

AN ANALYSIS OF THE CSARS V NWK CASE AND THE EFFECT ON THE SUBSTANCE OVER FORM DOCTRINE

by

MANDI KREBS
(Student No. 25104897)

A dissertation submitted in partial fulfilment of the requirements for the degree

LLM TAX LAW

in the

FACULTY OF LAW

at the

UNIVERSITY OF PRETORIA

Supervisor: Dr. Benjamin Kujinga

OCTOBER 2015

DECLARATION

I, **MANDI KREBS**, hereby declare that this dissertation is my own, unaided work. It is being submitted in partial fulfilment of the prerequisites for the degree of Masters in Tax Law at the University of Pretoria. It has not been submitted before for any degree or examination in any other university.

õ õ õ õ õ õ õ õ õ õ õ õ õ õ õ õ õ ..
MANDI KREBS

28 October 2015

ACKNOWLEDGEMENTS

Firstly, I would like to express my sincere gratitude to my supervisor, Dr. Benjamin Kujinga, for his continued support, guidance, motivation and the invaluable contributions that he made to this dissertation. I am extremely grateful for the time that he invested in my research and indeed in this dissertation.

Secondly, I would like to thank my parents for the many sacrifices that they have made, for my benefit, over the years. You have never ceased to believe in me and my abilities. Without your constant encouragement, support and love, I would not have been able to achieve my academic goals. Thank you for providing me with the opportunity to undertake further studies and for never questioning my ability to succeed.

A very big thank you to my friends and colleagues who have supported me over the years. I appreciate every one of you.

To the two most important people in my life, my husband and beautiful daughter, thank you! Thank you for being willing to sacrifice time with me, so that I may achieve this goal. Thank you for encouraging me and supporting me when I needed it the most. Thank you for always reminding me of what I am capable of, even when I felt like giving up. Most importantly, thank you for filling my life with more love and laughter than I ever knew to be possible. I love you both endlessly.

I want to thank my Heavenly Father, without whom, I would not have been able to complete this dissertation. Lord, thank you for carrying me through the difficult times and for always reminding me that I am capable of all things through You, who strengthens me. All the glory to God!

TABLE OF CONTENTS

DEFINED TERMS	vi
ABSTRACT	vii
CHAPTER 1: INTRODUCTION	
1.1 Background	1
1.2 Problem Statement	3
1.3 Objectives	4
1.4 Significance	4
1.5 Research Methodology	5
1.6 Data Analysis	5
1.7 Chapter Outline	5
CHAPTER 2: HISTORICAL BACKGROUND	
2.1 Introduction	7
2.2 Historical development of the Doctrine	7
2.2.1 Crucial judgments of the SCA	8
2.2.2 Summary	11
2.3 Intention and purpose	12
2.4 Analysing different approaches adopted internationally	14
2.4.1 Australia	15
2.4.2 Canada	16
2.4.3 Conclusion	18
2.5 Consequences of simulated transactions	18
CHAPTER 3: THE <i>NWK</i> CASE AND THE REQUIREMENT OF COMMERCIAL SUBSTANCE	
3.1 Introduction	20
3.2 Analysis of the <i>NWK</i> Case	21
3.2.1 Facts	21
3.2.2 Commissioners' arguments	22
3.2.3 <i>NWK</i> 's arguments	23
3.2.4 Decision of the SCA	24
3.2.5 Deviating from legal principles	26
3.2.6 Broomberg criticism	28
3.3 Conclusion	30

