

**The approach of the judiciary to tax motivated
transactions in South Africa and the United
Kingdom**

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Abstract

In his Budget Speech on 28 February 2005, Trevor Manuel expressed his concern regarding the application of section 103 of the Income Tax Act no 58 of 1962 by the Courts and suggested that a revamped section 103 may be necessary.

The formulation of an adequate anti-avoidance section has also presented a challenge to Revenue authorities elsewhere in the world. This report takes an in-depth look at case law in the British courts to determine how the United Kingdom has dealt with the issue of anti avoidance. Secondly, the report deals with the approach of the South African courts and discusses the requirements of section 103(1) of the Act by looking at case law pertinent to each requirement. Thirdly the report investigates South African case law where the doctrine of substance over form has been dealt with. Finally, the report briefly compares the approaches adopted by the British judiciary and the South African judiciary.

Key words: Tax avoidance, United Kingdom, South Africa

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Chapter One

1. Introduction

In his Budget Speech on 28 February 2005, Trevor Manuel expressed his concern regarding the application of section 103 of the Income Tax Act no 58 of 1962 (“the Act”) by the Courts and suggested that a revamped section 103 may be necessary.

The formulation of an adequate anti-avoidance section has also presented a challenge to Revenue authorities elsewhere in the world. In this report, I will take an in-depth look at case law in the British courts to determine how the United Kingdom has dealt with the issue of anti avoidance. Secondly, I will deal with the approach of the South African courts and discuss the requirements of section 103(1) of the Act by looking at case law pertinent to each requirement. Thirdly, I will look at case law which has dealt with the substance over form doctrine in South Africa. Finally, I will compare the approaches adopted by the British judiciary and the South African judiciary.

2. What is tax avoidance?

De Koker (*Silke on South African Income Tax November 2004* par 19.2) defines tax evasion as the:

“use of illegal and dishonest means to escape tax, for which penalties are prescribed under the Act.”

Tax evasion should be distinguished from tax avoidance which is characterized by “open and full disclosure”. Whereas the tax evader uses “illegal and dishonest

means” to escape the payment of tax, the tax avoider arranges his affairs in a legal manner so as to either reduce his taxable income or entirely eliminate his taxable income. (Silke, Chapter 19, “the distinction between tax avoidance and tax evasion”)

This concept was concisely put by Lord Tomlin in the British case of *Inland Revenue Commissioners v The Duke of Westminster* (1936) A.C:

“Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.” (19)

In the American decision of *Helvering v Gregory* (1934) 69 F 2d, Hand J stated:

“Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury.” (809)

This approach was supported in the South African case of *Commissioner for Inland Revenue v King* 1947 (2) SA 196(A):

“...it should be realised that there is a real distinction between the case of a man who so orders his affairs that he has no income which would expose him to liability for income tax, and 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. Similarly there is a distinction between reducing the amount of tax from what it would have been if he had not entered into the transaction and reducing the amount of tax from what it ought to be in the tax year under consideration.” (193)

The Act contains various provisions designed to put a stop to schemes, transaction and operations put into place to avoid tax. Section 103 is the general provision enacted for this purpose and Chapter two of this report will focus on this provision. However, I will firstly deal with the approach of the British Judiciary to anti-avoidance in Chapter one.

Chapter Two

2. The approach of the British judiciary to tax avoidance

2.1 Introduction

The United Kingdom does not have a general anti-avoidance provision. Therefore, the judiciary has developed anti-avoidance law in the United Kingdom by developing a “substance over form” doctrine.

As a result, the English courts have developed a series of principles to deal with the concept of anti-avoidance commencing with Lord Wilberforce's decision in *WT Ramsay Ltd v Inland Revenue Commissioners* [1981] 1 All ER 865. This judgement resulted in the so-called “*Ramsay principle*” and was clarified in *Furniss v Dawson* [1984] 1 All ER 530, *IRC v Burmah Oil Company Ltd* [1982] 5 TC 30 (HL), *Craven v White* [1988] 3 WLR 423 (HL) and *MacNiven v Westmoreland Investments Ltd.* [2001] 1 All ER 865.

2.2 *Floor v Davis (Inspector of Taxes)* [1978] 2 ALL ER 1079

The opinion expressed by Eveleigh LG in the *Davis* case was the predecessor of the “*Ramsay doctrine*”.

The appeal concerned a series of transactions by the taxpayer and his two sons-in-law. They wished to sell their shares in a company known as IDM Electronics Ltd (“IDM”) to a company known as KDI International Corporation (“KDI”) in such a way as to minimise their liability for capital gains tax. They therefore incorporated a

company known as FNW Electronic Holdings Ltd (“FNW”) and sold their respective shares in IDM to FNW. The following day, FNW sold its shares in IDM to KDI.

The question arose whether the taxpayer was liable for capital gains tax in respect of the proportion of the sum paid by KDI to FNW in consideration for the shares which corresponded to the shares held by the taxpayer in IDM, subsequently sold to FNW.

Sir John Pennycuik and LJ Buckley were of the view that the disposal of the taxpayers’ shares to FNW could not be regarded as a disposal by the taxpayers’ of their shares in IDM to KDI.

In contrast, Eveleigh LJ was of the opinion that there had been a disposal of the shares by the taxpayer to KDI. In support of this standpoint he said that it was clear from the beginning that KDI would purchase the shares and that the only rationale in forming IDM was for the purpose of reducing capital gains tax. Although the shares were transferred to IDM and not directly to KDI there was never any possibility that the shares would not eventually reach KDI. The shareholders were in control of the shares and as such were in a position to guarantee that the shares would be sold to KDI.

Furthermore, there was an arrangement between the shareholders that none of them would prevent the shares from reaching KDI. As a result, even though the shares were transferred first to IDM and then to KDI the shareholders *“controlled the destiny of the shares from beginning to end in pursuance of a continuing intention on their part that the shares should be transferred to KD”*(1078). Eveleigh was therefore of the opinion that the transfer of the shares to FNW was not a genuine transaction and in fact formed part of a larger transaction.

2.3 WT Ramsay Ltd v Inland Revenue Commissioners: The “Ramsay” principle

In this case, the taxpayer company (WT Ramsay Ltd) made a gain for purposes of corporation tax by a sale-leaseback transaction. In order to counteract the gain it established an allowable loss by purchasing a ready-made scheme. The rationale behind the scheme was to create two assets: one which would decrease in value for the benefit of the other asset. The decreasing asset would be sold to create a loss and the increasing asset would be sold at a gain.

Lord Wilberforce set out four principles reflecting the approach of the British courts at 871:

- 1) Any taxing Act of Parliament must be interpreted in accordance with the principle that a taxpayer may only be taxed on clear words. Clear words are to be ascertained on normal principles. The court is not confined to a literal interpretation and the context and scheme and purpose of the Act should be regarded as a whole.
- 2) A taxpayer may arrange his affairs in order to reduce his tax liability. If the motive for a transaction was to avoid tax, this does not invalidate it unless legislation specifically provides for this. The taxpayer is to be taxed according to the legal effect of the transaction into which he has entered.
- 3) The Commissioner must determine whether a document or transaction is genuine or sham. “Sham” means that while professing to be one thing, it is in fact another. “Genuine” means that in law it is what it professes to be.

- 4) If the document or transaction is genuine the court cannot go behind it to look for a supposed underlying substance. However, the principle does not require the courts to look at a document or transaction in isolation from its context. If the court can see that the document or transaction was intended to have effect as part of a series of transactions there is nothing in the doctrine to prevent it being regarded as such. If a Commissioner finds that a document or transaction is not a sham, the doctrine does not prevent him from considering what the relevant transaction was as evidenced by the documents or the manifest intention of the parties. Therefore, where a composite transaction is intended to be carried through as a whole, the Commissioner is not bound to consider each step individually.

In summary therefore, the principle stated in the *Ramsay* decision

“was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.” ([1984] 1 All ER 530 Lord Fraser at 532)

2.4 *Furniss v Dawson*

In the *Furniss* case, the taxpayers held all the shares in one company and most of the shares in another company. It was agreed that a third company, Wood Bastow, would purchase all the shares in the two companies. However, instead of selling the shares directly to Wood Bastow, the taxpayers arranged to exchange their shares for shares in a company to be formed in the Isle of Man. The company in the Isle of Man would in turn sell the shares to Wood Bastow. This scheme had the effect that the taxpayers were not liable for Capital Gains Tax.

The case of *Furniss v Dawson* supported the “Ramsay doctrine” as set out by Lord Wilberforce and clarified various misunderstandings that had emerged since the *Ramsay* judgement. The judgement focused on four principles.

