

**AN ANALYSIS OF THE EVOLUTION OF THE GENERAL ANTI-  
AVOIDANCE RULES AND THE SUBSTANCE OVER FORM  
DOCTRINE AND ITS EFFECTIVENESS TO COMBAT  
IMPERMISSIBLE TAX AVOIDANCE**

by

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## DISCLAIMER

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I, Lorika Anthea Tobias, hereby declare that this mini-dissertation is my own, unaided work. It is being submitted in partial fulfilment of the prerequisites for the degree of Master's in Mercantile Law at the University of Pretoria. I further confirm that my dissertation has not been submitted for any degree or examination at any other university.

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I hope that the research and conclusions drawn from the research can contribute positively to field of tax and help in providing analytical feedback re the development of our tax provisions.

## ABBREVIATIONS USED IN THIS DOCUMENT

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<b>TERM/CONCEPT</b>	<b>SHALL MEAN</b>
GAAR	General Anti-Avoidance Rules
The Income Tax Act	The Income Tax Act 58 of 1962
SARS	South African Revenue Service
SCA	Supreme Court of Appeal

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## ABSTRACT

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One of the most frequently quoted tax statements in articles and referred to by our judiciary must be that “*Every man has the right to arrange his affairs in such a manner to pay the least tax possible*”. However, every taxpayer, tax specialist and even SARS official should be aware that this right is limited.

Limited, in that this right does not allow the taxpayer to tread into the waters of tax evasion, meaning purposefully entering into impermissible tax avoidance arrangements to avoid paying any tax liability that they were liable for should the arrangement not have been entered into.

The content of this mini-dissertation is premised on researches which will primarily focus on two mechanisms which our law offers to detect impermissible tax avoidance arrangements and eliminate the effect thereof, namely the substance over form doctrine and the General Anti Avoidance Rules (hereinafter referred to as GAAR). More specifically, the development and the effectiveness of the substance over form doctrine as well as the GAAR.

What will be seen throughout the analysis of the research is that our judiciary, tax specialist and government has through research, amendments, judgments, analytical articles regarding specific areas of the principles underlying the concept of the GAAR and the substance over form doctrine, contributed to the development of both these concepts. These developments have been done to ensure that the principles contained in GAAR and the substance over form doctrine are equipped to detect impermissible tax avoidance arrangements entrenched in the more intricate arrangements that are being structured to avoid tax.

# Chapter 1: Background information

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## 1.1 General introduction and overview of literature

Impermissible tax avoidance is described as arrangements which manipulate loopholes in tax laws, resulting in minimal economic effect on the taxpayer while simultaneously negatively impacting on the government.<sup>1</sup>

Tax avoidance or rather impermissible tax avoidance has been an issue as early as 1930<sup>2</sup> and has since made its way into many conversations, journal articles, SARS publications and legislation.

The development of our economy has brought about the increase of tax liability on both residents and non-residents in the form of capital gains tax, dividends tax, tax on interest of 15% paid to a non-resident (effective 1 July 2013)<sup>3</sup> as well as the possibility of tax on trusts as mentioned in the budget speech of 2013.<sup>4</sup> The increase in tax liability and the current state of our economy may serve as motivation for certain taxpayers to seek ways in which to avoid paying taxes through impermissible tax avoidance schemes.<sup>5</sup>

Two measures are in place which assists our courts to detect impermissible tax avoidance schemes. Firstly, the substance over form doctrine comprising of the simulation principle and the label principle can be used as a first point of reference. This is a common law mechanism available to our judiciary and it is general practice of our courts to first apply the simulation principle before continuing to the label principle or GAAR.

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<sup>1</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005, p4. This is also confirmed in *Smith v CIR* 1964 1 SA (A) 333E-F, where the court held “*that the ordinary meaning of avoiding liability for a tax on income was to get out of the way or, escape or prevent an anticipated liability.*”

<sup>2</sup> *Duke of Westminster v Commissioners of Inland Revenue* [1936] AC 1.

<sup>3</sup> Haupt, P (2013) Notes on South African Income Tax. Thirty-second Edition. Republic of South Africa: H&H Publications.

<sup>4</sup> Radebe, K (2013) Newly proposed tax on trusts is meant to curtail tax avoidance. The Citizen, Citi Business. 25 March 2013.

<sup>5</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005, p8.



The GAAR is enshrined in section 80A-80L of Part II of the Income Tax Act 58 of 1962 (hereinafter referred to as the “Income Tax Act”) and provides an alternative mechanism for the courts to detect impermissible tax avoidance arrangements.

Hence, the question arises as to whether the GAAR as well as the substance over form doctrine have developed in such a way as to provide the South African Revenue Service (hereinafter referred to as “SARS”) with the necessary power to curb the tax avoidance schemes both in terms of domestic transactions as well as cross border transactions. And if not, should we be looking at further development of current tax legislation?

During the research process, a number of journal articles, internet articles, newspaper articles, case law and textbooks were reviewed. One recurring theme throughout the reviewed literature relates to impermissible tax avoidance schemes and whether the GAAR, given its development, has been a successful deterrent in combating impermissible tax avoidance schemes. Also, what has been scrutinised in the same light as the GAAR, is the substance over form doctrine due to the fact that both are used to curb tax avoidance. Once again, the importance of the effectiveness of both GAAR and the substance over form doctrine have to be emphasised, in that the tax paid by the taxpayers is the main source of revenue for the fiscus.<sup>6</sup> The fiscus needs the revenue to finance the social infrastructure and economic policies/programmes of the government.<sup>7</sup>

In this dissertation the development of both the GAAR and the substance over form doctrine is included. Firstly, a general overview as explained by Haupt<sup>8</sup> of the current provisions of GAAR and its impacts will be discussed. In analysing the previous GAAR principles, the SARS discussion paper in 2005<sup>9</sup> gave a brief history of GAAR, its development, the distinction between the different concepts used and the reason for the proposed amendments. The amended GAAR was analysed in more detail by

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<sup>6</sup> National Finance (unknown) available at <http://www.southafrica.co.za/about-south-africa/economy/national-finance/> (accessed on 30 April 2014).

<sup>7</sup> Croome, B (2013) The Administration Act and Taxpayers’ rights available at = <http://www.bericcroome.com/2013/02/the-tax-administration-act-and.html> (accessed on 30 April 2014).

<sup>8</sup> Haupt, P (2013) Notes on South African Income Tax. Thirty-second Edition. Republic of South Africa: H&H Publications.

<sup>9</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005.

Brincker<sup>10</sup> as he focussed on each section of the proposed GAAR in detail, incorporating the comments made by different tax scholars such as Mitchell, Meyerowitz and Broomborg with counter arguments by SARS. In addition, different journal articles were reviewed wherein the authors express a concern regarding the effectiveness of GAAR in light of the evolving technology and intricacy of schemes. These views are in direct contrast to other articles where the authors express the view that in comparison to other countries, GAAR has been effectively developed and the implementation of GAAR has deferred impermissible tax avoidance schemes.

The discussion regarding the substance over form doctrine will focus on case law and the different views expressed by our learned judges on the development of the substance over form doctrine, starting with *Zandberg v Van Zyl* 1910 AD 302 (hereinafter referred to as *Zandberg v Van Zyl*) in the 1920's up to and including the *Commissioner of South African Revenue Services v NWK Ltd* 2011(2) SA 67 (SCA ) (hereinafter referred to as "*NWK*")<sup>11</sup> case where the Supreme Court of Appeal (hereinafter referred to as the SCA) confirmed the focus of the doctrine, namely the substance and not the form. The latter judgment was criticised by Vorster<sup>12</sup> stating that the effect is that this renders the GAAR obsolete. On the other hand, Legwaila<sup>13</sup> criticises this statement by Vorster and counters it with the argument that even though the judgment in *NWK*<sup>14</sup> shifted the focus and is only applicable when certain requirements are met, this is irrelevant and does not affect the GAAR. Brincker expressed his view on the substance over form doctrine by stating that "a tenor of a transaction must be genuine before one can apply section 103(1) of the Act..."<sup>15</sup> in other words stating that you must ascertain what the transaction really is, before continuing onto GAAR.

The research will reveal a wide variety of information available in light of the research topic, which is mostly analytical in nature and provides different views on the

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<sup>10</sup> Brincker, TE (2004) *Taxation Principles of Interest and other Financing Transactions*. Lexisnexis.

<sup>11</sup> *NWK* 2011(2) SA 67 (SCA).

<sup>12</sup> Vorster, H (2011) *NWK* and purpose as a test for simulation. *The Taxpayer*, Volume 60, No 5, p83.

<sup>13</sup> Legwaila, T (2012) Modernising the 'substance over form' doctrine: *Commissioner for South African Revenue v NWK Ltd*: case comment. *SA Mercantile Law Journal*, Vol 24, Issue 1, p115.

<sup>14</sup> *Commissioner of South African Revenue Services v NWK Ltd* 2011(2) SA 67 (SCA).

<sup>15</sup> Brincker, TE (2004) *Taxation Principles of interest and other Financing Transactions*. Lexisnexis.

development of both the substance over form doctrine and the GAAR and its effectiveness in some instances.

### **1.2 Research question:**

The research question is whether the substance over form doctrine and the GAAR as per Part IIA of the Income Tax Act have developed sufficiently to effectively combat the effect of impermissible tax avoidance schemes?

### **1.3 Research aims and objectives:**

The research aims of the dissertation are as follows:

- to analyse the development of the substance over form doctrine;
- to analyse the development of the GAAR as per section 80A-80M of Part IIA of the Income Tax Act; and
- to assess whether the development of the GAAR and the substance over form doctrine is sufficient to curb the implementation or the benefit relating to more complex tax avoidance schemes being implemented due to the increase of tax liability.

### **1.4 Research Methodology:**

The research will be analytical in nature. In answering the research question an analysis of legislation, journal articles, case law will be done as well as its impact on the relevant principles and development thereof. Also, different views on the principles under discussion will be investigated and inferences drawn from all the information analysed.

### **1.5 Overview of chapters:**

Chapter 1 provides an overview of the background of the research question; it states the research question as well as the aims and objectives of the research.

Chapter 2 will analyse the doctrine of substance over form. This would entail looking at different case law illustrating the principle underlying the doctrine as well our judiciary's interpretation of the doctrine.

Chapter 3 will provide an analysis of the GAAR of the Income Tax Act. The chapter will initiate with a brief overview of the development of GAAR since its inception into the Income Tax Act. This will be followed by an analysis of various case law that made a significant impact on the application of GAAR and which led to the development of same in certain instances as well.

Chapter 4 concludes the dissertation, in that it summarises the conclusions reached in the different chapters and it provides concluding remarks on both GAAR and the substance of form doctrine and the effectiveness thereof.

