

THE REFORM OF SECTION 103(I)

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THE REFORM OF SECTION 103(1)-

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the degree of Master of Laws in approved courses and a minor dissertation. The other part of the requirement for this degree was the completion of a programme of courses.

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A. INTRODUCTION

With the increasing taxation burden that is placed on the citizens of the modern state, the practice has grown for those who are aggrieved by their share of the tax burden to try to reduce it. The methods adopted by those daring enough to challenge the revenue authorities have not always been favourably received and have even been considered improper or "evil", as, it is argued, the tax burden is shifted from those who avoid tax to those who, by reason of lack of access to skilled advice, or because their income is not readily susceptible to tax saving devices, must accept the demands of the Receiver of Revenue. Additionally, the resultant revenue that the State loses from these tax avoidance schemes, is presumably made up by placing a heavier burden on the shoulders of the innocent.¹ Thus the State has taken steps to ensure that tax avoidance schemes do not subvert the Receiver's ability to collect each citizen's fair share of the tax burden. This is achieved either by plugging each hole as it appears in the taxing legislation or by enacting a general anti-avoidance provision, supported by legislation covering specific areas of tax avoidance. Each method merely empowers the revenue authority to disregard the avoidance scheme used by the taxpayer and to regain the tax lost through the taxpayer's use of the scheme.² The determination and ingenuity of the taxpaying public is renowned and inevitably a new tax avoidance scheme evolves challenging the limits of the legislation. These efforts haven't gone

¹ see the remarks of MacDonald JP in *COT v Ferera* 1976 (2) SA 653 (RAD) at 655, 38 SATC 66 and the cases quoted therein. MacDonald JP strongly disapproved of tax avoidance, stating (at 656) that "...the avoidance of tax is an evil" and that :

"...the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that 'good citizens' will always fare badly. While undoubtedly the short term effects of the practice are serious, the long term effects could be even more so."

² See Vorster "The parameters of tax planning" LLM Thesis Wits 1984 at 39 *et seq.* for a summary of the various approaches that may be adopted by the legislature in countering tax avoidance.

unnoticed by the authorities and the Second Interim Report of the Katz commission stated that :³

“The Commissioner for Inland Revenue has been endeavouring to formulate new anti-avoidance legislation. The object of the new legislation would be **to substitute a business test for the normality test**, which has undermined the efficacy of the existing anti-avoidance legislation. The consequences of the successful application of the anti-avoidance legislation would also act as a greater deterrent to tax avoidance. The Commissioner recommends that appropriate anti-avoidance legislation be finalised as a matter of urgency.”(my highlights)

This obviously displays a certain dissatisfaction with the current tax avoidance legislation. However in the formulation of the legislation, two diametrically opposite principles must be catered for. The legislation should conform to Adam Smith's second cannon of taxation, namely that,

“The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment the quantity to be paid ought all to be plain and clear to the contributor and to the every other person.”⁴

Yet, the legislation must also be broad enough to capture the attempts by the taxpayer to opt out of the system.

In the search for a suitable test for avoidance, the courts and legislature have resorted to vague expressions, as Lord Denning stated,

“Try as you will, the word ‘avoidance’ is one of the most common English words which do not lend themselves readily to definition, but which all of us think we understand well enough. We recognise ‘avoidance’ when we see it, but are hard pressed to define it.”

And herein lies the principle difficulty in developing a workable general anti-avoidance provision, as Tiley says,

“There are two principal - and related - myths about avoidance which are relevant here; that it can be defined and that it can be defined with sufficient precision that all forms of avoidance can be stopped.”⁵

³ The Second Interim Report of the Katz Commission at par. 5.3.8.

⁴ A. Smith The wealth of nations, Book V, Chapter II, part II.

⁵ Tiley “Judicial anti-avoidance doctrines : corporations and conclusions” 1988 British Tax Review 108 at 136.

It is the aim of this paper to study the general anti-avoidance provision in South Africa and how it has been applied by our courts. Thereafter, attempts in other jurisdictions to solve tax avoidance will be examined. Finally, the proposal of the Katz commission to introduce a business purpose test will come under the spotlight.

B. IDENTIFYING TAX AVOIDANCE

B.1. DEFINING TAX AVOIDANCE

Right at the outset it is important to distinguish between the concepts of tax avoidance and tax evasion. Neither expression is defined in the Income Tax Act, but the courts have determined that **tax avoidance** is a legitimate attempt by the taxpayer to minimise his tax liability, e.g. by reducing his income or having no income on which tax is payable. **Tax evasion**, on the other hand, is an illegal means of reducing one's tax liability by e.g. falsification of books, suppression of income, fraudulent non-disclosure of income or the conclusion of sham transactions. There are severe penalties for these illegal acts, which (in South Africa) include a fine and/or a sentence not exceeding 2 years⁶ and the taxpayer also may be required to pay a penalty of up to twice the amount of tax she is in default.⁷ There is no halfway house between tax evasion and tax avoidance. Tax avoidance can only occur in the circumstances laid down by the Act, anything outside these circumstances is tax evasion.

However, the courts have recognised the right of the taxpayer to

“...order his affairs so that the tax attaching under the appropriate Acts is less than it would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”⁸

Thus the essential feature of tax avoidance is that it is done in a lawful manner, but it is an exercise of stressing the letter of the law rather than its spirit. It is this feature

⁶ Section 104 Income Tax Act 58 of 1962 (as amended to 1 January 1995).

⁷ Section 76 Income Tax Act.

⁸ Per Lord Tomlin in *Duke of Westminster v IRC* 51 TLR 467, 19 TC 490-at 520. See also *CIR v Estate Kohler* 1953 (2) SA 584 (A) at 591-2, 18 SATC 354 at 361-3; *Hicklin v SIR* 1980 (1) SA 481 (A), 41 SATC 179 at 195.

of tax avoidance, i.e. that the taxpayer is ostensibly acting within the scope of the law, that presents the major difficulty of identifying tax avoidance. A large part of the problem is that of definition, but the uncertainty surrounding avoidance is indicative of more than a definitional quibble. The ultimate goal of defining "avoidance" is to lay the foundation for a clear anti-avoidance policy. Over the last few years, there has been an abundance of legislation and regulations addressing tax avoidance. Often these attacks on tax avoidance schemes is done on an *ad hoc* basis. There does not seem to be a clear-eyed vision on what should be attacked, when and how. These are problems shared by other jurisdictions, not just South Africa. South Africa has tried to ameliorate the situation by the introduction of a general anti-avoidance provision, but, as we shall see, the uncertainty remains.

There is no norm representing a taxpayer's fair share of, or proper contribution to tax, but no taxpayer is expected to pay a greater amount of tax than is due in terms of the legislation. The taxpayer's liability is what the taxing statute says it is, and as long as the taxpayer minimises his tax liability "in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner"⁹ and he "fully and honestly completes his income tax return and fully and honestly answers any queries raised by the Commissioner,"¹⁰ he will have met his duties and obligations under the Act. However, tax avoidance is not a mere procedural inquiry, as a taxpayer who minimises her liability without "fraud, dishonesty, misrepresentation" or any other misleading actions may yet be found to be avoiding tax. This is because the flip side of the coin is that taxpayers should not be free to opt out of the tax system and the policy of the fair distribution of the tax burden (whatever that may mean) which underlies our tax system should not be subverted by allowing taxpayers to manipulate concepts for purposes the legislature

⁹ Practice Note No. 6 issued on 1 April 1987.

¹⁰ *ibid*

may reasonably be taken not to have intended.¹¹ However, very few of the reported cases involve the utilisation of particular incentive provisions in the Income Tax Act (as a matter of fact, Section 103 is only applied where the taxpayer has sought to exercise his right to arrange his affairs.)¹² Thus it appears that in practice, the utilisation of specific incentive provisions in the Income Tax Act is seldomly considered to be tax avoidance, even where the taxpayer manipulates the provisions in a manner unintended by the legislature. The practice of the South African Revenue authorities is not to attack schemes on the basis of Section 103, but rather to introduce specific amending legislation.

In the Privy Council decision in *CIR v Challenge Corporation Ltd*¹³, a distinction between tax mitigation and tax avoidance was made. The former involves one entering a commercial transaction in such a manner that the tax liability is less than it would have been had the transaction been entered into in another manner. The court emphasised that tax mitigation occurs when the person reduces her income or incurs expenditure "in circumstances in which the taxing statute affords a reduction in tax liability."¹⁴ Tax avoidance was found by the court to result from "an arrangement when the taxpayer reduces his tax without involving him in the loss or expenditure which entitles him to that reduction."¹⁵ Categorising the Challenger Corporation's actions as tax avoidance (as opposed to tax mitigation), entitled the court to apply New Zealand's general tax anti-avoidance provision. This distinction between tax avoidance and tax mitigation had never been made before this case and it is debatable whether it is correct. However, in many jurisdictions the debate has shifted from determining the line between tax evasion and tax avoidance to

¹¹ e.g. In the infamous film schemes or plantation schemes, the taxpayers were utilising specific allowances and incentives in the Income Tax Act to obtain tax deductions from the income. The alleged purpose of the allowances in the act is to encourage a particular form of economic activity and not to simply give taxpayers an opportunity to decrease their tax burden. See further, Haupt "Substance versus form in the application of tax law in South Africa" (1989) 28 Income Tax Reporter 231

¹² Vorster *supra* 2 16

¹³ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5, 219 [1987] 1 AC 155. This appeal to the Privy Council was from the Appeal Court of New Zealand.

¹⁴ *ibid* at NZTC 5, 226.

¹⁵ *ibid*.

determining the boundary between tax avoidance and tax mitigation. This distinction has not yet been made in any South African court, but seems to be made in practice, because a reduction of the tax burden, which is not tax evasion nor tax avoidance, has to be classified as tax mitigation.¹⁶

B.2. INTERPRETING SECTION 103(1)

A persistent issue that dogs the courts, is the question of how the law should be applied to transactions that appear designed to defeat it. Most try to solve it through the use of statutory interpretation, some by the use of the doctrine of substance and form. However, the quest for the "substance" through the haze of "form" is a difficult and arduous route. There is always universal assent that the legislature should not be defeated by artificial manoeuvres, designed to defeat it and that the "substance" of events should determine its legal consequences. When a person calls a dog a cat and refuses to pay his dog licence, the obvious response is that it does not matter what a thing is called, the consequences should be determined by the thing's underlying nature. As far back as 1910, our law recognised that it is the substance¹⁷ of the contract that prevails over the form chosen by the parties. Sir Rose Innes explained the nature and legal effect of contracts disguised by the parties thus :

"Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose) the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies, *plus valet quod agitur quam quod simulate concipitur*."¹⁸

¹⁶ see Clegg "Tax mitigation" (1987) 3 Tax Planning 67, where an appeal is made to the courts to accept such a distinction.

¹⁷ See Vorster *supra* n2 at 163 for examples where the doctrine of substance v form was applied in tax cases.

¹⁸ *Zandberg v Van Zyl* 1910 AD 302 at 309. See also *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369 at 395.

Thus, the court will not allow parties to circumvent or evade a statute in an indirect manner (e.g. either by denoting their contract by a name other than that used in the statute or by any other disguise of the nature of the contract). Generally, the court will examine the facts and expose the true nature of the transaction. For example, where an agreement for the disposal of land was designated by the parties as being partly agency and partly suretyship in order to evade the payment of transfer duty, the court held the contract to be a sale.¹⁹ Similarly, a transaction called by the parties a sale, in order to escape the provisions of the Usury Act, was held to be a loan.²⁰ And where a statute required that a full apology be inserted in a newspaper for a libel, it was decided that if the apology were printed in such a type or in such a part of the newspaper as would have been likely to escape the attention of ordinary readers, the statute would not be complied with.²¹

In interpreting tax legislation, the courts have adopted two divergent approaches.²² One approach is based on the assumption that the tax legislation should be strictly interpreted (i.e. a strict literal approach). This view holds that the literal meaning of the wording of a provision must be ascertained by applying ordinary grammatical rules.²³ It is premised on the notion that the Parliamentary intention is represented in the literal interpretation of the legislation. Thus this approach precludes attaching any considerations of fairness, equity or social policy to the interpretation of tax legislation :

“(It simply means that) in a taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a

¹⁹ *Treasurer-General v Lippert* (1881) 1 SC. 291.

²⁰ *Lawson & Kirk (Pty) Ltd v SA Discount and Acceptance Corporation (Pty) Ltd* 1938 CPD 273 at 278. See Hutchinson, *et al Wille's principles of South African law* 465 for further examples.