Firstly, the judgement explained and supported the principles of the “*Ramsay doctrine*”. Secondly, the Court had to consider whether the “*Ramsay doctrine*” applies to both “self-cancelling” transactions and “linear transactions”.

In the *Ramsay* case, the court had to consider an artificial, “self-cancelling” transaction in that the schemes were designed to return the taxpayer to his starting position except for the payment of expenses.

On the other hand, the scheme considered by the court in *Furniss* was “linear” and had “*enduring legal consequences*” and merely attempted to defer payment of tax.

Lord Wilberforce expressed the following in this regard:

“My Lords, in my opinion the rationale of the new approach is this. In a preplanned tax saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between (i) a series of steps which are followed through by virtue of an arrangement which falls short of a binding contract, and (ii) a like series of steps which are followed through because the participants are contractually bound to take each step seriatim. In a contractual case the fiscal consequences will naturally fall to be assessed in the light of the contractually agreed results. For example, equitable interests may pass when the contract for sale is signed. In many cases equity will regard that as done which is contracted to be done. Ramsay says that the fiscal result is to be no different if the several steps are preordained rather than precontracted.” (530)

Therefore, Lord Wilberforce concluded that the “*Ramsay doctrine*” is applicable to both “self-cancelling” transactions as well as to “linear transactions”.

Thirdly, Lord Brightman made it clear that should Revenue find a scheme involving several stages in a scheme designed to avoid the payment of tax, they are still obliged to consider each stage separately.

In this regard, Lord Brightman clarified the doctrine as set out in the *Ramsay* decision by setting out two requirements that had to be met for the doctrine to apply. Firstly, there must be a “preordained series of transactions” or a “composite transaction”. The “composite transaction” may or may not include the achievement of a “legitimate commercial end”. In this case, Lord Brightman concluded that the scheme did have a legitimate business transaction in that the shares were transferred from the taxpayers to Wood Bastow as originally intended.

Secondly, Lord Brightman stated that steps must have been inserted which have no commercial purpose apart from the avoidance of a tax liability. Should these two steps be present, then the inserted steps are to be disregarded for tax purposes. Lord Brightman concluded that there was an inserted step in the current case in that although the incorporation of the company in the Isle of Man had a business effect; it had no business purpose other than the deferment of tax.

Finally, Lord Brightman stated that where Revenue wishes to invoke the “*Ramsay doctrine*” the Commissioner must make two findings of fact. Firstly, the Commissioner must determine whether there was “a *preordained series of transactions, i.e. a single composite transaction*; second, whether that transaction contained steps which were inserted without any commercial or business purpose

apart from a tax advantage. Those are facts to be found by the commissioners. They may be primary facts or, more probably, inferences to be drawn from the primary facts.” (530)

2.5 *Craven v White*

In the *Craven* case the Crown attempted to extend the principle discussed in *Furniss* to include those transactions where the purchaser in the second transaction had not even been identified yet at the time that the taxpayer formed the intention to avoid tax.

Craven involved three appeals before the Court. All three cases exhibited certain common features in that in each of them there was a disposition by the taxpayers of assets to one or more companies and these companies in turn disposed of those assets to an ultimate purchaser. Furthermore, when the first transaction was entered into, there was no contractual obligation for the second disposition to take place.

The Crown asserted that in terms of the “*Ramsay doctrine*” both transactions should be treated as a composite transaction wherein the taxpayer disposed of the asset to the ultimate purchaser. In support of this contention, the Crown submitted that the “*Ramsay doctrine*” would not only be applicable to cases where a known purchaser existed as the time of the first transaction and the terms and price had been agreed upon.

The purpose of the “*Ramsay doctrine*”, it was submitted, was to identify the “real transaction” by ignoring artificially inserted steps. Therefore, in summary, the Crown’s contention was that the “*Ramsay principle*” was not dependant on whether an

ultimate purchaser had been identified but instead on the intention of the taxpayer at the time of entering into the first transaction.

Lord Oliver disagreed with the Crown's contention and found that there was no basis in the *Ramsay* case or in the subsequent *Furniss* case to justify such a stance. Lord Oliver stated that the "*Ramsay principle*" would be applicable if the following requirements were met

- "(1) that the series of transactions was, at the time when the intermediate transaction was entered into it, 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 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 to be applied."* ('Tax Avoidance: Recent United Kingdom precedent turns away from "Substance over Form', *The Taxpayer*, (2002) 82):

2.6 *MacNiven v Westmoreland Investments Ltd*

MacNiven marked a turning point in the United Kingdom court's approach to tax avoidance. Lord Hoffman made it clear in his judgement that the "*Ramsay principle*" should not be regarded as "*some form of judicial legislation*" and was of limited application. Lord Hoffman stated that following the *Ramsay*, *Burmah Oil* and *Furniss* case:

"...there was a tendency on the part of the Revenue to treat Lord Brightman's words as if they were a broad spectrum antibiotic which killed off all tax

avoidance schemes, whatever the tax and whatever the relevant statutory provisions.” (865)

The facts of the *MacNiven* case were briefly as follows. The respondent was owned by the Electricity Supply Pension Scheme (“ESPS”), an approved superannuation scheme which was exempt from income tax. ESPS used the respondent as a vehicle to make some property investments. These investments were financed by money lent to the respondent by ESPS. Once the respondents properties had been liquidated it was left with almost no assets and a large liability towards ESPS including over £40m arrears of interest.

In terms of British law, yearly interest paid by a company in an accounting period could be deducted against its total profits. However, the respondent was not in a position to pay the interest to ESPS and therefore no deduction could be claimed. Therefore, in order to circumvent this problem, ESPS lent the money to the respondent to pay the interest.

Relying on the “*Ramsay doctrine*”, the Crown contended that the only purpose of ESPS lending the respondent funds to “pay” the interest was in order to produce an allowable deduction for tax. Accordingly, the loans and payments had no commercial purpose and were entered into for the sole purpose of avoiding tax and therefore fell within the “*Ramsay doctrine*”. Revenue therefore submitted that there had been no payments of interest and that no deduction should be allowed.

The main issue in the appeal was the meaning, scope and applicability of the “*Ramsay doctrine*”.

In reaching his decision, Lord Hoffmann considered it important to determine what the concept “paid” meant in terms of the relevant legislation. When determining whether the “*Ramsay doctrine*” applied, it was important to determine whether the relevant legislation should be interpreted to refer to a commercial concept or not. It was stressed that before applying the “*Ramsay doctrine*” it is necessary to determine whether Parliament intended the particular concept to be given a commercial meaning and whether the scheme as a whole should be looked at and not its individual parts.

Lord Hoffmann concluded that there are some concepts which were intended to have a purely legal interpretation and that were not intended to have a commercial meaning. In these cases, if a transaction fell within the legal meaning then it would not be appropriate to apply the “*Ramsay doctrine*”. Lord Hoffmann interpreted the meaning of “paid” to be a purely legal concept and was therefore of the view that the “*Ramsay doctrine*” would not be applicable.

Therefore the test as laid out in the *Ramsay* case and the *Furniss* case were no more than:

“guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation. But Mr McCall’s formulation looks like an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision, save for the possibility of rebuttal by language which can be brought within his final parenthesis. This cannot be called a principle of construction except in the sense of some paramount provision subject to which everything else must be read, like s 2(2) of the European Communities Act 1972. But the courts have no constitutional authority to impose such an overlay upon the tax legislation and, as I hope to demonstrate, they have not attempted to do so.” (865)

Lord Hoffman did not question the correctness of the *Ramsay* case decision as Lord Wilberforce had concluded that the words “disposal” and “loss” refer to commercial concepts and under the particular circumstances of the *Ramsay* case, there had not been a loss from a commercial perspective. Lord Wilberforce therefore recognised that the intention of the legislature was to give the concepts of “disposal” and “loss” a commercial meaning. Due to this, Lord Hoffmann concluded that *“It [was] that decision, to give the statutory language such a construction, which [he] would regard as ‘the Ramsay doctrine’”* (865).

Lord Hoffmann expressed a concern that there had been a tendency to construe the *“Ramsay doctrine”* as a general principle applicable to all tax legislation and stressed that whether the guidelines set out in the *Ramsay* case could be applied would depend on the language and purpose of the particular legislation.

Lord Hoffman emphasised that the *“Ramsay doctrine”* was not a principle of construction but rather *“a statement of the consequences of giving a commercial construction to a fiscal concept.”*

Therefore, in conclusion, before applying the *“Ramsay doctrine”* it must be decided whether the legislature intended to give the concept a commercial meaning *“capable of transcending the juristic individuality of its component parts.”* There are circumstances where the legislature did not intend to give a specific concept a commercial meaning but rather a pure legal meaning and if this is the case, then the *“Ramsay doctrine”* will not be applicable.

