

**SIMULATED TRANSACTIONS: THE REQUIREMENT OF
'COMMERCIAL SUBSTANCE' TO DETERMINE SIMULATION AS
ENUNCIATED IN THE NWK-CASE – THE ESTABLISHED
SUBSTANCE OVER FORM DOCTRINE RENOVATED OR A MERE
INDICATOR OF A CONCEALED TRANSACTION?**

by

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DECLARATION

I, **HUGO STRUWIG**, hereby declare that this dissertation is my own, unaided work. It is being submitted in partial fulfilment of the prerequisites for the degree of **MASTER'S IN TAX LAW** at the University of Pretoria. It has not been submitted before for any degree or examination in any other University.

.....
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27 September 2013

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“First, have a definite, clear, practical ideal; a goal, an objective. Second, have the necessary means to achieve your ends; wisdom, money, materials and methods. Third, adjust all your means to that end.”

-Aristotle

To my Mom and Dad, I can't say any more than just plain *thank you*. No ideal of mine has been realisable without your die-hard support, your efforts to keep me motivated and your loving assistance through every step of my studies. You have equipped me with the opportunity and materials to achieve my goals, you have taught me how to reach higher and further and through your belief in me, you have instilled my belief in myself. Without you, the completion of this dissertation would simply not have been possible.

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ABBREVIATIONS

GAAR	The General Anti-Avoidance Rule contained in section 80A to 80L of the <i>Income Tax Act</i> , No 58 of 1962.
NWK	<i>Commissioner for the South African Revenue Service v NWK Ltd</i> 2011 (2) SA 67 (SCA)
SARS	The South African Revenue Service
SCA	Supreme Court of Appeal

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ABSTRACT

It is a settled principle in our tax law that a court will not be deceived by the form of a transaction, but that effect will be given to the true substance thereof. This principle, embodied in the common law doctrine of substance over form, has been affirmed and applied by the judiciary for well over a century, especially in matters where taxpayers avoid the imposition of potential tax through simulating their transactions. If a court was satisfied that the parties subjectively intended to give effect to some other agreement between them, the court would only have regard to the actual rights and obligations created by the parties and impose tax on their real transactions in accordance with the provisions of a taxing statute. The law in respect of simulated transactions was clear.

However, in *Commissioner for the South African Revenue Service v NWK Ltd* [2011 (2) SA 67 (SCA)] the court ostensibly introduced the requirement of commercial substance as a criterion to determine simulation. The requirement postulates that a transaction which lacks commercial substance will be regarded as simulated, irrespective of the parties' genuine intention to give effect to the agreement between them. The requirement appears to overrule the entrenched test under the common law doctrine of substance over form and ostensibly established a new objective, independent common law criterion to determine simulation.

The *NWK* requirement invariably ventures into the sphere of legitimate tax planning by virtue of its wide-ranging nature. Taxpayers need to understand the boundaries within which they may legitimately structure their affairs to reduce a potential tax burden as this advances the predictability of the law and respects the rule of law. *NWK* has, however, rendered the law on this subject rather uncertain and it is therefore crucial to establish the effect and applicability of the requirement to provide guidance to taxpayers on how to structure their affairs to legitimately avoid tax. The question, therefore, is whether the requirement is capable of independent application to determine simulation, or whether the requirement is only indicative of the presence of simulation in a transaction? If the latter, the common law position prior to the judgment will continue to prevail.

In this dissertation, compelling arguments which illustrate the incapability of the requirement to function independently to determine simulation is researched, analysed and advanced. These arguments support the view that from a legal and logical point of view, the requirement cannot constitute an independent criterion to determine simulation. In the premise, it is submitted that the established common law doctrine of substance over form, as enunciated in *Zandberg v Van Zyl* [1910 AD 302], remains reflective of the law on simulated transactions and that the commercial substance requirement is only indicative of the presence of possible simulation in a transaction.

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND AND OBJECTIVES OF RESEARCH

It often occurs that the simplest of transactions are achieved by the parties thereto through absurdly complex schemes, premised on various inter-related agreements, formalistic steps, interposition of tax indifferent third parties and extremely high implementation and transaction cost. The commercial value added through these complexities is often questionable and, understandably, a lay person considering the end result of the transaction ought to ask, more often than not, what the parties were on about.

The reasoning behind the complexity of such transactions is, in reality, carefully planned and constructed by the parties to the transaction. It is often designed to achieve a very specific goal through its precise implementation: The avoidance of a tax liability which would have ordinarily been imposed on the transaction had the parties implemented their transaction without such complex, unnecessary steps. These complexities, along with further indicators, are common attributes of abusive tax avoidance schemes employed by taxpayers to generate tax savings.¹

Especially in the current economic climate, it is not uncommon for taxpayers to attempt to structure their affairs to ensure that it remains outside the ambit of a taxing provision of a statute.² They often employ various tax avoidance *stratagems* to achieve this very result. A taxpayer is permitted to lawfully structure his affairs to ensure that it attracts the exemptions or benefits offered by tax legislation, but, in the words of *Hefer JA*,³

...when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the court will give effect to the true nature and substance of the transaction and will not be deceived by its form.

¹ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p19.

² *Michau v Maize Board* 2003 (6) SA 459 (SCA) at para 4.

³ *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA) at para 1.

Taxpayers sometimes endeavour to either disguise the true nature of their transaction to avoid a potential tax burden, or they deviously design their transaction to ensure that the revenue authorities cannot readily detect the parts thereof which may give rise to a tax liability.⁴ And whilst the lawful structuring of one's tax affairs may well entitle a taxpayer to the tax benefit sought, a taxpayer will not be so fortunate by employing a *stratagem* to conceal the true substance of a transaction through disguise. The former *stratagem* is subject, of course, to the qualification that it must pass the test contained in the statutory GAAR⁵ to obtain the tax benefit it sought, whereas the latter is subject to both an enquiry premised on the common law doctrine of substance over form as well as the test contained in the GAAR.

The mere fact that a transaction was perhaps structured in an impractical way or possibly lacked commercial substance may well lead to the transaction being questionable, but not necessarily objectionable.⁶ Where a court is tasked with considering whether a taxpayer is entitled to the tax benefit achieved through his transaction, the court should satisfy itself that the transaction passed the established tests laid out against tax avoidance. In doing so, an enquiry by the court predicated on the common law deterrents to tax avoidance is necessary prior to considering the applicability of the GAAR.⁷ These common law principles are capable of nullifying simulated or concealed transactions without requiring the invocation of the provisions contained in the statute.⁸

For at least the last century, the doctrine of substance over form has been the cornerstone of the common law deterrents to tax avoidance in South Africa, particularly where a transaction is simulated or contains elements of concealment. The doctrine consists of principles which are well established and have been applied by the judiciary on several occasions since its adoption into the South African law by *Innes CJ* in the matter of *Zandberg v Van Zyl*.⁹

⁴ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p22.

⁵ Sec 80A to 80L of the *Income Tax Act*, No 58 of 1962.

⁶ *Michau v Maize Board* 2003 (6) SA 459 (SCA) at para 4.

⁷ *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA) at para 2.

⁸ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁹ 1910 AD 309.

In brief, the doctrine envisages that fictitious rights and obligations created by the parties to a transaction will be disregarded and effect will only be given to the actual rights and obligations which ensue from their transaction. Accordingly, tax will be imposed on the true transaction between the parties rather than on the fictitious transaction which they expressed to the outside world. But in order for a court to make such a determination, it has to be satisfied that the substance of the transaction differs from its form. If this is the case, the transaction will be regarded as a simulated transaction through the invocation of the doctrine and the form in which the transaction was cast will be ignored. This much was trite in our law and reflected the legal position until recently.¹⁰

On 1 December 2010, the South African tax community was met with what appears to be a dramatic departure from the established common law doctrine of substance over form. In what has been dubbed one of its most extraordinary and controversial judgments,¹¹ the SCA delivered its decision in the matter of *Commissioner for the South African Revenue Service v NWK Limited*.¹² In this case, the SCA considered the established law relating to simulated transactions and, rather than applying the entrenched principles, introduced the “commercial substance” requirement to determine the presence of simulation in a transaction. By applying the requirement to a set of facts, a finding can ostensibly be made that a transaction is simulated if it lacks commercial substance, notwithstanding that its form and substance appears to be the same. It would seem as if the established common law doctrine of substance over form has therefore been rendered redundant.¹³

The introduction of the requirement immediately created doubt and legal uncertainty within the tax fraternity as it ostensibly disturbed over a century’s worth of judicial precedent and jurisprudence on the subject of simulated transactions. The dust created through the *NWK*-judgment had not even settled when SARS, some two weeks after the judgment, released a statement to the press in which it welcomed the SCA’s clarification of the principles embodied in the doctrine of substance over form.¹⁴

¹⁰ A full discussion of the doctrine and its requirements is contained in chapter 2, *infra*.

¹¹ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p187.

¹² 2011 (2) SA 67 (SCA).

¹³ A full discussion of the judgment and the requirement is contained in chapter 3, *infra*.

¹⁴ SARS Media Release (15 December 2010). Available on <http://www.sars.gov.za>. See also Temkin (2010) Spotlight on transactions aimed at reducing tax. *Business Day*. Available at <http://www.businessday.co.za/articles/Content.aspx?id=129699>. Accessed on 15 March 2012.

Moreover, SARS left little doubt as to how it perceived the judgment by issuing a stern warning to taxpayers of its intention to commence audits of transactions premised thereon.¹⁵ The effect of SARS' view, considered with the judgment, is that a transaction which was previously permissible in terms of the established common law principles would now become subject to potential attack by SARS as a simulated transaction.

Pursuant to this judgment, *NWK* has not come under further judicial scrutiny since a matter premised predominantly on simulation is yet to make it to court.¹⁶ The uncertainty which the judgment occasioned is therefore insurmountable as it is impossible to establish the acceptable boundaries of tax planning in the absence of clarification of the judgment. It must be stated that one cannot ignore the detrimental consequences which abusive tax avoidance structures have on the *fiscus* and other taxpayers,¹⁷ but to combat it in this manner is simply not tenable for the array of reasons which will be dealt with herein.

The question, in my mind, is to what extent taxpayers can continue to structure their affairs to legitimately decrease their tax burdens in the transitional period after *NWK* until judicial clarity on the matter is given. It should be remembered that *NWK*'s effect stretches beyond the dishonest simulating of transactions and certainly impacts legitimate tax avoidance transactions as well.

The objective of this research is to give some guidance on this problem by motivating why it is unlikely that *NWK* will have the effect in future matters on simulation as which it purports it will have. As the crux of *NWK* lies in the introduction of the requirement of commercial substance as a requirement to determine simulation, the independence of the requirement will be the determining factor of the judgment's effect.

¹⁵ *Ibid.*

¹⁶ A question of simulation has been considered by both the Tax Court, as court *a quo*, and the High Court, on appeal, pursuant to the judgment, but the prominent argument in the matter was not simulation. Although the High Court did not comprehensively deal with the *NWK* judgment, the approach followed by the respective judges therein on this subject is invaluable. This judgment is discussed in 4.4.4 *infra*.

¹⁷ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p9. Consequences on the *fiscus* include, *inter alia*, loss of revenue and a growing disrespect for the tax system, whilst the consequences for taxpayers is the promulgation of increasingly complex anti-avoidance legislation, thereby making it almost impossible to legitimately avoid tax.

The prominent question, therefore, is whether the commercial substance requirement has renovated the common law doctrine of substance over form to determine the presence of a simulated transaction in a particular factual matrix by reducing same to an independent criterion to reach a conclusion that a particular transaction was simulated; or whether the introduction of this requirement stands to be regarded as no more than a mere aid to the adjudicator tasked with determining the presence of simulation in a transaction as the lack of commercial substance is only indicative of the presence of simulation in a transaction, or as *De Koker (2011)*¹⁸ stated, '*merely as being symptomatic of a transaction that is indeed a pretence or disguise.*'

If the introduction of this requirement can be successfully refuted on defensible legal principles and it is found that the effect of the judgment is the latter, the judgment becomes academic – it would be of no more than persuasive authority and the common law position regarding simulated transactions prior to 1 December 2010 will prevail.

1.2 RESEARCH QUESTIONS

In order to determine whether the requirement of commercial substance is capable of being the independent factor to establish whether a particular transaction is simulated or not, the following questions must be addressed and answered:

- Where a particular transaction is properly implemented and given effect to by the parties in accordance with its form, but the transaction lacks commercial substance, in terms of the common law, on what basis can a court then disregard the actual rights and obligations created by the parties and impose a tax on a notional transaction?
- Notwithstanding the Appellate Division's affirmation of the common law doctrine of substance over form through the years, the SCA's introduction of the commercial substance requirement signified an abrupt departure from the

¹⁸ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

established law on simulated transactions – did the SCA properly observe the doctrine of *stare decisis* and the constitutional principle of the rule of law?

- Was the introduction of the commercial substance requirement part of the court's *ratio decidendi* and therefore binding authority, or is the paragraph through which the requirement was introduced *obiter dicta* and therefore only of persuasive value?
- From a practical perspective, can the commercial substance requirement co-exist with the statutory GAAR and moreover, did the SCA not possibly usurp the function of the legislative authority and disregard the constitutional doctrine of separation of powers?

These questions are considered, discussed and answered in chapter 4 below.

1.3 SCOPE OF RESEARCH

The research undertaken herein encompasses a critical analysis of the common law doctrine of substance over form as a deterrent for simulated transactions and the SCA's subsequent introduction of the commercial substance requirement. Arguments which weigh against the commercial substance requirement being independent are discussed, which include the English doctrine of fiscal nullity, the legal principles relating to the doctrine of *stare decisis* and the Rule of law, the nature and application of *obiter dicta* and the inter-relationship between the commercial substance requirement and GAAR, including the SCA's possible intrusion on the sphere of the legislature.

1.4 METHODOLOGY

This research focuses on the analysis of the legal-technical criticism against *NWK*, drawing on the legal consequences thereof and the formulation of a sustainable argument in support of the conclusions made herein. In arguing against the independence of the requirement, the approach adopted can therefore be described as

analytically-argumentative. To emphasise the differences in approach to simulation pre- and post *NWK*, a critical analysis of the established common law doctrine of substance over form and its historical development is necessitated. Finally, the law on the subject of simulation in the United Kingdom and the United States of America is considered and discussed as part of the comparative methodology adopted herein, although this approach is less prominent in this research.

1.5 CHAPTER OVERVIEW

In the chapters to follow, the historical development and application of the substance over form doctrine is examined,¹⁹ the *NWK*-case and the introduction of the commercial substance requirement is considered,²⁰ an extensive enquiry into sustainable arguments against the independence of the commercial substance is conducted²¹ and finally, my conclusion is stated.²²

¹⁹ Chapter 2.

²⁰ Chapter 3.

²¹ Chapter 4.

²² Chapter 5.

CHAPTER 2: THE ENTRENCHED PRINCIPLES: SIMULATED TRANSACTIONS AND THE DOCTRINE OF SUBSTANCE OVER FORM

2.1 INTRODUCTION

In considering whether a taxpayer legitimately managed to reduce a potential tax liability, the test to determine whether the taxpayer achieved success through his endeavours entails the application of a two-step inquiry by the court tasked with establishing whether the transaction in question is a simulated transaction or alternatively, an impermissible tax avoidance arrangement.²³ Firstly, a court ought to establish whether the common law doctrine of substance over form is applicable to the particular transaction insofar as the transaction may be simulated. If it is found that the transaction is not simulated, the court only then considers the provisions of the statutory GAAR to determine the permissibility of the transaction.²⁴ In applying this approach, the net to eradicate impermissible tax avoidance is cast wider as the test in terms of the common law is expressed in broader principles and is therefore not limited to the words contained in the GAAR.²⁵

In this chapter, the most important principles which form part of the inquiry into the common law counter to tax avoidance are explained. Further, the formulation, application and acceptance of the common law deterrent of substance over form as a measure of relief against a simulated transaction is analysed through its historical development in order to contextualise the law relating to simulation as it was prior to the *NWK* decision.

²³ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

²⁴ PriceWaterhouseCoopers (2010) Anti Avoidance: 1803. Tax Avoidance Schemes. *Integritax*, available at http://www.saica.co.za/integritax/2010/1803_Tax_Avoidance_schemes.htm, accessed on 5 June 2013.

²⁵ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

2.2 TAXPAYERS' ENTITLEMENT TO PAY LESS TAXES

There will always be tension between SARS and taxpayers insofar as the payment of taxes are concerned. This tension emanates from the fact that SARS is burdened by the legislator with the obligation to efficiently collect the taxes due by the public,²⁶ whereas taxpayers, in general, dislike paying taxes and seeks, in the most instances, to pay no more tax than what is legally due to the *fiscus*.²⁷ When one further considers the common law entitlement of a taxpayer to pay as little tax as possible, as will appear more fully from what is set out hereinafter, the source of the tension becomes even more evident: The statutory obligation on SARS pertaining to the collection of the maximum revenue potentially due to the *fiscus* stands in conflict with the taxpayer's common law right to legitimately reduce tax.

Under the common law, every taxpayer is entitled to genuinely and purposefully arrange his tax affairs to ensure that it falls outside of the ambit of the charging provisions in tax legislation to ensure that the least amount of tax is payable.²⁸ In *IRC v Duke of Westminster*²⁹ this principle was emphasised in the familiar statement made by Lord Tomlin:

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

Very few judgments pertaining to the avoidance of tax or the simulation of a particular transaction have gone without firstly giving recognition to this principle. Particularly, the Appellate Division has throughout expressed its acceptance of this principle in our tax law³⁰ and the principle was affirmed in *Commissioner for Inland Revenue v Conhage*

²⁶ Sec 3(a) of the *South African Revenue Service Act*, No 34 of 1997.

