TAX AVOIDANCE PROVISIONS OF THE SOUTH AFRICAN INCOME TAX ACT

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CHAPTER 1
INTRODUCTION

My thesis is on tax avoidance provisions in South Africa. I want to present an overview of tax avoidance in South Africa but I will concentrate more on section 103(1) which is the general anti - tax avoidance provision in South Africa.I will then proceed to look at the artificial tax avoidance, and a comparative analysis between United Kingdom (UK) and South Africa on the substance over form approach as a new approach to tax avoidance. Much has been said on tax avoidance and it is an area which has generated much interest and curiosity to the society at large.

While the main reason for concern about large scale tax avoidance and evasion is their effect on the equity of the tax system, they also result in a waste of economic resources. The amount that the revenue loses because of tax dodgers cannot be determined with precision. A progressive tax, designed to reduce inequality of incomes, inevitably means marginal rates which are both high in themselves and markedly higher than average tax rates. This is then an inducement to evade or avoid taxes.

CHAPTER 2

2.1 DIFFERENCE BETWEEN TAX AVOIDANCE AND TAX EVASION

Efforts within the existing law to minimise tax payments are described as tax avoidance; efforts outside the law to minimise tax payments are described as tax evasion. Thus legal avoidance of tax must not be confused with tax evasion. Tax evasion refers to illegal actions taken to reduce the tax burden, such as falsifying of records, not declaring all your income, or claiming false deductions.

These actions are illegal and punishable as a crime. The sums avoided legally by rich people's arrangement and disposition of their resources are, in *per capita* terms, doubtless quite considerable.

There is a general agreement that tax avoidance and evasion are similar economically but dissimilar morally and politically : tax avoidance is legal and tax evasion is criminal act. There is thus a thin line between tax avoidance and tax evasion and it is the economic similarity that constitutes a principal justification for the coinage "tax avoision". The difficulty experienced in maintaining the distinction between the lawful nature of tax avoidance and the illegality concerning tax evasion is evident from the ex - Minister of Finance, Mr Du Plessis' speech that :

> " It is regrettably true that there are those who consciously and wilfully evade taxation and those who cynically manipulate tax avoidance to such an extent that it cannot be construed as anything but evasion of taxation."[1]

The nature and extent of tax avoidance practices has caused a range of legislation introducing various anti tax avoidance measures in the Income Tax Act[2] designed to curb such practices. South Africa employs a combination of general and specific legislation aimed at a particular type of transaction or scheme. Thus apart from the general anti - tax avoidance section 103(1), there are specific measures which include the following :

1) **SECTION 7**

which is aimed at preventing the taxpayer from reducing his liability for income tax through artificial arrangements which divert income to minor child. If a taxpayer gives up a right to income and to any control over the income or source of the income, even with the avowed purpose of reducing his tax liability, he should not be taxed on that income.

[1] 1985 Taxpayer @ 53
[2] 58 of 1962

However if he contrives matters in such a way that he continues to enjoy the benefits of the income. or if he continues to control the source or disposition of income, he should not be allowed to reduce his liability below what a taxpayer in similar circumstances receiving the income would normally be expected to pay in which case section 7 deems accrual or receipt in such circumstances.

SECTIONS 7(3) AND (4)

deems any income which accrues to a minor child as a result of a disposition, donation or settlement by a parent to be income of a parent.

SECTIONS 7(5), (6) AND (7)

hit at tax avoidance through the medium of donation, settlement or disposition which are wholly or partly gratuitous by deeming the income accruing to or accumulated on behalf of the donee to be that of the donor.

2) **SECTIONS 8B, C AND D**

are aimed at dividend stripping operations.

3) **SECTION 8E**

which aims at preventing the lending of money in return for non - taxable dividends instead of interest, which is fully taxable, deems certain types of dividend income to be interest and therefore taxable in full.

4) **SECTION 8(5)**

which prevents the use of previously deducted rentals by lessee as part of the purchase price for the property.

5) **SECTIONS 9 AND 9A**

deem certain income received from foreign sources, to be from sources within the Republic, are aimed at tax avoidance schemes which take advantage of the principle of source, since South

Africa levies income tax on a source basis, to ensure that income is not taxable in the Republic.

6) SECTION 9C

Inorder to ensure that foreign sourced investment income is taxed in South Africa, section 9C has been introduced into the Income Tax Act to deem such income to be of o South African source. Investment income as defined in section 9C includes annuity, interest, rental, royalty or other similar income. It however excludes pensions as a result of pat employment, or payments under social security systems of other countries. This taxation of passive income accords with the Recommendations of the Katz Commission of Inquiry into tax avoidance structure in South Africa considering the implications of away from the source basis of taxation to residence or world-wide basis, as contained in its Fifth Interim Report.

7) SECTION 9D

Inorder to circumvent the provision of section 9C it may be the intention of certain residents to cause a company to formed in a foreign jurisdiction for the purposes of earning investment income . This foreign registered company will then pay dividends to the South African resident. Dividends are currently tax exempt in terms of section 10(1)(k) and the end result would be that the South African resident would be able to earn investment income free of tax, if the overseas company were to be set up in an overseas tax haven. Section 9D which has been introduced to counter this type of tax avoidance, taxes the South African resident on his proportionate share of the foreign company's investment income.

9) SECTION 23A

was introduced to counter "leverage" leasing schemes.

10) SECTION 23D

prevents deduction of excessive allowances claimed on assets acquired from connected persons or lessees who in turn claimed allowances on these same assets.

11) **SECTION 24H**

which is aimed at preventing the use of limited partnerships and the " limited partners" in an *en commandite* to the amounts for which they are " at risk". It therefore limits deductions that may be claimed by the limited partners to the amounts for which they are "at risk".

12) **SECTION 31**

which hits at transfer pricing.

13) **SECTION 103(2)**

aimed at remedying the mischief of trafficking in assessed loss.

14) **SECTION 103(5)**

aimed at certain schemes in which the taxpayer cedes his right to interest income in exchange for receiving dividend income which is tax exempt in terms of section 10(1)(k).

2.2 JUDICIAL ATTITUDES TO TAX AVOIDANCE : A COMPARATIVE ANALYSIS.

Judicial role in tax avoidance cases was stated as follows:

> " The role of the judges is always to make such construction as shall suppress the mischief and advance the remedy, and to suppress subtle inventions and evasions for the continuance of the mischief and *pro privato commodo*, and to add force and life to the cure and remedy according to the true intent of the makers of the Act *pro bono publico*." [3]

In **Cir v King**[4] Watermeyer CJ postulated a number of stratagems which a person might legitimately adopt with the intention of avoiding or reducing tax. For instance, he stated that a person might abstain from earning income by closing down his business, or by resigning his job; he might sell income producing investments and not re - invest the proceeds orelse buy a non -

[3] September Taxpayer 1976 @ 172
[4] 1947(2) SA 196 A

income producing capital asset; he might sell shares which produce high dividends and re - invest in securities which earned a lower but safer return; a professional man might reduce his fees, or work for nothing.

It is a right of every taxpayer to arrange his affairs in such a way that he pays the minimum amount of tax that is required of him. The right of every taxpayer to avoid or reduce his tax liability was stated in the leading case in the United Kingdom (UK) on the issue of tax avoidance as follows :

> "Every taxpayer is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in so 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."[5]

The legitimacy of tax avoidance in the UK was adopted by English courts in **Ayshire Pullman Motor Services v CIR**[6] by Lord Clyde stating as follows:

> "No man in this country is under the smallest obligation, moral or other, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel in his stores. The Inland Revenue is not slow - and quite rightly to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is in the like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue."

The same principle is recognized in the United States as per Learned Hand J who expressed similar sentiments in **Helvering v Gregory**[7] :

> " Every taxpayer is entitled to arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury."

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[5] Lord Tomlin in Duke Of Westminster v IRC, 51 TLR 467,19 TC 490 @520
[6] (1928) 14 TC 754 @ 763 - 4
[7] (1934) 69 F(2d) 809 (2nd Cir.) @810

And in **Commissioner of Internal Revenue v Newman**[8] the court stated as follows :

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands : taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

This is not to say that the courts have not expressed disapproval of the practice of tax avoidance, for instance Lord Denning in **Re Weston's Settlements**[9] stated that:

" The avoidance of tax may be lawful, but it is not yet a virtue."

Also, in the case of **Latilla v Inland Revenue Commissioners**[10] , Viscount Simon stated that :

"My lords, of recent years much ingenuity has been expended in certain quarters in attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are "entitled" to do so. There is of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of duties of good citizenship.

On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."

This is clear evidence of the evil inherent in tax avoidance as only those who have skills, money

[8] (1947) 159 F(2d) 848, @ 850 - 1
[9] [1968] 3 ALL ER 338 (CA) @ 342
[10] 1943 AC 377 @ 380 - 1

and have legal and business connections on how to pay the least tax possible will fare well such that the end result is that the rich become richer and the poor get poorer. The effect of those astute taxpayers who seek to avoid tax is to cast an additional burden upon those " honest citizens" who lack the know - how and financial means to embark on tax avoidance schemes.

Disapproval of such a practice was expressed by Lord Normand in the case of **Vestey's (Lord) Executors and another v Inland Revenue Commissioners**[11] as follows :

> "Parliament in its attempt to keep pace with the ingenuity devoted to tax avoidance may fall short of this purpose. That is the misfortune for the taxpayers who do not try to avoid their fair share of the burden, and it is disappointing to the Inland Revenue.
>
> But the court will not stretch the terms of taxing Acts inorder 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 inorder to subject to taxation people of whom they disapprove."

After citing the above passage in **Cot v Ferera**[12] MacDonald proceeded 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 aims opponents of our capitalist 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."

A better approach is to recognise the taxpayers right to so arrange his affairs that he ends up paying the minimum amount of tax that is legally expected and required of him. Then the next issue must be whether the taxpayer has succeeded in so arranging his affairs in such a way that

[11] (1949) 1 ALL ER 1108 @ 1120
[12] 1976(2) SA 653 (RAD), 38 SATC 66 @ 70

his conduct does not fall within the confines of the Income Tax Act as per section 103(1). This approach is correctly laid down in the practice note number 6 issued by the Commissioner of Inland Revenue on 1 April 1987 in connection with section 105A of the Income Tax Act :

> "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 if he fully and honestly completes his income tax return and honestly answers any queries raised by the Commissioner."

The mischief against which the legislature seeks to curb by the anti - tax avoidance provisions was thus summed up more eloquently in the English case of **Furniss v Dawson**[13] , by Lord Templeman stating that :

> "While tax avoidance is not, by definition, an illegal activity, a tax avoidance industry of the scale which developed in the 1970's had to be destroyed. The origins of the new approach by the courts had to be seen as a reaction to the growth and activities of this industry. An industry of that nature and that size had the capacity to make considerable inroads into government revenues and essentially created two nations of taxpayers; those "in the know" with the financial resources enabling them to use the artificial devices to avoid tax altogether, and those to whom, through lack of knowledge or resources, such opportunities were not open."

CHAPTER 4

THE GENERAL ANTI - TAX AVOIDANCE PROVISION : SECTION 103(1)

The anti - tax avoidance provision of the notorious section 103(1) of the Income Tax Act 58 of 1962 which seeks to remedy the mischief of tax avoidance in South Africa empowers the commissioner to determine the liability for any tax, duty or levy imposed by the Income Tax Act

[13] 1984 AC 474

and the amount of that tax, duty or levy :

- as if the transaction, operation or scheme in question has not been entered into or carried out; or
- in such a manner as in the circumstances of the case he deems appropriate for the prevention, postponement or reduction of liability for the tax I in question.

PRE - 1996 AMENDMENT

Before the commissioner could exercise his powers he had to be satisfied that -

(1) A transaction, operation or scheme, including one involving the alienation of property, was entered into or carried out (whether before or after the commencement of the Act);

(2) which has the effect of avoiding, postponing or reducing liability for any tax imposed by the Act; and

(3) having regard to the circumstances in which the transaction, operation or scheme was entered into or carried out, it

- was entered into or carried out by means or in a manner which would not ormally be employed in the entering into or carrying out of a transaction, peration or scheme of the nature of the transaction, operation or scheme in question, or
- has created rights or obligations which would not, normally be created between persons dealing at arms length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question;

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

All the above mentioned elements must co-exist before the commissioner can successfully invoke the anti - tax avoidance provisions of section 103, who cannot do so if any one or more of these elements is not present.[14]

The taxes referred to are :

(a) those imposed by the Act viz. normal tax, donations tax and non - resident shareholders'tax; and

(b)those imposed under any other law administered by the commissioner, viz.

(i) estate duty under the Estate Duty Act 45 of 1955;

(ii) marketable securities tax under the Marketable Securities Tax Act 32 f 1948;

(iii) stamp duty under the Stamp Duty Act 77 of 1968;

(v) transfer duty under the Transfer Duty Act 40 of 1949

(v) value added tax under the Value Added Tax Act 89 of 1991

SIGNIFICANT AMENDMENTS TO ANTI - TAX AVOIDANCE PROVISION SECTION 103(1)

Fundamental amendments have been made to improve the efficacy of section 103(1)

(a) the scheme, transaction or operation must have been carried out or entered into solely or mainly for the purposes of obtaining a tax benefit.