²¹ *Lafone v Smith* (1859) 28 LJE 33.

²² Compare the discussion of the cases in Meyerowitz & Spiro *Meyerowitz & Spiro on Income Tax* B4 *et seq.* and De Koker & Urquhart *Income Tax in South Africa* 2-3 *et seq.*; See also Botha *Statutory Interpretation* 79

²³ See *CIR v George Forest Timber Company Ltd* 1924 AD 516, where the court stressed the “letter of the law” in interpreting tax legislation. See also *CIR v Simpson* 1949 (4) SA 678 (A).

tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.”²⁴

However, there is no reason why tax legislation should be treated differently from other legislation. Thus, other cases have taken a different route, and held that “the ordinary recognised principles of statutory interpretation are applied, to determine what it is that is forbidden or taxed.”²⁵ In these cases the courts have determined the intention of the legislature and attempted to give effect to the purpose of the legislation.²⁶ They make full use of the aids to statutory interpretation in order to determine the parliamentary intention. Such aids to interpretation may include statutory presumptions, the history of a statute, the principles underlying a statute, the ordinary meaning of the text, etc.²⁷ In a recent Appellate Division case²⁸, Corbett JA, with the full bench concurring, stated that :

“It has been said that ‘there is no equity about a tax.’ While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the *fiscus*. And it may be fairly inferred that such a result is in conformity with the intention of the Legislature.”²⁹

It would seem that this approach is gaining favour with the courts, but more importantly for our purposes, this latter approach was unanimously adopted by the Appellate Division in the interpretation of Section 103 :

“Counsel has ... relied upon the so-called special rules laid down in several cases as being applicable to the interpretation of fiscal legislation. ...”³⁰

Apart from the rule that in the case of an ambiguity a fiscal provision should be construed *contra fiscum* (*Estate Reynolds & others v CIR* 1937 AD 57 at

²⁴ *Cape Brandy Syndicate v IRC* (1921) 1 KB 64 at 71; Quoted with approval in *CIR v Frankel* 1949 (3) SA 733 (AD) at 738, 16 SATC 251.

²⁵ *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd supra* n18 at 394.

²⁶ *Farrar's Estate v CIR* 1926 TPD 501, 2 SATC 81; *SIR v Kirsch* 1978 (3) SA 93 (T); *Blue Circle Cement Ltd v CIR* 1984 (3) SA 764 (A); See further, Botha *supra* n22 79, Meyerowitz & Spiro *op cit.* n22; Silke South African Income Tax 25-1 *et seq.*; De Koker & Urquhart Income Tax in South Africa *op cit.* n22.

²⁷ Botha *supra* n22

²⁸ *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A), 45 SATC 241, 1983 Taxpayer 204.

²⁹ *ibid* at 958

³⁰ Botha JA goes on to quote from several cases.

70) which is but a specific application of the general rule that all legislation imposing a burden upon the subject should, in the case of an ambiguity, be construed in favour of the subject, there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation. ...

In any event I do not understand the rule to be that every provision of a fiscal statute, whether it relates to the tax imposed or not, should be construed with due regard to any rules relating to the interpretation of fiscal legislation. Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefor. **It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed** (*Hleka v Johannesburg City Council* 1949 (1) SA 842 (A) at 852, and see generally Maxwell *Interpretation of Statutes* 12 ed. 40 *et seq.*) The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation.”³¹ (my highlights)

Thus in interpreting Section 103 the courts have attempted to “advance the remedy and suppress the mischief.” It will use the ordinary recognised principles of statutory interpretation as well as the interpretational aids at its disposal to determine the intention of the legislature. However, we have seen that the distinction between tax avoidance, tax evasion and tax mitigation is blurred and it is submitted that even if Section 103(1) is broadly interpreted, determining the category that a transaction falls into is still fraught with difficulty and uncertainty. The benefit of the section is that it provides parameters to the definition of tax avoidance. The court therefore has a clearer perception of what transactions the legislature believes is tax avoidance, resulting in less uncertainty in the law.

B.3. INTERPRETING THE CONTRACT

Innes CJ in *Dadoo Ltd v Krugersdorp Municipal Council*³² set out the *modus operandi* of the court when it attempts to identify the avoidance of a statute by parties to a contract. His reasoning was summarised into two steps by Watermeyer JA :

³¹ *Glen Anil Development Corp. Ltd v SIR* 1975 (4) SA 715 (A), 37 SATC 319, 1975 Taxpayer 226.

³² *Dadoo Ltd & others v Krugersdorp Municipal Council* 1920 AD 530.

“Firstly, the law has to be construed to ascertain what kind of transaction is forbidden or taxed, and secondly the transaction has to be interpreted to ascertain whether it is a transaction of the kind which is forbidden or taxed”³³

This formula has not always been consistently adhered to by our courts, but due to the nature of tax avoidance, it is inevitable that a transaction must at some stage be examined. It is at this stage that the court is concerned with determining the nature of the agreement between the parties; its so-called “substance.” It must be stressed that in the application of tax anti-avoidance provisions we are not dealing with contracts which are based on simulated facts, i.e. where the taxpayer uses some fictitious device which cannot itself give rise to effective legal rights or duties, but which attempts to cloak the real purpose of the transaction. Watermeyer JA said that such transactions are dishonest, because “the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world.”³⁴ In such cases the common law entitles the courts to determine the true nature or substance of the contract without having resort to statutory provisions such as the anti-avoidance legislation.³⁵ The anti-avoidance provision is only applicable if the contracting parties truly intend to be bound by the obligations created and be entitled to the rights created. Then, no matter how artificial the transaction appears to be or that it is entered into for what is considered an improper purpose, or even that the selected form of the transaction is inconsistent with nature of the transaction, the transaction and all the rights and obligations created by it must be taken into account when determining the tax position of the parties.³⁶ Of course, the dividing line between the dishonest deception of a simulated contact and the “honest” cloak of avoidance is often difficult to determine and in each case the

³³ *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd supra* n18 at 394.

³⁴ *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd supra* n18 at 395.

³⁵ See *CIR v Saner* 1927 TPD 162, 2 SATC 199; *Bailey v CIR* 1933 AD 204, 6 SATC 69; *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd supra* n18; Derksen “To what extent does the common law allow the avoidance of statutes” 1995 (1) SALJ 88. Most of such cases would probably fall into the realm of tax evasion and dealt with accordingly.

³⁶ In *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd ibid* at 395 Watermeyer, JA said :

“A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor...”

enquiry is “one of fact, for the right solution of which no general rule can be laid down.”³⁷

The search for the “real” or “true” transaction between the parties is similarly a factual enquiry. Generally, the nature of the transaction is determined by looking at its form³⁸ and a court will not lightly assume that a contract is something other than that it purports to be. However, where the surrounding facts and circumstances make it apparent that the contract is not what it purports to be, the court delves deeper and determines the true nature of the transaction by examining the rights and obligations created *inter partes*³⁹ and the circumstances surrounding the transaction.⁴⁰ Finding the true transaction is essential for tax purposes, because it is generally accepted in our law that tax must be based on the true transaction between the parties and not on the purported one. Thus the characterisation of the contract makes a significant difference to the tax position of the parties involved, e.g. whether money injected into a company is considered debt or equity determines the deductibility of interest paid to the lender. What is important to note, is that the court does not attempt to create new or different rights *inter partes* which they themselves have not created. The “real” or “true” contract consists of the rights and obligations which the parties themselves have created. Thus the search for substance is not a search by the court for a label for the contract. Our law has no *numerous clauses* of contracts and parties have almost complete freedom to contract,⁴¹ which no court will undermine, even if the contract creates rights and obligations which defies the standard legal categorisation into contracts of sale, lease, donation, carriage, etc. However, the contractual form cannot be discarded

³⁷ *Zandberg v Van Zyl op cit.* n18.

³⁸ See Tiley *supra* n5 at 138 and Moore “Form v substance : when will courts respect the form of the transaction?” (1987) 66 Journal of Taxation 66 where this notion is disputed.

³⁹ Haupt *supra* n11 at 233. Haupt maintains that the court must ignore the nomenclature used in the contract. It is respectfully submitted that a court must take this into account, however the evidential value it has of proving the true transaction will be affected.

⁴⁰ Christie The law of contract in South Africa 416.

⁴¹ The freedom to contract is not absolute, as a court will not uphold contracts which are statutory illegal or against public policy, etc. See Christie *ibid* 409 *et seq.*; Hutchinson *supra* n20 431 *et seq.*

as an outdated and superfluous legal concept. In our tax law, for example, many (if not most) tax consequences are attached to the legal form of contracts (e.g. contracts which can be defined as donations have specific tax consequences, so too do repairs, lease agreements, etc.) The courts also find the legal form of the contract useful for its understanding of the agreement and for the attaching of implied terms into the contractual relationship.⁴²

In the application of Section 103(1), we notice that the legislature requires that cognisance be taken of the legal form of the transaction. It provides that the agreement between the parties be compared to a "transaction, operation or scheme of the nature of the transaction, operation or scheme in question,"⁴³ before it can be determined whether the agreement is normal in terms of the section.⁴⁴ The section in no way imposes a limit on freedom of contract, as parties are still free to create the rights and obligations that they desire. However, in assessing the "normality" of the contract a court is obliged to compare it a contract of a similar nature, but this is not easily done. Firstly, the facts may not be readily ascertainable and often, characterising the contract depends on factors which are not readily observable (e.g. In a contract of sale, the seller agrees to deliver to the buyer *vacua possessio* of a thing in return for a price. In a contract of lease, the lessor agrees to give the other person the use of a thing in return for a price. In both types of contracts, the

⁴² Corbett AJA (as he then was) explained these terms in *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration* 1974 (3) SA 506 (A) 531 :

"...In legal parlance the expression 'implied term' is an ambiguous one in that it is often used, without discrimination, to denote two, possibly three, distinct concepts. In the first place, it is used to describe an unexpressed provision of the contract which the law imports therein, generally as a matter of course, without reference to the actual intention of the parties. The intention of the parties is not totally ignored. Such a term is not normally implied if it is in conflict with the express provisions of the contract. On the other hand, it does not originate in the contractual consensus : it is imposed by the law from without. Indeed, terms are often implied by law in cases where it is by no means clear that the parties would have agreed to incorporate them in their contract. Ready examples of such terms implied by law are to be found in the law of sale, e.g. the seller's implied guarantee or warranty against defects; in the law of lease the similar implied undertakings by the lessor as to quiet enjoyment and absence of defects; and in the law of negotiable instruments the engagements of drawer, acceptor and endorser, as imported by secs 52 and 53 of the Bills of Exchange Act 34 of 1964. Such implied terms may be derive from the common law, trade usage or custom, or from statute."

⁴³ Section 103(1) Income Tax Act.

⁴⁴ Refer to "ABNORMALITY OF THE TRANSACTION" page 25.

object and the money are physically exchanged. An observer of this exchange will not be able to determine whether the contract in question is one of sale or one of lease. Only an examination of the non-tangible factors, viz. the rights and obligations created between the parties, can the nature of the contract be ascertained). Secondly, the fact that parties have virtually complete freedom of contract makes it even harder to characterise contracts. Often contracts have some characteristics of two different types of contract and all of neither (e.g. a difference between debt and equity is that equity represents an investment in the company, while the return on debt is more secure and not dependent on the company's performance. Sometimes the distinction is blurred when the obligations have elements of both. Interest on the obligation could be conditioned on the company's performance. Or, an obligation could *prima facie* have more risk than "debt", as it has been subordinated or because the corporation is thinly capitalised, yet is less risky than equity, because of priority over other shareholders and payment is not dependent on profits but on simply avoiding insolvency). In most of these cases, the substance of the transaction can be cast into one of several forms, each of which have equal merit and there should be no reason why the court's label of the transaction should trump that chosen by the party.⁴⁵ Thirdly, the courts have claimed that the characterisation enquiry is a factual one; little guidance is given as to which facts are relevant to the enquiry. An obligation which *prima facie* appears to be a loan could with equal vigour be classified as a donation if the relationship between the parties is such that it is unlikely that repayment will be enforced. Here it is a factor external the contract, viz. the relationship between the parties, which is relevant.⁴⁶ Fourthly, the motive of the taxpayer is irrelevant in determining the nature of the transaction. However, it certainly does appear to influence the court.⁴⁷

Therefore, the courts have determined that Section 103(1) be broadly interpreted to give effect to the intention of the legislature. Also, it has been held that they must

⁴⁵ Moore *supra* n38 at 67.

