decision is that Part IV A can apply to ordinary commercial transactions. It is an important aspect of the decision that Part IV A is to be given equal weighting with other provisions of the **ITAA.** The Court also took the opinion that even though another provision provides for a certain interpretation if applied, it does not prevent the outcome from being tested against the criteria as set out above.

In **W D & H O Wills**[71] the Federal Court determined that the taxpayer did not have the dominant purpose of obtaining a tax benefit. The Court went through each of the eight tests as formulated above and found that there was a Commercial purpose to the scheme and that the taxation advantages where incidental considerations.

The attitude of the Australian Commissioner itself is quite interesting. The attitude of the Commissioner is that in itself the simple disposition of an Income producing asset by a Natural Person to a wholly owned private company is not an arrangement to which the Commissioner will apply Part IV A of the **ITAA.** However, where there are other associated transactions, transfers or arrangements, whether antecedent or sub-sequent, the disposition can be examined within the broader context within which it occurred.[71] Furthermore in the application of Part IV A to sale and lease

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69. **FCT v Spotless Services Ltd** (1996) 34 ATR 183.

70. **WD & HO Wills (Australia) Pty Ltd v FCT** (1996) 32 ATR 168.

71. **Australian Tax Determination** TD 95/4.

arrangements, the Commissioner takes the view that generally it will not apply, provided that the transaction is consistent with a Commercial sale and that the lease is unrelated, but that if special out of the ordinary features are present, it's application will need to be considered.[72]

The **Peabody v FCT**[73] case is important because the full Federal Court held that where a scheme consisted of a series of steps or a course of action, the Commissioner could not isolate one step out of course of action and classify that as a scheme.

Furthermore, it was a scheme identified by the Commissioner which had to be considered by the Court. On appeal to the High Court in **FCT v Peabody,**[74] the full High Court held that, although the Commissioner had identified the scheme as covering a wide series of transactions, he was able to rely on a narrower range than initially identified, provided that the narrower range were capable of standing on their own as a scheme without being devoid of all practical meaning.

This is one of a number of decisions delivered by the Australian Courts which emphasised that the Court will not hesitate to apply the legislation to a smaller part of the scheme where it was possible for a wider scheme to consist of a number of smaller schemes.

When examining the Australian case law it becomes clear that the Court prefers a "substance over form" approach. In the matter of **W T Ramsey Ltd v IRC**[75] the court held that in considering a series of transactions and their effect upon the taxation

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72. **Australian Tax Ruling** 95/30

73. **Peabody v FCT** (1993) 25 ATR 32.

74. **FCT v Peabody** (1994) 28 ATR 344.

75. **W T Ramsay Ltd v IRC** (1981) 11 ATR 752.

liabilities of a person involved in that series of transactions, it was the series that should be examined and not individual transactions in isolation.

The abovementioned court stated the following:[76]

> "Given that a document or transaction is genuine the Court cannot go behind it to some supposed underlying substance. This is a cardinal principle but it must not be overstated or overextended. While obliging the Court to accept documents or transactions, found to be genuine as such it does not compel the Court to look at a document or a transaction in blinkers, isolated from any context to which it probably belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer substance, or substance to form. It is the task of the court to ascertain the legal nature of any transactions to which it is sought to attach a tax or a taxed consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded".

The Australian Court have also found that if a combination of arrangements are inadequate to constitute the legal relationship sought, no question of sham or s 260 arises. It has been found in the case listed below that the taxpayer, an individual, attempted to establish a family trust with a nominee company as trustee but due to

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76. ibid at 756 - 757.

77. **Case R116** 84 ATC 761.

various defects in the way that this was carried out, that the Trustee never conducted any business. Accordingly, without resort to the doctrine of sham or s 260 of the **ITAA** the arrangements were ineffective to divert the income away from the taxpayer.[78]

I submit that this interpretation would be applicable in the South African context. It would be illogical to find that the requirement of "transaction, operation or scheme" has not been satisfied as a result of the fact the "transaction, operation or scheme" has been divided into smaller components with the possible result that an individual component which might be able to stand on its own results in the non-application of s 103. I would further submit that the words "operation" or "scheme" is wide enough to encompass a range of transactions, culminating in a scheme to avoid tax.