A 'tax benefit' as per by section 103(7) is defined as including ' any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by [the] Act or by any other law administered by the Commissioner." A definition of a tax benefit as contained in section 73(2) of the Value Added Tax Act 89 of 1991 is instructive in this regard, which is defined as including :

- any reduction in the liability of a person to pay tax;

[14] SIR v Geustyn, Forsyth and Joubert 1971(3) SA 567 A, 33 SATC 113

- any increase in the entitlement of a vendor to a refund;
- any reduction in the consideration payable by the person in respect of any supply; or
- any other avoidance or postponement of liability for the payment of any tax, duty,levy imposed by the Act or any other law administered by the commissioner.

(b) If the scheme is "in the context of business", it must, in the light of the circumstances in which it was entered into or carried out "in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit."

(c) In the case of any other schemes which are not "in the context of business", it must in the light of circumstances in which it was entered into or carried out, must have been entered into or carried out " by means or in a manner which would not normally be employed in the entering into or carrying out of a scheme, transaction or operation of the nature of the transaction, operation or scheme in question."

(d) Alternatively, in either above events, it must in the light of the circumstances in which it was entered into or carried out, have created rights or obligations which would not normally be created between persons dealing at arms length under a transaction, operation or scheme in question.

(e) Where the provisions of section 103 are successfully applied, commissioner's discretionary powers granted in terms of section 89 quat(3) and 3A in terms of which he may direct that interest shall not be paid have been circumscribed in terms of section 103(6). Section 103(6) has the effect that where the provisions of section 103 are successfully applied, interest will be payable in respect of so much of the tax as is attributable to the application of section 103

4.1 A TRANSACTION, OPERATION OR SCHEME

The first requirement which must be complied with inorder to enable the commissioner to invoke section 103(1) is that there must be a transaction, operation or scheme. These are not defined in the Act and we thus rely on judicial interpretation of these terms. Section 73(2) of the Value

Added Tax Act 89 of 1991 which defines the 'scheme' is instructive. A 'scheme' is defined as " any transaction, operation or scheme or understanding whether or not enforceable, including all steps and transactions by which it carried into effect." The phrase 'transaction, operation or scheme' is not exhaustive and has been further extended by the addition of the words 'involving the alienation of property'.

The courts have held that a series of transactions constituted a scheme, even though not all the steps were contemplated at the outset i.e the taxpayer need not have a tax avoidance purpose when the early steps of what will ultimately constitute a scheme are taken as in **Meyeworitz v CIR**[15] where in regard to the question whether the appellant's arrangements constituted a 'transaction, operation or scheme', it was argued on behalf of the appellant, that the various steps taken by him did not constitute a pre - conceived plan
and so did not have the essential continuity or inter - relationship to make up one of the types of arrangements referred to in the Act.

The Special Court held that, in regard to the legal textbooks, the creation of the "Visandra investments (Pty) Ltd", the transfer to it of the rights to the textbooks and subsequent transfer of these rights to the trust, constituted a scheme. The Appellate Division was satisfied that from beginning to end the steps taken in each of the two arrangements, including the formation of "The Taxpayer (Pty) Ltd", constituted schemes within the meaning of the section. It held that the argument that when "The Taxpayer (Pty) Ltd" was formed there was no intention to embark upon the series of steps eventually taken, did not hold water.

In this regard a passage from an English case of **Crossland (Inspector of Taxes) v Hawkins**[16] was cited with approval where the court stated as follows :

> "It was not necessary inorder to constitute an "arrangement" within section 397 of the Income Tax Act of 1952 that the eventual arrangement must be in contemplation from the very outset. Confining oneself for moment to the facts of this case and remembering that income tax is an annual tax, one finds the whole "arrangement" conceived, and in being in

[15] 1963(3) SA 863 A
[16] [1961] 2 ALL ER 812 (CA) @817

the one income tax year, 1954 - 1955. The company is formed, the service agreement executed and the deed of settlement made, all this in one year. Even were it otherwise, there is sufficient unity about the whole matter to justify its being called an arrangement for this purpose, because the ultimate object is to secure for somebody money free from what would otherwise be the burden or the full burden of surtax."

Merely because the final step to secure this objective is left unresolved at the outset, and decided on later, does not rob the scheme of the sufficient unity to justify its being called an "arrangement".

The principle laid down in *Meyeworitz* case ,therefore, is that the fundamental factor in determining whether a series of steps can constitute a transaction, operation or scheme is whether, looking in retrospect the steps taken, they are sufficiently inter - related to lead ultimately to the avoidance of tax. This involves an objective assessment of the facts but at the same time the subjective element cannot be disregarded entirely because in section 103(1)(c) the purpose with which a transaction was entered into is an essential ingredient of the arrangement.

The fact that the intention to avoid the payment of tax appears only from later steps is of no relevant consequence as evident in *Meyeworitz* case[17] where Beyers JA summed up the position as follows :

"In my opinion the commissioner was entitled to ignore completely "The Taxpayer (Pty) Ltd".It is true that the Special Court found that when it was formed there was no purpose of tax avoidance. But although it may have come upon the scene with good intentions, it ceased almost at one to be an innocent bystander. It became a party to the scheme when it ceded its only asset to the partnership : it was essential to the scheme that it should do so."

4.1.1 INVOLVING THE ALIENATION OF PROPERTY

[17] supra at page 875

One way to avoid income tax is to give away income producing property, in other words alienation of corpus.

In **Cir v King**[18] this position was stated by Watemeyer CJ as follows :

> "A taxpayer can, while retaining the ownership of his capital, arrange for the fruits of that capital which are in reality part of his income, to be received by someone else, and thus he can free himself from taxation in respect of these moneys."

We must however be aware of the distinction between alienation of income and alienation of corpus. A person may alienate income and retain dominium of corpus. Whether or not the taxpayer has succeeded in legitimately reducing his incidence of tax depends on the facts of each case. The best way of achieving this result is by disposing of the right to income in such a way that income never accrues to or in taxpayer's favour who has ceded his right to claim and receive the income, and has thus divested himself of that right as in **Taxpayer v Commissioner of Taxes, Botswana**[19] where Maisels P noted that :

> " there is an important distinction between a disposal of income after it has accrued to a person and the disposal by him of a right under which income would only accrue in future. In the former case, as the income has already accrued to the party who disposes of it, it remains taxable in his hands. In the latter case, the income accrues to the recipient of the right and not to the person who has disposed of the right."

If a taxpayer contrives matters in such a way that he continues to enjoy the benefits of income, or if he continues to control the source or disposition of income , in which case an 'out to out' cession has not taken place, he should not be allowed to reduce his liability below what a taxpayer in similar circumstances receiving the income would normally expect to pay under the tax system as in **ITC 1378**[20] where the taxpayer ceded his right to income from the shares to the

[18] 1947(2) SA 196 @ 211-12
[19] 43 SATC 118 @ 131
[20] 45 SATC 230

C fund for a limited duration.

The commissioner included the dividends paid to the C fund in the gross income of the taxpayer because he was of the opinion that it was not possible in law to cede dividends which have not yet been declared, this being tantamount to the cession of a mere *spes,* which he regarded as not being permissible.

Melamet J was of the view that a future right or *spes* is capable of cession. He went on to say that :

> " It is true that the alienation of income without the alienation of the corpus maybe a method of tax avoidance, but apart from section 103 there is no provision in the Income Tax Act which strikes cessions of the rights to income. In other jurisdictions specific legislation has been introduced. As set out above, there was no attempt to apply the provisions of section 103 in the present instance."

Since a tax motive for retaining a continuing interest and control over the disposition of income justifies continued taxation *ITC 1378* lead to the enactment of section 7(7) which provides that, if by reason of any donation, settlement or other disposition by the donor, the donor's right to income in respect of any property is ceded to another in such a way that the donor has the right to regain ownership of or the interest in the property, such income is deemed to be that of the donor. Such income is also deemed to be that of the donor if the donor's right to income is ceded upon terms which allow the donor to regain the right.

In **Smith v CIR**[21] the court was of the opinion that alienation of any asset by the taxpayer by which income, which would otherwise have accrued to the taxpayer, accrues to another can be regarded as having the effect of avoiding, postponing or reducing liability for tax, although the taxpayer has no right to or will receive no benefit from the income :

"by the specific inclusion in unqualified general terms of a transaction, operation or

[21] 1964(1) SA 324 A

scheme involving the alienation of property, the alienation of income - reducing asset is brought within the terms of the section. The effect of such an alienation would ordinarily be that income produced after the alienation would not be income of the seller. There could, of course, in such a case be some special arrangement by virtue of which it might be said that the income produced would in reality and for all practical purposes still be the income of the seller, but the generality of the language of the inclusion gives no indication of any intention to limit the inclusion to cases of that nature."[22]

Steyn CJ held further that that :

"although the income in question not having been produced by the Appellant's capital, may not in reality be his income...his effective control of the companies he formed would enable him, at such time as he might consider appropriate, to obtain payment of an equivalent amount to himself, in a form or a manner which would render it free from tax or subject to a lesser tax."

Therefore to counter such a result there must be an out to out cession by which the taxpayer antecedently revokes his right to income in such way that income never accrues or is never received by him. It is only when the taxpayer's actions do not properly terminate his source of income that section 103(1) may be invoked provided that other requirements of the section are satisfied.

4.2 WHICH HAS THE EFFECT OF AVOIDING OR POSTPONING THE LIABILITY FOR PAYMENT OF ANY TAX ... OR REDUCING THE AMOUNT THEREOF

The second condition for the successful invocation of the anti - tax avoidance provision is that the transaction, scheme or operation must have an effect of avoiding, postponing or reducing the liability for the payment of any tax, duty or levy imposed under the Income Tax Act.

[22] supra at 334

The landmark decision involving the interpretation of the words "avoiding or postponing liability" is **Smith v CIR**[23] where a taxpayer held shares in a company with large undistributed reserves that intended declaring a dividend. All the shares of this company were about to be exchanged for shares in another company, which would become its holding company.

The appellant had carried out a series of company re - organisations, with the result that his original shareholding in a company which enjoyed a substantial income from the sale of certain technical equipment was held by him through some four intermediary companies.

As anticipated by the taxpayer, the original company declared a dividend to its holding company, the holding company declared a dividend to its shareholders, including the South African company, and the South African company declared a dividend to the Rhodesian company. As a result, dividends declared by the operating company and its immediate holding company were absorbed by the intermediary companies and did not swell the appellant's income. The secretary invoked section 103, and included in his assessment of the appellant's income dividends which had been received by one of the intermediary companies.

The taxpayer did not dispute the abnormality of these transactions for the purposes of section 103 and admitted that certain of the transactions were designed to save estate duty and income tax. His sole contention was that these transactions or operations did not have the effect of " avoiding ... liability" for any tax on income and relied on a passage by Watemeyer CJ in **CIR v King**[24] who concluded that the meaning of the words " avoiding liability" was to be found by distinguishing the case of a man who so orders his affairs that he has no income which would expose him to liability for income tax from a case of a man who so orders his affairs that he escapes liability for taxation which he ought to pay upon the income which is "in reality his", and held, in effect that "the section was to be interpreted so as to apply to the former."

Relying on the above passage the appellants' argument in this regard was summed up by Steyn

[23] 1964(1) SA 324 A
[24] 1947(2) SA 196 A, 14 SATC 184

CJ[25] in his majority judgment as follows :

> "Counsel for the appellant submitted that they [the words "avoiding liability] bear the meaning of preventing liability in respect of accruals or moneys which are, in spite of any such transaction or operation, *in reality* [my emphasis] still the income of the taxpayer. In the present case the dividend of £ 6 951 did not accrue to and was not received by the appellant. It went to the Rhodesian company, a different persona. He argued that the legislation did not intend that a person should by the
> provisions of this section be made be made to pay tax on income which he has not received and may never receive, and which is not really his."

Steyn CJ rejected this contention holding that the introduction of these limitations [the abnormality test] was to eliminate, on the whole, the results by which the court was constrained to seek a narrower meaning. He went on to say that it was highly improbable that the legislature, while widening the general scope of the section, intended not only to
impose the limitations by which these results are eliminated, but also at the same time to retain the restrictions arising from the interpretation adopted in *King's* case.

Therefore the court considered that the meaning attached on the words "avoiding liability" in *King*'s case was no longer applicable holding that ordinary, natural meaning of the phrase under consideration should prevail and Steyn CJ came to the conclusion that :

> "The ordinary meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability."

Although the dividend ultimately received by the Rhodesian company was not "in reality" the income of the taxpayer but for the transaction in question, the dividend would have come into his hands and attracted liability for tax thereon.

Smith's case, therefore, lays down a principle that it is not a requirement of section 103(1) that it be shown that the taxpayer is avoiding the tax on what is "in reality his income" and, therefore,

[25] supra at page 330

that any action taken by the taxpayer which has the result of reducing, avoiding or postponing his present or anticipated tax liability brings him within the confines of the section irrespective of whether he is not the owner of such income or will never lay his hands thereon.

In **Hicklin v SIR**[26] Trollip JA in considering whether the agreement had the effect of avoiding liability for any tax on income, acknowledged that to avoid a liability for a tax on income is to "get out of the way of, escape or prevent anticipated liability" as per Steyn CJ who delivered the judgment of the court in *Smith*'s case, which stated that it meant " a liability for tax that the taxpayer anticipates will or may fall on him in the future".

Therefore the court accepted that liability for tax may vary from an imminent, certain prospect to a vague, remote possibility but held it unnecessary and hence inadvisable to decide whether a vertical line should be drawn somewhere along that wide range of meanings inorder to limit the meaning of the connotation of "anticipated liability".