⁴⁶ See further Rosenberg "Tax avoidance and income measurement" (1988) 87 Michigan Law Review 365 at 378 *et seq.*

⁴⁷ See in particular *COT v Ferera supra* n1

give effect to the "substance" of the contract. However, as we have seen, there is great difficulty in putting these requirements into practice.

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

South Africa has a multi faceted approach to tax avoidance. Examples of almost every possible approach and technique to prevent tax avoidance can be found in our law. There are specific provisions which identify with precision the type of transaction which is to be countered and detail the tax consequences of such transaction.⁴⁸ Section 103 on the other hand, is an example of a “shot-gun” approach to tax avoidance, as it is a catch all provision, imposing a tax burden on transaction which are defined in some general way. The Income Tax Act also has provisions which grant the revenue authorities wide discretionary powers to counter tax avoidance transactions⁴⁹ There are also legislative provisions which draw an arbitrary line, either inducing or excluding the taxpayer from paying tax, depending on which side of the line he is (e.g. the entertainment allowance is subject to a maximum amount. There is no reason why it is so limited). Section 103(1) is thus only one of several attempts to curb tax avoidance.

The precursor to Section 103(1) was Section 90 of Act 31 of 1941. This section was introduced to combat tax avoidance after the case of *Hidding v CIR*.⁵⁰ The section's purpose was to combat tax avoidance by giving the Commissioner the power to ignore any transaction, operation or scheme⁵¹ which had the purpose of avoiding or reducing tax liability. As the majority in *CIR v King*⁵² noted, giving effect to this would lead to an absurdity, because all transactions, whether made *bona fide* or with a tax

⁴⁸ e.g. Section 7

⁴⁹ e.g. Section 23A gives the Commissioner the power to determine the “taxable rental income” against which certain allowances may be set off.

⁵⁰ *Hidding v CIR* 1941 AD 111.

⁵¹ As a matter of convenience, hereafter, reference will be made to a “transaction” only, but the word is used compendiously to include operation or scheme.

⁵² *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184.

avoidance purpose, whereby a taxpayer tried to reduce his tax burden (by e.g. reducing profit margins, gratuitously providing professional services or by *bona fide* disposing of his income-producing assets) would be ensnared by the section.⁵³ The court therefore ascribed a narrow meaning to the words "avoiding liability for reducing" tax, limiting the application of the section to the

"...case of a man who so orders his affairs that he escapes from liability for taxation which he ought to pay upon the income which is in reality his."⁵⁴

Income is "in reality his" when it "is the product or fruit of a man's labour or of his capital or both".⁵⁵ It was Schreiner, JA who in the same decision aptly summarised how the section was to be applied :

"It is intended, I think, to deal with cases in which the Commissioner, as representing the *fiscus*, is properly aggrieved by a transaction or operation designed to enable one of the parties thereto to escape tax. The Commissioner is not properly aggrieved merely because at a stage before income has accrued to a taxpayer it might have been predicted with confidence, amounting even to certainty, that if the taxpayer took no steps in the matter such income would accrue to him, and because he then takes avoiding steps. But the Commissioner would be properly aggrieved if a transaction or operation were entered into which prevented income from accruing to a taxpayer while leaving him in a position of one to whom the income would normally and naturally accrue. The section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer's affairs which will result in him getting less income, it is designed to meet the Commissioner's objections to the creation of abnormal or unnatural situations, to the detriment of the *fiscus*."⁵⁶

Application of the above *dicta* resulted in the court sanctioning one of the most common means employed to avoid tax, namely that of alienating an income-producing asset. However, this *dicta* probably laid the basis for an amendment to the anti-avoidance provision aimed at overcoming the restrictions of the *King* case. The resulting amendment was an attempt by Parliament to draw a general anti-avoidance provision which would lay down more stringent guidelines for the courts, both by its reconstruction in more explicit terms and by its introduction of an objective criteria, the abnormality test, to distinguish tax avoidance from legitimate

⁵³ *ibid* 207

⁵⁴ *ibid* 211

⁵⁵ *ibid*

⁵⁶ *ibid* 216

business dealings.⁵⁷ Section 103(1) is the general anti-avoidance provision in the South African Income Tax Act and is the embodiment of this parliamentary intention.

It provides as follows :

“Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) -

- (a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
- (b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out-
 - (i) was entered into or carried out by a means or manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
 - (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and
- (c) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, duty or levy (whether imposed by this Act or any previous Income Tax Act, or any other law administered by the Commissioner) or the reduction of the amount of such liability,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.”

⁵⁷ Spiro (Ed) “The prevention of the avoidance or evasion of tax” (1953) 2 The Taxpayer 162; Spiro “Changes in the law of tax avoidance” (1959) 8 The Taxpayer 127.

The section gives the Commissioner the power to determine the liability⁵⁸ for any tax, duty or levy imposed by the SA Income Tax Act⁵⁹ or any other law administered by her⁶⁰ if the following four requirements are met :

1. there is a **transaction, operation or scheme** within the meaning of the section,
2. which has the **effect of avoiding, postponing or reducing liability** for any tax, duty or levy imposed by the SA Income Tax Act or any other law administered by her,
3. has been entered into by **abnormal** means or has created abnormal rights or obligations and which,
4. has as its **sole or one of its main purposes** the avoidance, postponement or reduction of liability for any tax, duty or levy.

All four elements must be present before the Commissioner can successfully invoke Section 103(1).⁶¹ Section 103(4) makes the Commissioner's task easier by creating the rebuttable presumption that if he proves that a transaction avoids, postpones or

⁵⁸ The Commissioner determines the amount of this liability :

- (a) as if the transaction has not been entered into or carried out or
- (b) in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction of liability for the tax in question.

⁵⁹ The following taxes are imposed by the Income Tax Act :

- (a) normal tax;
- (b) donations tax;
- (c) secondary tax on companies;
- (d) levy on financial services and
- (e) non-residents shareholder's tax.

⁶⁰ Taxes imposed under other laws administered by the Commissioner include :

- (a) estate duty under the Estate Duty Act 45 of 1955;
- (b) value-added tax under the Value-Added Tax Act 89 of 1991;
- (c) transfer duty under the Transfer Duty Act 40 of 1949;
- (d) stamp duty under the Stamp Duties Act 77 of 1968 and
- (e) marketable securities tax under the Marketable Securities Act 32 1948.

⁶¹ *SIR v Geustyn, Forsyth and Joubert* 1971 (3) SA 567 (A) at 571-572, 33 SATC 113 at 117; *ITC 1178* (1972) 35 SATC 29 at 31-32; *SIR v Gallagher* 1978 (2) SA 463 (A), 40 SATC 39 at 47-48; *Hicklin v SIR supra* n8 at 191,195; *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 at 66-67; *CIR v Louw* 1983 (3) SA 551 (A), 45 SATC 113 at 132.

reduces liability for any tax (i.e. items 1 and 2 above), then the sole or main purpose of the transaction is presumed to be the avoidance, postponement or reduction of such liability. Section 103(4) also provides that any decision of the Commissioner is subject to objection and appeal by the taxpayer.

C. I. THE MEANING OF "TRANSACTION, OPERATION OR SCHEME"

Presumably, because these words are so widely framed, the Commissioner has had little difficulty in showing that a taxpayer's operation does not fall within the meaning of the section and thus to date these words have only been thoroughly considered in one case, *Meyerowitz v CIR*.⁶²

In this case, the appellant had two sources of income. He received a share of the profit from the sale of two legal books that he wrote. He was also a shareholder in a company called "The Taxpayer (Pty)Ltd", which published a monthly journal of a similar name, of which he was the editor. The taxpayer ceded, for no consideration, his right to the income from the books to Visandra Investments (Pty)Ltd, a company in which he and his wife were the sole shareholders. This company, in turn, ceded the right to this income to a trust established for the benefit of the appellant's children. The rights in respect of income from the monthly journal were ceded from The Taxpayer (Pty)Ltd to a partnership consisting of the appellant's trust, a colleague's trust and a third person. The net result of these transactions, was that appellant's trust held the rights to the two text books and in partnership with two others, the rights to the monthly journal. Thus the trust received the profits derived from the sale of the books and from the journal, although these profits were produced by the skill and labour of the taxpayer. The Commissioner applied Section 103(1) and included in appellant's income the revenue derived from both sources.

⁶² *Meyerowitz v CIR* 1963 (3) SA 863 (A), 25 SATC 287.

On behalf of the appellant it was submitted to the court that the transactions described above were not part of a preconceived plan and so did not have the essential continuity or interrelationship to constitute a scheme as envisaged in Section 103(1). The Appellate Division did not agree. It held that the word "scheme" is a wide term and was sufficiently wide to cover a series of transactions. It examined the steps taken and asked whether the different steps upon examination in retrospect appear to be so interrelated that they could ultimately lead to tax avoidance. This test is objective. The Appellate Division was satisfied that in both situations the transactions of the taxpayer from beginning to end constituted a "scheme" within the definition of the act. The fact that not all the steps were contemplated at the outset or that the intention to avoid payment of tax appeared only from later steps was irrelevant. The taxpayer's appeal was dismissed.

Interestingly, this test is similar to the step transaction doctrine developed in other jurisdictions.⁶³ The test in our courts is whether there is sufficient interrelationship between the transactions that it can be considered a "scheme." If this unity is found to exist, then the scheme as a whole (as opposed to individual transactions that the scheme is composed of) must be judged in terms of Section 103.⁶⁴ In *CIR v Louw*⁶⁵ the court had to decide whether the lapse of time could be a fatal interruption between the steps of a series of transactions. The court found that as long as there is sufficient unity between the ultimate step and what has gone before, the passing of time cannot fatally interrupt the scheme.⁶⁶

⁶³ Refer to page 44.

⁶⁴ This is how the court treated the series of transactions in the *Meyerowitz* case.

⁶⁵ *CIR v Louw supra* n61.

⁶⁶ This unity was lacking in *Louw's* case and therefore, each transaction was looked at individually.

C.2. EFFECT OF AVOIDING LIABILITY FOR ANY TAX ON INCOME

The second condition that must be fulfilled for the application of Section 103(1) is that it has “the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act, or of reducing the amount thereof.”⁶⁷ In the case of *CIR v King*⁶⁸ “avoidance of liability” was given a very restrictive meaning.⁶⁹ In *Smith v CIR*⁷⁰ the court was of the opinion that Section 90 had undergone extensive amendments since the *King* case, that it was entitled to approach the interpretation of the words “avoiding liability” afresh.⁷¹ In particular, the introduction of the “abnormality” requirement in the amended Section 90 would prevent the absurd results feared in *King’s* case⁷² and thus the words could be given their natural meaning. Untrammelled, therefore, by “the reality of income” test formulated in *King*, Steyn, CJ came to the conclusion that :

“The ordinary natural meaning of the avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability.”⁷³

Thus almost any action a taxpayer takes which has the effect of reducing her tax burden will be trapped by these words. The Appellate Division in the case of *CIR v Louw*.⁷⁴ confirmed that the words “avoiding liability” must be interpreted widely. The words “postponing” and “reducing the amount of such liability” have not specifically been dealt with in any case, but it can be assumed that a court would interpret these words broadly as well, giving effect to the legislative intention of casting the general anti-avoidance provision as widely as possible.

⁶⁷ Section 103(1)(a) Income Tax Act.

⁶⁸ *CIR v King supra* n52.

⁶⁹ The test that was established in that case was whether the income of the taxpayer was “the product or fruit of a man’s labour or of his capital or both.” See page 18.

⁷⁰ *CIR v Smith* 1964(1) SA 324 (A), 26 SATC 1.

⁷¹ *ibid* at 333.

⁷² See page 18.

⁷³ *CIR v Smith supra* n70 at 333.

⁷⁴ *CIR v Louw supra* n61. For a criticism of the court’s approach in *Louw’s* case, see De Koker & Urquhart *supra* n22 26-11.

C.3. ABNORMALITY OF THE TRANSACTION

It has always been considered that tax avoidance can be identified by its use of forms and means foreign to ordinary daily transactions. This has been recognised by the legislature in the third requirement that must be satisfied for Section 103(1) to be applicable. This requirement relates to the means and manner in which a transaction was entered into and the question as to whether the rights or obligations created would normally be created by persons dealing at arm's length. As noted above,⁷⁵ this requirement may have been inspired by the *dicta* of Schreiner, JA in *CIR v King*.⁷⁶ In *King*, he was of the opinion that Section 90 was designed to overcome "the creation of abnormal or unnatural situations, to the detriment of the *fiscus*"⁷⁷ Schreiner, JA expounded this statement with the use of an example :

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

Thus, according to Schreiner, JA the requirement of "normality" is to be related to the source and nature of the income. Section 103(1)(b), however, pivots the normality test on (i) the means or manner the transaction was entered into or carried out or (ii) the rights or obligations created under the transaction. Conceivably there could be situations where the means or manner the transaction was entered into or carried out and where the rights or obligations created under the transaction are not abnormal, but where the owner of an income-producing asset does not receive the income or where the labourer does not receive the reward of her labour (e.g. where the owner of the income-producing asset or the labourer in question cede their respective right to income to another party. Such cessions occur daily in commerce and are an accepted legal and commercial practice.)⁷⁸ This transaction would fail

⁷⁵See page 18.