## Chapter 2: Analysis of the substance over form doctrine

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### 2.1 Introduction

This chapter will primarily focus on the substance over form doctrine and its different elements namely, the simulation principle as well as the label principal. The focus will then shift to the development of the doctrine in light of the case law which reaffirmed the premise on which the doctrine was formed as well as case law which contributed to the development of the doctrine. The information provided through the analysis of the elements of the doctrine and the analysis of the case law will assist in reaching conclusions regarding the effectiveness of the doctrine to curb the implementation of impermissible tax avoidance schemes.

### 2.2 Analysis of the Simulation principle

The simulation principle refers to the situation where a taxpayer devises a scheme or enters into a transaction that is in *fraudem legis*.<sup>16</sup> It is further confirmed in the *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD547 (hereinafter referred to as *Dadoo*) case, that a simulated transaction is designedly disguised to escape the statute while actually falling within the provisions.<sup>17</sup> Thus, the parties entering into the simulated transaction do not intend it to have legal effect as per the form of the transaction.

The principle of simulation has been utilised by our courts over the years. As the tax schemes have evolved, the courts applied the principle more frequently to ascertain what the true intention of the parties are and to ensure that the substance is in line with the form of the transaction. In the *Ladysmith (Pty) Ltd v Commissioner for Inland Revenue* 1996(3) SA 942 (A) (hereinafter referred to as *Ladysmith*) case Hefer, JA confirmed that the parties did not discharge the burden of proof relating to whether or not the agreements reflected the true intentions of the parties and that was the end of

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<sup>16</sup> Legwaila, T (2012) Modernising the 'substance over form' doctrine: Commissioner for South African Revenue v NWK Ltd: case comment. SA Mercantile Law Journal, Vol 24, Issue 1, p115. "*In fraudem legis is a Latin term which means in fraud of law. It includes any act done with the fraudulent intention of evading law. Any act done in fraud of law is void and therefore not enforceable. A bankrupt who issues a negotiable instrument even after his bankruptcy is said to act in fraudem*", available at <http://definitions.uslegal.com/i/in-fraudem/>. (accessed on 30 April 2014).

<sup>17</sup> *Dadoo*, p547.

the investigation.<sup>18</sup> This principle of simulation as envisaged in the doctrine has been interpreted by the courts since as early as 1910.<sup>19</sup>

The principle of simulation in *NWK*<sup>20</sup> broadened the enquiry to determine whether a transaction is simulated. The SCA decided that the enquiry as to whether a transaction is simulated as part of the doctrine, should be extended to require an examination of the commercial sense of the transaction, its real substance and purpose.<sup>21</sup> Thus, the transaction will be regarded as a sham if lacking in commercial sense.<sup>22</sup> Barry is of the opinion that the judgment of the SCA in the *NWK* matter changed the application and focus of the doctrine.<sup>23</sup> However, Davis, J (with Baartman J concurring) in the *Bosch* case<sup>24</sup> is of the view that the court in the *NWK* case<sup>25</sup> ‘...merely required, as part of the inquiry into whether a simulated transaction is present, examination of the real commercial sense of the transaction.’<sup>26</sup> The statements made by the SCA in *NWK*, were clarified in *Roschen (Pty) Ltd v Anchor Body Builders CC* (49/13)[2014] All SA 654 (SCA) (hereinafter referred to as *Roschen (Pty) Ltd*).<sup>27</sup>

In light of the above mentioned and the analysis of the case law to follow, it is clear that the principle of simulation as an element of the doctrine has developed in our courts and assisted our courts over the years as a valuable tool in determining whether the substance of the transaction in question coincides with the form, keeping in mind that each taxpayer is allowed to arrange its affairs in such a manner as to pay the minimum amount of tax.<sup>28</sup>

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<sup>18</sup> Ladysmith, p24. For further reading see also Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA3.

<sup>19</sup> This is illustrated in the analysis of the case law in points 2.4.1 to 2.4.5 below.

<sup>20</sup> *NWK*, p67.

<sup>21</sup> *NWK*, p87. See also Legwaila, T (2012) Modernising the ‘substance over form’ doctrine: Commissioner for South African Revenue v *NWK* Ltd: case comment. SA Mercantile Law Journal, Vol 24, Issue 1. p120.

<sup>22</sup> Legwaila, T (2012) Modernising the ‘substance over form’ doctrine: Commissioner for South African Revenue v *NWK* Ltd: case comment. SA Mercantile Law Journal, Vol 24, Issue 1, p123.

<sup>23</sup> Ger, Barry (2013) High Court challenges SCA’s interpretation of simulated transactions De Rebus, Jan /Feb 2013, p43.

<sup>24</sup> *Bosch v Commissioner for South African Revenue Service* 75 SATC 1.

<sup>25</sup> *NWK*, p67.

<sup>26</sup> *Bosch v Commissioner for South African Revenue Service* 75 SATC 1. Ger, Barry (2013) High Court challenges SCA’s interpretation of simulated transactions De Rebus, Jan /Feb 2013.

<sup>27</sup> *Roschen (Pty) Ltd*, p662.

<sup>28</sup> *Duke of Westminster v Commissioner of Inland Revenue* [1936] AC 1.

### 2.3 Analysis of the Label principle:

The second principle applicable to the substance over form doctrine is the label principle. The label principle refers to a scenario where the parties act in good faith and intend to give effect to a certain transaction, but attach the wrong label to it.<sup>29</sup> In this circumstance the parties are not necessarily being dishonest in attaching the wrong label to the transaction.<sup>30</sup> The label principle only becomes relevant once it is found that the transaction is not simulated, the court will attach the correct label and then determine whether anti-avoidance legislation applies. The court in the *Commissioner for Inland Revenue v Conhage (Pty) Ltd 61 SATC* (hereinafter referred to as *Conhage (Pty) Ltd*)<sup>31</sup> illustrated that once the court has ascertained that there is no simulation, they will as an interim measure look at the label principle and thereafter only apply the anti-avoidance regulations.

In *Conhage (Pty) Ltd*, the respondents entered into four sale and lease back agreements in terms of manufacturing, plant and equipment. They thereafter sought to claim deductions for the rentals paid in terms of the said agreements. The Commissioner argued that the agreements were not what they purport to be due to the fact that they contain clauses which was not reflective of a sale and lease back agreement, but in fact a loan agreement.

In this case, Hefer, JA upon investigation of the purpose of the transactions, confirmed that the taxpayer had a dual purpose with the transactions of which the main or dominant purpose was to provide capital and secondly to do it in a tax efficient manner. The parties thus could have provided the capital in terms of a loan or a sale and leaseback, but chose the latter option, due to the fact that the taxpayer could obtain the capital in a more tax efficient manner. Hefer, JA further confirmed that the parties would not have entered into any transaction was it not for the taxpayer who needed the capital.<sup>32</sup>

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<sup>29</sup> Legwaila, T (2012) Modernising the 'substance over form' doctrine: Commissioner for South African Revenue v NWK Ltd: case comment. SA Mercantile Law Journal, Vol 24, Issue 1, p115.

<sup>30</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA3.

<sup>31</sup> *Conhage (Pty) Ltd*, p391.

<sup>32</sup> *Conhage (Pty) Ltd*, p398.

The court confirmed that the evidence indicated that the parties had every intention of entering into the transactions and the transactions made good business sense.<sup>33</sup> Thus, once the court determined that the transaction was not simulated the court went on to consider whether the correct label was attached to the agreement as such and subsequently, whether section 103 of the Income Tax Act (tax avoidance provision at that time) would apply. It was held that section 103 would not apply due to the fact that the dominant purpose of the transaction was to obtain financing for the taxpayer.<sup>34</sup> The *Conhage (Pty) Ltd*<sup>35</sup> case clearly illustrates when the label principle would be utilised and how it can assist the courts.

Thus, as stated earlier and confirmed with case law, the label principle and the relevant anti-avoidance provisions will only come into effect once it is evident that it is not a simulated transaction.

## **2.4 Analysis of case law pertaining to the development of substance over form doctrine**

### **2.4.1 *Zandberg v Van Zyl***

Firstly, this matter is not a tax matter, however is significant for tax purposes in that it illustrates that our courts does not need any legislative powers to enquire into the true nature of a transaction.<sup>36</sup>

This is an appeal from the lower court in which the question before the court was whether the transaction was in fact a sale or a pledge.

Mrs. Van Zyl was indebted to Zandberg and in collecting the debt Zandberg attached a certain wagon which he believed belonged to Mrs. Van Zyl. However, it transpired that the owner of the wagon was in fact a Mr. Van Zyl (the respondent herein and Mrs. van Zyl's son in law).

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<sup>33</sup> *Conhage (Pty) Ltd*, p396.

<sup>34</sup> *Conhage (Pty) Ltd*, p398.

<sup>35</sup> *Conhage (Pty) Ltd*, p391.

<sup>36</sup> PricewaterhouseCoopers(2009) "Disguised" or simulated "transaction", July 2009, available at [https://www.saica.co.za/integritax/2009/1743\\_Disguised\\_or\\_simulated\\_transaction.htm](https://www.saica.co.za/integritax/2009/1743_Disguised_or_simulated_transaction.htm) (accessed on 2 May 2014).



Mrs. Van Zyl paid for her debt of 50 pounds owed to the respondent by transferring ownership of the wagon to the respondent. The terms of the sale were as follows:

- The wagon would remain with Mrs. Van Zyl, and stand next to her tent to shield her from the weather.<sup>37</sup>
- Mrs. Van Zyl can at any time re-purchase the wagon.<sup>38</sup>
- The respondent must return the wagon to Mrs. Van Zyl once he is finished using the wagon.<sup>39</sup>
- Mrs. Van Zyl could use the wagon whenever she felt like it.<sup>40</sup>

The question before the court of appeal was, whether the Magistrate in the court *a quo* was correct in determining that the transaction was a sale? Thus, the enquiry before the court was what was the true nature of the transaction between the respondent and his mother in law?

Three separate judgments were delivered by De Villiers, C.J; Innes, J and Solomon, J. Innes, J stated that:

*'...Now as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavor 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. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur. But the words of the rule indicate its limitations. The Court must be satisfied that there is real intention, definitely ascertainable, which differs from simulated intention. For if the parties in fact mean to 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*

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<sup>37</sup> Zandberg v Van Zyl, p311.

<sup>38</sup> *Ibid.*

<sup>39</sup> Zandberg v Van Zyl, p312.

<sup>40</sup> *Ibid.*

*make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.*<sup>41</sup>

All three judges, in their respective judgments, confirmed that even though preceding case law is a good indication of how to deal with this type of enquiry no matter is exactly alike and each case must be decided on the facts. The court confirmed that the onus was on the respondent to prove that the transaction was in fact a sale. However, to prove same the only witness that was called was the respondent himself, and his testimony was not enough to discharge the onus of proof on him.<sup>42</sup>

The court focused on the terms of the agreement, more particularly the fact that the mother in law had unrestricted use of the wagon, could re-purchase the wagon at any time and the fact that Mr. Van Zyl had to return the wagon once he is done using the wagon for whatever purpose. The terms placed limitations on the ownership of the respondent and indicated that the true nature of the transaction is not a sale but in fact a pledge.<sup>43</sup> Based on the facts of this matter at hand that the appeal was upheld.