3.3 Avoidance reduction or postponement of liability to pay tax.

As previously stated it is required in terms of South African Law that the Commissioner be satisfied that the transaction, operation or scheme entered into, had the effect of avoiding or postponing or reducing liability for any tax, duty or levy imposed by the Act or any previous **Income Tax Act.**[79]

In terms of s 103(c) it is stated that the "transaction, operation or scheme" should, before it falls foul of s 103, have been entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.[80]

The frase "tax benefit" is defined as including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the **Income Tax**

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78. **Case R116** 84 ATC 761

79. Section 103(1)(a) **Income Tax Act 58 of 1962.**

80. Section 103(1)(c) **Income Tax Act 58 of 1962.**

Act or by any other law administered by the Commissioner.[81] The taxes imposed by the **Act** are normal tax, donation tax, secondary tax on Companies (STC) and levies on financial institutions. Where s 103(1) applies, whichever of the taxes relevant to the case can be applied to the taxpayer.

The other statutes administered by the Commissioner are: the Estate Duty Act, the Value Added Tax Act, the Transfer Duty Act, the Stamp Duties Act and the Marketable Securities Act. Where the relevant purpose is present in relation to any of these Acts and the other conditions of s 103(1) are present, it will empower the Commissioner to apply the section to assess the taxpayer for any of the taxes mentioned here before, which may have been avoided, postponed or reduced. It is not necessary, though, that such avoidance, postponement or reduction was not a purpose of the transaction. Section 103(1), it should be noted, does not give the Commissioner the power to void the transaction in relation to the taxes or duties referred to here before.[82]

In **Smith v CIR**[83] the Court held that "avoiding liability" within the meaning of the section is to get out of the way of, escape or prevent an anticipated liability. It follows from this judgement the the alienation of any assets, or any other transaction, operation or scheme by or involving the taxpayer, by which income, which otherwise would have accrued to the taxpayer, accrued to another can be regarded as having the effect of avoiding, postponing or reducing liability to tax, although the taxpayer has no right to and will receive no benefit from the income. In this case the taxpayer created a

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81. Section 103(4) **Income Tax Act 58 of 1962.**

82. See in this regard also Meyerowitz, D on **Income Tax 1997 - 1998**, 29.4 The Taxpayer.

83. **Smith v CIR** 1964(1) SA 324(A), 26 SATC 1, 1964 Taxpayer 49, SATC 179.

number of companies of which he was the controller. He transferred his shares to one of the companies through which he controlled the remainder of the companies. It was held that, if it was not for the transaction, dividends would have accrued to him and not to the company, and it was common cause that the transaction was both abnormal and had the purpose of avoiding tax. As a result of the aforementioned he was held taxable on the dividend.

In **Hicklin v CIR**[84] the shareholders had alienated their share in "Reklame", a dormant Company which had undistributed profits. The Court confirmed that a liability for tax may vary from an imminent certain prospect to some vague, remote possibility, but found it unnecessary to decide in that case whether a vertical line should be drawn somewhere along that wide range of meanings in order to delimit the connotation of "an anticipated liability". It is clear that the Appellate Division envisaged an anticipated liability when it held that:

> "The liability of the appellant and the other shareholders to tax on "Reklame's" undistributed profits, albeit a liability contingent upon their declaring them as dividends, was clearly "an anticipated liability" within the contemplation of s 103(1). After all they were always mindful that something unforeseen might occur that would compel them to declare them as dividends and incur an ensuing tax liability, as, for example, the early death of one of them. And, as will presently appear, the possibility of such contingency occurring was sufficiently approximate and pressing to induce them the sell their shares under the RN agreement in order "to get out of the way of, escape or prevent" such liability from falling on them. The RN agreement undoubtably had the effect of avoiding that anticipated tax liability of theirs"

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84. **Hicklin v SIR** 1980(1) SA 481(A), 1980 Taxpayer 49, SATC 179.

