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**Simulation discussed**

*Tax avoidance in the common law*

by

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## FOREWORD

It was with mild amusement that I regarded the general upheaval and animosity of so many in the MCom Tax class at UCT, colleagues at PwC Tax Services and the general tax community at a seminar presented by Adv. EB Broomberg SC in Cape Town on a wet June evening – all because of the renowned *NWK*-case.

Only after studying the judgment myself (and the subsequent media release by SARS), did I realise what so many had feared would emanate from this judgment: 'the slippery slope' to which Adv. TS Emslie SC refers in one of his articles quoted below.

This paper is a humble attempt at more clearly providing guidance on the principle of simulation, both theoretically and practically.

Of course, this could not have been possible without the constant guidance of so many colleagues, of which De Wet de Villiers requires special mention, as well as my supervisor at the UCT Commerce Faculty, Prof. Jennifer Roeleveld. Also PwC Tax Services which financed the project deserves recognition. And of course thank you to the 'wielder of the red pen', Mrs Annetjie van Jaarsveld, for teaching English, debating and so much more for all those many years.

Finally, special thanks is owed to my ever-supporting wife, Esri, without whose help and sacrifice, very little, if indeed anything at all, would have been possible.

AJM

Cape Town

June 2012

*'There is no equity about tax.'*

Lord Cairns in *Partington v Attorney General* (1869) LR 4 HL 100

*'... nor, I would add, complete rationality.'*

Hefer JA in *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA)

## ABSTRACT

The simulation doctrine has, in the law of taxation, always played the role of being SARS' remedy in the common law, vis-à-vis its legislated cohorts, viz. both the specific and general anti-avoidance provisions contained in the various tax statutes.

Building on the principles established in *Zandberg v Van Zyl, Dadoo Ltd and others v Krugersdorp Municipal Council* and *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd*, the test which emerged and has been applied since, is broadly recognised as being that as formulated by Watermeyer JA in *Randles*, being that where the parties to a contract truly intended to act in accordance with the tenor of the agreement, irrespective of what their purpose for entering into that transaction was, that contract cannot be a simulated one.

However, the Supreme Court of Appeal judgment in *CSARS v NWK Ltd* has necessitated that the principles applied previously be revisited academically to determine whether the doctrine for determining whether a simulation is present has changed – and if so, to what extent. Some argue that the comments in *NWK*, which is perceived to have changed the simulation test, were merely part of the *obiter* of the judgment, though they hasten to add that this does not mean that such comments are void of import where lower courts may consider the doctrine in future. Opposed hereto are those who are of the view that the judgment has indeed changed the simulation doctrine's landscape.

In this paper it is concluded that the correct position is probably aligned to the latter group. This is not to opine whether the test is correct or not, but merely to comment on the outcome. It is submitted that from an honest reading of *NWK*, the test for whether a simulation has been present, is whether the parties to a contract did not honestly intend to give effect thereto in accordance with its tenor, OR where either of the parties entered into such agreement with a concealed purpose or motive. The extended test is therefore not just limited to whether a simulated intention is present for both parties to the contract, but whether either of the parties also exhibits a simulated purpose. Both the intention of the parties and the purpose of any one of them should be determined subjectively, which is only possible through the use of objective indicators which are available to a court for consideration.

Further investigation shows that this divergence from the test (which has been applied in South Africa for more or less 70 years) has also been an approach which has been considered by other countries, and comments by the various judiciaries indicate that some of the foreign benches may agree with the newly established *NWK* test. However, for the moment the simulation test applied in South Africa seems to be unique.

From the developed principles of the simulation doctrine, it is evident that SARS may now have a much more powerful weapon at its disposal, and taxpayers and –planners alike should take cognisance of this. Especially when one compares the requirements of the common law doctrine to the requirements for the general anti-avoidance rule, one realises that, where the facts allow therefore, SARS may now attack a transaction or arrangement in terms of simulation where previously this would not have been possible.

Finally, it is submitted that irrespective of whether the test for simulations has changed, the latest developments in *NWK* (and internationally) are bound to affect tax planning, and prudent tax planners should take note of the possible mutations thereof which may arise as a result. As a result of the considerable amount of uncertainty that has arisen since, it is recommended that specific transactions be reconsidered by tax planners, and that both SARS – and the Bench at the first available opportunity – give clarity on whether it agrees with the assertions which have been discussed in this paper and other published academic works.

#### Keywords

Australia, Canada, commercial substance, common law, GAAR, general anti-avoidance rule, income tax, Income Tax Act 58 of 1962, intention, Lewis, *NWK*, *plus valet quod agitur quam quod simulate concipitur maxim, obiter dicta*, purpose, simulated transaction, simulation, sham, sham transactions, *stare decisis*, substance over form, tax avoidance, UK, United Kingdom, Watermeyer.

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## CHAPTER 1

### INTRODUCTION

In the classic Greek legend of 'the Sword of Damocles', Cicero tells the story of young Damocles, courtier to King Dionysius II of Syracuse. Damocles, being a true flatterer of nature and employ, would constantly remind the King of his great fortunes and power by ruling over his kingdom. Growing weary of Damocles' constant pandering, the King invited Damocles to a banquet to show him the true enjoyment of being a ruler. Damocles was even to sit on the King's throne. However, to Damocles' horror, the King, to demonstrate the constant dangers that a ruler faces amidst his fortunes and happiness, ordered a sword to be suspended from the roof over Damocles' head for the entire banquet, hanging by a single hair from a horse's tail.<sup>1</sup>

Such were the perils of ruling in Greek mythology, and such is the nature of flaunting with simulated transactions in the tax arena.

#### 1.1 General comments

It is trite that the principle of simulation is not the fiefdom of the law of taxation only. However, for purposes of this paper, the development of this doctrine within the borders of the law of taxation exclusively, will be examined.

In his judgment in *CoT v Ferera*<sup>2</sup> at 70, MacDonald JP comments as follows:

*'I endorse the opinion expressed that the avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the fiscus, but the effect must necessarily be to cast an additional burden on taxpayers who, imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice and set up the necessary tax-avoidance machinery, fail to do so. Moreover, the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that "good citizens" will always fare badly. While undoubtedly the short term effects of the practice are serious, the long term effects could be even more so.'*

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<sup>1</sup> Damocles. Dictionary.com. Collins English Dictionary - Complete & Unabridged 10th Edition. 2009. HarperCollins Publishers. <http://dictionary.reference.com/browse/Damocles> (accessed: March 19, 2012).

<sup>2</sup> [1976] 38 SATC 66.

In contrast to this is the judgment of Lord Tomlin in *IRC v Duke of Westminster*:<sup>3</sup>

*'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. If he succeeds in ordering them so 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.'*

Generally speaking, in the tax milieu, it is where this 'ordering of affairs' take on proportions where a transaction is entered into: not so much to order affairs as to obtain some tax benefit, and obtaining this tax benefit so by dishonestly displaying the transaction to the world in a form which in substance it truthfully is not. Although not endorsing the view taken in *Ferera* as quoted above, one must sympathise and agree that tax avoidance obtained through dishonest means must be prohibited.

This prohibition is enforced through both the common law, as well as through legislation enacted specifically to prevent, as National Treasury would have it, the 'raiding of the *fiscus*'. Although similarities with the general legislated provisions are also discussed, this paper deals specifically with that common law arrow in the South African Revenue Service's ('SARS') bow i.e. preventing tax avoidance through the application of the simulation doctrine.

## 1.2 The scope of the simulation doctrine

The SA common law principle of simulation has over the years rested on two inter-dependent pillars *viz.* the doctrines of 'substance over form' and so-called 'sham'.<sup>4</sup>

The principle of 'substance over form' is embodied in the maxim '*plus valet quod agitur quam quod simulate concipitur maxim*' (the '*plus valet*'-rule) i.e. the true intention is of more value than the pretence/sham<sup>5</sup> (see *Zandberg v Van Zyl*).<sup>6</sup> In this regard, Emslie points out that:

*'the language of "substance and form" is sometimes used by our courts to signify an appropriate legal test in two different situations, namely simulated (or sham) transactions, which involve dishonesty, and bona fide transactions which are nevertheless construed in accordance with their substance rather than their form (for*

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<sup>3</sup> [1936] AC 1–19.

<sup>4</sup> Du Plessis, F. An unpublished and untitled article, used with permission of the author, discussing the principles of *plus valet* and *fraus legis*.

<sup>5</sup> Hiemstra & Gonin, *Engels-Afrikaanse Regswoordeboek*, 1963.

<sup>6</sup> [1910] AD 302.

*example, because the parties have in good faith but mistakenly attached the wrong label thereto).*<sup>7</sup>

The principle of 'sham' in turn is embodied in the phrase '*in fraudem legis*', (see *Dadoo Ltd and others v Krugersdorp Municipal Council*)<sup>8</sup> which, directly translated, means an act of evasion of the law or of an act.<sup>9</sup> Therefore, enjoined, it can be stated that where simulation occurs, the true intention of parties is of more importance than the fraudulent form with which the evasion of the provisions of an act is sought. 'Simulation' as discussed in this paper will therefore only refer to the former of Emslie's two situations above, i.e. dishonest simulation or simulation by way of sham transactions.<sup>10</sup>

### 1.3 Purpose of the research

The purpose of this paper is to explore the history of law, and as it currently stands, regarding what simulated transactions entail when used to reduce a taxpayer's income tax obligation when party to such a transaction(s). This paper addresses what currently constitutes simulation in the context of South African tax law, and commentary is offered on the consequences that this may hold for both the taxpayer and SARS in the future. To this extent, the research in this paper has been divided into three parts, *viz.* the history and development of the simulation doctrine, what this doctrine is currently defined as – both domestically and in other international jurisdictions – and, finally, what the consequences of the current developments of this legal principle may be in the future.

### 1.4 Methodology and structure

This research, which is Doctrinal in nature, has been conducted by studying and discussing various sources of literature, the writings of experts in the field and in particular case law which has led to the development of the simulation principle. From these sources deductive reasoning has been applied in order to offer what the simulation doctrine encompasses in a short but coherent and structured manner.<sup>11</sup>

In looking to the development of the simulation principle, this paper clarifies what the extended common law test for simulation was, based on the above-mentioned principles of 'substance

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<sup>7</sup> Emslie, T. *Simulated Transactions – A new approach?* The Taxpayer, January 2011, Vol. 60 No. 1.

<sup>8</sup> [1920] AD 530.

<sup>9</sup> Hiemstra & Gonin *supra*.

<sup>10</sup> It is useful in this regard to refer to '*bona fide* or honest simulations' not as '*simulations per se*'. Surtees & Millard choose to rather refer to this as the '*label principle*' (*SA Accountancy* November/December 2004). It is submitted that the correct approach would be for '*simulations*' to include as one of its *essentialia* an element of dishonesty or deceit. Refer in this regard to the discussion on the judgment in *Zandberg* *infra* at 2.1.

<sup>11</sup> Knight & Ruddock, *Advanced Research Methods in the Built Environment*, 2008: 3.

over form' and 'sham', what it currently is, and how this will practically affect transactions where our courts will in future adjudicate matters where tax avoidance through simulation is involved. A conclusion is reached by discussing past judgments in Chapter 2, and evaluating the evolution of the simulation doctrine with particular reference in Chapter 3 to the most recent Supreme Court of Appeal decision (*CSARS v NWK Ltd*)<sup>12</sup> ('*NWK*') which addressed the matter.

*NWK* is of particular importance both because it is the most recent authority on the matter, but further since it has drawn a significant amount of comment. Particularly, it is perceived at first glance at least to have had an astonishing disregard for the *stare decisis* principle. This impression is created by the Supreme Court of Appeal which, in delivering its judgment, seems to have unceremoniously cast aside judicial precedent set down by itself over just about 70 years. Centre to this is the perceived extension of one of the pillars of 'simulation', being the '*plus valet*'-rule referred to above, giving the test for simulation a distinct purposive (and objective) approach, as opposed to having regard to the intention (which is determined subjectively) of the parties involved, as a qualifying criterion to be satisfied. The source of this sentiment is derived from the following passage from *NWK*:

'The test should thus go further ... if (a transaction) has the purpose of tax evasion<sup>13</sup> (sic)..., then it will be regarded as simulated'.<sup>14</sup>

In an attempt to consider how the doctrine of simulation is to be applied in the future, it is further considered whether certain comments made in *NWK* were defining, in that they may have changed the well established common law principles developed thus far. Whether these comments constituted the *ratio decidendi* of the judgment or whether they were merely made as *obiter dictum* by the learned judge in the case is also considered at length.

Irrespective of the conclusion reached in this regard, the effect thereof on the common law is considered, as well as the impact that it may have on judgments to be made by lower courts in the future, bearing consideration to the principle of *stare decisis* and that even *obiter* comments made by the Supreme Court of Appeal would still carry persuasive weight in a lower court.<sup>15</sup>

Based on *NWK*, an evaluation into the current contents of the simulation principle will be conducted, and this will be compared to the approach that other jurisdictions have taken towards simulation in income tax. In Chapter 4, the position and principles regarding tax avoidance by way of simulation is considered from an international perspective. For instance, it

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<sup>12</sup> [2010] 73 SATC 55.

<sup>13</sup> In this regard, it is commonly regarded that Lewis, JA intended to use the word 'avoidance' instead of 'evasion' and that this was a mere 'slip of the judicial pen' (Emslie *infra* at 177). Not that this will rectify the uncertainty created. Refer in this regard also to Emslie *supra* at 7, Vorster *infra* at 38 and Broomberg *infra* at 34. It may be that the confusion regarding 'evasion' may have arisen through SARS' insistence that additional tax of 200% be levied as it contended *NWK* intentionally 'evaded' tax through the series of transactions. Refer in this regard to the Respondent's Heads of Argument at Appendix 1, as well as to the court *a quo* judgment in *ITC1833* [2008] 70 SATC 238 at 16 and 70.1.

<sup>14</sup> *NWK* at 42.

<sup>15</sup> Emslie *supra*.

has been proposed that tax avoidance (through the application of the simulation doctrine) be defined as:

*'the intention (motive, purpose, aim) to obtain a tax advantage contrary to the purpose of the norm, despite formally adhering to its wording'.<sup>16</sup>*

Alternatively:

*'I apprehend that, if it has any meaning in law, (sham) means acts done or documents executed by the 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 different from the actual legal rights and obligations (if any) which the parties intend to create... (F)or acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must 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. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived.'<sup>17</sup>*

The purpose of an international comparison is two-fold: firstly to attempt to draw a comparison between the perceived new approach taken by the Supreme Court of Appeal in the *NWK*-case (especially given the purposive approach taken), and secondly to determine whether there may be lessons to learn in developing our own common law, and what similarities already exist.

Specifically, the jurisdictions of the United Kingdom, Australia and Canada have been chosen, as these all have developed, as part of their common law, anti-avoidance mechanisms. In addition, these countries also share their legal developmental background, as does South Africa, from the British Common Law system as a basis from which these mechanisms were developed.

In reaching a conclusion to the possible effect of the test for simulation adopted in *NWK*, specific transactions are considered in Chapter 5 and how the latest developments to the simulation doctrine may impact on these, e.g. the acquisition of shares through debt financing by employing group relief provisions contained in the Income Tax Act<sup>18</sup> ('the Act', and all references to 'section' are to the relevant sections of the Act).

Finally, simulation will be discussed and considered within the context of the General Anti Avoidance Rules ('GAAR') introduced into the Act on 2 November 2006, and whether these, at least to some extent, address the simulation principle which has, until now, been addressed by the common law. Specifically, the notion of 'commercial substance' as envisaged in section 80C

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<sup>16</sup> Karimeri, R. *A Critical Review of the Definition of Tax Avoidance in the Case Law of the European Court of Justice*, Intertax, June 2011, Vol. 39 Issue 6/7.