CHAPTER 4: THE PERCEIVED IMPACT OF THE NWK JUDGMENT ON THE STATUTORY GENERAL ANTI_AVOIDANCE PROVISIONS	
4.1 Introduction	32
4.2 Analysis of the GAAR	33
4.2.1 General	33
4.2.2 Requirements of the GAAR	34
4.3 Comparison of the GAAR and the revised test for simulation	39
4.3.1 Defences for simulation of a transaction	39
4.3.2 Defences for the GAAR	40
4.3.3 Comparison to the approach adopted by the USA	40
4.4 Conclusion	42
CHAPTER 5: JUDICIAL CLARITY ON THE SUBSTANCE OVER FORM DOCTRINE AFTER NWK	
5.1 Introduction	43
5.2 Analysis of the Bosch Case	43
5.2.1 Facts	43
5.2.2 Findings of the Western Cape High Court	44
5.3 Analysis of the Roshcon Case	46
5.3.1 Facts	46
5.3.2 Findings of the SCA	47
5.4 Conclusion	49
CHAPTER 6: CONCLUSION	
5.1 Concluding remarks	50
5.2 Recommendations	51
LIST OF REFERENCES	53

DEFINED TERMS

Act	Income Tax Act 58 of 1962
ATO	Australian Taxation Office
Bosch	<i>Bosch and Another v Commissioner for the South African Revenue Service</i> 2013 (5) SA 130 (WCC)
Commissioner	Commissioner of the SARS
Doctrine	Substance over form doctrine
GAAR	General Anti-Avoidance Rules
NWK case	<i>Commissioner for the South African Revenue Service v NWK Ltd</i> 2011 (2) SA 67 (SCA)
Roshcon	<i>Roshcon (Pty) Ltd v Anchor Auto Body Builders CC</i> 2014 (4) SA 319 (SCA)
SARS	South African Revenue Service
SCA	Supreme Court of Appeal

ABSTRACT

In determining whether parties have entered into a simulated transaction, it is accepted legal practice to apply the principles encapsulated in the Doctrine. It is trite that the Doctrine attributes certain consequences to a transaction, namely such consequences as the parties actually intend, rather than the consequences that the parties simulate or intend to simulate. This test is applied irrespective of what the parties' purpose for entering into that transaction is, however, purpose may be regarded as one of several factors in determining what such parties' true intention is.

In the recent case of *Commissioner for the South African Revenue Service v NWK Ltd* 2011 (2) SA 67 (SCA), the SCA seemingly revised the test to determine simulated transactions by stating that when considering simulation, one cannot simply have regard to whether the parties had an intention to give effect to the contract in accordance with its terms, but instead, one should further regard whether the transaction lacks commercial sense.

This approach is spectacularly different from the traditional approach followed in a long line of cases decided before the *NWK* case. Consequently, this judgment resulted in great deal of uncertainty as regards the application of the Doctrine.

This study investigates the disturbance caused by the SCA's judgment in the *NWK* Case and sought to determine whether the judgment revised the established principles forming part of the Doctrine. Having considered the judgments handed down in the *Bosch* and *Roshcon* cases, the view is that there are no deviations from the established principles and indeed an enquiry as to simulation will place emphasis on the manner in which the parties to a transaction intend to implement such transaction.

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

The avoidance of tax is one of the inevitable consequences of tax. Tax can be avoided in many different ways and in many instances, taxpayers go to great lengths to structure transactions in a highly-complex manner, by concluding multiple agreements and interposing several parties or entities, all the while being very conscious of the potential tax liabilities that they may incur. Understandably, most taxpayers would not voluntarily elect to incur tax liabilities that, with some creative structuring, may possibly be avoidable.

For the lay or ordinary person, such highly complex and sophisticated structuring mechanisms, lead to the question, *So, what does all this lead to? Is this really necessary to achieve the objective sought?* However, tax avoidance through (overly) complex and sophisticated transactions is prevalent and, in our ever-changing and somewhat fragile economic climate, it would be naive to think that taxpayers would not take full advantage of structuring opportunities, complex or not, so as to optimise tax savings and to minimise tax liability.

