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ANTI-AVOIDANCE IN THE LEASING ENVIRONMENT

Dissertation submitted in partial fulfilment of the requirements for the degree Masters of Law in Taxation

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12 September 2005

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1 INTRODUCTION

Over the years financial institutions have developed innovative financing structures to offer clients alternative ways to satisfy their funding needs. The increased demand by clients for financing, the strong growth in the economy over the last decade and the increased competition among financial institutions have required financial institutions to develop more innovative and exotic financing methods. Most new forms of financing transactions were pioneered because traditional transactions for the provision of asset-based financing could not adequately address the new and more differentiated demand for financing caused by inflation, intense competition and new technological advances.[1]

In designing and developing these alternative asset-based financing structures financial institutions strive to enhance the benefits they will receive from such structures and to provide the client with a lower cost of funding compared to the traditional loan funding structures. Inevitably these asset-based financing structures are designed to create some sort of a tax advantage in the hands of either or both the financial institution and the client which will result in a direct or indirect lower cost of funding to the client. Some structures have also been designed to result in the financial institution obtaining a higher return as a result of a tax advantage in the hands of the financial institution.

As a result of the fact that almost all alternative or innovative financing structures are developed to create a tax advantage in the hands of either or both the client and the financial institution, these structures have come under the intense scrutiny of the

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[1] Nereus Joubert "Asset-based financing, contracts of purchase and sale, and simulated transactions" 1992 SALJ 707 at 707

Commissioner. These structures have been attacked by the Commissioner on various grounds including non-deductibility of expenditure incurred, simulated transactions, tax avoidance under section 103(1) of the Act [2] and various other provisions under the Act. It has also resulted in the Commissioner introducing specific provisions in the Act in order to address specific structures developed in the market.

As Joubert states "despite the fact that new asset-based financing transactions are often carefully drafted to reflect contracts of purchase and sale or contracts of letting and hiring, they almost invariably contain provisions which are not typically found in such types of contracts. These atypical or abnormal provisions, coupled with the fact that the provision of finance is not one of the typical objects of a contract of purchase and sale or a contract of letter and hiring, raise the question whether such .... asset-based financing transactions are in fact contracts of purchase and sale or contracts of letting and hiring, or whether they should be considered to be simulated transactions. The suspicion of simulation is often increased in circumstances where an asset-based financing transaction is drafted as a contract of purchase and sale or a contract of letting and hiring in order to avoid certain statutory provisions". [3]

Two of the most popular structures used by financial institutions are the sale and leaseback structure and the lease and sub-lease structure.

The sale and leaseback structure in its simplest form essentially entails the following :

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[2] Income Tax Act No. 58 of 1962
[3] Joubert op cit note 1 at 708

(a) a company will sell plant and equipment to a financial institution in terms of a sale and purchase agreement;

(b) the purchase price for the plant and equipment will be paid immediately by the financial institution to the company;

(c) ownership of the plant and equipment will transfer from the company to the financial institution immediately by way of constructive delivery, while all the risk in and to the plant and equipment will remain with the company;

(d) the financial institution and the company will, simultaneously with the sale and purchase agreement, enter into a lease agreement in terms of which the financial institution will lease the plant and equipment back to the company for a fixed period;

(e) the company will pay rentals to the financial institution for the duration of the lease agreement; and

(f) at the end of the lease period, ownership in the plant and equipment will pass from the financial institution back to the company.

The above type of leasing transaction used as an attractive financing method has been the subject of close scrutiny by the Commissioner in the past.

This research report examines the various bases upon which the above and other leasing transactions have been attacked by the Commissioner in the past as well as certain legislative measures introduced by the legislature to combat the above and other similar asset-based financing transactions, such as sections 23A, 23D and 23G of the Act.

2 DEDUCTIBILITY OF LEASE PAYMENTS BY A LESSEE

The primary benefit for a company in entering into the sale and leaseback structure is that the rental expenditure payable to the financial institution is deductible in the hands of the company as lessee. The Commissioner would typically argue that the object of the sale and leaseback structure is nothing more than an ordinary loan by the financial institution to the lessee consisting of the advance of a capital sum by the financial institution to the lessee and the repayment by the lessee of capital and interest to the financial institution over the period of the lease in the form of rental payments.[4] Accordingly, the Commissioner would disallow a portion of the rental payments as it argued that it represents the repayment of capital under the financing transaction and as such does not qualify as expenditure incurred in the production of income. The remaining portion of the rental payments would be allowed as a deduction under clause 11(a) as it represents the interest component under the financial transaction. It is therefore pertinent to conduct an analysis of section 11(a) of the Act.

Section 11(a) of the Act provides :

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[4] See Commissioner for Inland Revenue v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd) ITC 1636 SATC 60 1998 at 267

"For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

(a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature."

This section must be read in conjunction with Section 23(g) of the Act which provides that :

"No deductions shall in any case be made in respect of the following matters, namely-

(g) any monies, claimed as a deduction from income derived from trade, to the extent to which such monies were not laid out or expended wholly or exclusively for the purposes of trade."

Therefore, the current general deduction formula comprised by sections 11(a) and 23(g) of the Act can be broken down in the following elements:

- the expenditure and losses;
- must be actually incurred;
- during the year of assessment;
- in the production of the income;
- they must not constitute expenditure and losses of a capital nature; and

- if they are claimed as a deduction against income derived from trade, they must, either in part or in full, constitute monies that are laid out or expended for the purposes of trade. [5]

"Trade" is given a wide meaning in section 1 of the Act and includes "every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, copyright or any other property which is of a similar nature."

In order to ascertain whether the rentals payable by the lessee to the financial institution can be deducted in terms of the general deduction formula, each of the above elements must be examined.

"Expenditure and losses"

The lessee is required to make the rental payments to the bank in terms of the lease agreement on predetermined rental payment dates. Therefore, it is without doubt that the lessee will incur expenditure which satisfies the first element of the general deduction formula.

"Actually incurred"

[5] Alwyn de Koker "Silke on South African Income Tax" Volume 1 Service Issue 30 (December 2004) page 7 - 9

In deciding whether or not expenditure has actually been incurred, it is not essential to decide whether in was necessarily incurred. In other words, it is not for the tax authorities to decide whether or not the expenditure was prudent or otherwise. [6]

In Port Elizabeth Electric Tramway Co. Ltd v Commissioner for Inland Revenue [7] Watermeyer AJP stated that:

> "..... the words of the statute are "actually incurred" not "necessarily incurred". The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses are therefore not "necessary", but they are actually incurred and therefore deductible."

A further requirement for expenses to be "actually incurred" is that the obligation to pay or incur the expense must be unconditional. In other words, an expense is not actually incurred if there is a chance that the liability will not arise. [8]

In Edgars Stores Ltd v Commissioner for Inland Revenue [9] the Appellate Division confirmed the above submission by stating :

> "Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation

[6] Keith Huxham, Phillip Haupt "Notes on South African Income Tax 2004", 23rd edition, page 64, paragraph 5.3.2
[7] 1936 CPD 241 cit 244
[8] Huxham and Haupt op cit note 6 at 65
[9] 1988 (3) SA 876 (A) at 889

during the year of assessment in question may be deducted in terms of section 11(a) from income returned for that year. .... But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied.)"

Therefore, the lease agreement between the lessee and the bank must contain an unconditional obligation on the lessee to make the rental payments to the bank in accordance with its terms. If such payments are in fact made by the lessee, the rentals will have been actually incurred.