In the case where the income which accrues to another is the fruit of the taxpayer's capital or labour, this have been regarded as the "avoidance of liability" by the Appellate Division.[85] In the aforementioned matter the taxpayer and two others incorporated a company to publish a magazine and the company later sold it's rights for a nominal sum to a partnership, of which a family trust to the benefit of the taxpayer's minor children was a partner instead of the taxpayer who continued to provide editorial services. The Court held that the formation of the company had no tax avoiding purposes and that the rights which had been transferred not by the taxpayer but by the company were regarded as not being material in the circumstances where the taxpayer provided his personal labours.

In the case of **CIR v Louw**[86] the Directors had borrowed money from the Company, but the Court held that, had the loans been made, the Directors / Shareholders would probably have received the equivalent in salary or dividends and that this was sufficient to indicate that the effect of the loans was to avoid or postpone liability for tax.

From an Australian perspective s 260(1)(c) of the **ITAA** provides for the avoidance of any contract, agreement or arrangement sofar as it has the purpose or effect of "avoiding any duty or liability imposed on any person by this act".[87]

The Australian Supreme Court has already given some attention to the question of whether this refers to a present or future liability. In this regard the Australian position is quite similar to the South African position. In **FCT v Newton**[88] the Court stated the following:

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85. **Meyerowitz v CIR** 1963 (3) SA 863(A).

86. **CIR v Louw** 1983(3) SA 551(A), 1983 Taxpayer 145.

87. Section 260(1)(c) of the **Australian Income Tax Assessment Act 1936.**

88. **FCT v Newton** (1956) 7 AITR.

> "And since it is clear that the real work of the section is intended to be done in cases where the disputed item of income has not in fact or law been derived by a taxpayer, the section must be taken to contemplate that, even before income has been derived, the taxpayer may, by a legally effective contract, agreement or arrangement, avoid a liability to income tax on future payment".

On appeal to the Privy Council the council for the taxpayer unsuccessfully submitted that the words "liability imposed on any person" meant a liability which had already accrued and that "avoid" meant displaced. He further contended that, in order that an arrangement should be avoided, it must be an arrangement which sought to displace a liability which had already accrued to the taxpayer.

On the above contention the Court had the following to say:[89]

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

In terms of the provisions of s 177 of the **Australian Income Tax Assessment Act of** 1936 incorporating Part IV A it is specifically required that, after consideration of a number of factors, it must be concluded that a party to scheme entered into or carried it out or had the dominant purpose of enabling the taxpayer to obtain a "tax benefit" in connection with

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89. **Newton v FCT** 1966(7) AITR 7 at 303.

the scheme.[90] It is significant that in the Australian context the legislator regarded it as prudent to widen the net. The aforementioned prerequisite follows the requirement that a "tax benefit" must be obtained in connection with that scheme.

In the Australian case **FCT v Peabody**[91] a "tax benefit" was regarded as significant in the application of the anti-avoidance provisions because a taxpayer must have a "tax benefit" as the sole or dominant purpose of the scheme in which he or she is involved before these provisions can apply to the transaction. In broad terms a "tax benefit" is regarded as being obtained where the taxable income is reduced either by reduction of assessable income below what one would normally expect or by increasing the allowable deduction above what would normally be appropriate.

In the abovementioned **FCT v Peabody**[92] the High Court held that there was no tax benefit which came into being as a result of the fact that there was no **reasonable expectation** that any additional amount would have been included in her assessable income for the year in question, had the scheme involved not taken place.

It is clear that the "tax benefit" as envisaged in the **Australian Income Tax Assessment Act of 1936** is similar to the South African "tax benefit" as enunciated in s 103(c) of the **Income Tax Act 58 of 1962.**

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90. Section 177 F of the **Australian Income Tax Assessment Act 1936.**

91. Section 103(1)(b) of the **Income Tax Act 58 of 1962.**

92. ibid.