Complexity and sophistication in tax avoidance is not in itself impermissible. The problem arises when intricate and overly complicated tax avoidance transactions and group structures are found to be nothing more than a front to disguise the actual *status quo* or the actual transaction between the parties. Although taxpayers are entitled to structure their affairs in the most tax efficient manner,¹ all tax efficient transactions have to pass scrutiny in terms of South Africa's anti avoidance legislation in the form of the GAAR or specific anti avoidance rules (SAAR).² Additionally, where a transaction has been undertaken merely to conceal the

¹ This principle was established in many cases throughout the world. Lord Tomlin states in *IRC v Duke of Westminster*, (1936) AC 1 (19 TC 490) at 520 that: *every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.* This view was further developed by the House of Lords in 1981, in the case of *WT Ramsay Ltd v IRC* (1981) 54 TC 101, in which Lord Wilberforce stated: *any subject is only to be taxed upon clear words, not upon 'intendment' or upon the 'equity' of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What 'clear words' are is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded...".*

² As set out in sections 80A . 80L of the Act. During 2006, the Act was amended to introduce a more effective means of combating tax avoidance, hence the inclusion of the GAAR.

true terms and intentions of the parties, the common law doctrine of substance over form will be applied to give effect to the real transaction and deny the tax benefits sought or achieved.³

It has long been accepted that where parties to an agreement endeavour to conceal its true nature by giving it some form, different from what they really intend, a court will give effect to the transaction in accordance with its substance, not its form.⁴ This is the basis of the Doctrine. The Doctrine has various applications, the distinction in the two contexts in which the Doctrine is applied, may be concisely set out as follows:⁵

- a) Disguised transactions (i.e. instances where the parties to a transaction intentionally attempt to conceal the true nature of the transaction and endeavour to create the impression that the agreement is something other than what it is). This is referred to commonly as the *simulation principle* and has been considered extensively by our courts.⁶
- b) Instances where parties to a particular transaction attach the incorrect label to the transaction or to a particular aspect of the transaction, despite having every intention to give effect to the transaction, as originally contemplated between the parties. By way of example, the parties might in good faith refer to their arrangement as a purchase and sale agreement, whereas in fact it is a lease agreement. This is commonly referred to as the *label principle*.

For the purposes of this study, focus will be placed on the *simulation principle*.

The main point of departure of an analysis of the Doctrine, is based on the view that the true nature of a transaction is based on its tenor. In other words, the test to determine whether a transaction is disguised or simulated,⁷ requires one to give due regard to whether the parties to a contract truly intended to act in accordance with the tenor of the agreement, irrespective

³ It is also important to note the difference between tax evasion on the one hand and tax avoidance on the other. This distinction is briefly outlined in Chapter 3.

⁴ *MacKay v Fey NO & Another* 2006 (3) SA 182 (SCA).

⁵ P. Surtees & S. Millard *Substance, Form and Tax Avoidance* November/December 2004 *Accountancy SA* 14.

⁶ *Commissioner for Customs and Excise v Randles Bros & Hudson Ltd* 1941 AD 369 and *Erf 3183/1 Ladysmith and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (A).

⁷ This study does not purport to define the term *simulated transaction*. As regards making an attempt to define the term *simulated transactions* Blechner states that *“the result of such an attempt would be the artificial imposition of a meaning on a term that does not have the same meaning throughout history.”* Blechner M.D. *Simulated transactions in the later civil law* SALJ 1974 Vol 91 p358.

of what their purpose for entering into that transaction was. In such an instance, the contract cannot be said to be a simulated one.

The maxim *plus valet quod agitur quam quod simulate concipitur* is a fundamental principle in our law. Literally interpreted, it means that what is actually done is more important than that which seems to have been done. Therefore, where arrangements between parties constitute disguised transactions, i.e. the parties never intended to enforce the rights and obligations on the same basis that these rights and obligations are presented to others, then the form of the arrangements may be ignored and effect will be given to the real intention of the parties.

1.2 PROBLEM STATEMENT

The Doctrine has been considered and applied repeatedly in a number of cases. These cases have recognised requirements that need to be established before a transaction can be struck down as simulated. In recent years, some of these cases have led to confusion regarding the requirements for the application of the Doctrine. One of these cases, in a tax context, was the *NWK* case. The question before the court in the *NWK* case, was whether a particular transaction entered into between several parties should be regarded as being simulated, thus entitling SARS to give effect to the real underlying transaction between the parties involved.