"*Incurred during the year of assessment*"

Although this requirement is not specifically mentioned in section 11(a) the courts have held that the expenditure which the taxpayer claims as a deduction, must be incurred during the year in which it is claimed.[10] However, this requirement is subject to certain exceptions contained in section 23H of the Act, which limits the deduction available for expenditure in certain circumstances, for instance where the deduction of such expenditure is deferred until the particular benefit is received.

"*In the production of income*"

[10] Supra note 9 at 889 and Silke op cit note 5 at 7.7

To qualify as a deduction from income, the expenditure must actually have been incurred in the production of the income. The "income" referred to is that as defined in section 1 of the Act, namely the gross income less the exempt income. Again section 11(a) must be read with section 23(f) of the Act which prohibits a deduction of expenses incurred in respect of any amounts received or accrued that are not included in the definition of "income" as defined in section 1.[11] Accordingly, if the expenditure is incurred to produce income that falls outside the definition of "gross income" as defined in section 1 or to produce income that is exempt from tax in terms of section 10 of the Act, the expenditure is not deductible.

The meaning of the expression "in the production of income" has been the subject of a number of court cases which have tempted to define its meaning.

In the Port Elizabeth Electric Tramway case [12] Watermeyer AJP, stated the following:

> "The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."

Further in his judgment [13] Watermeyer AJP also said the following:

> "The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the

[11] Silke op at note 5 at 7.8
[12] Supra note 7 at 245
[13] Supra note 7 at 245

purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

In the case of Sub-Nigel Ltd v Commissioner for Inland Revenue [14] the court determined that the words "incurred in the production of income" do not mean that before a particular item of expenditure may be deducted it must be shown it produced any part of the income for the particular year of assessment.

According to *Silke*, [15] the important question is : "Was the expenditure incurred for the purpose of earning income as defined in section 1, whether in the current or in a future year of assessment?'

In Commissioner for Inland Revenue v Allied Building Society [16] the Appellate Division through the judgment of Ogilvie Thompson JA confirmed the test laid down in Port Elizabeth Electric Tramway and stated the following :

"For the court is not concerned with whether a particular item of expenditure produced any part of the income, but with whether that item of expenditure was incurred for the purpose of earning income."

The test laid down by Port Elizabeth Electric Tramway [17] and confirmed in subsequent judgments such as Allied Building Society, [18] was restated by the

[14] 1948 (4) SA 580 (A)
[15] Silke op cit note 5 page 7 - 18
[16] 1963 (4) SA 1 (A)

Appellate Division in Commissioner for Inland Revenue v Nemojim [19] but an additional element was added to the test. The court stated that :

> "…. In order to determine in a particular case whether moneys outlaid by the taxpayer constitute expenditure incurred in the production of income important, sometimes overriding factors, are the purpose of the expenditure and what the expenditure actually effects."

Therefore, the test laid down by the abovementioned authorities for expenditure to qualify as a deduction in terms of section 11(a), is that the expenditure must not only have been incurred for the purpose of earning income (as defined in section 1) but there must also be a sufficiently distinct and direct relationship or link between the expenditure incurred and the income earned.

In the Conhage case [20] the court also followed the application of the above test in determining whether the rental payments made by the applicant to the financial institution were deductible. Kroon J stated :

> "… two questions arise (a) whether the act to which the expenditure is attached is performed in the production of income and (b) whether the expenditure is linked to it closely enough." [21]

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[17] Supra note 7
[18] Supra note 16
[19] 1983 (4) SA 935 (A)
[20] Supra note 4
[21] Supra note 4 at 314

To the first question the learned judge stated that if the expenditure is performed for the purpose of earning income then the expenditure attendant upon it is deductible. To the second question he said that in his opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it. [22]

It is safe to say that the rental payments to be made by the lessee to the bank in terms of the lease agreement will be made for the purpose of earning income and are closely enough linked to the income earning activities of the lessee.

"*Not of a capital nature*"

In order for an expenditure or loss to be deductible pursuant to section 11(a) of the Act, such expenditure or loss must not be of a capital nature. This is a very important element in the deduction of lease payments by a lessee to the financial institution under the various leasing structures developed in the market. More importantly, most of the leasing structures were developed and sold on the premises that the entire lease payment by the lessee to the financial institution would be deductible under section 11(a).

[22] Supra note 4 at 315

The Commissioner would argue that the structure amounted to nothing more than a loan between the lessee and the bank, and that the lease payments represented repayments of the borrowed capital which consist of a capital and an interest component, while the latter is allowed as a deduction under section 11(a), the capital component would be disallowed as such expenditure is not incurred in the production of income as it is of a capital nature.

There is no definitive test to determine whether a particular expenditure or loss is of a capital or revenue nature. However, the courts have laid down a number of guidelines to determine whether a particular expenditure is of a capital or revenue nature. One also has to look at the facts of each case and the purpose of the expenditure concerned to ascertain whether it is of a capital nature or not.[23]

A valuable guideline was laid down by the court in Commissioner for Inland Revenue v George Forest Timber Co Ltd [24] in which Innes CJ made the following statement:

> "Now money spent in creating or acquiring an income producing concern must be capital expenditure. It is invested to yield a future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in making it. The one is capital expenditure, then other is not." [25]

[23] Silke op cit note 5 page 7 - 21
[24] 1924 AD 516
[25] Supra note 24 at 526

Another test was formulated in New State Areas Ltd v Commissioner for Inland Revenue [26] where Watermeyer CJ made a distinction between floating and fixed capital and stated the following:

> "When the capital employed in a business is frequently changing its form from money to goods and vice versa .... and this is done for the purpose of making a profit, then the capital so employed is floating capital. The expenditure of a capital nature, the deduction of which is prohibited under section 11(2), is expenditure of a fixed capital nature, not expenditure of a floating capital nature, because expenditure which constitutes the use of floating capital for the purpose of earning a profit, such as the purchase price of stock in trade, must necessarily be deducted from the proceeds of the sale of stock in trade in order to arrive at the taxable income derived by the taxpayer from that trade. [27]

Later in his judgment [28] Watermeyer CJ concluded by saying:

> "The conclusion to be drawn from all these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income

[26] 1946 AD 610
[27] Supra note 26 at 627
[28] Ibid

producing machine, then it is revenue expenditure even if it is paid in a lump sum."

Another guideline laid down by the court in determining whether expenditure incurred is of a capital or a revenue nature, was the "closeness of connection test" stated in Commissioner for Inland Revenue v Genn & Co. (Pty) Ltd [29] where Schreiner JA made the following statement:

"In deciding how the expenditure should properly be regarded the court clearly has to access the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects." [30]

The so called "enduring benefit" test was referred to in Commissioner for Inland Revenue v Manganese Metal Company (Pty) Ltd [31] when the court stated that "it is not necessary to turn to the "enduring benefit" test where you have a permanent fixed capital asset. It is only when you are dealing with some other form of property .... that you have to enquire whether it is a benefit or advantage which endures in the way that fixed capital does." [32]

From the above cases it is apparent that an expense is of a capital nature if it is part of the cost of acquiring an asset or a right which forms part of the taxpayer's income

[29] 1955 (3) SA 293 (A)
[30] Supra note 29 at 299
[31] 1966 (3) SA 591 (T)
[32] Supra note 31 at 601

earning structure, or if it creates an enduring benefit for the taxpayer. If the expense is not a capital nature, it must be of a revenue nature. [33]

"Laid out or expended for the purpose of trade"

Section 23(g) of the Act constitutes the negative test of what kind of expenditures may not be deducted. Accordingly, sections 11(a) and 23(g) of the Act must be read together in order to determine whether an amount is capable of deduction or not. In De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue [34] the Appellate Division stated that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade. It went on to say that moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of section 23(g).