²⁷ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p10; see also De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

²⁸ Broomberg SC (2011) NWK and Founders Hill. Cape Town: *The Taxpayer* (Vol 60) at p200; *Michau v Maize Board* 2003 (6) SA 459 (SCA) at para 4.

²⁹ [1936] AC 1 at p14.

³⁰ See for example *Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (SCA).

(Pty) Ltd³¹ where *Hefer JA*, in his opening address in his judgment, remarked as follows:

Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If eg the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax.³²

In a pursuit to reduce a potential liability for tax through the application of this principle, a taxpayer embarks on a venture which is commonly referred to as “tax planning”³³ or legitimate tax structuring. Tax planning entails that a taxpayer legitimately utilises a fiscally attractive option in the provisions of a taxing statute but, in so doing, accepts and suffers the detrimental economic consequences accompanied with the manner in which their transaction is structured.³⁴ It is therefore distinguishable from simulated transactions and abusive tax avoidance schemes, which are discussed below, as the taxpayer’s tax benefit gained through the utilisation of the provisions of tax legislation is counteracted by the economic hardship which is an unavoidable consequence of the strategy employed.³⁵

To illustrate this concept, a logical consequence for a taxpayer in reducing the income he may receive is an accompanying reduction of income tax payable. Likewise, where a taxpayer incurs more deductible expenses than he ordinarily would, the tax payable to the *fiscus*, like his net income, will decrease accordingly. This, in essence, is what tax planning entails and, save for the label it has been given, is no different from the principle of tax mitigation as recognised by foreign jurisdictions.³⁶

³¹ 1999 (4) SA 1149 (SCA) at para 1 of the judgment.

³² The example given by *Hefer JA* in the quoted statement refers to the ‘choice principle’ is briefly discussed below, which was also confirmed in *NWK* by the SCA at para 42 of the judgment.

³³ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p4.

³⁴ *CIR v Willoughby* [1997] 4 All ER 65 at p73, as referred to in the SARS Discussion paper, *ibid*.

³⁵ *Ibid*. See also *CIR v King* 1947 (2) All SA 155 (A) in which various examples are given by the court to illustrate tax planning, with the emphasis on the benefit of paying less tax being countered by reduction of income.

³⁶ It was held in *CIR v Challenge Corporation Ltd* [1987] AC 155 that ‘income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. [The GAAR] does not apply to tax mitigation because the taxpayer’s advantage is not derived from an arrangement but from the reduction of income which he accepts or the expenditure which he incurs.’

A further principle which finds its application premised on the principle enunciated in *IRC v Duke of Westminster*³⁷ is where the parties to a transaction can achieve the same commercial result through employing various strategies, the parties are not prohibited from adopting the strategy through which the least amount of tax is payable.³⁸ This principle refers to the “choice principle” which is also recognised and entrenched in our common law.³⁹ In *Van Blommenstein v KBI*,⁴⁰ the court illustrated the practical application of this principle in the following terms:

[W]here a taxpayer requires capital to finance his income earning operation, it is entirely up to him to choose the source from which he derives such capital. Even if he happens for example to have liquid cash available for such purpose, there is nothing which compels him to use the cash. There is in other words nothing which precludes such a taxpayer from borrowing money for the said purpose...what must be stressed...is that...the fact that he chooses to borrow the money will not debar him from deducting the interest payable on the loan.

Evidently, the “choice principle” is an extension of the principle in the *Westminster*-case.⁴¹ In the context of tax planning, the taxpayer obtains the benefit of a reduction in his tax liability through incurring a deductible interest expense. However, this benefit is accompanied by the economic burden of having to pay an interest expense to the institution from which the money was lent, thereby reducing his net income. Insofar as the “choice” principle is concerned, the taxpayer could have achieved the desired result of raising capital to finance his business through various alternative methods, either by utilising his available cash or alternatively obtaining finance through a loan. The taxpayer therefore exercised his “choice” and becomes entitled to the benefit the tax legislation offers under such circumstances. The fact that his motivation in adopting this method was tax-orientated should not render his election objectionable.⁴²

³⁷ [1936] AC 1.

³⁸ *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA) at para 1.

³⁹ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁴⁰ 59 SATC 221 (Cape Provincial Division), as referred to in De Koker (2011), *ibid*.

⁴¹ *Op cit n 33*.

⁴² De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3. The decisions of the New Zealand Court in *Challenge Corporation v C of IR* [1986] 2 NZLR 513 and *Manglin v C of IR* [1971] NZLR 591 (PC) are referred to as authority. The fact that the potential gain of a tax benefit served as the motivation in making a decision is part and parcel of the transaction, viewed in its entirety, to achieve the desired result.

It is therefore an established principle in our common law that no person is expected to subject himself to a tax liability which is more than what it could have been had he employed legitimate and acceptable strategies. These common law principles form the cornerstone of a good tax system and the integrity and sustainability of a tax system largely depends on the recognition of these principles. As these principles contribute to the fairness and equity of a tax system, their absence would result in taxpayers harvesting an increasing disrespect for laws which impose taxes in a capricious manner and, ultimately, would lead to the corrosion of the tax base as impermissible tax avoidance and illegal tax evasion would invariably increase.

It often occurs, however, that taxpayers seeking relief from their respective tax burdens through tax planning either seek a tax solution which the law does not permit or they refuse to accept the detrimental economic consequences which accompany their strategies.⁴³ Although the motivation behind embarking on a course of questionable tax avoidance is not limited hereto, invariably taxpayers seek to maximise their tax benefits without incurring economic losses or, at least, incurring minimal economic losses.

Exactly when a tax planning operation becomes an impermissible avoidance arrangement or a deceitfully designed simulated transaction is not always patently clear, as will become evident from the discussion to follow. The tension between SARS and taxpayers, as stated at the outset of this chapter, is exacerbated even further when issues of avoidance, simulation and evasion of tax become prominent in a particular set of facts. *Brincker (2004)*⁴⁴ notes that '[i]t is clear that SARS and taxpayers do not fully trust each other with reference to issues of avoidance and evasion of tax' and submits that the source of this tension possibly emanates further from a difference in understanding of the terms tax avoidance, tax evasion and the principles of the doctrine of substance over form. In emphasis of the conceptual misunderstanding and conflation of these terms, in the 1985 Budget Speech, for example, the then Minister of Finance made the following statement:⁴⁵

⁴³ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3. See in particular the *dictum* in the matter of *C of IR v Challenge Corporation* [1986] 2 NZLR 513 (PC) cited therein.

⁴⁴ Brincker (2004) *Taxation Principles of Interest and other Financing Transactions*. Durban: LexisNexis Butterworths at pZA-2.

⁴⁵ As referred to in Clegg and Stretch (2008) *Income Tax in South Africa*. Durban: LexisNexis (Vol 1A) at p 26-3; see also Brincker (2004) *ibid*.

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

Ordinarily, the distinction between the concepts of tax evasion and tax avoidance is clear and does not require further explanation. That being said, in *NWK* the SCA appeared also to conflate the two concepts to such an extent that the court's appreciation of these basic tax principles became questionable.⁴⁶

Before analysing the scope of the doctrine of substance over form as it existed in South Africa for over a century, it is therefore necessary that the concepts and distinguishing characteristics of tax evasion and impermissible tax avoidance be discussed, briefly, as these concepts and their differences will become relevant for the discussions on the *NWK*-case later on.

2.3 TAX EVASION AND TAX AVOIDANCE

*Emslie et al (2001)*⁴⁷ notes that there exists a clear distinction between the circumstances through which a taxpayer legitimately reduces his income which may expose him to a potential liability for tax and the circumstances through which a taxpayer arranges his affairs to escape a liability to pay tax on income which, in reality, is his. Under the first set of circumstances, and in accordance with the principles explained above, a taxpayer avoids the imposition of taxation, whereas in the latter, the taxpayer evades tax.

2.3.1 TAX EVASION

Tax evasion generally entails the employment of means which are unlawful, fraudulent and dishonest to either suppress income or inflate expenditure in order to reduce a tax

⁴⁶ Davis J (2010) Simulated Transactions. Cape Town: *The Taxpayer* (Vol 59)(Nos 11 & 12) November-December 2010 at p204.

⁴⁷ *Emslie et al (2001) Income Tax: Cases and Materials*. Cape Town: *The Taxpayer* (3rd Edition) at p895.

liability.⁴⁸ Generally speaking, an arrangement through which tax is evaded encompasses illegal conduct by a taxpayer through which an existing tax liability is either hidden from the revenue authorities or ignored by the taxpayer which results in the payment of a lesser amount of tax than what he is legally obliged to pay.⁴⁹ In declaring less income than the amount actually received, for example in a business which generally effects sales of merchandise in cash, or in claiming an expenditure which was not actually incurred or paid by the taxpayer, the taxpayer employs a strategy which is intended to deceive the revenue authorities in imposing the actual amount of tax due and payable.

A question which comes to mind is whether the evasion of tax must be deliberate and intentional, or whether tax evasion can occur innocently. It is difficult to disagree with the contention that in understating income or overinflating expenditure a taxpayer could only do so with the intention to deceive. In rendering a tax return, a taxpayer commits a positive act and generally makes a choice of whether to submit a truthful tax return or one riddled with falsities. However, room must be left for instances where a *bona fide* error is made in a return which occurs free of the intention to defraud SARS. Whether such an error occurs as a result from a *bona fide* attempt by a taxpayer to avoid tax,⁵⁰ through negligence or by virtue of a lack of knowledge or understanding,⁵¹ is irrelevant. Tax evasion can therefore occur free of intent. These errors should however be rectified by the taxpayer upon either realising that a mistake was made⁵² or alternatively, upon being notified by SARS that a tax return contains an error.

⁴⁸Surtees and Millard (2004) Substance, Form and Tax Avoidance. *Accountancy SA*. (November – December) at p14.

⁴⁹ SARS Law Administration (2005). *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)* at p2.

⁵⁰ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁵¹ South Africa's social environment is of such a nature that knowledge of tax law is simply not accessible to all taxpayers of the population. A misunderstanding of whether a particular receipt of income is subject to tax could invariably lead to a taxpayer negligently understating his income under the *bona fide* but mistaken belief that no tax on that money is payable. In doing so, tax evasion occurs free of a fraudulent intention in my view. This also appears to be the approach in New Zealand where the court in *C of IR v Challenge Corporation* [1986] 2 NZLR 513 (PC) specifically distinguished between innocent and intentional evasion and stated that only the latter should be criminally punishable.

⁵² This can be done, for example, through the Voluntary Disclosure Program offered by SARS in terms of Chapter 16 of the *Tax Administration Act*, No 28 of 2011, which even extends to circumstances in which tax was intentionally evaded.

The importance of the concept of tax evasion is that agreements entered into with the intention to evade tax essentially entail that the agreement is entered into with the intention to achieve an illegal purpose. In terms of the law of contract, such an agreement is *void ab initio*, as will be discussed later on.

2.3.2 TAX AVOIDANCE

Contrary to tax evasion, tax avoidance generally entails the utilisation of strategies which are *prima facie* lawful unless specifically prohibited by tax legislation.⁵³ It entails that parties structure their affairs in such a manner to ensure that it falls outside of the ambit of application of a taxing statute without employing dishonest or fraudulent methods.⁵⁴ In my view, tax avoidance is further distinguishable from tax evasion on the basis that the former denotes the efforts of a taxpayer to avoid the imposition of a potential liability, whereas the latter concerns a taxpayer escaping an already incurred tax liability by virtue of the transaction giving rise thereto having already been concluded.

Although the avoidance of tax is closely related to the *Westminster*-principle⁵⁵ and the principle of 'choice' as discussed above, it is distinct from tax planning in the sense that the taxpayer endeavours to obtain a tax benefit without suffering the economic hardship which his endeavours ought to attract. In line with this and in describing tax avoidance, the court in the *Challenge Corporation*-case⁵⁶ stated as follows:

Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

⁵³ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.1; Clegg and Stretch (2008) *Income Tax in South Africa*. Durban: LexisNexis (Vol 1A) at p26-4.

⁵⁴ Clegg and Stretch (2008) *Income Tax in South Africa*. Durban: LexisNexis (Vol 1A) at p26-4, states that "*the Act casts the tax net, but in so far as the taxpayer keeps outside that net he is free from the liability for the payment of tax.*" See also *Levene v IRC* (1928) AC 217 and *De Koker* (2011), *ibid*.

⁵⁵ *IRC v Duke of Westminster* [1936] AC 1.

⁵⁶ *CIR v Challenge Corporation Ltd* [1987] AC 155.

Although tax avoidance ordinarily does not involve fraud, dishonesty or deceit, it does not mean, however, that entering into such an arrangement enjoys the approval of the judiciary,⁵⁷ nor does it mean that a potential tax liability which the parties sought to avoid will in fact successfully be avoided. The legislator, in the ongoing effort to eradicate abusive tax avoidance schemes, has promulgated the rather complex and wide-ranging GAAR in section 80A to 80L of the *Income Tax Act*⁵⁸ through which tax consequences may still be imposed on a transaction, notwithstanding the fact that the transaction is neither unlawful nor fraudulent. Generally speaking, the GAAR stipulates the circumstances under which a tax avoidance scheme, operation or transaction will be regarded as impermissible and stipulates the consequences and SARS' powers in such a case.

Tax avoidance schemes are, however, ingeniously designed and often crafted to ensure that it would succeed the tests and requirements set out in the GAAR. But to legitimately do so and secure the result the parties are after are not always achievable through legitimate means. Taxpayers, under such circumstances, sometimes resort to schemes through which they disguise the true character of the transaction to achieve both the tax benefit and the result they seek. In this respect, as pointed out by *Surtees (2004)*,⁵⁹ in order to successfully avoid tax, a taxpayer should not only ensure that the transaction in question does not fall foul of any anti-avoidance provisions in the relevant tax statute, but also, that the form of the transaction should correctly reflect the substance thereof. If the substance and the form of the transaction differ, a court may conclude that the transaction is simulated, in which case the tax benefit ensuing from the simulated transaction will be a nullity.

The discussion to follow is intended to properly define simulated transactions and to analyse the doctrine of substance over form. Moreover, the doctrine's established place in our tax law on avoidance is discussed.

⁵⁷ See *COT v Ferera 1976 (2) SA 653 (RAD)* wherein the Rhodesian court expressed its view that the avoidance of tax "is an evil" and that a taxpayer, in avoiding tax, defaults in his civic responsibility by not paying his dues and therefore increases the burden on taxpayers who elect not to adopt such strategies.

⁵⁸ No 58 of 1962.

⁵⁹ *Surtees and Millard (2004) Substance, Form and Tax Avoidance. Accountancy SA (November – December)* at p15.

2.4 SIMULATED TRANSACTIONS AND THE COMMON LAW DOCTRINE OF SUBSTANCE OVER FORM

2.4.1 THE BASIC PRINCIPLES

It is a well established principle in our common law that a court, in determining which consequences to attach to a particular transaction, will disregard the form in which a transaction was cast and only give effect to the substance or the true transaction between the parties.⁶⁰ Through the application of this doctrine, the principle that the true intention of the parties behind a transaction will prevail over the terms contained therein is established.⁶¹ Although similar principles such as the *plus valet*-rule⁶² and the *fraus legis* principle⁶³ have been developed in our common law and have been greatly recognised by our courts, it was submitted in *Dadoo Ltd v Krugersdorp Municipal Council*⁶⁴ that these principles are no more than mere branches of the doctrine of substance over form. The doctrine and its various branches are especially applied to render aside simulated transactions to ensure that the applicable legal consequences are attributed to the true essence of a particular transaction, rather than to its form.

In illustrating what the concept of a simulated transaction entails, the following example is of assistance: A maize farmer, endeavouring to escape a levy imposed by statute on the sale of his maize, enters into an agreement with a chicken farmer through which he would purchase the latter's day-old chickens, feed them his maize

⁶⁰ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁶¹ Stighling (Ed) *et al* (2011) *SILKE: South African Income Tax*. Durban: LexisNexis at p738. See also Ger (2011) Supreme Court of Appeal a-'maize'-s tax planners with watershed judgment. *De Rebus* (April) at p44.

⁶² The full maxim is *plus valet quod agitur quam quod simulate concipitur* which means "what is actually done is more important than that what seems to have been done". See De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 46.

⁶³ Derksen (1989) 'n *Benadering to die uitleg van wette, met besondere verwysing na die Inkomstebelastingwet 58 van 1962 en vermydingskemas*. Unpublished LLD thesis, at p15. The principle entails that where an act occurred with the specific intention to avoid the application of a statutory provision, certain legal consequences will follow which would not otherwise have been applicable. In *Dadoo v Krugersdorp Municipality 1920 AD 530* the court held that "[a] transaction is in fraudem legis when it is designedly disguised so as to escape the provisions of the law, but in truth falls within these provisions."

⁶⁴ 1920 AD 530.

until they are fully grown and thereafter, sell them back to the chicken farmer at an inflated price. The maize farmer has no intention to farm chickens and, moreover, has no intention other than to sell his maize. Furthermore, the agreements entered into between the respective farmers have the effect of creating the appearance that a sale of chickens occurred and that the maize farmer used his maize in his own farming operation, thereby avoiding the imposition of the levy.⁶⁵ In reality however, the price paid by the chicken farmer to re-acquire the chickens related to the delivery of maize rather than the re-purchase of its chickens.⁶⁶ The transaction is therefore a simulation.