<sup>17</sup> Diplock, L.J. in *Snook v London & Westriding Investments* [1967] 2 QB 786.

<sup>18</sup> 58 of 1962.

will be considered and whether there may be some overlapping between this and the approach in the common law, especially given the curious choice of words used by the court in *NWK*.

#### 1.5 Limitations to the study

The GAAR will not be discussed in any detail, but will only be alluded to as is necessary for the subject area. As noted above in 1.2 simulation is only discussed in the context of sham transactions and dishonest simulation.

However, the GAAR will be briefly discussed in Chapter 5.2 to determine how this interacts with the simulation doctrine.

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## CHAPTER 2

### THE PAST

#### **The decisions in *Zandberg*, *Dadoo* and *Randles Brothers***

The principle of simulation has been developed by a host of well known, and often quoted, cases. The judgments of the former Appellate Division (now the Supreme Court of Appeal) in *Zandberg v Van Zyl*<sup>19</sup>, *Dadoo Ltd and others v Krugersdorp Municipal Council*<sup>20</sup> and *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd*<sup>21</sup> bear particular reference in that they set the basis upon which the doctrine of 'simulation' was developed. These cases are considered below in more detail in order to determine what the crisp test for simulation was clear to be, prior to the confusion emanating as a result of the *NWK*-judgment.<sup>22</sup> It is acknowledged that the development of the simulation principle cannot be attributed solely to these three cases discussed. However, in the interest of not labouring unnecessarily on the history of the doctrine, other cases which had a role to play in the establishment of 'simulated transaction' are referred to in this chapter and throughout this paper.<sup>23</sup> It is submitted though that the three cases discussed in this chapter laid the foundation for the development of the doctrine, which is reason enough for their facts and judgments to be revisited here again.

Up until the *NWK* judgment, the test for simulation developed by our courts (and applied by courts in other common law jurisdictions as well, as discussed in chapter 4 *infra*) has been based upon the maxim *plus valet quod agitur quam quod simulate concipitur*<sup>24</sup>, and is probably best formulated in *Zandberg*.

This subjective 'standard test'<sup>25</sup> seems to have been applied consistently over the years in determining whether transactions were simulated to obtain a tax benefit.

However, it needs to be investigated whether this position may have been altered by the *NWK*-judgment, as alluded to in Chapter 1 above, by introducing an objective element to the test:

*'The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose.'* (own emphasis)

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<sup>19</sup> Ibid. at 6.

<sup>20</sup> Ibid. at 8.

<sup>21</sup> [1941] 33 SATC 48.

<sup>22</sup> As an aside, it is interesting to note that the notion of 'ownership' is a common theme in all these and other *loci classici*, ranging from the ownership of a wagon to textiles, from ownership of a loan to immovable property. Even in the latest addition of *NWK*, ownership of maize was centre to the issue at hand (at 76).

<sup>23</sup> The judgments which particularly deserve mention in this regard (in chronological order) are *Vasco Dry Cleaners v Twycross* [1979] 1 All SA 321 (A), *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* 1992 (1) SA 867 (AD), **Erf** 3183/1 *Ladysmith (Pty) Ltd and another v CIR* [1996] 58 SATC 229 and *CIR v Conhage (Proprietary) Limited* [1999] 61 SATC 391.

<sup>24</sup> De Koker & Brinckler, *Silke on International Tax*, 2010: 46.5.

<sup>25</sup> Emslie, referred to *supra*.

## 2.1 Zandberg v Van Zyl

The first South African case to truly deal with the principle of 'simulation' was that of *Zandberg*. It will be noted from the title of the case that this is not a tax case – however, the reader is reminded that 'simulation' is not the property of the law of taxation only.

The respondent was in the unenviable position of having his mother-in-law, one Mrs van Zyl, as a debtor. Mrs van Zyl was not only indebted to her son-in-law, but also to the appellant. Of contention in the matter was a wagon which the Messenger of the Court had attached as payment for the debt owing to the appellant. However, according to the respondent, Mrs van Zyl had already sold him this wagon in consideration for a loan of £50 which he had previously extended to her, and as such the wagon was not the property of Mrs van Zyl and it could therefore not be attached for the payment of her debts.

The appellant contended that the wagon was not sold to the respondent, but that he had merely taken possession thereof as security for the amount owed to him by Mrs van Zyl. Accordingly, the appellant was entitled to have the wagon attached in partial fulfilment of the amount advanced to Mrs van Zyl, since the wagon was her property. If however Mrs van Zyl was not the owner of the wagon, but rather the respondent, the appellant would not be entitled to take the wagon for himself.

In a unanimous judgment, upholding the appeal, Innes, J. held at 309:

*'Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is: not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur. But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.'* (own emphasis)

From this celebrated extract, it is evident that a mismatch between the substance and form of an agreement by itself is not enough to pierce the 'contractual veil'.<sup>26</sup> By using words such as 'disguise' and 'simulated intention', intent to deceive is of primary importance to the learned judge. This extract, and case, laid the basis for a subjective test to be applied in determining whether a simulated transaction has been entered into. And 'simulated' in *Zandberg* would have to be something which intently has been designed to take the form of something which the substance of is not.

It would seem, from the above, that 'simulation' as developed in *Zandberg* would exclude *bona fide* transactions where '*the parties have in good faith but mistakenly attached the wrong label thereto*'. The inappropriate form of a transaction is not enough to render a transaction 'simulated' for the purposes of the common law – intent would be a necessary requirement.<sup>27+28</sup>

## 2.2 Dadoo Ltd and others v Krugersdorp Municipal Council

Whereas *Zandberg* proved to be the first South African authority on 'substance over form', *Dadoo* serves as the leading authority on the '*in fraudem legis*'-principle. The facts are shortly as follows:

In terms of now repealed statute, persons of Asiatic descent were prohibited to acquire land in the Krugersdorp Municipal district. The appellant company was incorporated to acquire land in the district. Both its shareholders, Messrs Dadoo and Dindar, both of whom were of Asiatic origin, were the sole shareholders of the appellant.

The respondent Municipal Council approached the then Transvaal Provincial Division, seeking and successfully obtaining an order to set aside the transfer of property acquired by the appellant on the basis that the transaction was one which was *in fraudem legis*. To this, the appellants appealed to the Appellate Division.

In delivering the majority judgment (Innes, CJ writing a separate concurring judgment and De Villiers JA dissenting), Solomon JA, in reference to the extent of the doctrine of *in fraudem legis* held at 558:

*'The law on this subject is based mainly upon two leges of the Digest, 1.3.29 & 30, which read as follows:- "29. Contra legem facit, qui id facit quod lex prohibet, in fraudem vero, qui salvis verbis legis sententiam eius circumvenit. 30. Fraus enim legi fit, ubi quod fieri*

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<sup>26</sup> Refer to *Kilburn v Estate Kilburn* 1931 AD 501 at 507 where Wessels ACJ held: '*Courts of law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance.*'

<sup>27</sup> Du Plessis *supra*.

<sup>28</sup> Surtees & Millard *ibid.* at 10.

noluit, fieri autem non vetuit, id fit: et quod distat dictum a sententia, hoc distat fraus ab eo, quod contra legem fit."<sup>29</sup>

*Now it has already been pointed out that in interpreting a statute a court is entitled to have regard not only to the words used by the Legislature but also to its object and policy. But clearly more than that is embraced in these two leges. Indeed, at first sight it would almost appear as if it were intended to lay down that a court may construe a statute so extensively as to declare invalid an act which, though it did not contravene the prohibition of the law, nevertheless did violence to its spirit and intent. If that were the correct meaning of these two leges it would in effect enable a court of justice to legislate by supplying what it conceived to be omissions of the Legislature. Such an authority, however, has never, so far as I know, been claimed by the courts of this country, and an examination of the examples referred to in the Digest, in which these leges were applied in practice shows, I think, conclusively that this is not what was meant by their authors, but that all that they intended to lay down was that where a statute prohibits anything being done, the law cannot be circumvented by the doing of that act in an indirect manner. These rules, indeed, are, in my opinion, merely an application of a general principle, which is as much a part of English as of Roman Jurisprudence, that courts should have regard to the substance rather than to the form of a transaction, and should strip off any disguise which is intended to conceal its real nature.' (own emphasis)*

And later at 560:

*'It is perfectly legitimate, however, for persons to evade a statute by deliberately keeping outside of its provisions and by doing something which effects their purpose equally well, but without bringing themselves within the scope of the law*.' (own emphasis)

A reading of the above extract shows that the test for 'simulation' is now developed not necessarily further, but has at least been more refined: Not only is a mismatch between the substance and form of a transaction required, but also the intentional disguise thereof as primary reason for moulding the transaction in that particular form.<sup>30</sup>

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<sup>29</sup> Translated (by Prof. AH van Wyk) in Afrikaans, and by the author into English for purposes of this paper: 'Dig. 1.3.29. A person does something that is contrary to the law, if he does that which the law prohibits. Nonetheless he does it fraudulently if he, within the wording of the law, circumvents the purpose of the law. Dig. 1.3.30. A fraud is committed against the law if that which it did not want to occur, but that which he did not prohibit to occur, in fact does occur: and the farther that which is said/determined is from the purpose, the farther that which is done contrary to the law is from fraud.'

<sup>30</sup> This principle has been applied in both *CIR v Conhage (Proprietary) Limited* at 1 as well as in *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR* at 950I-952C: 'Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If eg the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax.'

Of further interest are Solomon JA's comments regarding the interpretation of statutes. Although it supports the so-called 'purposive' approach to the interpretation of statutes, it also places a clear border to the proverbial field of play within which it operates: a court may not write statutes, but that which is written may be applied in the manner which has been intended by the Legislature.<sup>31</sup> This proves to be a double-edged sword: courts have the power to look beyond what is strictly determined by statute, but this ability would also have to be practiced with disciplined restraint.

In this regard, the following *dictum* from *Vestey's (Lord) Executors & another v IRC*<sup>32</sup> at 1120 bears reference:

*'Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved.'*

On a practical level, this becomes increasingly difficult when dealing with the interpretation of law in terms of the amorphous rules of the common law. However, one would expect courts to exercise the same degree of restraint in interpreting the common law as would be the case in interpreting statutes. Courts should exercise discipline in not using the common law as a legislative pen in its hands. This is at the very heart of the rule of law.

### 2.3 Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd

The respondent company was the importer of materials to be used in clothing. On the import of its products, the company received a rebate from customs duty since the company met the requirement that the goods were after import given to a manufacturer who manufactured clothing from the materials provided. Thereafter the finished goods were handed back to the respondent for sale into the market. For the manufacturing of the clothing from the respondent's materials, the respondent paid the manufacturer a fee. It is important to note that at no point did the ownership of the materials during this period pass to the manufacturer.

Later, in 1936, the requirements for receiving the rebate from customs duty were changed. To qualify for the rebate under the new regulations, the importer had to also be the manufacturer

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<sup>31</sup> De Koker & Brinckler, *Silke on International Tax*, 2010: 46.3.

<sup>32</sup> [1949] 1 All ER 1108.

of the finished clothing goods. As the respondent was still enthusiastic to draw advantage from the customs rebate, he varied his agreement with the manufacturers. In terms of the new agreement, the manufacturers would purchase the uncut materials from the respondent and manufacture this into the clothing required by the respondent. The finished products would be sold back to the respondent at cost price plus a margin for the labour which the manufacturer had incurred. In addition, the respondent contracted with the manufacturers that they were not required to pay for the materials purchased until the articles of clothing were purchased back from them by the respondent (the risk of not selling any products was therefore removed – a risk normally associated with any retailer of tangible goods).

It was contended for the Commissioner that Randles Brothers & Hudson Ltd was still the true importer of the textiles, and that the transactions had been varied *in fraudem legis* to, in form, show the manufacturers as the importers of the materials, where in actual fact ownership had never passed to them.

The bench was split three to two in the matter. Watermeyer JA, in delivering the majority judgment and dismissing the appeal, referred as follows to the judgment in *Zandberg* at 395 to 396:

*'I wish to draw particular attention to the words "a real intention, definitely ascertainable, which differs from the simulated intention" because they indicate clearly what the learned Judge meant by a "disguised" transaction. A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.*

*A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, inter partes the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be in *fraudem legis*, and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties.*

*Of course, before the Court can find that a transaction is in *fraudem legis* in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible agreement is a pretence. The blurring of this distinction between an honest transaction devised to avoid the provisions of a statute and a transaction falling within*

*the prohibitory or taxing provisions of a statute but disguised to make it appear as if it does not, gives rise to much of the confusion which sometimes appears to accompany attempts to apply the maxim quoted above.'*

This majority judgment is a ringing endorsement of the test for 'simulation' laid down by the Appellate Division in *Dadoo*, with perhaps one further development: a mismatch between the substance and form of a transaction is required as a result of the intentional disguise thereof as reason for moulding the transaction in that particular form, and that intention must be present for both parties to the transaction (i.e. an element of collusion).<sup>33</sup> It is worth noting that Watermeyer JA seems to exclude the 'primary purpose'-requirement, as quoted at 560 in *Dadoo* above, i.e. even if the sole purpose of a transaction is the avoidance of tax, this will not be simulation if the parties intend to act in accordance with its tenor.<sup>34+35</sup>

De Wet CJ for the dissenting minority held that for ownership to pass through a contract of sale, both the purchaser and the seller had to intend this to in fact take place. If this intention was absent in either party, no actual contract of sale was concluded. Even though it may be so that the respondent actually intended to sell the materials to the manufacturers, there existed no intention or *animus emendi* from the manufacturers to acquire ownership of the materials imported.

As discussed *infra* at 3.2.1, the *NWK*-judgment<sup>36</sup> seeks to draw a distinction between the different approaches taken by Watermeyer JA and De Wet CJ – the latter preferring to adopt a more objective approach as compared to the subjective approach followed by Watermeyer JA.<sup>37</sup>

Without pausing unnecessarily at this point, it is submitted that one could agree with *Vorster's* submission that in actual fact, there is no real difference in approach adopted by either judge, other than on matters of fact.<sup>38</sup> However, it is submitted that the added requirement of Watermeyer JA, i.e. that both parties to the transactions seek to intentionally conceal the true nature thereof, was indeed a new development in law at the time and a new consideration added to matters raised in previous precedent in considering matters of simulation.

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<sup>33</sup> Although the cases do not directly relate to one another, the notion of multi-party conspiracy has subsequently been endorsed by the internationally recognised authoritative (refer *Raftland* at 115 and 116 *ibid.* at 118) judgment on the matter in *Snook* (*ibid.* at 17): '*For acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must 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.*' (*own emphasis*)

<sup>34</sup> Broomberg, E.B. 2011. The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association.

<sup>35</sup> It is submitted that 'for parties to intend to give effect to a contract in accordance with its tenor', can also be translated into 'the parties intending, however difficult it is to subjectively determine, to honour the maxim *pacta servanda sunt* (i.e. contracts should be honoured)'. For a further brief discussion on the application of the law of contract to simulated transactions, refer to Chapter 3.2 *infra*.

<sup>36</sup> At 47 and 48.

<sup>37</sup> As also referred to in *Vasco Dry Cleaners v Twycross* [1979] 1 All SA 321 (A) at 334(2).

<sup>38</sup> *Vorster, H. NWK and purpose as a test for simulation*, *The Taxpayer*, May 2011, Vol. 60 No. 5.