*Zandberg v Van Zyl* laid down a good basis in terms of the implementation of the substance over form doctrine and emphasized that the enquiry into the true nature of a transaction is a question of fact.<sup>44</sup>

#### **2.4.2 *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369**

This is an appeal from the Natal Provincial Division for customs duty claimed to be payable in respect of goods which have from time to time been cleared from the defendant's bonded warehouse under rebate of duty.<sup>45</sup> The majority of the court confirmed the judgment of the court *a quo* and dismissed the appeal.

The facts of the matter can be summarised as follows: The relevant customs and excise duties which form the basis of the dispute are the regulations in force since July

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<sup>41</sup> *Zandberg v Van Zyl*, p309.

<sup>42</sup> *Zandberg v Van Zyl*, p311.

<sup>43</sup> *Zandberg v Van Zyl*, p312.

<sup>44</sup> 1910 AD 302. This was also confirmed in *Roschen (Pty) Ltd*.

<sup>45</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369.

1934. These regulations allows for a rebate in terms of cotton and woolen piece goods, buttons, women labels, tabs etc. for the intended use in the shirt, collar and pajama suit manufacturing industry. The regulations further permitted registered persons other than manufacturers to import goods for the purpose of having such goods manufactured for them into garments by registered manufacturers.<sup>46</sup>

The said regulations were amended in 1936, so that the registered importers were out and out registered manufacturers had to import their material or acquire their material locally in bond. The defendants under the old rules were registered importers and have employed the services of manufacturers to make them garments. They changed their procedure after the implementation of the new rules. However, prior to changing their procedure, they wrote to the collector of customs and ascertained clarity as per the new regulations and how they should be doing business to ensure that they were will be compliant.<sup>47</sup> This letter was followed by a number of interviews for similar purpose.

In terms of the new procedure, the defendant decided that it would sell to different manufactures material and subsequently the manufacturers would sell the garments back to the defendants.<sup>48</sup> In terms of this procedure, the prices of the material sold was fixed at cost price; the price was not paid until delivery of the garments by the manufacturers and the cost was paid off by set-off and lastly the price of the garments to be made out of the material was to be determined on the basis of the cost of material plus cost of making.

It was this procedure adopted by the defendant that was challenged in the Natal Provincial Division. The trial judge confirmed that the transactions were both in substance and form sales and the *dominium* in the material had passed to the manufacturers.<sup>49</sup> The trial judge further confirmed that based on the evidence and the witnesses, that the transactions were wholly legitimate. The plaintiff appealed against this decision of the trial judge on the basis that ownership never passed to the manufacturers in terms of the transactions and thus the defendant was thus liable to pay the full duty.<sup>50</sup>

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<sup>46</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD, p377.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

<sup>49</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD, p379.

<sup>50</sup> *Ibid.*

Watermeyer, JA outlined the applicable legal principles in determining whether ownership did in fact pass or not. In doing this, the court had to look at the true nature of the transactions and the court confirmed that the true nature of a transaction is sometimes difficult to ascertain as the parties conceal the true nature of the transaction.<sup>51</sup> Watermeyer, JA went on to refer to *Zandberg v Van Zyl* where Innes J confirmed that the court must, based on the facts of a particular matter, give effect to the true nature of a transaction. Thus, the court must give effect to the real intention of the parties.

Watermeyer, JA pointed out that based on the above interpretation, a disguised transaction is a dishonest transaction, dishonest in the sense that the parties to it do not really intend it to have any legal effect.<sup>52</sup> Furthermore, for there to be a dishonest agreement there must be some kind of tacit agreement or underlying understanding between the parties and if there is no such underlying agreement there cannot be a dishonest agreement.<sup>53</sup>

The court confirmed that during the transactions between the defendant and the manufacturers, based on the facts, ownership of the material was transferred. Watermeyer, JA then drew a distinction between the facts of the matter at hand and the facts of the *Zandberg v Van Zyl* case.<sup>54</sup> In the latter case the court held that possession raises a presumption of ownership, Watermeyer, JA then confirmed that the fact the material changed possession to the manufacturers meant that ownership transferred to the manufacturers.<sup>55</sup>

Furthermore, the grounds on which the court in *Zandberg v Van Zyl* relied on to indicate that the contract was a pretense was not present in the current matter. The court went on to confirm that the transactions were sales and legitimate as the defendants delivered the goods with the intention of passing ownership. The majority of the court agreed with the judge.

The minority judgment is interesting because, De Wet, CJ and Tindall, JA looked at what was done and not said. They confirmed that the parties could not have intended

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<sup>51</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD, p394.

<sup>52</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 396.

<sup>53</sup> *Ibid.*

<sup>54</sup> 1910 AD 302.

<sup>55</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD, p396.

sales, in light of the facts indicating that the manufacturers acquired the right devoid of content.<sup>56</sup> The minority judgment was followed in case law such as *Vasco Dry Cleaners v Twycross*<sup>57</sup> and *Skjelbreds A/S and Others v Hartless*.<sup>58</sup>

#### **2.4.3 *Ladysmith (Pty) Ltd v Commissioner for Inland Revenue (1996) (3) SA 942 (A)***

This is an appeal against the decision of the Special Tax Court, upholding two additional assessments for normal and additional tax issued by the respondent (hereinafter referred to as the commissioner) during the 1990 year of assessment, for the alleged omission of income.<sup>59</sup>

In 1983, Pioneer Seed Company (Pty) Ltd (hereinafter referred to as Pioneer) and its subsidiary Pioneer Seed Holdings (Pty) Ltd (hereinafter referred to as Holdings) decided to establish a furniture factory in Ladysmith. Subsequent to this decision, on an undisclosed date Holdings decided to purchase the total shareholding of ERF 31383 /1 Ladysmith (Pty) Ltd and Rem 3186 Ladysmith (Pty) Ltd, the appellants herein. The appellants owned the stands on which Holdings wanted to erect the operations.

On 27 March 1984, 8 agreements were entered into, for both the 1<sup>st</sup> and 2<sup>nd</sup> appellant simultaneously, 4 respectively. The agreements were exactly the same and signed by the same person/director of the relevant entities for all parties involved. The first agreement was a lease in terms of which the appellants respectively would lease their stands to a third party, namely the board of executors pension fund (hereinafter referred to as the Fund) for the period of 1 April 1984 to 31 July 1991. The main clause in the lease stated that the lessee is allowed to build buildings or make improvements to the property leased and all buildings or improvements to the land shall become the property of the lessor.

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<sup>56</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD, p394. The court specifically looked at the fact that the manufacturers had no obligation to repay, no risk passed to the manufacturers and the manufacturers could not alienate the goods.

<sup>57</sup> 1979 (1) SA 603 (A), p332.

<sup>58</sup> 1982(2) SA 710 (A), p773B-E, p736A-C.

<sup>59</sup> *Ladysmith*, p2.

The second agreement entered into was a sub-lease in terms of which the Fund sub-leased the land to Pioneer for the period 1 August 1984 to 31 July 1991. In terms of the sub-lease, Pioneer will pay the Fund a premium to erect buildings on the land. The agreement further stipulates that the Fund will be discharged from paying rent for the period of 1 April 1984 until 31 July 1984 in terms of the main lease agreement, basically until the implementation of the sub-lease.

Prior to the agreements being entered into the parties to the agreements obtained advice from a tax expert and banker as to what would be the best option for them.

The issue before the Special Tax Court and the court of appeal was, whether paragraph (h) of the definition of gross income is applicable.<sup>60</sup>

The appellant's argument was premised on the principle that *'every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be'*<sup>61</sup> The commissioner argued that the agreements do not reflect the true intention of the parties, because the entire purpose of the transaction was to evade tax.

Therefore, the arguments were mainly based on two principles. One being the principle illustrated in *The Commissioner of Inland Revenue v The Duke of Westminster* 1936 AC 1 19.<sup>62</sup> The second principle, as confirmed in *Killburn*,<sup>63</sup> is that the court will examine the facts or details of a transaction to determine the true nature and substance of the transaction and not only look at the form. Hefer, JA went on to consider whether both principles can be used in the same matter and confirmed that even though it is a contentious issue in the English courts, South Africa has adopted the approach to look at the substance of a transaction rather than its form. This was confirmed in the *Dadoo* matter.<sup>64</sup> Thus, the court concluded that as long as the two principles are used within their bounds, they do not conflict. Hefer, JA further pointed out that *"the court only becomes concerned with the substance of a transaction once a party has succeeded in avoiding the application of a statute by an effective*

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<sup>60</sup> *Ladysmith*, p13. Paragraph (h) of the definition of "gross income" Income Tax Act referred to the accrual of a right to have improvements effected.

<sup>61</sup> *The Commissioner of Inland Revenue v The Duke of Westminster* 1936 AC 1 19. Thereafter quoted in *Ladysmith*, p12.

<sup>62</sup> As explained above.

<sup>63</sup> 1931 AD 501, p507.

<sup>64</sup> *Ladysmith*, p19.

*arrangement of his affairs, thus applied the two principles do not conflict*".<sup>65</sup> The court will thus rend aside the corporate veil to ascertain the true substance and nature of the transaction.

Hefer, JA went on to make reference to what he referred to as the *locus classicus* of simulated transactions, being the judgment of Innes, J in *Zandberg v van Zyl* where Innes, J,<sup>66</sup> confirmed that the inquiry is, what was the real intention of the parties? The judge further confirmed that the manner in which the taxpayer structures its transaction will not be invalid, just because there is an alternative way of receiving the same result that the taxpayer could have followed. The important thing is that one must look at the facts of each case to ascertain the true intention of the parties or taxpayer.<sup>67</sup>

The court in the *Randles* case<sup>68</sup> contributed to the statements made in *Zandberg v Van Zyl*<sup>69</sup> by stating that there are basically two things that need to happen. Firstly, the court must ascertain whether the parties intend that the transaction should have effect according to its tenor and secondly, if given its effect as contemplated by the parties, it falls within or outside the prohibition.<sup>70</sup>

Hefer JA further pointed out that a disguised transaction is in fact a dishonest transaction, where the parties involved does not intend for it to have the legal effect as which its terms convey to the outside world. Thus, there is another underlying agreement that the disguise is concealing. Furthermore, the court must be satisfied that there was in fact an underlying agreement that the parties want to conceal.<sup>71</sup>

Hefer JA, upon scrutiny of the facts and agreements, found that there was a real likelihood that there was an underlying agreement between the parties. The judge was of the opinion that the evidence does not exclude what is thus a real likelihood that the written agreements do not reflect the true or full intention of the parties. Therefore, the appellants did not discharge the onus on them to show that a right to have improvements effected did not accrue to them in terms of paragraph (h) of the definition

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<sup>65</sup> *Ibid.*

<sup>66</sup> As stated earlier in point 2.4.1.

<sup>67</sup> *Ladysmith*, p20.