On the facts, therefore, the court held that :

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

In *Meyeworitz* case[27] it was held that the income of the Meyeworitz Trust was in its entirety the product of appellant's personal labours and that where the taxpayer had by means of 'artificial

[26] 1980(1) SA 481 A
[27] supra

manoeuvre' diverted income from himself to his minor children, it was appropriate for the commissioner to tax the income in the taxpayer's hands as the person to whom it in reality belonged. This is so because where the income is the fruit of the taxpayer's labour or capital or both, then that leaves the taxpayer in a position of one to whom income would normally and naturally in the ordinary course of the events accrue since income could clearly be traced to the appellant's labours.

Once the commissioner discharges the onus of proving that a transaction, operation or scheme or change in shareholding or members' interests had the effect of avoiding or postponing tax it is presumed, unless the taxpayer proves otherwise, that he had the requisite purpose of tax avoidance as per section 103(4) which provides that whenever in proceedings relating to an appeal under section 103 it is proved that the transaction, operation or scheme, agreement or change in shareholding or members' interests would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act or any other law administered by the commissioner or in reduction of the amount thereof, it shall be presumed, until the contrary is proved that :

(a) in the case of a transaction, operation or scheme, it was entered into or carried out solely or mainly for the purpose of such avoidance, postponement or reduction;

(b) in the case of any agreement or change in shareholding or members' interests, it was effected solely or mainly for the purpose of utilising the assessed loss inorder to avoid, postpone or reduce the liability for tax.

4.3 WAS ENTERED INTO OR CARRIED OUT - IN THE CASE OF A TRANSACTION, OPERATION OR SCHEME IN THE CONTEXT OF BUSINESS, IN A MANNER WHICH WOULD NOT NORMALLY BE EMPLOYED FOR *BONA FIDE* BUSINESS PURPOSES, OTHER THAN THE OBTAINING OF A TAX BENEFIT.

In the Explanatory Memorandum on the Income Tax Bill 1996 clause.29 it is stated that the Katz

Commission examined the Anti - tax avoidance provisions of section 103 in depth. It specifically referred to the problems specifically experienced with the abnormality test which was seen as not covering the schemes which, although initially abnormal, had through common usage and commercial acceptability become normal and thus fell outside the scope of the section. It later on expressed its concern that there is no disadvantage for taxpayers who enter into a tax avoidance transaction, even if successfully challenged by the commissioner. Therefore the tax commission recommended the introduction of a "business purpose test" to amend the provisions to make them more effective. These recommendations indeed led to the amendment of section 103.

The 'business purpose' phrase was preferred to the concept of 'trade purposes' because the latter would have widened the application of the section and given the commissioner even greater powers to interfere with tax avoidance arrangements. Due to the specific inclusions in the definition of trade (section 1 - "trade") in the Income Tax Act 58 of 1962 the fear that the concept of trade may very well be wider than 'business' as to lead to absurd results seems to be justified.

'Trade' is defined as including every profession, trade, business employment, calling, occupation or venture, including the letting of any property and the use of or the grant of or permission to use intellectual property i.e any patent, design, trade mark, copyright or similar property.

The 1996 Amendment requires a division of schemes between those :

- in the context of business
- and those other schemes which are not in the context of business.

In the light of the amendment, for the anti - tax avoidance provision not to apply to schemes " in the context of business", they must :

- have a bona fide business purpose, other than the obtaining of a tax benefit, and
- not create rights or obligations which would not normally be created between dealing at arms length under schemes of the kind in question.

Therefore a transaction in the context of business will be abnormal either if it was concluded or executed in a manner which is normally employed for bona fide business purposes except to obtain a tax benefit ,or has created rights or obligations which would not normally be created between persons dealing at arms' length. As regards schemes falling within section 103(1)(b)(i)(bb) which do not fall "in the context of business" inorder to avoid the successful invocation of the anti - tax avoidance provision in section 103(1) these schemes :

- must not have been entered into or carried out in a manner not normal in relation to the scheme in question, and

- must not create rights or obligations which would not normally be created between persons dealing at arms length under the schemes of the kind in question.

In the invocation of the extended provisions, the two new phrases to be considered are "business context" and "bona fide business purpose".

4.3.1 BUSINESS CONTEXT

The term "business" is not defined in the Income Tax Act but is included in the definition of "trade" which is defined as including :

"every profession, trade, business, employment, calling, occupation or venture including the letting of property ..."

There has yet been no judicial pronouncement on the meaning to be attached to the phrase "business context". Wessels J in **Modderfontein Deep Levels Ltd v Feinstein**[28] held that:

"To constitute a business there must either be a definite intention at the first act to carry on similar acts from time to time if opportunity offers, or the act must be done not once or twice but successively, with the intention of carrying it on, so long as it is thought desirable."

[28] 1920 TPD 288 @ 291

In **Smith v Anderson**[29] the word business was judicially interpreted as meaning :

"anything which occupies the time and attention and labour of a man for the purpose of profit or improvement."

The existence of a profit motive is not essential as held in **De Beers Holdings (Pty) Ltd v CIR**[30] where Corbett JA pointed out that :

"The attainment of profit is not necessarily the hallmark of the trading transaction. A trader may for commercial reasons be compelled to resell goods at a loss. Conceivably also he may elect to resell goods at a loss inorder to gain some other commercial advantage for his business."

Broomberg argues that "in the context of business", if there is an innocent purpose, it is likely to be found in the function of a particular transaction in the economy of the taxpayer. The taxpayer may be able to prove, for example , that he embarked upon a transaction inorder to secure import permits or labour qoutas, or industrial capacity or to overcome stock exchange committee requirements or indeed to avoid the provisions of some other Act of parliament, like section 38 of the Company's Act : the perennial thorn that bars a company from giving any financial assistance for the purpose of the purchase of any shares in the company.

Therefore the best interpretation of the word 'context' in the phrase "business context" would to give it its natural meaning of "in relation to" or "circumstances in which an event occurs". The courts will be actively interventionist in this regard and will give these word "business context" an interpretation which best suppress the mischief of tax avoidance.

However, the interpretation of the phrase "carrying on business" is instructive to the interpretation by our courts of the meaning "business context". It has been held that the words "carrying on business" must be given their ordinary meaning in the commercial sense. Beadle CJ

[29] (1880) 15 ChD 247 @ 258
[30] 1986(1) SA 8 (A), 47 SATC 229 @30

summarised the enquiry in **Estate G v Commissioner of Taxes**[31] as follows:

> "The sensible approach, i think, is to look at the activities concerned as a whole, and then to ask the question : Are these the sort of activities which, in commercial life, would be regarded as "carrying on business"? The principal features of the activities which might be examined inorder to determine this are the nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, he intention with which the property was acquired. This list of features does not purport to be exhaustive, nor is any one of these features necessarily decisive, nor is it possible to generalise and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances."

Therefore whether or not a person is carrying on business is an inference from the totality of facts and circumstances, which inference is a matter of law. The courts in interpreting the words "business context" will most probably adopt a similar approach.

4.3.2 BONA FIDE

It is doubtful whether the addition of the word "bona fide" to the "business purpose" adds much force to the meaning of "business purpose" except as to clarify that the business purpose must be legitimate and real. In other words it must be done in "good faith".

4.3.3 BUSINESS PURPOSE

"Purpose" is to be distinguished both from "effect" and presumably from "motive" in true sense. A taxpayer may have tax avoidance motive but the relevant transactions may have a business purpose.

Since there has yet been no judicial pronouncement on the meaning of "business purpose" by our

[31] 26 SATC 168 @ 173 - 174

courts, cognisance must be given to jurisdictional models elsewhere in the world learning from their successes and avoiding their mistakes.

The business purpose test originated in **Gregory v Helvering**[32] . The facts in that case were : Miss Gregory owned all stock of United Mortgage Company which in turn owned 1,000 shares of Monitor Securities Corporation. Gregory sought to have Monitor shares sold and to have the proceeds of sale inure to her personal account. To accomplish these results with a minimum of tax liability, Gregory caused United Mortgage to transfer Monitor shares to a newly formed subsidiary, Averill, which was distributed to Gregory and then immediately liquidated, leaving Gregory in possession of Monitor shares which she then sold.

Gregory contended that the formation of Averill and the subsequent distribution of the Averill stock to her was a tax free re - organisation (defined in section 112(g)(1)(i)(B) of Revenue Act of 1928 as including " a transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.") and that the only tax significant transaction was the liquidation of Averill which resulted in a relatively small capital gains tax to Gregory. The subsidiary was brought into being only to die, serving merely as a channel for the passing of desired shares from the holding company to its shareholder.

Despite the fact that the transfer of Averill appeared to meet the statutory language defining a reorganisation, the court held that the distribution of Averill was not a reorganisation, and that Gregory should be taxed as if she had instead received a dividend taxable at a substantially higher ordinary income rates.

The court explained that the reorganisation provision, which speaks of a transfer of assets by one corporation to another, refers only to a transfer made in "in pursuance of a plan of reorganisation" of a corporate business, and not a transfer of assets by corporation to another to another in pursuance to a plan and having no relationship to business.

[32] 293 US 465 (1935)

It went on to state that the transaction which had occurred was "simply an operation having no business or corporate" purpose and as such "the transaction upon its face lies outside the plain intent of the statute."

The apparent instruction to be gained from the court's language is that a transaction which has no business or corporate purpose is not a "reorganisation". Since the *Gregory v Helvering*[33] appeared to make it clear that one of the essential elements of classification as corporation reorganisation was a business purpose, it was claimed that the transaction at issue, lacking the essential purpose, could not be so characterised. *Gregory* case, therefore, lays down a principle of tax law that inorder to fit within a particular provision of the statute a transaction must comply not only with the letter of the section, but must have a business purpose other than a desire to avoid taxes.

A person would argue that she was driven by a significant business purpose, to which any tax advantage would have been secondary. From the standpoint of the commissioner, it is unsatisfactory that a taxpayer who can establish some degree of business purpose may succeed in obtaining the tax advantage without which he would not have acted at all. It must be doubly unsatisfactory that a taxpayer whose tax avoidance purpose is dominant and whose business purpose is slight can be saved by the business purpose of the other party to the transaction. It can therefore be argued that the new amendment as regards the "business purpose" will afford opportunities for tax manipulation. If it evident that a particular loophole is attracting too many avoiders, the Revenue must seek to close it.

The question that faces the courts is whether the business purpose test could be used and sustained where the transaction which is inspired by tax avoidance considerations, has so many abnormal features that it can no longer be regarded as a transaction. In **Burgess v CIR**[34] the court in considering whether the trade requirement was met EM Grrosskopf stated that :

"If a taxpayer pursues a course of conduct which, standing on its own, constitutes

[33] supra
[34] 1993(4) SA 161 (A), 55 SATC 185

the carrying of a trade, he would not in my view, cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage.Of course the position might be different if a transaction:is so affected or inspired by fiscal considerations that the shape and character of the transaction are no longer that of a trading transaction. This is clearly not the case here. As I have pointed out, the shape and character of the transaction in the present case were inspired entirely by commercial considerations."

Therefore, a business purpose will have to be fundamental and significant enough to withstand an attack on the grounds of *de minimis* principle. Although the court in that case was dealing with a trading transaction which is not the issue in our case, the courts decision is relevant in so far as it enunciates that in the light of the business purpose test, a taxpayer's tax avoidance incentives may be so dominantly operating in the mind of the taxpayer as to outweigh the business purpose for entering into a scheme in question.

Also in **CIR v Transport Trading and Terminal Corporation**[35] Learned Hand J stated that:

"in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for no other motive but to escape taxation."

In short, therefore, the business purpose test can be said to apply where there is no business reason at all in engaging in a particular transaction. A transaction lacks a business purpose if its "*raison d'etre*" is tax reduction, avoidance or postponement.

In the UK the business purpose test has long been standing and the "business purpose" test was applied to attack schemes characterised by a series of pre - ordained, interdependent transactions, in which some steps had no commercial purpose, not "no business effect", but were aimed at the avoidance of tax and which in the absence of those particular steps it would have been payable.

[35] (1949)176 F(2d) 570 , 572

It is relevant whether the series of transactions or scheme involves the achievement of a legitimate commercial or business end or effect .

Lord Brightman in his judgment in **Furniss v Dawson**[36] summed up the position as follows:

> "My Lords, in my opinion the rationale for the new approach is this. In a pre - planned tax saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between (i) series of steps which are followed by virtue of an arrangement which falls short of a binding contract, and (ii) a like series of steps which are followed through because the participants are contractually bound to take each step seriatim. In a contractual case the fiscal consequences will naturally fall to be assessed in the light of contractually agreed results ... **Ramsay**[37] says that the fiscal result is to be no different if the several steps are pre - ordained rather than pre - contracted. For example, in the instant case, tax will, on the Ramsay principle, all to be assessed on the basis that there was a tripartite contract between the Dawsons, Greenjacket and Wood Bastow under which the Dawsons contracted to transfer their shares in the operating companies Greenjacket simultaneously contracted to transfer the same shares to Wood Bastow for sum in cash. Under such a tripartite contract - the Dawsons would clearly have disposed of the shares in the operating companies in favour of Wood Bastow in consideration of the sum of money paid by Wood Bastow, with the concurrence of the Dawsons, to Greenjacket. Tax would be assessed, and the base of the Greenjacket shares calculated, accordingly. *Ramsay* says that this fiscal result cannot be avoided because the pre - ordained series of steps are to be found in an informal agreement instead of a binding contract.

The day is not saved for the taxpayer because the arrangement is unsigned or contains the magic words "this is not a binding contract" ... Secondly there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax - not "no business effect."