## CHAPTER 3 THE PRESENT – SOUTH AFRICA

### The decision in *NWK*

As alluded to above, *NWK* has the potential (whether applied, distinguished or differed from in cases to follow) to be a landmark decision in the development of the simulation doctrine. However, it is yet to be considered by another court and until then, its full impact remains open for speculation. Accordingly, it is compelling to pause sufficiently at this point to dissect the judgment in *NWK* in some detail so as to better understand the issues and considerations at hand and how they are likely to be applied and interpreted in future. This is necessitated by the outcry from the larger tax community over the judgment, as well as credence and much influence given to certain comments by the court in the judgment, even if made in passing and as part of *obiter*, through the principles of *stare decisis*.

A study of the judgment is therefore essential for two reasons: the first being that, from a theoretical angle, one is required to determine how (if so) the judgment altered the position of 'simulation' in South African tax law. The second is that, even if no such alteration has taken place, what the practical effect of the judgment will be.

#### 3.1 The *NWK*-case<sup>39</sup>

The case came before the Supreme Court of Appeal as an appeal by the Commissioner for SARS (for ease of reference hereinafter referred to as 'SARS') against an appeal upheld by the Tax Court sitting in Johannesburg. The appeal was brought before the Tax Court by *NWK* against certain assessments issued to it. At issue was whether interest payments claimed as deductions by the respondent (*NWK*) for the 1999 to 2003 years of assessment should be permitted.

SARS, having originally allowed the deductions, issued revised assessments in 2003 in which it disallowed interest on a portion of a loan which it regarded as simulated. In addition, it also sought to levy interest and a 200% penalty.

SARS' claim of a simulation was in respect of a loan granted to *NWK*, a maize trader, from essentially First National Bank ('FNB'). Before discussing the loan agreement, it is necessary to appreciate that for the finance to be granted in the current case, no simple contract was entered into between FNB and *NWK* to obtain the financing. In fact quite to the contrary, a range of transactions and contracts<sup>40</sup> were entered into between amongst others *NWK* and FNB to secure the loan facility in question. The essential facts relating to the complex loan in question are as follows:

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<sup>39</sup> The keen historian will note the interesting coincidence that the judgment in *NWK* was handed down 7 days short of the centenary of the celebrated judgment of Innes, J quoted above in *Zandberg v Van Zyl*, seen by most to be the first classical case on simulation.

<sup>40</sup> Reminiscent of the facts in *Ladysmith*.

Slab Trading Company (Pty) Ltd ('Slab'), a subsidiary of FNB, lent NWK an amount of R96,415,776 carrying interest at a fixed rate of 15.41% per annum, payable every six months. For payment of the interest, Slab was issued 10 promissory notes with a total face value of R74,686,861 by NWK. The capital was to be repaid at the end of the 5-year loan period by the delivery of 109,315 tons of maize by NWK to Slab. NWK, to hedge against the exposure of the risk in fluctuation in the maize price (according to testimony given on its behalf), contracted with FNB to acquire the right to obtain the delivery of 109,315 tons of maize in 5 years' time for consideration amounting to R46,415,776 and payable immediately. Therefore, in 5 years, NWK would both deliver and receive 109,315 tons of maize.

Slab now exits from the transaction: it sells its promissory notes received for the future interest payments to FNB at its discounted value. It further also sells the right to receive the maize from NWK to FNB (for a price being materially the same as the corresponding right was sold to NWK above).

The net effect<sup>41</sup> of the above for NWK was that it received a net amount from the FNB Group of R50,000,000 and made 10 payments every six months (i.e. over five years) of R7,468,686 amounting to R74,686,861.

What the court found in substance to have taken place was that a loan of R50,000,000 was made, to be repaid in equal instalments of R7,468,686 every 6 months for 5 years. The total repayment over the 5 year term would amount to the payments above of R74,686,861, the total amount of which was portrayed by the parties as interest. In actual fact, this amount would however consist of the repayment of the R50,000,000 capital, as well as a fee of R697,518 and interest of R23,989,343.<sup>42</sup>

While SARS allowed so much of the interest as would have been payable on a loan of R50,000,000 as a section 11(a) deduction, i.e. R24,686,861 (the R697,518 fee + interest R23,989,343), the amount disallowed was the interest charged on the loan amount exceeding R50,000,000, as well as additional tax and interest.

Considering the above facts, one may be inclined to agree with Emslie<sup>43</sup> that the above transactions were tantamount to simulated transactions. The question of import is however, how does one reach such a conclusion: by the consideration of objective or subjective considerations?

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<sup>41</sup> The court held that, by operation of *confusio*, NWK's obligation to both deliver and receive the same amount of maize on 28 February 2003 was cancelled.

<sup>42</sup> Refer *NWK* at 31, as well as par. 63 of the Head's of Argument presented to the Supreme Court of Appeal by the Appellant.

<sup>43</sup> *Ibid.* at 7.

## 3.2 A new test?

### 3.2.1 Lewis JA's test

According to Broomberg,<sup>44</sup> the 'Golden Rule' with regards to simulation in South African tax law, based upon the extract in *Randles* quoted above, is:

*'A transaction will not be regarded as simulated if the parties genuinely intended that their contract will have effect in accordance with its tenor, and that the rule applies even if the transaction is devised solely for the purpose of avoiding tax.'*<sup>45</sup>

At first blush, this may seem to be unfairly prejudiced against SARS, especially if considered that, on the strength of the above *dictum*, transactions devised with the sole purpose of avoiding tax falls outside the perimeter of simulated transactions if it is acted on in accordance with its tenor. However, one is reminded of the legislative protection that SARS is also afforded in terms of GAAR in the Act at section 80A and 80L, which would be the corrective and an additional remedy available to SARS if not able to rely on the common law.<sup>46</sup>

At this point it would be appropriate to revisit what the common law test for simulation was as concluded in Watermeyer JA's judgment in *Randles*:<sup>47</sup>

1. The substance of a transaction must be different from the form in which it is cached;
2. There must exist an intention to have presented the transaction in the disguised form;  
and
3. The intention referred to in 2. above must be present in both contracting parties.

In *NWK*, Lewis JA confirms that the principles (although in her mind not applied consistently in past judgments) that, on the one hand, a taxpayer may organise his financial affairs so as to pay as little tax as possible and, that on the other hand, the true nature and substance of a transaction is to be regarded by a court, are not in conflict.<sup>48</sup> However, because of the 'divergence' in the application of the two principles, Lewis JA felt compelled to clarify what the test for simulation should be.

According to the learned Judge, the best example of the two different approaches to balancing the above two principles is found in the majority (delivered by Watermeyer JA) and minority

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<sup>44</sup> *Ibid.* at 34.

<sup>45</sup> In this regard, it is interesting to note that the first form of GAAR was introduced into the Income Tax Act of 1941 in the form of section 90 – the same year that the *Randles* judgment was delivered.

<sup>46</sup> For a more detailed comparison between the common law doctrine of simulation and the provisions of GAAR, refer to Chapter 5.2.

<sup>47</sup> Refer 2.3.

<sup>48</sup> Thereby confirming the position taken by the court in *Ladysmith*.

decisions (delivered by De Wet CJ with Tindall JA concurring in a separate judgment) of *Randles*.

Referring to the test for simulation by Watermeyer JA (as set out above), the focal point of the 'divergent' application for Lewis JA seems to be the judge's focus on the parties' intention to transfer ownership through contract of sale. The view expressed in *NWK* was that this test did not go far enough.<sup>49</sup> In this regard it is submitted that Lewis JA did not propose a 'new' test *per se*, but rather sought to extend the test for simulation to 'go further'. This is however discussed in more detail *infra* at 3.3.

Juxtaposed to Watermeyer JA's test is the judgment of De Wet CJ who '*preferred to look at the substance of what was done*', as well as that of Tindall JA, who '*too considered that the court should have regard to what was done rather than what was said*'.<sup>50</sup>

Elaboration of and content to this extract is to be gleaned from what followed in *NWK* at 49 to 54, where various past judgments are quoted by Lewis JA in support of her assertion of past divergence. These judgments, it was put by the court, followed the minority's approach in *Randles*.<sup>51</sup> Instead of looking to the intention of the parties concerned, the court inferred that in these cases the court rather had regard to other criteria to ascertain the purpose<sup>52</sup> of the transactions. In short, it was held by the court in *NWK* that:

- In *Vasco Dry Cleaners*, the features of the contract in question were considered;
- The court in *Hippo Quarries* considered the form in which the transaction had been concluded and from there deduced whether the parties' intention was in accordance therewith;
- In *Conhage* 'business sense' was the overriding factor;
- The 'purpose' of the transaction was another important factor considered in *Hippo Quarries* (a factor which was emphasised by the court in *NWK*); and
- Although in both the cases of *Conhage* and *S v Friedman Motors (Pty) Ltd*<sup>53</sup> the intention of the parties to perform in accordance with their tenor was present, there were sound commercial reasons for structuring the transactions in the way they were.

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<sup>49</sup> At 55.

<sup>50</sup> *NWK* at 48.

<sup>51</sup> The correctness of this statement by the court has been questioned by Vorster (*ibid.* at 38). However, for purposes of this paper, this will not be evaluated. The purpose of this paper is not to present a critical analysis on *NWK*, but rather to ascertain what the court crisply decided the contents of 'simulation' should be, as well as to venture an opinion on how this would be applied in future.

<sup>52</sup> It should be pointed out that, in the tax milieu, the purpose which is scrutinised is specifically whether there is a commercial purpose to the transaction, other than one of obtaining some tax advantage, this as tax invariably occurs in the economic environment. It will be noted that throughout the contents of this paper, reference will interchangeably be made by the writer or sources quoted to *inter alia* business purpose, commercial purpose, commercial sense, economic purpose, etc. It is submitted that these are all various guises of the same requirement as a potential objective test for simulated transactions.

<sup>53</sup> 1972 (1) SA 76 (T), upheld on appeal, 1972 (3) SA 421 (A).

It would be fair to say from a study of the above-mentioned examples that the full bench in *NWK* clearly favoured a test different, or extended, from the one laid down in the majority judgment in *Randles*. To summarise and conclude on the court's view of what the test should be for simulated transactions, Lewis JA comments as follows at 55 (a stark contrast to Watermeyer JA's judgment in *Randles*):

*'In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion (sic)<sup>54</sup> of tax, or of a peremptory law, then it will be regarded as simulated.'*

It follows that the requirements set out by Lewis JA in *NWK*, which, after consideration of the above, can only be interpreted as an endorsement of a purposive approach i.e. what the purpose of the transaction was (as opposed to an analysis of the intentions of the parties involved). Lewis JA's test can therefore be paraphrased as follows:

1. The substance of the transactions must be different from the form in which it is cached;
2. The above substance must have the effect to avoid tax (or any other peremptory of law);  
and
3. To obtain the above tax benefit must have been the purpose<sup>55</sup> (albeit the primary purpose)<sup>56</sup> of entering into that transaction of at least one of the contracting parties.<sup>57</sup>

As submitted earlier, this does not encompass the entire test for simulation, but merely the extension thereof. The test for simulation following from *NWK* is regarded in its entirety in Chapter 3.3 below.

Perhaps, as a concluding remark on this point, it is necessary to state that many have lamented the creation of a new and unjust so-called 'deemed simulation' (i.e. that requirement 3. above

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<sup>54</sup> Read 'avoidance'.

<sup>55</sup> It is conceded that, at 56, Lewis JA comments that it needs to be ascertained what the parties really 'intended' to achieve. It is submitted that this is not a reference to the determination of the intention of the parties in binding themselves contractually, but rather as a synonym for 'purpose' used loosely. This therefore does not serve as a basis for arguing that Lewis JA through this *dicta* in fact did not choose to deviate from the test laid down in *Randles*.

<sup>56</sup> The requirement for the primary purpose to be the obtaining of a tax benefit will be discussed and substantiated below under Chapter 4.1 and compared to the 'sole or main purpose' requirement of GAAR.

<sup>57</sup> The requirement that the simulated purpose of only one of the contracting parties will be sufficient to create a simulation will be discussed below in this chapter.

is sufficient under the 'new' test to create a simulation).<sup>58</sup> Some have gone as far as to suggest that, on the strength of the above quoted *dictum*, if a transaction is entered into with the purpose of saving on tax, then it will be regarded as a simulated transaction. With respect, it would seem that the fears of a 'deemed simulation' as described above and in the context of the judgment are ill-founded.

Upon a closer reading of par. 55 of the judgment, one would notice Lewis JA using words such as that the 'test should go further' and that one has to determine the 'real substance' of the transaction. All of these are clear indicators that requirements 1. and 2. above are conceded to be necessary requirements of the simulation test, and that Lewis JA has not, as many would have it, thrown out the baby with the bath water.

### 3.2.2 The requirement for 'intention' or 'purpose'

The seemingly opposing requirements of 'intention' and 'purpose' warrants further analysis. How, one could ask, do these differ from another? In this regard, the *dictum* by Nienaber JA in *Hippo Quarries*<sup>59</sup>, quoted by Lewis JA in *NWK* bears reference:

*'Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.'* (emphasis supplied by Lewis JA)

#### 3.2.2.1 Intention

'Intention' as used here is determined subjectively, and is one of the requirements for entering into a contract.<sup>60</sup> As an aside, no case law<sup>61</sup> could be found, nor could a scenario be conceived, where simulation can occur outside of the bounds of a contract. It is therefore submitted that there can be no simulation without a contract to act as a vehicle through which that simulation is carried out.

Simply put, a contract is an agreement between parties in which the creation of an obligation(s) is intended, the basis of which is consensus between the contracting parties. This can be traced

<sup>58</sup> Broomberg *supra* at 34.

<sup>59</sup> At 405.

<sup>60</sup> Van der Merwe *et al*, *Contract General Principles*, 2003: 1.3.1 & 2.1 – 2.3.

<sup>61</sup> Even in *Dadoo's* case, the relationship between company and shareholder is one of contract in so far as a contract creates obligations to both parties – *Dadoo* is obliged to perform as instructed by its shareholders, who in turn are obliged to fund the company through the share capital acquired.

back to the Roman legal system where a meeting of intentions between contracting parties was regarded as the basis of a legal contract. The elements of consensus, according to the Will Theory,<sup>62</sup> are:

- a) Agreement on the consequences of the obligations created;
- b) The intention by all parties concerned to be legally bound to the obligations in a); and
- c) The parties must be aware of the agreement.<sup>63</sup>

When analysing the form of a contract to determine what rights and obligations are meant to be created by it, a court has to determine what 'type' of contract it is dealing with. E.g. a contract of sale generally gives the seller the right to receive payment, whilst it also incurs the obligation to deliver the *merx*. In a contract of lease, the lessor retains the ownership of the *merx*, but gives the right of use thereof to the lessee, in exchange for the right to receive lease payments.

In classifying a contract, regard must be had to the *essentialia* thereof. This should not be mistaken as requirements for a contract, but rather as essential elements to the classification of a contract, e.g. a contract of sale, lease or pledge. Still, it is possible for parties to a transaction to phrase a contract in such a manner so that the *essentialia* thereof (and the ensuing *naturalia* (terms attached by law to a contract) and *incidentalia* (further detailed terms, e.g. the method of payment, which is attached to a contract)) is coloured in such a manner as to provide a guise to the actual *essentialia* intended.<sup>64</sup> In such a case, one would have the difficult task to determine what the rights and obligations are which is created by a contract and which 'type' of contract this would more closely resemble.

Furthermore, the parties to a contract may portray to the world in their agreement, which has been reduced to writing, that it seeks to create rights and obligations which in actual fact they have silently or secretly agreed it would in actual fact not. It is therefore necessary for a court to determine in seeking to apply the 'simulation' principle, as envisaged by Watermeyer JA in *Randles*, whether the parties to the contract have sought to be actually bound by the wording of the contract *inter partes*, or whether a silent or tacit understanding existed between them that they will not strictly keep one another to the terms thereof. And in a modern, commercial society with unique rights and obligations being created or reserved, classifying contracts as a certain 'type' of contract may not always be a simple task.