It appears, without a doubt, that the lease payments by the lessee to the bank would qualify as expenditure laid out for the purposes of trade and as such would be deductible under Section 11(a) read with section 23(g).

3 SIMULATED TRANSACTIONS

Another way in which the Commissioner attacks asset based financing transactions which include the various forms of leasing transactions that have been developed in the financial markets over the years, is on the basis that such transactions constitute simulated transactions and, accordingly do not reflect the true intention of the parties.

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[33] Huxham and Haupt op cit note 6 at 69
[34] 1986 (1) SA 8 (A)

A simulated or disguised transaction is one in which the parties, in order to secure some advantage or to avoid some disability, conceal the true character of the agreement. [35] It has also been said that a "sham" transaction is one in which the parties do not intend to give effect to the ostensible terms of their arrangement; the sham transaction is a cloak to conceal their intent. The true nature of the transaction is determined by the legal rights and obligations arising from the real arrangement. [36]

Joubert also states [37]that a common characteristic of many of these new asset-based financing transactions is that they are founded on types of contract which are not traditionally associated with the provision of finance. Normally the provision of finance is associated with loans, pledges, suretyships and mortgages, while new asset-based financing transactions are typically based on contracts of purchase and sale or contracts of letting and hiring. [38]

Joubert identifies the following three characteristics as typical characteristics to be found in the "new breed" of asset-based financing transactions: [39]

(a) they include the use of a traditional type of contract (for example a contract of purchase and sale) to achieve an object (for example financing) which is not typical of that kind of contract;

(b) the atypical object of the contract is usually the typical object of another type of contract (for example a contract of loan) which;

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[35] Joubert, "The Law of South Africa", First Reissue, Volume 22, Part 1, at paragraph 634
[36] WT Ramsay Ltd v IRC (1981) 11 ATR 752 (HL)
[37] Joubert op cit note 1 at 707
[38] Joubert op cit note 1 at 708
[39] Ibid

(c) the parties elect not to conclude, since there are certain legal rules applicable to such a contract which the parties seek to avoid.

In determining whether a particular transaction is a simulated transaction, two very important principles in our law must be applied. The first is the recognised legal principle that any person is entitled to so order his affairs that the tax attracted under the relevant legislation is less than it otherwise would be. When applying this principle, one should also take account of the other principle namely that South African law embraces the concept of "freed of contract". Freedom of contract not only entails the freedom to conclude contracts with whom and whenever one chooses, but also the freedom to determine the content of a contract. Freedom to determine the content of a contract includes the freedom to choose between the different types of contracts.[40]

The second principle the courts apply in determining whether a particular transaction is a simulated transaction, is whether a transaction was in substance a true and genuine transaction according to the form in which it was recorded or whether it was in truth a different transaction and the form in which it was couched was simulated. [41]

The two principles appear to be mutually exclusive but in the Conhage case the court stated that there is no reason why both principles cannot be applied in the same case. It was stated 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

[40] Joubert op cit note 1 at 709
[41] Supra note 4 at 302

in avoiding the application of a statute by an effective arrangement of his affairs, and this applied, the two principles do not conflict.

The first principle, namely the freedom to order one's affairs in order to achieve the most tax efficient position is known as the Westminster principle as laid down in the matter of Inland Revenue Commissioner v The Duke of Westminster [42] where Lord Tomlin stated :

> "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be" [43]

and

> "This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable." [44]

The Westminster principle was adopted into South African law by Centlivres CJ in his minority judgment in Commissioner of Inland Revenue v Estate Kohler and Others [45] where he said :

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[42] 1936 AC 1
[43] 1953 (2) SA 584 (A)
[44] Supra note 42 at 20
[45] 1953 (2) SA 584 (A)

"It is true also that the device adopted was designed in order to escape death duties, but it has long been a well-recognized principle of law that a person may so order his affairs as to escape taxation" [46]

and

> "So long as there is no such provision in the Death Duties Act a taxpayer may (to adopt the words of Lord Tomlin in the Duke of Westminster's case, supra), so order his affairs that the amount of tax sought from his estate is not legally claimable." [47]

The Westminster principle was also affirmed in subsequent judgments of the court. In Secretary for Inland Revenue v Hartzenberg [48] Botha JA stated that "....purchaser was undoubtedly entitled, if he could, so to arrange his affairs that the duty payable by him under the Act is less than it otherwise would have been ....." [49] and in Hicklin v Secretary for Inland Revenue [50] the court stated that "..... they were perfectly entitled to try to avoid such tax liability by adopting some other legitimate cause ...." [51]

The Westminster principle in effect involves the application of the more general principle namely, which permits parties to arrange their affairs so as to remain outside

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[46] Supra note 45 at 591E
[47] Supra note 45 at 592G
[48] 1966 (1) SA 405 (A)
[49] Supra note 48 at 408H
[50] 1980 (1) SA 481 (A)
[51] Supra note 50 at 494G

the premises of a particular statute. This principle was formulated in the matter of Dadoo Ltd and Others v Krugersdorp Municipal Council [52] where Innes CJ said :

> "But an Act thus construed, may nevertheless be evaded; parties may genuinely arrange their transactions so as to remain outside its provisions. Such a procedure is, in the nature of things, perfectly legitimate." [53]

In every lease financing transaction and for that matter all asset-based financing transactions, where the principle is involved it is for the court to decide whether the party concerned has succeeded in achieving the principle laid down in the Westminster case and adopted in cases such as Estate Kohler and Hartzenberg. The outcome may depend entirely on the facts or on the application of the law to the facts. [54] It is in this regard that the second principle namely, substance over form, will be examined by the courts.

The principle of substance over form was adopted in the case of Kilburn v Estate Kilburn [55] where Wessels ACJ stated the following:

> "..... courts of law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance." [56]

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[52] 1920 AD 530
[53] Supra note 52 at 548
[54] Supra note 4 at 303
[55] 1931 AD 501
[56] Supra note 55 at 507

The leading case on the subject of simulated transactions is the matter of Zandberg v Van Zyl. [57] The facts were briefly that Mrs van Zyl owed the claimant £50 and gave him a promissory note for that amount. Mrs Van Zyl could not pay the £50 to the claimant but agreed with the claimant that he could have her wagon for £50. Presumably at the same time, it was understood that she might, when able, repurchase the wagon or use the wagon whenever she required it. The question which the court had to decide was whether the transaction amounted to a pledge of the wagon to the claimant for £50, or whether it constituted as sale of the wagon for the previously paid £50, with a resolutive condition to the effect that Mrs Van Zyl could later repurchase the wagon from the claimant. Innes J said the following :

> "Not frequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to cancel its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form its purports to be." [58]

Innes J went on to say :

> "The court must be satisfied that there is a real intention definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the

[57] 1910 AD 302
[58] Supra note 57 at 309

same object might have been attained in another way not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact...." [59]

Therefore, it seems clear from the above passage that if a court has to decide whether a particular transaction is a simulated one or not, the court must look at the facts to ascertain the true intention of the parties.