⁷⁶ *CIR v King supra* n52.

⁷⁷ *ibid* at 216.

⁷⁸ Note however that section 1 Gross Income definition paragraph (c)(ii) and section 7(7) govern the tax implications of ceding income and thus Section 103(1) would generally not be applied to cessions.

the normality test postulated by Schreiner, JA but would not offend Section 103(1)(b).

The opening words of Section 103(1)(b), "having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out." stress the external *indicia* of the transaction. Presumably, by stressing the external *indicia* of the transaction, tax avoidance transactions could more easily be identified. Thus the circumstances surrounding a transaction is essential in any inquiry into the normality of the transaction. As Trollip, JA observed in *Hicklin's* case:⁷⁹

"... when considering the normality of the rights or obligations so created or of the means or manner so employed, due regard has to be paid to the surrounding circumstances. As already pointed out s103(1) itself postulates that. Thus, what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. The last observation is that the problem of normality or abnormality is a factual one. The court in 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 thereon by either party."

What would be considered "normal" in one case would not be "normal" in another because of differing circumstances. Yet, there is no guidance as to which circumstances are to be taken into account. The section merely proceeds to stipulate two inquiries which must be satisfied before a transaction can be deemed abnormal. Subsection (b)(i) refers to the means or manner the transaction was entered into or carried out and subsection (b)(ii) focuses the investigation on the rights or obligations created under the transaction.⁸⁰ These subsections have been framed in the alternative, so that if either of the "abnormalities" referred to is found to exist, the transaction is abnormal. Initially, the courts had the tendency to deal with both tests simultaneously by simply inquiring whether the transaction was normal,⁸¹ but in *SIR v Geustyn, Forsyth and Joubert*,⁸² the Appellate Division departed from treating the

⁷⁹ *Hicklin v SIR supra* n8 at 494.

⁸⁰ See page 20 for the text of the Act.

⁸¹ See Steward "The prohibition of tax avoidance : an evaluation of Section 103 of the South African Income Tax Act (No 58 of 1962)" III *CILSA* (1970) 168 at 183; De Koker & Urquhart *supra* n22 26-13.

⁸² *SIR v Geustyn, Forsyth and Joubert supra* n61.

inquiry as a single test and investigated the applicability of each test to the set of facts before it. Section 103(1)(b)(ii) differs from Section 103(1)(b)(i) in that it has the additional stipulation that the rights and obligations which are considered normal, are those which are created between persons dealing at arm's length under a similar transaction. Section 103(1)(b)(i) does not have this requirement and presumably when examining the means and manner employed in the transaction, one must only look at the circumstances surrounding the transaction and the nature of the transaction, without reference to any arm's length criteria.

C.3.1. THE MEANS AND MANNER EMPLOYED

The courts appear to struggle with determining the yardstick by which normality must be measured. The fact that the Commissioner must have "regard to the circumstances under which the ... scheme was carried out" and "the nature of the ... scheme in question" has been interpreted as meaning that he must compare the means or manner in which the scheme was carried out with that of other similar schemes and circumstances. If they are the same, it is implied that no abnormality exists. This was particularly evident in *SIR v Geustyn, Forsyth and Joubert*,⁸³ where the court placed great emphasis upon the fact that should a certain business transaction be "fairly common-place in the commercial world" in similar circumstances, that there is nothing abnormal about the scheme. And in ITC 963, Galgut J was persuaded with a similar argument:

"This (the normality of the transaction) is all the more so when we are told that this is a test case, which indicates that several persons have entered into such transactions."⁸⁴

This seems to imply that the basis of the normality test is statistical. However, it is submitted that such an approach is ineffective in determining what is abnormal. The fact that many schemes carry the same characteristics should not negate the fact that they are abnormal. After all, the purpose of Section 103(1)(b) itself is to identify tax avoidance schemes in an objective manner. The criteria set out in the section

⁸³ *ibid.*

⁸⁴ ITC 963, 24 SATC at 709.

prescribe objective measures to be used in distinguishing tax avoidance schemes from other similar but *bona fide* schemes which have been or would be carried out in similar circumstances. As Broomberg notes:

“If the word ‘normal’ is to be interpreted purely on a sort of ‘70 million can’t be wrong’ basis, this vulnerability (of the section) is patent. Unfortunately, experience shows that where there is an opportunity to avoid tax, 70 million men of any nation are more than likely to be wrong, in the tax sense.”⁸⁵

Some courts have interpreted this provision as allowing it to use a form of the business purpose test. In ITC 1113,⁸⁶ the learned President held that;

“... it seems to me that there are several features of this transaction which are not normal, and which would not have been incorporated in a similar agreement entered into by ordinary businessmen.”

Thus, the normality of the transaction was tested with reference to what would be considered the “action of a normal businessman.” What ordinary businessmen do may be relevant in determining the normality of the means and manner in which the transaction was entered into or carried out, but this can never be the only criteria. It is submitted that in assessing the normality of the transactions, the courts must take several factors into account, in particular, the “circumstances under which the transaction, operation or scheme was entered into or carried out.”

C.3.2. THE ARM’S LENGTH CRITERIA

The arm’s length test is objective, namely whether parties dealing at arm’s length who enter into a transaction of a similar nature would have created the rights and obligations which were created. This does not mean that there is a standard contract which parties at arm’s length enter into and against which the “normality” of the transaction can be measured, but as Trollip, JA said :⁸⁷

“When the ‘transaction, operation or scheme’ is an agreement, as in the present case, it is important, I think, to determine first whether it was one concluded ‘at arm’s length’. That is the criterion postulated in para (ii). For ‘dealing at arm’s length’ is a useful and often easily determinable premise

⁸⁵ Broomberg “Tax recognition of a professional company” (1971) 88 SALJ 288.

⁸⁶ ITC 1113, 30 SATC 8 at 12.

⁸⁷ *Hicklin v SIR supra* n8 at 494-495.

from which to start the inquiry. **It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.** Indeed, in the Afrikaans text the corresponding phrase is 'die uiterste voorwaardes beding'. Hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by para (ii). And the means or manner employed in entering into it or carrying it out are more likely to be normal than abnormal in the sense envisaged by para(i)." (My highlights)

So, an arm's length test postulates two requirements :

1. the parties are independent of each other and
2. each strives to get the utmost possible advantage out of the transaction for herself.

If these two requirements are satisfied then "the rights and obligations it creates are **more likely to be regarded as normal than abnormal**". These two requirements are not overriding factors as Section 103(1)(b) instructs the court to also have due regard to "the circumstances under which the transaction, operation or scheme was entered into or carried out." Therefore, although the parties in *CIR v Louw*⁸⁸ did not fully satisfy both of the above criteria, the control exercised by the shareholders of the company over that company was one of the factors favourably considered by the court when deciding the normality issue in relation to the sale of the shareholder's practice to the company.

Commercial reality dictates that contracts take a variety of forms and create a variety of rights and obligations as are necessary in the circumstances in which the parties to the transaction may find themselves in. These advantages do not necessarily emerge in monetary form nor as rights and obligations, but could take a more insubstantial form such as greater awareness for a business' product or the gaining of expertise in a particular area. Trollip, JA seems to imply that such advantages are to be taken into account. As long as the parties are independent of each other and "strive to get the utmost possible advantage out of the transaction for himself" the rights and obligations are more likely to be considered normal than abnormal. Whether the advantages actually materialise or not is irrelevant. Thus if

⁸⁸ *CIR v Louw supra* n61 and see page 31 for the facts of the case.

two independent persons transact and each strives to get an advantage out of the transaction, but it so happens that only one party gets an advantage, the transaction ought to be considered "normal" even though the rights and obligations created are not generally encountered in commerce.

However, there is a logical inconsistency in trying to apply the test as set out in Section 103(1). The test is based upon the rights and obligations which would have been created between parties dealing at arm's length, but then requires the peculiar factors of the scheme being examined to be taken into account.⁸⁹ In applying the "normality" test under Section 103(1) to any given set of facts, the courts have taken note of this difficulty, particularly in situations where transactions are not concluded at arm's length. Often contracting parties are not independent of each other and share some sort of relationship. The question troubling the courts is whether the relationship between the parties constitutes a circumstance to which regard must be had. In *SIR v Geustyn, Forsyth and Joubert*⁹⁰ this problem was recognised :

"Section 103(1) is couched in very comprehensive terms, but in forming his opinion in relation to sub-paragraphs (i) and (ii) 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 'persons dealing at arm's length' mentioned in s 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 to a transaction, operation or scheme 'of the nature of the transaction, operation or scheme in question.' Yet the court is in the present case *ex hypothesi* concerned with partners who have, in the circumstances outlined above made over their practice, not to an independent third party with whom they would ordinarily deal 'at arm's length', but to an unlimited company of which they are the sole shareholders and directors and wherefore they have full and complete control. However, inasmuch as it is not essential for the decision of this case to pronounce upon this particular aspect of the matter (which was not exhaustively argued before us), I prefer to express no conclusion upon the point."

⁸⁹ As Silke (*supra* n26) at 1271 states:

"How can a transaction be required to be at arm's length having regard to circumstances that are anything but arm's length?"

⁹⁰ *SIR v Geustyn, Forsyth and Joubert supra* n61 at 574.

The impact of a special relationship *inter partes* was also considered in the *CIR v Louw*.⁹¹ The facts in *Louw's* case were fairly similar to *Geustyn's* case. In *Louw's* case, the respondent and his partners had decided to incorporate their business in 1966. The partnership business was transferred into the company and payment was made partly by an issue of shares and partly by crediting loan accounts. Profits which had previously accrued to the taxpayer by way of salary and drawings from the partnership, now accrued to the newly formed company. A portion of such profits was paid to the taxpayer as a salary while the balance was drawn from the company by way of loan account. The loan accounts eventually went into debit in about 1972. By 1976, the debit of all the directors' loan accounts exceeded R1 million. The amount which accrued to respondent by way of salary and dividends after incorporation was substantially lower than the income which had previously accrued to him from the partnership. The Commissioner sought to apply Section 103 to tax the shareholders on the profits accruing to the company (as the company tax rate was lower than that of individuals, the formation of the company had had the effect of reducing tax on profits). In applying Section 103 to the facts of the case, the court found that there was in fact two schemes, namely the incorporation of the business in 1966 and the subsequent making of loans to directors. Having drawn this distinction, the court examined each of the schemes in turn.

In this case, the court had to make a finding on the problem at hand, namely how to apply Section 103 to transactions in which the parties share some relationship. Corbett, CJ held that:⁹²

“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 s103(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 the very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as its shareholders and directors the

⁹¹ *CIR v Louw supra* n61.

⁹² *CIR v Louw supra* n61 at 574.

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 the case such as the present the transaction is a multi-partite one to which all the partners and the company are parties; each partner contracts both with the company and his fellow partners and seeks to extract from the transaction the best possible advantage for himself.”

Corbett, CJ therefore accepts that relationships between the parties can play a role if, and only if, such a relationship is part of the very nature of the transaction in question. If a relationship between the parties is part of the essence of such a transaction, then the arm's length requirement must fall away, as it is not possible for the Court to “ignore this special relationship and yet give proper effect to the concluding words of s103(1)(ii).”⁹³ In this situation, the contract was an incorporation scheme and it was inevitable that the parties to the transaction had a special relationship, as the partners of the practice had become the directors and shareholders of the company to which the practice was sold to. Corbett CJ's approach to the normality question requires an inquiry into the following :

1. The nature of the transaction in question;
2. the circumstances surrounding the transaction;

If it is part of the nature of the transaction for the parties to have a special relationship, take this into account. If it is not part of the nature of the transaction for parties to share a special relationship, then only those circumstances which would be relevant in a transaction between independent parties (i.e. an arm's length transaction) must be taken into account.