Therefore, a contract, stripped bare of its label and '*outward trappings*'<sup>65</sup> (and even the writing in which the agreement was purportedly recorded), if acted on exactly in accordance with what the parties have agreed, is one that the parties have intended on agreeing. This is what was

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<sup>62</sup> The Will Theory, according to Van der Merwe *et al supra*, was predominantly developed as part of Roman-Dutch law.

<sup>63</sup> Van der Merwe *et al* *ibid.* at 60.

<sup>64</sup> Van der Merwe *et al*, *Contract General Principles*, 2003: 9.4.4.

<sup>65</sup> *NWK* at 80.

envisaged by Watermeyer JA in *Randles*: to determine whether the parties to a contract have acted in accordance with the *essentialia* of the contract which they have wanted to create.

Studying simulation from a contract law perspective better allows one to appreciate why *Watermeyer JA* endorsed multi-party involvement as a requirement for simulation: a contract simply cannot be created by one person acting on their own. The consensus of two or more parties (i.e. all the parties to the agreement) is required. And as the existence of some contract as a vehicle for a simulation is essential for that simulated transaction to be created, the same requirement for multi-party involvement is true for simulations.

Presumably however, where one opts to apply the 'purpose' requirement for simulation (*vis-à-vis* that of intention), multi-party involvement as a prerequisite for simulation falls away as 'purpose' is not a necessary element for a contract to come into being, as is the case with the necessity for 'intention'. It can be conceived quite easily that a party can enter into a contract, fully intending to honour the maxim *pacta servanda sunt*, but with a motive or purpose to perform some act in contravention of a statute, this purpose further being entirely absent from the co-contractor.<sup>66</sup>

### 3.2.2.2 Purpose

As Lewis JA interprets the common law and De Wet CJ's minority judgment in *Randles* (which *NWK* seems to approve of), the question is not what the intention of the parties were when entering into the contract, but rather what the purpose of the contract was – what did any one of the parties to the contract seek to achieve?<sup>67</sup>

As opposed to 'intention', 'purpose' or 'motive' speaks to the reason for entering into the transaction. E.g. if the parties intended to enter into a contract of sale, why was it that they wanted to do so? What was the purpose/motive for the contract of sale?

A simple example to illustrate the 'purpose' requirement can be as follows:

A customer purchases a diamond ring from a local jeweller. However, unknown to the customer, the item purchased from the jeweller has been smuggled illegally into the country by the jeweller. The customer fully intends to pay for the purchase of the ring from the jeweller, who in turn also intends to honour the agreement by handing over the ring to the customer. Clearly, both parties intend to give effect to the contract of sale in accordance with its tenor.

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<sup>66</sup> For an example of the 'multi-party' requirement being absent from the test for 'purpose', refer to the example below in Chapter 3.2.2.2.

<sup>67</sup> In this regard it is significant to note that in the judgment, nowhere does the court conclude on FNB's purpose (although admittedly it would presumably have been easy for the court to conclude that its purpose with the transaction was to obtain a tax benefit for *NWK*). This should be distinguished from the test in *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR* where the court at 243 did make a determination as to the involvement of both parties to the agreement. It is accordingly understood that, whilst there can only be one intention between parties to a contract, the purpose or motive for entering into that contract may differ. When this principle is applied to simulations, the effect is that for a simulated intention to be present, this is required for both contracting parties, whereas a simulated purpose may only be present in one.

However, the purpose with which both parties entered into the contract would differ: the customer's purpose was to buy the jewellery for legitimate purposes. The smuggling jeweller's purpose was to make a profit and rid himself of the illegal contraband in his possession.

Note that the above example is not one to illustrate 'simulation', but merely of how 'purpose' differs from 'intention'. Clearly, it would be incorrect to allege that a simulation has occurred as the necessary requirements of 'substance over form' and '*in fraudem legis*' have not been breached.

Once ascertained however that the purpose of any one contracting party for entering into the contract is to be determined, the question that still begs answering remains: how is this to be determined? To this, Lewis JA provides the answer in *NWK* at 55:

*'The test ... require(s) an examination of the commercial sense of the transaction: of its real substance and purpose.'*

The commercial rationale of a transaction would seem, from the *NWK*-judgment, to be the overriding factor to determine whether simulation is present between parties. This is not to imply that this would always be the test for simulation, or even the overriding factor in applying the test. It is submitted that, as every case should be evaluated on a case by case basis, so the overriding factor would need to be determined for each individual case. However, one would probably find that, as tax is a commercial matter, that the commercial reason for a transaction would inevitably always be a primary indicator in tax cases where simulation is involved.<sup>68</sup>

The phrase 'commercial reason/sense/substance/purpose' is used interchangeably a total of 9 times by Lewis JA in her judgment.<sup>69</sup> And used in the context which it was in the extract quoted above, the inference seems to be made that the commercial reason for the transaction would expose the real substance and purpose of the transaction (i.e. other than the one portrayed).

At first glance, one is struck by the apparent contradiction of 'real substance and purpose' and how this would differ from the 'substance and purpose'. However, the only logical explanation to be made is that the court refers to the 'real substance and purpose' of the transaction as opposed to the substance and purpose portrayed and presented to the court by *NWK* (and *FNB* and *Slab*). It is therefore significant that the court looks beyond the *ipse dixit* of the parties or the wording of the contract to arrive at a conclusion of the real substance and purpose of the transactions.<sup>70</sup> In this regard, the judgment in *Ladysmith* (as approved in *NWK*) also noted that '*the mere production of agreements does not prove that the parties genuinely intended them to have the effect they appear to have*'.<sup>71</sup> The wording of a contract can therefore not be used as *prima facie* proof of the subjective purpose of the parties at conclusion of a contract, although it

<sup>68</sup> The most recent Supreme Court of Appeal case on simulation, *Conhage*, is an example of this.

<sup>69</sup> Refer to Chapter 4.1 below for a discussion on whether the phrase 'commercial substance' as used by the court in *NWK* has any connotation to the defined term in GAAR.

<sup>70</sup> *Malan v KBI* [1983] 45 SATC 59.

<sup>71</sup> *NWK* at 40.

is conceded that this would be one of the factors which a court would need to take into account in determining the purpose of a contracting party.

Plainly speaking, it is evident from the judgment that the judge sought to determine what NWK stood to gain from the transactions commercially. And from the judgment it is clear– in lending some R46 million in excess of the R50 million for which it initially applied to FNB, nothing other than a tax benefit was to gain. The purpose therefore was to (solely or mainly) obtain a tax benefit through disguised means and, as a result, the interest on the additional R46 million lent for these purposes alone was disallowed as an income tax deduction.

### 3.2.3 Subjective v Objective: determining 'purpose'

Under the heading '*A genuine intention to borrow R96,415,776? The peculiar features of the transactions*', Lewis JA continues to set out the '*several inexplicable aspects to the whole series of transactions*' which she further considered. They were:

- On the same day that the loan agreement of R96,415,776 was signed, NWK also accepted a short-term loan of R50,000,000 from FNB. The court drew the inference that the R50,000,000 was what was actually required, with the first-mentioned loan required for other purposes;
- The loan was not to be repaid by money, but rather through delivery of a commodity;
- FNB received and paid substantially the same amount on the same day for the respective right to receive and obligation to deliver the same quantity of maize i.e. 109,315 tons;<sup>72</sup>
- NWK's own witness conceded that it was impossible to ascertain or accurately estimate what the price of maize is expected to be in 5 years;
- The description of the quality of the maize to be delivered by NWK in 2003 were vague;
- No security was required of NWK for delivery of the maize, an indication that both NWK and the FNB Group were aware that the different delivery obligations relating to the maize would effectively disappear through *confusio*; and
- Slab's role in granting the loan when both NWK and FNB knew that all rights and obligations would be ceded to FNB.

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<sup>72</sup> In this regard, the term 'round tripping' was used. This will be further scrutinised in Chapter 4.1 *infra*.

Other considerations mentioned by Lewis JA in her judgment elsewhere include:

- The respective obligations by NWK and FNB to deliver the same quantity of maize to each other were dependent on each other. *'If one did not perform the other could not.'*<sup>73+74</sup>
- Originally an overdraft of only R50 million was required; and
- The various contracts at issue were linked (which is reminiscent of *Ladysmith*)<sup>75</sup>.

In law, to carry out either a subjective or an objective test, a court only has objective indicators which it can apply at its disposal. This, although perhaps undesirable, is understandable, as to apply a subjective test, a court is unable *ex post facto* to look into the mind of a person – it can only do so through looking at the facts brought before it to determine what the intention was at the time in question.

This principle, which is one of established law, was explained as follows by Miller J (as he then was) in *ITC 1185*<sup>76</sup> at 123 to 124:

*'It is no difficult matter to say that an important factor is: what was the taxpayer's intention when he bought the property? It is often very difficult, however, to discover what his true intention was. It is necessary to bear in mind in that regard that the ipse dixit of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions. The facts in regard to those matters will form an important part of the material from which the court will draw its own inferences against the background of the general human and business probabilities. This is not to say that the court will give little or no weight to what the taxpayer says his intention was, as is sometimes contended in argument on behalf of the Secretary in cases of this nature. The taxpayer's evidence under oath and that of his witnesses must necessarily be given full consideration and the credibility of the witnesses*

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<sup>73</sup> At 29.

<sup>74</sup> Although not specifically mentioned, this reminds one of Hefer, JA's judgment in *Ladysmith* at 242, *'These anomalies are consistent with a wider, unexpressed agreement or tacit understanding the terms of which have not been divulged. As such they bear significantly on the question whether the accrual to the [taxpayers] of a right to the erection of the buildings has been concealed. Of course, as [the taxpayers'] attorney stressed, the documents clearly distinguish between the Fund's rights and obligations vis-à-vis the [taxpayers] (deriving from the main leases) and its rights and obligations vis-à-vis Pioneer [the] (deriving from the sub-leases). But this in fact confirms the impression of a deliberate attempt to give to each agreement a semblance of self-sufficiency which it did not have.'* and earlier at 241, *'But the fact remains that it was obvious to all concerned that this was no ordinary transaction.'* It was also this delivery and counter-delivery of the same maize which caused Lewis JA to now famously remark (at 21), *'What a charade.'*

<sup>75</sup> At 29.

<sup>76</sup> [1972] 35 SATC 122.

*must be assessed as in any other case which comes before the court. But direct evidence of intent and purpose must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts.*<sup>77</sup> (own emphasis)

This is of course true for tax law as much as it is for other branches of law. Unfortunately, in order to apply the subjective test to determine what the actual intentions of the contracting parties were, as opposed to those portrayed by the wording of the contract between them *inter partes*, a court would have to make use of objective indicators. These would be *inter alia* the *ipse dixit* of the parties, the wording used in the contract itself, their actions leading up to and after conclusion of the contract, etc.

It is therefore submitted that Lewis JA, in using the above indicators in determining the 'commercial reason' for the transactions, did not necessarily apply these to determine the purpose of the transactions *objectively*. Quite the opposite: the court was applying its new test developed to determine the purpose of NWK *subjectively*, but with the use of objective indicators it was able, if not compelled, to do. And with the *ipse dixit* of NWK being of limited value,<sup>78</sup> the primary objective indicator available would be the commercial purpose of the transactions under consideration.

In questioning whether the transactions in NWK actually even amounted to simulation in the first place, Emslie commented as follows:<sup>79</sup>

*'We agree that, in testing whether a transaction is a simulated transaction, a court can examine the "commercial sense of the transaction" and "its real substance and purpose", but this should be done through the eyes of the parties to the transaction. The test for simulation is necessarily a subjective one, for the question whether parties have an intention to deceive can only be subjective. However, Lewis JA appears to have opted for an objective test.'*

It would be foolish to disagree with the assertion made in the first sentence of the above extract. It is submitted that, as is alluded to by Emslie, that the test for simulation is necessarily a subjective one. However, as Emslie would probably agree, the (primary) purpose to obtain a tax benefit, as envisaged in NWK, will also be necessarily a factor which needs to be determined subjectively.<sup>80</sup> Therefore, it is respectfully submitted that Lewis JA, after at length discussing that the test for simulation should be based upon the purpose of a contracting party, continued to apply this purpose test, and to apply it subjectively at that as proposed by Miller

<sup>77</sup> Subsequently approved in *Malan v KBI* [1983] 45 SATC 59.

<sup>78</sup> Refer 70 *supra*.

<sup>79</sup> Emslie, T SC, *Simulated Transactions – NWK revised*, The Taxpayer, Vol. 60 No. 2.

<sup>80</sup> As an example, refer to *Conhage* at 9 where Hefer JA remarks: 'All in all the transactions made perfectly good business sense.'

J<sup>81</sup> the case should be. Had this not been the case, and had Lewis JA indeed promoted one test at length in *obiter* but applied another in *ratio*, the reader would again be afforded the opportunity to exclaim: '*What a charade*'.<sup>82</sup>

### 3.3 The test for simulation

It has been often suggested that the 'new test' in *NWK* has been set out as part of *obiter* comments by the court.<sup>83</sup> The reasoning is that the 'new test' is based on the determination of objective factors, whereas the 'old test' of Watermeyer JA in *Randles* was clearly applied by determining the subjective intention of the parties to a contract. Therefore, the argument goes, as the *ratio* of *NWK* was reached by applying a subjective test, therefore the majority decision in *Randles* was the one actually applied. As justification for this, the following extracts of the *NWK* judgment are quoted:

At 75:

*'Barnard understood the consequences of the cession: effectively NWK's obligation to deliver the maize was cancelled. The debts were reciprocally discharged by confusio – the concurrence of the right and the obligation in the same person – FNB. (sic)'*

At 88:

*'There was no evidence that Barnard was deceived by FNB. He knew how the contracts, even those to which NWK was not a party, were to be structured and that the deliveries in respect of maize were simulated.'*

It is conceded that it is quite clear that a subjective approach has been followed by Lewis JA. However, this does not necessarily indicate a divergence from the approach to determine the purpose with which the transactions were entered into. It is accordingly submitted that the application of the subjective test is not proof that the court in *NWK* actually applied Watermeyer JA's test. As discussed above, both Watermeyer JA's, as well as Lewis JA's tests are subjective. However, one would be justified to claim that the court in *NWK* did apply the 'intention test' from *Randles*, as is evident from the following *dictum*:

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<sup>81</sup> *ITC1185 supra*.

<sup>82</sup> *NWK* at 21.

<sup>83</sup> Emslie *ibid.* at 7; Broomberg *ibid.* at 34; Vorster *ibid.* at 38.

At 87:

*'(NWK) did not intend, genuinely, to borrow a sum approximating the one it purported to borrow.'*

And at 89:

*'These aspects all lead to the conclusion that the agreements in respect of maize were illusory: there was never any intention to deliver maize in the future. The loan was a simulated transaction, designed to create a tax benefit for NWK.'*

However, it would simply be inaccurate to intimate that the 'purpose test' was not also applied:

At 85:

*'The balance was added on for a purpose that Barnard could not explain, other than as a hedge.'*

At 86:

*'As I have said, the appropriate question to be asked, in order to determine whether the loan and other transactions were simulated, is whether there was a real and sensible commercial purpose in the transaction other than the opportunity to claim deductions of interest from income tax on a capital amount greater than R50m.'*

At 87:

*'The contract was dressed up in order to create an obligation to pay interest, and consequently a right to claim a tax deduction, to which NWK was not entitled.'*

And finally at 90:

*'...the conclusion that I have reached (is) that the loan for R96 415 776 was a transaction designed to disguise the real agreement between the parties...'*

As such, the subjective test applied by Lewis JA, as is evident from the above extracts, is that the test applied is not the crisp test of *Randles*. But, it is again conceded, based on the above extracts, nor is it the test conceived by Lewis JA in 42 to 55 of *NWK*. Rather, the test actually applied seems to be a mixture of the 'purpose' and 'intention' tests.