The basic anatomy of a simulated transaction is illustrated through this example. It occurs when the parties seek to achieve a certain, predetermined objective on which a particular statute may impose some form of burden, but through the design of their transaction they achieve the desired objective by concealing the elements thereof which is susceptible to a statutory charge.⁶⁷ Such concealment may occur either through disguising the true nature of their transaction or through the fictitious creation of rights and obligations which differ from the rights and obligations which is actually created between them.⁶⁸ Such transactions are subject to the application of the doctrine of substance over form.

The doctrine is however not applied indifferently by our courts and requires that certain established criteria are met before a court can decide the legal consequences of the transaction premised on its substance rather than its form. In *Zandberg v Van Zyl*,⁶⁹ the court, by way of *Innes J*, gave the following summary of the doctrine:

⁶⁵ *Michau v Maize Board* 2003 (6) SA 459 (SCA).

⁶⁶ PriceWaterhouseCoopers (2004) Tax Avoidance 1213. Simulated Tax Avoidance Agreements holds no water. *Integritax*. Available at http://www.saica.co.za/integritax/2004/1213_Simulated_tax_avoidance_agreement_holds_no_water.htm, accessed on 15 March 2012.

⁶⁷ Christie (2001) *The Law of Contract*. Durban: Butterworths (4th Edition) at p396.

⁶⁸ *Snook v London & West Riding Investments Ltd* [1967] 2 QB 786. Although the court was referring to a “sham” transaction in this matter, the concept of a “sham” and a “disguise” or simulated transaction is so closely related that, for the purposes of this research, it is not necessary to discuss the concepts independently from one another. In this regard, see De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁶⁹ 1910 AD 302 at p309.

Firstly, the court summarised the anatomy of a simulated transaction:

Not infrequently, however (either to secure some advantage which the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by name, or give it a shape, intended not to express but to disguise its true nature.

Secondly, the court addressed concisely what the doctrine entails:

And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be.

Finally, the court laid down the requirements and limitations of the doctrine of substance over form:

But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact meant that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than what it purports to be.

The requirements and limitations of the doctrine and the consequences of its application require analysis whilst the basic anatomy has already been discussed above. It is necessary, however, to distinguish firstly between two differing forms of simulation premised on the intention of the parties to the transaction.

2.4.2 DISHONESTY AS A REQUIREMENT

The conclusion of a simulated transaction does not necessarily require *mala fides* from the parties to be considered as such and, in the absence thereof, a simulated transaction is susceptible to differing consequences.

*Surtees (2004)*⁷⁰ distinguishes between two concepts of which the doctrine consists, namely the 'simulation principle' and the 'label principle'. Although these concepts vastly differ from one another in what each of them entail, the fact that the substance of the transaction and the form which is attached thereto differs, remains consistent.

The 'simulation principle' refers to a transaction in which the parties act *mala fide* by intentionally and dishonestly concealing the true nature of their transaction in order to circumvent the operation of the charging provisions of a tax statute. This scenario coincides with the underlying principle of simulated transactions as set out in *Zandberg's case*,⁷¹ in that the parties "*call it by name or give it a shape intended not to express but to conceal its real character.*" Under this concept, the transaction is said to be a 'sham transaction' or a 'disguised transaction' to which the doctrine applies. In *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd*⁷² the court stated that a transaction which can be categorized under this principle is tainted with dishonesty insofar as the parties thereto have no desire, *inter partes*, to be bound by the terms of their agreement. Such a transaction is said to be *in fraudem legis*⁷³ and a court will therefore determine the legal consequences of such a transaction in accordance with the substance of the transaction or, simply put, what is found to be the real agreement between the parties.

Contrary hereto, the 'label principle' refers to instances where the parties, acting in good faith and without an intention to be dishonest, either accidentally or as a result of a lack of knowledge, label their transaction incorrectly which results in the substance of the transaction being different from its form.⁷⁴ *Brincker (2004)*⁷⁵ believes that a transaction falling under this concept is distinct from a transaction under the 'simulation principle' in that the parties intend to give effect to the contract in accordance with its terms. A court will nevertheless disregard the simulated transaction and label it in accordance with what it in reality is. Because there is no intention to give effect to

⁷⁰ Surtees and Millard (2004) Substance, Form and Tax Avoidance. *Accountancy SA* (November – December) at p15.

⁷¹ 1910 AD 302.

⁷² 1941 AD 369 at p395.

⁷³ *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530.

⁷⁴ Surtees and Millard (2004) Substance, Form and Tax Avoidance. *Accountancy SA* (November – December) at p15.

⁷⁵ *Brincker (2004) Taxation Principles of Interest and other Financing Transactions*. Durban: LexisNexis Butterworths at pZA-4.

some other agreement, the court will then only apply the statutory GAAR to determine the tax consequences of the transaction.⁷⁶

Although the court does not decide the tax consequences of the transaction in accordance with the common law doctrine under the 'label principle', the doctrine is still invoked to strip the transaction of its incorrect label and to categorize it correctly. The doctrine therefore finds application to both these concepts, albeit in a different context. It is especially the 'simulation principle' which is relevant for the purpose of this research. What this distinction illustrates, however, is for the common law doctrine of substance over form to be applied in full, there must be an intention to be dishonest. This concept is almost analogous to intentional and unintentional tax avoidance discussed above.

2.4.3 INTENTION: A *CONDITIO SINE QUA NON* FOR SUBSTANCE OVER FORM

In the context of the 'simulation principle', the absolute requirement for a transaction to be regarded as simulated is that the parties to the transaction must have a real intention which is different from the purported intention which their transaction ostensibly conveys. In the *Randles* case,⁷⁷ the court expressed this requirement in the following terms:

Of course, before the Court can find that a transaction is *in fraudem legis* [simulated] in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible agreement is a pretence.

It has been reiterated by our courts that insofar as the parties honestly intend their transaction to have effect in accordance with its tenor or the words in which it was expressed, the court will give effect to the agreement in accordance therewith and decide, on that basis, whether the particular transaction fell within the taxing provisions of the relevant statute.⁷⁸ The intention-requirement is therefore entrenched as the

⁷⁶ *Ibid.*

⁷⁷ 1941 AD 369.

⁷⁸ *Ibid.* Although the transaction may survive the common law test, it may still be susceptible to the GAAR.

paramount consideration in determining simulation. For example, in *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*⁷⁹ the court held that –

[t]he 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...

and in *CIR v Saner*,⁸⁰ the court emphasised that “[i]t 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 thought...”.

Although the intention of the parties to give effect to an unexpressed agreement effectively constitutes a *conditio sine qua non* for the doctrine to be applied, it is no simple task to determine the true intention of the parties. The test to determine the parties’ intention has, at the best of times, proven to be a difficult determination by virtue of the subjective nature of intention.⁸¹ In establishing whether the taxpayer intended to give effect to his agreement in accordance with its tenor, a court should evaluate the objective factors present in conjunction with the taxpayer’s evidence of what his intention was in concluding the transaction.⁸² For example, in *Michau v Maize Board*,⁸³ the court’s consideration of the *ipse dixit* of the appellant (the subjective factors) and the court’s subsequent inferences drawn from the parties’ conduct and actions as well as the end result of the transaction (the objective factors) illustrate the manner through which the true intention of the parties ought to be established.⁸⁴ The prevailing factor, however, remains the subjective intention of the parties.

As a result of the difficulty to establish a taxpayer’s true intention, it often occurs that the distinct concepts of the subjective ‘intention’ and the objective ‘motive’ or ‘purpose’ are conflated. In this regard, the requirement that the parties’ intention with their

⁷⁹ 1996 (3) SA 942 (SCA).

⁸⁰ 1927 TPD 162.

⁸¹ Stighling (Ed) *et al* (2011) *SILKE: South African Income Tax*. Durban: LexisNexis, at p27. A person’s intention refers to his own plans and agendas, which exist in his own thoughts and reasoning. The enquiry into a juristic person’s intention is more objective as it entails the consideration of the results of the formal acts of its directors, which in turn is only an objective inquiry.

⁸² *Ibid.*

⁸³ 2003 (6) SA 459 (SCA).

⁸⁴ *ITC 1833 70 SATC 238* (the Tax Court’s judgment in the *NWK*-case) at para 31 of the judgment.

transaction should be consistent with their intention to give effect to the expressed terms of their agreement is subject to a very important qualification which lies within the difference between ‘intention’ and ‘purpose’. Invariably, where the parties structure their affairs to remain outside of the ambit of a taxing provision there ought to be an underlying purpose to obtain a tax advantage. As is evidenced from the following extract from the *Randles* case,⁸⁵ however, the objective purpose behind the transaction is completely irrelevant to the enquiry whether the doctrine of substance over form is applicable:

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...

In distinguishing between ‘purpose’ on the one hand and ‘intention’ on the other, the court in *Hippo Quarries (Tvl) (Pty) Ltd v Eardley*⁸⁶ held that a purpose which is unlawful, immoral or *contra bonos mores* will render the transaction ineffectual through the operation of the law, irrespective whether the parties’ intention to give effect thereto was genuine. In contrast hereto, a simulated intention will also be ineffectual, but only through the application of the common law doctrine of substance over form, notwithstanding the acceptability of the objective purpose. Although the law effectively takes care of the respective transactions in both instances, unlawful agreements are rendered ineffectual through the operation of established principles in the law of contract whilst simulated agreements are rendered ineffectual solely on the basis of the doctrine.

The relevance of this distinction, simply put, emanates from the consequences ensuing from unlawful contracts and simulated transactions respectively. An agreement which is ineffectual by virtue of the illegality of its purpose is unenforceable insofar as *inter partes*, the parties thereto cannot claim specific performance of the agreement, nor can they claim payment in terms thereof or contractual damages ensuing from it, but only that the agreement is null and void.⁸⁷ The only tax consequences which can ensue from such an illegal contract is premised on actual

⁸⁵ 1941 AD 369.

⁸⁶ [1992] 1 All SA 398 (A) at p405.

⁸⁷ Christie (2001) *The Law of Contract*. Durban: Butterworths (4th Edition) at p452.

income received, whilst speculative income is not taxable premised on the accrual principle by virtue of the unenforceability of the right to receive such income.⁸⁸

However, where the agreement is simulated and the doctrine of substance over form is invoked, the parties cannot escape the tax consequences since their unexpressed agreement is not a nullity. Such an unexpressed agreement creates enforceable rights and obligations which attract fiscal consequences, irrespective of whether income is actually received or whether only a right to receive such income exists.

To summarise, a transaction is only simulated where a definite, ascertainable intention by the parties to give effect to an agreement other than the expressed agreement exists. Failing the existence of another agreement, the doctrine of substance over form can provide no relief. This concept is logical – if there is truly only one agreement, substance and form cannot differ. The doctrine therefore necessarily requires that multiple agreements must exist in reality. It would lead to inconceivable results if rights and obligations were to flow from an unintended, unexpressed and non-existing agreement unless the law specifically stipulates such a consequence.⁸⁹ Moreover, an objectionable purpose does not create a further agreement and an inquiry premised thereon is irrelevant to determine simulation.

2.4.4 CONSEQUENCES OF THE APPLICATION OF THE DOCTRINE

If a court is satisfied that the requirements of the doctrine of substance over form in a particular transaction have been met, as discussed above, a court will disregard the form of the transaction and only have regard to the real transaction between the parties. In so doing, the court will consider what the tax consequences of the real transaction are and apply it to the transaction in accordance with the relevant charging provision.⁹⁰

⁸⁸ *MP Finance Group CC (in liquidation) v Commissioner for the South African Revenue Service* 2007 (5) SA 521 (SCA); *Christie (2001) ibid* also submits that unenforceability in this instance does not prohibit the court from looking at the transaction for any purpose whatsoever.

⁸⁹ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para19.3.

⁹⁰ In *Kilburn v Estate Kilburn* 1931 AD 501 the court held that it will not be deceived by the manner in which the parties concealed their transaction and that it would, in such circumstances, “*rend aside the veil in which the transaction is wrapped and examine its true nature and substance.*” Similarly, in *Michau v Maize Board* 2003 (6) SA 459 (SCA), the court

A court is therefore authorised in terms of the common law to apply a statute to a concealed transaction which in reality exists. Through the invocation of the doctrine, taxes which are legally due to SARS are imposed on the transaction, notwithstanding the taxpayer's efforts to structure the true transaction to avoid it being detected for tax purposes.

2.5 CONCLUDING REMARKS

Although the doctrine of substance over form has been in existence for well over a century, it was specifically adopted in our tax law since the decision in the *Zandberg* case.⁹¹ During the years following this judgment, the requirements and effect of the doctrine were never substantially varied, if at all, and were well established and entrenched in our law. The doctrine always required that a court would have to satisfy itself that the parties concealed another, underlying and unexpressed transaction between them and that they had no intention of giving effect to the transaction which was embodied in the words of the ostensible transaction between them. The enquiry was therefore subjective.

Importantly, this approach to simulation respected the balancing of a taxpayer's right to legitimately minimise his tax liability against the obligation on SARS to collect taxes which are legally due. Moreover, the law relating to simulation was certain, clearly defined and established. However, *NWK* appears to have disturbed the established law relating to simulation.

held that it would strip the transaction of its ostensible form and only give effect to the true agreement.

⁹¹ 1910 AD 302.

CHAPTER 3: THE NWK CASE AND THE INTRODUCTION OF THE REQUIREMENT OF COMMERCIAL SUBSTANCE

3.1 INTRODUCTION

On 1 December 2011 the SCA delivered its unanimous judgment in the matter between the *Commissioner for the South African Revenue Service v NWK Ltd*⁹² on simulated transactions which has evoked substantial interest from the tax community by virtue of the impact which the matter purportedly has on the established doctrine of substance over form.⁹³ Notwithstanding the entrenched law on the subject of simulated transactions, the SCA potentially overturned the principles⁹⁴ which had been expressed by its very own bench in matters such as *Zandberg*⁹⁵ and *Randles*.⁹⁶ In paragraph 55 of its judgment, the court, by way of *Lewis JA*, held as follows:

[55] In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an object other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that the parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.

⁹² 2011 (2) SA 67 (SCA).

⁹³ Dachs (2011) The interpretation of substance over form. *In Practice – Edward Nathan Sonnenbergs*. Available at http://www.ens.co.za/images/news/14_02_11%2001%2001lr1402LAW_AL_2.pdf, accessed on 24 August 2013.

⁹⁴ Surtees (2013) NWK revisited and clarified. *Without Prejudice* (February) at p45; see also Ger (2013) High Court challenges SCA's interpretation of simulated transactions. *De Rebus* (January/February 2013) at p62 in which the author indicates that the SCA 'abandoned' the longstanding tests to determine simulation in terms of the common law principles.

⁹⁵ 1910 AD 302.

⁹⁶ 1941 AD 369.

It is uncertain whether the SCA created a new substance over form doctrine in our tax law or whether the SCA merely extended the entrenched principles dealing with simulated transactions. The court evidently introduced a commerciality-test which requires consideration as part of the enquiry into whether a particular transaction is simulated or not.⁹⁷ However, the question which arises is whether the introduction of this commercial substance requirement renovates the doctrine of substance over form by establishing the requirement as an independent criterion to determine simulation, or whether the requirement should be regarded as no more than an indicator that a transaction is potentially simulated. Having regard to the judgment in its entirety, it would appear as if the SCA expressed itself in these words with the intention to formulate a new test to determine simulation based on the requirement it introduced.⁹⁸

In order to consider this proposition, an analysis of the facts of the case and the commercial substance requirement is necessary.

3.2 OVERVIEW OF THE FACTS IN THE CASE⁹⁹

NWK entered into a series of agreements through which it obtained a structured finance loan facility in the sum of R50 million from First National Bank (“*FNB*”). Through structuring their transaction with *FNB* in the manner which it did, *NWK* would not only raise the aforesaid amount as a loan, but also generate excessive interest expenses which it would be able to deduct from its taxable income pursuant to section 11(a) of the *Income Tax Act*.¹⁰⁰

A loan agreement with a subsidiary of *FNB* was entered into in terms of which the latter would lend a sum of approximately R96 million to *NWK* on the basis that the capital amount will be repayable in five years’ time, partially through the delivery of maize to

⁹⁷ Van der Walt (2011) *NWK Case casting its shadows*. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (14 October 2011) at p1.

⁹⁸ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

⁹⁹ As it appears from the judgment in par 5 to 41, read with the summary thereof in Davis J (2010) *Simulated Transactions*. Cape Town: *The Taxpayer* (Vol 59)(Nos 11 & 12) November-December 2010 at p203; see also Legwaile (2012) *Modernising the ‘Substance over Form’ Doctrine: Commissioner for the South African Revenue Service v NWK Ltd*. *SA Mercantile Law Journal* (Vol 24) 115-127, at p117.