<sup>68</sup> 1941 AD 369.

<sup>69</sup> 1910 AD 301.

<sup>70</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369, p 395-396.

<sup>71</sup> *Ladysmith*, p23.

of “gross income”. Consequently, the appeal was dismissed with costs of the two counsels.

Even though the type of arrangement illustrated above, has been countered with amendments of the legislation subsequent to the matter, the case is still of importance in that it confirmed the approach followed in *the Randles case*.<sup>72</sup> In the latter matter the courts made it clear that they would only give effect to the agreements if that is in line with the intention of the parties involved.<sup>73</sup>

#### **2.4.4 CSARS v Cape Consumers (Pty)Ltd 1999 (61) SATC 91**

This is an appeal from the Cape Income Tax Court where the Commissioner of Inland Revenue (hereinafter referred to as the appellant) was aggrieved by the lower court’s decision.

Cape Consumers Pty Ltd (hereinafter referred to as the respondent) traded as a mutual buying organisation and during the years of assessment under question received discounts as well as invested monies on behalf of their clients in a reserve fund. The appellant contends/contended that these monies received should be included in the gross income of the respondent.<sup>74</sup>

The respondent entered into numerous agreements with its clients in terms of which at all times any monies received by the respondent were received on behalf of the clients and not for the benefit of the respondent.<sup>75</sup> The particular clause in the agreement on which the respondent relied in this respect was clause 2 of the memorandum of incorporation which stated that ‘... to carry on and conduct the business of a buy-aid for and on behalf of Buyers and accordingly to assist the said Buyers to effect economies and savings in regard to the expenditure by them on their requirements...’<sup>76</sup> The clause 85bis of the articles of association had the following clause ‘...the Buyers Reserve

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<sup>72</sup> *The Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369. For further reading see Davis, D (1997) Reflections on the *Ladysmith* Case. February 1997, Volume 56, p23.

<sup>73</sup> *Ibid.* For further detail see paragraph 2.4.2 above.

<sup>74</sup> *CSARS v Cape Consumers (Pty) Ltd* 1999 (61) SATC 91, p93.

<sup>75</sup> *Ibid.*

<sup>76</sup> *CSARS v Cape Consumers (Pty) Ltd* 1999 (61) SATC 91, p95.



*Fund shall be created and administered for and on behalf of Buyers and shall consist of the amounts credited to it from time to time ...*<sup>77</sup>

The issue before the court was whether the amounts received by the respondent were to be included in its gross income.<sup>78</sup> The appellant's argument was that the amounts received and invested in the reserve fund should be included in the respondent's gross income and based this on the argument that the transaction entered into between the parties was disguised transaction. The appellant relied on the *Ladysmith* matter.<sup>79</sup>

On analysis of the facts Davis, J drew a number of conclusions. Firstly, that the argument presented by the appellant implies that the provisions of the articles of the association must give way to the reality that the respondent traded for its own account. Davis, J continued to confirm that the court must look at whether the parties intended the agreements to have legal effect.<sup>80</sup> If the answer is in the negative, then the court must give effect to what the transaction really is.<sup>81</sup>

In light of this Davis, J.A confirmed that the true nature of the various agreements must be examined to determine the true nature accruing in terms of the agreements. Therefore based on the evidence and the different agreements the court held that the both the respondent and the buyers intended that the relevant agreements between the parties must be given effect according to their tenor.

Lastly and most importantly, the court confirmed that the doctrine of disguised transaction is not a panacea for the appellant to ignore agreements where the parties in fact and law intend that the must be given their legal effect.<sup>82</sup>

The appeal was dismissed and this decision was concurred by Van Reenen, J and Van Heerden, JA.

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<sup>77</sup> *CSARS v Cape Consumers (Pty) Ltd* 1999 (61) SATC 91, p97.

<sup>78</sup> There was also a VAT appeal involved however that is not of importance in this discussion.

<sup>79</sup> Please see discussion of the case under point 2.4.3 above.

<sup>80</sup> This was also confirmed in the *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369. 1941 AD 369 and the *Ladysmith* case.

<sup>81</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369.

<sup>82</sup> *CSARS v Cape Consumers (Pty) Ltd* 1999 (61) SATC 91.

#### 2.4.5 *Commissioner of South African Revenue Service v NWK Ltd 2011 (2) SA 67 (SCA)*

This is an appeal from the Tax Court who found in favor of the taxpayer. The facts are as follows: During the year of assessment in question, a number of transactions were entered into in terms of which the taxpayer claimed certain deductions in terms of interest on loans. The commissioner allowed these deductions at first. However, the commissioner issued revised assessments at a later stage on the basis that the transactions were simulated.<sup>83</sup>

The just of the transactions entered into between the parties were as follows:

- A subsidiary of First National Bank (FNB) that dealt in financial instruments, Slab, would lend a sum of R96 415 776 to NWK, to be repaid over five years.<sup>84</sup>
- The capital amount would be repaid by NWK delivering to Slab, at the end of the five year period, 109 315 tons of maize.<sup>85</sup>
- Interest would be payable on the capital sum at a fixed rate of 15, 41% per annum, payable every six months. To this end NWK would issue ten promissory notes with a total value of R74 686 861.<sup>86</sup>
- To fund the loan Slab would discount the notes to FNB. NWK, on the due date would pay FNB.<sup>87</sup>
- Slab would sell its rights to the First Derivatives, a division of FNB to take delivery of the same quantity of maize for the sum of R46 415 776, payable immediately on the conclusion of the contract, but delivery to take place only five years hence. The contract would neutralise the risk associated with delivery in future.<sup>88</sup>
- First Derivatives would sell to NWK the right to take delivery of the same quantity of maize for the sum of R46 415 776, payable immediately on the conclusion of the contract, but delivery to take place only five years hence. This contract would neutralize the risks associated with delivery in the future.

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<sup>83</sup> *NWK Ltd*, p70.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*

<sup>86</sup> *Ibid.*

<sup>87</sup> *Ibid.*

<sup>88</sup> *Ibid.*

- NWK and Slab would cede their respective rights to the delivery of the Maize to FNB.<sup>89</sup>
- Slab would cede its right to a trust company to relieve Slab of the administrative burden of the transaction. (This transaction never materialized).<sup>90</sup>

Prior to the series of transactions, FNB afforded NWK two bank facilities of R50 million for five years and NWK would be precluded from lending from another bank without FNB's consent. The offer was accepted by NWK the same day as the other loan agreements.<sup>91</sup> In addition and on the same day as the loan transaction, NWK also accepted a short term loan in the amount of R50 million from FNB. The commissioner's main argument on appeal, was that the transactions were simulated and that they were entered solely for the purpose to evade taxes and in the alternative the commissioner was of the view that section 103(1) was applicable due to the fact that the transactions were entered into to avoid tax.

Lewis, JA investigated the notion of simulation and unpacked the different case law providing precedence and guidance in the matter. Firstly, the court referred to the *Ladysmith* case in which it was said that there must be distinguished between the two principles namely where the taxpayer is allowed to arrange its affairs in the manner which it wants to and the principle that the court will not be misled by the form of a transaction, it will rend aside the corporate veil to look at the true nature and substance of the transaction.<sup>92</sup>

The court also confirmed that in *Zandberg v Van Zyl*<sup>93</sup> it was held that in certain instances parties disguise the true nature of a transaction. Thus, the court must first ascertain what the real transaction is and give effect to the rights under the real transaction.<sup>94</sup>

It then proceeded to re-iterate the fact that Watermeyer, JA in the *Randles* case,<sup>95</sup> confirmed that just because a transaction is executed in such a way to evade tax, does

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<sup>89</sup> *Ibid.*

<sup>90</sup> *Ibid.*

<sup>91</sup> *NWK Ltd*, p71.

<sup>92</sup> *Ladysmith*, p19.

<sup>93</sup> 1920 AD 302.

<sup>94</sup> *NWK Ltd*, p77.

<sup>95</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369.

not mean it is a disguised transaction. The court must first decide on the facts of a particular matter what the taxpayer's intention was and whether the transaction reflects that intention.<sup>96</sup>

Lewis, JA confirmed that throughout the case law the courts do not approach the notion as to what is really meant with a party's intention in concluding a contract, consistently. This is specifically seen in the minority and majority judgment of the *Randles* case.<sup>97</sup> In the minority judgment in the latter case De Wet, CJ and Tindall, JA, preferred to look at the substance of what was done. This view expressed in the minority judgment was followed in a number of cases subsequent to the decision.<sup>98</sup>

However, Lewis, JA went on to confirm that in addition to the above principles, the more relevant factor to look at is whether the transactions made commercial sense. Thus, to determine whether the loan and other transactions were simulated the court had to ascertain whether was a real and sensible commercial purpose in the transaction other than the opportunity to claim deductions of interest from income tax on a capital amount greater than R50 million?<sup>99</sup> The court could not find, based on the evidence, any commercial purpose for the loan and other transactions other than the fact that NWK wanted a tax advantage.

This case added a different dimension to the doctrine in extending to ascertain whether there was any commercial sense in the transactions at hand. This extension of the doctrine as per *NWK Ltd*<sup>100</sup> was subsequently applied in Tax Court (WCC) 12760, 12828, 12756 (14 Sept). The latter matter turned around the tax consequences of the deferred delivery share incentive schemes. In such schemes, almost immediately after the option to take up the shares is granted to the employee, the employee would exercise the option, thereby eliminating any gain in the value in of the shares in terms of section 8A of the Income Tax Act. It was assumed that the tax event (which gave rise to the tax liability) occurred when the option was exercised by the employee and not on the actual delivery of the shares. The question the court had to answer was,

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<sup>96</sup> *NWK Ltd*, p78.

<sup>97</sup> *Ibid.*

<sup>98</sup> *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A); *Skjelbreds Rederi A/S and Others v Hartless (Pty) Ltd* 1982 (2) SA 710 (A).

<sup>99</sup> *NWK Ltd*, p87.

<sup>100</sup> *NWK Ltd*, p67.

when did the employee unconditionally purchase the shares?<sup>101</sup> The court turned to the principles applied in *NWK*, that a transactions must be of substance being, specifically commercial reason.<sup>102</sup> Hence the court concluded that looking at the true substance of the agreement, the purchase of the shares is only on the delivery of the shares. Thus, the shares are purchased conditionally and only becomes unconditional on delivery of the shares.<sup>103</sup>

Legwaila confirmed that *NWK Ltd*<sup>104</sup> modernized the doctrine and enables it to deal with more developed and complex tax structures.<sup>105</sup> However, the SCA clarified or cleared up the misconception that the court extended or changed the simulation principles, in the *Roschen (Pty) Ltd*.<sup>106</sup>

To explain briefly, *Roschen* is not a tax matter and the concerned supplier and floor plan agreements reserving ownership to finance house as security over the trucks before they were fully paid for by the purchaser.<sup>107</sup> The appellant failed to provide evidence that there was some type of underlying agreement between the respondents and the appeal was dismissed. Wallis, J in his concurring judgment went on to clarify the SCA's previous statements in *NWK Ltd*.<sup>108</sup> He confirmed that the statements made in *NWK Ltd* should be read within the context of the facts of the case and the court only extended the simulation principle to look at the commercial purpose of the transaction, because in this instance the parties actually intended to give effect to the provisions of the simulated transaction.<sup>109</sup> Furthermore, the SCA confirmed that the principles as laid down in fundamental case law such as *Zanberg v Van Zyl*,<sup>110</sup> *Conhage*,<sup>111</sup> *Dadoo*,<sup>112</sup> and *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd*<sup>113</sup> remains relevant and the enquiry into the commercial purpose would only be done as

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<sup>101</sup> Tax Court (WCC) 12760, 12828, 12756 (14 Sept), p 99.