Ostensibly, the SCA judgment in the *NWK* case requires that the enquiry, as to whether a transaction is simulated or not, be focused on the transaction itself, as opposed to having regard to the intention of the taxpayers who entered into same. This approach is spectacularly different from the traditional approach followed in a long line of cases decided before the *NWK* case. Consequently, this judgment resulted in great deal of uncertainty regarding the following:

- a) the correct manner in which to determine whether a transaction is simulated (i.e. whether indeed the common law test to determine simulated transactions has also been revised, and if so, to what extent); and
- b) whether the court established a new judicial anti-avoidance principle in the *NWK* case.

After the *NWK* case, some cases, most notably the *Bosch* case as well as the *Roshcon* case, were heard and decided, which led to a return to the usual/traditional interpretation and application of the Doctrine. The problem now is whether the approach in the *NWK* case, with the uncertainty and inconsistency it caused, was short lived and is now relegated to history,

and whether the latter cases signify a return to the traditional approach to determining substance over form.

1.3 OBJECTIVES

The objectives of this dissertation will be to analyse the recent upheaval experienced with the interpretation and application of the Doctrine. In this regard, this research will determine whether or not the judgment handed down in the *NWK* case revised the test to determine simulated transactions, and whether this revision was a theoretically and jurisprudentially justifiable development of the principles of the Doctrine.

In the event that it is found that indeed such principles have been revised, this research paper will consider the:

- a) impact same may have on simulated transactions entered into by taxpayers in the future; and
- b) the impact same may have on the Commissioner's ability to combat tax avoidance.

Furthermore, this research will also discuss the cases that were decided after the judgment in the *NWK* case, which took a different approach therefrom and ostensibly returned to the traditional interpretation of the Doctrine. This discussion will analyse whether these latest cases settle the confusion brought by the *NWK* case and whether the *NWK* case should be relegated to history and not be applied in South African law.

1.4 SIGNIFICANCE

In view of the uncertainty created as a result of the *NWK* case, it is important to determine conclusively whether the judgment expands or rather completely revises the traditional understanding of the common law principles encompassed in the Doctrine. The study is also important in the sense that it analyses the current position after the *Bosch* and *Roshcon* cases and seeks to settle the upheaval experienced in the last few years regarding the Doctrine. The answer, in this regard, has far-reaching consequences not only for taxpayers and the manner in which they structure their dealings, but also for the Commissioner's ability to effectively combat tax avoidance.

1.5 RESEARCH METHODOLOGY

The research forming part of this analysis will be conducted by an extended study and analysis of the historical as well as current application of the Doctrine after the *Bosch* and *Roshcon* cases, and careful consideration of the contents of the judgment handed down in the *NWK* case in order to conclusively determine the impact, if any, the judgment in the *NWK* case has had on the principles set forth in terms of the Doctrine.

In addition, as part of the research being undertaken in this study, a brief analysis of the approaches to simulation in several other jurisdictions has been undertaken as part of a comparative analysis. The jurisdictions specifically being looked at are Australia and Canada, as both these jurisdictions have, over time, developed their common law to address impermissible tax-avoidance through simulated transactions.

1.6 DATA ANALYSIS

The data will be analysed by way of studying and discussing various sources of literature, writings of experts in the field, case law, relevant legislation, commentary thereon, journals, articles, media releases and other literature relating to the application of the Doctrine as well as the impact the *NWK* case has had on the Doctrine.

Upon completion of the literature review, the conclusion and deductions made will be used to determine whether the principles forming part of the Doctrine have indeed been revised and if so, the possible consequences thereof.

Upon completion of the data analysis and study, a conclusion or inference will be made as to the appropriate enquiry to be made so as to determine whether a transaction is disguised or simulated and, possibly, what questions and/or elements form part of such enquiry.