3.4 The test of normality

As previously pointed out s 103(i)(b)(i) as well as s 103(1)(b)(ii) set down a test of "normality" which serves as measuring stick for the application of s 103. Section 103(1)(b) implies that a transaction, operation, or scheme would fall foul of the "normality test" if it was entered into in the context of a business in a manner which would not normally be employed for **bona fide** business purposes, either for the obtaining of a tax benefit and in the case of any other transaction in a manner which would not normally be employed in the transaction or scheme in question.

As an alternative a further test is stated pertaining to "normality", implying that where obligations or rights which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme are created such arrangement may fall foul of s 103.[93]

It is, however, clear that the normality or abnormality of a transaction is not to be judged solely by the question of whether the parties are independent persons dealing at arm's length with each other. It is an important factor to be taken into consideration but not necessarily conclusive, because the Commissioner must take into account the circumstances under which the transaction was entered into or carried out, and it may well be that in relation to a particular transaction between two parties who are not independent persons dealing at arm's length the means and manner as contemplated in s 103(1)(b)(i)[94] adopted may be the normal procedure.

The determining factor in deciding whether the transaction, operation or scheme is normal has been held to be the action of a normal businessman.[95] However, the

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93. ibid.

94. ibid.

95. **ITC 113.**

circumstances under which the transaction was entered into or carried out and it's nature must be considered. In **CIR v LOUW**[96] the court held that the control exercised by the shareholders of an incorporated company over the relevant company was one of the factors favourably considered by the court in relation to the sale, by them to the company, of their professional practice on the question of the normality of the rights and obligations thus created.

In **SIR v Geustyn Forsyth & Joubert**[97] the Court held that there was nothing indicating abnormality in the transfer of an existing partnership business company and held that it was common commercial practice. The Commissioner argued that the conversion from a partnership to an unlimited liability company had created rights and obligations that would not normally be created between business men dealing at arm's length under similar circumstances.

The problem that the Court was confronted with is basically illustrated by 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"? It is clear that the relationship between a man and his company or between a man and his son may display features of a transaction that is quite normal in the circumstances but would be abnormal between independent parties.

A good description of the requirement of "normality" can be found in the case of **Hicklin v SIR**[98] where Trollop JA furnished the following comments about the test of normality:

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96. **CIR v Louw** 1983 (3) SA 551(A), 45 SATC 113.

97. **SIR v Geustyn Forsyth and Joubert**: 1971(3) SA 567(A), 33 **SATC** 113, 1971 Taxpayer 148.

98. **Hiklin v SIR** 1980(1) SA 481(A), 41 **SATC** 179 at 195.

> "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"... it connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. Indeed, in the Afrikaans text the corresponding phrase is "die uiterste voorwaardes beding..." The next observation is that, when considering the normality of the rights or obligations so created or of the means or manner so employed, due regard has to be paid to the surrounding circumstances ... The last observation is that the problem of normality or abnormality of such matters is mainly a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence adduced or furnished by either party".

It is clear that the court is applying an objective test even though the **Hicklin** case dealt with a situation in which the parties were dealing at arm's length. This judgement can be reconciled with the judgement of **SIR v Geustyn Forsyth & Joubert** where the parties were not dealing at arm's length. Where there was a close proximity between the parties involved in the transaction the court in **CIR v Louw**[99] described the application of the test as follows:

> "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 s 103(1)(b)(ii)."

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99. **CIR v Louw** 1983 (3) SA 551(A), 45 SATC 113.

From an Australian perspective the courts have applied the so called **"Ramsey Principle"**[99] which can be formulated as follows:

a. First, there must be a pre-ordained series of transactions or one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial end.

b. Secondly there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax.

c. If the abovementioned elements are present, the inserted steps are to be disregarded for fiscal purposes.