The issue of a simulated transaction was also dealt with in the matter of Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd. [60] The question which the court had to decide was whether ownership of certain garments passed between the parties as a result of the transactions between the defendant and the manufacturers, and this was dependent on whether the transactions were genuine sales or not. Watermeyer JA stated the following :

"A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax." [61]

The court went on to explain a disguised transaction and stated that it is a dishonest transaction, inasmuch as the parties to it do not really intend it to have, *inter partes*,

[59] Ibid
[60] 1941 AD 369
[61] Supra note 60 at 395

the legal effect which its terms convey to the outside world. Watermeyer JA stated that :

> "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." [62]

In the Randles case the court stressed that before a court can find that a transaction is in *fraudem legis*, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties.

S v Friedman Motors (Pty) Ltd and Another [63] was a case where the question was whether a sale agreement followed by a re-purchase agreement in the form of a hire-purchase agreement at a higher price constituted a money lending transaction as envisaged in Act 73 of 1968. The court stated that :

> "A court which is concerned with such a transaction will disregard the cloak or mask which the parties have imposed upon it, and give effect to the consequences, whatever they may be, which attach to the true transaction." [64]

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[62] Supra note 60 at 396
[63] 1972 (1) SA 76 (T)
[64] Supra note 63 at 79

The court dealt with a number of other cases and the principles laid down in those cases and concluded with the following statement :

> "What follows from that and other cases, it seems to me, is this : If two people, instead of making a contract for a loan of money by one of them to the other, genuinely agree to achieve a similar result through the sale and repurchase of a chattel, there is no room for an application of the *maximum plus valet quod agitur quam quod simulate concipitur.* The transaction is intended to be one of sale and repurchase, and that, at common law, is what it is." [65]

On the question whether, before an agreement may be struck down on the grounds that it is not what it purports to be, it is necessary that it be found that the parties dishonestly intended to disguise the real agreement between them by clothing it in a different form, reference may be had to the matter of McAdams v Fiander's Trustee and Bell [66] which concerned a sale and hire-purchase agreement between the parties. The matter concerned a partnership which was in financial need and had to raise £800 to pay its debts. The partnership owned machinery worth £1600 which it used to operate its business. The plaintiff was advised that he could not safely advance the required amount to the partnership on a pledge of the machinery if the machinery was to remain in the possession of the partnership and it was decided that he would buy the machinery and leave it in the possession of the partnership. The parties then entered into a hire-purchase agreement whereby the partnership agreed to pay by way of hire £100 per month plus interest until the sum for which the plaintiff had

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[65] Supra note 63 at 80
[66] 1919 AD 207

purchased the machinery (ie. £800) had been repaid, when the machinery would again become the property of the partnership.

The court *a quo* concluded that despite the elaborate agreements entered into, the transaction constituted a loan and that the machinery had been pledged and not sold to the plaintiff. The Appelate Division agreed with this judgment and De Villiers AJA stated the following :

> "…. for the question in cases of this kind always is what is the true nature of the transaction, and this is not necessarily determined by what a party may conceive the contract, which he enters into, to be. Parties may honestly think that they are entering into a contract of purchase and sale, which turns out to be one of pledge. Whether it is the former depends upon whether the essential elements of such a contract are present …. There can be no contract of purchase and sale without the *animus emendi* on the part of the purchaser, and the *animus vivendi* on the part of the seller. And it must be a genuine *animus* of the one to sell and the other to buy. It is not enough for the parties to think that they have the intention, the intention must be proved as a fact apart from what they sought. Now, here it is quite clear that neither of the parties had a genuine intention, the one to sell and the other to buy the machinery." [67]

The court went on to state that there was no genuine purchase price, as the £800 represented the amount required by the partnership for the loan, while the value of the machinery at the time was at least double that amount.

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[67] Supra note 66 at 223-224

Parties to a transaction may elect to conclude a particular type of contract by including the *essentialia* of that particular contract in their contract. Although parties to a transaction may in this way determine to some extent the legal rules and principles applicable to their contract, it is not in their power to agree that rules and principles of another type of contract than the type of contract which they have in fact concluded should be applicable. In other words, they may elect to enter into a contract of sale instead of a contract of loan, but they may not elect that the rules and principles of the contract of loan should be applicable if they have in fact concluded a contract of sale. [68]

It is evident from the Friedman Motors and McAdams cases that when parties to a contract formulate their transaction to, for instance, reflect a contract of sale, it does not necessarily mean that they have in fact intended to conclude a contract of sale. If it was in reality the parties' intention to conclude, for example, a contract of loan, the *plus valet* rule will apply, and the contract will be regarded as a contract of loan regardless of what the parties have called it.

One of the leading cases on the common law principles relating to simulated transactions is Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue. [69] The facts of the case were that the appellant companies had leased two vacant stands to a pension fund in terms of two identical lease agreements. Each lease was coupled with a sub-lease and building contract. The sub-lessee was a company operating the factory established on the stands. A subsidiary of this company owned

[68] Joubert op cit note 1 at 709
[69] 1996 (3) SA 942 (A)

the entire shareholding in each of the appellant companies. Each of the lease agreements provided that the lessee (ie. pension fund) shall be entitled at its expense to erect such buildings and other improvements on the land as it may determine. In terms of the sub-lease agreements, the pension fund was obliged to erect a building on the vacant stands. The Commissioner was of the view that the building of the factory on both stands by the sub-lessee brought about an accrual of income to the appellant companies under paragraph (h) of the definition of "gross income" in section 1 of the Act, pursuant to which the Commissioner issued additional assessments.

In this case, the court reaffirmed a number of the principles laid down in the earlier cases discussed above. The appellants relied on the Westminster principle and agreed that they were entitled to order their affairs so as to pay a minimum of tax. They agreed that effect had to be given to the lease agreements according to their tenor notwithstanding their underlying purpose, and that a right as envisaged in paragraph (h) of the definition of "gross income" did not accrue to them in terms of the losses because the main lease entitled but did not oblige the pension fund to build.

The Commissioner, relying on the doctrine of substance over form, agreed that the agreements did not reflect the real intention of the parties and that inasmuch as the purpose of the transaction had been to evade tax, the agreements had been concluded in a form which concealed the fact that the appellants did acquire the right to have the buildings erected.

Hefer JA in delivering the judgment of the court stated :

> "The agreement on both sides focused largely on the application of two well-known legal principles. The first is the one expounded in The Duke of Westminster case ..... In effect it involves the application of the more general principle, recognized in .... Dadoo Ltd and Others v Krugersdorp Municipal Council which permits parties to arrange their affairs so as to remain outside the provisions of a particular statute. Of course, in every case in which this principle is involved it is for the court to decide whether the party concerned has succeeded in achieving that result. The outcome may depend entirely on the facts .... or on the application of the law to the facts. It is in this regard that the second principle comes into play." [70]

whereupon he referred to the substance over form principle.

Hefer JA went on to say :

> "Provided that each of them [Westminster principle and the doctrine of substance over form] is confined to its recognised bounds there is no reason why both principles cannot be applied in the same case ..... 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. This applied, the two principles do not conflict." [71]

Hefer JA said :

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[70] Supra note 69 at 950 - 951
[71] Supra note 69 of 952

> "The real question is, however, whether they actually intended that each agreement would *inter partes* have effect according to its tenor. If not, effect must be given to what the transaction really is." [72]

The court found that on an analysis of the agreements, the impression was irresistible that the parties deliberately sought to give each agreement a semblance of self-sufficiency which it did not in reality possess. Certain anomalies were consistent with a wider, unexpressed agreement or tacit understanding, the terms of which were not divulged. As such they bore significantly on the question whether the accrual to the appellants of a right to improvements was concealed.