3. And finally whether each party attempted to gain the utmost possible advantage out of the transaction for herself.

How did the special relationship between the parties affect the inquiry into the normality of the transaction in *Louw's* case? After deciding that the special relationship between the parties had to be taken into account, the Chief Justice proceeded to examine the features of the incorporation scheme and in particular the rights and obligations created under the scheme. He concluded that the unspecified date for the payment of the purchase price, the non-payment of interest on the

⁹³ *ibid.*

purchase price and the smaller salary received by the erstwhile partners did not carry enough weight to convince the court that the transaction in question created abnormal rights and obligations. Contrast this with the court's approach to the director's loans in the same case.⁹⁴ The court did not even take the relationship of the parties into account when examining the normality of the loans, as it considered that a special relationship between the parties is not an essential ingredient of such a transaction. The court's decision rested on its classification of the transaction as a loan (as opposed to a director's loan). A director's loan is a specific form of loan transaction which often occurs between a director and his company. It is almost inevitable that the parties to such a loan will have a relationship. However, the director's loans were compared to loans which would have been concluded between parties trading at arm's length, thus ignoring the specific circumstances of the transaction in this case. The result of this was that factors such as that there was no time limit for repayment of the loans, that they were granted to the directors free of interest and that as a consequence of the loans, the directors accepted smaller salaries, were considered factors of sufficient merit to deem the rights and obligations created under the loan transaction as abnormal. The same factors which were not sufficient to convince the court of the abnormality of the incorporation scheme counted against the taxpayer in the loan transactions. Thus the classification of the transaction by the court as one in which a special relationship between the contracting parties does not play a role, affected the weight given to each of the circumstances surrounding a transaction, resulting in the director's loan being deemed abnormal.

Thus, to summarise : In most cases, the transaction will be an arm's length transaction and it will be approached and analysed by the court as such. However, Section 103(1)(b) demands that the circumstances surrounding a transaction be taken into account. This is not normally a problem unless the parties to the transaction have a special relationship. This relationship must be taken into account only when the transaction in question by its very nature requires a special

⁹⁴ *ibid* at 577.

relationship between the parties. It must be stressed that the court looks at the legal nature of the contract between the parties because it is the legal nature of the transaction that determines whether the relationship between the parties plays a role in determining the normality of the transaction. The fact that the transaction is commonly encountered in daily business activities (i.e. that it is a "normal" transaction in the sense of "usual" or "common") is not taken into account. The approach adopted by the court, viz. to analyse the transaction as an arm's length one or to analyse it in the light of the special relationship between the parties, will affect the weight given to each of the factors in the transaction. Thus the same factors can give different results in similar transactions. This, of course, presents problems for any taxpayer, as the normality of a transaction often is dependant on whether or not a court considers a relationship between parties as an essential component of the transaction in question.

C.4. PURPOSE OF THE TRANSACTION

If all the other requirements of Section 103(1) are complied with, the Commissioner may apply the section if she is satisfied that the transaction was carried out "solely or mainly for the purpose of the avoidance or the postponement of liability for the payment of any tax, duty or levy...or the reduction of the amount of such liability."⁹⁵ The "purpose" referred to in this section, does not have the same meaning as the "effect" of the transaction, but rather refers to the intention of the taxpayer.⁹⁶ The insertion of this requirement into the anti-avoidance provision was necessary, because according to the South African common law, the purpose with which a person avoids a statute is irrelevant when deciding whether a particular statute is to be applicable to a set of facts.⁹⁷

⁹⁵ Section 103(1)(c) Income Tax Act.

⁹⁶ *SIR v Geustyn, Forsyth and Joubert supra* n61 576; *SIR v Gallagher supra* n61 at 471.

⁹⁷ *Dadoo Ltd & others v Krugersdorp Municipal Council supra* n32 at 559-60; *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd supra* n18 at 379-80.

The test for the taxpayer's purpose is a subjective one⁹⁸ and therefore, the evidence of the progenitor of the scheme is of prime importance.⁹⁹ However, to view this requirement as one that favours the taxpayer is largely illusory, as once it is proved that the transaction would result in the avoidance or the postponement of liability for the payment of any tax, Section 103(4) creates the rebuttable presumption that the transaction was entered into for the sole or main purpose of avoiding or postponing taxation. It is the taxpayer who has the onus of rebutting this presumption and the mere assertion by him that his purpose was not the avoidance of tax does not carry much weight.¹⁰⁰ To rebut the presumption, the taxpayer must have had some compelling reasons for entering into the transaction and convince the court that these reasons are in themselves good enough to have motivated his actions.¹⁰¹

Section 103 does not apply unless the tax avoidance purpose was the sole or main purpose. This means that tax avoidance must have been the dominant factor motivating the taxpayer to enter into or carry out the scheme or, at the very least, it was an equally important factor motivating the transaction. Thus if tax avoidance is only one of the purposes the taxpayer entered into the scheme, but it was not decisive in any way in the taxpayer's decision to enter into the transaction, the section will not apply. When determining the sole or main purpose of the transaction, it is the time when the scheme is implemented and not when it was first conceived that must be looked to. The purpose of a scheme when it is first formulated may not be to avoid tax, but it may have become the purpose when the scheme is implemented.¹⁰²

Derksen¹⁰³ has argued that this requirement of Section 103 is bad in law. He maintains that whether or not the taxpayer has the intention of avoiding liability

⁹⁸ *op cit.* n50.

⁹⁹ *ibid*; *CIR v Louw supra* n61 at 575.

¹⁰⁰ *SIR v Gallagher supra* n61; *Ovenstone v SIR supra* n61.

¹⁰¹ *De Koker & Urquhart supra* n22 at 26-21.

¹⁰² *Ovenstone v SIR supra* n61.

¹⁰³ Derksen "n Benadering tot die Uitleg van Wette, met besondere verwysing na die Inkomstebelasting wet 58 van 1962 en vermydingskemas" unpublished LLD thesis UNISA 1989 at 178.

should be irrelevant. The effect of legislation is to be determined by its interpretation and should not be dependant on a person's intention. The intention to avoid a law was also considered to be irrelevant in Roman Law and Roman-Dutch Law. Thus, Derksen maintains that the inclusion of this requirement is against both the common law and logic.

C.5. THE COMMISSIONER'S REMEDY

Once all the requirements of Section 103(1) have been complied with, then the Commissioner is obliged to determine the taxpayer's liability for any taxation under the act. Measuring the effect of the avoidance to determine the taxpayer's liability is not easy. The amount is to be determined in one of two manners :

1. as if the transaction has not been entered into or carried out; or
2. in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of the avoidance, postponement or reduction of taxation.¹⁰⁴

It follows that there must be an anticipated flow of income and a tax implication thereof, before the Commissioner can show that the effect of the scheme was to avoid tax. In essence, this provision allows the Commissioner to assessment for tax on the *status quo ante* and even if the taxpayer is not the owner of the income and can never lay her hands on it she will be liable for the tax. This is of course a hypothetical state of affairs, because the transaction in fact exists between the parties and the Commissioner could have great difficulty in determining the tax liability.

In *CIR v Smith*,¹⁰⁵ the former alternative was applied and the existence of several intermediate companies was ignored. The taxpayer in this case did not receive any benefit from the income (as he was taxed on dividends which would have come into his hands had it not been for the scheme). In the scheme, he had ensured that

¹⁰⁴ Section 103(1) Income Tax Act.

¹⁰⁵ *CIR v Smith supra* n70.

certain dividends accrued to a Rhodesian company. The court's finding that Section 103 was applicable, resulted in the taxpayer being liable for the taxation on the dividend even though he had not actually received it. In the process of determining the taxpayer's liability, the court made up a fictional set of facts, i.e. it compared the real/actual factual matrix with a made up one. It has always been a principle of our law that effect must be given to the intention of the legislature. In the Income Tax Act, the intention is clearly one to tax the individual on that which she earns through the use of her skill, labour or capital. Thus, if a person channels the income thus earned through a trust or through a series of companies (as in *Smith*), then the legislative intention has not been given effect to. The courts have not always been willing to give effect to this intention and therefore, the introduction of Section 103. However, the section does not try to clarify the legislative intent. It attempts to mould the factual matrix. The section requires that the same legislative effects must occur as would occur had the factual matrix imagined by the legislature (the normal transaction) occurred. The problem is therefore trying to be solved by the creation of an imaginary set of facts. To require a court to create such an imaginary set of facts is unacceptable and can have harsh results.

The powers of the Commissioner are considerably extended by the latter alternative to assess the taxpayer's liability for tax. It allows the Commissioner to :

“...pull down part of that edifice and tax on the basis that 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 this provided that the result is not to subject any portion of the taxpayer's income to double income tax...”¹⁰⁶

In pulling down or partly pulling down a tax avoidance scheme, the Commissioner may not create or impute rights and obligations to a transaction that do not exist in the contract between the parties. He may not create income or subject to taxation notional income which does not exist. Therefore, the Commissioner is not entitled to subject to tax a lender of an interest-free loan on an amount that she could have earned had she charged interest, or to tax a person who offers professional services to another free of charge, nor is he entitled to change the nature of the receipt from

¹⁰⁶ *H v COT* 1972 (2) SA 719 (RAD).

capital to income and subject the amount to tax. Despite this, the Commissioner's powers are wide and she may re-open prior year assessments to make the necessary adjustments the taxpayer's tax liability.¹⁰⁷

¹⁰⁷ *ibid*; *CIR v Louw supra* n61; see Haupt "The commissioner's remedy" (1987) 2 Tax Planning 93 and De Koker & Urquhart *supra* n22 26-11 for a criticism of the court's approach in *Louw's* case.

D. TAX AVOIDANCE IN OTHER JURISDICTIONS

D. I. UNITED STATES OF AMERICA

Like the United Kingdom, the United States has no general tax anti-avoidance provision and has had to develop a judicial anti-tax avoidance doctrine to carry out the policy of the legislature. However, any comparison between the American system and that of Britain or South Africa must be done cautiously.¹⁰⁸ Firstly, the American court structure is such that judicial interpretation emanates from many different sources. Its structure contrasts sharply with our more unified court structure.¹⁰⁹ Further, the American courts have a very different approach to the interpretation of statutes. They are far more creative and daring in identifying the statute's purpose and giving effect thereto. This has resulted in the courts developing a multitude of general principles and doctrines which can be applied to solve problems. Notwithstanding, some valid generalisations can be made and valuable lessons learnt from a review of the United States' approach to tax avoidance.¹¹⁰

Several doctrines were developed and are widely used in the United States, such as the business purpose test, the step transaction doctrine, continuity of interest, continuity of business enterprise, substance over form doctrine and the doctrine of

¹⁰⁸ For a more detailed analysis, see : Popkin "Judicial anti-avoidance doctrine in England : A United States perspective" (1991) British Tax Review 283; Tiley "Judicial anti-avoidance doctrines : the US alternatives" (1987) British Tax Review 180.

¹⁰⁹ There is a specialised tax court with jurisdiction that is limited to a single state. The district courts have a more general jurisdiction. The decisions from these courts are reviewed by the Courts of Appeal. There are also Claim Courts whose decisions are reviewed by the Court of Appeals for the Federal circuit. The Supreme Court hears few appeals from the Appeal Courts.

¹¹⁰ The reader is referred to the following texts : Millet "Artificial tax avoidance : The English and American approach" (1986) British Tax Review 327; Brown "Applying circular reasoning to linear transactions : substance over form theory in US and UK tax law" (1992) 15 Hastings International and Comparative Law Review 169; Ward *et al* "The business purpose test and abuse of rights" (1985) British Tax Review 68; Tiley *supra* n5;. Tiley *supra* n108; Popkin *supra* n108.

recharacterisation.¹¹¹ Of these doctrines, the business purpose test has emerged as the most widely applied and most workable doctrine. It is generally accepted that the business purpose test was first introduced in the United States' tax law in the case of *Gregory v Helvering*,¹¹² which involved a taxpayer's attempt to receive a dividend at a reduced tax cost by transferring his shares in a company to a newly formed subsidiary company, which subsequently distributed its stock to the taxpayer. The test established in that case is best summarised by the Learned Hand J, who gave the majority judgement in the case :

"In construing the words of a tax statute which describe commercial or industrial transactions, we are to understand them to refer to transactions entered upon for commercial or industrial purposes, and not to include transactions entered upon for no other purpose but to escape tax."¹¹³

And in *Gilbert v CIR*¹¹⁴ he said :

"It is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions they are meant to cover; and their interpretation demands the projection of their expressed purpose upon occasions not present in the minds of those who enacted them. 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 itself is a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect 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 the liabilities it sought to impose."