It is interesting to note that from an Australian perspective the application of the so-called "business test" as formulated in **ITC 113**[100] correspondents with the **Ramsey Test.**

It is interesting to note that in the Australian Statute neither s 260 nor s 177 specifically formulates a "normality test". An analysis of the Australian cases however indicated the application of an unformulated "normality test". In the matter of **W T Ramsey Ltd v IRC**[101] the court had to consider an elaborate and entirely artificial scheme for avoiding liability to tax. The court however found that the scheme had "enduring legal consequences"[102] and in this indirect way proceeded to analyse the results of the scheme by measuring it against the normal consequences of a typical transaction of the nature as concluded in this matter.

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99. ibid

100. **ITC 113.**

101. **W T Ramsay Ltd v IRC** (1981)1 11 ART 752.

102. ibid of 758.

3.5 Sole or main purpose of a transaction

The last main condition to be fulfilled before the Commissioner can fix liability in terms of s 103 upon a taxpayer is that the transaction was entered into or carried out solely or mainly for the purpose of tax avoidance, that is, for the purpose of avoiding, postponing or reducing the amount or the liability for any of the taxes or duties referred to in s 103.[103]

"Purpose" as used in s 103(1) brings the intention of the taxpayer with which the transaction was entered into, into play. It has no bearing on the effect of the transaction. While the transaction may have the effect of avoiding tax it does not follow that the purpose of entering into the transaction was to avoid, postpone or reduce liability for tax.

The test has been held to be a subjective one and is therefore of prime importance in determining the purpose of the scheme from the perspective of the taxpayer.[105]

It is clear that a Court would not only utilise the subjectively displayed intentions of a taxpayer but would also use objective indicators such as the effect of the transaction, the manner in which the transaction has been structured and the parties involved in the transaction to determine the subjective intentions of the taxpayer.

The section does not apply unless the tax avoidance purpose was the sole or main purpose.[106]

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103. Section 103(1) of the **Income Tax Act 58 of 1962.**

104. **SIR v Geustyn, Forsyth and Joubert** 1971(3) SA 567 A.

105. **Ovenstone v SIR** 1980(2) SA 721(A).

106. Section 103(1)(c) of the **Income Tax Act 58 of 1962.**

In **CIR v KING**[107] the Court defined the word "mainly" as conveying the idea of dominance. It (The Afrikaans version is "hoofsaaklik") means "for the most part; principally or chiefly"[108].

If a strict application of the wording of the **Act** takes place it can emphatically be stated that, even where tax avoidance is one of two or more purposes in entering into or carrying out a transaction, s 103(1) will not apply unless the tax avoidance was the dominant purpose. If it was the other purpose or purposes which were decisive in bringing about the transaction, the fact that tax avoidance was a subsidiary or secondary purpose will not matter.[109] It would be correct to assume that, if the scheme would have been entered into or carried out, irrespective of whether it had the effect of avoiding tax, then tax avoidance is not even a purpose.

It is submitted that where there is more than one transaction, operation or scheme involved, the taxpayer's purpose must be as ascertained taking the transaction, operation or scheme as a whole, unless there is a particular transaction, operation or scheme which has no real connection with the taxpayer's claim that his sole or main purpose was not tax avoidance. This principle has been confirmed by the Courts and it is further submitted that the transaction, operation, or scheme viewed as a collection of steps cannot be divided into smaller steps even though one of the subsidiary steps conveys a different intention than the dominant intention if his scheme is taken as a whole.[110]

Whether or not a transaction falls foul of s 103(1) must be answered by referring to the effect and purpose of the transaction and the circumstances surrounding it at the

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107. **CIR v King** 1947(2) SA 196 A, 14 SATC 184. The Court applied this meaning.

108. Shorter Oxford Dictionary.

109. **ITC 1307** 1983 Taxpayer 177, 42 **SATC** 147.