¹⁰⁰ No 58 of 1962.

the subsidiary. To make provision for the interest expense which would be incurred over this time, *NWK* issued promissory notes to the subsidiary with a value of approximately R75 million. To ensure that *NWK* had sufficient quantities of maize at hand to be able to deliver the agreed volume of maize to the subsidiary at the end of the five year term, another division of *FNB* entered into a purchase agreement with *NWK* in terms of which it would sell the same quantity of maize to *NWK* as which *NWK* was supposed to deliver in terms of the loan agreement. The purchase consideration, which *NWK* paid on the date of conclusion of this agreement, was approximately R46 million, whilst the delivery of the maize to *NWK* was only to take place on the same date as the date on which *NWK* had to deliver maize to the *FNB* subsidiary. On exactly the same terms and on the same date, the *FNB* subsidiary sold the same quantity of maize to the *FNB* division for approximately R46 million, which maize would also only be delivered some five years later. Finally, and also on the same date, the *FNB* subsidiary ceded its rights to the promissory notes to *FNB* at a discounted value of approximately R51 million, through which *FNB* would become entitled to receive interest payments from *NWK* premised thereon, as and when they become due. Moreover, the *FNB* subsidiary was placed in a position of liquidity to make a R96 million loan to *NWK* by virtue of its sale of maize to the *FNB* division and the cession of the right to receive interest payments to *FNB*.¹⁰¹

Through implementing this transaction, *NWK* claimed deductions in terms of section 11(a) of the *Income Tax Act* to the sum of the face value of the promissory notes over the five year period in respect of interest payments made to *FNB*.

The issue before both the Tax Court, firstly, and thereafter the SCA, was that the loan was effectively only for a sum of R50 million, not the approximate R96 million, and that the transaction was therefore “*specifically designed to conceal the fact that, in reality, the actual loan amount advanced to NWK was R50m.*”¹⁰² SARS contended that the interest claimed as a deduction constituted both a payment of a portion of the actual capital of the loan as well as interest thereon in reality, and therefore sought to disallow the deductions insofar as it related to the repayment of the capital. However, it was contended on behalf of *NWK* that the contracts between the parties were not only

¹⁰¹ Some four months after these transactions, both *NWK* and the *FNB* subsidiary ceded their respective rights to receive maize under their respective purchase agreements to *FNB*, whereafter *NWK* and *FNB* concluded a short term facility of R50 million.

¹⁰² Para 30 of the judgment.

intended to be performed in accordance with their tenor, but that this actually transpired and that there was no unexpressed agreement between them to which they actually intended to give effect.

The Tax Court¹⁰³ considered the established principles relating to a taxpayer's right to legitimately minimise his tax liability and the doctrine of substance over form as a common law deterrent for simulated transactions¹⁰⁴ and concluded that *NWK* successfully discharged its *onus* to demonstrate that its true intention was to give effect to the agreements in accordance with their terms. The Tax Court therefore found that simulation was not present in the structure implemented by *NWK* and set aside the additional assessments raised by SARS. This decision was appealed by SARS and the SCA was approached to finally adjudicate on the matter.

3.3 THE JUDGMENT OF THE SCA AND THE INTRODUCTION OF THE COMMERCIAL SUBSTANCE REQUIREMENT

The court gave recognition to the principle entrenched in our tax law of a taxpayer's entitlement to reduce a potential tax liability¹⁰⁵ as well as to the established requirements to conclude that a transaction is simulated and that it is therefore taxed in accordance with its substance.¹⁰⁶ However, in considering the law on simulation, the court specifically examined the approach followed in the existing authorities but concluded that there had been no consistency in the approach to establish the true intention of the parties to the transaction or, as the court would have it, to establish the 'purpose' which the taxpayer sought to achieve.¹⁰⁷

Moreover, the court distinguished the facts of the case from, *inter alia*, the facts in the *Conhage* case¹⁰⁸ in which it was found that the parties gave effect to their agreement in accordance with its tenor and reasoned that in the aforesaid case, the manner in which

¹⁰³ *ITC 1833 70 SATC 238*; see also Emslie SC (2010) Simulated Transactions. Cape Town: *The Taxpayer* (Vol 59)(Nos 6 & 7).

¹⁰⁴ See *id* at para 27 to 35.

¹⁰⁵ See para 42 of the judgment in which the court gave recognition to the principle enunciated in *IRC v Duke of Westminster* [1936] AC 1.

¹⁰⁶ See para 43 of the judgment in which the rule laid down in *Zandberg v Van Zyl* 1910 AD 301 was affirmed by the court.

¹⁰⁷ See the discussion of 'purpose' and 'intention' at 2.3.3, *supra*.

¹⁰⁸ 1999 (4) SA 1149 (SCA).

the transactions were structured was justified as there were sound commercial reasons for the parties to structure their transaction in the manner they did.¹⁰⁹

The fact that the parties intended to give effect to the transaction in the form that it was cast, as contended for on behalf of *NWK* and as required in terms of the entrenched principles, did not satisfy the SCA's enquiry into whether the transaction was simulated or not. In paragraph 80, the court stated as follows:

[80] It is correct that FNB and *NWK* outwardly performed in terms of the various contracts, as indicated earlier...[The *court a quo*] should have asked whether there was actually any purpose in the contract other than tax evasion. This is not to suggest that a taxpayer should not take advantage of a tax-effective structure. But as I have said, there must be some substance – commercial reason – in the arrangement, not just an intention to achieve a tax benefit or to avoid the application of a law. A court should not look only to the outward trappings of a contract: it must consider, when simulation is in issue, what the parties really sought to achieve.

The court therefore insisted that an economically justifiable purpose for the transaction must exist and, in the absence of such purpose, it would lead the court to conclude that the transaction is simulated.¹¹⁰ On the facts of the matter, the court found that there was no real and sensible commercial purpose in the transaction¹¹¹ and that the only apparent purpose which the parties sought to achieve was the tax benefit ensuing from *NWK*'s ostensible entitlement to claim a deduction from its taxable income in respect of the interest expenses it incurred on an artificially inflated loan amount.¹¹² Premised hereon, the SCA found in favour of SARS on the basis that the transaction was simulated and upheld the appeal.

It is not so much the court's finding in favour of SARS which has solicited interest in the judgment and the debate and criticism thereto, but rather the court's findings in respect

¹⁰⁹ Para 54 of the judgment.

¹¹⁰ Para 54-55 of the judgment.

¹¹¹ The court considered various aspects of the transaction to reach a conclusion that the agreements reached in respect of the sale of the maize was a charade: see para 89 of the judgment in this regard.

¹¹² Para 86 of the judgment.

of the established law on simulated transactions.¹¹³ If one has regard to paragraph 55 and paragraph 80 of the judgment, it is clear that the SCA either departed from the established rules pertaining to simulation by creating a new, independent test to determine simulation, or it broadened the interpretation of the substance over form doctrine by widening the scope of circumstances in which a transaction may potentially be simulated. Either way, the court definitely endeavoured to introduce a further requirement to the effect that a transaction must have some commercial substance in order to escape the detrimental consequences of being labelled as a simulated transaction.

The exact application of this requirement – as either an independent criterion for simulation or as *De Koker (2011)*¹¹⁴ put it, “*merely as being symptomatic of a transaction that is indeed a pretence or disguise*” – remains uncertain and is examined in the remainder of this research.¹¹⁵ However, it is necessary to firstly consider the effect of the requirement to better understand the SCA’s reasoning.

3.4 THE COMMERCIAL SUBSTANCE REQUIREMENT

Pursuant to the judgment, the view has been expressed by various commentators that taxpayers need to ensure that there is a defensible commercial purpose when they structure their affairs to avoid a potential liability for tax – a ‘*demonstrable, non-fiscal financial, business or economic*’ purpose underlying their transaction.¹¹⁶ Although this proposition seems simple enough, the SCA’s exact intent with its introduction of this requirement and what it entails remains debatable. *De Koker (2011)*¹¹⁷ points out this difficulty with reference to the SCA’s utilisation of similar, yet different expressions in

¹¹³ PriceWaterhouseCoopers (2011) The SCA advances the Law on Simulation. *TaxTalk* (January/February 2011) at p29.

¹¹⁴ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

¹¹⁵ See chapter 4 below.

¹¹⁶ DLA Cliffe Dekker Hofmeyr (2012) Anti-Avoidance: 2033. Simulated Transactions (March 2012 – Issue 150). Available at http://www.saica.co.za/integritax/2012/2033.Simulated_transactions.htm. Accessed on 5 June 2013.

¹¹⁷ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

the judgment which appears to refer to commercial substance¹¹⁸ and enquires whether the SCA intended that all these expressions should bear corresponding meanings. The question as to what exactly commercial substance entails and what level of commerciality would satisfy the requirement is therefore a very relevant question.

The SCA's decision resembles the approach to simulation by virtue of a lack of commercial substance followed by the courts in the United States of America ("US").¹¹⁹ Their approach may be of some guidance as to what the court meant with the requirement. In the context of the decisions of these courts, *Fraser (2011)*¹²⁰ submits that various subcategories of the doctrine of substance over form have been developed by the US judiciary, such as the 'business purpose test' and the 'step transactions' principle to name but a few. To this extent, it is specifically the possible convergence of our SCA's decision with the US' 'business purpose test' which is of relevance.

*Gregory v Helvering*¹²¹ is regarded as the landmark decision in the US which led to the formulation of the judicial doctrine referred to as the 'business purpose test'¹²² which essentially forms part of the US doctrine of economic substance.¹²³ Without elaborating on the facts of the case, it is sufficient to state that the taxpayer had structured a particular transaction in accordance with the provisions of the relevant US revenue legislation and ensured that the transaction was implemented by giving effect to every element required in the statutory provision to obtain relief from taxation. The taxpayer contended that the mere fact that the transaction was premised on a motive to avoid a potential liability for tax should not impact on the eventual tax consequences of the structure.

In delivering the opinion by the US Supreme Court, *Justice Sutherland* stated the following:

¹¹⁸ *Ibid.* The author identifies the SCA's use of the terms 'commercial reason or purpose', 'commercial sense', 'real substance and purpose', 'commercial substance', 'business sense', 'good commercial sense', 'purpose or commercial sense', 'commercial reason' and 'real and sensible commercial purpose' from the judgment.

¹¹⁹ Van der Walt (2011) NWK Case casting its shadows. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (14 October 2011) at p 2.

¹²⁰ Fraser (2011) The 'New' Economic Substance Doctrine: The Three C's: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011) at p26.

¹²¹ 293 U.S. 465 (1935).

¹²² Also referred to as the 'doctrine of Gregory v Helvering'.

¹²³ Robertson *et al* (2010) Codification of the Economic Substance Doctrine. *Journal of Business Administration Online* (Vol 9)(No 2).

The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

The US approach is therefore to establish the economic substance of a transaction premised on a constructive interpretation of a particular provision of a statute through which a tax benefit was derived. To illustrate this approach, *Fraser (2011)*¹²⁴ uses the following example based on the facts of this case:

[W]hen the statute speaks of a transfer of assets by one corporation to another, it means a transfer made in pursuance of a plan of reorganisation of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either.

Effectively, the 'business purpose test' postulates that a transaction will not be respected by the US courts in circumstances where a viable business purpose or economic substance, as required by the statute through inference, is absent. The intention of the parties to the transaction becomes meaningless under this doctrine as a purpose to obtain a tax benefit only will satisfy the enquiry of the court to determine simulation.¹²⁵ In *CIR v Transport Trading & Terminal Corporation*¹²⁶ the doctrine was expanded in the US to all statutes in which a commercial or industrial transaction may be described.

¹²⁴ Fraser (2011) The 'New' Economic Substance Doctrine: The Three C's: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011) at p 27.

¹²⁵ *Ibid.*

¹²⁶ 176 F.2d 570 (2d Cir. 1949), as referred to in *Fraser (2011)*, *ibid*, and in Waizer (1981) *Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability*. 49 *Fordham Law Review* at p1078. Available at: <http://ir.lawnet.fordham.edu/flr/vol49/iss6/7>. Accessed on 26 August 2013. Essentially, the court held that where a statute envisages a transaction in a commercial context, for example a true loan to serve a business' need for capital, the actual transaction should not deviate in its purpose from the envisaged statutory purpose. If this is so and a tax benefit is derived from such other purpose, the doctrine ought to be invoked to nullify the tax benefit under the transaction.

In the *NWK* judgment, however, there is nothing to suggest that the SCA's approach was premised on the US doctrine save for the similarities in approach. It would therefore not be conclusive to state that the economic substance requirement should be regarded in South African tax law as it is in the US. The main similarity, as is evident from the discussion above, is that a court can go behind the true intention of the parties to the transaction to seek a commercially justifiable purpose for the transaction, notwithstanding the authority which stands directly in conflict with this position.

Although the US approach gives some guidance on what economic substance may entail, it cannot be regarded as providing a conclusive answer in a South African context. What exactly the SCA meant with economic substance therefore remains unanswered to an extent.

In paragraph 54 of the judgment, the SCA indicated that it was satisfied that the transactions in *CIR v Conhage (Pty) Ltd*¹²⁷ had sufficient commercial substance to justify the findings of the court therein. In this matter, the taxpayer was desirous of expanding its business and required capital to do so. Instead of entering into a loan agreement, the taxpayer elected to enter into a more tax-efficient transaction to raise the requisite capital by selling and leasing back its manufacturing equipment to a financial institution. In terms of the lease agreement, the taxpayer would not acquire ownership of the equipment at the expiration of the lease, but its continuous use thereof was secured by virtue of the renewal clauses contained in the agreements. The commercial purpose of the transaction was to obtain the requisite capital and not only to reduce its tax liability, whilst the detrimental consequence was that the taxpayer lost ownership of its equipment.

In this matter, the court found that the transactions made good business sense – although the taxpayer would have indefinite use of the equipment, it had lost ownership of the equipment, a necessary but accepted disadvantage in exchange for the benefits which ultimately ensued from the transaction.¹²⁸ Considering that the court in *NWK* was satisfied that commercial substance was present in this matter, the extract quoted from the *Challenge Corporation*¹²⁹ becomes relevant again: where a taxpayer reduces a potential tax liability without involving himself in the detrimental consequences of the

¹²⁷ 1999 (4) SA 1149 (SCA).

¹²⁸ See *id* at para 9.

¹²⁹ *CIR v Challenge Corporation Ltd* [1987] AC 155, *supra* at 2.2.2.

manner in which the transaction was structured, the transaction, in terms of *NWK*, does not satisfy the commercial substance requirement.¹³⁰ If this is the correct approach, which is submitted it is not, the requirement essentially states that if a transaction amounts to the impermissible avoidance of tax, the transaction will be simulated. This illustrates a clear conflation of the proposed commerciality test under the common law and the commerciality test under the GAAR.¹³¹ This overlapping between the tests for simulation under the common law and impermissible tax avoidance under the GAAR is rather problematic in itself, as discussed in chapter 4 below, and not tenable.

What the requirement of commercial substance entails remains uncertain. In my view, what the requirement entails will depend from case to case and will require a factual enquiry in every instance. In this respect, the view expressed by *Legwaile (2012)*¹³² is perhaps accurate: Premised on *NWK*, an enquiry is necessary to establish whether the particular transaction has the actual substance which it should have, which substance should be both commercial and rational for an agreement of that nature.

3.5 CONCLUDING REMARKS

Through the introduction of the commercial substance requirement, the SCA has undoubtedly broadened the scope within which SARS can attack complex structures which have the effect of reducing a potential tax liability, particularly in the context of structured finance transactions. It is submitted, however, that the *NWK* decision is far more wide-ranging in its nature than to be constricted to the confines of structured finance.¹³³ The principles enunciated by the SCA in this matter would invariably affect all spheres of tax planning and even agreements which do not fall within the realm of tax law.¹³⁴

¹³⁰ This approach appears to coincide with the US business purpose test – see Fraser (2011) The ‘New’ Economic Substance Doctrine: The Three C’s: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011) at p26.

¹³¹ Sec 80C(1) of the *Income Tax Act*, No 58 of 1962.

¹³² Legwaile (2012) Modernising the ‘Substance over Form’ Doctrine: Commissioner for the South African Revenue Service v *NWK Ltd*. *SA Mercantile Law Journal* (Vol 24) 115-127, at p121.

¹³³ Ger (2011) Supreme Court of Appeal a-‘maize’-s tax planners with watershed judgment. *De Rebus* (April) at p43.

¹³⁴ *Ibid*.

The requirement that a transaction must have economic substance in order for it not to be a simulated transaction appears to have created an objective, independent criterion if one considers the words of the judgment and the reasoning of the court in this matter.¹³⁵ The court was satisfied that the parties gave effect to their agreements in accordance with its tenor and also, that there was ostensibly no intention to give effect to some other unexpressed agreement between them.¹³⁶ The court was seemingly satisfied that the entrenched common law requirements for simulation were not present, but sought a different basis on which it could find that the transaction was simulated. Certainly, if the requirement of economic substance was intended by the SCA to be no more than an indicator of simulation, the enquiry should have stopped there, notwithstanding the transaction's lack of commercial substance.

The effect of the requirement, as applied by the SCA, purportedly trumps the entrenched principles as it annihilates the subjective enquiry into the intention of the parties to give effect to the agreements in accordance with their tenor, and also, whether an unexpressed agreement exists. It is therefore difficult to contend that the requirement did not postulate an objective criterion which independently determines simulation. This proposition stands to be challenged.

It is worth noting that notwithstanding the contentious nature of the SCA's reasoning in concluding that a substantial portion of the transaction implemented in this matter was simulated, it is submitted that the court nevertheless came to the correct conclusion. Although the judgment does not seem to allow for a finding premised solely on the established principles, *De Koker (2011)*¹³⁷ and *Broomberg (2011)*¹³⁸ contend that it is clear that the matter involved an out-and-out simulation: the parties did not, in reality, intend to create a loan for R96 million, but intended only to create a loan for R50 million. The agreements therefore could not have been given effect to in accordance

¹³⁵ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

¹³⁶ Para 55 and 80 of the judgment.