Lord Hoffman also stressed that *“Even if a statutory expression refers to a business concept, one cannot disregard a transaction which comes within the statutory*

language, construed in the commercial sense, simply on the ground that it was entered into solely for tax reasons. Business concepts have their boundaries no less than legal ones.” (865)

The *MacNiven* case therefore provided clarity on the “*Ramsay doctrine*” and made it clear that the “*Ramsay doctrine*” would only be applicable to cases where it is clear that the legislature intended for the statutory language to be given a commercial meaning.

2.7 Recent British Case Law

Barclays Mercantile v Mawson [2005] STC 1 was decided subsequent to the *MacNiven* decision. The *Barclays* case softened the distinction that Lord Hoffmann had made in the *MacNiven* case between “commercial” concepts and “legal” concepts.

In its judgement, the court explained that prior to the *Ramsay* decision, the courts had been insistent on treating every transaction which had an individual identity as having its own separate tax consequences. When determining what the tax consequences of a transaction should be, the court stated that a simple questions needs to be answered i.e.:

“whether the relevant provision of statute, upon its true construction, applies to the facts as found.” (97)

Therefore, the court stressed that the *Ramsay* case did not introduce a new doctrine but on the contrary “*it rescued tax law from being some island of literal interpretation and brought it within generally applicable principles.*” (97)

The court went on to discuss the *MacNiven* case and warned against over simplifying the issue by classifying a concept as either “commercial” or “legal”. The rationale behind the decision of the *MacNiven* case was that the statute must be given a purposive interpretation i.e. there must be an analysis of what the statute means before deciding on the tax consequences thereof.

2.8 Conclusion

The United Kingdom does not have a legislated anti-avoidance provision. Therefore, it has been left up to the judiciary to develop anti-avoidance legislation in the United Kingdom. The “*Ramsay doctrine*” set out the basis for determining whether a scheme would be viewed as a tax avoidance scheme by the British courts. Basically, the Ramsay doctrine allowed the courts to look past the each step of a transaction individually and consider the composite transaction as a whole. The principle was further developed by the *Furniss* and *Dawson* cases as discussed above. The “*Ramsay doctrine*” was however constrained by the *MacNiven* decision where Lord Hoffman stressed the importance of ascertaining what Parliament had intended by using the language in the statute that it had chosen to use. Therefore, where it was clear that Parliament had intended a term to have a “commercial” meaning, then the “*Ramsay doctrine*” would be applicable. On the other hand, where the courts are of the opinion that a term was intended by Parliament to have a purely “legal” meaning, then the “*Ramsay doctrine*” would not be of application.

The *MacNiven* decision was clarified further in the *Barclays* decision which stressed that the intention and purpose of the statute must always be the deciding factor. In other words, it would be over simplifying the interpretation if the courts were merely to decide whether the concept was “commercial” or “legal” in nature. It is clear from

the above British case law that the lack of a general anti-avoidance provision can result in great uncertainty. In addition, Katz is of the opinion that it “[allows] a judiciary, unaccountable to the electorate, to make major fiscal policy decisions.”

Chapter 3- The South African courts approach

3.1 Introduction

Contrary to the United Kingdom, South Africa has a general legislative provision dealing with tax avoidance in the Act.

Section 103 of the Act states the following:

“103. Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.-

(1) 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—

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

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of

item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

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

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

Therefore, in terms of section 103(1) of the Act, four requirements need to be met before the Commissioner can disregard the terms and conditions of a transaction.

Firstly, there must be a transaction, operation or scheme which has been entered into or carried out. Secondly the transaction, operation or scheme must have the effect of avoiding or postponing or reducing the liability for the payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act. Thirdly, the transaction, operation or scheme must not be normal with reference to the rights and obligations and/or the manner of the transaction. Lastly, the transaction, operation or scheme must have been entered into solely or mainly for the purpose of obtaining a tax benefit.

In terms of section 103(4), when the Commissioner has proved that the transaction, operation or scheme would result in the avoidance, postponement or reduction of liability for payment of tax, there is a rebuttable presumption that the sole or main purpose of the transaction, operation or scheme was the avoidance, postponement or reduction of the tax liability (Clegg D, Stretch R, (May 2005) *Income tax in South Africa*, Chapter 26.3).

Before commencing on the application of section 103(1), it is necessary to clarify the scope of this section. In *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975(4) SA 715 (A) Botha JA stated the following at 727H-728I:

“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 or to the incidence thereof, but rather to schemes designed for the avoidance of 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.”

This approach is echoed in the case of 38 SATC 66 where the following was said (at this stage the relevant section was still section 91):

“The approach therefore to be adopted by the courts in construing the remedial provisions of s91 is – so far as the language permits and without stretching it – to ensure that the legislature’s intention to suppress the mischief succeeds and to this end suppress ‘subtle inventions and evasions for the continuance of the mischief’ and ‘add force and life to the cure and remedy according to the true intent of the makers of the Act pro bono publico’. Clearly the courts must not, by their interpretation of the provisions of the section, deprive them of their efficacy.” (71)

In Income Tax Case no 1636, Kroon J said the following with regard to the application of section 103:

“The immediate comment which requires to be made is that s103 must not be interpreted as a penalty section or as widening the net of taxation beyond the general scope of the Act. It is aimed at a truer and fairer determination of the liability for the taxes imposed by the Act and their due payment when so determined.”

This Chapter will deal with the South African courts application of the four requirements as set out under section 103(1) of the Act. The following Chapter will deal with the case law where section 103(1) has not been applied but the common law principle of substance over form instead.

3.2 Onus

Section 82 of the Act states the following:

“The burden of proof that any amount is—

- (a) exempt from or not liable to any tax chargeable under this Act; or*
- (b) subject to any deduction, abatement or set-off in terms of this Act; or*
- (c) to be disregarded or excluded in terms of the Eighth Schedule,*
shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.”

However, Section 103(4) of the Act provides that when it is proved that the transaction would result in the avoidance of liability for the payment of tax, it is presumed until the contrary is proved, that the transaction was entered into or carried

out solely or mainly for the purposes of such avoidance. The onus therefore rests on the Commissioner to prove that the transaction would result in the avoidance of tax liability.

With respect to where the onus lies with regard to whether a transaction was entered into or carried out by the taxpayer and whether the abnormality requirement has been met, Kroon (ITC 1636 at 324) took an in-depth look into the question of onus. He concluded that section 103 is removed from the application of the general provision contained in section 82 of the Act and that the primary onus of proving the fulfilment of the four requirements laid out in section 103(1) rests on the Commissioner.

This conclusion is supported by the Katz Commission where it was stated that the nature of the anti-avoidance section required that section 33 (at that stage section 24) of the Constitution be taken into account. Section 33 provides for the right to just administrative action and reads as follows:

- "1) Everyone has the right to administrative action that is lawful, reasonable and procedurally fair.*
- 2) Everyone whose rights have been adversely affected by administrative action has the right to be given written reasons.*
- 3) National legislation must be enacted to give effect to these rights, and must*
 - a) provide for the review of administrative action by a court or, where appropriate, an independent and impartial tribunal;*
 - b) impose a duty on the state to give effect to the rights in subsections (1) and (2); and*
 - c) promote an efficient administration."*

The Commission was of the view that once section 33 of the Constitution had been taken into account, the onus to prove tax avoidance should be on Revenue with the exception of the presumption that once the avoidance of tax is proved it is presumed that the main purpose was to avoid tax.

3.3 Transaction, operation or scheme which has been carried out

The first requirement requires that the Commissioner must be satisfied that a transaction, operation or scheme has been entered into or carried out.

In the case of *Meyerowitz v CIR* 25 SATC 287 the question arose whether various transactions amounted to “schemes” within the meaning of section 90 of the Income Tax Act (section 90 was the forerunner to section 103(1)).

The facts of the case were as follows. Meyerowitz (“the taxpayer”) was the author of two legal textbooks published by the same firm. The taxpayer and the publisher shared the profits. The taxpayer had formed a company, known as “The Taxpayer (Pty) Ltd”, together with two other shareholders, which produced a journal. The shareholders had formed the company to limit their liability. The company published the journal for a fee and the profit or loss was passed on to the company. During 1952 the taxpayer decided to form another company called Visandra Investments (Pty) Ltd (“Visandra”) to gratuitously cede his shares in the “Taxpayer” to.