The conclusion is therefore reached that the 'new test' is not *obiter*, but part of the *ratio* of the judgment as this was applied exactly in reaching the decision of the full bench of the court. However, the test formulated is not a purely purposive approach. The opinion has been voiced that *NWK* has muddied the distinction between purpose and intention in determining whether simulation was present.<sup>84</sup> It is submitted that such a reading of the judgment is incorrect.

Rather, an honest reading of *NWK* points to the fact the 'purpose' approach has been added on to the existing test of Watermeyer JA's as an extension or additional arm. This approach and intention of the court inferred from the judgment is substantiated by the following remark in *NWK* at 55:

*'In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms... The test should thus go further...'*

And again at 80:

*'But as I have said, there must be some substance – commercial reason – in the arrangement, not just an intention to achieve a tax benefit or to avoid the application of a law.'* (own emphasis)

This supports the notion that Watermeyer JA's 'intention test' still stands, but with an added element of purpose. Another element which has been added to the doctrine (which seems to have been ignored by Vorster, Emslie and Broomborg) is that multi-party involvement is no longer required by the *NWK*-test. Indeed, it will be noted from the judgment that nowhere is a determination made as to either the purpose or intention of FNB.<sup>85</sup> Had the *Randles* test of Watermeyer JA been applied in its true sense, then a ruling as to FNB's intention would have also been required. As this is absent, this adds further proof that a varied test from that in *Randles* was applied in *NWK*.

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<sup>84</sup> Williams, RC, *Simulated transactions – moving the goalposts*, PwC South Africa Synopsis Tax Today, January 2011.

<sup>85</sup> Refer 67 *supra*.

Therefore, the test for simulation, as set down in *NWK*, would have received additional requirements (with 3.2 below 'going further' than previously envisaged in *Randles*). Finally, it would be more appropriate to phrase the test in the negative, i.e.:

*For a simulation principle to be present:*

1. *The substance of the transaction must be different from the form in which it is presented; and*
2. *The substance must have the effect to avoid tax (or another peremptory of law).*
3. *If both criteria 1 and 2 above are present, the simulation doctrine will apply if either:*
  - 3.1 *A subjective intention is present:*
    - 3.1.1 *To have presented the transaction in the disguised form; and*
    - 3.1.2 *In both contracting parties; or*
  - 3.2 *The subjective<sup>86</sup> purpose of any one of the parties is to achieve a goal different to the one portrayed, i.e. a tax benefit.*

Simulation is therefore present if, either the parties intended to conceal the true nature of any contract, or if any party to a contract concealed that its purpose/motive to enter into the contract was to obtain some tax advantage.<sup>87</sup>

*NWK* has, admittedly, not expressly spelled out whether, for a simulation to be present, both the 'purpose' and 'intention' tests need to be considered, or whether it would be sufficient for either the tainted 'purpose' or 'intention' to be present. However, from the context of the judgment itself, even though both tests are applied, it is conceivable that the court would have found simulation to be present had only either a prohibited intention or purpose been present. It follows, however, that *NWK*, although it failed both, would have been on the losing end had it failed only either the 'intention' or 'purpose' tests. This is further supported by Lewis JA's remarks quoted above at 55 and 80 that the test of Watermeyer JA 'should go further' and should not be limited to determining 'just an intention'. The transpiring effect is therefore that the principle of simulation should not be limited by creating another requirement for it, but

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<sup>86</sup> Refer Chapter 3.2.2.

<sup>87</sup> It should be noted that this test will lead to the absurdity that, if a party conceals its purpose for entering into a contract to obtain a tax benefit, then simulation will apply. However, if the purpose of the transaction is not concealed, it will not fall within the scope of the simulation doctrine, and it may still be safe from the application of GAAR, granted that it meets the normality requirements thereof.

rather to enable it to be applied to a wider range of transactions, i.e. creating a new basis upon which simulation can be established.

It could be argued that the 'purpose' test should be reserved for application by GAAR and not the common law. Again, it is not the purpose of this paper to take a view on the accuracy of *NWK*. What is however evident from the above discussion is that the test for simulation has been extended and that it has as a result become an increasingly more powerful weapon in SARS' ever-growing weaponry.

The fact of the matter is that the simulation doctrine now has wider application.<sup>88</sup> In brief, previously one only had to prove that the intention of the parties involved in an agreement was genuine. Now, the taxpayer must in addition also show that the purpose of the transaction was not to obtain some tax benefit through presenting a legal form which in substance the transaction is not.

To illustrate, it is perhaps best to use the facts in *Randles*. Both parties to the contract intended to enter into contracts of sale. Thus, requirement 3.1 above is met. However, *Randles* simulated the purpose with which it entered into the contracts – it pretended to have done so with the purpose of merely transacting in textiles, where in actual fact the purpose was to obtain a tax benefit. As such, according to *NWK*'s test, a simulation would have been present.

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<sup>88</sup> A view supported by Silke. See Silke, J. *From NKR to NWK*, Tax Planning Corporate and Personal, Volume 25 No. 6, December 2011. This view has also been endorsed by Williams *ibid.* at 84.

## CHAPTER 4

### THE PRESENT – INTERNATIONAL APPROACH

An interrogation into the international approach to simulated transactions proves to be as vibrant and current as is the case in South Africa. In fact, this is even truer in those jurisdictions that rely solely on common law to combat tax avoidance in the absence of legislated general anti-avoidance legislation, such as e.g. the United Kingdom ('UK').

The three jurisdictions decided on for the comparative legal study are the UK, Australia and Canada. The latter two were both at one time British colonies (like South Africa) and therefore share the same underlying legal basis from which the simulation doctrine was developed.

By conducting this comparison, it is important to note the reliance that the various countries place on the simulation doctrine to enforce tax legislation. Of further import is what the contents of these principles currently entail compared to the South African position discussed in Chapters 2 and 3 *supra*. Specifically in this regard, the focus of the commentary is on whether the test is exclusively one of purpose, intention or a combination of these.

Even though the comparison is made only with regards to the three jurisdictions mentioned, it is important to note that the existence of the simulation doctrine is not limited to these. Rather, it also finds support from the OECD, indicating that it enjoys recognition and application even beyond the boundaries of the historic common law systems:<sup>89</sup>

*'A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer... However, there are ... particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. (W)here the economic substance of a transaction differs from its form ... the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance.' (own emphasis)*

#### 4.1 The United Kingdom

##### 4.1.1 A judicial GAAR

For long, UK courts have adopted, through a literal interpretation of fiscal statutes, a conservative approach to tax avoidance. If upon a literal reading of statute a person could not

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<sup>89</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 22 July 2010.

be brought within the taxing provisions of the relevant act, no tax was levied. This is perhaps best explained in the *dictum* by Lord Cairns in *Partington v Attorney General*:<sup>90</sup>

*'If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'*

Although the UK courts may not have been closed to the notion of a purposive interpretation of statutes; where fiscal statutes in particular were however concerned, these Acts were protected from the application of a purposive interpretation to those statutes, as is evident from the above extract.

*IRC v Duke of Westminster* for long formed the basis of UK courts' approach to tax avoidance, and specifically the *dictum* of Lord Tomlin at 19 quoted in Chapter 1.1 *supra*. This judgment displays not only the courts' insistence of a literal approach to statutes taxing, but also to its animosity towards using the common law as a means to circumvent a literal interpretation of the Legislature's intention in enacting the provision concerned. In this regard, following on Lord Tomlin's *dictum* at 19, he continues to display his disaffection as follows:

*'This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.'*

However, this position has since been substituted for a purposive approach, particularly by the landmark decision in *Ramsay*:<sup>91</sup>

*'What are "clear words" is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.'*

This approach, which is still followed currently in the UK as ruling precedent, '*liberated the construction of revenue statutes from being both literal and blinkered*',<sup>92</sup> and enabled the UK

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<sup>90</sup> [1869] LR 4 HL 100.

<sup>91</sup> *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300.

courts to keep in pace with more ingenious tax avoidance schemes not addressed by fiscal legislation.<sup>93</sup> Prebble & Prebble supports this notion, and continues to state that under a purposive approach, courts would '*determine whether the legal form of a transaction matches its economic substance*'.<sup>94</sup> This approach was approved and established in *Barclays Mercantile Business Finance Limited v Mawson (Inspector of Tax)*<sup>95</sup> at 32:

*'The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found.'*

As commented in note 93 *supra*, a purposive approach is less restricting upon courts in interpreting statutes, and would indeed be a more effective mechanism to combat tax avoidance, especially in a jurisdiction where no general anti-avoidance provisions have been enacted. This may however prove to be an unwieldy weapon, especially when specific anti-avoidance provisions are introduced in future, as is currently being considered by the UK Legislature.<sup>96</sup>

#### 4.1.2 A legislated GAAR

It remains to be answered whether taxpayers will have to be weary of both the courts' wide discretion in combating tax avoidance through the common law under the reigning purposive approach to fiscal legislation as well as under the terms of general anti-avoidance provisions so legislated. Although new legislation may merely supplant what the UK courts would also deem to be avoidance transactions, the risk exists that the UK courts may through the common law

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<sup>92</sup> *Barclays Mercantile Business Finance Limited v Mawson (Inspector of Tax)* [2004] UKHL 51.

<sup>93</sup> It is natural that courts should prefer a purposive approach, as this allows for wider discretion. However, it is submitted that where such an approach is exercised without caution or restraint, this would go against the very rule of law: it is not the courts' role in a democratic society to keep up with the ingenuity of taxpayers, but that of the Legislature. This is not to say that a purposive approach to fiscal legislation is an evil, but rather that the motive for exercising discretion in applying a purposive approach to fiscal legislation should not be because a court feels obliged to fulfil the role of the Legislating body.

<sup>94</sup> Prebble, Z., Prebble, J. *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, Bulletin for International Taxation, April 2008.

<sup>95</sup> [2004] UKHL 51.

<sup>96</sup> Correspondence with the tax directors of the Norton Rose Group on 22 February 2012.

have provided themselves with powers reaching even beyond legislation – a risk which has been identified in South Africa following *NWK*.<sup>97</sup>

With this as background, it is probably unsurprising that the Study Group<sup>98</sup> assembled to advise the UK Government on the advisability of introducing a GAAR to the UK fiscal statutes, advised against such a 'broad spectrum' rule being legislated. However, it proposed the following as alternative:<sup>99</sup>

*'I have concluded that introducing a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system. This would carry a real risk of undermining the ability of business and individuals to carry out sensible and responsible tax planning. Such tax planning is an entirely appropriate response to the complexities of a tax system such as the UK's...*

*However, introducing a moderate rule which does not apply to responsible tax planning, and is instead targeted at abusive arrangements, would be beneficial for the UK tax system.'* (own emphasis)

Therefore, some form of a GAAR is accordingly proposed, although some care is taken to distinguish this as an 'anti-abuse rule' as opposed to a broad spectrum general anti-avoidance rule, as is envisaged in the extract above.<sup>100</sup> One might sceptically wonder what the difference would be between a GAAR and the preferred so-called anti-abuse rule, and whether this may in fact be nothing more than a euphemism to appease those opposed to a legislated GAAR.<sup>101</sup> This scepticism is not appeased by the possibility mentioned by Adv. Aaronson to have the anti-abuse rule applied retrospectively.<sup>102</sup> Of further note in this regard is the risk pointed out by Lethaby that the proposed anti-abuse rule may go beyond catching the so-called 'Category 1' arrangements (i.e. arrangements with the sole purpose of reducing a tax liability) and also ensnare 'Category 2 and 3' arrangements (respectively arrangements with the main purpose to obtain a tax benefit, but which also has a commercial purpose and arrangements with an

<sup>97</sup> Refer Broomberg's comments on the rule of law and the doctrine of separation of powers at *ibid.* 34 at 16.

<sup>98</sup> The Study Group was lead and assembled by Aaronson, G. QC, who was commissioned to do so by the Exchequer Secretary. <http://www.hmrc.gov.uk/news/news-211111.htm>.

<sup>99</sup> The GAAR Study Group lead by Aaronson, G. QC. *GAAR Study – A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system.* 11 November 2011. At 1.5 to 1.7.

<sup>100</sup> It is interesting to note that one of the reasons offered in support of a GAAR by the Study Group at 3.13 is to prevent the need by courts to 'stretch' the interpretation of statutes through a purposive interpretation thereof. Compare to the comments made in note 82 *supra*.

<sup>101</sup> From the correspondence with the tax directors of the Norton Rose Group noted at 96 *supra*, it is curious to note that the four *essentialia* (to borrow from the law of contract) of the South African (SA) GAAR are all conspicuously present, albeit accompanied by various 'safeguards' (some more subtle than others), *viz.* the presence of an arrangement, abnormality, a tax benefit and the sole or main purpose to achieve said benefit. Since the scope of this paper is not to compare the proposed UK GAAR with the virgin SA GAAR, further comments regarding the contents of the proposed UK GAAR will be limited. However, as to the SA GAAR, the influence thereof and possible overlapping with the simulation doctrine as part of the SA common law will be discussed in more detail in Chapter 5.2.

<sup>102</sup> *Ibid.* at 96.

overriding commercial purpose but which also incorporates an element designed to neutralise certain tax effects).<sup>103</sup>

Be that as it may, without a GAAR or anti-abuse rule, the three anti-avoidance mechanisms currently available to Her Majesty's Revenue and Customs ('HMRC') are:<sup>104</sup>

- 1 A purposive interpretation of tax statutes;
- 2 Specific anti-avoidance legislation to target specifically identified areas of vulnerability in fiscal legislation; and
- 3 So-called DOTAS (Disclosure of Tax Avoidance Schemes).<sup>105</sup>

A quick glance at the above list is sufficient to conclude that, compared to the South African position, the UK anti-avoidance arsenal is lacking only in the existence of a legislated GAAR. As for the rest, the weaponry is mostly identical. The question of course is whether a GAAR is a necessity for an effective combating of tax avoidance schemes, and whether a judicial GAAR would not suffice without having to also enact a legislative GAAR.

#### 4.1.3 A solution to HMRC's (and other revenue collectors') woes?

One of the greatest flaws of a purely judicial GAAR, it is argued by Freedman,<sup>106</sup> is the uncertainty linked thereto:<sup>107</sup>

*'Judges inevitably are faced with the temptation to stretch the interpretation, so far as possible, to achieve a sensible result; and this is widely regarded as producing considerable uncertainty in predicting the outcome of such disputes.'*

In line with this sentiment, Aaronson states at 4.22 of the GAAR Study Group report:

*'A number of representative bodies expressed the hope that, given the protection against unacceptable tax schemes which the GAAR would provide, the Courts should not seek to extend the application of the Ramsay principle beyond the stage already reached in the decided cases. This was, again, in order to reduce the uncertainty affecting the centre ground of tax planning.'*

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<sup>103</sup> Lethaby, H, *Aaronson's GAAR*, British Tax Review, 2012, Number 1.

<sup>104</sup> *Ibid.* at 96.

<sup>105</sup> Which is not unlike the South African version of Reportable Arrangements as contained in sections 80M to 80T.

<sup>106</sup> Freedman, J, *GAAR as a process and the process of discussing the GAAR*, British Tax Review, 2012, Number 1.

<sup>107</sup> HMRC & HMT, *Simplifying Unallowable Purpose Tests Discussion Document and Summary of Responses 2009*; Freedman, J, *GAAR as a process and the process of discussing the GAAR*, British Tax Review, 2012, Number 1.