¹³⁷ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3: "The judgment could therefore simply have held that – squarely on the basis of the criteria laid down in *Zandberg v Van Zyl and Randles Bros & Hudson* – there had been a disguised or simulated transaction, in which a loan was dressed up to appear to be for a higher amount than it really was."

¹³⁸ Broomberg SC (2011) NWK and Founders Hill. Cape Town: *The Taxpayer* (Vol 60) at p206.

with their tenor, which also suggests that an unexpressed transaction between the parties existed.¹³⁹

Was it therefore really necessary for the SCA to go to the extent it did and in so doing, potentially reinvent the doctrine of substance over form? The fact that the court did not give any indication that the established principles were in need of renovation or, at the very least, reconsideration, supports the conclusion that the court should not have done so.¹⁴⁰

It is noteworthy that *NWK* is also not the only recent case in which the SCA departed from the established principles relevant to the case or went beyond the scope of the issues before it. In *Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd*¹⁴¹ the court reinvented our tax law pertaining to realisation companies and in so doing, created a rule that, in general, a realisation company acquires assets from its shareholder as trading stock, rather than the established principle which was exactly the opposite. Also, in *Commissioner for the South African Revenue Service v Sprigg Investments 117 CC t/a Global Investment*¹⁴² for example, the SCA advanced the law on SARS' duty to give reasons for assessments whilst the issue before the court was simply whether the Tax Court had been properly constituted.¹⁴³ Both these cases were decided around the time when *NWK* was decided and by substantially the same bench of Judges of Appeal.

One does not want to become cynical about the judicial process and draw unnecessary inferences which impugn the independence of the judiciary, yet, one cannot ignore the "Judge-made" law which appears to be introduced through judgments of this nature, especially where established principles existed or where the court was not burdened to adjudicate on a particular facet of the matter before it, but nonetheless elected to do so. The reasoning of the SCA is questionable in all these matters and, although there is no merit in diverging into a debate as to why the SCA reasoned as it did, especially in light of the inherently abrasive tone which such an argument would have, the following

¹³⁹ *Ibid.*

¹⁴⁰ See *id* at p199.

¹⁴¹ 2011 (5) SA 112 (SCA).

¹⁴² 2011 (4) SA 551 (SCA).

¹⁴³ Mazansky (2012) And you thought an *obiter dictum* was not binding! Cape Town: *The Taxpayer* (Vol 61)(No 3) at p45.

extract from a jurisprudential point of view may leave the readers of these judgments with something to think about:¹⁴⁴

Judge Jerome Frank, *enfant terrible* of the legal realists, presents an even more provocative analysis of the judicial process. He contends that a judge seldom works out a conclusion from principle. In most cases he reaches his conclusion first and then finds legal rules to justify it. The conclusion is really a judicial ‘hunch’ produced by the interaction of rules of law and concealed in stimuli such as the judge’s education, race or class, and his political, economic and moral prejudices. In short, ‘a judge’s decisions are the outcome of his entire life story.’

Of course, the subjective mindset of each of the Judges who presided in these matters is, in actual fact, of no relevance. The hard and fast fact remains that these judgments have been made and constitute legal precedent unless the contrary can be convincingly proven. From *NWK*, the test to determine simulation therefore goes beyond the subjective intention of the parties and requires that the transaction must have economic substance, objectively viewed, unless the contrary can be proven.

The question whether this constitutes a binding precedent and that the economic substance requirement established by the SCA is therefore an independent requirement, is considered in the chapter to follow.

¹⁴⁴ Dugard (1971) The Judicial Process, Positivism and Civil Liberty. *The South African Law Journal*. (Vol 88) p188.

CHAPTER 4: THE INDEPENDENCE OF THE *NWK*-REQUIREMENT

4.1 INTRODUCTION

The independence of the *NWK*-requirement depends largely on the enquiry into whether the SCA's judgment constitutes a binding precedent which other courts, including the SCA, are bound to follow in matters pertaining to simulated transactions. Moreover, the ability of the requirement to operate as an independent requirement is a paramount consideration in establishing the effect of the requirement. The pertinent question which is considered in this chapter is therefore whether the commercial substance requirement constitutes an independent, self-sufficient requirement which, if not satisfied, will lead a court to conclude that a particular transaction was simulated. If it is not, the requirement is surely only indicative of a possible simulation in a particular transaction which would lead to a court applying the established principles from our common law to determine the true substance of the transaction.¹⁴⁵

In this chapter, arguments premised on both the material and procedural law are discussed to support the finding that the requirement is not capable of independent application to determine simulation. Before dealing with these arguments, the most relevant criticism against the judgment is discussed as it does not only support the view that the requirement cannot function independently, but it is also of relevance for the arguments discussed hereinafter.

4.2 RELEVANT CRITICISM

It would be superfluous to traverse the vast amount of criticism published by commentators on the SCA's controversial judgment for the purposes of this research.

¹⁴⁵ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

There are, however, three relevant points of criticism raised against the judgment which warrant mentioning:

Firstly, the paramount enquiry with which a court is tasked when considering transactions of this nature is whether the provision of a taxing statute through which the tax benefit was derived allow for that benefit to ensue, if properly applied to the facts of the case.¹⁴⁶ In *NWK*, the general deduction formula contained in section 11(a) of the *Income Tax Act*¹⁴⁷ is relevant as the interest expenses¹⁴⁸ were claimed as deductions from normal tax through this provision.¹⁴⁸ In terms of the criteria contained in section 11(a), a taxpayer shall only be entitled to claim a deduction of its interest expenditure in the event that it actually incurred the expense in the course of producing income.¹⁴⁹ *De Koker (2011)*¹⁵⁰ is of the view that *NWK* would not have been able to demonstrate that it had actually incurred all of its claimed deductions by virtue of the true loan amount being only R50 million, and submits that this enquiry of the application of the statutory criteria should have been the starting point and central focus in *NWK*. To do so, however, the true nature of the transaction still had to be established by the court as *NWK* did not concede that the loan was only for R50 million. An enquiry into the actual substance of the transaction would therefore necessarily accompany this suggested approach.

Secondly, the SCA's appreciation of the distinction between 'tax avoidance' and 'tax evasion' is of concern as the court clearly conflated these two concepts.¹⁵¹ *Vorster (2011)*¹⁵² indicates that the court's interchangeable use of these concepts creates uncertainty as to whether the court intended that the requirement should only be applicable in instances where the transaction sought to evade an existing tax liability, or whether it should be applicable where the purpose was to avoid a potential liability. *Vorster* correctly asserts that if the court meant for the commercial substance requirement to only apply to instances where parties sought to evade taxation, the law

¹⁴⁶ *MacNiven v Westmoreland Investments Ltd [2003] AC 311* at p320.

¹⁴⁷ No 58 of 1962.

¹⁴⁸ See the *NWK*-judgment at para 12.

¹⁴⁹ Stighling (Ed) *et al* (2011) *SILKE: South African Income Tax*. Durban: LexisNexis at p110.

¹⁵⁰ *De Koker (2011) SILKE on South African Income Tax (Vol 1-4)* LexisNexis (Online Version) at para 19.3.

¹⁵¹ Davis J (2010) Simulated Transactions. Cape Town: *The Taxpayer* (Vol 59)(Nos 11 & 12) at p204.

¹⁵² *Vorster (2011) NWK and Purpose as a test for Simulation*. Cape Town: *The Taxpayer* (Vol 60) at p83.

of contract renders such a transaction ineffectual.¹⁵³ Logically, an unlawful agreement does not necessitate an enquiry into its true character - the enquiry stops at the moment when the contract is found to be unlawful. The SCA therefore failed to instil any confidence through its reasoning by virtue of the uncertainty caused by it through the interchangeable use of two vastly different concepts. *Broomberg (2011)*¹⁵⁴ contends, however, that by virtue of the absurdity to which it would lead if the SCA was using the phrase 'evasion', the court probably really intended to refer to 'tax avoidance'.

Finally, a further aspect in which the judgment lacks clarity is in the SCA's use of the phrase 'simulated'. If one has regard to the judgments in *Zandberg*,¹⁵⁵ *Randles*¹⁵⁶ and *Ladysmith*,¹⁵⁷ the ordinary meaning of the word 'simulated' connotes a 'pretence' or 'concealment' and therefore implies that there is another, identifiable transaction behind it.¹⁵⁸ The SCA's use of the term, however, refers to a transaction which lacks commercial substance, notwithstanding the absence of a pretence, disguise or alternate unexpressed transaction. *De Koker (2011)*¹⁵⁹ therefore considers the SCA's reference to a 'simulated' transaction to be an inappropriate label attributed to the word which differs from the sense in which it had been used by the Appellate Division in previous decisions. The SCA appears to have attached a new meaning to the word to accord with its test for simulation premised on commercial substance. The question then, however, is what the situation would be if a transaction has commercial substance but its actual substance and form differs – can it be said, then, that the transaction is 'simulated' in accordance with the meaning attributed to it by the SCA? It would be no surprise to find the judiciary applying the established principles in such a case and correctly referring to a transaction as 'simulated' in the same context as what it was used prior to *NWK*.

Although this criticism is purely semantic and of superficial value, it demonstrates the ambiguity occasioned by the judgment and the uncertainty to which it gives rise. In order to challenge the independence of the requirement, the arguments to follow are of immeasurable value.

¹⁵³ *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* [1992] 1 All SA 398 (A).

¹⁵⁴ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p198.

¹⁵⁵ 1910 AD 302.

¹⁵⁶ 1941 AD 369.

¹⁵⁷ 1996 (3) SA 942 (SCA).

¹⁵⁸ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3.

¹⁵⁹ *Ibid.*

4.3 THE DOCTRINE OF FISCAL NULLITY

4.3.1 INTRODUCTION: *NWK*

In *NWK*, the parties entered into a series of arrangements in order to obtain a tax deduction in terms of section 11(a) of the *Income Tax Act*.¹⁶⁰ The SCA barely contended that the parties had an intention other than to give effect to the various agreements in accordance with their tenor, but found that the transaction lacked commercial substance and that the transaction was therefore simulated. Against the background of this proposition by the SCA, *De Koker (2011)*¹⁶¹ submits that under the entrenched common law approach to simulation, a court will disregard the disguise and attach tax consequences to the real transaction between the parties. However, he poses the following question:

Where, by contrast, a transaction is not disguised, but merely lacks 'commercial substance', what assessment can the Commissioner conceivably make and what order is the court empowered to hand down – acting in terms of the common law principles – to nullify the tax benefit?

Stated in broader terms, on what common law basis can a court disregard the tax consequences attaching to actual rights and obligations created by the parties through entering into and properly implementing a particular transaction premised on the proposition that the transaction lacks commercial substance? *De Koker (2011)*¹⁶² suggests that if the transaction cannot be found to be a simulated transaction, the only manner in which a court can nullify the tax consequences ensuing from it, in terms of the common law, is through the adoption of a doctrine of fiscal nullity, similar to which has been introduced by the English court in *WT Ramsay Ltd v IRC*¹⁶³ and affirmed and applied in *Furniss (Inspector of Taxes) v Dawson and related appeals*.¹⁶⁴

In the context of *NWK*, the doctrine postulates that a court may disregard the tax consequences ensuing from the steps in the overall transaction which lack commercial

¹⁶⁰ No 58 of 1962.

¹⁶¹ *De Koker (2011) SILKE on South African Income Tax (Vol 1-4) LexisNexis (Online Version)* at para19.3.

¹⁶² *Ibid.*

¹⁶³ [1981] 1 All ER 865, [1982] AC 300.

¹⁶⁴ [1984] 1 All ER 530.

substance, notwithstanding the creation of real and enforceable rights which the parties intend to give effect to in such steps. Effectively, a court is then only required to consider the position of the taxpayer prior to implementing the transaction and the taxpayer's position after the transaction has been fully implemented in order to impose tax on the net result. The fact that the steps in the transaction legitimately manufactured tax savings therefore becomes irrelevant. In the absence of a firm rule in the common law which authorises this treatment of a transaction, the position created through it is highly untenable. It is submitted that at present, no rule in our common law exists which authorises a court to nullify the tax benefits ensuing from a transaction which was properly entered into and given effect to.

The independence of the requirement of economic substance greatly hinges on the existence of a rule through which a court can nullify actual rights and obligations, simply because the requirement would be worthless in the absence thereof. The established common law principles were limited to disguised transactions, as pointed out in *Zandberg's case*.¹⁶⁵ Where there was a disguise, the rule required no further extension as the doctrine of substance over form already provided effective relief to the *fiscus*. Where no simulation actually occurred, however, there is no disguise of which the transaction can be stripped. Yet, *NWK* postulates that such a transaction may nevertheless be regarded as simulated by virtue of the lack of commercial substance. But on what transaction does the requirement then propose that tax should be levied differently than in the normal course? Unless a rule exists through which a court can impose tax on a notional transaction, the requirement proves to be completely worthless and ineffectual. If this is the case, the requirement simply cannot be regarded as an independent factor to determine simulation.

It is therefore necessary to consider the English law doctrine of fiscal nullity and its possible introduction into our law.

¹⁶⁵ 1910 AD 302.

4.3.2 THE RULE CREATED IN *FURNISS V DAWSON*¹⁶⁶

In order to understand the rule enunciated by the English court, the issue which was before it is of relevance, although it is not necessary to traverse the facts of the matter in detail. In broad terms, the taxpayer sought to avoid the imposition of capital gains tax which would ordinarily ensue from the sale of his shares in a company to another company. In following the exemption provided for in the charging statute, the taxpayer created a new company to facilitate the sale of shares through an exchange transaction and accordingly escaped the ambit of the taxing provision as, within the literal meaning of the statute, no disposal occurred. The substance of the transaction was, however, that he had sold his shares to the acquiring company without implicating the transaction in the ambit of application of the statute, yet all the transactions entered into were actual and therefore not simulated.¹⁶⁷

The House of Lords, in considering the transaction and its tax consequences, summarized the principles which underlie the doctrine of fiscal nullity as follows.¹⁶⁸

First, there must be a preordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (ie business) end...Second, there must be steps inserted which have no commercial (business) *purpose* apart from the avoidance of a liability for tax, not 'no business *effect*'. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.

The doctrine therefore proposes that the adjudicator must completely disregard the various steps in a transaction which lack economic substance and which form part of the overall, single composite transaction entered into to achieve a particular result, such as obtaining a loan or effecting a sale of shares. This is done, of course, without the transaction being simulated, provided that the requirements for the invocation of the doctrine are present. A discussion of the requirements of the doctrine would not be

¹⁶⁶ *Furniss (Inspector of Taxes) v Dawson and related appeals* [1984] 1 All ER 530. For the historic formulation of the doctrine, see *Floor v Davis (Inspector of Taxes)* [1978] 2 All ER 1079, [1978] Ch 295 and *WT Ramsay Ltd v IRC* [1981] 1 All ER 865, [1982] AC 300.

¹⁶⁷ *Ibid.*

¹⁶⁸ [1984] 1 All ER 530 at p543.

of any value as the difficulties with the doctrine are embodied in the consequences which ensue from its application.¹⁶⁹

The consequence of the application of the doctrine is therefore that a court must “think away” the actual rights and obligations created in steps which lack commercial substance and apply a tax consequence to the transaction as if the parties had not entered into the agreements which constitute the steps in the transaction.¹⁷⁰ An implied consequence where actual agreements are merely disregarded is furthermore that a set of fictional facts must be invented – a notional transaction – to enable the adjudicator to impose a tax on the transaction.¹⁷¹ For example, in the context of this case, no actual sale of shares occurred, but in substance, a sale was manufactured through the insertion of certain steps. If these steps are disregarded, the court must invent a set of facts to establish the sale of shares, otherwise there would be no such sale to tax. The rule therefore allows the imposition of tax on a notional transaction.

Unless an express rule to this extent is adopted by our courts, there is nothing in the common law authorising this treatment of a transaction.¹⁷² Having regard to the SCA’s judgment, the authorities it relied on as well as the absence of any indication that the court was intent on adopting the doctrine or some similar rule, it can only be inferred that the court did not endeavour to do so, at least not expressly.¹⁷³

Of interest, the doctrine of fiscal nullity is remarkably similar to the US ‘step transaction’ doctrine which was introduced in *Minnesota Tea Co v Helvering*.¹⁷⁴ The ‘step transaction doctrine’ entails that a series of formally separate transactions are treated as part of a single transaction where such transactions are interrelated and entered into to achieve a particular result.¹⁷⁵ When considering the tax consequences of the transaction, the integrity of the transaction is not compromised by dissecting the

¹⁶⁹ For a discussion of the requirements of the doctrine, see Derksen (1990) Should the South African Courts adopt the English Anti-Avoidance Rule in *Furniss v Dawson*? *The South African Law Journal* (Vol 107) at p420.

¹⁷⁰ See *id* at p430.

¹⁷¹ *Ibid.*

¹⁷² The principle of legality prohibits action without a rule to effect. This, in essence, is embodied in the Rule of Law. See Bekink (2007) Principles of South African Constitutional Law (Revised Edition) *University of Pretoria* at p59.

¹⁷³ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para19.3.

¹⁷⁴ 301 US 609 (1937).