The position adopted and the principles applied by the courts in respect of simulated transactions is well summarized by Kroon J in the Conhage case [73] when he said :

> "…. in deciding whether the parties to an agreement entered into same *bona* or *mala fide*, whether there was any fraud on their part, whether the agreement was a genuine or simulated one and what, in the final result, whatever the parties thought, was the true substance of the agreement concluded between them, the court will have regard to all the relevant circumstances. …. It need hardly be added that the relevant circumstances must be looked at in their entirety and with regard to their commulative effect." [74]

With reference to the Westminster principle Kroon J made the following statement :

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[72] Supra note 69 at 953
[73] Supra note 4
[74] Supra note 4 at 313

> "Where there are alternative ways in which a transaction may be effected, or more accurately, where there are alternative ways in which a specific purpose may legally be achieved, one of which would attract a certain liability for payment of tax and the other(s) of which would result in either the reduction or even the elimination of such liability, then provided that the adoption of one of the latter ways is both *bona fide* and factually genuine from a commercial and legal point of view, there is no reason why the adoption thereof shall not receive the sanction of the courts. It is not the function of the courts to widen the net of the liability, but that of the legislature ..... The remarks are of course, subject to an application of the provisions of section 103 of the Act ..." [75]

From the above cases it is clear that the courts had over the years applied different guidelines and set various criteria for a transaction to be found a simulated one. In some instances it has been held that there must be fraud, dishonesty or an agreement to disguise before a transaction can be found to be a simulated one. In other cases the courts have held that a transaction can be a simulated one even if there was no dishonesty or fraud on the part of the parties. A further indication of a simulated transaction would be if that transaction contains abnormal terms or create abnormal rights or obligations. However, the fact that a particular transaction is abnormal or contains abnormal terms does not necessarily mean that it is a simulated transaction. The courts will have to determine the true intention of the parties by having regard to all the relevant circumstances.

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[75] Supra note 4 at 314

4 SECTION 103(1) OF THE ACT

In addition to the common law remedies available to the Commissioner discussed in the previous chapter, the Commissioner also has statutory powers in relation to transactions which have the effect of avoiding or reducing liability for tax or of postponing the liability for tax. The Commissioner may exercise such power in the form of section 103(1) of the Act, which is described as the general tax avoidance provision in the Act. Asset-based financing transactions and leasing transactions in particular, have invariably been the subject of an attack by the Commissioner under section 103(1). This chapter will examine the components of Section 103(1) as well as the interpretation thereof by the courts.

Firstly, it is important to distinguish between tax evasion and tax avoidance. It has been said that tax evasion is characterized by fraud and deceit and it refers to all those activities deliberately undertaken by a taxpayer to free himself from the obligation to pay tax. Tax avoidance however is characterized by open and full disclosure in terms of which a taxpayer arranges his affairs in a legal manner in order to reduce his liability to pay tax. [76]

Section 103(1) provides as follows :

> "(1) Whenever the Commissioner is satisfied that any transaction, operation or scheme ....

[76] Silke op cit note 5 at 19.1

(a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax .... 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) .....; 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

(iii) 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 .... imposed by the 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."

The remedy available to the Commissioner if he invokes his powers under section 103(1), is to determine the liability for any tax and the amount of that tax as if the operation, transaction or scheme in question had not been entered into or carried out.

In order to apply section 103(1), the Commissioner must be satisfied that the following four sets of circumstances exist, each of which must be present :

(1) a transaction, operation or scheme has been entered into or carried out;

(2) which had the effect of avoiding or postponing liability for the payment of any tax or of reducing the amount of such liability;

(3) in a manner that would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit or created rights or obligations that would not normally be created between persons dealing at arm's length under a transaction of the nature of the transaction in question;

(4) entered into or carried out solely or mainly for the purposes of obtaining a tax benefit.

The four requirements for a successful application of section 103(1) will be examined below.

"*transaction, operation or scheme*"

The courts have held that a series of transactions constituted a scheme, even though not all the steps were contemplated at the outset.[77]

In the matter of Meyerowitz v Commissioner for Inland Revenue [78] the Appellate Division agreed with the following statement made by Watermeyer J in the court *a quo*:

> "... the effect of the transaction was to avoid liability by the appellant for tax on that income .....The word "scheme" is a wide term and I think that there can be little doubt that it is sufficiently wide to cover a series of transactions....."

It has been stated that there must be some unity between the steps, and the scheme can be regarded as commencing only when the ultimate result is decided upon. [79]

"*has the effect of avoiding or postponing liability for the payment of any tax*"

The question arises whether the liability for tax referred to in section 103(1) is an existing liability or maybe an accrued liability for the payment of tax. It has been

[77] Joubert op cit note 77 at paragraph 637
[78] 1963 (3) SA 863 (A)
[79] Supra note 77

accepted that the liability for the payment of any tax referred to in section 103(1) does not refer to an accrued or existing liability, for such a liability cannot be avoided, but refers to an anticipated liability.[80]

In the matter of Commissioner for Inland Revenue v King [81] the court had to consider the issue of tax avoidance under section 90 (now section 103) of the Act which was introduced in 1941 as the general tax anti-avoidance provision. At that time, dividends received were taxable in the hands of the recipient and King sold certain shares he owned in various companies to his child. The Commissioner disregarded the agreement between King and his son and taxed the dividend income in the hands of King and not in the hands of his son. The court determined that the reference to liability for tax in section 90 refers to an anticipated liability for tax. Watermeyer CJ stated :[82]

> "The only liability for tax imposed by the Act which can exist at the time when a transaction is entered into is a liability for a past accounting period, and with regard to that, it is impossible to avoid it.... Section 90 must therefore refer to anticipated liabilities for tax, either in respect of a current tax year or in respect of future years."

In the matter of Smith v Commissioner for Inland Revenue [83] the court examined the meaning of the phrase "to avoid liability" contained in section 90 of the Income Tax Act of 1941. In that case the taxpayer held shares in a South African company. As a

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[80] Silke op cit note 5 at 19-9
[81] 1947 (2) SA 196 (A)
[82] Supra note 81 at 207
[83] 1964 (1) SA 324 (A)

result of a series of transactions entered into by the taxpayer, he became the sole shareholder in a South West African company which in turn held all the shares in a Rhodesian company which, indirectly, held the shares in a South African company. As a result, Smith did not earn the dividends declared by the South African company. He argued that the transactions did not have the "effect of avoiding liability for any tax on income" since the dividend accruing to the Rhodesian company had not been and would never be received by him. The Appellate Division dismissed Smith's contention and held that "the ordinary natural meaning of avoiding liability for tax on income is to get out of the way of, escape or prevent an anticipated liability." [84]

In considering the effect of a transaction for purposes of the application of section 103(1), it has been held that regard must be had to the terms of such transaction and the surrounding circumstances at the time of the implementation thereof and not at the time the transaction was formulated. In the matter of Ovenstone v Secretary for Inland Revenue [85] Trollip JA made the following statement with reference to the application of section 103(1) :

> "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 .... For it is only when it is implemented or carried out that it becomes a practical reality concerning the

[84] Supra note 83 at 333E
[85] 1980 (2) SA 721 (A)

fiscus; in particular, it is only then that the purpose and effect in respect of the taxpayer's liability for income tax arises for consideration." [86]

It is clear from the above cases that the requirement of section 103(1) that the transaction concerned must have the effect of avoiding or postponing liability for tax, refers to an anticipated liability of the taxpayer, that the ordinary meaning should be given to the phrase and that the effect of the particular transaction should be judged at the time it is implemented and not when it is formulated.