If nothing else, these extracts echo the sentiment that (which it is submitted is not only applicable to UK tax practitioners) the bold, purposive interpretation of fiscal statutes lead to uncertainty. If nothing else, it is conceded that one of the primary objectives of courts are to provide clarity on laws which the Legislature through perhaps clumsy drafting were not able to. At issue however is not so much the interpretation of tax statutes, but rather the uncertainty which is created when courts are given full reign on developing the law in a way which they deem fit. This manifests in, where statutes are concerned, a disregard for the wording used by the Legislature to communicate its intent,<sup>108</sup> and in the case of the common law, by candidly disregarding the doctrine of *stare decisis*, or swerving past it by conveniently distinguishing from the facts of the authoritative judgment.<sup>109</sup>

The answer is not necessarily that a GAAR should be legislated, but merely that courts should exercise their powers of interpretation of statute with restraint, especially where fiscal statutes are concerned.<sup>110</sup> If these principles are not adhered to, it is with respect submitted that a subversion of the rule of law would take place, as contemplated in footnotes 97 and 108 above. And, returning to South African soil, this is exactly what the problem is perceived to be with *NWK* as far as the common law is concerned. However, irrespective of the accuracy or correctness of *NWK*,<sup>111</sup> if one accepts that *stare decisis* will be observed in future, then *NWK* is here to stay.

Comparing the UK position with the South African development in anti-avoidance tax law observed in recent history, it is interesting to note that the movement in the UK is away from primarily relying on the courts to safeguard the *fiscus*, towards an increasing pro-legislative GAAR approach. This seems in fact to also be in line with international trends.<sup>112</sup> In South Africa however, the movement seems to be the other way round in the past 6 years for which the South African GAAR has been on the statute books. In fact, a memo received from the Norton Rose tax directors<sup>113</sup> points to the fact that since the South African GAAR has been in existence, '*SARS has never used it*'.

Perhaps the UK should take its cue from South Africa in the all the more dawning realisation that a legislated GAAR is not necessarily a more powerful weapon (given of course that its courts are bold enough to interpret the common law liberally, as was recently the case in South Africa with the *NWK* judgment): In South Africa, tax avoidance is being combated by all means necessary, except seemingly the GAAR.

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<sup>108</sup> In *Defy Ltd v C:SARS* [2010] 72 SATC 99 at 46, Nugent JA commented: 'I have some difficulty with the idea that a construction of the parts of a statute can produce one result but a construction of the sum of its parts can produce another. It needs to be born in mind that a statute is not a statement of policy by the legislature that leaves the detail to be filled in by a court. It is policy that has been translated into law. If it has not been adequately translated I do not think that it is for courts to rewrite the statute. That would seem to me to strike at the heart of the rule of law.'

<sup>109</sup> Refer to Chapter 5.4 for a discussion on the *stare decisis* doctrine.

<sup>110</sup> This holds specifically true for the law of tax as the virtues of rationality and equity are not always, unlike the other branches of the law, present. In this regard the comments in *Cactus Investments* and *Partington* referred to *supra* are particularly relevant.

<sup>111</sup> Which has been repeatedly mentioned is not the aim of the paper to comment on.

<sup>112</sup> Examples of which are discussed below in Chapters 4.2 and 4.3.

<sup>113</sup> *Ibid.* at 96.

Be it as it may, it is evident that the UK is now doing more than to merely commission an investigative study, but is in fact one step closer to enacting a GAAR. In a paper published on 21 March 2012, the UK Government in principle accepted the necessity to legislate a GAAR in the near future:<sup>114</sup>

*'The Government accepts the recommendation of the Aaronson Report, published on 11 November 2011, that a GAAR targeted at artificial and abusive tax avoidance schemes would improve the UK's ability to tackle tax avoidance whilst maintaining the attractiveness of the UK economy as a location for genuine business investment. The Government will consult on: new draft legislation which will be based on the recommendations of the Aaronson Report; establishment of the Advisory Panel; and the development of full explanatory guidance... The consultation will be issued in summer 2012 with a view to introducing legislation in Finance Bill 2013. The Government is committed to ensuring that this legislation effectively tackles abusive tax avoidance and that the supporting guidance is practical both for taxpayers and for HMRC.'*

## 4.2 Australia

### 4.2.1 Approach to tax avoidance

The Australians were quite quick in taking up the very much in vogue international position of adopting a GAAR (as early as in 1981) to afford additional protection to the *fiscus* together with other mechanisms available to combat abusive behaviour by taxpayers.<sup>115</sup> Not only does the Australian Taxation Office ('ATO') depend on these provisions regularly, but these are also set to be revisited, and upgraded, by the Australian legislature in an attempt to make it more difficult for *'those taxpayers who are not doing the right thing ... (to) escape their tax obligations'*.<sup>116</sup> These amendments, which are not unexpected, follow an array of tax cases in which the ATO were on the losing side.<sup>117</sup>

Irrespective of the fact that the Australian authorities are growing increasingly dependent on reliance on the legislated GAAR provisions in their Income Tax Assessment Act, this is not to say that the simulation doctrine is unknown 'down under'. In fact, in the most recent Australian tax case dealing with dishonest simulations, or 'sham' transactions, *Raftland Pty Ltd as trustee of*

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<sup>114</sup> HMRC & HM Treasury, *Overview of Tax Legislation and Rates* at 2.58, 21 March 2012, accessed on 8 May 2012 at <http://www.hmrc.gov.uk/budget2012/ooflar-main.pdf>.

<sup>115</sup> Income Tax Assessment Act, act no. 27 of 1936, contained in Part IVA.

<sup>116</sup> Arbib, M. *Maintaining the effectiveness of the general anti-avoidance rule*. Assistant Treasurer in Australia in a media statement by his office released on 1 March 2012.

<sup>117</sup> Collins, Earl & Thompson, *Reforms to Australia's General Anti-Avoidance Rules*, PwC ITS News, International Tax Services, Issue 107, March 2012.

*the Raftland Trust v Commissioner of Taxation*,<sup>118</sup> this was the main argument advanced by the ATO.<sup>119</sup>

#### 4.2.2 Australian sham

It has been held in *Sharrment Pty Ltd v Official Trustee in Bankruptcy*<sup>120</sup> that the concept of 'sham' is defined as follows:

*'A "sham" is ... for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive.'*

To this, Kirby J in *Raftland*<sup>121</sup> comments:

*'Important to this description is the idea that the parties do not intend to give effect to the legal arrangements set out in their apparent agreement, understood only according to its terms. In Australia, this has become essential to the notion of sham, which contemplates a disparity between the ostensible and the real intentions of the parties. The courts must therefore test the intentions of parties, as expressed in documentation,<sup>122</sup> against their own testimony on the subject (if any) and the available objective evidence tending to show what that intention really was.' (own emphasis)*

From the above it is clear that the sham doctrine subscribed to in Australia is *ad idem* with the pre-NWK approach followed in SA, and is as set out in the Watermeyer JA judgment in *Randles supra*. What is further evident is that this purist approach is still been followed in Australia, whereas the South African approach seems to have diverged from this route, as explained in Chapter 3.

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<sup>118</sup> [2008] HCA 21.

<sup>119</sup> This judgment, and in particular the minority concurring judgment is discussed in more detail below. Of particular assistance is the judgment delivered by Kirby J wherein he sets out the various positions and development of the simulation doctrine internationally.

<sup>120</sup> [1988] 18 FCR 449 at 454.

<sup>121</sup> *Ibid.* at 118. It should be noted by the reader as an aside that the *Raftland* case was heard by the High Court of Australia, being the apex court in that country which is able to deal with tax disputes (the equivalent of South Africa's Supreme Court of Appeal).

<sup>122</sup> I.e. determine the subjective with the use of objective factors. Compare to the comments made in Chapter 3.2.3.

However, as Kirby J explains in *Raftland*, the question is more and more asked of courts to adopt a more 'ample' approach to embody the simulation doctrine, in order to keep in touch with other legal developments. These factors, according to Kirby J, are:

- Both legal and public criticism of avoidance schemes mustering judicial scrutiny;
- The increasing legal shift away from strong formalistic requirements (for all guises of law);
- A growing preference given to purposive interpretation of legislation vis-à-vis strict literalism;
- Following on the above, an increased reliance by courts on external materials and evidence to interpret legislation; and
- The growing realisation that fiscal legislation cannot stand in isolation, but should follow these general legal developments.

What Kirby J is referring to is the increasing confrontation which courts are faced with to acknowledge that simulation also (or rather) has a 'purpose' element as a test requirement which must be passed. Specifically, what Kirby J points out is that this 'purpose' element which courts are beckoned to acknowledge is, under the 'ample' approach, whether an economic purpose is also linked to a transaction as a further requirement that should be scrutinised.<sup>123</sup>

The glaring question is of course: is it necessary for non-simulated transactions to have some economic purpose (other than tax saving) for the doctrine to be able to sufficiently protect against abusive taxpayer practices? As is discussed in Chapter 5.2, the submission is that surely, where taxpayers *intend* to circumvent a tax prohibition, protection against this intention is afforded to the *fiscus* under the simulation doctrine. Similarly, where no intention between parties is present, that purpose to obtain a tax benefit from the transaction should be dealt with under a legislated GAAR. Therefore, the fact that malevolence arising from either the intention or the purpose of the parties is *sine prole*; i.e. there should be no need to extend the simulation doctrine into the realms of the purpose of a transaction.

The problem, as with so many tax provisions, is not that the law, or the judiciary for that matter, is unwilling to support the state in its quest to grow the *fiscus*. Rather, the legislated provisions, be it specific or general anti-avoidance provisions, are either not drafted with the necessary care to provide for the support which is required to prevent transactions which purport to abuse tax legislation, or carefully drafted legislation does not adequately envisage the cunningness of taxpayers.

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<sup>123</sup> A requirement which was proffered by Lewis JA in *NWK*.

The Australian courts are, for the time being, showing resiliency and continuing to adopt the position which has been held for many years, persisting with a narrow interpretation of the sham principle. Thereby, in common law, it is restricting the remedy available to the ATO in terms of sham to the subjective intent of the parties alone, without the 'purpose' requirement (whether in Australia this will be determined subjectively or objectively) being an alternative option under the doctrine.<sup>124</sup> This has been confirmed in the recent decision of *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd*:<sup>125</sup>

*'As the expression 'real money' might suggest, the point which the respondents sought to make in these matters appeared to be one about the economic rather than the legal effect of the transactions in question.'*

#### 4.3 Canada

The Canadians, as the Australians, also have a legislated GAAR in Part XVI of their Income Tax Act.<sup>126</sup> This, similar to the South African GAAR, contain the four *essentialia*, viz.

- The presence of a tax benefit;
- Arising from a transaction or a series of transactions;
- The main purpose of which is not a *bona fide* purpose; and
- The transaction is not at arm's length.

In addition to their GAAR, the Canadians have also accepted, and relied on the existence, of dishonest simulations, or sham. Drawing from its British common law roots, it has accepted the *Snook*<sup>127</sup> rendition as an accurate enunciation of what the doctrine also entails in Canada.<sup>128</sup>

However, the Canadians have not been immune to the temptation of whether simulation goes further than looking to the intentions of the parties concerned, and whether the transaction under scrutiny also had a commercial or business purpose. In *Minister of Revenue v Leon*, it was held that:<sup>129</sup>

*'If (an) agreement or transaction lacks a bona fide business purpose, it is a sham'.<sup>130</sup>*

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<sup>124</sup> *Raftland* *ibid.* at 118 at 130.

<sup>125</sup> [2004] HCA 55.

<sup>126</sup> R.S.C., 1985, c. 1 (5<sup>th</sup> Supp.)

<sup>127</sup> Refer *supra* note 17.

<sup>128</sup> *Minister of National Revenue v Cameron* [1974] SCR 1062.

<sup>129</sup> [1977] 1 FC 249 at 256.

<sup>130</sup> Reverberations of this echo only reaching the southern shores of Africa some 33 years later.

The requirement for the above 'business purpose' was not allowed to reach *rigor mortis*, and was soon met with disapproval in *Stuart Investments Ltd v The Queen*,<sup>131</sup> wherein the 'purpose' requirement was effectively rejected:

At 545:

*'This expression "sham transaction" comes to us from decisions in the United Kingdom, and it has been generally taken to mean (but not without ambiguity) a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction; or, simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality.'*

And at 540:

*'A transaction may be effectual and not in any sense a sham ... but may have no business purpose other than the tax purpose.'*

Irrespective of the various flirtations with the purpose test for simulation along the way,<sup>132</sup> the above approach in *Snook* adopted in *Stuart* has been confirmed to be the correct one again in *McClurg v Canada*,<sup>133</sup> thereby confirming the current *status quo* of the doctrine in Canada. The conservative test long heralded in *Randles* in South Africa therefore also seems to find application in Canada.

#### 4.4 Conclusion

One cannot but be inclined to agree that a review of comparative law on the subject makes for interesting reading, especially when recent developments in South Africa are borne in mind.

What is evident is that, for all of the above jurisdictions and more, courts have time and time again confirmed their unwillingness to extend the test for simulation beyond the subjective, or intention, of all the parties involved. All have been confronted with the seduction of including a purpose element to the doctrine, and specifically, with a business or commercial purpose requirement.

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<sup>131</sup> [1984] 1 SCR 536.

<sup>132</sup> Which is alluded to by Kirby J in his minority judgment in *Raftland supra* as minority decisions and academic articles.

<sup>133</sup> [1990] 3 SCR 1020.

The New Zealand case of *Accent Management Ltd v Commissioner of Inland Revenue*<sup>134</sup> bears reference:

*'[A]rtificiality and lack of commercial point (other than tax avoidance) are not indicia of sham. And the concepts of sham and tax avoidance are not correlatives. As well, while there are elements of pretence (and certainly concealment) associated with [the] transactions [here at issue], these are explicable on bases other than sham.'* (own emphasis)

This stands in dire contrast to the latest approach taken in South Africa and is cause for alarm to South African taxpayers, as is explained in Chapter 5.2 *infra*.

What is true however domestically for the simulation doctrine, seems as much the case internationally, as was predicted in 1964 already by Bob Dylan when obviously having the simulation doctrine in mind:

*'The times, they are a-changin'...*

However, regardless of whether the South African position diverges from the international, this does not detract from the authority with which the *NWK* judgment, which set the stage for an ample approach, is to be treated.<sup>135</sup>

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<sup>134</sup> [2007] NZCA 230 at 59.

<sup>135</sup> Refer Chapter 5.4 *infra* for a discussion on the *stare decisis* doctrine.

## CHAPTER 5

### THE FUTURE - APPLICATION

#### 5.1 Introduction

In looking at the development of the simulation doctrine in Chapter 2, as well as how it is currently applied, both domestically and internationally,<sup>136</sup> the question still begs as to the future application of the doctrine. Indeed, looking to the history of the doctrine would be nothing more than an academic exercise if the application thereof and its future impact cannot be ascertained.

Accordingly therefore, given recent developments domestically, the interaction between simulations and the GAAR is investigated in this chapter, as well as what possible transactions the doctrine is bound to effect and what the judicial *gravitas* of *NWK* will be going forward.

#### 5.2 Interaction with the GAAR

##### 5.2.1 The GAAR

Briefly, the GAAR determines that the Commissioner for SARS may attach other tax consequences to any 'impermissible tax avoidance arrangements'.<sup>137</sup> An impermissible tax avoidance arrangement consists of four elements, namely:<sup>138</sup>

Requirement 1	The existence of an arrangement.
Requirement 2	The existence of a tax benefit (that is, arrangement resulting in a tax benefit).
Requirement 3	The sole or main purpose of the avoidance arrangement is to obtain a tax benefit.
Requirement 4	The avoidance arrangement is characterised by the presence of <u>any one or more of four tainted elements for arrangements in the context of business</u> and any one or more of three tainted elements for arrangements in the context other than business, which renders it an impermissible avoidance arrangement. (own emphasis)

<sup>136</sup> Chapters 3 and 4 respectively refers.