Courts have acknowledge the point that tax does not exist in abstract i.e it cannot be divorced from practical commercial considerations as in **Gilbert v Commissioner of Internal Revenue**[38] where the court said that :

> "The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does appreciably affect

[36] [1984] AC 494 (HL) 515
[37] WT Ramsay Ltd v IRC [1982] AC 300 (HL)
[38] (1957) 248 F(2d) 399, 411

his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from liabilities that it sought to impose."

4.4 IN THE CASE OF A TRANSACTION, OPERATION OR SCHEME ENTERED INTO IN ANY OTHER CONTEXT, WAS ENTERED INTO OR CARRIED OUT IN A MANNER WHICH WOULD NOT NORMALLY BE EMPLOYED IN THE ENTERING INTO OR CARRYING OUT OF A TRANSACTION, OPERATION OR SCHEME OF THE NATURE IN QUESTION OR ALTERNATIVELY HAS CREATED RIGHTS OR OBLIGATIONS WHICH WOULD NORMALLY BE CREATED BETWEEN PERSONS DEALING AT ARMS LENGTH UNDER THE SCHEMES OF THE NATURE IN QUESTION.

As regards this requirement, the inquiry is still the same as before the 1996 Amendment. Section is couched in very comprehensive terms and before the commissioner can successfully invoke the section he must be satisfied that, having regard to the circumstances under which the transaction, operation or scheme :

- in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the context of business, by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme in question.[39]

- alternatively, has created rights or obligations which would not normally be created between persons dealing at arms length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question.[40]

To make the anti - tax avoidance provision more effective, the test is framed in the alternative so that the Commissioner need only find that one of the abovementioned items has been satisfied

[39] Section 103(1)(b)(i)(bb)
[40] Section 103(1)(b)(ii)

inorder to successfully invoke the provision of section 103(1).

The word "normally" is used in section (103)(1)(b)(i)(aa), section 103(1)(b)(i)(bb) and in section 103(1)(b)(ii) in the context of transaction, operations or schemes which are supposedly or professedly business or trading transactions, operations or schemes and not in the context of transaction, operations or schemes which are admittedly not concerned with trade or business but simply with obtaining a tax benefit as was held in **ITC 1113**[41]
that what must be determined is whether the transaction, operation or scheme is the action of a normal businessman. In that case the court held that no businessman would make a loan where :

(a) interest was left to be agreed upon from time to time :

"...if no agreement could be reached, all that the appellant could have done was to demand payment of the capital sum, which might entail loss of interest in the interim;[42]

(b) and where the security was inadequate :

"... payment of that debt in Northern Rhodesia could never be enforced by X investments, owing to exchange control regulations.[43]

The court's emphasis on the action of a businessman followed from its finding that:

"there are several features of this transaction which were not normal, and which would not have been incorporated in a similar agreement entered into by ordinary businessmen."

In *Smith v CIR*[44] Steyn CJ suggested that the legislature in framing the abnormality test in relation to the question of normality of means, manner, rights and obligations, it must have been inspired by Schreiner JA's remarks in *CIR v King*[45] that the mischief sought to be suppressed by the general anti - tax avoidance section where he stated that :

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[41] 30 SATC 8
[42] supra at page 12
[43] Ibid
[44] supra at page 333
[45] supra at page 216

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

The abnormality test is to be assessed in the context of and taking into account "the circumstances under which the transaction, operation or scheme was entered into or carried out." Secondly, the section enjoins the application of that criterion in relation to a transaction, operation or scheme "of the nature of the transaction, scheme or operation in question". The importance of the relevance of this fact was summarized in *Hicklin v SIR*[46]
by Trollip JA where he stated that :

"What may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. The last observation is that the problem of normality or abnormality of such matters is mainly a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of expert or other evidence adduced thereanent by either party."

The "arms length" requirement and the abnormality test are interrelated as noted in *Hicklin's* case that :

"In an arms length agreement, the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by paragraph (ii). and the means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal in the sense envisaged by paragraph (i)."

In *Hicklin v CIR* [47] the phrase at "arm's length" was held to connote that "each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction of himself. The fact of the matter is, parties to a transaction, are not always in fact at arms length. This is so where the parties are associated with one another e.g they may be

[46] supra at page 495
[47] supra

partners, relatives, associates, or shareholders in the company as in **SIR v Geustyn,Forsyth and Joubert**[48].

In that case Geustyn, Forsyth and Joubert who were practising as consulting engineers since 1961, converted their partnership in 1966 into an unlimited company. The company was formed with a share capital of R 5 000 divided into 5000 shares of R1 each, all of which were issued in equal shares to the taxpayers who were also the sole directors.

The practice of a partnership was sold to the company for a goodwill consideration of R240 000, and the three former partners were each employed by the company at an annual salary of R 10 000. The goodwill consideration valued at R 240 000 was credited in equal parts to the loan accounts of the former partners, at an interest of 8,5% per annum. In addition each taxpayer received an annual director's fees of R 7 500. During the year of assessment up to 28 February 1967, the company's taxable income was R 72 480 on which the normal company tax would have amounted to R 29 136.

The commissioner invoked section 103(1) of the Income Tax Income and taxed the profits of the company in the hands of the taxpayers as he was of the opinion that the formation of the company amounted to a scheme which had been entered into with the object of reducing the liability to pay tax. The commissioner in so doing ,apportioned the total taxable income of the company in equal parts to the partners, and issued the company with an assessment which showed that it had no taxable income for the tax year in question.

The court found in respondents' favour that the provisions of section 103 did not apply and found that there was nothing abnormal in either the aforementioned conversion of a partnership into an unlimited company or in relation to the latter's undertaking to pay
R 240 000 for goodwill. The special court came to the conclusion that there was nothing abnormal with the transaction as envisaged by section 103 of the Act and that the avoidance, reduction or postponement of tax was not a factor which was taken into consideration by the

[48] 1963(3) SA 863 A, 25 SATC 287

partners in deciding to convert its partnership as an unlimited company.

As to the means by which and the manner in which the transaction had been entered into, the court came to the conclusion that the finding of the Special Court that the transaction in question was not abnormal was not one which could not reasonably have been reached from the facts by the Special Court.

Olgivie Thompson CJ went on to say that generally speaking, there is nothing abnormal in transferring an existing partnership business to a company : indeed, such a transaction may fairly be regarded as relatively common - place in the commercial world. That professional men carrying on their profession in partnership should transfer their practice to an unlimited company may no doubt at first sight appear to be somewhat extraordinary.

Not only has the South African Association of Consulting Engineers of which, as already mentioned, the aforenamed three erstwhile partners are members - expressly sanctioned its members forming unlimited companies to conduct their practices, but more than half The Association's membership has already adopted that form of practice.
Similarly, it said that more than half of the twenty eight known non - members who are practising as consulting engineers are at present registered companies. Nor is this peculiar to the Republic; for according to the stated case, the majority of consulting engineers in England. Canada, France, Switzerland and Japan practice in corporate form.

Moreover the stated case shows that the erstwhile partners regarded as considerable the advantages to be derived from incorporation, as contrasted with partnership which was liable to dissolution consequent upon death, resignation and the like. Such advantage *inter alia* embraced the facility of participation in consortiums of engineers engaged upon large projects, the ability to increase the participation in profits by qualified engineer - employees while, at the same time, eliminating the necessity to restrict the number of partners to the legal limit of twenty.

In this last mentioned connection, it is not inapposite to mention that on 1 March 1967 the three

original shareholders in respondent sold 1 500 shares to six new shareholders, each receiving 250 shares. These six new shareholders were all qualified engineers employed by the respondent. The admission of more employee - engineers as shareholders was contemplated, and it was anticipated that the total number of shareholders would in the forseeable future rise to fifteen.

In addition to a salary of R 10 000 per annum each, the three aforementioned erstwhile partners each received a director's fee of R 7 500 for the tax year in issue and interest calculated at 8,5% on their respective loan accounts. All these receipts were, of course, subject to tax.

The figure of R240 000 for goodwill was arrived at by aggregating three year's profits, a computation which, in itself, in not critisized by the Secretary. The absence both of any security furnished by the respondent and of any service contracts binding the erstwhile to continue to work for respondent is explicable by reason of inherent circumstances that the aforenamed erstwhile partners made over their practice to respondent, of which they remained in full control.[49]

As regards the question whether the rights and obligations were created which would not normally be created between persons dealing at arm's length in terms of the transaction of the nature of the transaction in question, where the transaction is of a kind which would not normally be concluded at arm's length between parties, the test could not be applied as it stands. The difficulty encountered in this regard is evident in *Geustyn*'s case[50] where Olgivie Thompson stated that :

> "Section 103(1) is couched in very comprehensive terms, but, in forming his opinion in relation to sub - paragraphs (i) and (ii)[51] of the section, the secretary is required to have regard "to the circumstances under which the transaction, operation or scheme was entered into or carried out". The criterion of the "persons dealing at arms length" mentioned in section 103(1)(ii) is, however, not easy of application in a case such as the present. For the section enjoins the application of that criterion in relation of a transaction, operation or scheme 'of the nature of the transaction, operation or scheme in question'.Yet the court is in the present case *ex hypothesi* concerned with partners who have, in the circumstances outlined above made over their

[49] supra at page 573 - 574
[50] supra at page 574
[51] References to section 103(1)(i) and (ii) to the section before the 1996 amendment. These should be read as references tothe current amended section 103(1) (b)(i)(bb) and (ii) .

practice, not to an independent third party with whom they would ordinarily deal 'at arm's length', but to an unlimited company of which they are sole shareholders and directors and whereof they have full and complete control.

However, in as much as it not essential for the decision of this case to pronounce upon this particular aspect of the matter (which was not exhaustively argued before us), I prefer to express no conclusion upon the point. I shall accordingly assume, without deciding, in favour of the Secretary that ,despite the Special Court's appreciated conclusion that the transaction was 'not abnormal as contemplated by section 103 of the Act',it erred in law in not finding that the transaction in issue 'created rights or obligations which would not normally be created between persons dealing at arm's length' within the meaning of these words as they occur in section 103(1)(ii) of the Act."

The court in **CIR v Louw**[52] considered this issue and concluded that the special relationship between the parties could not be ignored.Corbett JA after quoting from *Geustyn*'s case the passage that the court was *ex hypothes i*concerned with partners who have made over their practice, not to an independent third party but to a company of which they are the sole shareholders and directors, went on to say :

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

'under a transaction, operation or scheme of the *nature of the transaction, operation or scheme in question'* ... (My italics)

For it is of very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as its shareholders and directors the self same partners and will be controlled by them. Those are the realities of the situation. Moreover it must be borne in mind that in a case such as the present the transaction is a multipartite one to which all the partners and company are parties; and each partner contracts both with the company and his fellow partners and seeks to extract from the transaction the best possible advantage for himself. (Here I might point out that this case differs from Hicklin's case supra in that there the court was considering (see 494H - 495F) an agreement which was entered into by parties dealing with one another at arm's length and remarks of *Trollip JA*, particularly at the top of 495, must be read in the light of that fact.)

With this in mind, it does not seem to me that the features stressed by appellant's counsel constitute the

[52] 1983(3) SA 551 A, 45 SATC 113 @574 - 575

creation of abnormal rights and obligations. As to the arrangement that the payment of the purchase price was to be made only as and when the company was in a financial position to do so, there is little else the parties could have done. Initially the company had very limited capital and the idea was that it would pay off the purchase price out of profits. This it proceeded to do over a period of five to six years. Since the sellers were mainly instrumental in earning those profits and were in complete control over the company, it was perfectly sound and businesslike arrangement. It was not an arrangement that would not normally have been created by persons dealing at arm's length in this type of transaction. The same goes for the non - payment of interest on the purchase price."The non - payment of interest increased the profits of the company; and this directly benefited the erstwhile partners as shareholders in the company for it enabled the company to pay off the purchase price more rapidly. Likewise, in the particular circumstances, there was, in my view, no abnormality in the fact that the erstwhile partners gave their services to the company for no previously stipulated salaries. As controllers of the company they were able from year to year to determine in their own interests what their salaries were to be. The fact that in the tax years under review - and in previous years, it would seem - respondent received a salary which was much smaller than his income as a partner had been was again a matter of his own choice, in consultation with his co - directors and co - shareholders."

The court found that subsequent to the incorporation of the company, but independently thereof, the credit loans having been exhausted, the company lent the shareholders large sums of money out of the profits interest - free, and without security and without any definite conditions of repayment. Having regard to all these circumstances ,in terms of
section 103(1)(b), the court held that the director's loans, seen in the context of the amounts allocated to directors by way of salary and dividends, were abnormal both as to the means and manner employed in granting them and as to rights and obligations created thereby. The arm's length principle is thus relaxed as far as necessary to account for the special relationship between the parties.

It would therefore be wise for the taxpayer in executing a tax avoidance scheme to ensure that he takes all the necessary pre - cautions to conclude and execute a transaction in a manner used for business purposes and thus ensure that rights and obligations that ensue are those which would normally be found between parties who are strangers to one another in a transaction and who are striving to get the best possible advantage from the transaction. For example, Broomberg suggests that the parties get papers and all the necessary documentation in order, even though this may be costly it is worth the fuss. Even though the manner employed is that normally used

for business purposes, the court still has to consider whether rights and obligations that ensue are normal.