<sup>102</sup> Tax Court (WCC) 12760, 12828, 12756 (14 Sept), p103.

<sup>103</sup> Tax Court (WCC) 12760, 12828, 12756 (14 Sept), p105.

<sup>104</sup> *Ibid*.

<sup>105</sup> Legwaila, T (2012) Modernising the 'substance over form' doctrine: Commissioner for South African Revenue v *NWK Ltd*: case comment. SA Mercantile Law Journal, Vol 24, Issue 1, p126.

<sup>106</sup> *Roschen (Pty) Ltd*, p14.

<sup>107</sup> *Roschen (Pty) Ltd*, p2.

<sup>108</sup> *Roschen (Pty) Ltd*, p14.

<sup>109</sup> *Roschen (Pty) Ltd*, p20.

<sup>110</sup> 1910 AD 302.

<sup>111</sup> 1920 AD 530.

<sup>112</sup> 61 SATC 391.

<sup>113</sup> 1941 AD 369.

an additional measure depending on the facts of the matter.<sup>114</sup> The court in the Roschen (Pty) Ltd matter confirmed that NWK did not bring about a new test, however just indicated another factor to take into account, namely commercial purpose.<sup>115</sup>

The court then proceeded to re-affirm that the position remains that the court should take into account the transaction as a whole, all the circumstances of a transaction as well as any unusual features of a transaction when ascertaining whether a transaction is simulated or not.<sup>116</sup>

## 2.5 Analysis of the effectiveness of the substance over form doctrine

Whether or not the substance over form doctrine is effective in determining if a transaction is simulated or not can be seen in various judgments where the court made use of the substance over form doctrine.

In 1997 in the matter of *the Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd*<sup>117</sup> the SCA held that the right to use interest-free loans had an ascertainable money value and thus, should be included in the income of the taxpayer and this decision was based on the substance over form principle.<sup>118</sup> In this matter the occupier entered into standard agreements which stipulated that the interest free loans were consideration for the life rights, however the evidence revealed that the interest free loans were in fact utilized by the companies as a source of financing for the development of the unites and nothing was invested in income earning investments . The repayment of the loan was in turn financed by the granting of a new loan and the intention of the companies was ultimately to sell at a profit.<sup>119</sup> Thus, looking at the substance of the transaction, the right to use the interest free loans

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<sup>114</sup> *Roschen (Pty) Ltd*, p19. See also ENSafrica (2014) Simulated transactions: welcome clarification from the Supreme Court of Appeal, 14 April 2014, available at <http://www.lexology.com/library/detail>. (accessed on 30 April 2014) where the writer of the article concluded that with Wallis, J in *Roschen (Pty) Ltd*, clarifying the comments in *NWK Ltd*, it is clear that the principle of simulation still requires an element of dishonesty.

<sup>115</sup> *Roschen (Pty) Ltd*, p22.

<sup>116</sup> *Ibid.*

<sup>117</sup> 69 SATC 205.

<sup>118</sup> *The Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 69 SATC 205. Also see Kadar, N (2011) Substance Over Form Nothing New. 6 May 2011, available at <http://www.thesait.org.za/news/96632/Substance-Over-Form-Nothing-New.htm#> (accessed 4 March 2014).

<sup>119</sup> *The Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 69 SATC 205, p206.

constituted income in the hands of the Brummeria Renaissance (Pty) Ltd with a money value and thus should be included in the “gross income” of the company.<sup>120</sup>

However, Olivier warns that the principles of substance over form as applied in the *Ladysmith* matter does not mean that the principle will be successful in countering all impermissible tax avoidance arrangements and one have to be aware of the principle as illustrated in *Duke of Westminster* case,<sup>121</sup> that the taxpayer is free to arrange his affairs to pay the least amount of tax.<sup>122</sup> Also, SARS attempted, without success, to use the principle of substance over form subsequent to the *Ladysmith* matter, due to the reason that SARS mistakenly thought to believe that legal substance is equivalent to economic substance.<sup>123</sup>

The fact that our learned judges continues to utilise the doctrine consistently<sup>124</sup> is an indication that our courts have seen success in ascertaining the true nature/substance of the transactions in the implementation of the doctrine. The members of judiciary have interpreted it in different ways as illustrated in the minority and majority judgments of the *Randles* case<sup>125</sup> and the doctrine has not remained without change as illustrated with the *NWK Ltd* case<sup>126</sup> where the court extended the enquiry focus to look at the commercial purpose of a transaction.<sup>127</sup>

The fact that our courts have continuously applied the doctrine in ascertaining the true intention of parties where there is a probability that the parties have created a simulated transaction so as to obtain an undue tax advantage is an indication that there must be merit in the application of the doctrine. Thus, with the evolving of the

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<sup>120</sup> *The Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 69 SATC 205, p208.

<sup>121</sup> *Duke of Westminster v Commissioners of Inland Revenue* [1936] AC 1.

<sup>122</sup> Olivier, L. (1996) *Tax Avoidance and Common Law Principles*, Tydskrif vir Suid- Afrikaanse Reg. p378.

<sup>123</sup> *ITC 1833*[2008]; 70 SATC 238, See also PricewaterhouseCoopers(2009) “Disguised” or simulated “transaction”, July 2009, available at [https://www.saica.co.za/integritax/2009/1743\\_Disguised\\_or\\_simulated\\_transaction.htm](https://www.saica.co.za/integritax/2009/1743_Disguised_or_simulated_transaction.htm) (accessed on 2 May 2014) where the writer explained the difference between economic substance and legal substance. The writer confirmed that “...in the former the economic effect is crystallised by reference to the receipt and payment of cash, whereas in the latter, the law looks to the rights and obligations created, and whether these were intended by the parties in entering into and carrying out their transaction.”.

<sup>124</sup> As was illustrated in the analysis of the case law in clause 2.4.

<sup>125</sup> *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369.

<sup>126</sup> *NWK Ltd*, p67.

<sup>127</sup> *Ibid.*

impermissible tax avoidance schemes our courts are also developing the doctrine to ensure that it remains effective.

## 2.6 Conclusion

What stems from the above analysis of the doctrine is that it is a measure that has been implemented with success which does not impugn on the principle that a taxpayer is allowed to arrange his affairs in the most tax efficient manner. Also, the courts have actively ensured that the doctrine is developed/extended and scrutinised to develop with the development of the schemes as illustrated in the *NWK Ltd*<sup>128</sup> matter. It is clear that the doctrine of substance over form is an integral part of our law which provides an alternative mechanism to our courts to ascertain the true intention of parties in the transactions under scrutiny.

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<sup>128</sup> *Ibid.*



## Chapter 3: Analysis of the General Anti-Avoidance Rules of the Income Tax Act 58 of 1962

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### 3.1 Introduction: the development of GAAR

The main purpose of GAAR is to protect the tax base and to ensure that taxpayers comply with their tax liability. Therefore, taxpayers will not be allowed to evade their tax liability through impermissible tax avoidance schemes.<sup>129</sup>

GAAR was first introduced in South Africa in terms of section 90 of the Income Tax Act of 1941. GAAR at that point consisted of three elements namely, (i) a transaction, (ii) carried out for the purpose of avoiding or (iii) reducing liability for tax.<sup>130</sup> Since its inception in 1941,<sup>131</sup> GAAR has been developed numerous times, whether in part or in whole.

Firstly, GAAR was expanded to four elements and these elements were (i) a transaction, operation or scheme, (ii) which is abnormal, (iii) that has the effect of avoiding or reducing tax liability and (iv) of which the sole or one of the main purposes is obtaining a tax liability.<sup>132</sup> This expansion was followed by various amendments to different elements of the test. In 1978 and in 1996 the purpose and abnormality requirements were amended.

GAAR then became entrenched in section 103 of the Income Tax Act. Section 103 was later criticised in the discussion paper 2005.<sup>133</sup> The discussion paper issued by SARS for comment highlighted various limitations of the GAAR provisions and it confirmed that as it stood at that time it was not equipped for the purpose of protecting the tax

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<sup>129</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005.

<sup>130</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA6.

<sup>131</sup> Satumba, R (2011) An analysis of the General Anti-Avoidance Rule In South Africa and a comparison with Foreign Anti-Avoidance Provisions. November 2011, p2.

<sup>132</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA6.

<sup>133</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005).

base.<sup>134</sup> The writer of the discussion paper highlighted a number of problem areas such as the complexity of the schemes, complexity of financial instruments, other accommodating parties etc.<sup>135</sup> To address the problems highlighted by SARS, tax practitioners and taxpayers, a new GAAR was introduced in 2006 which is entrenched in section 80A- 80L of the Income Tax Act.

It is against this background, that this chapter will discuss the different provisions of GAAR as it stands, analyse case law forming the base of GAAR and indicate a number of views expressed by various writers regarding the effectiveness of GAAR.

## **3.2 Analysis of section 80A-80L of Part IIA of the Income Tax Act**

### **3.2.1 Section 80A: Impermissible tax avoidance arrangements**

An arrangement can only be an impermissible tax avoidance arrangement if there is some kind of tax saving, being the motivation or purpose behind the arrangement.<sup>136</sup> Brincker<sup>137</sup> also confirmed the latter requirement when he summarised the four requirements of the new GAAR. Basically, he confirmed that in terms of the new GAAR there must be an arrangement, there must be a tax benefit for the arrangement to qualify as an avoidance arrangement and it must have a tainted element for it to fall within the category of an impermissible tax avoidance arrangement.<sup>138</sup>

Section 80A encompasses the four requirements that must be satisfied, before a transaction or scheme can be said to be an impermissible tax avoidance arrangement.

#### **3.2.1.1 The arrangement requirement**

The first requirement entails that there should be an 'arrangement'. "Arrangement" is defined to mean *"any transaction, operation, scheme, agreement or understanding...including all steps therein or parts thereof; and includes any of the foregoing involving the alienation of property."* This definition is seen to be one of the

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<sup>134</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005.

<sup>135</sup> *Ibid.*

<sup>136</sup> Haupt, P (2014) Notes on South African Income Tax Republic of South Africa: H&H Publications.p 642-643.

<sup>137</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA27.