This test coupled with the United States' court attitude of judicial activism, has proven to be a very effective and flexible method of countering tax avoidance.¹¹⁵

However, while the doctrine is pervasive, it is also unpredictable. In the case of *Commissioner v Court Holding Company*,¹¹⁶ the Supreme Court applied the *Gregory* principle and held that a corporation sold an apartment building, even though title to

¹¹¹ Isenbergh "Musings on form and substance in taxation" (1982) 49 University of Chicago Law Review 859.

¹¹² *Gregory v Helvering* 69 F.2d 809 (2d Cir. 1934), 293 US 465 (1935).

¹¹³ *CIR v Transport Trading & Terminal Corporation*, 1176 Fed. 2nd. 570 (1949).

¹¹⁴ *Gilbert v CIR* 248 Fed. 2nd 299 at 411 (1957).

¹¹⁵ See Popkin *supra* n108 284; Tiley *supra* n108 185.

¹¹⁶ *Commissioner v Court Holding Company*, 324 US 331 (1945).

the building was actually transferred by the shareholders. A mere five years later, the Supreme Court reached the opposite result in a similar sale.¹¹⁷ Thus the United States taxpayers have been almost equally successful in getting the courts to rule in their favour as the Revenue authorities. Also, the business purpose doctrine overlaps with the other doctrines, making its consistent application of to a set of facts even more difficult.¹¹⁸ This has led to at least one writer to comment that in the United States "the court has no chance of demonstrating a firm intellectual foundation for what it is doing."¹¹⁹

D.2. TAX AVOIDANCE IN THE U.K.

There is no single tax anti-avoidance provision in the United Kingdom. The authorities there plug any loop-holes in the taxing legislation, as and when they are identified. They have also relied on the courts to develop an anti-avoidance policy, but the English courts have not always been supportive of Revenue's attempts to curb tax avoidance. The prevailing view of the English judiciary for most of this century, was the pro-taxpayer literalism embodied in the famous *Duke of Westminster* case.¹²⁰ However, the judiciary slowly began to shift away from this approach and the pro-taxpayer bias started to weaken, culminating in the *Ramsay*¹²¹, *Burmah*¹²² and *Furniss*¹²³ trilogy of cases. This evolution of a judicial anti-avoidance principle was halted by *Craven v White*¹²⁴, which essentially decided that the courts had gone too far.

¹¹⁷ *United States v Cumberland Pub. Serv. Company*, 338 US 451 (1950).

¹¹⁸ *Surrey et al Federal Income Taxation, cases and materials* describes the test as "a technique of statutory interpretation difficult to apply but essential to [the United States] tax system as it now operates" - quoted in *Ward et al supra* n110.

¹¹⁹ *Tiley supra* n5 142.

¹²⁰ *Duke of Westminster v IRC supra* n8.

¹²¹ *W.T. Ramsay v IRC* [1981] 2 WLR 449; [1981] 1 All ER 865 (HL); [1982] AC 300

¹²² *IRC v Burmah Oil Company Ltd* [1982] STC 30 (HL); [1982] Brit. Tax Cases 56.

¹²³ *Furniss v Dawson* [1984] 1 All ER 530; [1984] AC 474.

¹²⁴ *Craven v White* [1988] STC 476 (HL).

D.2.1. IRC v DUKE OF WESTMINSTER

Under English law, payments covenanted to be made for at least seven years were deductible by the payor. The taxpayer made use of a covenant to convert non-deductible wages paid to his personal servants into deductible payments. The Law Lords held that the taxpayer was entitled to the letter of the law, as long as the legal rights created by the covenant were what they purported to be. They insisted that the "letter of the law must determine tax obligations" and looked with "disfavour" upon the doctrine that the "substance of the transaction" should be taxed if it comes within the "spirit of the statute."¹²⁵ And the dictum of Lord Tomlin emphasised that the taxpayer had a wide latitude to arrange her affairs so that her taxes are as low as possible.¹²⁶ The primary principle behind this "*Westminster* doctrine" was that : "Given a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance."¹²⁷ Therefore, given that legal rights are created between parties, these rights are taken into account in determining the tax consequences of the transactions and the result is binding on the court.

D.2.2. THE JUDICIAL ANTI-AVOIDANCE DOCTRINE

In the 1960s, the English judiciary's attitude began to shift towards the suspicion of tax avoidance. The catalyst for change was probably the large body of anti-tax avoidance legislation. The hostility of Parliament to the avoidance of tax, made it very difficult for the courts to insist that when interpreting tax law, a pro-taxpayer point of view must be adopted. Most of the cases during the 60s and 70s dealt with specific tax avoidance provisions or with provisions that could easily be interpreted to require the taxpayer to have the object of reducing tax.¹²⁸ However, the courts were taking a broader interpretative approach to statutes and moving away from the literalism of the *Westminster* case. In 1982 the English courts were finally prepared

¹²⁵ *Duke of Westminster v IRC supra* n8 at 24.

¹²⁶ *Duke of Westminster v IRC supra* n8 at 19 and see text thereto (page 6).

¹²⁷ *W.T. Ramsay v IRC supra* n121 at 323.

¹²⁸ For a more detailed analysis of this period, see Popkin *supra* n108 291 *et seq.*

for the introduction of a more pervasive judicial anti-avoidance doctrine, which has become known as the *Ramsay* principle.¹²⁹

D.2.2.1. *W.T. RAMSAY LTD v IRC*

The taxpayer in *Ramsay's* case wished to manufacture a capital loss so as to reduce an existing capital gain. It purchased a capital loss scheme, which involved the use of a company and two loans. The result of this scheme was that the taxpayer returned all the funds it had borrowed to finance the scheme and also incurred a capital loss equivalent to the capital gain that it wished to offset. Thus the taxpayer secured a tax advantage without any financial effects, i.e. he neither gained nor lost on the scheme, and was not liable for capital gains tax on his initial capital gain. The principal question before the court was whether, as a matter of law, the separate individual stages of a transaction, intended from the outset to be circular and self-cancelling, were capable of having fiscal consequences. The answer of the House of Lords was a resounding "Yes."

Ostensibly, the House of Lords did not seek to overrule the *Westminster* doctrine but rather to apply it, without overstating or overextending it, to a series of transactions.¹³⁰ Lord Wilberforce acknowledged the principle established in English Law that the taxpayer should be entitled to rely on the "clear words" of the statute, but he then proceeded to knock down each of the pillars supporting pro-taxpayer literalism. He stated that in applying the legislation, the courts are not confined to the literal interpretation of the statute and although the taxpayer will be taxed according to the clear literary words of the statute, the Act must be placed in context, the purpose of the legislation as well as the "scheme of the act" must be taken into account.¹³¹ This, the court claimed, was not a new principle; rather a new approach.¹³² Fundamental to this new approach is that the true legal effect of the

¹²⁹ After the case of *W.T. Ramsay v IRC supra* n121.

¹³⁰ *ibid* 323.

¹³¹ *ibid* 480.

¹³² *ibid* at 326 Lord Wilberforce says :

transaction (which Lord Fraser in a later case called “the relevant transaction”¹³³) and of the parties’ actions must first be determined.¹³⁴ Once the true legal nature of the transaction has been determined, the tax legislation must be applied to the finding.

Where a transaction consists of separate individual stages (and especially where these transactions are intended from the outset to be circular and self-cancelling), both Lord Wilberforce and Lord Fraser emphasised that the courts were entitled and bound in these cases to look at the scheme as a whole, i.e. each transaction must be construed and given effect in the context of the whole series, and not as if it stood alone :

“To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process...To say that a loss (or gain) which appears to arise at one stage in an individual process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, is not such a loss (or gain) as the legislation is dealing with is in my opinion, well and indeed within the judicial function.”¹³⁵

And where the transaction or series of transactions has been concluded substantially without a business purpose and merely for the obtaining of a beneficial tax result, the court has the authority to strike down, or recharacterise transactions for purposes of determining a taxpayer’s liability for tax. This approach of the Law Lords was to become known as the step transaction doctrine. And when this doctrine was applied to the facts in this case the court found that the individual transactions should be ignored; the only legal consequences were those which flowed from the series of transactions, taken as an indivisible whole.

“[T]he approach for which the Crown contends does not introduce a new principle; it would apply to new and sophisticated legal devices, the undoubted power and duty of the courts to determine their nature in law and to relate them to existing legislation.”

¹³³ *Furniss v Dawson supra* n123 at 513.

¹³⁴ *W.T. Ramsay v IRC supra* n121 at 323.

¹³⁵ *ibid* 449, 450.

D.2.2.2. *FURNISS v DAWSON*

After *Ramsay's* case, it was believed that the new attitude of the English courts was limited to situations where losses and tax relief were fabricated, where commercial reality was lacking and where the main objective of the transaction was the avoidance or reduction of tax. However, the Law Lords made it clear that the principle which emerged in *Ramsay's* case was not to be limited to its facts¹³⁶ and extended it in the case of *Furniss v Dawson*.¹³⁷ In this case, the Dawsons wished to sell their shares in their private company to another company, but this would have led to an immediate capital gains tax. In order to defer the payment of capital gains tax on the gain which would have been realised on the sale of the shares, the taxpayers set up an Isle of Man investment company, Greenjacket and transferred the shares in the private company in exchange for shares in Greenjacket. This intermediate company then sold the original shares to the ultimate purchaser. The Dawsons thought that they had rolled over their gain until such time as they disposed of the shares in Greenjacket. The Court of Appeal had found for the taxpayer, stressing the enduring legal consequences arising from the continued existence of the Isle of Man corporation. However, the Law Lords did not find this fact critical. The governing principle as per the majority judgement, was that tax should be imposed in accordance with the end result when "preordained" steps short of a contract are carried through with the insertion of a step having "no commercial purpose apart from the avoidance of a liability to tax", regardless of whether there is a "legitimate commercial end."¹³⁸ Lord Brightman set this approach out thus :

"First, there must be a pre-ordained series of transactions; or if one likes, a single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end... Second, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax - not 'no business effect.' If those two ingredients exist, the inserted steps are to be disregarded

¹³⁶ *Furniss v Dawson supra* n123 at 543, the majority chastised the lower court for limiting the *Ramsay* principle to self-cancelling transactions and for resisting "what they conceive to be a deplorable inroad into the sacred principles of the *Westminster* case."

¹³⁷ *Furniss v Dawson supra* n123.

¹³⁸ *ibid* 543.

for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied”¹³⁹

The result was that the House of Lords held, that looking at the transactions as a whole, the legal nature of these transactions was that the taxpayer had disposed of his shares directly to the purchaser in return for consideration paid to the intermediate company, therefore, capital gains tax was payable immediately.

Furniss was different from *Ramsay* in several respects. Firstly, it involved a real outside party (the purchaser of shares). Secondly, the transactions involved were “linear” and not “circular”. Thirdly, the Isle of Man corporation played an enduring role, because it survived the transaction and retained the sales proceeds. Fourthly, to obtain the desired fiscal consequences, viz. to impose tax as though the taxpayer had sold the asset and received the proceeds, it was necessary to restructure the events into something which had not occurred. The court could not achieve this result by simply ignoring the intermediate steps. It is especially this fourth aspect that has attracted much criticism.

D.2.2.3. *CRAVEN v WHITE*

Craven v White,¹⁴⁰ like *Furniss* involved a plan to use an Isle of Man corporation to avoid tax on the sales proceeds of stock, except that the transfer of the shares to the Isle of Man corporation occurred when the ultimate purchaser of the stock and the terms of sale were uncertain. In a three to two decision, the House of Lords held that the sale by the corporation was not “pre-ordained” and could therefore not be reconstructed as a direct sale by the taxpayer.¹⁴¹ The tension between the literalist approach to statutory interpretation and the purposive approach which had been evolving in the former cases, came to a head in the judgements of the court. The majority opted for the literalist view, but tempered it with the recognition that the

¹³⁹ *ibid* at 527.

¹⁴⁰ *Craven v White supra* n124.

¹⁴¹ The case also involved two other instances of transfers to related corporations to avoid tax on a sale by the transferor to a third party. In both instances, the sales negotiations were suspended and later revived, leading to an eventual sale. All five judges held for the taxpayers in these instances.

court may recognise and implement some principle that underlies the statute. This containment of the *Ramsay* doctrine and the halt in the development of the judicial anti-tax avoidance doctrine is evidenced in the cases following *Craven's case*.¹⁴² This is not to say that there is a return to the pro-taxpayer literalism of *Westminster*, rather the English Law seems to have settled at the balancing of the interests of the taxpayer with that of the Revenue authorities. However, uncertainty in which direction the English law will develop in future still exists.