<sup>137</sup> Section 80A.

<sup>138</sup> Draft Comprehensive Guide to the General Anti-Avoidance Rule. Issued by SARS, 13 December 2010.

The above four requirements were all present in the GAAR's predecessor in the now repealed section 103(1), and are all *sine qua non* for the application of the GAAR – in the absence of any one of these, the taxpayer will be safe.

The four tainted elements referred to as part of Requirement 4 (formerly the requirement for the presence of abnormality) are regarding arrangements of which the following would be true:<sup>139</sup>

Test 1	Entered into or carried out by an abnormal means or manner, not used for a bona fide business purpose (the business abnormality test) other than obtaining a tax benefit
Test 2	<u>Lack of commercial substance; which consists of objective indicative tests and an objective general or –presumptive test</u> (own emphasis)
Test 3	Creation of non-arm's length rights or obligations
Test 4	Abuse or misuse of the provisions of the Income Tax Act

Flowing from the provisions of section 82, there is little contestation that the onus for proving the absence of any of the first-mentioned three requirements, viz. the existence of an arrangement, the sole or main purpose and a tax benefit, is upon the taxpayer.

However, as far as the requirement for abnormality is concerned, under section 103(1), the view expressed in *Conhage*, and followed in *ITC 1699*,<sup>140</sup> was that the onus for proving this requirement rested on SARS. However, where that abnormality now arises in terms of the new GAAR as a result of a 'lack of commercial substance',<sup>141</sup> both SARS<sup>142</sup> and Broomberg<sup>143</sup> seem to be *ad idem* that this position is now different.

Regarding the onus of proof, there seems to be little respite for the taxpayer when challenged instead in terms of simulation, as opposed to GAAR. This is because the application of section 82 is of as much application to remedies of SARS in terms of the Act as it is in common law, as ultimately simulated transactions affect the working of the provisions of the Act. This position was confirmed in *NWK*<sup>144</sup> at 38 and 39:

*'In terms of s 82(b) of the Act NWK bore the onus of proving that the transactions were not simulated... The mere production of the agreements was not enough to discharge*

<sup>139</sup> Ibid. at 138.

<sup>140</sup> [1999] 63 SATC 175.

<sup>141</sup> Refer Test 2 below.

<sup>142</sup> Refer SARS' draft guide *supra* at 138 at 9.8 and 6.1. De Koker, A.P., *Silke on South African Income Tax*, 2010: 19.40.

<sup>143</sup> Broomberg, E. *Then and now – V: The commercial substance test*, Tax Planning, 2008, Vol. 22.

<sup>144</sup> Which applied the position taken in *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR*. Hefer JA held: *'Therefore, unless the appellants have shown on a preponderance of probability that the agreements do indeed reflect the actual intention of the parties thereto, the Commissioner's decision cannot be disturbed.'*

*the onus. NWK had to refute the assessment that it had a dishonest intention to disguise a transaction.'*

Dependent on the circumstances, it is submitted that any matter which may potentially involve a simulation in a matter between SARS and a taxpayer would invariably fall within the scope of the provisions of section 82, thus placing the onus of proof on the taxpayer to show to a court that no simulation is present.

### 5.2.2 Interaction between GAAR and the simulation doctrine

It is curious to note that the court in *NWK* chose to use the specific phrase 'commercial substance' in testing for the presence of a simulation; a term which seems to have been borrowed from its legislated brother, the GAAR. In this regard, one would be forgiven to read the *NWK* judgment for the first time and to later confusingly page back to the front: "Was the court not supposed to first address the primary grounds for appeal, namely that a simulation occurred first? Then why is the judgment dealing with 'commercial substance'?"

After embarking on an extensive search, no South African cases (dealing with tax or, for what it's worth, any other matter) could be found where any court had previously used this phrase. If the court intentionally borrowed the phrase from the GAAR, one would not even want to hazard the guess that the court sought to align the simulation doctrine with the GAAR. As a matter of law, other than for the fact that both are mechanisms through which the *fiscus* is protected, in the purist's view, these two remedies available to SARS share very little other similarities, and correctly so.

Section 80C defines commercial substance to be present in an arrangement:

*'... if it would result in a significant tax benefit for a party ... but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained...'*

It is submitted though that the commercial substance being referred to in *NWK* is not as is defined in section 80C. In fact, nowhere in the judgment where it deals with the simulation doctrine is reference made to the definition of the term in section 80C. Further, at the time when the facts on *NWK* took place, section 80C was not yet in effect. It is submitted therefore that not too much should be read into the court's choice of words when seeking to draw a line between the judgment and the GAAR. Nonetheless, the terms 'commercial reason', 'commercial substance', 'commercial sense' and 'real purpose', as used interchangeably throughout the judgment, should be understood to describe exactly what it says: In determining whether the

purpose of the transaction was mainly to avoid tax, was this reason subordinate to another commercial (or economic or business) goal?

Therefore, although the section 80C defined meaning of 'commercial substance' was not necessarily applied in *NWK*, it is submitted nonetheless that the ordinary meaning of it was.

### 5.2.3 Picking one's poison

A comparison between the requirements of simulation and the GAAR makes for interesting reading. Bearing in mind that the onus for the below would always fall on the taxpayer,<sup>145</sup> the taxpayer has to prove any of the below in order to escape respectively the application of the GAAR or the simulation doctrine:

<b><u>Taxpayer's defences under GAAR<sup>146</sup></u></b>	<b><u>Taxpayer's defences under simulation<sup>147</sup></u></b>
Absence of an arrangement	
	The substance and form of the transaction correlates to its form
Absence of a tax benefit	The simulation did not have the effect of avoiding tax
Tax benefit was not the sole or main purpose of the arrangement	The intention of either party was not to disguise the transaction AND the main purpose was not to avoid tax (i.e. that the transaction <i>inter alia</i> had commercial substance).
In the context of business: <ul style="list-style-type: none"> <li>• Entered into or carried out by abnormal means or manner, not used for a <i>bona fide</i> business purpose;</li> <li>• Lack of commercial substance;</li> <li>• Creation of non-arm's length rights or obligations; AND</li> <li>• Abuse or misuse of the provisions of the Act.</li> </ul>	

<sup>145</sup> Refer Chapter 5.2.1.

<sup>146</sup> Section 80A to 80L.

<sup>147</sup> Refer Chapter 3.3.

If one were to assume that it should mostly be common cause between the taxpayer and SARS that an arrangement and a tax benefit were to be present, the taxpayer would under simulation be limited to two possible defences, i.e.:

- that the substance of the transaction matches the form; or
- that it was neither the purpose of the transaction NOR the intention of the parties, to conceal the transaction to obtain a tax benefit.

In comparison, the possible defences in terms of GAAR are:

- the tax benefit was not the sole or main purpose of the arrangement; or
- the arrangement was normal, i.e.:
  - it was entered into by normal means for *bona fide* business purposes;
  - it had commercial substance;
  - the arrangement was entered into at arm's length; and
  - it did not result in the abuse or misuse of the provisions of the Act.

Although it may seem from the above that the hurdles for disproving a simulation are less, they may be higher than the obstacles presented to the taxpayer in terms of GAAR.

Boiled down, the GAAR requires the taxpayer to prove, in essence, that the taxpayer's purpose was not to avoid tax, or that the transaction was normal. However, under simulation, the taxpayer is required to prove either that the substance of the transaction matches its form, in that the parties honestly intended to give effect to the contracts according to their tenor and that the transactions were both normal and not entered into with the concealed purpose of obtaining some tax advantage.

From the above analysis, it seems certain that, where available, SARS may view the remedy in terms of the simulation doctrine (where the facts allow for its application) stronger than the protection afforded in terms of GAAR.

It is predicted that, with the latest development of the simulation doctrine, a flurry of activity will be seen surrounding the simulation doctrine. Indeed, the submission is that post-*NWK*, this remedy presents much greater powers to SARS than the GAAR.

Two reasons exist why SARS would rather opt to attack a transaction in terms of simulation than the GAAR:

- The subjective intention of parties to a transaction is only vulnerable to attack by SARS in terms of the simulation doctrine (refer Chapter 5.2.3.1); and
- The 'purpose' and 'normality' requirements under GAAR poses alternative defences for the taxpayer, only one of which needs to be absent for the taxpayer to succeed. However, in terms of simulation, the taxpayer would need to prove the absence of both, as these requirements are viewed as akin (Chapter 5.2.3.2).

As a result, it may be easier for the taxpayer to escape the GAAR obstacles than it would be the simulation requirements. These will be discussed in turn below.

#### 5.2.3.1 Subjectivity – absent from GAAR

In terms of the old GAAR contained in section 103(1), the 'sole or main purpose' requirement (which is also present in the simulation doctrine, albeit not in that specific wording, if one accepts that the doctrine has been developed to include this in *NWK*) have in our courts long been heralded as being determined by way of a subjective test.<sup>148</sup> However, this position seems to now have changed where the new GAAR is concerned, by virtue of the introduction of section 80G:

*'An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.'*

*Res ipsa loquitur* it seems, and Broomberg agrees.<sup>149+150</sup> If this is the case, then the entire GAAR test now rests squarely on objective considerations. This is both interesting and relevant where simulations are concerned, given that the subjective purpose requirement, which has now been abandoned by the GAAR, was promptly thereafter recalled for use by *NWK*, however this time as part of the common law simulation doctrine.

<sup>148</sup> See *Secretary for Inland Revenue v Gallagher* [1978] 40 SATC 39.

<sup>149</sup> Broomberg, E. *Then and now – II: The first three prerequisites*, Tax Planning, 2007, Vol. 21.

<sup>150</sup> The position is also confirmed to be the view of SARS in its Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005.

Where an intention was present in the parties to a transaction to obtain a tax benefit, this could in the past have been attacked by SARS under either the common law or under GAAR. However, this is now only possible in terms of simulation, another reason why this course of action may seem more lucrative for SARS to explore in future matters before courts. It is submitted however that this was not the envisaged intention with which the new GAAR was brought into being.

### 5.2.3.2 Purpose and commercial substance

It is ironic against the backdrop of the *NWK* judgment to read the following passage from the SARS draft guide on the GAAR referred to above,<sup>151</sup> at 1.4.4:

*'The South African common law "substance over form doctrine" is applied to determine the true nature of an arrangement. Where a court finds that the legal substance of the transaction differs from the legal form, it will give effect to the substance.*

*This doctrine must not be confused with the well established United States of America (USA) economic substance over form doctrine, (also referred to as the "real economic substance" doctrine), the effect of which is to some extent introduced into South Africa's anti-avoidance measures by virtue of the commercial substance test contained in section 80C, read with the purpose requirement.'* (own emphasis)

And it is precisely here where the lines become blurred. From the above it is clear that what the draft guide discussed the position of simulation to be (with which, it is submitted, most academic scholars would have had no qualms with) is exactly what the court in *NWK* did not apply – the USA 'real economic substance' doctrine now not only forms part of the GAAR, but has ostensibly been applied by the court in *NWK* as part of the simulation doctrine.

The court in *NWK* seems to have applied the USA doctrine<sup>152</sup> (which has been built into the GAAR) to simulations – thereby inferring that a lack of commercial substance under simulation is enough to bring about a purpose to simulate. This perhaps gives context to Lewis JA's comments that where a transaction lacks commercial substance, *'then it will be regarded as simulated'*. It is reiterated that this does not give rise to a deemed simulation.<sup>153</sup> However, what the court seems to have inferred is that, where a transaction with a seemingly other purpose than to obtain a tax benefit, has no commercial substance then the purpose to simulate must have been present (except if other objective indicators points to a different subjective purpose).

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<sup>151</sup> At 138.

<sup>152</sup> Admittedly this has not been done so in name, but it is submitted well so in substance. Refer Lewis JA's various comments as to the 'commercial substance', 'business sense' or 'business purposes'.

<sup>153</sup> Refer Chapter 3.2.1.

Yet another reason why SARS will always prefer to use the simulation doctrine where available – not only does it allow for an attack on the subjective intention of the taxpayer, but it also requires only a lack of commercial/economic substance (as this lacking, under the doctrine, infers a purpose to simulate)<sup>154</sup>. However, under the GAAR purpose and commercial substance are two different requirements, only one of which needs to be absent for the taxpayer to succeed.

### 5.3 Transactions affected

From the above analysis (both domestically and internationally) it is evident that there is a growing movement from the judiciary to expand the simulation doctrine beyond its previous realms of intentionalist exclusivity. As aptly asserted by Kirby J *supra*, there are various reasons for this. The risk flowing from these developments is however that the net of the doctrine has been cast too wide: not only that it goes beyond the principle laid down in *Randles*, referred to above, being that no simulation would be present if '*the parties honestly intend(ed) (an agreement) to have effect according to its tenor*', but also that it may go further than commercial reality, or even common sense.

Philosophically, it may be argued that, as a matter of jurisprudence, where the subjective intent is present to achieve some tax advantage, the matter is best dealt with under the common law exclusively, and where the purpose of a transaction is problematic (irrespective whether this is determined objectively or subjectively) to the *fiscus*, then the matter should be concluded in terms of GAAR. However, there is no authority for such a clear-cut approach, nor is it submitted that it is required. However, the risk arises, where the two remedies of simulation and GAAR overlap, that the former may be a tool more powerful than the latter. The possible anomaly lies therein that the GAAR sets the boundaries within which tax planning is condoned by the Legislature. Where the judiciary however sees itself fit to still disallow certain transactions within this field of play: that is where the very foundation of the rule of law is at stake.<sup>155</sup> If the development of the simulation doctrine has now intruded into the previously allowable field of condoned tax planning, it may have done so unintentionally. Irrespective of this however, this will have practical consequences, and may ironically even go further than SARS' itself submits is necessary:<sup>156</sup>

*'A taxpayer who has carried out a legitimate tax avoidance scheme, i.e. who has arranged his affairs so as to minimise his tax liability, in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner, will have met his duties and obligations under the Act...'*

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<sup>154</sup> Support for this notion is found in *NWK* at 58: '*Was there any purpose or commercial sense – other than creating a tax advantage to NWK – for the loan by Slab to NWK to be structured in the way it was?*' (*own emphasis*)

<sup>155</sup> Refer comments in Chapters 2.2 and 4.1.3, as well as *ibid.* at 97 & 108.

<sup>156</sup> SARS Practice Note No. 5, 1 April 1987.

With the shift in both GAAR and the common law doctrine of simulation in recent years, it is submitted that various matters before our courts, although the outcome would have been the same, would have been decided based on the GAAR instead of on grounds of simulation, and *vice versa*. However, this is plainly only of academic importance.<sup>157</sup> Of practical relevance however is where these developments would have given a different result altogether to a matter before the court, had that matter been heard in terms of the law as it currently stands. Clearly, e.g. *Randles* would have been decided differently, if the *dicta* of Lewis JA is anything to go by.

Two other situations, where an arrangement which would have previously been left alone and may now fall within the tax net, are conceived; examples of which are discussed below.

### 5.3.1 The corporate veil

In *Secretary for Inland Revenue v Geustyn, Forsyth and Joubert*,<sup>158</sup> the incorporation of a partnership was under scrutiny in terms of section 103(1). In essence what the court found was that both the incorporation of a business is not abnormal, nor was it in this instance done with the sole or main purpose of obtaining a tax benefit. Therefore, the Secretary's appeal failed and the GAAR was not applied to the respondents' incorporation.

However, for the purposes of conducting a practical study, it is convenient to amend the facts slightly. What would be the position if, keeping in mind that incorporation of a business is regarded as being normal, the main purpose of such incorporation was to limit a partnership's tax expense?