"in a manner that would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit or created rights or obligations that would not normally be created between persons dealing at arm's lengtht"

It has been submitted that the judicial doctrine of "business purpose" is not always very clear, and that the wider interpretation of this rule is to the effect that if, in the context of a business, a transaction was entered into in a manner not normally employed for *bona fide* business purposes, it will be presumed that the avoidance of tax was one of the main purposes of the transaction. [87]

Silke states that [88] there is no universally applicable test to be applied in determining whether a transaction was entered into or carried out by means or in a manner that would not normally be employed. It goes on to state that it is nevertheless considered that the normality or abnormality of a transaction is not to be judged solely by the question whether the parties are independent persons dealing at arm's length with

[86] Supra note 85 at 731 - 732
[87] Silke op cit note 5 at 19-6
[88] At 19.13

each other, but also by the circumstances under which the transaction was entered into or carried out. The question whether a transaction was carried out for *bona fide* business purposes and by means that would normally be employed for purposes of the application of section 103(1), was considered by the courts in a number of cases.

In the Hicklin case [89] the court stated that when considering the normality of the rights and obligations created by a transaction, one must look at the circumstances under which the transaction was entered into or carried out. The court went on to say that the inquiry into the requirement of normality is one of fact. Trollip JA, who delivered the judgment of the Appellate Division, made the following statements regarding the test of normality :

> "When the 'transactions, operation or scheme' is an arrangement ..... it is important.... to determine first whether it was one concluded at 'arm's length'. That is the criterion postulated in para (ii). For 'dealing at arm's length' is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. ..... Hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by para (ii). And the means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal in the sense envisaged by para (i)." [90]

[89] Supra note 50
[90] Supra note 89 at 495

Another case that dealt with the test of normality for purposes of section 103(1) was the case of Commissioner for Inland Revenue v Louw.[91] The case dealt with the incorporation of a professional partnership of consulting engineers. As a result of the incorporation of the partnership, the income of the shareholders of the newly formed company by way of salaries and dividends was considerably less than their income as partners in the former partnership. After a while the shareholders also borrowed the surplus funds of the company by way of interest-free loans. The court found that there were in fact two sets of transactions, namely the incorporation of the partnership and the subsequent granting of the loans to the shareholders. With respect to the incorporation of the partnership, the court found that it was normal to transfer a professional partnership to a company, and it was in fact common practice to do so. On examining the rights and obligations created under the incorporation, the court also found that they were normal vis-à-vis the relevant parties. However, dealing with the loans made by the company to the shareholders, the court found that they amounted to a transaction which had the effect of avoiding tax and which was abnormal, for had the loans not been made, the shareholders would have derived equivalent or nearly equivalent amounts by way of salaries and dividends. The granting of the interest-free loans to the shareholders failed both tests of normality referred to in paragraph (ii) of subsection (b) namely, the test of "means or manner" and the test of "rights and obligations".

In the Conhage case [92] where the transaction in question was a sale and leaseback transaction, Kroon J said the following in respect of the normality test :

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[91] 1983 (3) SA 551 (A)
[92] Supra note 4

> ".....that the circumstance that a particular type of transaction is common place is a factor to be thrown into the melting pot as constituting a pointer to the normality of the transaction .... On the other hand .... the fact that a transaction is an unusual one does not by itself justify the inference of abnormality." [93]

The court held that the sale and leaseback transaction in question was not abnormal and said the following :

> "..... where two alternative options are open to a taxpayer one of which would entail a lesser liability for tax for him, the mere fact that he adopts the latter alternative does not necessarily justify the inference that one of his purposes was tax avoidance." [94]

Kroon J concluded his judgement by saying that a taxpayer is free to transact in the most tax-efficient way and if there are two ways to do it, both normal, namely by means of a conventional loan or by means of a sale and leaseback transaction, the mere fact that he chooses the most tax-efficient transaction, does not itself point to any abnormality.[95]

"entered into or carried out solely or mainly for the purposes of obtaining a tax benefit"

"Tax benefit" is defined in section 103(7) as including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income

[93] Supra note 4 at 333
[94] Supra note 4 at 334-335
[95] Supra note 4 at 392

Tax Act or any other law administered by the Commissioner. Accordingly it also includes estate duty, value-added tax, stamp duty, transfer duty, etc.

If the sole or main purpose of a transaction is not the avoidance of any of the specified taxes, section 103(1) may not be applied. Accordingly, a scheme designed solely or mainly to achieve business objectives or for proper commercial reasons other than the avoidance of tax, would be safe from the application of section 103(1), even if incidental savings of taxes were achieved. [96]

The matter of Secretary for Inland Revenue v Gallagher [97] also dealt with the "purpose" requirement of section 103(1). Because of the nature of his occupation and the growth in his assets the taxpayer had formed a company, the shares of which was held by three trusts formed for the benefit of his three children. He had then sold significant listed and unlisted investments to the company. The Commissioner sought to tax the taxpayer on the dividends accruing to the trust in terms of section 103(1), on the grounds that the scheme had been entered into for the purpose of avoiding tax. The taxpayer contended that section 103(1) was not applicable because his sole or main purpose in forming the trusts had been estate planning and not tax avoidance. At the time of the case the purpose clause in section 103(1) only referred to tax avoidance and not to the avoidance of any other levy administered by the Commissioner.

The court carefully considered the judgment of the court *a quo* and the evidence presented to that court and was satisfied that there was no ground to differ from the

[96] Silke op cit note 5 at 19-6-1
[97] 1978 (2) SA 463 (A)

judgment reached by the court *a quo* that the avoidance or reduction of liability for income tax was not the sole or main purpose of the scheme. The court accepted the taxpayer's evidence that his purpose in carrying out the scheme was to save estate duty and not to avoid income tax.

In the Conhage case, Kroon J said to qualify as the main purpose, the purpose in question must preponderate over any other purpose (or, possibly, at least be as important as any other purpose).[98] He went on to say that the question of determining the sole or main purpose is one of fact and the purpose must be determined with reference to the time of implementation of the transaction. He held that the test to be applied is a subjective one and stated :

> "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.... the other evidence advanced and the probabilities." [99]

5 SPECIFIC STATUTORY PROVISIONS REGARDING LEASING TRANSACTIONS

As the demand for financing increased and financial institutions became more innovative in providing asset-based financing solutions, the Commissioner started to

[98] Supra note 4 at 334
[99] Ibid

play catch-up with these transactions in order to eliminate any loopholes in the Act which benefited financiers and borrowers alike. Especially with respect to the utilization of various types of leasing transactions as an alternative to conventional types of financing transactions, the Commissioner called for legislative reform in order to curtail the abuse of these types of financing transactions. Three sections in the Act that deserve special mention are sections 23A, 23D and 23G.