D.3. AUSTRALIA

Australia has in addition to specific anti-avoidance provisions, two general anti-avoidance provisions :

- Section 260 of the Income Tax Assessment Act, which applies to transactions entered into prior to 27 May 1981;
- Part IVA Income Tax Assessment Act, which deals with all other transactions.

D.3.1. SECTION 260

This section is a very broadly-worded tax anti-avoidance provision, which gives the Commissioner the power to ignore the transactions which are caught by it. The Australian courts did not place much significance on this section and limited its application severely by developing the "choice" principle which states :¹⁴³

"The taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes specific provision and the validity of the transaction is not affected by section 260 merely because the tax consequences which it attracts are more advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining the advantage."

Even though, section 260 was rendered largely ineffective by the Australian Court and its application of the choice principle, the fact of its existence was seen as sufficient reason to exclude the development of any judicial approach towards

¹⁴² Popkin *supra* n108 at 303.

¹⁴³ *Gridland v COT* [1978] 52 AJJR 96 at 98.

nullifying tax avoidance schemes.¹⁴⁴ As it appeared that the section was all but decimated, the High Court of Australia gave it a startling new lease of life in 1985 when it relied on the section in a finding against a group of medical taxpayers.¹⁴⁵ Although cases on this section are still being heard, it has been superseded in importance by a rising star, Part IV A.

D.3.2. PART IV A OF THE INCOME TAX ASSESSMENT ACT

Because of the failure of Section 260 in countering tax avoidance schemes, the Australian legislature introduced a new general anti-avoidance provision¹⁴⁶ to replace the tax anti-avoidance provision. A statutory provision¹⁴⁷ directing the Australian courts, in interpreting statutes, to recognise the purpose or object underlying the statute was also enacted. Essentially, the new tax anti-avoidance provision, Part IV A, provides that where a taxpayer enters an agreement with the sole or dominant purpose of gaining a tax benefit, the Commissioner may deny the taxpayer such benefit. Paragraph (b) of section 177D of Part IV provides eight alternative tests which Revenue can consider in deciding whether the scheme was entered into for the purpose of enabling the taxpayer to obtain a tax benefit. These tests include, *inter alia*, the manner in which the scheme was entered into or carried out, the form and substance of the scheme, the time which the scheme was entered into and the period during which the scheme was carried out, the result which would be achieved by the scheme, any change in the financial position of the taxpayer arising out of the scheme, any change in the financial position of any other person and any other consequences for the relevant taxpayer or any other person connected with him. It is evident from this that, as any general anti-avoidance provision, Part IV A is broadly worded. The legislature has attempted to cover all possible forms of tax avoidance, compromising only in that it requires that the

¹⁴⁴ There have been calls for a similar approach by the South African courts. See Spiro (Ed) "An Australian approach to tax avoidance" 38 (1989) *The Taxpayer* 84.

¹⁴⁵ *Federal Commissioner of Tax v Gulland; Watson v Commissioner of Tax and Pincus v Federal Commissioner of Tax* 85 ATC 4765, (1985) 17 ATR 1.

¹⁴⁶ Part IVA Income Tax Assessment Act.

¹⁴⁷ Section 15AA Acts Interpretation Act.

purpose of conferring a tax benefit upon some person must be the dominant purpose of the scheme.

Part IV was considered in *FCT v Peabody*.¹⁴⁸ The court held that although the section required the Commissioner to exercise her discretion, it could only be exercised when the alleged tax benefit is established as an objective fact. The court then went on to examine the scheme under attack in its overall context. It found that the scheme as a whole had a commercial purpose and could be justified on a commercial basis. From this case it appears that the Australian legislature is hardly any better off than it was prior to the enactment of the new general anti-avoidance provision, as it is not clear how judicial attitudes will change with these amendments, if at all. The new provisions seem capable of having a wide interpretation, but there is still a great deal of debate and speculation as to their scope. The only thing that is certain in Australian law, is that the Australian Courts have conclusively rejected the path chosen by their English brethren. In the case of *John v FCT*¹⁴⁹ the full bench of High Court Justices concurred "that where there is a specific statutory provision on a topic there is no room for implication of any further matter on the same topic" and therefore there was no room in Australian law for the *Ramsay* principle.¹⁵⁰

D.4. REJECTION OF THESE DOCTRINES

This brief analysis has given us some insight to the approach to tax avoidance adopted by the courts in other countries. It has also demonstrated to us that these courts are all wrestling with similar problems. However, the approach of the American courts and that of Australia cannot be accepted as suitable for the South African legal system. The level of judicial activism, present in the approach of the United States, has never been followed by a South African court. The extent to

¹⁴⁸ *FCT v Peabody* 28 ATC 344.

¹⁴⁹ *John v FCT* (1988) 166 CLR 417.

¹⁵⁰ *ibid* 421. Of course, the same reasoning applies to the application of Section IV A.

which the courts are prepared to go to give effect to the purpose of the taxing statute and to counter tax avoidance is admirable. However, the resultant uncertainty and seemingly lack of principle is unacceptable in our legal system. The diametrically opposite approach of the Australian courts, is equally unattractive. These courts virtually ignore the tax anti-avoidance provisions introduced by the legislature. However, the English courts' balancing of the interests of the taxpayer and that of the legislative intention is intensely appealing. There is certainly some merit in the proposition that Section 103(1) would be more effective if our courts follow the route of the English courts. It is not to say that our courts must vacillate between judicial activism and restraint (as the English courts have done), but rather that the current English doctrine which takes into account the interests of both interested parties could be adopted by our courts.

Derksen¹⁵¹ has convincingly argued that the South African courts should not to adopt the English tax anti-avoidance rule. He argues that the substance over form approach of the English courts amounts to the creation of a legal rule (the *Furniss* rule). This rule was developed because the House of Lords wanted to give effect to the principle underlying the tax statute. The rule which was created provides that

“where a preplanned series of transactions which probably would have been entered into was in fact entered into, and steps were inserted in the series with the purpose of avoiding tax, tax should be levied as if the steps had not been inserted.”¹⁵²

In other words, where certain factual prerequisites are met, the taxing statute must be applied as if the intermediate steps had never taken place. The factual prerequisites that have to be met were summarised by Lord Oliver in *Craven v White*:¹⁵³

As the law currently stands, the essentials emerging from *Dawson* appear to me to be four in number : (1) that the series of transactions was, at the time when the intermediate transaction was entered into, preordained in order to produce a given result, (2) that that transaction had no other purpose than tax mitigation, (3) that there was at that time no practical likelihood that the

¹⁵¹ Derksen “Should the South African courts adopt the English anti-tax-avoidance rule in *Furniss v Dawson*” (1990) 107 SALJ 416.

¹⁵² *ibid.*

¹⁵³ *Craven v White supra* n124 at 507.

preplanned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and (4) that the preordained events did in fact take place. In these circumstances the court can be justified in linking the beginning with the end so as to make a single composite whole to which the fiscal results of the single composite whole are applied'

The rule prescribes a certain approach to the interpretation of statutes and has the effect that when the statute is applied, the beneficial results which a tax-avoidance scheme may otherwise have had for the taxpayer is eliminated. This approach to the interpretation of statute is not acceptable in South Africa. The South African courts have always interpreted statutes by using certain interpretational aids, such as the history of the statute, the wording of other statutes, the principle underlying the statute. These interpretational aids are guidelines which assist the court to determine the content and manner of application of the legal rule in question. Each of the interpretational aids are carefully considered and weighed before a meaning is attached to the statute under consideration. Unlike the *Furniss* rule, they do not in themselves determine that certain legal consequences result if certain facts exist. It is unacceptable that one rule (the *Furniss* rule) determines when another rule (the statute in question) is to be applied.

Further, the factual requirements for the application of the *Furniss* rule are that the acts must be performed with the purpose of avoiding the statute and that the series of acts should have been "preordained,"¹⁵⁴ before the tax statute could be applied. Such a stance has never been accepted in our courts. Whether a statute is applicable or not is a question of interpretation.¹⁵⁵ The applicability of the statute to the subject is not dependent on the person's purpose or to any element of preplanning. The statute may indicate that these requirements are to be considered and weighed together with the other interpretational aids when deciding whether the statute is applicable to the set of facts, and the cases cannot be criticised for considering these elements. However,

"[W]hat can be criticised about *Furniss v Dawson* is that the element of preplanning was held to be a (fixed) element of a legal rule independent of the legal rule contained in the statute concerned. It is not possible to lay down fixed, precisely formulated rules on what the ratio of a particular statute or of all the statutes (or of all tax statute) will contain. The ratio legis may indicate that the purpose with which an act is performed is relevant in one case but not in another."¹⁵⁶

Derksen provides a third reason for rejecting *Furniss*.¹⁵⁷ According to that case, the tax has to be levied as if the inserted steps (which were inserted with the purpose of avoiding the taxing statute) had never been inserted. This means that the court has to "think away" the acts in question and apply the tax statute to a fictional sets of facts. This is *contra* South African legal principles, as a court may only apply a statute to the set of facts before it and has no authority to invent facts. Sometimes, a statute empowers the creation of a fictional set of facts, (e.g. Section 103 allows the Commissioner to invent a set of facts) and in such a case the applier of the statute may do so.

It is therefore submitted that the English approach to substance over form as

¹⁵⁴ In *Craven v White (ibid)*, Lord Oliver found that the term "preordained" implied that the transaction must have been preplanned and that it would have probably been entered into at the time it was in fact entered into.

¹⁵⁵ Derksen *supra* n151 at 425.

¹⁵⁶ *ibid* at 428.

¹⁵⁷ *ibid* at 429.

applied in *Ramsay* and *Furniss* is not acceptable in our law.¹⁵⁸ However, an important lesson can be taken from the change in the court's attitude. It has been unofficially estimated that the decision in *Ramsay's* case alone yielded in excess of £1 000 million to the Royal Exchequer.¹⁵⁹ This gain was achieved by the court's willingness to be more progressive in its interpretation of taxing statutes and thus move away from the strict pro-taxpayer approach of the *Westminster* case.

¹⁵⁸ The doctrine was also rejected in Canada in the case of *Stubart Investments Ltd v The Queen* [1984] CTC 294, 84 DTC 6305.

¹⁵⁹ Millett "A new approach to tax avoidance schemes" 98 (1982) Law Quarterly Review 209

E. REFORM ?

E.1. THE KATZ COMMISSION RECOMENDATIONS

The third interim report of the Katz Commission¹⁶⁰ suggested that Section 103(1) be amended. This recommendation follows on from the Commission's second report¹⁶¹ and from the 1986 recommendations of the Margo Commission.¹⁶² The Margo Commission had noted two deficiencies with the anti-avoidance provision. These were :

- “(a) the test of abnormality presents difficulties for Revenue in that if a particular form of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its utilisation becomes normal; and
- (b) there was no disadvantage from the taxpayer's point of view in embarking even upon tax avoidance schemes with little probability of success against a challenge by the Commissioner in terms of the provisions of Section 103.”¹⁶³

The Katz Commission took cognisance of the former deficiency and included it in its recommendations, but rejected the latter, on the basis that :

“A taxpayer should be allowed to arrange his/her affairs to the best advantage within the ambit of the Act. In short, avoidance is not to be equated with evasion. A general tax anti-avoidance provision has been included to allow Revenue to counter tax avoidance practices which would otherwise fall within the ambit of the Act. It is and must remain a discretionary section and given its inevitable uncertainty should be treated carefully in the context of a *Rechstaat*. To penalise a taxpayer by an effective retrospective imposition of interest in respect of what could otherwise be a reasonable act on the part of

¹⁶⁰ Third interim report of the commission of inquiry into certain aspects of the tax structure of South Africa, November 1995 (hereafter “Katz Commission Report”).

¹⁶¹ Second interim report of the commission of inquiry into certain aspects of the tax structure of South Africa, November 1994.

¹⁶² Report of the commission of inquiry into the tax structure of the Republic of South Africa, November 1986.

¹⁶³ Summary of Margo Commission recommendations in the Katz Commission Report at 112.

the taxpayer would indicate a distorted appreciation of the distinction between evasion and avoidance.”¹⁶⁴

This is certainly a welcome approach to tax avoidance. Further comfort is given the taxpayer by the Commission’s stated approach in reforming the general anti-avoidance provision; it stated that it was guided by the following principles:¹⁶⁵

- “(a) The anti-avoidance legislation is only intended to operate where the specific legislation contained in the Act is ineffective. ...
- (b) Adherence to the principle stated above would promote equity and certainty and facilitate orderly planning of the taxpayer’s affairs.
- (c) The existing anti-avoidance provisions have been the subject matter of much commentary and judicial decisions. It would therefore be preferable to retain the existing provisions, remedying the defects which have been identified by the Commission, rather than starting afresh.”
- (d) Safeguards of an administrative nature, for example, the obtaining from the Commissioner of his reasons for exercising an opinion pursuant to the anti-avoidance provisions, are of fundamental importance to the taxpayer. However, it is unnecessary to incorporate such safeguards in the anti-avoidance provisions since those safeguards exist in the Constitution and are thus available to the taxpayer.”