4.4 THE TRANSACTION MUST HAVE BEEN ENTERED INTO OR CARRIED OUT SOLELY OR MAINLY FOR THE PURPOSES OF OBTAINING A TAX BENEFIT

Inorder to successfully invoke the operation of section 103(1) the commissioner must prove that the transaction, operation or scheme was entered into solely or mainly for the purposes of obtaining a tax benefit. The word 'purpose' must be distinguished from both the 'effect' and presumably from 'motive' in the true sense. A taxpayer may have a tax avoidance motive but the relevant transaction may have an overriding non - fiscal advantage. 'Purpose' as used in section 103(1)(c) connotes the reason in the taxpayer's mind for undertaking the transaction i.e his object for undertaking the transaction and although a scheme may have the effect of obtaining a tax benefit, this effect objectively speaking of avoiding, postponing or reducing liability for tax is not necessarily the purpose for which the scheme was entered into.

As noted in **CIR v Pick 'n Pay Employee Share Purchase Trust**[53] that in a tax case one is not concerned with what possibilities apart from his actual purpose, the taxpayer forsaw and with which he reconciled himself. One is solely concerned with his object, his aim and his actual purpose.

Given the subjective nature of purpose it is clear that of utmost importance in ascertaining the purpose of the scheme would be the evidence of the taxpayer, the progenitor of the scheme, as to why it was carried out. Therefore, the onus in terms of section 82 of the Income Tax Act rests on the taxpayer to establish on balance of probabilities, that he did not have the purpose set out in section 103(1)(c).

As Colman J observed in **SIR v Gallagher**[54] that the court is not bound to accept what the taxpayer says, even on oath, with regard to his intentions at a particular time or with regard to

[53] 1992(4) SA 39 (A), 54 SATC 271
[54] 1978(2) SA 463 (A), 40 SATC 39 @472

any other matter and further noted that :

> "That is true. But, on the other hand, the sworn testimony of a witness, given with the appearance of truthfulness and condour, is not lightly to be discarded unless some reason appears for disbelieving the witness. What he says may be discarded if there is credible evidence to the contrary, or if there are such weighty probabilities against what he has deposed to that the court does not feel justified in accepting his evidence. A witness may be found to have been wilfully untruthful, or he may be found to have been mistaken or confused."

Therefore, the taxpayer's credibility on this matter will be tested by an inquiry into whether there existed objective reasons, unconnected with tax avoidance, for carrying out the transaction.

Section 103(1)(c) is clear that the requisite tax avoidance purpose under section 103(1) must be a sole or main purpose for entering into or carrying out a scheme, operation or transaction in question.

If the transaction entirely lacked such a purpose of obtaining a tax benefit, or if it was present merely as an incidental or secondary purpose, section 103(1) would not be applicable as in *SIR v Geustyn, Forsyth and Joubert*[55] where the court held that , on the facts, there existed various reasons, quite unrelated to the incidence of tax, in
favour of converting the partnership into a company. These reasons included advantages of practising in corporate form such as eliminating the necessity to restrict the number of partners to the legal limit of twenty; to increase the participation in profits by qualified engineer - employees and the facility of participation in consortiums of engineers engaged in large projects.

CHAPTER 5

POWERS OF THE COMMISSIONER UNDER SECTION 103(1) : DETERMINING THE

[55] supra

LIABILITY FOR THE PAYMENT OF TAX

If all the requirements for the application of section 103(1) are present, the commissioner is obliged to determine the liability for any tax, duty or levy imposed by the Act, and the amount thereof in one of the two manners :

(a) as if the transaction, operation or scheme had not been entered into or carried out; or

(b) in such a manner as in the circumstances he deems appropriate for the prevention or diminution of the avoidance, postponement or reduction of tax.

The first requirement can be interpreted in the light of **Newton v COT**[56] where the Privy Council in interpreting the Australian tax avoidance section which provides that the arrangement which has the effect of avoiding liability for tax is void against the commissioner, was as annihilating one and that it was not enough to ignore the transactions which had the effect of tax avoidance; the ignoring of the transactions did not in itself create a liability for tax.

The commissioner had to find income in the hands of the taxpayer as Lord Denning put the matter in the following :

> "In this case what is meant is that the commissioner is entitled to disregard the arrangement - and the ensuing transactions - so far as they have the purpose or effect of avoiding tax. In the words of courts of Australia, it is an "annihilating" provision - the commissioner can use the section so as to ignore the transactions which are caught by it. But the ignoring of the transactions - or the annihilation of them - does not itself create a liability to tax."

While *Newton's* case may afford some guidance in the interpretation of the first mentioned commissioner's powers, it has no bearing on the words which confer discretion on the commissioner as noted in *Meyeworitz* case[57] that the alternative provision empowering the commissioner to tax in such a manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction distinguishes the

[56] (1958) 2 ALL ER 759 (PC)
[57] supra

South African section from the Australian position.

The first remedy entitling the commissioner to determine the liability to tax 'as if the transaction, operation or scheme has not been entered into or carried out' was applied in Smith's case[58]. In that case the taxpayer expected a dividend to be paid on shares which he held in the T company. He then incorporated companies A, B and C, which he controlled. The taxpayer sold the shares in the T company to company C. The dividend declared by the T company duly accrued to C company which declared a similar dividend to company B; but no dividend had yet been received by the taxpayer.

The commissioner relying on his 'annihilating' powers, ignored the incorporation of the intermediate companies B and C and assessed taxpayer's liability for tax as though he had received the dividend declared by the T company on the basis that had it not been for the offending transactions entered into, the dividend declared by the T company would have come into the taxpayer's hands and he would have been liable to tax thereon.

The commissioner's powers under section 103(1) to determine liability for payment of tax and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out have been held to empower the commissioner to select those parts of the transaction as is objectionable and which he wishes to ignore for tax purposes, while allowing others to stand for this purpose, so long as he does not act a so as to expose the taxpayer to double taxation as laid down in **H v COT**[59] that :

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

[58] supra
[59] 1972(2) SA 719 (RAD),34 SATC 39

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

This decision is the correct statement of the commissioner's powers, both alternatives presuppose the existence of income which can be taxed in the hands of the taxpayer by removing or ignoring all or part of the structure erected by the taxpayer in terms of the transaction, operation or scheme in question. It is considered that this does not empower the commissioner to create, or to subject to tax notional income which in fact does not exist as the court noted in Meyeworitz case[60] that :

"to restore the company notionally to the register and then to attribute to it a notional income would in these circumstances be an extremely artificial and unrealistic manner of determining the appellant's liability to tax, I cannot think that section 90 [now section 103] intended such a result."

Similarly the commissioner cannot exercise his powers under section 103(1) so as to increase tax.

The court in **CIR v Louw**[61] took a contrary view and held that the commissioner was entitled to apply section 103 to the loans *simpliciter* and assess the taxpayer's additional income tax liability accordingly and in so doing he would determine what amount, but for the loans, the taxpayer would have received by way of an additional salary and/or dividend from the company in each of the tax years in question.

This approach empowers the commissioner to act ultra vires and to create taxable income which does not in fact exist and subjecting to tax of loans which are amounts amounts of a capital nature and which clearly do not form part of the gross income.[62]

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[60] supra
[61] 1983(3) SA 551 (A), 45 SATC 113
[62] Silke at paragraph 19;14 is of the view that the commissioner has not the power under section 103(1) to change the nature of the receipt from capital to income and subject the taxpayer to tax as if he had received income.

CHAPTER 6

SECTION 103(2) : TRAFFICKING IN ASSESSED LOSS AND THE COMMISSIONER'S POWERS TO DISALLOW A SET OFF OF COMPANY'S ASSESSED LOSS AGAINST INCOME.

'Assessed loss' means any amount by which the deductions admissible exceeded the income in respect of which they are so admissible.[63]

Section 103(2) was enacted inorder to counter a tax avoidance transaction commonly known as "trafficking an assessed loss".

Section 103(2) provides that :

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

The mischief which section 103(2) sought to remedy is laid out by D.M Steward in his article 'The Prohibition of Tax Avoidance : An Evaluation of Section 103 of the South Africa Income Tax Act, 58 of 1962'[64] where he states that :

> "The reason for this subsection is that elsewhere in the Act [section 20] it is recognized that to divide a taxpayer's business up into separate yearly compartments is largely artificial, and, as a result, where in one year allowable

[63] Section 20(2)
[64] (1970) 3 CILSA 168 @189

deductions exceed income, the taxpayer may carry the balance of deductible excess forward as an "assessed loss". This loss may be deducted from income earned in the next or subsequent year. As a result, certain taxpayers, whose businesses have failed to profit, build up large assessed losses. Where these taxpayers are individuals the Revenue has nothing to fear for the assessed loss is not itself transferable, but where the taxpayer is a company, whose shares can readily change hands, new proprietors will attach themselves to the company and inject new income into it inorder to exploit the assessed loss. It is this "trafficking" in the shares of companies with assessed loss which gave rise to the enactment of section 103(2)."

Therefore, before section 103(2) can apply the commissioner must be satisfied of the following :

(a) an agreement affecting any company has been entered into; or

(b) a change in the shareholding of any company or in the members' interests in any close corporation has taken place; and

(c) as a direct or indirect result of the agreement or change in shareholding, income has been received by or has accrued to the company concerned during the year of assessment; and

(d) the agreement has been entered into, or the change in shareholding effected solely or mainly for the purpose of utilising any assessed loss or any balance of assessed of loss incurred by the company concerned inorder to avoid liability, or to reduce the amount of that liability, for the payment of any tax, duty or levy on income by the company concerned or any other person.

The section may only be successfully invoked if the above requirements are satisfied.

Section 103(4) further provides that where it is proved that the agreement or change in

shareholding or reduction or postponement of liability for the payment of any tax imposed by the Act or under any other Act administered by the Commissioner, it is presumed, until the contrary is proved, that the agreement or change in shareholding was effected solely or mainly for the purpose of utilising the assessed loss concerned to avoid, reduce or postpone liability for tax.

In terms of section 103(2) a set off is claimable unless the sole or main purpose is the avoidance or reduction or postponement of liability for tax. In other words, for the section to operate the avoidance, reduction or postponement of liability for tax must at least have been the principal purpose of the taxpayer. If a sound commercial reason can be advanced, that the taxpayer was moved by non - tax considerations to take over the company with an assessed loss ,and if it can be shown that the existence of the assessed loss was merely incidental to the main purpose of the transaction or scheme, section 103(2) will not apply.

As Meyeworitz that if for example the main purpose was to obtain the benefit of the company's assets, or goodwill, or trademarks, permits and the like, in other words, if there was some good business reason for the agreement or change in shareholding, the fact that the assessed loss was also taken into account, but was merely subsidiary, will not invoke the operation of section.[65]

In **ITC 983**[66] all the shares in the appellant company which manufactured clothing were bought by another company in the same line of business which also manufactured clothing. The appellant company had an assessed loss. During the year that ended on 30 June 1958, the appellant company ceased its activities, but recommenced the business of clothing manufacturing which it had previously carried on, during the following tax year. The company manufactured garments at a fixed price per article for the controlling company.

The company showed a profit of *L* 3 839. Purporting to act in terms of section 90(1)(b) [now section 103(2)] of the Income Tax Act, the commissioner refused to allow a set off of an assessed loss brought forward in determining the taxpayer's taxable income for the year ended 30 June 1959 and assessed the taxpayer in respect of a taxable income of *L* 3 839.

[65] paragraph 29.11
[66] 25 SATC 55

On appeal the taxpayer succeeded because the court was satisfied that although the avoidance or reduction of tax was one of the purposes, it was not the main purpose *inter alia* the object of utilising the assessed loss to diminish the amount of tax payable was subordinate to the main purpose with which the shares had been acquired, that is, to increase the efficiency and productivity by acquiring a production unit which could go into immediate operation to supplement the taxpayer's own production capacity.

Broomberg[67] warns that in such cases it would be more than dangerous to refer to an assessed loss in the agreement of sale , for example, by way of inserting a warranty by the seller that the assessed loss is "good" or by providing for a reduction in the purchase price if the assessed loss is forfeited or paying more for the shares in the assessed loss company than they are worth.

Section 103(2) applies not only to income diverted from another entity to the taxpayer, but also to income produced by by the company's own activities as a result of change in shareholding. The view that section 103(2) did not apply where the company with an assessed loss commenced a new business thereby earning fresh income because the new shareholders are able to and do conduct the business more efficiently or undertakes anew enterprise or venture, was rejected in **ITC 1123**[68] .

In *ITC 1123*, the taxpayer acquired control of the appellant company which had a large assessed loss at the time when the company had no finance, no assets, no liabilities, no premises, and at a time when its business of manufacturing had ceased. To this company he divested income from other sources and launched it upon an entirely new kind of business and the same time caused the company to commence earning income afresh on its own behalf.

While the counsel for the appellant company was of prepared to concede that the divested income was wholly taxable, he submitted that the assessed loss ought to be set off against the remaining income. Trollip J, however was of the opinion that the section was drawn broadly enough to catch both types of income and considered that section 103(2) was wide enough to

[67] at page 217
[68] 31 SATC 48

include income produced by the company with an assessed loss by its own activities in contradistinction to income diverted to it.

Trollip J, further remarked that :

> "The section was intended to apply where income was diverted from another person to a company inorder to avoid liability for tax on their part of that person is clear from its very language. But its wording is wide and there is no warrant for limiting its application to such cases. It refers in the first place to 'income ... received by or ... accrued to that company during any year of assessment ...'. That is wide enough to include income produced by its own activities in contradistinction to avoiding liability for tax 'on the part of ... any other person'; that shows not only diverted income but income produced by the company's own activities can fall within the ambit of the section if other requirements are fulfilled."