The same year the taxpayer formed a trust in favour of his children and Visandra ceded its interest in the “Taxpayer” to the trust for £75 (despite there still being 200 books in stock valued at £300). One of the other shareholders also formed a trust in favour of his children. The two trusts and the remaining shareholder then formed a

partnership known as "Legal Publications". Subsequently, an agreement was concluded between "Legal Publications", "the Taxpayer" and the publishing firm whereby "Legal Publications" was substituted for "the Taxpayer". "Legal Publications" now published the journal and paid the taxpayer and the two other former shareholders for their editorial services. The profits derived from the sale of the Taxpayer's books and journal flowed to the trust for his children's benefit. The Taxpayer reflected the profits from the sale of the books and additional income from the monthly journal in the trust's tax return and not in his individual tax return.

Counsel was of the view that although a scheme could consist of a series of transactions, they must be connected and form part of a preconceived plan. It was contended that at the time the taxpayer registered the "Taxpayer" and "Visandra" he did not contemplate the formation of the trust six months later. In this regard, Beyers stated the following:

"It is possible that the formation of Visandra and the cession to it of the appellant's interests in his books were not comprehended in the scheme at the time when these transactions were entered into. But however adventitious these circumstances may be, it seems to me that once they are pressed into the service of the scheme they become part and parcel of it." (287)

In support of this view, Beyer quoted Donovan L.J from the United Kingdom case of *Crossland (Inspector of Taxes) v Hawkins [1961] 2 All E.R. 812* at 817:

"I do not think that the language of section 397 requires that the whole of the eventual arrangement must be in contemplation from the very outset. Confining oneself for the moment to the facts of this case, and remembering that income tax is an annual tax, one finds the whole "arrangement" conceived and in being in the one income tax year. The company is formed, the service agreement executed, and the deed of settlement made, all in one year. Even if it were otherwise, I think that there is sufficient unity about the whole matter to justify its being called an arrangement for this purpose, because the ultimate object is to secure for somebody money free from what

would otherwise be the burden or the full burden of surtax. Merely because the final step to secure this objective is left unresolved at the outset, and decided on later, does not seem to me to rob the scheme of the necessary unity to justify its being called an "arrangement".'

It should be noted that this decision does not appear to be in accordance with the view taken by the British courts at a later stage. For example, in the *Furniss* case, discussed in Chapter two above, Lord Wilberforce specifically mentions a "preplanned" or "pre-ordained" tax saving scheme.

In *Ovenstone v Secretary for Inland Revenue* 42 SATC 55 Trollip expressed the following opinion in respect of s 103:

"It appears from its provisions that the question whether or not the scheme in question is hit by them must be answered by reference to the effect and purpose of the scheme and circumstances surrounding it at the time it is implemented or carried out, and not at the time it was formulated, i.e. conceived, decided or agreed upon, or otherwise evolved. For it is only when it is implemented or carried out that it becomes a practical reality concerning the fiscus; in particular, it is only then that its purpose and effect in respect of the taxpayer's liability for income tax arises for consideration...It follows therefore that, even if the purpose or effect of the scheme when it is formulated is not to avoid liability for tax, it may have that effect or that may become one of the taxpayer's main purposes when he subsequently carries it out, thereby rendering s 103(1) applicable if its other requirements are fulfilled." (68)

Therefore, even if a transaction does not have as its purpose the avoidance of tax at its inception, it may have the effect when it is carried out and therefore fall within the scope of s103(1).

3.4 The transaction, operation or scheme must have the effect of avoiding or postponing or reducing the liability for the payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act

Once the Commissioner is satisfied that a transaction, operation or scheme has been carried out he must determine whether it has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by the Act of any previous Income Tax Act or of reducing the amount thereof

In the case of *King* case, Watermeyer CJ looked closely at the meaning of the words “which has the effect of avoiding or postponing liability for any tax, duty or levy on income” of section 90(1). He held that the section refers to anticipated liabilities for tax either in respect of a current tax year or in respect of future years.

He then went on to look at the meaning of avoiding tax in respect of the section and answered the question of the type of transaction the Legislature intended to catch by enacting the anti-avoidance provision:

“What type of transaction or operation was the Legislature intending to nullify for taxation purposes? Obviously it must be one which has the effect of avoiding liability for a tax or of reducing its amount. But in what sense is the word “avoid” used and from what amount is a reduction contemplated? In order to answer these questions it should be realised that there is a real distinction between the case of a man who so orders his affairs that he has no income which would expose him to liability for income tax, and 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. Similarly there is a distinction between reducing the amount of tax from what it would have been if he had not entered into the transaction and reducing the amount of tax from what it ought to be in the tax year under consideration.”

Watermeyer CJ was of the opinion that the legislature intended the words to have the latter meaning i.e. the case of a man who so orders his affairs that he escapes from liability for taxation. Watermeyer CJ provided various examples of circumstances where a taxpayer may escape liability from taxation, for instance a taxpayer may, whilst retaining the ownership of his capital, arrange for the fruits of the capital to be received by someone else. In addition, he emphasised that it may sometimes be difficult to decide whether or not a sum of money forms part of a taxpayer's income. In this regard, he was of the view that the word "income" should be given its natural meaning i.e. *"the fruits derived from a man's labour, capital or from both"*.

This interpretation was held to be not applicable to the amended section 90(1) in the case of *Smith v CIR 26 SATC 1*.

In this case, the taxpayer's sole contention was that the transaction in question did not have the effect of avoiding liability for any tax on income. Counsel for the appellant was of the view that the same approach to the avoidance of tax on income as applied in the *King* case should be applied notwithstanding the fact that the wording of section 90(1) had been amended. Steyn was not in agreement with this and stated that it appeared that Watermeyer had arrived at his interpretation *"under the compulsion of the unsatisfactory and absurd results which would otherwise follow, and not by reason of the ordinary meaning of the language used."* (10)

Steyn made a comparison of the section as enacted in 1941 and the amended section and found that there were significant differences in that amongst other changes the amended section added the words "any scheme" and the word "purpose" to include "one of the main purposes". Steyn therefore found that the intention of the legislature had not been to confirm the meaning given to the section in the *King* case and concluded that the amended wording eliminated most of the

absurdities outlined in the *King* case. Steyn was therefore of the view that the ordinary meaning of avoiding liability for tax on income should be applied and that meant “*to get out of the way of, escape or prevent an anticipated liability.*” (12)

In the case of *Hicklin v Secretary for Inland Revenue* 41 SATC 179 the issue raised by the appeal was whether or not the Secretary correctly invoked the tax avoidance provisions of s103 of the Act for the purpose of attributing liability to the appellant for tax on part of the distributable profits of a dormant, private company of which he had been a shareholder. Trollip JA quoted the *Smith* case with approval. He further considered that an anticipated liability may “*vary from an imminent certain prospect to some vague, remote possibility*” (179) but did not consider it necessary to decide whether the line should be drawn to limit the connotation of an anticipated liability.

3.5 The transaction, operation or scheme must not be normal with reference to the rights and obligations and/or the manner of the transaction

3.5.1 The requirements to determine the abnormality of a transaction- *CIR v Conhage*

Hefer JA succinctly set out the requirements to determine the abnormality of a transaction in the case of *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd)* 61 SATC 391 (this was the appeal from ITC 1636).

The respondent and Firstcorp Merchant Bank Ltd (“Firstcorp”) entered into two agreements comprising of a sale and leaseback of some of the respondent’s manufacturing plant and equipment. The respondent subsequently tried to deduct the rental paid to Firstcorp as expenditure in the production of income. The Commissioner refused to allow the deduction and contended that the agreements

were not what they purported to be and had in substance borrowed the purchase price for the equipment from Firstcorp.

Hefer JA rejected the Commissioner's contention that the agreement was not what it purported to be. The second issue to be dealt with was whether the Commissioner correctly invoked section 103(1). Hefer quoted Watermeyer in the *King* decision

"if a transaction is covered by the terms of the section its provisions come into operation, if it is not then its provisions cannot be applied." (209)

Hefer JA summarised three points taken from *Secretary for Inland Revenue v Geusteyn, Forsyth and Joubert* 33 SATC 113 to be considered when determining the normality of a transaction:

Firstly, although the Commissioner may invoke section 103(1) when he is satisfied that all the requirements have been met, a special court may re-hear the whole case. In this regard, the court may substitute its decision for that of the Commissioner.

Secondly, when deciding on the effect, purpose and normality of a transaction these are questions of fact and the onus is on the Commissioner in this regard. This is in line with the view of the Katz Commission.

Thirdly, what has to be determined in every case is the subjective purpose of the taxpayer.