<sup>138</sup> *Ibid.*

fundamental differences between the previous section 103 and the current GAAR.<sup>139</sup> This definition of arrangement broadens the scope of what an arrangement covers in that it includes steps within an arrangement and it also includes an understanding.<sup>140</sup>

### 3.2.1.2 A tax benefit and Section 80G: The purpose requirement

Secondly, the arrangement must be entered into to obtain a tax benefit. A 'tax benefit' includes "any avoidance, postponement or reduction of any liability for tax". In *Smith v CIR*, the court held "that the ordinary meaning of avoiding liability for a tax on income was to get out of the way or, escape or prevent an anticipated liability."<sup>141</sup>

In addition, the purpose requirement must also be complied with. Section 80G shifts the burden of proof to the party obtaining the tax benefit, in that the avoidance arrangement will be presumed to be entered into with the sole or main purpose of obtaining a tax benefit unless the party proves otherwise.<sup>142</sup> This section specifically uses the wording "...reasonably considered in light of the facts..." so as to make this an objective test based on the facts and circumstances.<sup>143</sup>

Subsection (2) further provides that the purpose of a particular step may differ from the purpose of an avoidance arrangement as a whole.<sup>144</sup>

### 3.2.1.3 Tainted element

A tainted element is present when either one of the proviso's as per subsection 80(a), 80(b) or 80(c) is satisfied.<sup>145</sup> For purposes of this requirement this section differentiates

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<sup>139</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA31.

<sup>140</sup> *Ibid.*

<sup>141</sup> 1964 1 SA (A) 333E-F. See also *Hicklin v CIR* where the court confirmed "that the meaning of 'avoiding liability' is based on the legislature's intention".

<sup>142</sup> Section 80G of the Income Tax Act.

<sup>143</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA40. See also a discussion on the purpose requirement in the SARS (2006) revised proposal on tax avoidance and section 103 of the Income Tax Act available [www.sars.gov.za](http://www.sars.gov.za) (accessed on 30 April 2014) where SARS also confirms that one of the changes to the GAAR is regarding the purpose requirement and how it is shifted from a subjective enquiry to an objective enquiry in light of the facts and circumstances of each matter.

<sup>144</sup> Section 80G of the Income Tax Act.

<sup>145</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA28.

between an arrangement entered into in the business context, context other than business and any context.

### **3.2.1.3.1 The business context**

In the business context, subsection (a) states that in addition to the purpose requirement,<sup>146</sup> this arrangement must either be entered into in a manner which would not normally be employed in the business context, other than obtaining a tax benefit or it lacks commercial substance in whole or in part and subject to the provisions of section 80C.<sup>147</sup>

### **3.2.1.3.2 Context other than business**

Alternatively, in any context other than business, subsection (b) requires the abnormality requirement similar to section 80(a)(i) to be satisfied in addition to the purpose requirement.<sup>148</sup>

### **3.2.1.3.3 Any context**

Lastly, subsection (c) states that in any context the avoidance arrangement must have created rights and obligations not normally associated with transactions where individuals are dealing at arm's length or it would result either directly or indirectly in the misuse or abuse of the provisions of the Income Tax Act.

The inclusion of the latter requirement as per section 80A(c)(ii)<sup>149</sup> is one of the fundamental changes that came about. The purpose of the misuse or abuse provision is to ensure that the modern approach (conceptualism and purposivism) is followed when it comes to the interpretation of statutes.<sup>150</sup> Broombergs of the view that the test

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<sup>146</sup> Section 80G of the Income Tax Act

<sup>147</sup> Section 80C of the Income Tax Act.

<sup>148</sup> See discussion in paragraph 3.2.3 below.

<sup>149</sup> Section 80A(c)(ii) of the Income Tax Act.

<sup>150</sup> Van Schalkwyk, L (2009) Section 80A(c)(ii) of the Income Tax Act and the interpretation of tax statutes in South Africa. *Meditari Accountancy Research*, Vol 17, No 2, p167.

contained in the misuse or abuse provision is inserted to attack the arrangements which is not avoidance scheme in the normal sense.<sup>151</sup>

What should be noted is that the new GAAR as implemented since November 2006 has received criticism and the question has been raised whether it is an effective deterrent. These comments as well as contradictory views will be discussed later in the chapter.

### **3.2.2 Section 80B: Tax consequences of an impermissible tax avoidance**

Section 80B provides guidance on the powers of the commissioner in the event that an avoidance arrangement is determined to be an impermissible tax avoidance arrangement.

The commissioner's powers to determine the tax consequences are wide and the commissioner can raise tax as if no arrangement was entered into or alternatively use any other method that he is authorised to, to prevent the impermissible tax avoidance.<sup>152</sup> These powers includes, disregarding any steps or part of the impermissible avoidance arrangement; combining or re-characterising same.<sup>153</sup> Furthermore, the commissioner may deem persons who are connected persons in relation to one another to be one and the same person. In addition the above-mentioned the commissioner may also disregard any accommodating or tax indifferent party.<sup>154</sup>

### **3.2.3 Section 80C: Lack of commercial substance**

Section 80C<sup>155</sup> is two-fold. Firstly, it provides guidelines in terms of when an avoidance arrangement lacks commercial substance and secondly, it identifies characteristics which would indicate the lack of commercial substance.

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<sup>151</sup> Kruger,D (2012) Broomberg on Tax Strategy.Lexisnexis, p267.

<sup>152</sup> Haupt,P (2014) Notes on South African Income Tax Republic of South Africa: H&H Publications, p640.

<sup>153</sup> Section 80B of the Income Tax Act.

<sup>154</sup> *Ibid.*

<sup>155</sup> Section 80C of the income Tax Act.

In terms of the first enquiry of the section, an avoidance transaction will lack commercial substance, if there is a significant tax benefit for the party, however the party's cash flow will not be significantly affected nor will there be any significant business risks for the parties involved.<sup>156</sup> The characteristics in subsection (2) refers to the legal substance of the transaction as a whole, which differs from the individual steps, round trip financing, an accommodating or tax indifferent party and elements having the effect of offsetting or cancelling each other out.<sup>157</sup>

In reading subsection 80(c)(1) it is said to be a "black and white test"<sup>158</sup> as described by Broomberg.<sup>159</sup> Meaning, if there is a tax benefit for the taxpayer yet no effect on his business risks or cash flow, the arrangement is an impermissible tax avoidance arrangement. On the contrary, if there is an effect on the taxpayer's business risks or cash flow, it's not an impermissible avoidance arrangement. A transaction will lack commercial substance if there is significant tax benefit with limited or no effect on cash flow and business risks. Thus, there is commercial substance if there is significant impact on cash flow and there are business risks. Whereas subsection (2) deems an avoidance arrangement as lacking in commercial substance if it reflects the characteristics mentioned in the subsection. Also, important to note is that this list as per subsection (2) is not exhaustive and other factors depending on the circumstances can be taken into account.

### 3.2.4 Section 80D: Round trip financing

Round trip financing<sup>160</sup> indicates lack of commercial sense and the lack of commercial sense indicates the presence of a tainted element.<sup>161</sup> Therefore should the requirements of this section be met, the arrangement would be deemed to be lacking in commercial substance. This section defines round trip financing as<sup>162</sup> including any avoidance arrangement where tripped amounts are being transferred having the result of a tax benefit for the parties and simultaneously reduces or eliminates and business

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<sup>156</sup> *Ibid.* For further reading see, Haupt,P (2014) Notes on South African Income Tax Republic of South Africa: H&H Publications, p643.

<sup>157</sup> Roundtrip financing and tax indifferent parties or accommodating parties are dealt with in detail in paragraph 3.2.4 and 3.2.5.

<sup>158</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, pZA34.

<sup>159</sup> *Ibid.*

<sup>160</sup> Section 80D of the Income Tax Act.

<sup>161</sup> Roundtrip financing is referred to in point 3.2.3 as a tainted element.

<sup>162</sup> *Ibid.*

risks incurred by any party involved in the avoidance transaction. Subsection (2) then broadens the application in relation to the round trip amounts. It includes all round trip amounts without having regard to the parties involved in the avoidance arrangements, the timing and sequence of nor the manner of transfer of the round trip amounts.<sup>163</sup>

An example of round trip financing can be illustrated as follows. *“Holdco owns all the shares of company A and company B. Company A owns an administrative building on which no capital allowances can be claimed. A sale-and-lease back transaction was concluded between company A and company B in terms of which company A sold the building to company B who immediately leased the same building back to company A. Company B has an assessed loss and therefore incurs no tax cash flow resulting from the lease income that it receives. Company A entered into this arrangement to eliminate risk associated with the ownership of the building.”*<sup>164</sup>

Silke is of the view that this section basically states that one of the most frequent characteristic of unacceptable tax avoidance, is that there is no real genuine business transaction and there is no real passing of money as the money just travels in a circle.<sup>165</sup>

Brincker on the other hand is of the view that because of the fact that there is nothing specific that the transaction must be circular, the net as per section 80D is so wide that it covers any commercial transaction.<sup>166</sup>

Round trip financing is present in the above example as the same funds used to purchase the building from company A will be used to make payments in terms of the lease and company A will qualify for a deduction in terms of the expenses relating to the lease.<sup>167</sup>

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<sup>163</sup> *Ibid.*

<sup>164</sup> Jordaan, K( Unknown) General anti-avoidance rule (GAAR), Date unknown, available at <http://www.sataxguide.co.za/general-anti-avoidance-rule-gaar/> (accessed on 4 March 2014).

<sup>165</sup> Silke, D (2013) Silke: South African Income Tax. (Stigling, M, Ed.) Durban: LexisNexis.

<sup>166</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA36-1.

<sup>167</sup> *Ibid.*

### 3.2.5 Section 80E: Accommodating or tax indifferent parties

Similarly to round trip financing, accommodating or tax indifferent parties is indicative of a tainted element. An avoidance transaction will lack commercial substance if both requirements entrenched in section 80E are satisfied. In terms of the first requirement, a party is a tax indifferent or an accommodating party if amounts received by the party in lieu of an avoidance arrangement are not subject to normal tax or it can be offset against expenditure incurred, loss incurred or assessed loss. Secondly, due to the participation of the accommodating or tax indifferent party, money that would have been included as gross income of the party is instead included in the gross income of the tax indifferent's income.

Alternatively, if a non-deductible expense is now deductible in the hands of the party due to the participation of the tax indifferent party. Furthermore, where what would otherwise be taxable income of the party, is now either not included in its gross income or not subject to normal tax, due to the participation of the accommodating party. Lastly, where another party makes a prepayment as a direct or indirect result of the participation of the accommodating party.<sup>168</sup>

There are two exceptions in this provision, namely where the accommodating party is taxed in a foreign country and this amounts to at least two thirds of what the tax would have been in South Africa<sup>169</sup> and secondly, if the accommodating party engages directly in substantive trading activities in connection with the arrangement for at least 18 months.<sup>170</sup> Furthermore, a person can be an accommodating or tax indifferent party irrespective whether or not it is a connected person in terms of any party.<sup>171</sup>

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<sup>168</sup> Section 80E of the Income Tax Act.