As to the submission that where a company with an assessed loss earned income afresh by the company's own activities, it thereby rendered itself immune from any charges of tax avoidance, Trollip's brief answer was that tax avoidance lay in the exploitation of an assessed loss created by the "old and discontinued business of the company under its erstwhile shareholders."

By utilising such an assessed loss the new proprietor was avoiding tax on income which he would otherwise have had to pay. Otherwise, as the court pointed out, the income from a new and unrelated type of business started by new shareholders of the company with the assesses loss who acquired the shares solely or mainly for the purpose of using loss would escape taxation.

The section envisages continuity in setting off of assessed loss. Where, in any year of assessment, for any reason this continuity was interrupted, then there was no 'balance of assessed loss" for that year which was capable of being carried forward into the following year. In other words, the essential continuity was fatally interrupted as held in **New Urban Properties Ltd v SIR**[69] . In that case Beyers JA explained that the fatal interruption could occur in two ways :

[69] 1966(1) SA 219 (A), 27 SATC 175

> "In the *SA Bazaars* case[70] that interruption occurred through the taxpayer ceasing to trade in a particular year and therefore it was not competent for it to set off in its income tax return for that year the balance of assessed loss incurred by it in the previous years. In the present case it has occurred through the operation of section 90(1)(b) [the forerunner and, substantially, equivalent of section 103(2)] which prohibited the balance of assessed loss from being set off against the only income received by the appellant, in respect of the only trading activities conducted by it."

The effect of the section was, therefore, not merely to disallow the set off for the year of assessment concerned, but to eliminate or extinguish it altogether in the same manner as if trading had not been carried on during the year of assessment in question in terms of section 20(1)[71]

The section expressly provides that the set off which is to be disallowed is not against *all* the income of the company concerned, but only against 'such' income as is caught by the section and if a company should have any other income, its assessed loss may be set off against such income.

For clarity, we have to distinguish between 'tainted' income and 'untainted' income. Income which falls foul of section 103(2) or which for any reason cannot be set off and balanced in any particular year, is called 'tainted' income and in that year the carrying forward of an assessed loss is "fatally interrupted"[72] and if the company does not earn any 'untainted' income for the whole of the year of assessment, then the assessed loss is irretrievably lost.

If the income of the current year of assessment includes both 'tainted' and 'untainted' income, then losses incurred in the current year of assessment and the balance of the prior year's assesses losses can be set off against the untainted income. Thus it is possible for a company to be issued

[70] SA Bazaars (Pty) Ltd v CIR 1952 (4) SA 505 (A), 18 SATC 240
[71] SA Bazaars case supra
[72] SA Bazaars case and New Urban Areas case supra

with two assessments by the commissioner : one showing income which is not set off against and the other reflecting the position after income which is not affected by section 103(2) has been set off against the assessed loss.

Therefore, the tax planning implications are clear : it is possible to preserve assessed loss and keep it alive by reason of a continued cashflow of untainted income from a business conducted before and after section 103(2) attack and which business continues unchanged after the successful section 103(2) attack. It is therefore important that the target company retain pre - existing assets which are capable of generating 'untainted' income and which will continue to produce 'untainted' income inspite of the successful section 103(2) attack.[73]

The words 'any agreement affecting any company' in section 103(2) cannot be restricted to agreements affecting the control of the company or affecting any person's right to participate in the profits or dividends of the company.

In **CIR v Ocean Manufacturing Ltd**[74] the court was of the opinion that section 103(2) should be construed in such a manner as to advance the mischief against which it was directed and that there was nothing in section 103(2) to suggest that the word "any" should be used in the limited sense.

The court held that section 103(2) was applicable even where there was no change in the shareholding of taxpayer's company, but an agreement was entered into whereby the existing business that was conducted by the corporate shareholders of the company with an assessed loss was sold to the latter company inorder to utilise its assessed loss for tax avoidance purposes. Therefore, where there has been a change in the shareholding, section 103(2) can apply even if the agreement or change in shareholding was not the cause of the subsequent earning of income.

In **Conshu (Pty) Ltd v CIR** [75] Harms J held that the word "income" used in the introductory

[73] Broomberg on page 219 : Tax Strategy
[74] 1990(3) SA 610 (A), 52 SATC 151 @2 618
[75] 1994(4) SA 603 (A), 57 SATC 1

part of section 20(1) is not used in its defined sense but rather as the income taxable but for the set off. In other words a set off in terms of section 20 can only arise if there would otherwise have been taxable income i.e a pre - tax profit. That is, to determine whether an assessed loss exits in any year of assessment in carrying on in the Republic any trade, one has to subtract deductions from income as defined i.e gross income minus exempt income; then further minus deductions from income and see whether one gets a positive amount (taxable income) or a negative amount of a deductible excess which represents an assessed loss.

Harms JA's use of the word "pre - tax profit" must not be interpreted to mean that if losses are made in successive years the assessed loss from the previous year would be lost merely because the taxpayer showed no profit in the following tax year. According to section 20(1)(a) a balance of assessed loss incurred in any previous year of assessment can be carried forward from the preceding year provided the taxpayer preserves untainted income so that in each succeeding year a balance can be struck to the satisfaction of the commissioner which can then be carried forward from year to year until it is exhausted.

The point that continuity in setting off assessed loss can be maintained even if the taxpayer shows no profit in the succeeding year of assessment is illustrated by Schreiner's dicta in **Louis Zinn Organisation (Pty) Ltd**[76] where he stated the position as follows :

> "Wherever there has been a trading loss in the tax year, or where there has been a balance of assesses loss brought forward from the previous year, there has to be a determination of a balance of assessed loss to be carried forward into the next year. There may have been a profit in the tax year but not large enough to obliterate the balance of assessed loss carried over from the previous year. Then the new balance of assessed loss will be smaller than the previous one. If there has been a working loss in the tax year the balance to go forward will be increased."

The Commissioner has no time limits at to when he can invoke section 103(2) i.e irrespective of when a section 103(2) agreement was entered into. In *Conshu* case[77] the question before the court

[76] 1958(4) SA 477 (A), 22 SATC 85 @485 - 486
[77] supra

concerned the time as to when the Commissioner was entitled to exercise his discretionary powers i.e whether the Commissioner not having applied the provisions of the section during the year of assessment in which the section 103(2) agreement had been entered into, was entitled to apply it in respect of the succeeding year of assessment.

If regard is had to the wording of section 103(2) tax avoidance provision, in the light of the mischief which it seeks to remedy, it contains no limitation as time and does not state that failure by the Commissioner to have applied section 103(2) provisions in the year of the agreement bars him from doing so in any future year of assessment.

Harms JA noted that there was :

> "...no occasion for the Commissioner to disallow the set - off of any assessed loss or balance of assessed loss during the 1985 year of assessment. In addition, the taxpayer had no taxable income during 1985 against which the assessed loss could have been set off."

He further concluded the position as follows :

> "To hold that because the Commissioner could not have applied section 103(2) to the 1985 year entails that he could also not have done it in relation to 1986 would be destructive of the purpose of the provision. It would also allow for the evasion of the provision."

The operation of section 103(2) can be summed up as follows :

> (a) The section applies to any agreement of any kind which affects a company, whether that agreement relates to shareholding, dividends or any other aspect of the company or its business and is not restricted to an agreement which affects the control of the company or one which affects any person's right to participate in the profits or dividends of the company.

The initial requirement is therefore all embracing and widely stated and should , therefore, be construed in such a way as to advance the remedy provided by the section and suppress the mischief against which the enactment is directed. This will bring within the net of the section

every transaction or agreement of any sort entered by a company with an assessed loss and affecting the company itself.

(b) It is common cause that in addition to the first requirement, the transaction must lead to the receipt or accrual of income in the company. Given the fact thatconsiderable trafficking in company' s losses has the effect of enabling taxpayers to reduce their tax liability by transferring profitable businesses to companies which they have taken over with accumulated assessed losses, usually income is received on which tax would otherwise have been payable but for the agreement or change in shareholding.

The requirement is not met if any agreement, change in shareholding or transaction entered into does not give rise to the receipt or accrual of income to the company in consequence thereof.

(c) Finally, of importance is the existence of the tax avoidance purpose of trafficking in assessed loss which must be satisfied for the successful invokation of section 103(2), unless the taxpayer can prove existence of some commercial or business reason unrelated to the incidence of tax for the agreement or transaction carried out.

In terms of section 103(4) of the Act, any decision by the commissioner in terms of section 103(2) is subject to objection and appeal.

Section 103(4) in addition provides that when in the proceedings relating to such an objection and appeal it is proved that the agreement, change in shareholding or members' interests in question would result in the avoidance, or the postponement of liability for payment of any tax, duty or levy imposed by the Act or any other law administered by the commissioner, or in the reduction of such tax, duty or levy, it is presumed until proved otherwise, that the agreement or change in shareholding or members' interests was entered into or effected solely or mainly for the purpose of utilising the assessed loss or the balance of assessed loss in question, inorder to avoid, reduce or postpone the relevant tax liability.

The onus is on the taxpayer to prove the contrary on balance of probabilities.If section 103(2) is successfully invoked, section 103(6) provides that where the transaction, operation or scheme was entered into or carried out, or the agreement was entered into or effected after 2 July 1996, the commissioner is prohibited from remitting, in terms of section 89quat(3) or (3A), any interest payable on the shortfall in provisional tax because of the successful application of section 103(2).

CHAPTER 7

SUCCESSFUL APPLICATION OF SECTION 103 : IMPOSITION OF SECTION 89QUAT INTEREST

Before the 1996 Amendment the taxpayer had nothing to lose on successful invokation of section 103 but at worst was burdened with the liability for tax which he would have borne in the first instance had he not entered in the section 103 tax avoidance scheme. The discretion granted to the commissioner in terms of section 89 quat (3) and (3A) whereby he may direct that interest shall not be paid has been seriously circumscribed.

With effect in respect of the transactions, operations or schemes entered into or carried out after 2 July 1996[78], section 103(6) prohibits the commissioner from exercising his discretion in terms of the provisions of section 89quat(3) or (3A) so as to direct that interest shall not be payable in respect of so much of the tax as is attributable to the application of section 103.

Section 89quat provides for interest to be paid on the shortfall between the amount of tax assessed in respect of a year of assessment and the provisional tax paid in respect of that year of assessment; but subsections (3) in particular require the commissioner to exercise his discretion, if he is satisfied that the circumstances warrant such action, to direct that no interest should be paid in respect of the shortfall to the extent that it can be attributable to tax on the amount of

[78] The promulgation of the Income Tax Act 36 of 1996

income not included by the taxpayer in her return or a deduction or allowance claimed by her where she had on reasonable grounds contended that the amount should not have been included or that the deduction or allowance should have been allowed.

According to A.R. Ilersic[79] in his article on tax avoidance he stated that :

> "people must be made to understand that if they defraud the Revenue they are committing a mean and despicable offence against every one of their fellow taxpayers. The offender should be made by his punishment to feel the ignominy and disgrace attaching to the crime he has committed."

Therefore, the mischief sought to be cured by the enactment of section 103(6) in imposing interest is that, after a period of grace in which the exact liability for tax may be calculated, the taxpayer enjoys the use of moneys due to the Revenue and so should be charged interest. The taxpayers will thus in the light of section 103(6) think twice before implementing a tax avoidance scheme because failed schemes either of a general nature or concentrated upon use of assessed loss will fall foul of section 103(6) and the taxpayer will have to pay normal tax and also interest on it, calculated under section 89quat.

Therefore, section 89quat interest is more than just an interest payable but it is also a penalty.

7.1 CONSTITUTIONALITY OF SECTION 103(6)

Meyeworitz[80] expressed his concern that section 103(6) can be challenged as unconstitutional. He states that the denial of the benefit of section 89quat(3) to a taxpayer merely because section 103 is applied without regard to the reasonableness of his grounds is unfair discrimination and cannot be supported as an exception to the equality clause section 9 of the Final Constitution, which directs that no person shall be discriminated against directly or indirectly, as being reasonable and justifiable in terms of section 36 of the Final Constitution.

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[79] 1979 on page 35
[80] at paragraph 29.5A

Tax avoidance is not a culture that we should encourage and the growth of this industry has led to loss of millions. Tax avoidance leads to decline in public morality, it lowers respect for law and for decent communal behaviour. It forces the Revenue to spend much time, more money and effort in devising and amending tax statutes and complex administration and inspection systems like South African Revenue Services.

Seen in this context, imposition of section 89quat interest on section 103 schemes seems justifiable and reasonable in an open and democratic society under section 36(1) of the 1996 Final Constitution.

Of relevance, also, is the decision of the court in **Mirhadizadeh v Ontario**[81] where Blair JA described the Canadian position, as regards the Equality Clause, as follows :

> "The mere fact that legislation may treat one group of Canadians differently from another is not sufficient to invoke the protection of the section. Indeed *Andrew*'s[82] judgment recognizes the obvious fact that governments and legislatures must make distinctions and treat groups differently.
>
> As McIntyre J said at page 13 : it is not every distinction or differentiation in treatment of law which transgress the equality guarantees of Section 15 of the Charter. It is, of course obvious that the legislatures may - and to govern effectively - must treat different individuals and groups in different ways. Indeed, such distinctions are one of the main preoccupations of the legislatures. The classifying of individuals and groups, the making of different provisions respecting such groups, the application of different rules, regulations, requirements and qualifications to different persons is necessary for governance of modern society."