Hefer JA concluded that the agreements of sale and leaseback served the dual purpose of providing Tycon with capital and the advantage of the tax benefits to be derived from that type of transaction. In addition Hefer stated that even if the type of

transaction had been chosen purely because of the tax benefits, Tycon would not have entered into the transaction at all if it had not required capital. Therefore Tycon did not approach Firstcorp because it wanted to reduce its tax burden but rather because it needed capital and this was the main purpose of the transaction. It was therefore not necessary to deal with the abnormality of the transaction. However, Hefer JA did stress that the Commissioner had to establish the abnormality of the transactions as sales and leasebacks and that the court had correctly taken all the circumstances of the case into account. This interpretation was supported in Income Tax Case 1636 where Kroon J stated the following:

“As regards the third requirement, that of normality, the following comments fall to be made: It is to be emphasised that, as the opening words of para(b) of s103(1) prescribe, the setting in which the normality or otherwise of the means by which or the manner in which the transaction was entered into or carried out or of the rights or obligations created thereby, is to be determined, is the circumstances under which the transaction was entered into or carried out.”

Further in his judgement he stated the following:

“However, subject to what follows, what must be determined is whether the transaction was the action of an ordinary, normal businessman (or man). The reference is not to a businessman or man in the abstract, but to the particular individual parties in the particular circumstances in which they were.” (331)

Another factor to be taken into account according to Kroon J in Income Tax Case no 1636 is that where a particular type of transaction is common place this a factor which should be taken into account when determining the normality of the transaction. Although the transaction may be “unusual” this will not automatically result in the transaction being “abnormal”. Kroon J went on to say that a helpful test

to determine whether a transaction is abnormal was that posed by Mr Solomon (Counsel for Respondent) in argument:

“if, having regard to the surrounding circumstances and the nature of the transaction in question, the means/manner and rights/obligations are what one is more likely to encounter, the transaction is probably a normal one.”

It should be noted that *Conhage* discussed above, was decided before the amendment of section 103(1) in 1996 which introduced the business element into the abnormality requirement. In this regard, the abnormality test was extended in respect of schemes “*in the context of business*” to those schemes carried out “*in a manner which would not normally be employed for bona fide business purposes, other than that of obtaining a tax benefit.*” However, the test for schemes not entered into in the context of business, the abnormality test remained the same.

3.5.2 Section 103(1)(b)(i)(aa) -Bona fide business purpose

Prior to the 1996 amendment to section 103(1), most income tax avoidance schemes turned around the abnormality requirement. However, transactions structured to avoid tax had become so common that they could no longer be regarded as abnormal in the business community.

In Chapter 11 of his Third Interim Report, Katz stated that for a number of years, commentators had viewed the abnormality requirement as the “Achilles heel” of section 103(1). He quoted Stewart who stated the following:

“While transactions which the section is designed to catch are in their developing stages, they might readily accede to the description of abnormal and so fall within the provisions of the section but once they become firmly

established business practices the applicability of the section is more doubtful.”

RC Williams interpreted the meaning of the 1996 amendment as follows in ‘The 1996 Amendments to the General Anti-Tax-Avoidance Section of the Income Tax Act’ SALJ (1997)675:

“First, the criterion centres not just on the substance of the transaction itself, that is to say on the terms of the transaction, but on the “manner” in which it was entered into, which seems to widen the inquiry. Second, the section does not say that the inquiry is into whether the transaction ‘ was entered into for bona fide business purposes’, but is expressed in the subjunctive, the operative phrase being ‘would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit’. I believe, therefore, that the section does not mandate an inquiry into whether or not the particular taxpayer entered into the particular transaction for bona fide business purposes, but that it necessitates an inquiry into a hypothetical situation: whether the manner in which the transaction was entered into “would not normally be employed” for bona fide business purposes.”

RC Williams is of the view that the enquiry is an objective one into whether the enquiry is explicable in terms of bona fide business purposes other than the obtaining of a tax benefit. At 682, he states that:

“the court must first take cognizance of the circumstances of the particular taxpayer and then ask whether, in those circumstances, the generality of taxpayers would not normally have entered into the given transaction, or entered into it in the given manner for bona fide business purposes other than the obtaining of the tax benefit. If the answer is no, they would not have, then-irrespective of whether it is the business purpose that attracted the particular taxpayer-s103(1) will be applicable.”

RC Williams states further at 683 that once a transaction has a bona fide business purpose other than the obtaining of a tax benefit, the taxpayer will have a right to enter into it, even if he is motivated by that tax benefit. He concludes therefore, that the amended s103(1) will only apply in two circumstances.

Firstly, s103(1) will apply where the transaction has no business purpose at all. Secondly s103(1) will also apply where a taxpayer has entered into a transaction for bona fide business purposes and then amends the manner of the transaction by renegotiating the terms of the contract and cannot show any bona fide business purpose for the restructuring other than a tax benefit.

The subjective enquiry comes into play when determining whether the taxpayer entered into the particular transaction solely or mainly for the purpose of obtaining a tax benefit. Therefore, the taxpayer may fail the business purpose test, but if he did not subjectively enter into the transaction with the sole or main purpose of obtaining a tax benefit, then the requirements of section 103(1) will not have been met.

Income Tax Case no 1712 63 SATC 499 dealt with this extended abnormality test. In this case the taxpayer had leased four tank containers for a five year period from a bank. The taxpayer subsequently entered into an agreement with another party in terms of which he would lease the containers to a third party overseas. The taxpayer claimed a deduction during the 1997 year of assessment in respect of his initial rental expense, but the Commissioner only allowed a much lower amount. The issue to be determined by the court was whether the transaction was abnormal and whether the taxpayer's sole or main purpose was to avoid, reduce or postpone liability for tax.

It was common cause that there was a transaction, operation or scheme, and that this had the effect of postponing or reducing the appellant's liability for tax.

The Commissioner's representative contended that when determining whether a transaction was normal, the question should be asked how businessmen generally with a real/genuine business rationale without being motivated by any possible tax advantage would have structured a corresponding transaction. Cloete J accepted this test without deciding the point as he was of the opinion that the Commissioner's case fell down on the facts. This test is basically the same as that put forward by RC Williams discussed above and it is submitted that the test is correct.

The Commissioner was of the view that the lease was structured in an abnormal manner because the hypothetical model of a "normal" financing transaction for a tank container investment would not have necessitated that a large percentage of the cash consideration be redeemed immediately upon entering into the transaction and would have shown a more even spread of the rental payments over the period of the transaction.

Cloete rejected the first argument on the basis that all banks usually require payment up front of not less than 35% of the initial value of the contract to reduce their exposure to an amount which could be serviced by the rental income of the containers in the case of default, due to the fact that the containers provide very little security as they are sent over the world making it difficult for a bank to repossess.

With respect to the uneven rental payments, the taxpayer provided evidence that the payments were stipulated by the bank and he had no choice but to accept the terms. The court was satisfied with the evidence and held that the Commissioner had not discharged the onus that the transaction was abnormal.

3.5.3 Section 103(1)(b)(i)(bb) – Any other transaction or scheme

In Income Tax Case no 1699 (63 SATC 175), the dispute between the parties was based on the “normality requirement”. The appellant joined a firm of auditors in 1997. His new employer gave him advice on how to structure his remuneration package in the most tax effective manner. This included the grant of residential accommodation taxed as a fringe benefit in terms of a concessionary formula. Later on, the appellant informed his employer that he intended to purchase a house whereupon his employer advised him to buy the house in an inter vivos trust in order to ensure the continued application of the concessionary formula. The appellant followed this advice and a lease was entered into between the employer and the trust.

In 1990 the relevant paragraphs of the Seventh Schedule were amended by providing that the fringe benefit would be deemed to be the rental payable by the employer in respect of the accommodation if the employer had an interest in the accommodation.

An employer was deemed to have an interest in the accommodation if the accommodation was owned by a trust in which the employee, his/her spouse or his child was a beneficiary or where any increase in the value of the accommodation indirectly or directly accrued for the benefit of the employee, his/her spouse or his/her child. The appellant's employer therefore advised that if he wanted to continue being taxed on the basis of the concessionary formula, he should remove himself, his spouse and his children as beneficiaries of the trust. The appellant did so and replaced the beneficiaries with his parents-in-law.

The Commissioner contended that rights and obligations had been created which were abnormal in the circumstances and therefore fell within the provisions of

s103(1) of the Act and sought an application of s103(1) to set aside the appellants supposed scheme of avoidance.

Davis J stated at 180 that when determining abnormality, this turns on questions of fact and quoted with approval Trollip JA who said in the case of *Hicklin v Secretary for Inland Revenue* (1980 (1) SA 481 (A) at 495):

“The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of expert evidence adduced thereanent by either party.”

With regard to the question of onus, Davis J followed Hefer's approach in *Conhage* and placed the onus of determining abnormality on the Commissioner. When proving the abnormality requirement, the transaction has to be measured against other transactions of a similar nature.