The primary focus of the Commission’s attention was the abnormality requirement of Section 103(1). It recognised that the abnormality requirement is the “Achilles heel” of Section 103(1) and suggested that a business purpose test,¹⁶⁶ similar to the general anti-avoidance provision in the Vat Act¹⁶⁷ be introduced into Section 103(1). It recommended that Section 103’s principal defects be remedied, as follows:

¹⁶⁴ Katz Commission Report 127

¹⁶⁵ *ibid* at 124.

¹⁶⁶ *ibid* at 125.

¹⁶⁷ Section 73(1) Vat Act, which provides that whenever the Commissioner is satisfied that any scheme:

- (a) has been entered into or carried out which has the effect of granting a tax benefit to any person; and
- (b) having regard to the substance of the scheme;
 - (i) was entered into or carried out by a means or in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit; or
 - (ii) has created rights or obligations which would not normally be created between persons dealing at arm’s length; and
- (c) was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit; the Commissioner must determine the liability of any tax and the amount thereof as if the scheme had not been entered into or carried out or in such a manner as in the circumstances of the case be deemed appropriate for the prevention or diminution of such tax benefit.

- “(a) where the transaction occurs in the context of trade, a business purpose test should be substituted for the normality test; and
- (b) where the transaction occurs in a non-business context, the existing normality test should continue to apply;
- (c) the provisions of Section 103(1) must not apply where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole.”

In paragraphs 11.5.5 and 11.5.6,¹⁶⁸ the Commission made it clear that it only recommends the amendment of subsection b(i) of the anti-avoidance provision. It is this subsection that will contain the business purpose test. Section 103(1)(b)(ii) will not contain a business purpose test and, the Commission notes, that it is the more appropriate test wherever a transaction is entered into outside of the context of trade. Thus the Commission’s recommendations focused on (a) clarifying the logical inconsistency which exists in the current formulation of Section 103(1),¹⁶⁹ (b) instituting the recommendation of the Margo Commission¹⁷⁰ and (c) introducing a business purpose test. The first two recommendations are necessary, but it is uncertain exactly why a business purpose test needs to be introduced for commercial transactions.

In the Second Katz Commission Report, the Commission justified the introduction of a business purpose test by highlighting the factors that contributed to what it termed “the tax gap and leakage.” In its opinion, the major causes of the tax gap and leakage are :

- “(a) poor tax administration, including poor collection;
- (b) problems relating to recognition of income and expenditure;
- (c) excessive tax burden;
- (d) high scale of evasion;
- (e) ineffective countering of avoidance; and
- (f) poor tax morality.”¹⁷¹

¹⁶⁸ Katz Commission Report *supra* n165 at 125.

¹⁶⁹ Refer to page 30.

¹⁷⁰ Refer to page 54.

¹⁷¹ Second Katz Commission Report at paragraph 5.3.2.

None of the above factors that the Commission identified referred to a deficiency in the anti-avoidance provision itself.¹⁷² Most of the Commission's explanations for the inadequacy of the anti-avoidance provision surrounded the inability of the Revenue authorities to apply the provision. As a matter of fact, the Commission seemed generally satisfied with the application of the section by our courts. (The Commission did, however, express disapproval of the judicial intervention evidenced by the recent Cape Special Income Tax Court decision, ITC 1496.¹⁷³) This is evidenced by the fact that in neither of the Commission's reports, did it recommend a provision similar to the Vat Act, requiring that regard has to be paid to the **substance** of the scheme, be introduced. As discussed earlier,¹⁷⁴ the Income Tax Act does not specifically require that a "substance-over-form" approach be adopted by a court, it merely requires that regard has to be paid to the **surrounding circumstances** of the scheme. The Commission's recommendation to change the anti-avoidance provision itself therefore begs the question: Why change Section 103(1) if the inadequacies lie with the Revenue Authorities?

E.1.1. THE BUSINESS PURPOSE RULE

The business purpose rule means what it seems to mean - a purpose other than that of reducing taxes. It has been described as a rule which

"... is applied by the courts to strike down, or sometimes recharacterise, transactions for purposes of determining a taxpayer's liability for tax where a transaction, or certain steps in a transaction, although genuine, has or have been carried out substantially without a business purpose and for the purpose of obtaining a beneficial tax result."¹⁷⁵

Thus the business purpose rule has a potentially wide application. It is also akin to the principle that tax avoidance is detected by ascertaining whether there was an intention which defeats or contradicts the apparent transaction. That doctrine may

¹⁷² After listing the above factors, the Commission proceeded to explain each one. No explanation made a reference to a deficiency in the anti-avoidance provision. The recommendation to introduce the business purpose test was made suddenly and without explanation in the final paragraph of the chapter, paragraph 5.3.8.

¹⁷³ ITC 1496 53 SATC 229.

¹⁷⁴ See "abnormality of the transaction" page 25.

¹⁷⁵ Ward *et al supra* n110 at 68.

be combined in practice with the business purpose rule by concluding that if a taxpayer pretends one purpose (business) but actually has another (e.g. a tax saving) the transaction will be ignored for tax purposes. Naturally, this is quite appealing: if a transaction is arranged for business purposes, tax consequences should be recognised; when it is established for tax saving purposes, it should be ignored.

It will be interesting to see how our courts apply the business purpose rule, should it be introduced. It is submitted that this business purpose test cannot be construed as another rule of statutory interpretation. - The courts cannot interpret the taxing legislation so that it only applies to transactions which were entered into for a business purpose (unless, of course it is a specific requirement of the section). Nor can the rule be applied to the subjective intention of the taxpayer to avoid tax. To this end, Section 103(1)(c) caters. Nor can the rule be interpreted, as in some jurisdictions, as an aid to statutory construction, i.e. the language of the statute is interpreted in the light of the meaning intended to be put upon it by the legislature, which in turn intended the statute to be applicable only to transactions which were entered into with a business purpose.¹⁷⁶ The principle that a tax-avoidance purpose is irrelevant will be further eroded by such an interpretation of the business purpose rule. (As discussed earlier,¹⁷⁷ the intention to avoid a statute should be irrelevant in determining tax avoidance.) It is submitted that the business purpose rule, as it is stated in the Vat Act, should be applied objectively, i.e. the statutory intention of applying a particular provision only to transactions motivated by a business purpose and the taxpayer's purpose or motive of entering into the transaction, is irrelevant. A transaction should only offend the business purpose test if, compared to other similar business transactions, it was entered into or carried out by a means or in a manner which would not normally be employed by such for other business transactions. However, it is wholly erroneous to believe that the tax consequences of transactions can be determined "objectively," that is, from facts other than those

¹⁷⁶ See Rice "Combating tax avoidance" 1953 (51) Michigan Law Review 1021 at 1043; Ward *et al* *ibid*.

¹⁷⁷ Refer to page 35.

bearing on purpose (in the sense of referring to reasons a person does something). Only a very crude tax system could function, without taking into account the reasons behind actions. Thus it is inevitable that the business purpose rule, which the Katz Commission recommends be introduced into Section 103(1) and the taxpayer's subjective intention which must be determined in terms of Section 103(1)(c), will overlap. It will be interesting to see how the interrelationship between these two requirements will be treated by our courts.

In the Canadian case of *Stuart Investments Ltd v The Queen*¹⁷⁸ the use of the business purpose test was explained :

“I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose. A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which, in the modern taxing statutes, may have a dual aspect. Income tax legislation, such as the Federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by the government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to a taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* purpose. Thus by imposing a positive requirement that there be such a *bona fide* business purpose, the taxpayer might be barred from undertaking the very activity Parliament wishes to encourage.”

This approach must be correct, as taxing statutes are intended to apply to transactions which have a commercial or financial effect on the parties. If the transaction lacks such effect, it should be scrutinised anyway and rebuffed. And when a transaction with a business purpose does have real consequences, it should still be examined to determine whether the desired tax advantages should be allowed. The tax benefits should not be given to the parties merely because the transaction has a business purpose. However at some point, the business purpose must weigh in the taxpayer's favour and the tax advantage sought granted him, but there is no guidance as to the weight to be accorded to the taxpayer's business

¹⁷⁸ *Stuart Investments Ltd v The Queen supra* n158.

purpose. Nor is it certain whether different purposes will be accorded a different weight. This is an aspect of the business purpose rule that was not considered by the Katz Commission Report and it is assumed that it will be left to the courts to decide on this.

Thus if the Commissions recommendations are accepted, the business purpose rule will be introduced. It is submitted that the rule will not have a significant impact on the application of the anti-avoidance provisions by the courts, who have always taken a wide interpretation of the anti-avoidance provisions, tempered with a balancing of the interests of the legislature and taxpayer. The major advantage of amending the section, will be its application by the Revenue authorities and taxpayers, who will now have a clearer indication of the limits of tax avoidance.

F. CONCLUSIONS

The notions of preventing tax avoidance are usually based of fuzzy concepts and indefensible distinctions between tax avoidance, tax evasion and tax mitigation. Categorising a transaction into one of these categories is fraught with difficulty and uncertainty.

The nature of the tax process requires that statutes be drafted so as to establish only the broad outlines of revenue responsibility. Frequently, taxpayers take advantage of this and engage in commercially astonishing transactions which would result in tax savings under literal interpretation of the statute. In measuring the tax consequences of such, courts must weigh the dangers of successful tax avoidance against the perils of imposing tax responsibility by the judiciary in cases where no such responsibility is imposed by statute. The issue to be explored is both where and how the line is to drawn.

The courts have attempt to "advanced the remedy and suppressed the mischief" by using the ordinary recognised principles of statutory interpretation as well as the interpretational aids at its disposal to determine the intention of the legislature. However, due to the fuzzy nature of the concepts that are being used, the doctrines which have emerged to prevent tax avoidance are hardly encouraging in determining the distinction between tax avoidance and other transactions. The doctrine of substance-over-form often fails to establish where substance ends and form begins. This is particularly true when attempting to determine the substance of the contract. Similarly, terms such as *bona fide* and normality do not inform where the line ought to drawn. Also, in applying the doctrine to determine the nature of the contract, the courts have encountered difficulty.

Rules such as that enunciated in Section 103(1) and others, such as the business purpose doctrine and step transaction rule have the taxpayer's intention as one of

the touchstone requirements of the rule. Yet, it is acknowledged that the intention of the taxpayer to avoid a statute should not be considered at all. The question of whether a particular conduct was tax-motivated should be irrelevant in determining tax avoidance. Our legislature has chosen to ignore this and introduced this requirement in the general anti-avoidance provision.

In South Africa, the legislature and Revenue have not relied solely on Section 103(1) to counter tax avoidance. Most of the techniques used in other jurisdictions have been used by the authorities and also by our courts (e.g. an approach similar to the step transaction doctrine developed in other jurisdictions¹⁷⁹ has been developed in South Africa.). However, not all of the approaches to tax avoidance in other jurisdictions are acceptable in terms of our law. (E.g. The effect of the finding of the House of Lords in *Furniss v Dawson*¹⁸⁰ was that anti-avoidance measures have as their object the determination of tax consequences according to the result achieved, in defiance of the substance of the transaction. There exists no principle in South African law which could support this finding and it is submitted that the South African courts will reject the doctrine.)

Even though the general anti-avoidance provision seems to have had little impact in the courts, as few cases have come before them, it does serve to discourage tax avoidance practices. It also serves as an outer limit to judicial activism, thus avoiding the see-saw exploration for an acceptable tax avoidance doctrine, as was the British experience.

The recommendation by the Katz Commission to amend Section 103(1) is welcomed, however it is submitted that the introduction of the business purpose rule will have little impact on the approach of our courts to tax avoidance. The courts have always interpreted the legislation widely and taken the interests of all interested parties into account. It is predominantly the Revenue authorities in their

¹⁷⁹ Refer to page 44.

¹⁸⁰ *Furniss v Dawson supra* n123

search for tax avoidance schemes and perhaps even the taxpayer who may benefit from the introduction of this test. However, to achieve a more successful application of the anti-avoidance provisions, it is submitted that the reform efforts be directed at improving the efficiency of the Revenue and not by the introduction of new tax anti-avoidance legislation.

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