Of importance also is a passage by Greene, M.R., in the judgment of the court in case of

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[81] (1989) 60 DLR (4th) 597 @600
[82] Andrew v The Law Society of British Columbia 1989(1) SCR 143

Lord Howard De Wadde v Inland Revenue Commissioners[83] , where he stated :

"For years a battle of manoeuvre has been waged between the Legislature and those who are minded to throw the burden of taxation off their shoulders on to those of their fellow subjects. In that battle the Legislature has often been worsted by the skill, determination and resourcefulness of its opponents of whom the present appellant has not been the least successful. It would not shock us in the least to find that the Legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers."

CHAPTER 8

OBJECTION, APPEAL AND ONUS

A decision of the commissioner in regard to the anti - tax avoidance sections, sections 103(1) and 103(2), is subject to objection and appeal.[84]

The presumption in section 103(4) casts a burden of proof on the taxpayer, creating a presumption in favour of the commissioner. The onus is discharged on balance of probabilities. Since this presumption arises only when it is proved that the avoidance, postponement or reduction of tax would result from the transaction, operation or scheme [in terms of section 103(1)], or the change in shareholding or agreement affecting the company [in terms of section 103(2)], it is considered that the onus of proving this effect lies on the commissioner.

The onus of proving the abnormality of the transaction, operation or scheme also lies upon the commissioner. In *Hicklin v SIR*[85] the court noted that the issue of normality and abnormality was mainly a factual one , and stated that :

"The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence adduced thereanent by either

[83] [1942] 1 KB 389 at 397
[84] section 103(4) of the Income Tax Act 58 of 1962
[85] supra

party. It is unnecessary to decide what happens if at the end of the day, because of the lack of its own knowledge or such evidence, the court cannot resolve the problem."

This is in contrast to the normal rule that the onus lies upon the taxpayer.[86] Moreover, since it is the commissioner in terms of the Act, who must form an opinion that the transaction, operation or scheme is abnormal, it seems reasonable that the onus of so proving should lie with him.

CHAPTER 9

ARTIFICIAL TAX AVOIDANCE : SUBSTANCE OVER FORM - A NEW APPROACH TO TAX AVOIDANCE

On the issue of simulated transactions entered into for the purposes of obtaining a tax benefit, Silke[87] correctly states the position as follows :

"As regards disguised transactions entered into for the purpose of tax evasion, the fiscus is sufficiently protected by common law, in that a court will not hesitate to strip the transaction of its disguise and expose the true nature or substance of the contract."

There are principles under which tax avoidance or tax planning schemes may be open to attack under the common law :

(a) The 'sham' principle,
(b) The 'substance over form' approach, and
(c) The principle of 'lifting the corporate veil'

(a) A sham transaction is one that never occurred. The transaction is ineffective, regardless of what would otherwise be the true legal nature of the transaction. Frequently a transaction will be disregarded because it is fraud or nullity, rather than a sham. But occasionally the courts will ignore or give a different effect to the transaction on the basis that although it appears to be real

[86] section 82
[87] Silke on South African Income Tax 11 Mem Ed (1989) at paragraph 19.1 @ 19 - 2

and effective, it is not what it is made out, to the world, to be.

(b) If not a sham, a scheme may likely be open to attack under the second principle of common law, which is now very important following the judgment in **Erf 3183/1 Ladysmith and another v CIR**[88]. In **Dadoo Ltd and others v Krugersdorp Municipal Council** [89] Innes CJ stated the principle of substance over form as follows :

> "A transaction is *in fraudem legis* when it is designedly designed so as to escape the provisions of the law, but falls in truth within these provisions. Thus stated the rule is merely a branch of the fundamental doctrine that the law regards the substance rather than the form of things - a doctrine common, one would think , to every system of jurisprudence and conveniently expressed in the maxim *plus valet quod agitur quam qoud simulate concipitur.*"

The idea is that the courts and the commissioner may disregard the strict legal consequences of a particular transaction in a tax avoidance exercise ,representing the form, and will instead look to the economic reality, the substance and the end result of the scheme in question.

(c) The 'lifting of the corporate veil' principle can be invoked only where an avoidance exercise involves the use of a company. The basis of the principle is that in certain circumstances the separate legal personality enjoyed by the company can be ignored, so that the acts and assets of the company may be treated as those of its shareholders. Given the wide application of the 'form over substance' approach, the lifting of the corporate veil principle is likely to be of less practical importance in the field of tax avoidance because the 'substance over form' approach can often achieve for the Revenue all that the 'lifting the corporate veil' principle can similarly achieve.

This was the case in **Long Oak Ltd v Edworks (Pty) Ltd** [90] where the court found that the plaintiff company was infact an instrument created by Horne which was being used by him to conduct his own personal affairs. The court observed that notwithstanding the existence of the

[88] 1996(3) SA 942 (A), 58 SATC 229
[89] 1920 AD 530 @547
[90] 1994(3) SA 370 (SE)

plaintiff company as a separate legal persona (juristic person), the existence of a company used merely as a mask to hide the features of some other person, will be ignored.

9.1 THE UNITED KINGDOM POSITION

In the United Kingdom there is no statutory general anti - tax avoidance measure, but the courts became highly interventionist and developed a 'substance over form' approach in an attempt to curb tax avoidance. Sir Peter Millett in his article on "Artificial Tax Avoidance"[91] notes that 'by the 1970's, sophisticated tax avoidance had reached such heights of artificiality and absurdity, that many schemes, brilliantly concerned and executed by leading practitioners, cried aloud for the simple person's reaction : Don't be silly!'

The basic principle, for which the classic authority was the *Duke of Westminster* case[92], was that the form of transactions could not be ignored whatever the underlying substance. In the *Duke of Westminster* case the Duke had executed deeds of covenant in favour of employees of an amount equal to their wages, on the understanding that the employees would accept payment under the covenants *in lieu* of wages. The Revenue challenged the scheme, arguing that the Duke ought not to be allowed to deduct the payments made under the covenant, because they were in substance payments as wages instead of covenanted payments, he should be taxed 'as if' he had done so.

This argument was rejected. It was held to contravene the fundamental principle that a person must be taxed by reference to what he or she has actually done, and not by reference to what she or he might have done, but did not do, to achieve the same result. Lord Russell, after stating that the Inland Revenue conceded that the deeds were genuine and thus not a sham went on to say :

> "The commissioners and Mr Justice Finlay took the opposite view on the ground that, as they saw it, looking at the substance of the thing the payments were payments of wages. This simply means that the true legal position is disregarded and a different legal right and liability which the parties have created ... If all that is meant by the doctrine is that having

[91] (1988)5 Australian Tax Forum on page 8
[92] 19 TC 490, [1936]AC 1

once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability and non - taxability in accordance with legal rights, well and good...If on other hand 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 rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine."[93]

On the other hand. Lord Tomlin in dismissing the Revenue's arguments stated that :

"This so called doctrine of '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 sought from him is not legally claimable."[94]

Lord Tomlin's use of the word 'substance' in the *Duke of Westminster* case was misunderstood as authority for the proposition that, in English tax law, form was to be preferred to substance and gave rise to two allied and dangerous myths :

- that in tax cases, to an extent unknown in other areas of law, form prevails over substance; and
- that the substance of the transaction and the only thing to be regarded, is its legal effect.

The doctrine of substance over form was formulated by the House of Lords in **W .T Ramsay v Inland Revenue Commissioner**[95]. Lord Wilberforce said :

"Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance.This is the well known principle of *IRC v Duke of Westminster* ... This is the cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at the document or transaction in blinkers isolated from

[93] @25
[94] @20
[95] [1982] AC 300 [HL]

any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as whole, there is nothing in the doctrine to prevent it being so regarded : to do so in not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded."

Lord Wilberforce[96] in *Ramsay's* case finally destroyed the myth of *Duke v Westminster* saying :

'It is true that the taxpayer must be taxed by reference to what he or she has actually done, not only by reference to what he or she might have done to achieve the same result.
But in ascertaining what the taxpayer has done, it does not follow that a preordained series of transactions, planned and carried through as a whole, must be broken up into its several steps before applying the statute to each step separately. It is now clear that this approach is wrong.

Where there is a single, preordained, composite transaction intended to be carried through as a whole, and no likelihood in practice exists that it will not, the court must consider the scheme as a whole and is not confined to a step by step examination...To force the courts to adopt, in relation to closely integrated situations, a step by step, dissenting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process...*viewed as whole, a composite transaction may produce an effect which brings it within a fiscal provision.*[my emphasis]"

In *Ramsay* case, the court did not rely on the presence of tax avoidance motive, but on the absence of any purpose or effect other than the avoidance of tax.

Lord Diplock in **IRC v Burmah Oil**[97] noted that :

[96] Ramsay case supra
[97] [1982]STC 30

"it would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume that *Ramsay's* case did not mark a significant change in the approach adopted by this House in its judicial role to a pre - ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable."

Similarly, Lord Scarman in *Furniss v Dawson*[98] correctly noted the importance of the judicial role in curbing tax avoidance schemes stating as follows :

> "[The] legal profession (and others) must understand that the law [concerning the *Ramsay* doctrine] is in an early stage of development... the law will develop from case to case. Lord Wilberforce in *Ramsay* referred to the "emerging principle" of the law. What has been established with certainty by the House in *Ramsay* is that the determination of what does, and does not, constitute unacceptable tax evasion is a subject suited to development by judicial process... The limits within which [the *Ramsay*] principle is to operate remain to be probed and determined judicially. Difficult though the task may be for judges...it is one which is beyond the power of the blunt instrument of legislation of legislation. Whatever a statute may provide, it has to be interpreted and applied by the courts, and ultimately it will prove to be in this area of judge - made law our elusive journey's end will be found."

In *Furniss v Dawson* the doctrine over form approach was extended and the House of Lords held that even genuine transactions could be disregarded if they formed part of a planned series of transactions and had been inserted without any commercial purpose. The House of Lords was concerned to set aside the transaction only on the basis that it made no commercial sense other than avoiding tax. It was therefore the absence of any commercial or financial purpose which

[98] supra

was fatal in this case.

This stricter approach was tempered with by the House of Lords in **Craven v White**[99] where it was held that the motive of avoiding tax was not in itself a sufficient reason to disregard a transaction, but that the absence of any commercial or business purpose could indicate that a transaction was artificial.

Taking *Ramsay, Furniss and Burmah* cases together, the English Law position can be summarised as follows :

(a)The avoidance scheme is either a ready - made plan purchased for a fee (Ramsay), or a pre - conceived plan tailor - made for the taxpayer by his advisers (Lord Fraser in Burmah case)

(b) There must be a 'pre - ordained series of transactions', or 'pre - planned tax saving scheme' or a 'single composite transaction' and there is no 'practical likelihood' that any subsequent transaction would not be implemented in the planned sequence. The test is whether the series of transactions are pre - ordained, not whether they are pre - contracted. (Lord Brightman in Furniss case)

(c) There must be steps in the series of transactions, scheme or operation which have no 'commercial or business purpose' apart from the purpose of avoiding, deferring or saving tax or obtaining a tax advantage.

(d) The scheme comprises a number of steps to be carried out, documents to be executed and payments to be made in rapid succession according to a timetable.

(e) The scheme involves the taxpayer being in the same position as he started with no real loss being made, except the fees and expenses paid in the implementation

[99] [1988] STC 476

of the scheme.

9.2 SOUTH AFRICA : THE LADYSMITH CASE

One might have thought that since in South Africa we have a general anti - tax avoidance section, unlike in the United Kingdom, that obviated the need for South African courts to invoke the common law 'substance over form' approach in the interpretation of the tax legislation. In a landmark decision of *Ladysmith*[100] the court applied the substance over form approach to a series of pre ordained transactions which were devised and aimed at maximising a tax benefit for the group. The significance of the *Ladysmith* case is that the court did not invoke the provisions of section 103(1) of the Income Tax Act but rather applied the principles of common law.

Under section 103(1) the Commissioner would have had to first prove existence of all the requirements thereunder before the court could declare the scheme a tax avoidance scheme.At the same time the invokation of the 'substance over form' approach, instead of section 103(1), operates to the taxpayer's advantage since successful attack of his scheme under the substance over approach would not render him liable to section 89quat interest which would otherwise have been payable.

The court in *Ladysmith* case was of the view that the substance of a transaction prevails over mere nomenclature and that in determining the legal rights of the parties to the scheme will look to the real, true and genuine intention of the parties to the transaction, and will effect to what a transaction really is and not merely to what in form it purports to be. Before the court can invoke the substance over form approach it must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention.[101]

In the case of **CCE v Randles Brothers and Hudson Ltd**[102] Watermeyer JA said :

"A transaction is not necessarily a disguised one because it is devised for the

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[100] supra
[101] Zandberg v Van Zyl 1910 AD 302
[102] 1941 AD 369, 33 SATC 48 @ 395

purpose of evading the prohibition in the Act or avoiding liability for tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect 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 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."

The court found as question of fact that there was ample evidence to show that the consequences of the arrangement between the company and the manufacturer were fully intended and that ownership did in fact pass i.e both parties had intended the consequences of the agreement.

The approach of the South African Appellate Division as manifested in *Randle Brothers* case is completely different from from the English substance over form approach which focuses on the purposive interpretation of the legislation to curb tax avoidance. *Randle Brothers* case is concerned with the actual agreement, such that if the actual agreement is set out accurately in the written contracts even the existence of a tax avoidance does not allow these agreements to be

ignored. In *Furniss v Dawson*[103] the court accepted that the transactions between the parties were completely genuine; the parties intended the transactions to have full effect in accordance with the tenor of the agreement. There was no suggestion of a 'tacit' or an 'unexpressed' agreement between the parties.