110. **CIR v Louw** 1983 (3) SA 551(A), Taxpayer 145, 45 **SATC** 113.

time it was implemented or effected and not at the time it was formulated, designed, agreed upon or otherwise involved.[111] It is now accepted that even if the purpose or effect of the scheme when it was formulated was not to avoid liability for tax, it might have become one of the taxpayer's main purposes when it was subsequently carried out. This question was especially dealt with in **Ovenstone v SIR**.[112] In the aforementioned matter the taxpayer decided in 1969 to sell shares held in a South West African Company to a trust he was in the process of creating, with the intention and actual legal effect that the purchase price would be interest-free. The Court found that it was the taxpayer's dominant intention to save estate duty. At the time the dividends on the shares were exempt from tax in South Africa but when the scheme was eventually carried out in 1969 dividends on the shares had become taxable in South Africa. The Court found that the taxpayer had not discharged the onus of proving that the avoidance of Income Tax was not one of his main purposes in 1969 when he implemented his scheme.

From an Australian perspective it was previously herein stated that every contract, agreement or arrangement made or entered into, orally or in writing, whether before or after the commencement of the Act, shall sofar as it has or purports to have the purpose or effect of effecting a tax advantage be absolutely void against the Commissioner.[113]

An examination of the relevant Australian Case Law indicates that the purpose or effect of the arrangement must be seen from the terms of the arrangement itself or from the acts by which it was implemented.[114] The purpose of the arrangement is not

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111. Meyerowitz on **Income Tax 1997 - 1998,** The Taxpayer 29-12.

112. **Ovenstone v SIR** 1980(2) SA 721 A.

113. Section 260(1) of the **Australian Income Tax Assessment Act of 1936.**

114. **FCT v Lutovi Investments Pty Ltd** (1978) 140 CLR 434 of 466.

regarded as the same thing as the motivation of the taxpayer to reduce the income for which he would otherwise be liable in the future.[115] The purpose of an arrangement is the result aimed at and it's effect is the result achieved. Ordinarily the two terms do not require separate consideration because the effect of an arrangement coincides with it's purpose and it is hardly likely that the Australian Commissioner would pursue under s 260 an arrangement which failed to achieve it's purpose. It is regarded as unnecessary to draw any distinction in this case between the purported purpose or effect or the arrangement and it's actual purpose or effect. Such a distinction can, practically speaking, not ever have any significance in enabling the Commissioner to make a decision to pursue a tax benefit in terms of s 260.[116]

A further analysis of the dominant Cases shows that, even though the wording of the statutory clause does not refer to a dominant purpose, the interpretations of the Australian Supreme Court shows that s 260 requires that the avoidance of tax needs to be the "pre-dominant" purpose.[117]

In the matter of **Newton v FCT**[118] the Privy Council stated the following:

> "It is clear from this analysis that the avoidance of tax was not the sole purpose or effect of this arrangement. The raising was an associated purpose, but, nevertheless, the Section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says "sofar it has" the purpose or effect". This seemed to their Lordships to import that it need not be the sole purpose. Looking at the whole of this arrangement, their Lordships have no doubt that it was an

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115. ibid at 456.

116. ibid at 457.

117. **Hancock v FCT** (1961) 8 AITR 328.

118. **Newton v FCT** (1958) 7 AITR 298 at 305.

> arrangement which is caught by s 260. The whole of the transactions show that there was concerted action to an end - and that one of the ends to be achieved was the avoidance of liability for tax."

If one interprets this case in conjunction with later case law a slightly different picture manifests itself. In the matter of **Hancock v FCT**[119] Kitto J said the following:

> "The arrangement was therefore, a means for avoiding the Income Tax which the Hancocks would have been liable to pay if they had achieved the same results without an arrangement. One may accept without hesitation their stoutly maintained assertion that in their minds the arrangement was predominantly a means for getting the shares. That was, no doubt their long standing ambition. It was that which draw them into the arrangement when it was proposed to them. But the stubborn fact remains that, for whatever els the arrangement was, it was a means for the avoidance of tax."

An analysis of the above two cases indicates that in time the Court interpreted s 260 as requiring a "dominant intention".

It is also clear that the Australian Supreme Court tends to emphasise the purpose of the arrangement as demonstrated by the arrangement itself over the subjective purposes of the parties involved. In **Peate v FCT**[120] Kitto J said the following in considering whether there was the necessary arrangement:

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119. **Hancock v FCT** (1961) 8 AITR 328 of 341.