¹⁷⁵ Fraser (2011) The ‘New’ Economic Substance Doctrine: The Three C’s: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011) at p28.

transaction into its separate steps, but rather, tax consequences are attached to the end result of the transaction.

The doctrine of fiscal nullity does not exist in our common law, although it has been introduced, to an extent, under the statutory GAAR, as discussed below. The discussion to follow is premised on the enquiry whether the doctrine is capable of introduction into our common law.

4.3.3 THE DIFFICULTIES WITH THE DOCTRINE IN A SOUTH AFRICAN TAX LAW CONTEXT

From the outset, it should be noted that the English courts developed the doctrine of fiscal nullity to counter tax avoidance schemes as a result of the absence of a GAAR in its revenue legislation. Invariably, the courts therefore had to adopt a stringent rule in order to protect the *fiscus*.¹⁷⁶ This is an important consideration throughout the discussion to follow as it is submitted that the rule created through it would lead to unsatisfactory and harsh results in a South African context where a statutory GAAR exists.¹⁷⁷

To ascertain whether the commercial substance requirement has any credibility as an independent criterion as already explained, the doctrine of fiscal nullity or a similar rule would have to be adopted in our common law for the reasons advanced above. There are, however, material reasons why this should not occur.

Firstly, section 80B(1)(a) of the *Income Tax Act*¹⁷⁸ provides SARS with the power to disregard, combine or re-characterise any step or part of a transaction if it is found to be an impermissible avoidance arrangement in order to determine the tax consequences thereof, similar to what the doctrine allows. It is therefore contended that by virtue of statutory provision having already been made to regard actual rights and obligations created by the parties to a transaction as a fiscal nullity, there is no

¹⁷⁶ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para19.2.

¹⁷⁷ Derksen (1990) Should the South African Courts adopt the English Anti-Avoidance Rule in *Furniss v Dawson*? *The South African Law Journal* (Vol 107) at p430.

¹⁷⁸ No 58 of 1962.

need, and in fact no desire, for our courts to expand our common law to incorporate a similar rule.¹⁷⁹ The doctrine would lead to an unnecessary conflation of tests premised on the common law and statute respectively and would, in my mind, lead to inconsistencies and differential treatment of similar transactions.

Furthermore, an enquiry into a simulated or disguised transaction is firstly predicated on the principles of the common law and only thereafter on the GAAR to determine the permissibility of the transaction. It would therefore be superfluous to have the same relief for SARS under both the common law and statute to disregard non-commercial steps in a transaction where the requirements to obtain such relief substantially differ.

Secondly, the doctrine relies heavily on the purpose with which a particular transaction was entered into – a purpose to avoid taxation. It is trite in our tax law, however, that the purpose to avoid tax should not be a consideration in the process of determining the tax consequences of a particular transaction under the common law.¹⁸⁰ To this extent, and correctly so in my view, *Derksen (1990)*¹⁸¹ notes as follows:

[The field of application of a statute] cannot be dependent upon the subject's purpose that the statute will or will not be applicable. Such a purpose is consequently irrelevant when it has to be decided whether or not the statute is applicable to a set of facts.

The enquiry into the applicability of a statutory provision should be predicated on no more than the ordinary rules of statutory interpretation.¹⁸² In order to determine the consequences prescribed by statute, the adjudicator must consider the relevant provision and its jurisdictional requirements through ordinary interpretation principles, consider the facts of the transaction in question and apply the provisions of the statute to the facts.¹⁸³ To broaden the scope of this enquiry into the applicability of a statutory provision to include a purpose-requirement would lead to a departure from the basic

¹⁷⁹ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.2.

¹⁸⁰ *Supra*, 2.3.3. In particular, see *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* [1992] 1 All SA 398 (A) and *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369.

¹⁸¹ Derksen (1990) Should the South African Courts adopt the English Anti-Avoidance Rule in *Furniss v Dawson*? *The South African Law Journal* (Vol 107) at p425.

¹⁸² See *id* at p430; also, see *MacNiven v Westmoreland Investments Ltd* [2003] AC 311 at p320 in which the court stated that “[t]he paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case.”

¹⁸³ *Ibid.*

principles of interpretation as it is well established that the only subjective enquiry in this respect would be to find the intention of the legislature, unless the statutory provision specifically provides that a further purpose should be considered.

Finally, although the GAAR allows for the statutory power of SARS to disregard certain steps in a transaction, it would lead to an insurmountable variance with the principles of legal certainty and the rule of law to empower SARS or a court, in terms of the common law, to impose tax on a notional transaction by ‘thinking away’ the facts which are detrimental to the objectives of the *fiscus* and inventing facts which would suit it. To emphasize the difficulty with this consequence of the doctrine, *Broomberg (2011)*¹⁸⁴ asks whether *NWK* then proposes that SARS (and the court) should be entitled to unilaterally decide what rights and obligations the parties should be deemed to have created and impose tax thereon. He submits that this would be problematic, especially in circumstances where various alternative methods of achieving the same result are possible. Again, if this were the case, tax would be imposed inconsistently on transactions of this nature and taxpayers would be treated differently on similar sets of facts by virtue of the lack of a firm rule to determine which deemed rights and obligations should exist in a non-simulated transaction.

In this regard, one should bear in mind that tax is not imposed in terms of the common law – it is imposed by way of statute. If a tax statute makes provision for SARS or the court to disregard actual rights and obligations and invent a set of facts on which a tax could be imposed, such as in the GAAR, then, however harsh the consequences may be, it is the legislator’s prerogative and is therefore a whole different matter altogether.¹⁸⁵ To extend this power under the common law, especially where such an extension is not necessary, would be absurd. The fact that the doctrine and similar rules are applied abroad in jurisdictions without a GAAR does not detract from the fact that the consequences of this principle are irreconcilable with good tax governance in our country. Such countries require strong deterrents to counter the mischief at which complex and aggressive tax avoidance structures are aimed as no statutory sanctions are contained in their revenue legislation.

¹⁸⁴ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p203.

¹⁸⁵ Derksen (1990) Should the South African Courts adopt the English Anti-Avoidance Rule in *Furniss v Dawson*? *The South African Law Journal* (Vol 107) at p430.

In the premise, it is submitted that it is not desirous for the doctrine to be introduced into our common law. Significantly, the SCA's silence in its judgment in *NWK* on a rule through which a court can nullify rights and obligations is indicative of the court's intention not to do so. It is therefore easy to side with the view of the commentators on the subject of the doctrine of fiscal nullity who are *ad idem*: the doctrine should not be incorporated into our common law.¹⁸⁶

4.3.4 CONCLUSION

Where a transaction consists of various interrelated agreements of which some or all lack commercial substance, but each agreement was duly entered into and given effect to by the parties in accordance with the tenor of the agreement, it is not competent for a court or SARS, under the common law, to disregard the various steps and to merely tax the end result of the overall transaction. Our common law does not authorise this treatment of a transaction and does not leave any room for the adoption of a rule to this extent. Under the common law, there simply exists no authority, and no legality, for a court to impose taxes on a notional transaction.

This leads to serious doubts whether the requirement of commercial substance can be an independent criterion to determine simulation. If an agreement is not simulated in terms of the rule established in *Zandberg's case*¹⁸⁷ but nevertheless lacks commercial substance, there is no recourse for SARS or a court to make an assessment which could nullify the tax benefits ensuing from the various steps in the overall transaction by virtue of the absence of a rule as explained herein.¹⁸⁸ In my view, the *NWK* requirement is therefore ineffectual in this context and on this basis alone, should not be regarded as being an independent criterion to establish simulation.

¹⁸⁶ See for example *Derksen (1990)*, *ibid*, and De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para19.2 and 19.3.

¹⁸⁷ 1910 AD 302.

¹⁸⁸ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para19.3.

4.4 THE DOCTRINE OF *STARE DECISIS*¹⁸⁹ AND THE RULE OF LAW

4.4.1 INTRODUCTION

Arguably one of the most debated issues surrounding the *NWK* judgment is the contention that the requirement introduced by the SCA signified a departure from the established and entrenched principles pertaining to simulated transactions in our law. Now, it is a settled principle in our law that courts are obliged, in general, to follow the previous decisions of a higher court or a court of similar stature.¹⁹⁰ Yet, *Lewis JA* expressed the view that the test to determine simulation cannot simply stop at the enquiry into the intention of the parties, as proposed by the Appellate Division in the *Zandberg*¹⁹¹ and *Randles*¹⁹² matters. Instead, she suggests that the test for simulation should reach beyond the aforesaid enquiry and requires that the commercial substance of the transaction must be considered.

The effect hereof is simply that although the requirements of the former enquiry may have been satisfied, by not satisfying the latter requirement, the transaction would be regarded as simulated. By implication, the commercial substance requirement therefore supersedes the intention-requirement¹⁹³ which is indicative of the intended independence thereof. For this reason, it could be argued that the introduction of the *NWK* requirement was therefore in disregard of the principles embodied in the doctrine of substance over form if it is indeed capable of independent application.¹⁹⁴

The pertinent question is whether the SCA properly observed and respected the doctrine of *stare decisis* and the rule of law in its ostensible departure from the established principles. If it can be successfully argued that the SCA failed to do so or that it expanded the established rules under circumstances wherein it failed to fulfil the

¹⁸⁹ The full maxim is *stare decisis et non quitesa movere*, which means “that one stands by decisions and does not disturb settled points”, as per *Kriegler J* in *Ex parte Minister of Safety and Security: In re S v Walters* 2002 (4) SA 613 (CC) at para 57. It is also referred to as the “doctrine of judicial precedent”.

¹⁹⁰ *Daniels v Campbell and Others* 2004 (5) SA 331 (CC) at para 94.

¹⁹¹ 1910 AD 302.

¹⁹² 1941 AD 369.

¹⁹³ Legwaile (2012) Modernising the ‘Substance over Form’ Doctrine: Commissioner for the South African Revenue Service v *NWK Ltd.* *SA Mercantile Law Journal* (Vol 24) 115-127 at p122.

¹⁹⁴ Ger (2013) High Court challenges SCA’s interpretation of simulated transactions. *De Rebus*. (January/February 2013) at p63.

requirements to do so, it would be equally arguable that the introduction of the requirement was premised on incorrect principles and that it therefore does not constitute a binding precedent on the subject of simulation. Needless to say, if this is the case, the commercial substance requirement can simply not be independent.

It is necessary to consider the principle embodied in the doctrine of *stare decisis* and its necessity for the rule of law before considering whether the SCA properly adhered to it.

4.4.2 THE RULE OF LAW AND THE DOCTRINE OF JUDICIAL PRECEDENT

The principle of the rule of law embodies the ideal that no person, nor the state, is above the law and that the government, including the *fiscus*, must conduct itself in a manner which is consistent and in abeyance with the law.¹⁹⁵ It is therefore imperative that any power exercised by the *fiscus* requires a rule which authorises it to conduct itself in the manner in which it does in order to protect the basic rights of private individuals. In the absence of such a rule, unauthorised conduct is unlawful and invalid.¹⁹⁶ This principle is well entrenched in our Constitution¹⁹⁷ and promotes, *inter alia*, the values of legal certainty, fiscal transparency, satisfaction of legitimate expectations and equality before the law which, in more recent times, has manifested itself in a branch of the rule of law referred to as the principle of legality.¹⁹⁸

A necessary requirement for the 'law to rule' is that the law must be reasonably predictable.¹⁹⁹ This does not only imply that legislative and policy considerations and rules must be established and adhered to, but also that our judiciary cannot simply depart from its prior decisions without good reason. If this were to happen, it would lead to a result which would be counter-productive to the values envisaged through the rule of law and, for that matter, the Constitution. For this very reason, the doctrine of judicial precedent is applied in our law and has been accepted and affirmed by the

¹⁹⁵ Bekink (2007) *Principles of South African Constitutional Law (Revised Edition)* University of Pretoria at p59.

¹⁹⁶ *Ibid.*

¹⁹⁷ Sec 1(c) of the Constitution of the Republic of South Africa.

¹⁹⁸ Bekink (2007) *Principles of South African Constitutional Law (Revised Edition)* University of Pretoria at p59; see also Woolman (2007) *Constitutional Law of South Africa: Student Edition*. Cape Town: Juta & Co Ltd (2nd Edition) at Chapter 11 and *Gcaba v Minister of Safety and Security and Others* 2010 (1) SA 238 (CC).

¹⁹⁹ See para 62 of the *Gcaba*-matter, *ibid.*

Constitutional Court on various occasions. In *Camps Bay Ratepayers' and Residents' Association v Harrison*²⁰⁰ the court stated as follows:

Observance of the doctrine has been insisted upon, both by this Court and by the Supreme Court of Appeal. And I believe rightly so. The doctrine of precedent not only binds lower courts but also binds courts of final jurisdiction to their own decisions. These courts can depart from a previous decision of their own only when satisfied that the decision was clearly wrong. *Stare decisis* is therefore not simply a matter of respect for courts of higher authority. It is a manifestation of the rule of law itself, which in turn is a founding value of the Constitution. To deviate from this rule is to invite legal chaos.

The necessity of this doctrine for the rule of law was confirmed in *Van der Walt v Metcash Trading Ltd*²⁰¹ wherein the Constitutional Court held that the doctrine of judicial precedent is incidental to the rule of law and similarly, in *Gcaba v Minister of Safety and Security and Others*,²⁰² the Constitutional Court reiterated that the doctrine is essential for the rule of law. Without a doctrine applicable to the judiciary which gives effect to the supremacy of the law, erratic decision-making would be unavoidable and would abolish the required predictability of the law. Not only would this lead to legal uncertainty, but invariably taxpayers' equality before the judiciary would be jeopardised by virtue of the inconsistent decisions in which it would result.

From a tax planning perspective, principles such as the choice principle²⁰³ and the *Duke of Westminster*-principle²⁰⁴ would become redundant as it would be impossible to conclude permissible tax effective structures where no clear lines are drawn within which the taxpayer may legitimately reduce a potential tax burden. On this basis and in support of this view, the court held in *Robin Consolidated Industries v CIR*²⁰⁵ that the doctrine of judicial precedent must therefore be observed, especially in circumstances

²⁰⁰ (2011) 4 SA 42 (CC) at para 28.

²⁰¹ 2002 (4) SA 317 (CC).

²⁰² 2010 (1) SA 238 (CC) at para 62.

²⁰³ *Supra*, at 2.1.

²⁰⁴ [1936] AC 1.

²⁰⁵ 1997 (3) SA 654 (SCA).

where the decision has been acted upon for an extensive period “*in such a manner that rights have grown up under it*”, as is the case regarding simulated transactions.²⁰⁶

The importance of the *nexus* of the doctrine of judicial precedent to the rule of law manifests in the consequence that a failure by a court to uphold the previous decisions of the judiciary would amount to the failure of a court to respect the rule of law. If this is the case, the particular judgment should not be followed and cannot be regarded as a binding precedent.

However, the doctrine of legal precedent is not absolute. The tax law, like any other branch of law, continuously evolves with time and necessarily requires new rules, principles and precedent to keep pace with innovative avoidance structures and the public’s perception on how it should be dealt with. The doctrine therefore makes provision for a court to deviate from previous decisions, although not lightly.²⁰⁷

For a court to deviate from a previous decision, the court must be satisfied that the previous decision was either incorrectly decided or that the issues serving before the court are distinguishable from the issues which served before the court which gave the precedent-setting decision.²⁰⁸ Alternatively, the court must be satisfied that the particular point on which it is required to adjudicate was not argued in the previous matter and that it is therefore unconstrained to make a decision thereon.²⁰⁹ By implication, it is necessary for a court to explain why it does not share the view expressed in the previous decision and motivate, with good reason, why a departure from the principles established by the prior decision is necessitated. In my view, the requirement to deviate from judicial precedent should stretch even further and requires that the court should also formulate its new principle in a manner which is unambiguous, clear and concise. Moreover, the new principle should be reconcilable

²⁰⁶ See also *Media 24 Ltd v Taxi Securitisation (Pty) Ltd* 2011 (5) SA 329 (SCA) at para 35 in which the court stated that decisions of the courts are followed by litigants and legal practitioners by arranging their affairs in accordance with precedent-setting judgments.

²⁰⁷ *Camps Bay Ratepayers’ and Residents’ Association v Harrison* (2011) 4 SA 42 (CC) at para 30; see also *Gcaba v Minister of Safety and Security and Others* 2010 (1) SA 238 (CC) at para 62.

²⁰⁸ *Daniels v Campbell and Others* 2004 (5) SA 331 (CC) at para 95.

²⁰⁹ *Ibid.* In para 96, *Sachs J* refers to similar precedent systems applicable in other jurisdictions, including Canada. For the sake of interest and also, in support of the view affirmed that judicial precedent is not to be lightly departed from, the Canadian court laid out requirements for deviating from a previous decision, which include, *inter alia*, that the precedent must be in conflict with their constitution, where the precedent is too narrow and requires extension or where the precedent creates uncertainty or is too complex.

with the particular law to which the principle relates. If the court fails to do so, its new principle would fail to uphold the strive towards legal certainty and would invite more confusion than clarity.²¹⁰

Premised on these principles, the introduction of the commercial substance requirement in *NWK* and its possible infringement on the doctrine of judicial precedent requires analysis.

4.4.3 OBSERVANCE OF THE DOCTRINE OF LEGAL PRECEDENT IN *NWK*

Did the SCA properly observe the established law pertaining to simulated transactions and conclude that it was justified for the court to deviate from these principles and if so, did the SCA clearly and concisely express why such deviation was necessary? For the reasons as set out hereinafter, the quick answer to these questions is in the negative.