The court instead adopted a purposive approach and held that even genuine transactions could be disregarded if they formed part of a planned series of transactions and had been inserted without any commercial purpose on the basis that it made no commercial sense other than avoiding tax. In *Randle Brothers* case, on the other hand, the Appellate Division was at pain to point that the court had to give effect to the true intention of the parties to an agreement and that if the parties genuinely arranged their affairs to avoid tax then the courts will not interfere. Only if the parties purported to enter into one transaction, whereas in reality and by tacit understanding they were entering into a completely different
transaction, would the courts rend aside the veil of the disguised transaction.

The decision in *Randles Brothers* case is still good law in this country and has never been tempered with.

9.2.2 THE LADYSMITH JUDGMENT

In *Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR*[104] the facts were : In 1983 the directors of Pioneer Seed Company(Pty) Ltd ('Pioneer') and its subsidiary Pioneer Seed Holdings (Pty) Ltd ('Holdings') decided to establish a furniture factory which 'Pioneer' would operate. Two plots were acquired appellants using a person acting as nominee. In 1984, inorder to achieve leasing of the land and construction of the factory, eight separate but interrelated written agreements comprising two practically identical sets of four agreements were concluded between the taxpayers, the pension fund (hereinafter referred to as the fund) and pioneer. One set of agreement related to the stand owned by the first appellant and the other to the stand owned by the second appellant. The sets of agreement consisted of the following :

[103] supra
[104] supra

(a) A lease agreement in terms of which the appellant leases its stand to the Board of Executors Pension Fund for the period 1 April 1984 to 31 July 1991. In terms of the head lease the lessee *shall be entitled* at its expense to erect buildings and other improvements on the said stand as it determined; and the buildings were to become property of the lessor, the lessee having no claim against the lessor for compensation.

(b) A sublease agreement between pioneer and the fund in terms of which the fund sublets the property to pioneer for the same period of 7 years as the initial lease. In addition the agreement provides that the buildings to be erected by the fund, to be occupied by pioneer, in accordance with plans approved by pioneer, and for which pioneer was required to pay a monthly rental and a premium, in consideration for the sublessor having agreed to erect the buildings on the land, on the date of completion of the building.

(c)A building contract between the fund and a building contractor for the construction of a factory building on each piece of land.

(d) Certain rent variation agreements : that the fund's liability to the taxpayers in respect of the rent due had to discharged from the rent accruing to it from the sublessee.

The Commissioner assessed the taxpayers on the basis that the erection of the building on two stands brought about an accrual of income under paragraph (h) of the definition of the gross income which includes :

> "In the case of any person to whom, in terms of the agreement relating to the grant to any other person of the right to use or occupation of land or buildings, or by virtue of the cession of any rights under any such agreement, there has accrued in any such year or period the right to have improvements effected on the land or to the buildings by any other persons."

The appellants contended that effect had to given to the set of agreements according to their tenor despite their underlying purpose relying on the principle expounded by Lord Tomlin in *IRC v*

Duke of Westminster[105] that 'every man is entitled if he can to order his affairs so that the tax attaching the appropriate Acts is less than It otherwise would be'. The court then had to decide whether the taxpayers had succeeded in achieving that result.

The appellant also contended that the amount relating to leasehold improvements(the buildings) did not fall into its gross income under paragraph (h) because paragraph (h) does not deal with the *benefit accruing* to the owner of the land as a result of the improvements of his property, but with the accrual of a *right to have improvements effected.* The appellants agreed that the main lease *'entitles'* but did not *'oblige'* the fund to erect the buildings on the leased property and the fund was indeed obliged to erect the buildings but that obligation stemmed from the terms of the sub - leases.

This obligation was, however, enforceable by pioneer and not by them i.e the appellants and therefore, in the absence of an obligation enforceable by them, a right to have the buildings erected did not accrue to them.

On evidence the witness stated that the aim of the scheme was to procure the benefit of a deduction under section 11(f) of the Income Tax Act. The court rejected the appellant's claim that section 11(f) deduction was the aim of the scheme. Hefer JA, who delivered the judgment of the court, correctly pointed out that had section 11(f) deduction been the main consideration, it would have been unnecessary to introduce a third party into the scheme. Hefer JA was of the opinion that it was perfectly obvious that the appellant's tax liability had been their dominant consideration.[106]

Hefer correctly noted the following :

> "Affiliated companies are of course at liberty to structure their mutual relationships in whatever legal way their directors may prefer; but when, for no apparent reason, a third party is interposed in that might equally well have been an arrangement between affiliates, it is not unnatural to seek the motive elsewhere."

[105] supra
[106] @ 236

The legislature put an end to this fancy arrangement by disallowing a deduction of lease premium, under section 11(f), or the cost of improvements under section 11(g) where the accrual under paragraph (g) or (h) of the definition of the gross income is to a person exempt from tax thereon because this was unfair to the Revenue to allow a deduction on amounts which are not taxable or are of capital nature in the hands of the recipient.

On the facts, therefore, the court was required to determine whether paragraph (h) of the definition of gross income applied. The Commissioner contended that the agreements did not reflect the real intention of the contracting parties because the entire purpose was to evade tax. He further contended that the agreements were concluded in a form which concealed the fact that the appellant did acquire the right to have the buildings erected and for this contention relied on the terms of the agreement considered in totality.

The court considered that the issue before the court was whether the contracting parties actually intended that each agreement would have an effect *inter partes* according to its tenor. If not, Hefer JA, pointed out that effect must be given to what the transaction really is and further said that :

> I must point out that, by virtue of the provisions of section 82 of the Act, the burden to prove that any amount is exempt from tax and the duty to show that the Commissioner's decision to disallow their objection to the assessments was wrong rests on the appellants. Therefore unless the appellants have shown on preponderance of probability that the agreements do indeed reflect the actual intention of the parties thereto, the Commissioner's decision cannot be disturbed."[107]

In order to ascertain whether the lessor had acquired the right to have improvements effected , examined the intention of the parties in the light of the facts of the case and in the light of the totality of circumstances surrounding the conclusion of the four agreements. This gave rise to a

[107] @ 953E

conclusion that there was a 'real likelihood that there was an unexpressed agreement or tacit understanding between the appellants and pioneer (the sub lessee) that the taxpayer would be entitled, if need be, to enforce compliance with the terms of the sublease, viz. the erection of the improvements by the lessee (the fund), either against the sub - lessee or against the lessee and the sub - lessee jointly'.

In other words the court found that the real intention of the parties, given that all the agreements were interdependent on one another, despite the fact that the parties attempted to give the agreements a semblance of self - sufficiency which they did not in reality have, was that the appellants were just as much entitled to demand the erection of the factory as was the fund. On the basis of this conclusion the court found that the appellants had not discharged the onus resting on them of proving that a right under paragraph (h) of 'gross income' has not accrued to them nor that there was no such unexpressed or tacit understanding.

In **ITC 1611**[108] on the same facts as that in *Ladysmith case,* Wunsh J found it unnecessary to go as far as invoking the substance over form approach but instead relied on the intention of the parties to the contract. In so doing he rejected the English substance over form approach. To me the means used may be different but the end is the same i.e to suppress the mischief of tax avoidance. In finding that the taxpayer was taxable on the cost of improvements in terms of paragraph (h) of the gross income definition in similar circumstances to that of *Ladysmith* case, Wunsh J held that a court could examine whether there was a tacit term in the contract, that is the term to which the parties actually intended and agreed upon but did not reduce to writing. The enquiry was thus found to be 'whether on the basis of the proved facts and circumstances it was probable that a tacit agreement had been reached.'

Accordingly the court's approach was based upon ascertaining the true intention of the parties to the contract. The court found that this is what Watemeyer JA meant when he said in *Randle Brothers*[109] case that, 'before the court can find that a transaction is *in fraudem legis* ... it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties.'

[108] 59 SATC 126
[109] @396

In short therefore, *Ladysmith* case marks a further important step in the development of the court's increasing critical approach to the manipulation of commercial transactions to the advantage of the taxpayer. In a tax avoidance scheme, it is now not necessary for the steps involved to be carried out pursuant to a binding contractual arrangement. It is sufficient if there is a non - binding contractual understanding, intention or real likelihood inferred from the totality of circumstances in the case, which differs from what the transaction purports to be.

It may further be said that the *Ladysmith* case is an important judgment in the area of tax avoidance and sends a message that tax reduction is not an evil if not done evilly. The courts will not be deceived by taxpayer's use of fictitious devices and disguised transactions, but will look at the true intention of the parties. *Ladysmith* case at the same time strengthens the judicial role in combating tax avoidance without having to resort to statutory provisions of section 103 but by merely invoking the common law principles. It also makes the taxpayer and tax planners more aware than ever before that the transactions characterised by good tax planning must stand up to scrutiny and exposure
not only by the Commissioner, but also with the judiciary which is responding to tax avoidance not only through the application of section 103(1) but also by means of highly effective principles of common law.

Of relevance in this regard is decision in **Johnson v Jewitt**[110] where a taxpayer attempted to create an artificial loss of huge sum of money by creating and juggling with 79 companies and so claimed a large tax rebate. The transaction was held to be a complete sham and the court went on to state that :
"We were asked, what was this if it were not trading?...I would call it a cheap exercise of fiscal conjuring and book keeping phantasy, involving a gross abuse of the Companies Act and having as its unworthy object the extraction from the Exchequer of an ernomous sum which the Appellant had never paid in tax and to which he has no shadow of a right whatsoever."

[110] (1961) 40 TC 231

CHAPTER 10

TAX PLANNING

Every taxpayer who wishes to avoid tax legally must be aware of what constitutes good tax planning.

One of the best definitions of personal tax planning was given by *Gavin Urquart* at a seminar on "Personal Tax Planning" presented by 'Finance Week' and 'The Taxpayer' during September 1987 :

"Person tax planning can properly be described as .. the management and arrangement of the affairs of an individual, so as to legally minimise as far as possible and as cost effective as possible, all taxes payable within the constraints imposed by the commercial and other objectives of that and associated taxpayers."

This definition emphasises most of the important principles of a successful tax planning which include the following :

- tax planning must take cognisance of not only the Income Tax Act but also of all tax legislation administered by the Commissioner i.e

(a) Estate Duty Act 45 of 1955
(b) Marketable Securities Tax Act 32 of 1948
(c) Stamp Duty Act 77 of 1968
(d) Transfer Duty Act 40 of 1949
(e) Value Added Tax 89 of 1991

- in the light of the 'business purpose test' in section 103(1), commercial and business purpose, not concerned with the incidence of tax, must be primary considerations so as to make the scheme commercially viable.

- the tax plan must be cost effective.

- the transaction which constitutes a plan must be perfectly legitimate and legal.

- the tax plan must relate not only to the individual concerned but also to financially associated taxpayers and family members.

- in the light of the *Ladysmith case*, taxpayers must not only confine themselves, when tax - planning, to the application of section 103 but must also take cognisance of the limitations imposed by common law, since fiscus is also protected by common law, on the right to arrange the affairs of a tax with the object of paying the minimum amount of tax that is legally required of him.

A taxpayer must have a thorough knowledge of all the tax legislation administered by the Commissioner so that he will not have to resort to tax evasion to save tax, and in so doing a taxpayer will be able to plan his affairs in such a way that his tax planning will coincide with the principles of tax legislation itself. It the taxpayer knows the basic principles of the tax legislation, he will also be able to arrange his affairs in such a way that he receives the smallest possible amount of taxable income and may simultaneously be able to deduct as many of his expenses.

The taxpayer must also the important distinction between tax avoidance and tax evasion and the legal consequences of such. Tax evasion is serious offence and attracts serious penalties under sections 75, 76 and 104 of the Income Tax Act. On the other hand, tax avoidance is legal and if the taxpayer's scheme falls foul of section 103(1) or (2), he will at worst be liable to section 89quat interest.

Harvey Dale[111], an American lawyer stated that :

> " a loophole in tax which is too readily and obviously usable becomes not a loophole but a noose. It will be closed and the taxpayer may be unable to extricate himself."

[111] P. Pencharz in "Tax Havens" 1979 De Rebus 265 @270

In other words, loopholes are allowed to remain provided that they are not over exploited. But once it is evident that a particular loophole is attracting too many avoiders, then it is the duty of the Revenue to close it. If a loophole exists, nothing prevents the taxpayer from using it and take advantage of it before it closed.

CHAPTER 11

CONCLUSION

The problems with tax avoidance will not disappear, and unless some alternative better approach is available, it may be that misdirected solutions are better than none at all. The fate of the 'business purpose' test is yet to be seen. Although some may argue that it is a loophole which will make the tax avoidance provision ineffective, there is a difference between not trying and not winning. The *Ladysmith* case is not an end in itself but is an 'emerging principle' of law which will be developed by judges from case to case in an attempt to curb tax avoidance. Therefore the court is not only armed with the tax avoidance provisions as contained in tax legislation, but is also armed with common law principles in protecting *fiscus.*

Tax payers can tailor their conduct in ways that increase the distortions in the system, decrease their share of tax liability, and produce results that are economically either meaningless, or at worst, undesirable. As long as many of the countries best lawyers and tax experts continue to be so well paid for finding and maximising the mismeasurements that lead to abuse, it is likely that tax experts and their clients will almost always at least remain ahead of the legislators and judiciary's attempts to curb tax avoidance. Nor does the fact that current approaches to tax avoidance may seem irrational, imply that tax avoidance in South Africa cannot be dealt with reasonably. It simply means that it has not been so dealt with yet, and that the struggle between the taxpayer and the Revenue will continue! and will not be laid to rest.

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