<sup>169</sup> *Ibid.* For further reading see Haupt, P (2014) Notes on South African Income Tax Republic of South Africa: H&H Publications.p647.

<sup>170</sup> Section 80E of the Income Tax Act. For further reading see Haupt, P (2014) Notes on South African Income Tax Republic of South Africa: H&H Publications.p647.

<sup>171</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA23.



### 3.2.6 Section 80F: Treatment of connected persons and accommodating or tax indifferent parties

This particular provision extends the powers of the commissioner to treat parties who are connected persons in relation to each other as one and the same person or to disregard any tax indifferent party or accommodating party or treat any accommodating or tax indifferent party and any other party as one and the same person.<sup>172</sup>

A connected person is defined in section 1<sup>173</sup> and covers a number of entities, for the purposes of this document section 1(d)(i)<sup>174</sup> relating to a company would be most important. The latter section states that “*any company that would form part of the same group of companies as that company if the expression “at least 70 per cent of the equity shares in” in paragraphs (a) and (b) of the definition of “group companies” in this section were replaced by the expression “more than 50% per cent of the equity shares or voting rights in.”*”<sup>175</sup> For example subsidiaries of the same holding company are connected persons.<sup>176</sup>

This section was criticised to the extent that this counters the advantages of having separate taxpayers in a group, however, SARS confirmed that the advantages falls outside the context to the extent that they are used for commercial purposes.<sup>177</sup>

### 3.2.7 Section 80H: Application to steps in or parts of an arrangement

This short section confirms that the commissioner is not limited to look at the arrangement as a whole, but may apply the provisions of section 80A-80L to the individual steps of the arrangement.<sup>178</sup>

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<sup>172</sup> Section 80F of the Income Tax Act.

<sup>173</sup> Section 1 of the Income Tax Act.

<sup>174</sup> Section 1(d)(i) of the Income Tax Act.

<sup>175</sup> *Ibid.*

<sup>176</sup> Silke, D (2014) Silke: South African Income Tax. (Stigling, M, Ed.) Durban: LexisNexis, p220.

<sup>177</sup> Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA40.

<sup>178</sup> Section 80H of the Income Tax Act.

### 3.2.8 Section 80I: Use in the alternative

In terms of this provision the particular provisions of Part II of the Act<sup>179</sup> can be used in the alternative in addition to any other basis for raising an assessment.<sup>180</sup> However, there has been conflicting case law regarding the use of GAAR provisions in the alternative.<sup>181</sup> The matter was, however settled recently by the SCA in *NWK*, in which the court confirmed that section 103 could be invoked in the alternative.<sup>182</sup>

### 3.2.9 Section 80J and section 80K : Notice and Interest

These provisions relate to the procedural aspects and the powers of the commissioner relating specifically to interest. In terms of section 80J<sup>183</sup> the commissioner must give the party notice of its intention to apply the provisions as per Part II<sup>184</sup> and also provide the reasons for applying these provisions, before the liability can be determined. The party then has 60 days to respond to the notice and provide reasons why GAAR should not be applied.

The commissioner is then given another 180 days from date of receipt of the reasons or the expiration of the 60 days to either request additional information, give notice that the original notice is withdrawn or determine the liability if the tax. The commissioner is also given the power to amend the reasons for applying the provisions, subsequent to receiving additional information.

In terms of section 80K,<sup>185</sup> the commissioner's powers are limited in that the commissioner may not exercise his discretion to waive interest, where the commissioner has applied Part II to determine tax liability.

### 3.2.10 Section 80L: Definitions

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<sup>179</sup> Sections 80I of the Income Tax Act.

<sup>180</sup> *Ibid.*

<sup>181</sup> ITC 1833 70 SATC 238; Unreported Judgment case 10808(Judgment 16 May 2001).

<sup>182</sup> *NWK Ltd* 2011(2) SA 67 (SCA. For further reading please see Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis, p ZA41.

<sup>183</sup> Section 80J of the Income Tax Act.

<sup>184</sup> Part II of the Income Tax Act.

<sup>185</sup> Section 80K of the Income Tax Act.

This section defines the following concepts; arrangement, avoidance arrangement, impermissible tax avoidance arrangement, party and tax.

### 3.3 Analysis of case law relating to the GAAR provisions

#### 3.3.1 *Meyerowitz v CIR (1963AD) 25 SATC 287*

This is an appeal and cross-appeal from the decision of the court *a quo*. The matter before the court involved a series of transactions which the commissioner (hereinafter the respondent) confirmed to be a tax avoidance scheme and calculated the appellant tax liability should the scheme not have ensued.

The appellant appeals against the decision of the court *a quo* confirming that the series of transactions constituted a scheme and the respondent cross-appealed against the finding of the court *a quo* that the respondent incorrectly determined the tax liability of the appellant. The facts of the case were as follows. The appellant was an author who wrote two textbooks, he held shares in a company called the Taxpayer (Pty) Ltd which produced a monthly legal journal. Later on the appellant formed another company, namely Visandra Pty Ltd, to take over his interest in both of his textbooks. This was followed by the formation of a trust for the benefit of the appellant's children, namely Meyerowitz Trust. The appellant then proceeded to form a partnership which would step into the shoes of the Taxpayer (Pty) Ltd and continue to publish the monthly journals. For the years of assessment under question the income from the sale of books together with the income stemming from the publication of the monthly journal were reflected in the books of the trust and not the appellant. The respondent included the said income in that of the appellant and the appellant appealed against this decision in the court *a quo*.<sup>186</sup>

The respondent contended that the appellant entered into these transactions so as to avoid his tax liability. The respondent then relied on section 90<sup>187</sup> to determine the

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<sup>186</sup> *Meyerowitz v CIR* 1963AD 25 SATC p295.

<sup>187</sup> Section 90 of the Income Tax Act 31 of 1941. GAAR was incorporated into Act 31 of 1941 prior to the current Income Tax Act. Section 90 basically stated that “..*whenever the SARS was satisfied that a transaction or operation had been entered into or carried out for the purpose of avoiding or reducing liability for tax, the tax may be determined as if the transaction or operation has not been entered into..*” For further reading see Mazansky, E (2006) A New GAAR for South Africa-the *Duke of Westminster* Struck a Blow, p126.

appellant's tax liability on the basis that the sole/main purpose of the appellant was to avoid paying tax and the transactions entered into does not make commercial sense.<sup>188</sup>

The appeal court in this regard investigated section 90 of the Income Tax Act in light of the facts. Firstly, the court confirmed that the purpose of section 90 is to protect the charging provisions of the Income Tax Act and prevent the avoidance of tax liability. The court then referenced Watermeyer, CJ in *Commissioner for Inland Revenue v King*<sup>189</sup> where he held that it is normal that "...the labourer receives the reward of his labour."<sup>190</sup> Both the tax court and this court of appeal agreed with this contention and thus the fact that the appellant ceded his income to the trust was held to be a scheme as defined.<sup>191</sup>

Further as to the cross-appeal the court held that the commissioner was entitled to determine the tax in totally ignoring the Taxpayer Pty Ltd. This was qualified by the statement that section 90 is wide and the commissioner can determine the tax liability as if the transaction is not entered into and he can do so as the circumstances of the matter at hand determines it necessary for the prevention of tax avoidance.<sup>192</sup>

What should be taken from this matter is that even though a transaction does not initially form part of the scheme it can become part of the scheme at a later stage.<sup>193</sup>

### 3.3.2 *Hicklin v SIR* (1980 AD) 41 SATC 179

The appellant was a shareholder, together with two other individuals of Reklame Bestuur (Edms) Bpk (hereinafter referred to as Reklame). A number of transactions ensued which had the end result of Reklame being a dormant company.<sup>194</sup> During the course of these transactions Reklame made unsecured loans to the shareholders. At some later stage, Ryan Nigel offered to purchase the dormant company of which the

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<sup>188</sup> *Meyerowitz v CIR* 1963AD 25 SATC p 297. Please note that even though this matter was decided on the old GAAR, the basic principles illustrated is still applicable to the new GAAR.

<sup>189</sup> *Meyerowitz v CIR* 1963AD 25 SATC p 299.

<sup>190</sup> *Ibid.*

<sup>191</sup> *Meyerowitz v CIR* 1963AD 25 SATC p 300.

<sup>192</sup> *Meyerowitz v CIR* 1963AD 25 SATC p 302.

<sup>193</sup> *Meyerowitz v CIR* 1963AD 25 SATC p 297. See also Kanamugrie, J (2013) A Critical Analysis of Tax Avoidance in the South African Tax Act 58 of 1962, As Amended, Mediterranean Journal of Social Sciences, Vol 6, p352.

<sup>194</sup> *Hicklin v SIR* 1980AD 41 SATC p485.

terms and conditions (as set by Ryan Nigel) were set out in an agreement. The appellant approached their auditor to ascertain whether it is a good offer and subsequently accepted the said offer.<sup>195</sup>

The secretary of inland revenue (hereinafter referred to as the respondent) then issued a letter stating that the payment received by Ryan Nigel in terms of the agreement was part of a scheme as per section 103 of the Income Tax Act. The appellant objected to this letter and the commissioner disallowed the objection, after which the special court dismissed the appeal from the appellant which brings the matter on appeal. The appeal court thus had to decide whether or not the respondent was correct in invoking section 103 of the Income Tax Act. The court came to the conclusion that the abnormality requirement in terms of section 103(i) and (ii) was not met and thus the special court erred in coming to their conclusion.

Three important principles were illustrated in the judgment. One, the court confirmed the principle that “*every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be.*”<sup>196</sup> Secondly, it was confirmed that the meaning of ‘avoiding liability’ is based on the legislature’s intention.<sup>197</sup> It was confirmed that the ordinary natural meaning of avoiding liability for tax on income is to get out of the way of, escape or prevent an anticipated liability. This statement was based on the judgment of *Smith v Commissioner of Inland Revenue*.<sup>198</sup>

Lastly, the court examined the abnormality requirement in which the court held that for a transaction to be normal it must be at arm’s length<sup>199</sup> and in determining the normality of the rights and obligations created one must take into account the surrounding circumstances.<sup>200</sup>

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<sup>195</sup> *Hicklin v SIR* 1980AD 41 SATC p488.

<sup>196</sup> *Ibid.* See also Olivier,L(1996) Tax Avoidance and Common Law Principles, Tydskrif vir Suid- Afrikaanse Reg, p378.

<sup>197</sup> *Hicklin v SIR* 1980AD 41 SATC p492.

<sup>198</sup> 1964(1)SA 324 (A) at 333E-G.

<sup>199</sup> *Hicklin v SIR* 1980AD 41 SATC p494.