Section 23A

Section 23A applies in situations where a taxpayer is the lessor of certain assets, i.e. "affected assets" as defined in the Act. The section was introduced in an attempt to limit transactions in terms of which taxpayers who were not in the leasing business became party to lease agreements (as lessors) purely to take advantage of the machinery capital allowances contained in the Act.[100] This section had specific relevance for financial institutions who would become lessors of certain assets in respect of various types of leasing transactions offered to clients as alternatives to conventional loans. Section 23A limits certain allowances available to lessors of "affected assets". The limitation ensures that the sum of the deductions allowable to such taxpayer in a year of assessment on the "affected assets" let by him may not exceed the taxable income derived by him during that year from "rental income".[101]

"Affected assets" is defined as :

- machinery, plant or aircraft;

[100] Huxham and Haupt op cit note 6 at 148
[101] Section 23A(2)

- which has been let;
- in respect of which the lessor is or was entitled to an allowance in terms of section 12 or section 14bis;
- other than machinery, plant or aircraft let under an agreement signed before 15 March 1984;

  or

- machinery, plant implement, utensils, articles, aircraft or ship;
- which have been let;
- in respect of which the lessor is or was entitled to an allowance in terms of sections 11(e), 12B or 12C;
- other than those let in terms of an agreement signed before 19 November 1988;

  but excluding

- any such asset let under an operating lease or any such asset used by the lessor mainly in the cause of any trade carried on by him, other than the letting of such asset.[102]

"Rental income" is defined as :

- income derived by way of rent;
- from the letting of movable property; or
- from the letting of any machinery or plant in respect of which an allowance has been granted to the lessor under sections 11(e), 12, 12B or 12C.[103]

[102] Section 23A(1)
[103] Ibid

Therefore, in terms of section 23A the deductions which are allowed under sections 11(e), 12, 12B, 12C or 14bis in respect of "affected assets" let by the taxpayer are limited to the taxpayer's taxable income derived from "rental income". For example, if a taxpayer owns plant and machinery which he leases to a lessee who uses it in a process of manufacture, the lessor is entitled to a section 12C deduction of say 20% of the cost of the machine. Assuming that the machine cost R1 000 000, the section 12C allowance is R200 000. However, if the lessor's taxable income derived from rental income is only R100 000 for the year, he will only be allowed a 12C deduction of R100 000. The R100 000 portion which was not allowed, may be carried forward to the following year and may be deducted in that year subject to the limit.

The introduction of section 23A and the subsequent amendments thereto have reduced the tax benefits achieved by financial institutions in offering asset-based financing solutions in the form of certain lease financing structures to its clients. However, I believe that there are still certain limitations to the operation of section 23A that may be utilised by financial institutions in offering financing to clients in the form of leasing transactions, subject of course to sections 23D and 23G.

Section 23A only applies if the asset in question is an "affected asset" as defined. Accordingly, a financial institution will be able to enter into leases in respect of assets not falling under the definition of "affect assets" such as incorporeal property like patents, designs and know-how, and immovable property.

From a technical legal point of view, an asset will not be an "affected asset" if it has not been "let" by the taxpayer. In other words, if the *essentialia* of a contract of lease

is not present, the asset in question will probably not qualify as an "affected asset". The argument can be made that section 23A will probably not apply if the taxpayer provides the use of the asset in terms of a joint venture or a partnership agreement.

It seems that section 23A will also not be applicable if the leased asset qualifies for deductions and allowances other than in terms of sections 11(e), 12, 12B, 12C and 14bis. Sections of the Act that provide for other deductions and allowances include sections 11(a), 11(f), 11(g), 11(gA), 11(l), 11(p) and (q), 11sex, 12D, 12E, etc.

Finally, as section 23A limits the deductions which are allowed to a taxpayer under the relevant sections of the Act to the taxpayer's taxable income derived from "rental income", the limitation can be circumvented by maximizing the taxpayer's "rental income" for instance by profiling the rental payable and by substituting interest, fees, commissions, etc. with "rental income".

Section 23D

The Act contains two sections which deal specifically with sale and leaseback transactions. The first of these is section 23D which is aimed at restructuring the allowances which the lessor may claim on the leased assets.

"Asset" is defined as :

- any machinery, plant, implements, utensils or articles contemplated in section 11(e);

- any invention, design, patent, trademark, copyright or any other property which is of a similar nature, contemplated in section 11(gA);
- any building or improvements contemplated in section 13;
- any ship contemplated in section 14; and
- any aircraft contemplated in section 14bis.[104]

The section provides, *inter alia* :[105]

- where any asset has been let by a taxpayer to a lessee;
- and the asset was acquired by the taxpayer, whether directly or indirectly from;
    - the lessee; or
    - a person who is connected to the lessee; or
    - a sub-lessee in relation to such asset; or
    - a person who is a connected person in relation to the sub-lessee;
- and the lessee or connected person or sub-lessee had previously claimed a deduction in respect of such asset under sections 11(e), 11(gA), 12B, 12C, 13, 14, 14bis or 27(2)(d);
- the deduction which the lessor (taxpayer) may claim on the asset (under sections 11(e), 11(gA), 11(o), 12C, 13, 14 or 14bis) shall be calculated on an amount not exceeding the lesser of the cost of the asset to the lessee or his connected person or the sub-lessee, or the market value on the date the asset was acquired by the lessor (taxpayer).

[104] Section 23D(1)
[105] Section 23D(2)

Therefore, section 23D seems to address a transaction in terms of which assets owned by the taxpayer, which have substantially increased in value, are sold at current market value to, for example, a financial institution, which then leases the asset back to the seller (taxpayer), effectively enabling the seller (taxpayer) to claim an income tax deduction (the lease rentals) determined on the increased value of the asset. Equally important in a sale and leaseback transaction is that the lessor (financial institution) be entitled to claim section 11(e) allowances based on the purchase price of the asset, otherwise it would have to pay income tax on the full amount of the rentals received which would in turn reduce its anticipated profit margin on the transaction. Accordingly, the attractiveness of sale and leaseback transactions from a financial institution's point of view was severely diminished by the introduction of section 23D. [106]

Prior to the amendment to section 23D in 1995, it only referred to assets acquired from the lessee (or a person connected with the lessee) and it would appear that the provisions of section 23D would have been circumvented by the introduction of a third party as intermediary who would purchase the assets from the lessee and thereafter sell it to the financial institution who would then lease the assets to the lessee, and in those circumstances would be entitled to claim section 11(e) allowances based on the purchase price it paid to the intermediary. However, it would seem that such loophole was removed by the 1995 amendment which introduced a reference to the acquisition of the asset from a sub-lessee, as defined (or a person connected with such sub-lessee).[107]

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[106] Supra note 4 at 335 - 336
[107] Supra note 4 at 336

Section 23G

After the amendment in 1995 to section 23D as discussed in the previous paragraph, it would appear that the only circumstances in which it would still be attractive for financial institutions to enter into sale and leaseback transactions, whether directly or indirectly, would be where the lessee or intermediary was a tax exempt entity. The Commissioner also closed this loophole by the introduction of section 23G in 1997, which is aimed at combating transactions in which tax exempt persons are used as lessors or lessees in sale and leaseback transactions.

The section applies to all sale and leaseback transactions involving both moveable and immovable as well as corporeal and incorporeal assets. It provides, *inter alia*, that where the receipts and accruals of the lessee in a sale and leaseback transaction do not constitute income for purposes of the Act, any amount which is received by the lessor shall be limited to an amount which constitutes interest as contemplated in section 24J and such lessor will not be entitled to any deduction under sections 11(e), (f) or (gA), 12B, 12C or 13 in respect of the asset. Conversely where the receipts and accruals of the lessor in a sale and leaseback transaction do not constitute income, any deduction which the lessee or sub-lessee can claim in respect of the lease payments is limited to the amount which constitutes interest as contemplated in section 24J.