Davis J went on to investigate the transaction in further detail and questioned

“whether a group of beneficiaries would agree their complete removal from a class of beneficiaries and in particular whether a person in the position of appellant and his spouse would effectively destroy any interest that they may have enjoyed in their principle asset. A further question arises as to whether the trustees acting in a honest and diligent fiduciary capacity would have agreed to alter a trust deed in circumstances whereby a whole class of beneficiaries including the children of appellant and his spouse would be denied any potential legal benefit to the assets of the trust.”

Davis J concluded that the transaction was not carried out in a normal manner. Under normal circumstances, the taxpayer's parents could have been added to the beneficiaries and the trustees could have been granted the power to make a

distribution to the taxpayers parents in the event that he or his spouse were to pre-decease them. It was clear to Davis that the parties entered into the transaction in order to circumvent the amendment to the Act.

He stated that:

"They were motivated solely by such a purpose. It is correct that a distinction must be drawn between purpose and abnormality such that it is indeed possible that, notwithstanding a tax saving purpose, a transaction may nonetheless be normal. However, when the changes are effected in a manner described above which is not only unusual but abnormal in terms of similar trust transactions, the Commissioner, on the evidence has discharged the onus of proving the abnormality requirement." (175)

Accordingly the changes were effected in a manner which was not only unusual but also abnormal in terms of similar trust transactions and the Commissioner was able to discharge the onus of proving the abnormality requirement.

3.5.4 Section 103(1)(b)(ii)- has created rights and obligations which would not normally be created between person's dealing at arm's length

In the case of *Hicklin* case, Trollip JA's decision turned on whether requirement (c) in section 103(i) or (ii) relating to normality had been fulfilled. It should be noted that this decision was reached before the amendment of section 103(1) in 1996. However this amendment did not affect the application of section 103(1)(b)(ii) which this section will focus on.

Trollip JA suggested that when an agreement has been entered into, it is useful to determine first and foremost whether the transaction was concluded at arms length as this is often an easily determinable premise from which to start the enquiry.

If the agreement was reached at arms length this suggests that the parties are independent of each other and will look after their own interests before that of the other party. Trollip also mentioned that when considering the normality of the rights or obligations created (or the means or manner), due regard must be had to the surrounding circumstances and that

“what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances.” (179)

When deciding the *Hicklin* judgement, Trollip JA applied the abovementioned principles. Firstly, he determined whether the parties were dealing with each other at arm's length. Taking the surrounding circumstances into account, he concluded that the parties were evidently dealing with each other at arm's length in that neither the company, nor its shareholders or directors were associated with or interested in the purchaser.

In addition, it was the purchaser and not the seller who drew up the terms of the agreement and presented it on an “accept-it-or-reject-it” basis. Next, Trollip JA investigated whether the respective rights and obligations created would normally be created between person's dealing at arms length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question. In determining the aforementioned, Trollip JA once again took the surrounding circumstances of the transaction into account and concluded that the reciprocal obligations created were normal incidents of a contract of sale and that there was nothing abnormal about the agreement.

3.6 The transaction, operation or scheme must have been entered into solely or mainly for the purpose of obtaining a tax benefit

3.6.1 Introduction

Section 103(1)(c) of the Act reads 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)...

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit, the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such a manner as in the circumstances of the case it deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.”

A tax benefit is defined as amongst other things, including any avoidance, postponement or reduction of any liability for payment of any tax, duty or levy imposed by the Act or by any law administered by the Commissioner.

Emil Brincker (‘The purpose requirement of the general anti-avoidance provision in South African fiscal law’ *TSAR* (2001)158) states that the purpose requirement is much broader than that of the business purpose element dealt with above.

It was traditionally thought that the purpose requirement would not be met if the taxpayer could prove that there were valid business reasons why a transaction was entered into. However this approach is not necessarily correct as the Commissioner

may look at the manner in which the transaction was implemented and this may suggest a contrary purpose i.e. that the purpose is to gain a beneficial tax consequence.

As previously mentioned, once it is proved that the transaction would result in the avoidance or postponement of a tax liability or in a reduction thereof, it is presumed that the fourth requirement has been met until the taxpayer has proved the contrary. In the case of *Secretary for Inland Revenue v Gallagher* 40 SATC 39, the court stated the following:

“the provisions of s 103(4)(a) ...creates a presumption (until the contrary is proved) that the sole purpose or one of the main purposes of the transaction, operation or scheme in issue was the avoidance, postponement or reduction of income tax, once it is proved that a transaction, operation or scheme would result in such avoidance postponement etc”.

3.6.2 Determining the purpose of a taxpayer

Emil Brincker (Brincker op cit 158) mentions four issues distilled from case law that should be taken into account when determining the purpose of a taxpayer.

Firstly, the test to be applied is subjective. In *Gallagher* it was submitted by appellant's counsel that when determining the purpose of a transaction, operation or scheme, an “objective” and not a “subjective” test was to be used. Corbett JA disagreed with this contention and stated that the test is definitely a subjective test. This was supported by previous case law, for example, the *Geusteyn* decision and in *Glen Anil*.

In addition, Corbett JA pointed out that section 103(1) makes a clear distinction between the “effect” of a scheme and the “purpose” thereof and that it would be incorrect to interpret the “purpose” of the scheme objectively as this would equate it to the “effect” of the scheme. Furthermore, Corbett emphasised the importance of the evidence of the respondent as to why the scheme had been carried out when determining the purpose of the scheme.

Income Tax Case 1636 was in agreement with Corbett’s judgement and Kroon J stated the following:

“The test to be applied is a subjective one, i.e. what was the subjective intention of the taxpayer in entering into or carrying out the transaction? Because a subjective approach is to be applied in the determination of the purpose of the transaction, the evidence of the taxpayer, the progenitor of the transaction, as to why it was entered into or carried out, is of prime importance. The ipse dixit of the taxpayer is, however, not decisive and it must be measured against the credibility of the witnesses who give the evidence, the other evidence adduced and the probabilities.”

Secondly, when determining the purpose of the taxpayer, this is a question of fact. In *Geusteyn*, the judge looked at the surrounding facts to determine whether the partners had incorporated their practice with the sole or main purpose to avoid tax:

“As indicated earlier in this judgment, there existed various reasons, quite unrelated to the incidence of tax, in favour of converting the partnership into a company. The Special Court’s finding that tax avoidance was not a factor which was taken into consideration by the partners in deciding to practise as an unlimited company was a finding on a question of fact. That finding was made with full appreciation of the onus imposed by s 103(4) of the Act, and there was evidence – namely, that of Mr Forsyth and Mr Johnson mentioned in the above extract from Hill J’s judgment and which was accepted by the Special Court – to support that finding. Under those circumstances, it is not

possible for this court to say that the conclusion reached by the Special Court that tax avoidance was 'not a factor which was taken into consideration' in converting the partnership into a company is a conclusion which could not reasonably be reached by it. It follows that this court cannot disturb the judgment of the Special Court."

Thirdly, even if the purpose of a transaction is not formulated to avoid tax liability at the onset, it may become the sole or main purpose of the taxpayer when the transaction is carried out (refer to 3.4.above). For example in the *Meyerowitz* case, the taxpayers main purpose of avoiding tax only arose at a later stage. This is also supported by the judgment in the *Ovenstone* case. In the *Ovenstone* case, the facts were as follows:

The appellant was a member of a family controlling a group of public companies. The appellant was a director of the companies and he derived an income in the form of salaries, director's fees, interest, rentals and dividends. During 1966 the financial director of the group of companies suggested to the appellant that he establish a trust for the benefit of his children and then sell his shares to the trust at their market price. The shares would be paid for by the dividends received by the trust on the shares. After several delays, the appellant finally registered the trust after becoming aware that Parliament was on the verge of repealing section 10(1)(k)(vi) of the Act which had previously prevented dividends received by him from being taxable.

The appellant contended that he had discharged the onus resting on him in respect of the fourth requirement in that he had established that when the scheme was entered into the sole purpose was to save estate duty and that even though there had been substantial delays; the scheme had never been abandoned.

Trollip JA was in agreement with the appellant that the scheme was not a new one however; he did not believe that this furthered the appellant's case:

"It appears from its provisions that the question whether or not the scheme in question is hit by them must be answered by reference to the effect and purpose of the scheme and the circumstances surrounding it at the time it is implemented or carried out, and not at the time it was formulated, i.e. conceived, decided or agreed upon, or otherwise evolved. For it is only when it is implemented or carried out that it becomes a practical reality concerning the fiscus; in particular, it is only then that its purpose and effect in respect of the taxpayer's liability for income tax arise for consideration." (68)

Trollip JA therefore concluded that even if the purpose or effect of the scheme when it was first formulated was not to avoid liability for tax, when the scheme is subsequently carried out this could have become the effect and section 103(1) would then be applicable.