The SCA gave recognition to the *Duke of Westminster*-principle,²¹¹ the established principles pertaining to simulation as expressed in the *Zandberg*²¹² and *Randles*²¹³ matters and the distinction between effective and legitimate tax avoidance structures on the one hand and simulated or concealed transactions on the other. However, in paragraph 45 of the judgment, the SCA held as follows:

[T]he cases do not consistently approach what is really meant by a party's intention in concluding a contract – what purpose he or she seeks to achieve – and this warrants some further consideration. Indeed, the best illustration of this divergence is to be found in *Randles*, where the different approaches are to be found in the minority and majority judgments.

It is necessary to pause at this juncture to firstly explain the difficulties already imminent from this extract before considering the SCA's reasoning on the *Randles* matter.

²¹⁰ This view is also expressed by *Waglay J*, as is indicative from the minority judgment in *Bosch and Another v Commissioner for the South African Revenue Service* 2013 (5) SA 130 (WCC) at para 7.

²¹¹ [1936] AC 1.

²¹² 1910 AD 302.

²¹³ 1941 AD 369.

The SCA evidently conflated “intention” and “purpose” as part of the same concept, whilst in the *Hippo Quarries* case,²¹⁴ the court clearly found that these concepts differ from one another. It should be borne in mind that the SCA also conflated the concepts of “evasion” and “avoidance” in its judgment, as already discussed herein, and stated that a purpose to evade tax, as oppose to the avoidance of tax, would result in the transaction being simulated.²¹⁵ The effect of this line of reasoning by the SCA culminates in the conclusion that a purpose to unlawfully evade taxation would result in simulation, which, in itself, is anomalous in the context of the law of contract which already provides for the legal consequences where a contract has an unlawful purpose.

Contrary hereto, the court in the *Hippo Quarries* case²¹⁶ did not decide that an unlawful purpose underlying a transaction would render the transaction as simulated by virtue of the established principle that the law will regard contracts with an immoral or unlawful purpose as ineffectual. *PriceWaterhouseCoopers (2011)*²¹⁷ is of the view that the SCA’s proposition conflicts the principle established in *Dadoo Ltd v Krugersdorp Municipal Council*,²¹⁸ namely that our law does not forbid parties from entering into genuine transactions which are constructed with the purpose to circumvent the operation of a legal prohibition.²¹⁹ This principle is the cornerstone for legitimate tax planning which has been endorsed by our courts on numerous occasions.

The SCA’s reasoning appears to depart from a premise which conflicted well established judicial precedent, although it is likely that this conflict was inadvertently occasioned through the SCA’s apparent misconception of ‘avoidance’ and ‘evasion’. It has already been submitted that the SCA probably intended to refer to “tax avoidance” rather than to “tax evasion” as it did and for this reason, this departure from the judicial precedent pertaining to legitimate tax planning will not be pursued further. It is rather the SCA’s reasoning and departure from the principles in the *Randles* matter²²⁰ which

²¹⁴ [1992] 1 All SA 398 (A).

²¹⁵ Para 55 of the judgment.

²¹⁶ [1992] 1 All SA 398 (A).

²¹⁷ *PriceWaterhouseCoopers (2011) Tax Avoidance: 1966. Simulated Transactions. Integritax.* Available at http://www.saica.co.za/integritax/2011/1966_Simulated_transactions/htm. Accessed on 15 March 2012.

²¹⁸ 1920 AD 530.

²¹⁹ See also the extract from the judgment in *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369 at 2.3.3, *supra*, in which this principle was confirmed by the court.

²²⁰ 1941 AD 369.

is important as the SCA's finding in *NWK* conflicts the decision expressed by the court in this case.

The SCA reasoned that the approaches followed by *Watermeyer JA* and *De Wet CJ* for the majority and the minority judgments respectively in the *Randles* case²²¹ differed. According to *Lewis JA*, the majority concluded that the taxpayer *in casu* had such a desire to pass transfer of ownership of the materials in order to obtain a tax rebate in terms of the relevant customs legislation that the parties invariably intended that the transaction should be given effect to in accordance with its terms. Contrary hereto, according to *Lewis JA*, the minority judgment rather looked at the substance of the transaction than the intention of the parties only. It appears as if the SCA felt that the majority of the court was satisfied that the true intention of the parties was reflected in the wording of the agreement, whilst the minority of the court went beyond the words of the agreement to seek the commercial effect thereof.²²² Of course, the SCA preferred the latter approach and, on this basis, justified its conclusion to depart from the established intention-requirement.

The difficulty with this reasoning, according to both *Broomberg (2011)*²²³ and *Vorster (2011)*,²²⁴ is that the SCA misunderstood the difference in the conclusions of the majority and minority judgments in the *Randles* case. *Vorster (2011)*²²⁵ correctly points out that both the judges applied the principles established in the *Duke of Westminster*,²²⁶ *Zandberg*²²⁷ and *Dadoo*²²⁸ judgments, but that their different conclusions were premised on their respective interpretations of the charging provisions of the relevant statute and different understandings of the evidence presented to them during the hearing of the matter. *Broomberg (2011)*²²⁹ agrees with this contention and states that the difference in the conclusions reached by the court in this matter was “*not because of a difference in approach to simulated transactions*” by

²²¹ *Ibid.*

²²² Broomberg SC (2011) *NWK* and Founders Hill. Cape Town: *The Taxpayer* (Vol 60) at p204.

²²³ *Ibid.*

²²⁴ Vorster (2011) *NWK* and Purpose as a test for Simulation. Cape Town: *The Taxpayer* (Vol 60) at p84.

²²⁵ *Ibid.*

²²⁶ [1936] AC 1.

²²⁷ 1910 AD 302.

²²⁸ 1920 AD 530.

²²⁹ Broomberg SC (2011) *NWK* and Founders Hill. Cape Town: *The Taxpayer* (Vol 60) at p204.

the judges, as suggested by *Lewis JA* in her judgment. In fact, both the majority and minority judgments left the established simulation-principles undisturbed.

It appears as if the SCA's eventual decision to introduce a further requirement for simulation was premised predominantly on its interpretation of what the minority judgment held in the *Randles* matter. It should be borne in mind that the court in *Randles* expressly followed the principles established in the *Zandberg* matter²³⁰ and confirmed that a purpose to avoid tax would not amount to simulation if the parties intend to give effect to their transaction in accordance with its terms.

Albeit by virtue of the SCA's misunderstanding of the minority judgment in *Randles*, the SCA departed from the established principles without adequately motivating why a departure was necessary. It is therefore submitted that the SCA failed to properly observe the doctrine of judicial precedent, especially as the requirements to deviate from a previous decision in order to observe the doctrine of *stare decisis*, as laid down by the Constitutional Court in the *Daniels* matter,²³¹ were not satisfied by the SCA. Even if it could be argued that it was justified for the SCA to depart from the established principles as it did, the judgment lacks clarity and contains too many ambiguities to constitute a precedent which later courts should be bound to follow. The court's conflation of distinguishable, basic tax concepts in the judgment results in difficulties with the view that its decision should be binding.

4.4.4 THE *NWK* JUDGMENT JUDICIALLY CONSIDERED

In *Bosch and Another v Commissioner for the South African Revenue Service*,²³² the High Court considered the *NWK* judgment and in particular, its deviation from the established principles as discussed above. Although the judges in this matter were *ad idem* as to the order to be made in respect of the matter before it which did not pertain to simulation *per se*, SARS' reliance on *NWK* and the court's consideration of the judgment lead to a minority judgment premised on the difference in opinion of *NWK*'s effect.

²³⁰ 1910 AD 302.

²³¹ *Daniels v Campbell and Others* 2004 (5) SA 331 (CC) at para 95.

²³² 2013 (5) SA 130 (WCC).

Davis J, for the majority of the court, refused to accept that *NWK* signified a departure from the established principles pertaining to simulation. He expressed the view that the SCA did not disturb the law relating to simulated transactions but rather that the *NWK* judgment “*should be interpreted to fit within a century of established principle, rather than constituting a dramatic departure.*”²³³ However, the words used in the majority judgment already create a difficulty with this approach. By requiring that the *NWK* judgment should be “interpreted” in the context of the established case law, *Davis J* implies that the words of the judgment must not merely be considered in their plain and ordinary sense. He suggests that it must rather be constructed differently to be harmonious with the law as it is.

In my view, such interpretive approach is not tenable. Judgments should convey the concise findings of a court of law, the reasoning and the law applied. It should not require a special interpretation to enable the findings of a court to co-exist with the standing judicial precedent. A court’s judgment should be read and understood in the manner in which it was written and the effect of the judgment should depend on the words selected by the judge who wrote it.

That being said, *Emslie (2012)*²³⁴ believes that *Davis J*’s reasoning in delivering this view on *NWK* is attributable to the judge’s respect for the doctrine of *stare decisis* and that he attempts to salvage the judgment from further criticism premised on the SCA’s disregard for judicial precedent. By interpreting the law as a coherent whole for *NWK* to co-exist with the established principles, the High Court perhaps felt that it would leave room for *NWK* to have some effect, although not to the extent probably envisaged by *Lewis JA*. By approaching the judgment in this manner, it would appear as if the majority of the court reasoned that the commercial substance requirement should only be indicative of the presence of simulation where it is coupled with a purpose to avoid tax.²³⁵ This, in my view, acknowledges that the commercial substance requirement, if considered as an independent requirement to determine simulation, would infringe the doctrine of *stare decisis* and that it therefore cannot be regarded as having created an independent criterion to determine simulation.

²³³ See para 78 and 86 of the majority judgment.

²³⁴ *Emslie (2012) Tax Avoidance*. Cape Town: *The Taxpayer* (Vol 61)(No 11 & 12) at p208.

²³⁵ DLA Cliffe Dekker Hofmeyr (2012) *Avoidance as Accepted Practice*. *Tax Alert*. (30 November 2012) at p2.

Whilst *Davis J's* reasoning is commendable, it is submitted that in reality, the SCA indeed departed from the existing law on simulated transactions,²³⁶ as held in the minority judgment of the court. *Waglay J* stated the following in his judgment with reference to *Davis J's* approach to interpreting the judgment:²³⁷

Such interpretation would be somewhat strained. *NWK* is a dramatic reversal of what has been a consistent view of what constitutes a simulated transaction. *NWK*, considered in its entirety, not by extraction of words and phrases out of their real context, does in fact lay down the rule that any transaction which has as its aim tax avoidance will be regarded as a simulated transaction irrespective of the fact that the transaction is for all purposes a genuine transaction.

It is submitted that this view is probably correct.²³⁸ The *NWK* judgment departed from the existing principles regarding simulation and sought to introduce a requirement which is capable of determining simulation independently, contrary to the existing law on the subject. The judgment therefore flouts the doctrine of *stare decisis*.

Furthermore, by virtue of the confusion created by the judgment, in both the uncertainty it occasioned in respect of its effect and perhaps also through the difficulties created in the judgment through the conflation of distinct concepts, *Waglay J* held that *NWK* should not be regarded as a binding precedent.²³⁹ This submission by *Waglay J* demonstrates the judiciary's respect for the rule of law as he essentially submits that *NWK* lacks the substantiated averments for its departure from the existing law on simulated transactions and also, that the judgment is too vague to constitute a binding precedent.²⁴⁰

4.4.5 CONCLUSION

The introduction of the commercial substance requirement by the SCA as an independent requirement to determine whether a particular transaction is simulated

²³⁶ *Ibid.*

²³⁷ See para 4 of the minority judgment.

²³⁸ Emslie (2012) Tax Avoidance. Cape Town: *The Taxpayer* (Vol 61)(No 11 & 12) at p208.

²³⁹ See para 7 and 9 of the minority judgment.

²⁴⁰ DLA Cliffe Dekker Hofmeyr (2012) Avoidance as Accepted Practice. *Tax Alert*. (30 November 2012) at p2.

disregards the doctrine of *stare decisis*. Moreover, the introduction of this principle detrimentally impacts on the predictability and certainty of the law and abruptly blurs the lines within which a taxpayer may legitimately arrange his tax affairs – lines which were so clearly drawn by classic tax law decisions such as *Duke of Westminster*²⁴¹ and *Randles*.²⁴² To consider the *NWK* requirement as an independent criterion to determine simulation would therefore impede the rule of law and the values envisaged through it, a result which the SCA would certainly not have sought to achieve.

In the premise, the observance and adherence to the doctrine of judicial precedent, as a requirement for respect for the rule of law, serves as a strong argument in favour of the *NWK* requirement being no more than an indicator for simulation.

4.5 PARAGRAPH 55 OF THE JUDGMENT: *OBITER DICTA* OR *RATIO DECIDENDI*?²⁴³

Paragraph 55 of the judgment, in which the commercial substance requirement was introduced, has already been quoted above and discussed in detail.²⁴⁴ The finding of the court expressed therein is the main catalyst which has solicited the debate and uncertainty surrounding the judgment and the law on simulated transactions.

However, the nature of the words used by the SCA in the contentious paragraph and the controversial introduction of the commercial substance requirement has the effect of diverting attention from another important paragraph in the judgment which potentially gives much guidance on the intended effect of the judgment and the introduction of the requirement. In paragraph 87, the SCA held as follows:

The contract was dressed up in order to create an obligation to pay interest, and consequently a right to claim a tax deduction, to which *NWK* was not entitled. *NWK* deliberately disguised the true nature of the loan for this purpose. It did not intend, genuinely, to borrow a sum approximating the one it purported to borrow.

²⁴¹ [1936] AC 1.

²⁴² 1941 AD 369.

²⁴³ *Obiter dicta* refers to remarks made by a court in passing, whereas the *ratio decidendi* of a judgment refers to the rational or basis upon which a court based its decision.

²⁴⁴ *Supra*, chapter 3.

Did the SCA, after introducing a revolutionary, yet highly controversial common law criterion to determine simulation in paragraph 55, only rely on the established principles to conclude that the transaction was simulated in its *ratio decidendi*, thereby implying that the introduction of the commercial substance requirement was *obiter* and therefore merely of persuasive value?

*Broomberg (2011)*²⁴⁵ appears to think so.²⁴⁶ He argues that the words used by the SCA in the aforementioned paragraph of the judgment, read with paragraphs 89 and 90 thereof,²⁴⁷ is indicative of the SCA's reasoning that the transaction in question was simulated, premised solely on the application of the established principles. Similarly, *Vorster (2011)*²⁴⁸ mentions that the introduction of the commercial substance requirement appears to him to be *obiter* and reasons that if this is the case, the SCA did not overrule the judicial precedent in existence prior to the judgment and that it therefore properly observed the doctrine of *stare decisis*.

If it is accepted that the introduction of the commercial substance criterion was made *obiter* by the SCA, from a theoretical point of view, the introduction thereof is not binding as a precedent. In support hereof, it was held by the Constitutional Court in *Camps Bay Ratepayers' and Residents' Association v Harrison*²⁴⁹ that it is trite in our law that the doctrine of judicial precedent does not extend to *obiter dicta*, only to the *ratio decidendi* of a decision. If paragraph 55 of the judgment was not part of the SCA's *ratio decidendi*, theoretically, the commercial substance requirement cannot be an independent criterion to determine simulation as it simply would not constitute a requirement which courts are bound to apply. If this theoretical point of view is correct, the conclusion reached that the introduction of the commercial substance requirement flouted the doctrine of judicial precedent would therefore, by implication, be flawed. These two arguments would be mutually destructive and are not capable of being raised concurrently against the independence of the *NWK* requirement, from a theoretical point of view at least.

²⁴⁵ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p206.

²⁴⁶ See also the view expressed by De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3 which coincide with *Broomberg's* view.

²⁴⁷ The crux of these paragraphs is that the SCA submitted that the agreements were "illusory" and that there was no intention by the parties to give effect to the transaction insofar as the delivery of maize in the future was concerned.

²⁴⁸ Vorster (2011) *NWK and Purpose as a test for Simulation*. Cape Town: *The Taxpayer* (Vol 60) at p85.

²⁴⁹ (2011) 4 SA 42 (CC) at para 30.

It is submitted, however, that practically, *obiter dicta* from a court with the stature of the SCA extends further than being of mere persuasive value.²⁵⁰ *Mazansky (2012)*²⁵¹ is of the view that few lower courts will deviate from the SCA's *obiter* remarks on a point of law and submits that even the SCA itself is unlikely to disregard its previous remarks where it is confronted with a similar point in a later case. It is difficult to disagree with this observation, especially when considering *obiter* remarks from the SCA in a string of decisions which will invariably be followed in later decisions, contrary to the theoretical approach to judicial remarks of this nature. A pristine example hereof can be found in *Commissioner for the South African Revenue Service v Sprigg Investments 117 CC t/a Global Investment*²⁵² in which the SCA, in *obiter*, discussed SARS' duty to provide the taxpayer with reasons to enable the taxpayer to draft its objection thereto, whilst the *ratio* of the court was premised on a completely different issue.²⁵³ It is highly likely that the remarks made by the SCA in this matter will be followed in decisions to come. Contrary to the theoretical approach, if the practical view of *obiter dicta* as explained herein is correct, the conclusion reached in respect of *NWK*'s disregard for the doctrine of legal precedent is not in conflict with the argument that the introduction of the commercial substance requirement was done *obiter* by virtue of the effect which the SCA's remarks will have.