120. **Peate v FCT** (1964) 9 AITR 355 of 358.

> "...it is clear also that the question whether an arrangement has or purports to have the purpose or effect of avoiding liability to tax under the Act is a question as to the purpose or effects of the arrangement itself, rather than the purpose in the minds of the parties. That is to say that it is a question whether, upon consideration of the overt fact which have been done in carrying out the plan, the arrangement is to be recognised as a means for the avoidance of a tax liability, whether or not it be a means to other ends also.

It seems that even though s 260[121] does not specifically make provision that the avoidance of tax need to be the sole "purpose" or "effect", the development of the Australian Case Law has been such that it is now regarded that s 260(1) requires a dominant purpose.

From **Newton v FCT**[122] as quoted above it is also clear that the avoidance of tax need not be the "sole purpose" of an "arrangement".

A problematic aspect of the Australian Case Law seems to be the fact that a number of conflicting decisions exist regarding the question of whether the purpose of an arrangement needs to be the dominant purpose. It would seem, as stated above, that certain **dicta** as quoted above indicated a swing towards a requirement of "dominance" while other **dicta** firmly stated that the presence of "dominant purpose" is unnecessary.

In contradiction to the above cases **Dawson J** stated the following in **FCT v Gulland**[123].

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121. Section 260(1) of the **Australian Income Tax Assessment Act** of 1936.

122. **Newton v FCT** (19588)7 AITR 298.

123. **FCT v Gulland (1985)** 17 AITR 1 of 33.

> "It is unnecessary for the purpose or effect of an arrangement to fall within s 260 that it be the sole or, it would seem, even the dominant purpose. This flows from the terms of the section itself which is expressed to operate only sofar as the purpose of the arrangement falls within one or other of the descriptions which it contains, thus reorganising the possibility of other purposes to which the section has no application.

In the subsequent amendments to s 260(1) of the **Australian Income Tax Assessment Act of 1936** by way of Part IV A this chaotic turn of events has been rectified with the introduction of s 177A[124] stating that, after consideration of a number of enumerated factors it must be concluded that a party to the scheme entered it or carried it out for the "dominant purpose" of enabling a taxpayer to obtain a tax benefit in connection with the scheme.

It would seem that the new Australian Enactment as incorporated in s 177A[125] is in line with it's South African counterpart as incorporated into s 103(1)(c).[126]

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124. Section 177A of the **Australian Income Tax Assessment Act of 1936.**

125. ibid.

126. Section 130(1)(c) of the **Income Tax Act 58 of 1962.**

CHAPTER 4: CONCLUSION

The above analysis of the South African and Australian Income Tax Avoidance measures, indicates that the Australian and South African systems are at a more or less equal level of development. It is clear that the amendments to the **Australian Income Tax Assessment Act of 1936** by means of the introduction of s 177A - 177G has afforded wide ranging powers to the Australian Commissioner to attack tax avoidance schemes.

From a South African perspective it is proper to conclude that s 103 of the **South African Income Tax Act 58 of 1962** affords wide discretionary powers to the Commissioner.

It would seem that s 103 of the **Income Tax Act 58 of 1962** avoids some of the pitfalls of the original s 260 of the **Australian Income Tax Assessment Tax of 1936**, specifically with regards to the ability of the Commissioner to determine a taxation level with regards to a specific taxpayer commensurate with the taxpayer's true income as measured by Commercially viable business principles.

It is recommended, however, that care should be taken not to fall in the original pitfall of Section 260 of the **Australian Income Tax Act of 1936** in that the original s 260 was formulated so wide that the Courts had no option than to interpret the operation of s 260 restrictively.

It is, however, reasonable to expect that further developments of Income Tax Avoidance measures would rather revolve around specific tax avoidance measures, than general tax avoidance measures.

A further recommendation is that there should be ample clarification of what precisely a "transaction, operation or scheme" entails.