1.7 CHAPTER OUTLINE

In order to truly understand the meaning of the judgment in the *NWK* case, as well as the potential consequences which may arise as a result thereof, one must analyse and understand the vast existing jurisprudence on the subject of simulation and the tests used to determine whether a transaction has indeed been simulated. For this reason, the second chapter seeks

to create a foundation on which this study will be based, by traversing the existing principles laid down in more than one hundred yearsworth of case law.

In the third chapter, the study will seek to examine, in detail, the judgment handed down by Lewis JA in the *NWK* case, in an attempt to better comprehend the reasons for the judgment as well as the possible consequences which may spring therefrom. Following this, in the fourth chapter, an analysis is undertaken in order to determine the need for an overhaul of the existing principles regarding simulation and a brief discussion ensues regarding the existing statutory anti-avoidance provisions set out in the Act.

Subsequent to the *NWK* case being heard, the Western Cape High Court as well as the SCA delivered judgments in which the *NWK* case was addressed. In the penultimate chapter, chapter five, the judgments of these courts are carefully studied and interpreted.

CHAPTER 2

HISTORICAL BACKGROUND

2.1. INTRODUCTION

The Doctrine has been applied to simulated transactions in general for over a century.⁸ As discussed previously, and set out in more detail below, the Commissioner would traditionally apply the Doctrine if it was established that a transaction that a taxpayer entered into was a simulated transaction, which would lead to the avoidance of tax.

As the first point of departure, it is trite that the Doctrine is a general legal principle that attributes certain consequences to a transaction, namely such consequences as the parties actually intend, rather than the consequences that the parties simulate or intend to simulate. As such, the Doctrine cannot merely be analysed as a tax principle and for this reason, an analysis regarding the background and development thereof will require a study of various judicial precedents, not exclusively handed down by tax courts.

This chapter will focus on, and analyse, the historical basis and application of the Doctrine. In this analysis, emphasis will be placed on some of the primary cases in which the Doctrine was considered and applied. One of the aims of this chapter is to establish the requirements for the application of the Doctrine, as determined and established by the courts over the years.

2.2. HISTORICAL DEVELOPMENT OF THE DOCTRINE

The Doctrine has repeatedly been considered and affirmed by South African courts. The development of the Doctrine can be attributed to three crucial judgments of the SCA (formerly known as the Appellate Division) being *Zandberg v Van Zyl*,⁹ *Commissioner for Customs and Excise v Randles Bros & Hudson Ltd*¹⁰ and *Erf 3183/1 Ladysmith and Another v Commissioner for Inland Revenue*.¹¹

⁸ See *Hofmeyer v Gous* 10 SC 115.

⁹ (1910) AD 302.

¹⁰ 1941 AD 369.

¹¹ 1996 (3) SA 942 (SCA).

2.2.1. Crucial judgments of the SCA

Zandberg v Van Zyl

In 1910, the South African courts addressed the simulation principle for the first time by considering whether, in terms of an existing arrangement between two individuals, ownership of a wagon had in fact been transferred, or whether as an alternative, the wagon was merely being held as security for a debt owed, meaning that no ownership had passed from the one party to the other.

The court held that:¹²

Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express, but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is: not what in form it purports to be. The maxim then applies plus *valet quod agitur quam quod simulate concipitur*. But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than 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. (own emphasis)

Having regard to the underlined considerations in the *Zandberg case* ruling, it is clear that in determining whether the transaction amounted to a simulation, the court focused primarily on whether the parties had a real intention, which differed from the simulated intention created by their agreement. This was to become the standard test to be used by the judiciary in determining simulation.

Customs and Excise v Randles Bros & Hudson Ltd

The test to determine simulation was further developed by the court in *the Randles Brothers case*. Here, the court was required to consider the true intention of the importer of textiles and as a result was required to analyse agreements that were entered into between the manufacturers and importers of the textiles in question. The Commissioner contended that the agreements between the manufacturers and importers had been varied *in fraudem legis*.

¹² Judgment . para 309.