<sup>200</sup> *Hicklin v SIR* 1980AD 41 SATC p495. Even though this case dealt with the previous GAAR, it is still of importance in that it explains the underlying principle relating to the abnormality requirement. See also Kanamugrie,J (2013) A Crytical Analysis of Tax Avoidance in the South African Tax Act 58 of 1962, As Amended, Mediterranean Journal of Social Sciences, Vol 6,p353.

### 3.3.3 ITC 1936 (1997) 60 SATC 267

In this matter the appellant carried on a manufacturing business. He wanted to raise financing against plant and machinery owned by the company, for future expansions by way of a sale and leaseback arrangement. In terms of the leaseback arrangement the appellant would sell the assets to the financial institution (lessor) which in turn would lease back the assets to the appellant. This arrangement had certain advantages in it namely the deductibility of the rental expenditure. Also the financial institution could claim depreciation allowance in terms of section 11(e) of the Income Tax Act. The appellant would furthermore be taxed in terms of section 8(4) (a) of the Income Tax Act in light of recoupsments on the sale of the assets.<sup>201</sup>

On 6 may 1992 two agreements were entered into to give effect to the sale and leaseback arrangement and these agreements were followed by two subsequent agreements entered into on 16 March 1993 on the same basis.<sup>202</sup> The commissioner (hereinafter referred to as the respondent) questioned the validity of the arrangements and held that they were simulated transactions and should be disregarded in terms of section 103(1) of the Income Tax Act. The court had to answer two questions, one being whether the respondent's assessments were correct in terms of section 11(a) and section 23(g) of the Income Tax Act and two, whether section 103 of the Income Tax Act applies.<sup>203</sup> For purposes of this discussion, the focus will be on the second enquiry of the court in relation to the application of section 103(1).

The court confirmed that the test in terms of section 103<sup>204</sup> consists of four requirements namely there must have been a scheme, the scheme must have the effect of postponing or avoiding liability; it must be entered into for the sole or main purpose of avoiding or postponing the tax liability and whether the scheme was entered into in a manner which would not normally be employed or created rights and obligations which would not normally be created.<sup>205</sup> All four requirements must be met for an impermissible anti-avoidance arrangement to exist and to confirm the applicability of section 103.<sup>206</sup> Secondly, the court held that looking at section 103 in its

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<sup>201</sup> ITC 1936(1997) 60 SATC p275.

<sup>202</sup> ITC 1936(1997) 60 SATC p280.

<sup>203</sup> ITC 1936(1997) 60 SATC p282.

<sup>204</sup> ITC 1936(1997) 60 SATC p291.

<sup>205</sup> *Ibid.*

<sup>206</sup> *Ibid.*

entirety, the onus to prove the four requirements rests on the respondent.<sup>207</sup> The respondent discharged this onus in terms of the second requirement in that the transaction resulted in some tax benefit. However, the respondent failed to prove that the abnormality requirement is present. Thus the, court held in this regard that the transactions were at arm's length and the rights and obligations arising from the transactions were normal.

The case reaffirmed the general principles as per other case law as seen in paragraph 3.3.1 and 3.3.2 above, showing that our courts have consistently applied and improved the core principles on which GAAR is based, irrespective of the amendments it has undergone through the years.

### **3.4 Analysis of the effectiveness of GAAR**

GAAR can only be effective if it serves its purpose effectively, being to protect the tax base and ensure that taxpayers comply with their tax liability.<sup>208</sup> Whether or not GAAR has been effective in achieving its purpose, has been a regular topic under discussion amongst tax specialist, taxpayers and academic writers.

Olivier expressed the opinion that it is not easy for the commissioner to successfully use the GAAR (section 103) where the taxpayers structure their affairs in such a way to circumvent the GAAR (section 103).<sup>209</sup> This similar view was expressed in the *Conhage (Pty) Ltd* matter. GAAR has since been developed and have granted the commissioner wider powers to a certain extent, i.e. section 80B (1).<sup>210</sup> The commissioner in terms of section 80B(1) has six remedies to combat impermissible tax avoidance, which can be applied to any step of the transaction.<sup>211</sup>

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<sup>207</sup> *ITC 1936*(1997) 60 SATC p273.

<sup>208</sup> See paragraph 3.1 above.

<sup>209</sup> Olivier, L. (1996) Tax Avoidance and Common Law Principles, Tydskrif vir Suid- Afrikaanse Reg. p378.

<sup>210</sup> For Further reading see Cassidy, J (2009) The holy grail: the search for the optimal GAAR. South African Law Journal, Vol 126, Issue 4, p745.

<sup>211</sup> Section 80B of the Income Tax Act. For further reading see also Brincker, TE (2004) Taxation Principles of interest and other Financing Transactions. Lexisnexis. pZA40.

On the other hand, Van der Walt is of the view, that the GAAR is a powerful weapon in the hands of SARS and they will most probably make use of it more often.<sup>212</sup> Van der Walt further recognises the fact that section 80J ensures or provides a safeguard for taxpayers, as explained in paragraph 3.2.9 above, in that the commissioner cannot just arbitrarily apply GAAR.<sup>213</sup>

Also, Broomberg is of the opinion that even though many writers and tax specialist question whether the previous GAAR (being section 103(1) of the Income Tax Act) was effective, our law reports shows that there has been much success in the application of GAAR.<sup>214</sup> Mezansky, expressed a similar view in his observations of the previous GAAR, where he opines that SARS has been successful with GAAR in many matters especially in the tax court where the taxpayer clearly entered into an avoidance scheme.<sup>215</sup>

All in all, the development of GAAR over the years has seen the evolution of GAAR in that many 'problem areas' have been addressed and tax practitioners together with our government have developed a GAAR as it stands today that is indeed effective in identifying impermissible tax avoidance schemes, subject to the rights of the taxpayer. Tax specialists in an article<sup>216</sup> subsequent to the new GAAR (section 80A-section 80L) was of the view that the new GAAR is geared at targeting more complex structures which deals with the concern as raised by Olivier<sup>217</sup>

Roelofse<sup>218</sup> further confirms that the new GAAR has been broken down in manageable pieces of legislation which would make it easier for purposes of interpretation and the changes made to the GAAR has been effected to remain in line with international anti-

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<sup>212</sup> Van der Walt, J (2012) The South African GAAR: who guards the guards? 14 September 2012, available at <http://www.thesait.org.za/news/102925/The-South-African-GAAR-who-guards-the-guards.htm> (accessed 15 February 2014).

<sup>213</sup> Van der Walt, J (2012) The South African GAAR: who guards the guards? 14 September 2012, available at <http://www.thesait.org.za/news/102925/The-South-African-GAAR-who-guards-the-guards.htm> (accessed 15 February 2014).

<sup>214</sup> Kruger, D (2012) Broomberg on Tax Strategy. Lexisnexis, p257.

<sup>215</sup> Mazansky, E (2006) A New GAAR for South Africa-the *Duke of Westminster* Struck a Blow, p127. See for example, *Income Tax Case (ITC) 1113, 30 SATC 8; ITC 1151, 33SATC 133; ITC 1178, 35 SATC 29; ITC 1496, 53 SATC 229.*

<sup>216</sup> Temkin, S. (2007) GAAR and tax avoidance, *Business Day*. 4 October 2007.

<sup>217</sup> Olivier, L. (1996) Tax Avoidance and Common Law Principles, *Tydskrif vir Suid- Afrikaanse Reg*. p378.

<sup>218</sup> Roelofse, L (2007) the New General Anti-Avoidance Rules. 17 April 2007, available at [http://www.deloitte.com/assets/DcomSouthAfrica/Local%20Assets/Documents/ZA\\_Pressrelease\\_Antiavoidancerules\\_170407.pdf](http://www.deloitte.com/assets/DcomSouthAfrica/Local%20Assets/Documents/ZA_Pressrelease_Antiavoidancerules_170407.pdf) (accessed 4 March 2014).



avoidance provisions. However, Temkin cautions that the ultimate effectiveness of GAAR will depend on the interpretation of our courts.<sup>219</sup>

Clearly there are conflicting views as to whether the GAAR historically and as it stands is indeed effective. SARS has gone to great lengths to investigate the application and implementation of GAAR in various jurisdictions to assist in the development of our GAAR principles.<sup>220</sup> Thus, even though it is said that there is no model GAAR,<sup>221</sup> SARS has gone to great lengths to ensure that the GAAR, as amended in 2006, will be seen as an effective measure to target impermissible tax avoidance arrangements.

One thing is for certain and this has been confirmed by Jordaan, that SARS is serious about tax compliance and combatting impermissible tax avoidance arrangements with the new GAAR provisions contained in section 80- 80L.<sup>222</sup>

### 3.5 Conclusion

In light of the analysis of GAAR throughout this chapter, the purpose and development of GAAR, the views illustrated by the tax specialists and our courts interpretation of the various principles, it is submitted that GAAR has been developed to be effective in its purpose. However, our courts should continue to be proactive in applying GAAR and ensuring that it is developed continuously to effectively identify and counter the effect of impermissible tax avoidance schemes.

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<sup>219</sup> Temkin,S. (2007) GAAR and tax avoidance,Business Day.4 October 2007.

<sup>220</sup> SARS (2005) Discussion paper on tax avoidance and section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), November 2005. These countries include Canada; New Zealand; Spain; United Kingdom and United States

<sup>221</sup> Unknown(2012) Tax Controversy and Dispute resolution Alert, 4 June 2012, available at [www.pwc.com/taxcontroversy](http://www.pwc.com/taxcontroversy) (accessed on 30 April 2014).

<sup>222</sup> Jordaan, K( Unknown) General anti-avoidance rule (GAAR), Date unknown, available at <http://www.sataxguide.co.za/general-anti-avpoidance-rule-gaar/> (accessed on 4 March 2014).

## Chapter 4: Conclusion

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Now to answer the question posed in chapter 1 namely whether the GAAR and the Substance over form doctrine have developed sufficiently to effectively combat the effect of impermissible tax avoidance schemes?

Firstly, chapter 2 looked at the substance over form doctrine and critically analysed the relevant case law as well as highlighted views of various tax specialists on the subject matter. Evident from the analysis, is that the substance over form doctrine is being utilised by our courts, with success, and the principle has been developed to by our courts over the years so as to be able to be applied to keep abreast with the development of tax avoidance schemes, keeping in mind the fact that every taxpayer is allowed to arrange his affairs to pay the least tax possible.

Chapter 3 shifts the focus to the GAAR, which clearly shows how GAAR has been developed over the years to effectively combat impermissible tax avoidance arrangements. The GAAR has seen success in our courts and SARS with the recent development attempted to address problem areas as highlighted with the preceding section 103<sup>223</sup> as emphasised by taxpayers and tax specialists.

In conclusion and looking holistically at the research material and various opinions expressed by writers, our judiciary and tax specialists regarding the substance over form doctrine as well as GAAR, it is clear that both mechanisms has been developed sufficiently to keep abreast with and combat the effect of impermissible tax avoidance arrangements. How effective these amendments will remain and for how long before further developments are required, is yet to be seen.

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<sup>223</sup> Section 103 of the Income Tax Act.

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