"Interest" for purposes of this section is defined in section 24J(1) as :

> "the absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in

section 23G throughout the full term of such arrangement, to which such person is a party....."

It would therefore seem that with respect to sale and leaseback transactions, the legislature has succeeded to a great extent in closing every possible loophole in the Act available to financial institutions in offering this kind of asset-based financing structure to prospective clients in order to maximise their profit margins.

6 SECTION 76A : REPORTABLE ARRANGEMENTS

The Revenue Laws Amendment Act 45 of 2003 introduced a new section 76A in the Act to provide for the reporting of certain arrangements as defined. Section 76A came into effect on 1 March 2005 and establishes special reporting rules for transactions that contain indicators of potential tax avoidance.

The section provides that every company or trust which derives or will derive any tax benefit in terms of a reportable arrangement must report that arrangement to the Commissioner within 60 days after the date that any amount is first received by or accrues to any person or is paid or actually incurred by any person in terms of that arrangement. A further extension of 60 days will be granted by the Commissioner where reasonable grounds for delay exist.[108]

"Reportable arrangement" is defined, *inter alia*, as any transaction operation or scheme which has certain characteristics identified by the Minister of Finance by

[108] Section 76A(2)

notice in the Government Gazette, which is likely to lead to an undue tax benefit, or in terms of which –

- the calculation of interest (as defined in section 24J), finance costs, fees or any other charge is wholly or partly dependent on the tax treatment of the arrangement;[109]
- provision is made for the variation of that interest should the actual tax treatment differ from what was anticipated, or is challenged by the Commissioner;[110]

  and
- the potential amount of the variation contemplated exceeds R5 million.[111]

The section does not apply to any arrangement which the Minister of Finance has by notice in the Government Gazette identified as not likely to lead to any undue tax benefit.

In submitting the required report, the company or trust must submit the following :[112]

- steps and key features of the arrangement;
- a list of all the parties to the arrangement;
- copies of all signed documents relating to the arrangement; and
- financial models, spreadsheets or computer models of the implementation of the arrangement.

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[109] Section 76A(1)(a)(i)
[110] Section 76A(1)(a)(ii)
[111] Secion 76A(1)(a)(iii)
[112] Section 76A(3)

If the taxpayer fails to report the arrangement, it will be deemed to have entered into the arrangement by abnormal means or to have created abnormal rights or obligations as contemplated in section 103(1). If the company or trust is wilful or reckless in failing to report the arrangement, it will have to pay an additional charge, equal to the tax benefit in terms of the arrangement.[113]

The introduction of section 76A is yet another attempt by the Commissioner to discourage innovative asset-based financing transactions including leasing transactions which provide for certain tax benefits to the parties entering into those transactions. The Commissioner has stated that the existing reporting provisions in the Act have certain limitations as, firstly, they are not sufficiently proactive due to the fact that the information is only obtained once the taxpayer has filed its return and, secondly, they fail to properly describe what is meant by a "structured finance" transaction. Section 76A was designed, *inter alia*, to address these deficiencies and to act as an early warning system to the Commissioner as to the type of tax structuring taking place in the market.[114]

Reporting of an arrangement in terms of section 76A does not have the effect that the Commissioner approves of the arrangement. The purpose is to enable the Commissioner to evaluate the arrangement from an anti-avoidance point of view at an early stage of the implementation thereof.

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[113] Section 76A(4)(a), (b)
[114] SARS Reportable Arrangement Guide, 1 March 2005

7 CONCLUSION

In the last few years the Commissioner has adopted an aggressive stance towards the design and implementation of asset-based financing transactions that provide for some tax benefit to the parties entering into such transactions. This has prompted financial institutions to develop even more innovative structures to try and remain one step ahead of the Commissioner. The question begs whether there remains a future for structured finance transactions in such an environment. The Commissioner did not hide the fact that its goal is to bring an end to all structured finance transactions when he said as much on various occasions in the media. I fully endorse the principle laid down in the Westminster case that every man is entitled if he can to order his affairs to pay as less tax as possible, provided that he does so in a manner not contrary to the letter of the law. Further, in doing so, every taxpayer should be free to choose the form of the transaction in order to achieve that. Whether it is morally right in striving to pay less tax should not be a factor. The law is laid down by the legislature. If parties by applying the law achieve a result in which their liability to pay tax is reduced or even eliminated, it is up to the Commissioner to examine and introduce preventative measures. It should also not be the task of the courts to widen the net on taxpayers based on moral or other grounds. It is the function of the judiciary to interpret the law and apply it in an unbiased way regardless of whether the result is prejudicial to the Commissioner and the contribution to the social well-being of other taxpayers.

In developing new and innovative asset-based financing transactions, including various forms of leasing tractions, the anti-avoidance provisions dealt with in this paper should always be borne in mind.

The deductibility of the lease payments in the hands of the lessee is an important component of structured finance leasing transactions. When such transactions are formulated and entered into, the parties must ensure that the lease payments would qualify as expenditure laid out for the purposes of trade and as such would be deductible under section 11(a) read with section 23(g). The two most important requirements to be fulfilled under section 11(a) is that the expense should be incurred in the production of income and that it should not be of a capital nature. When leasing transactions are used as an alternative to conventional loan transactions, the parties should ensure that the transaction is formulated and implemented in such a manner as to ensure that the anticipated tax benefit is not nullified by a lack of proper design and implementation of the transaction.

When entering into financial leasing transactions, the parties must ensure that such a transaction will survive an attack by the Commissioner on the basis that it constitutes a simulated transaction. The parties must be able to demonstrate that they entered into such transaction for commercially justifiable reasons, and that the terms and conditions thereof are market-related and make commercial common sense. The parties' conduct must be consistent with the rights and obligations in terms of the agreements constituting the relevant transactions.

For a successful attack by the Commissioner based on section 103(1), the Commissioner must be satisfied that the four requirements of subsection (1) as discussed under chapter 4 are present.

Such an attack would probably be best defended by the parties by demonstrating that the transaction was not entered into solely or mainly for the purposes of obtaining a tax benefit. In formulating these kinds of financing structures, parties must be able to demonstrate that the relevant transactions were designed mainly to achieve business objectives or for proper commercial reasons other than the avoidance of tax, and that the saving of taxes were incidental to the main purpose of the transaction, namely the financing of the taxpayer's business. The question whether a transaction is entered into solely or mainly for the purpose of obtaining a tax benefit is a question of fact.

In respect of particular leasing transactions and the players that have taken part in these transactions in order to obtain the maximum tax benefit, the Commissioner has introduced certain specific provisions such as sections 23A, 23D and 23G. Although the introduction of these provisions have in a way made it less attractive for financial institutions to offer them to their clients, lease financing transactions remain viable alternative ways to provide financing to clients. A client's business requirements and the way in which its business is set up and functions could still make a lease financing transaction the preferred manner of financing of that client's business.

Despite the Commissioner's recent comments in the media regarding structured finance transactions and its more aggressive stance towards financial institutions who design and implement these structures, I believe that there is still a future for asset-based financing transactions as an alternative to conventional loan financing. We find ourselves in a competitive, dynamic and innovative market and if financial institutions can continue to improve their profit margins and at the same time offer a client a

better interest rate, all within the letter of the law, asset-based financing transactions, including leasing tenants will have a future in our market.

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