If under GAAR a partnership, such as in *Geustyn's* case, would incorporate, but this for the main purpose of decreasing its tax liability, then, under both the current and previous GAAR, that transaction would have been safe, because of the ruling in *Geustyn* which deems this act to be normal:

*'Generally speaking, there is nothing abnormal in transferring an existing partnership business to a company: indeed, such a transaction may, I think, fairly be regarded as relatively commonplace in the commercial world.'*<sup>159</sup>

A normal transaction removes one of the four pillars required for GAAR to be applied, *viz* the presence of abnormality, and thus the GAAR cannot be applied to the facts at hand. Also, in terms of Watermeyer JA's simulation test, the incorporation would have been safe. The parties to the incorporation actually intended to incorporate a company, with all its legal consequences

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<sup>157</sup> Even the position of penalties in terms of section 76 would be unchanged, as the intention to avoid tax, which is a requirement for the 200% penalty was also a requirement for the application of either the GAAR (under section 103(1)) or the simulation doctrine.

<sup>158</sup> [1971] 33 SATC 113.

<sup>159</sup> At 119.

and obligations attached. This position may however have changed if the true purpose of incorporation (i.e. to obtain a tax benefit) was concealed.

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*Example:*

Assume A and B operate a successful business, with an annual gross income of less than R14 million. From their tax advisers, they learn of the beneficial tax treatment afforded to 'small business corporations' as defined in section 12E. A and B therefore decides to incorporate their partnership in order to qualify for the beneficial tax treatment afforded in terms of section 12E. Although they fully intend to have the partnership incorporated, and also accept the advantages and consequences of this, not much has changed for them, except that they are happy that the purpose of the incorporation has come to fruition – a lower tax bill. A and B's business still continue in exactly the same fashion as before and they each take home as much as before, irrespective thereof that their accountant now shows their drawings in the books as a dividend.

Further, when asked by SARS why the business was incorporated, it was stated that the main purpose was to limit the liability of the erstwhile partners. (Although in fact this was a consideration for A and B, this was not the main purpose.)

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Due to the normality requirement in the GAAR, the above incorporation will not be subject thereto. However, as regards to simulation, it is an altogether different matter. Even though the incorporation was carried out as intended by the parties, the fact that they in effect still trade as before and because of the tainted purpose with which they are doing so in the form of a company, the absurdity arises that a legislated provision, designed to stimulate business, may be halted by the common law. Clearly, such a position is untenable. With the above example in mind, the irony arises that where the purpose of the incorporation had not been concealed, neither the simulation doctrine nor the GAAR would have applied. Only by virtue of the fact that the purpose with incorporation had been concealed, does the simulation principle apply.

Where the above is the result in terms of the doctrine as it stands, one sympathises with Lord Russell of Killowen in his judgment in the *Duke of Westminster's* case at 25:

*'If ... the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine.'*

### 5.3.2 Loans without terms of repayment

Another arrangement which may be affected is a loan account with no fixed terms of repayment. These arrangements are so commonplace in South African commerce that it would be ambitious to suggest that these are abnormal.

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#### *Example:*

A owns a beach house in the Western Cape. Knowing that it is prudent for estate duty purposes to freeze the capital growth of this asset by rather transferring the house to a family trust, of which he is both one of the trustees and a beneficiary, he swiftly makes arrangements for the sales transaction to be actioned. After A sold the house to the trust, very few things in practice however change: A and his family still visit the house once a month and no rent is charged to him by the trust for his use thereof.

While both the trust and A intended to transfer ownership of the house to the trust, the trust's real purpose or commercial reason for entering into the arrangement was genuinely to acquire ownership of the property.

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The above transaction is one which is often witnessed. It is also one which is not affected by the GAAR, as income tax is not at stake, and Watermeyer JA's simulation test would also not have applied – the parties intended the sales contracts to have effect according to its tenor. However, insofar as A's purpose for the transaction is concerned, it is clear from the above that the purpose or motive of the transaction was mainly to acquire some tax benefit. And this can be deduced from various commercial factors (as is prescribed by *NWK* to determine purpose):

- The house was probably sold at cost (less than its market value so as to not result in capital gains tax for A);
- No rent is charged for the use of the house;
- The utilities accounts are likely still sent to A's residential address; and
- The loan account on which the house has been sold would in all probability carry no interest or terms of repayment.

### 5.3.3 Conclusion

Although the knell is sound for the above two arrangements as examples of what might possibly be included under the scope of the newly developed simulation doctrine, it is nonetheless

submitted that this is an unintentional result of the current formulation thereof. Even though it is evident from the above analysis that the incorporation of a business and loans with no terms of repayment may give rise to the application of the simulation doctrine, it is submitted that this should not be allowed to fall within the scope of the common law doctrine, and that its formulation should be curbed accordingly. However, given that the law as such was laid down by the Supreme Court of Appeal, this may set dangerous authority for future application by lower courts, as will be discussed in Chapter 5.4. In the words of Lord Hoffmann:<sup>160</sup>

*'There is no need for such spooky jurisprudence.'*

In the recent 'SHIPS 2' judgment,<sup>161</sup> both the court *a quo* and the court of appeal lamented its decision to let the taxpayer walk free, despite a scheme employed deliberately for the purposes of avoiding tax of some GBP 24 million. This loss suffered by HMRC was one of the reasons that the Aaronson study group was commissioned to comment on the advisability of introducing a GAAR in the UK.<sup>162</sup> In his concurring judgment, Thomas LJ at 100 comments:

*'The higher-rate taxpayers with large earnings or significant investment income who have taken advantage of the scheme have received benefits that cannot possibly have been intended and which must be paid for by other taxpayers. It must be for Parliament to consider the wider implications of the decision as it relates to the way in which revenue legislation is structured and drafted.'*

In South Africa now perhaps the risk exists that the converse may be exploited to the detriment of the taxpayer.

#### 5.4 *Stare decisis*: the future application of *NWK*

It remains to be seen if simulation doctrine, which it is advanced has been developed as envisaged in Chapter 3.3, would be applied as such – no court has yet had the opportunity to comment on the judgment. It has been suggested separately by Vorster, Broomberg and Emslie<sup>163</sup> that the comments perceived to extend the simulation test (specifically with reference to the requirement for a real purpose and commercial substance to be present) were made as *obiter*. Williams<sup>164</sup> and Silke<sup>165</sup> however disagree.<sup>166</sup>

<sup>160</sup> *Norglen Ltd (in liquidation) v Reeds Rains Prudential Ltd & others* [1998] 1 All ER 218 at 226.

<sup>161</sup> *Mayes v HMRC* [2011] EWCA Civ 407.

<sup>162</sup> Refer Chapter 4.1.2.

<sup>163</sup> *Ibid.* at 83.

<sup>164</sup> *Ibid.* at 84.

<sup>165</sup> *Ibid.* at 88.

<sup>166</sup> A view which is subscribed to. Refer to Chapter 3.

Irrespective of this, as has been conceded by both Emslie<sup>167</sup> and Williams,<sup>168</sup> even if the comments referred to above were merely part of the *obiter dicta* of the judgment, these would still carry considerable weight in lower courts, e.g. tax courts.<sup>169</sup> It is submitted that it would carry even more weight if simulation was at issue when one is in settlement negotiations with SARS.

In *Camps Bay Ratepayers' and Residents' Association v Harrison*,<sup>170</sup> the Constitutional Court held as follows regarding the doctrine of *stare decisis*:

*'What (the doctrine of stare decisis) boils down to... is: "certainty, predictability, reliability, equality, uniformity, convenience: these are the principal advantages to be gained by a legal system from the principle of stare decisis." Observance of the doctrine has been insisted upon, both by this Court and by the Supreme Court of Appeal. And I believe rightly so. The doctrine of precedent not only binds lower courts but also binds courts of final jurisdiction to their own decisions. These courts can depart from a previous decision of their own only when satisfied that that decision is clearly wrong. Stare decisis is therefore not simply a matter of respect for courts of higher authority. It is a manifestation of the rule of law itself, which in turn is a founding value of our Constitution. To deviate from this rule is to invite legal chaos.'*

And in *Ex Parte Minister of Safety and Security: In re S v Walters* at 61:<sup>171</sup>

*'High courts (and tax courts) are obliged to follow legal interpretations of the SCA, whether they relate to constitutional issues or to other issues, and remain so obliged unless and until the SCA itself decides otherwise...'*

It has been observed by some that in reaching its decision, the SCA itself did not observe this principle.<sup>172</sup> In this regard, in *Robin Consolidated Industries Ltd v Commissioner for Inland Revenue*<sup>173</sup> it was held that:

*'Particularly is it important to observe stare decisis when a decision has been acted on for a number of years in such a manner that rights have grown up under it.'*

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<sup>167</sup> Ibid at 7.

<sup>168</sup> Williams, RC, *The role of the doctrine of stare decisis*, PwC South Africa Synopsis Tax Today, September 2011.

<sup>169</sup> Refer also to Mazansky, E, *And you thought an obiter dictum was not binding!* The Taxpayer, March 2012, Vol. 61, No. 3 at 44.

<sup>170</sup> [2011] (2) BCLR 121 (CC) at 28.

<sup>171</sup> [2002] (7) BCLR 663 (CC).

<sup>172</sup> Broomberg *ibid.* at 34.

<sup>173</sup> [1997] 59 SATC 199.

However, whether the SCA did have regard to its own previous judgments in *NWK* is beyond the matter currently at hand. What is relevant however is that if the above is to be adhered to, *NWK*'s effect will remain until the SCA itself has had the opportunity to direct otherwise. In this regard, Vorster hopes that '*the Supreme Court of Appeal will soon be given the opportunity to re-assess its judgment in NWK and to clarify its effect on the legal principles of simulation.*'<sup>174</sup>

The possibility also exists that a court may in future seek to distinguish from the facts of *NWK* in an attempt to escape having to comment on *NWK* or to have the arduous duty of interpreting the judgment. This is again the view of Vorster who comments that the facts in *NWK* are both unusual and specific and that a court should only be bound to *NWK* to the extent that these facts are closely resembled. In support of this assertion, he refers to *Hippo Quarries*<sup>175</sup> where it was held that:

*'These factors are, of course, all absent in the present case. In my view Skjelbreds' case is clearly distinguishable from the present one on the facts and to the extent that the enquiry into the intention of the parties to the cession is a purely factual one the reasoning and the remarks of this court in Skjelbreds' case must be confined to cases in which its facts are substantially duplicated.'*

Of course the above is a judicial reality that lower courts, in an attempt to escape the judicial straightjacket of the *stare decisis* doctrine, seek to distinguish the facts of the matter before it from the precedent from which they seek to be liberated. The question however is whether they are justified in doing so. The problem with using *Hippo Quarries* as justification for Vorster's assertion, is that, as is evident from the above, the enquiry into the intention of any person is purely factual.

Now, it is true that a court is entitled to distinguish on matters of fact (as for instance which factors are required to ascertain intent). A lower court is however unable to distinguish on matters of legal principle. It is not submitted that *Skjelbred's* case was incorrectly distinguished from. It is however submitted that a lower court would not be able to distinguish from *NWK* as to what constitutes a simulation. The former is a question fact, the latter a question of law.

Since the proposition of this paper is to assert that the test for the simulation doctrine has changed in *NWK*, it is further submitted that this test has not been made in *obiter*, nor was it made based on fact. As such, it has changed the simulation test with permanent effect and one which in law is required to be adhered to by lower courts, at least until the SCA is afforded the opportunity to dictate otherwise.

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<sup>174</sup> Ibid. at 38.

<sup>175</sup> Ibid. at 23.

## CHAPTER 6

### Conclusion and recommendation

*'If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck.'*<sup>176</sup>

Had the test for what a simulated transaction is been that easy.

It is evident that the *NWK*-decision has brought about widespread comment, and even criticism. As Emslie points out:<sup>177</sup>

*'While it seems to us that the outcome of NWK was correct, due to the legal effect of confusio, we respectfully question whether there was any true simulation at all...'*

It is submitted that not only did the principle of *confusio* apply to the facts in *NWK*, but its English derogative was also present in the mind of various tax scholars subsequently, rightly or wrongly so. What is certain, however, is that the decision in *NWK* will influence the way forward in which taxpayers and SARS alike more carefully scrutinise transactions entered into for their 'commercial reasons'.

As was discussed in Chapters 2 and 3, it appears that the contents of the simulation doctrine may have been changed with at least some degree of permanency: no longer is an intention to deceive by both parties the only requirement, but a second tier has also been added to the test: is the purpose of the transaction for any one party, subjectively determined, to obtain a tax benefit rather than the purpose/motive which is portrayed to the world? Otherwise stated: was there either an intention or a purpose to simulate?

Examples of transactions of this sort which may now fall foul of the common law doctrine, which would not have been the case pre-*NWK* have been illustrated in Chapter 5 above, as well as how the GAAR has until now not afforded the *fiscus* protection against these. From the common law comparison performed with the GAAR, it would seem that SARS may prefer to attack tax avoidance in terms of the simulation doctrine rather than in terms of the GAAR where the facts allow therefor. As commented however above, this sets a dangerous precedent if the common law doctrine's application submits certain transactions to tax which the Legislature did not intend should have happened. Looking to the future with one of SARS' anti-avoidance weapons

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<sup>176</sup> Author unknown.

<sup>177</sup> Emslie, T *supra* at 79.

been strengthened, taxpayers should be more vigilant than ever before entering into disputes with SARS, if SARS' winning rate in the court is anything to go by at least.<sup>178</sup>

The fact of the matter is that the tax landscape has changed. To what degree however, it seems that there remains uncertainty amongst various renowned academic writers. The recommendation is therefore that at the earliest possible stage the judiciary acknowledges the confusion that reigns regarding simulated transactions and move to address this by clarifying matters as to the correct approach which should be taken where possible simulated transactions are concerned. Although it has been submitted in this paper that the test for simulated transactions may entail a test which diverges from the view of others, this emphasises the various perspectives which are held in this regard, and are symptomatic of general legal uncertainty regarding the matter. Indeed, it is submitted that it is one of the functions of the judiciary to provide legal certainty. Therefore, the opportunity to provide clarity should be embraced at the first opportunity which is presented.

However, it is not the role of the judiciary only to promote legal certainty, but also that of the State, i.e. SARS where matters of tax are involved. The recommendation would therefore also be that SARS goes further than merely issuing a media release on the matter. An interpretation note at the very least is necessitated to present SARS' view on *NWK*. Irrespective of the perceived accuracy of this, it will at least afford taxpayers the opportunity to understand what it is that they should guard against in exercising their entrenched right of effective tax planning within the bounds of the law.

Finally, it is both the aim of this paper as well as a recommendation thereof, that taxpayers and tax planners alike take cognisance of the ever-changing tax environment. One is so used to limiting this to legislative changes that sight is lost of changes in the common law. Even if the views taken in this paper are not agreed with, they purport to act as a warning to taxpayers of what the consequences of the simulation doctrine in the common law as regards the law of taxation may be.

The importance of understanding the crisp test and contents of the simulation doctrine is highlighted by the rather ominous Media Statement released by SARS shortly after the *NWK*-judgment had been delivered:

*'SARS is aware that a number of other taxpayers have entered into simulated transactions, including compulsorily convertible loans similar to the one at issue in the NWK case, with the effect of artificially reducing their tax liabilities. Starting from 15 February 2011 SARS will commence audits of these taxpayers.'*

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<sup>178</sup> According to a pwc document published, *Creating opportunities in tough times: Budget 2012*, SARS in 2010 won 17 of the 33 disputes before courts (i.e. 52%). In 2011, its success rating has improved to 21 from 26 (81%).

From the above, it would seem that it was both Soccer fans and SARS alike who were afforded the opportunity in 2010 to exclaim, 'Ke nako!'

The ever-hovering sword of Damocles may have finally dropped...

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