Although the latter approach is more preferable in my view, it is submitted that the SCA's introduction of the commerciality requirement should not summarily be dismissed as *obiter dicta* as many of the commentators suggest. In commenting on the judgments delivered in *Bosch and Another v Commissioner for the South African Revenue Service*²⁵⁴, *Emslie (2012)*²⁵⁵ remarks that it is odd that neither the majority, nor the minority judgments of the court considered whether the introduction of the commercial substance requirement was *obiter*. In my view, however, this omission can

²⁵⁰ Mazansky (2012) And you thought an *obiter dictum* was not binding! Cape Town: *The Taxpayer* (Vol 61)(No 3) at p44.

²⁵¹ *Ibid.*

²⁵² 2011 (4) SA 551 (SCA).

²⁵³ The *ratio decidendi* of the SCA was that the Tax Court was not properly constituted; see also *Mazansky (2012)*, *op cit n 250* at p45. *Mazansky* also refers to *NWK* falling within this category, as does *Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd* 2011 (5) SA 112 (SCA).

²⁵⁴ 2013 (5) SA 130 (WCC).

²⁵⁵ *Emslie (2012) Tax Avoidance*. Cape Town: *The Taxpayer* (Vol 61)(No 11 & 12) at p208.

probably be explained premised on the following *dictum* by *Brand AJ* in the *Camps Bay Ratepayers'* case:²⁵⁶

But the fact that a higher court decides more than one issue in arriving in its ultimate disposition of the matter before it does not render the reasoning leading to any one of these decisions *obiter*, leaving lower courts free to elect whichever reasoning they prefer to follow.

By considering this *dictum* in conjunction with the reference made by the SCA in paragraph 86 of its judgment in which it reiterated the necessity for an enquiry into the commercial substance of the transaction to determine simulation, it is arguable that the introduction of the commercial substance requirement forms part of the reasoning by the court towards its *ratio decidendi* in paragraph 87, although not expressly stated. This could potentially imply that the introduction of the requirement was not merely *obiter*.

In concluding, to categorize the SCA's introduction of the commercial substance requirement in paragraph 55 of the judgment as *obiter dicta* is therefore daunting as the distinction of it from the *ratio* in the judgment is not crystal clear. Nonetheless, if the requirement was in fact introduced *obiter*, the requirement is not independent from a theoretical point of view as it would not create binding authority, whilst from a practical point of view, it is in disregard of the doctrine of *stare decisis* depending on how later courts perceive its effect. If it was introduced as part of the court's *ratio*, however, it is submitted that an argument premised on the doctrine of *stare decisis* and the conflation between the requirement and the GAAR, as discussed hereafter, should prevail over the requirement's independence. For the reasons submitted herein with the difficulty of this categorization, it would be advisable not to challenge the independence of the requirement on this argument alone.

²⁵⁶ (2011) 4 SA 42 (CC) at para 30.

4.6 THE INTRUSION OF THE *NWK* REQUIREMENT ON THE STATUTORY GAAR: THE POWERS OF THE LEGISLATOR USURPED?

A final argument against the future independent application of the *NWK* requirement is that it cannot co-exist with the provisions of the GAAR by virtue of the conflation of these respective deterrents to tax avoidance and the undesired consequences which would ensue from it. Moreover, by conflating the test for simulation under the common law with a statutory provision which is aimed at combating the same mischief, the constitutional doctrine of separation of powers appears to be infringed which is potentially detrimental to the functions of the legislator and impacts on the independence of the judiciary.

Although an argument premised hereon turns more on the incorrectness of the approach suggested by the SCA to simulated transactions than the enquiry whether the requirement is independent or not, it is a logical consequence that the *NWK* requirement cannot function as a test for simulation if its introduction was bad in law and incorrect. It is for this reason that a discussion hereof is warranted.

Failing the applicability of the common law principles on simulated transactions, a secondary deterrent against a transaction through which tax was avoided is contained in section 80A to 80L of the *Income Tax Act*.²⁵⁷ In essence, the statutory GAAR provides that any arrangement through which a tax benefit was derived may attract fiscal consequences, *inter alia*, as if the transaction had not been entered into between the respective parties.²⁵⁸ This relief is only available if the sole or main purpose of the arrangement was for either of the parties to obtain a tax benefit and the arrangement lacked normality, lacked commercial substance, created rights and obligations which would not ordinarily have been created or resulted in an abuse of the provisions of the Act.²⁵⁹ The lack of commercial substance is therefore only one of the so-called “tainted

²⁵⁷ No 58 of 1962.

²⁵⁸ Sec 80B(1)(f).

²⁵⁹ Sec 80L (definitions), read with sec 80B (consequences) and sec 80A (impermissible tax avoidance arrangements).

elements”²⁶⁰ which must be present along with the sole or main purpose of the parties with the transaction to obtain a tax benefit.²⁶¹

If the coupling between the sole or main purpose requirement and at least one of the tainted elements is absent, the jurisdictional requirements for the invocation of the GAAR will not have been met and the relief provided for under section 80B will not be at SARS’ disposal.²⁶² It is therefore to be inferred that the legislator simply did not envisage the lack of commercial substance as capable of being an independent requirement through which avoidance could be combated.

The *NWK* requirement envisages that any transaction through which a tax benefit is derived will be regarded as simulated if it lacks commercial substance, in which event fiscal consequences may be applied by regarding the transaction in the same manner as envisaged in section 80B(1)(f) – the actual rights created through the transaction may be regarded as a fiscal nullity. The tests postulated by the respective deterrents are almost identical, save for the *NWK* approach to simulation only requiring that a court needs to be satisfied that the transaction lacked commercial substance without having to consider what the intention with the transaction was. It is therefore correctly submitted that the SCA conflated the test to determine simulation with the test envisaged in the GAAR, which is evident from the requirements and consequences of the respective deterrents.²⁶³

The immediate problem created by conflating these deterrents is that the decree of the legislator of the requisite coupling between the purpose of the transaction and the tainted elements is rendered redundant through the simplification of the test for simulation by the SCA.²⁶⁴ This conflation created between the concepts renders the requirement susceptible to attack premised on constitutional principles, in particular through the encroachment by the judiciary on the designated functions of the

²⁶⁰ Sec 80A(a), (b) and (c).

²⁶¹ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.35.

²⁶² *Ibid.*

²⁶³ Ger (2013) High Court challenges SCA’s interpretation of simulated transactions. *De Rebus*. (January/February 2013) at p62.

²⁶⁴ Vorster (2011) *NWK and Purpose as a test for Simulation*. Cape Town: The Taxpayer (Vol 60) at p84; see also De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.35 in which the author states that the *NWK* requirement is a duplication of the criteria envisaged in the GAAR, with the only difference its purported independence.

legislative authority. The question which therefore follows is whether the SCA adhered to the doctrine of separation of powers?

In order to prevent excessive governmental powers manifesting in a single body of the state, the doctrine of separation of powers between the executive authority, the legislative authority and the judiciary is recognised in our law and entrenched in the Constitution.²⁶⁵ The doctrine entails that the courts are empowered with the judicial authority and must be independent, subject only to the Constitution and the law, and that it is tasked to perform its functions impartially, without fear, favour or prejudice.²⁶⁶ On the other hand, the legislative authority vests in Parliament²⁶⁷ and is tasked with the function of passing legislation. In order for the judiciary to maintain its status as an independent adjudicator of disputes, it is necessary for each of the varying spheres of government to respect this distinction which by implication entails that the judiciary should not embark on a course of law making,²⁶⁸ nor should it render statutory provisions superfluous contrary to the expressed intention of the legislature, unless the statute stands in conflict with the Constitution.²⁶⁹

It is submitted that the SCA ventured into the domain of the legislative authority by disregarding the legislator's construction of the limits within which a court is entitled to deem rights and obligations a nullity. The SCA rendered the GAAR obsolete²⁷⁰ and effectively usurped the functions of the legislature by affording the judiciary a non-statutory power to disregard actual rights and obligations created by the parties to a transaction. The doctrine of separation of powers was therefore not properly observed and adhered to by the SCA, which places a big question mark on the correctness of the SCA's introduction of the commercial substance requirement.

²⁶⁵ Bekink (2007) Principles of South African Constitutional Law (Revised Edition) *University of Pretoria* at p4. See sec 43, 85 and 165 of the Constitution.

²⁶⁶ Sec 165(2) of the Constitution.

²⁶⁷ Sec 44(1) of the Constitution.

²⁶⁸ See for example *Coetzee v Government of the Republic of South Africa* 1995 (4) SA 631 (CC) as referred to in *Bekink (2007)*, *op cit n 265*.

²⁶⁹ *Bekink (2007)*, *id* at p42, submits that the separation is not an absolute separation, especially as a result of the system of checks-and-balances through which a court is tasked, for example, to review the exercise of powers of the other spheres.

²⁷⁰ De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.2; see also Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p200.

In addition to the SCA's infringement on the doctrine of separation of powers, there are two further consequences occasioned through the conflation of the common law and statutory deterrents which support the view that the commercial substance requirement cannot co-exist with the GAAR.

*Firstly, Broomberg (2011)*²⁷¹ submits that it is highly undesirable that a similar test should be applied under both the common law and statutory deterrents to tax avoidance. He contends that unfair discrimination will necessarily ensue where substantially the same test is applied to determine the tax consequences of a transaction under either of the deterrents, especially because different assessors will invariably apply the deterrents unevenly, thereby resulting in differential tax treatment of taxpayers in similar circumstances. It is difficult to argue with *Broomberg's* logic on this issue. The consequences of invoking the common law principles to disregard a concealed transaction differs from the consequences envisaged in the GAAR, albeit slightly. To have substantially the same requirements in order to obtain relief under either of the deterrents is therefore simply not tenable, as SARS would become entitled to elect the relief under either the common law or statute, depending on what would suit it best. This would not only be a harsh and unfair consequence, but invariably taxpayer equality would be negated through the differential treatment by the *fiscus*.

Secondly, the observation by the court in *CIR v King*²⁷² that it is unthinkable that a singular criterion of a tax avoidance purpose could render a transaction a nullity, as required by the old GAAR,²⁷³ is of relevance. Where a transaction completely lacks commercial substance, the purpose of the transaction would invariably be to avoid the imposition of a potential tax liability.²⁷⁴ As a result of the court's strict interpretation of the old GAAR, the legislature reviewed the provisions and eventually formulated it into the present GAAR. However, *NWK* seemingly returns to the position postulated in the old GAAR by re-introducing essentially the same independent requirement. The objections which were raised in the *King* case may therefore very well be relied on again by taxpayers when they are faced with assessments premised on the *NWK*

²⁷¹ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p201.

²⁷² 1947 (2) ALL SA 155 (A).

²⁷³ Sec 90 of the *Income Tax Act*, No 31 of 1941, postulated that the tax consequences of a transaction may be determined as if such transaction had not been entered into if the purpose with the transaction was to avoid the imposition of tax.

²⁷⁴ Broomberg SC (2011) *NWK and Founders Hill*. Cape Town: *The Taxpayer* (Vol 60) at p206.

decision.²⁷⁵ Moreover, the view that the SCA ventured into the sphere of the legislator by effectively re-introducing an outdated and abolished legislative requirement is affirmed.

In concluding, the doctrine of separation of powers is essential to avoid an overconcentration of powers in any single organ of state. It especially requires that the respective authorities should not lightly venture into the sphere of one another. To uphold the principles embodied in this doctrine is of immense importance to respect the independence of each of the authorities and to protect individuals against the arbitrary application of state powers.

The SCA, however, usurped the functions of the legislature for the reasons already advanced herein. On this basis alone, the correctness of the *NWK* decision is questionable and casts doubt on whether the commercial substance requirement is capable of independent operation, or at all. Even if the doctrine of separation of powers had been properly observed, the conflation of the respective deterrents against tax avoidance and the consequences which would ensue from it is simply not tenable. Whereas the established principles pertaining to simulated transactions were capable of co-existence with the statutory GAAR, it is submitted that the principle enunciated in *NWK* is not. The only inference to be drawn from this is that the *NWK* requirement cannot be regarded as an independent criterion to determine simulation.

4.7 CONCLUSION

The *NWK* requirement has been widely criticised for the undesired consequences and impracticalities it would occasion if it were to be regarded as an independent criterion to determine simulation. Admittedly, much of this criticism is attributable to the callousness of the SCA's introduction of a new test for simulation, rather than considering it against defensible legal principles in order to establish its true effect and its potential independence. The defensible arguments raised in this chapter support the view that the commercial substance requirement is incapable of application as the sole criterion to determine simulation. Not only does it disregard the established law on simulated transactions and important constitutional principles, it also lacks a common

²⁷⁵ *Ibid.*

law rule to give it any potential effect and it negates the test postulated in the GAAR. It is therefore submitted that the commercial substance requirement does not establish a satisfactory requirement if applied in isolation and cannot be regarded as the independent criterion to establish simulation.

CHAPTER 5: CONCLUSION

The judgment handed down by the SCA in *NWK* has not only solicited an outcry by the tax community and commentators, but has also left the judiciary to ponder about the approach which should be applied where reliance is placed on its judgment. This uncertainty is clear from the respective judgments by the High Court in the *Bosch* case.²⁷⁶ The majority of the court endeavoured to interpret the judgment to ensure that it is capable of application in conjunction with the established principles, yet it only applied the established test for simulation in that particular case by examining the actual rights created through the transaction, irrespective of commercial substance.²⁷⁷ Contrary hereto, the minority held that the transaction in question ought to be regarded as simulated premised on the arguments advanced by the court in *NWK*,²⁷⁸ yet it reasoned that it is not bound to the SCA's decision and concurred with the order made by the majority of the court that the transaction was not simulated.²⁷⁹

NWK has created legal uncertainty which is clearly not desirable. Fiscal certainty is a founding value of a good tax system, yet it stands threatened by the purported effect of the judgment. In a tax planning context, the fiscal uncertainty created through the judgment is compounded even further and is best emphasised as follows.²⁸⁰

It is sometimes possible for taxpayers to achieve the same economic effect in different ways, some of which are less susceptible to the vicissitudes of fiscal uncertainty than others; and in such cases the taxpayer's remedy lies in astutely navigating the sands of uncertainty in order to 'go home by another way'. But to be able to do this it is necessary to know the terrain, in order to arrive at a destination that is safe from unpleasant surprises.

²⁷⁶ *Bosch and Another v Commissioner for the South African Revenue Service* 2013 (5) SA 130 (WCC).

²⁷⁷ Para 93 of the majority judgment.

²⁷⁸ Para 5 of the minority judgment.

²⁷⁹ *Supra* at 4.4.4.

²⁸⁰ *Editorial Article* (2010) Coping with Fiscal Uncertainty. Cape Town: *The Taxpayer* (Vol 59)(No 1) p2.

Whereas the established principles drew clear lines within which a taxpayer could structure his affairs to minimise a potential tax liability, *NWK* has unfortunately gone a long way to erase it. In entering into a transaction through which a potential tax liability is avoided, should taxpayers now ensure that their transactions encompass commercial substance to satisfy the common law enquiry into it?

It is submitted that *NWK* has a less dramatic impact on simulated transactions than what appears to be the case. The requirement of commercial substance is not capable of functioning as an independent common law criterion to determine whether a transaction is simulated or not, premised on the following reasons:

- There exists no rule in our common law which authorises a court to disregard actual rights and obligations created between the parties to a transaction to nullify the beneficial tax consequences attached thereto.
- The introduction of the requirement flouts the doctrine of *stare decisis* whilst no rational motivation was advanced by the court why it was necessary to deviate from the established principles. The SCA's failure to observe this doctrine impedes the rule of law by virtue of the detrimental impact the requirement has on the predictability of the law.
- The portion of the SCA's judgment in which the requirement was introduced appears to be *obiter dicta* and should theoretically have no more than persuasive value.
- By inadvertently aligning the test and consequences under the common law for simulation with that under the GAAR for impermissible tax avoidance, the SCA usurped the functions of the legislator and transgressed the doctrine of separation of powers. Moreover, the respective tests are not capable of co-existence.

The established principles, as enunciated in *Zandberg's* case,²⁸¹ should therefore continue to prevail to determine whether a transaction is simulated or not. In my view, taxpayers should therefore ensure that their transactions satisfy the enquiry laid out in

²⁸¹ 1910 AD 302.

this case to avoid their transaction being found to be a simulation premised on the common law.

The final question to be determined is, failing its independent application, as what should the requirement then be regarded? Admittedly, the established principles cannot be regarded as an absolute remedy against simulation as these principles do not make provision for the situation where the parties conceal a transaction but truly give effect to the terms of their agreements in accordance with its tenor, as in *Furniss (Inspector of Taxes) v Dawson and related appeals*.²⁸² In this respect, *NWK's* value should not be summarily dismissed. A transaction's lack of commercial substance ought to be regarded as a strong indicator of the presence of potential simulation in the transaction, but no more than that. If a transaction has no commercial substance, a court should carefully establish the true intention of the parties and determine whether an element of concealment exists. However, insofar as the intention-test is satisfied by the taxpayer, the court's attention should be turned to the application of the GAAR as the final means to impose a tax on the transaction.

Did the SCA therefore renovate the established doctrine of substance over form through the introduction of an independent requirement to determine simulation? It is submitted that it did not.

²⁸² [1984] 1 All ER 530. This *lacuna* is duly pointed out in De Koker (2011) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.3, yet the author provides no suggestion on how this situation should be dealt with.

* **Word count: 26,991**

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