Fourthly, just because a transaction results in a tax benefit, this doesn't mean that the sole or main purpose of the transaction was to obtain the tax benefit.

In the *Knuth* case, Leach J concluded that merely because the transaction carried out had the welcome result of reducing the taxpayer's tax liability, this did not in itself mean that it was the taxpayer's main or sole intention to avoid tax. Leach J took both the taxpayer's evidence as well as the surrounding objective factors into account to reach the decision that it had been shown on a balance of probabilities, that the sole or main purpose of the transaction was to enable the taxpayer to own his own business and was not to avoid tax.

Corbett J in ITC 1636 did however point out that the effect of the transaction will not necessarily be irrelevant when determining what the main purpose of entering into

the transaction is as the effect may point towards the purpose that the taxpayer had in mind. However, Corbett stressed that where a taxpayer is faced with two alternatives: one which result in a greater tax saving than the other, just because he chooses the option with the lesser tax liability does not mean that the main purpose of the transaction is to avoid tax.

In the case of *KBI v Botha 2000 1 SA 908* the respondent was employed as a buyer at the Free State Technikon and used his own car to carry out his duties. The respondent's employer had previously provided its employees with a thirteenth cheque payable in the month of the employee's birthday.

However in 1992, the employer provided the choice to its employees to either continue receiving a thirteenth cheque or alternatively to be provided with a monthly car allowance instead. The employer made it clear that should the employee choose the monthly car allowance, the employee's monthly cash flow would be better (due to the car allowance being taxed only at 50%). However the employee would not have the advantage of receiving a lump sum in cash.

The respondent elected to receive the monthly car allowance. Upon the submission of his annual tax return, the Commissioner did not allow his travel expense claim. The respondent noted an objection and appeal against the assessment and claimed that he was entitled to the deduction as he was required to travel to carry out his duties at the Technikon. The Commissioner was of the view that the election between a bonus and a motor allowance was a "concealment of the material facts" and gave rise to an abnormality and fell within the scope of section 103(1) of the Act.

In reaching his decision Lombard J quoted with approval the Ladysmith judgment that a taxpayer is entitled to arrange his affairs so that he may pay as little tax as

possible, however the transaction should not fall within the provisions of section 103(1) and should not be a mere sham.

Lombard J decided that the fourth requirement had not been met based on the evidence that he would have chosen the car allowance even if it had held no tax benefits for him.

Emil Brincker in (Brincker op cit 158) states that the *Botha* case qualified Lord Tomlin's principle dealt with in Chapter 1 that every man "*is entitled if he can to so order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.*" in that Lombard stated that you may arrange your affairs to pay as little tax as possible as *long* as the transaction does not fall within the scope of section 103(1) of the Act.

Therefore, although a taxpayer had the freedom to so arrange his affairs that he may pay as little tax as possible, the courts will look at whether the parties in fact intended to give effect to the terms of the agreement. Therefore, there should be a legitimate purpose for the taxpayer entering into the scheme

3.6.3 The meaning of "Solely or mainly"

Kroon J cited various cases when interpreting the meaning of "solely or mainly" in Income Tax Case 1636.

Firstly he looked at Income Tax Case 983 (25 SATC 55), where the court dealt with section 90(1)(b) of Income Tax Act of 1941, however these contained words similar to those in section 103(1). Watermeyer J said the following:

“... for the section to operate the avoidance of tax must at least have been the principal purpose of the taxpayer. In the present case the court is satisfied that although the avoidance or reduction of tax was one of the purposes, it was not the main purpose. The main purpose was to obtain a production unit which could go into immediate operation, as indeed the Appellant company did.” (58)

Next, Kroon J looked at Income Tax Case 1307 which dealt with a previous version of s103(1) of the Act which contained the words “the sole or one of the main purposes”. Nicholas J stated the following:

“The word ‘main’ means principal, major and most important, and the ascertainment of a main purpose involves a weighing against each other of the various purposes of a scheme. In a case such as the present, where at most two purposes have been suggested (a saving on income tax and a saving on estate duty), if one purpose preponderates over the other it cannot be said that the other is a main purpose.”

Kroon J was not in agreement with Nicholas J’s interpretation of s103(1) as it was worded at the time his judgement was made. However, he was of the view that Nicholas J’s interpretation was appropriate when applied to the law as it now stands i.e. where it is required that there only be one main purpose. Kroon therefore summarised as follows:

“In short, to qualify as the main purpose, the purpose in question, must preponderate over any other purpose (or, possible, at least be as important as any other purpose).” (267)

In *Geusteyn* it was determined that when determining whether the sole or main purpose is to avoid/reduce liability for tax, this is a question of fact.

3.6.4 The Commissioners Remedy

The remedy available to the Commissioner is to determine the liability for any tax, duty or levy imposed by the Act (see above), and the amount of that tax, duty or levy—

- (a) as if the transaction, operation or scheme in question 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 the avoidance, postponement or reduction of liability for tax in question

Therefore, the Commissioner has two alternatives available to him when determining the liability, duty or levy imposed by the Act.

In *Smith*, Steyn CJ applied the first alternative. Counsel for the appellant had contended that section 103(1) applies to circumstances where income has accrued to the taxpayer and in respect of which he has avoided liability either because he had made arrangements to divest himself of that income or has arranged that such income accrue to him in a non-taxable form.

Steyn CJ was in disagreement with this interpretation.

“These requirements, moreover, diminish the persuasive force of an argument based upon the absurdity of exacting income tax which is not ‘in

reality', or otherwise, the income of the taxpayer. Where they are satisfied, it may be presumed that the income, although it may for the time being not be the taxpayer's income in any sense, has not been permanently placed out of his reach. It is not common practice for a taxpayer to divest himself completely and for all time by a transaction, operation or scheme displaying the abnormal characteristics mentioned in the section, of an income-producing asset or of the fruits of his labour, merely for the purpose of avoiding or postponing liability or reducing the amount thereof, without creating or retaining, as in the present case, the means of recovering the income, or a substantial portion thereof, in some form or another, not subject to tax or subject to a lesser tax, at some time in the future. It is not, therefore, altogether unreasonable that he should be taxed as if the transaction, operation or scheme had not been entered into or carried out. In so far as the exaction of tax in such circumstances may be said to be something in the nature of a penalty for entering into or carrying out such a transaction, operation or scheme, it would not be a penalty designed to exceed the amount by which the taxpayer would otherwise have enriched himself by outwitting the fiscus, and the means by which he would have done so may, because of its abnormal features, well be described as not permissible in the contest between the taxpayer and the tax-gatherer." (14)

Based on the above, Steyn CJ therefore ruled that had not it been for the transaction or operations entered into, the dividend would have been received in his hands and he would have been taxable thereon.

The alternative remedy was utilised in the *Meyerowitz* case. Although at the time "The Taxpayer (Pty) Ltd"

"... may have come upon the scene with good intentions, it ceases almost at once to be an innocent bystander. It became a party to the scheme when it ceded its only asset to the partnership: it was essential to the scheme that it should do so... The company died, as it were, in the service of the scheme and it seems to me to be illogical to hold that the Commissioner ought not to have ignored the company but ought to have resurrected it for the purpose of

determining the appellant's liability to tax. To now seek to reinvest the company with the income from The Taxpayer is to imply – contrary to the finding of the Special Court – that the cession of its rights to the partnership was a legitimate transaction and played no part in the avoidance-of-tax scheme.” (287)

Therefore, as stated by Silke, the Meyerowitz case is authority for the view that *“that the Commissioner is not limited to the annihilation of only so much of the scheme as is objectionable”*.

3.7 The way forward for Section 103(1) - an overhaul of section 103?

In his 2005 budget speech, Trevor Manuel indicated that we may expect a complete overhaul of the anti-avoidance measures contained in section 103 of the Act. This he said was due to section 103 being based on antiquated notions of legal form and intent. This problem he said was exacerbated by the formalistic judicial interpretations that undermine the legislations goal of curtailing tax avoidance. It has been indicated that a discussion paper on the proposed new section 103 will be circulated later this year.

When drafting the new section 103 the legislators would do well to recall the principles which guided the Commission before the amendments made to section 103(1) in 1996.

Firstly that anti-avoidance legislation is only intended to operate where the specific legislation contained in the Act is ineffective and anti-avoidance legislation should only be utilised in exceptional cases.

Secondly, should the first principle be adhered to, this would promote equity and certainty and allow a taxpayer to plan his tax affairs. Thirdly, because the existing anti-avoidance provisions have been the subject of much commentary and judicial decisions, it would be better to keep the existing provision as is and rather just remedy the defects. Lastly, safeguards of an administrative nature are not necessary to be incorporated into section 103 as these safeguards are already enshrined in the constitution. The overhauled section 103 is expected to be circulated for comment this year.

Chapter 4-Substance versus Form in South Africa

4.1 Introduction

As pointed out by Lynette Olivier in 'The Substance-over-form doctrine applied to Tax-Avoidance Schemes' SALJ (1998)646, prior to the *Erf 3183/1 Ladysmith(Pty) Ltd And Another V Commissioner For Inland Revenue* (58 SATC 229) decision, it was widely believed that if a scheme did not fall within the provisions of section 103(1) of the Act, then effect would be given to it. The Ladysmith case made it clear that the courts will still apply the doctrine of substance over form, whether or not the scheme falls within the ambit of section 103(1) of the Act.

4.2 Erf 3183/1 Ladysmith(Pty) Ltd And Another V Commissioner For Inland Revenue

4.2.1 The facts of the case

The case dealt with a structure widely used in the 1980's (Meyerowitz D 'Reflections on the Ladysmith Case' *The Taxpayer* (1997)23). The Pioneer Group of companies wished to erect a furniture factory in Ladysmith. Normally this would be effected by one company in the group purchasing the ground and letting it to a subsidiary. The lease would require that the lessee effect improvements to the land by building a factory. In terms of the Act the lessee would be entitled to deduct the expenditure in building the factory. However, the lessor would be taxed on the value of the improvements. In order to prevent the lessor being taxed on the value of the improvements, the parties interposed a tax-exempt institution (a pension fund) to accept the taxable right whilst allowing the tax deductible obligation to remain with

the lessee. The lessor stated that the tax-exempt institution was entitled but not obliged to erect a factory. The tax-exempt institution in turn sub-let the property to the subsidiary company and the terms of the sub-lease agreement required the subsidiary company to erect a factory. This resulted in the lessor not being taxable on the improvements made to the land.

It must be kept in mind that the *Ladysmith* events occurred before the amendments to section 103(1) in 1996. Therefore, the court could not apply the business test to the transaction. Although the transaction was entered into for the sole or main purpose of avoiding tax, it could not be said that the transaction was abnormal. Nevertheless, the courts applied the substance over form doctrine as developed in the common law.

4.2.2 The decision

The argument focused on two concepts. Firstly that parties may arrange their affairs in order to remain outside the provisions of a particular statute. Secondly, that a court will look past the form of a transaction and examine its true nature and substance. In commenting on whether both principles could be applied simultaneously, Hefer JA stated that:

“Provided that each of them is confined to its recognised bounds there is no reason why both principles cannot be applied in the same case. I have indicated that the court only becomes concerned with the substance rather than the form of a transaction when it has to decide whether the party concerned has succeeded in avoiding the application of a statute by an effective arrangement of his affairs. Thus applied, the two principles do not conflict.” (229)

Hefer JA quoted from Innes J's judgement in *Zandberg v Van Zyl* 1910 AD 302 in his discussion on simulated transactions and determined that it is a factual enquiry which requires that the court determine what the actual intention of the parties is.

Following this, he went on to quote from the well known case of *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 AD 369 which confirmed that just because a transaction is devised for the purpose of evading a prohibition in the Act or avoiding liability for tax, this does not necessarily mean that it is a disguised transaction. A transaction is disguised when the parties do not intend for the contract to have the effect which its terms convey to the outside world.

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

It should be noted that in ITC 1636, the following was said in respect of whether the contracting parties should be guilty of *mala fides*:

"In the light of the above discussion I consider that the law which this court is bound to apply includes the principle that notwithstanding that the parties may honestly intend to enter, and may bona fide think that they are entering, into a contract of sale and/or a contract of lease and in no way are fraudulent or have an improper aim and the agreement(s) is/are not designedly disguised in any manner, the court may nevertheless, on an analysis of all the relevant

facts, conclude that in fact the agreement is not one of sale or lease, as the case may be, but some other agreement...”

Therefore, in terms of ITC 1636, it is not a requirement that the parties are *mala fides* in order for the courts to determine that the transaction is a simulated one.

Hefer looked at the various agreements entered into between the parties and concluded that in substance, there was:

“... a real likelihood that there was an unexpressed agreement or tacit understanding between the appellants and Pioneer that the appellants would be entitled if need be to enforce compliance with the relevant terms of the sub-leases, either against Pioneer or possibly against Pioneer and the Fund jointly. Of this the Fund could not have been unaware: as stated earlier, it could not have been kept in the dark about the purpose of its intervention; indeed, on the available evidence, there is reason to believe that the Fund was not unaccustomed to the role it was required to play in this kind of transaction. On this basis the Fund too could well have been a party to the agreement or understanding referred to. The evidence does not exclude what is thus a real likelihood that the written agreements do not reflect the true or full intention of the parties.” (242)

Therefore, the courts looked at the substance of the agreements and determined that there had been an unexpressed agreement or tacit understanding which brought the taxpayer within the taxing provisions of the Act.

4.3 Conclusion

The *Ladysmith* case made it clear that the courts will not hesitate to apply the doctrine of substance over form to anti avoidance schemes even though section 103(1) may not be applicable. However, the introduction of the business purpose test in 1996 may have the effect that section 103(1) is more widely applicable resulting in the courts not being forced to resort to the common law principle of substance over form. The “substance over form” doctrine as set out in the *Ladysmith* case is not only confined to circumstances where section 103(1) does not apply. In ITC 1636, Kroon J stated the following:

*“In the application of s 103 the substance of the arrangement will first have been ascertained and it is that substance that will be subjected to the tests imposed by s103. If, to translate the words in Silke, those tests are successfully negotiated by the taxpayer, the provisions of the section cannot be invoked against him. As it was put in King’s case at 192:
‘...if a transaction is covered by the terms of the section its provisions come into operation; if it is not, then its provisions cannot be applied.’”*

It is submitted however, that the application of the business purpose test would deal with most circumstances where the common law principles would have previously been applicable.

Chapter 5 – Conclusion

This report has looked at the approach of the British and South African courts to anti-avoidance schemes. Firstly, British case law was analysed. It was found that the British courts currently focus on a purposive interpretation of applicable section of tax legislation. To assist the courts in this task, the courts may determine whether the concept is of a “commercial” or “legal” nature. If the concept is of a “commercial” nature, then the courts may be assisted by the *‘Ramsey doctrine’*. If the concept is of a legal nature then the courts must determine whether the scheme falls within these parameters. However, as stressed in the *“Barclays”* decision, the courts should not over generalise when determining how/ whether to tax a scheme. In each case the courts must apply a purposive interpretation and decide what the purpose of Parliament was when enacting the particular piece of legislation.

It is clear from the case law dealt with in the British courts that the lack of a general anti-avoidance provision in British legislation has led to a great deal of uncertainty.

Secondly, I have dealt with case law decided in South Africa. The introduction of the “business test” in 1996 has assisted with the problem previously experienced by Revenue with the requirements of the abnormality test. Section 103(1) consists of four requirements and the section will only be applicable if the requirements are met. The requirements encompass both subjective and objective elements. When determining the abnormality of a transaction, this is an objective test. On the other hand, when determining the purpose of the taxpayer, this is a subjective test.

The *Ladysmith* case came as a surprise to many tax practitioners. Prior to the Ladysmith case, it was thought that where a scheme did not fall within the scope of

section 103(1) of the Act that it would be out of the reach of the Revenue Authorities. *Ladysmith* made it clear that courts will not hesitate to apply the common law principle of substance over form. The common law principle of substance over form as applied in the *Ladysmith* case is not the same as the substance over form principle developed by the British courts. The British test based on the *Ramsay* and *Furniss* decisions required the existence of a preordained series of transactions, or a single composite transaction and the insertion of steps which had no commercial purpose other than to avoid tax liability. On the other hand, the *Ladysmith* decision applied South African jurisprudence in coming to its decision. The South African jurisprudence dealt with “sham” transactions in other words the parties enter into a transaction which conveys to the outside world terms which they do not intend to have *inter partes*. Therefore, the South African substance over form interpretation is to look at the true intention of the parties.

It should also be noted that as section 103(1) was not applied in the *Ladysmith* judgement, the onus lay on the appellants to prove that the right to have improvements effected as envisaged in para(h) did not accrue to them. Therefore, in conclusion, the South African courts have not applied English jurisprudence in its application of common law principles. Instead *“the court applied itself to the real intention of the parties to a series of contracts, such application having been derived from an examination of the written agreements as read together and the purpose which such agreements were entered into.”* (Davis D *The Taxpayer* (1997)26).

Trevor Manuel has indicated that we may expect section 103(1) to undergo a facelift in the near future. It is hoped that the legislature will recall Lord Tomlin’s passage that every man should be entitled to manage his affairs in such a manner as limit his payment of tax

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