Although the bench was divided, when delivering the majority judgment, Watermeyer JA, having reference to the *Zandberg* judgment stated the following:¹³

I wish to draw particular attention to the words a real intention, definitely ascertainable, which differs from the simulated intention because they indicate clearly what the learned Judge meant by a disguised transaction. A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax. A disguised transaction in the sense in which the words are used above is something different. In essence, it is a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be *in fraudem legis*, and is interpreted by the courts in accordance with what is found to be the real agreement or transaction between the parties. Of course, before the court can find that a transaction is *in fraudem legis* in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible agreement is a pretence. The blurring of this distinction between an honest transaction devised to avoid the provisions of a statute and a transaction falling within the prohibitory or taxing provisions of a statute, but disguised to make it appear as if it does not, gives rise to much of the confusion, which sometimes appears to accompany attempts to apply the maxim quoted above. (own emphasis)

The crux of the judgment is that cognisance must be had to the true intention of the parties to a transaction, regardless of the terms of the agreement between them. It is vital to note that according to this case, this principle will only apply where the parties to such a transaction, do not intend the transaction to have, *inter partes*, the legal effect that the terms thereof convey to third parties.¹⁴

The decision of the court, clearly relying on the fundamental principles enunciated in the *Zandberg* case, set the tone regarding the determination of simulation by the judiciary going forward.

¹³ Judgment . p395 . 396.

¹⁴ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2015*. LexisNexis. Johannesburg at paragraph 28.5.

Erf 3183/1 Ladysmith and Another v Commissioner for Inland Revenue

Until recent developments in several court decisions, the leading case regarding the principle of simulation was the *Ladysmith case*.¹⁵ The appellants, being two companies forming part of the same holding company (Holding Co), were the registered title holders of certain immovable property and elected to lease such property to a pension fund (Fund), which would erect buildings on the appellants' immovable property. Holding Co's sole shareholder, Pioneer Co, leased the immovable property from the Fund and in terms of this arrangement, the Fund was obliged to erect the buildings and Pioneer Co would pay the consideration required for the construction as well as rental. The appellants were only entitled to receive rental payments from the Fund, should the Fund receive rental payments from Pioneer Co.

In terms of paragraph (h) of the definition of gross income in section 1 of the Act, income is deemed to accrue to a taxpayer where such taxpayer leases land and acquires a right to have the land improved. Briefly, the question before the court was whether a right, in terms of paragraph (h) of the definition of gross income in section 1 of the Act, had accrued to the appellant companies. From the agreements, it appeared as though the appellant companies orchestrated the complex structuring in an attempt to prevent the rights contemplated in paragraph (h) of the definition of gross income from accruing to them. Although the Fund did have such a right accruing to it, it was exempt in terms of the Act. The respondent contended that the parties interposed the Fund in order to circumvent the provisions of the Act and that in actuality, the lease arrangement was between the appellants and Pioneer Co.

In delivering the judgment, Hefer JA commenced by stating the following:¹⁶

Affiliated companies are, of course, at liberty to structure their mutual relationships in whatever legal way their directors may prefer; but when, for no apparent reason, a third party is interposed in what might equally well have been an arrangement between affiliates, it is not unnatural to seek the motive elsewhere.

The court reaffirmed that a transaction could only be disregarded where it is evident that the arrangement in fact constitutes a disguised or simulated transaction. Interestingly, the *Ladysmith case* distinguishes between two principles, which as stated by the court, are not in conflict:

¹⁵ Modernising the Substance over Form Doctrine: Commissioner for the *South African Revenue Service v NWK Ltd.* (2012) 24 SA Merc LJ 115 . 127. Dr Thabo Legwaila.

¹⁶ Judgment . para 8.

- a) a person may arrange his/her affairs so as to remain outside the provision of a particular statute; and
- b) the court will not be deceived by the form of a transaction, but will rend aside the veil in which the transaction is wrapped and examine its true nature and substance.

In discussing the interaction between the aforementioned principles, Hefer JA noted that:

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

In concluding on the matter, Hefer JA stated the following:¹⁷

Therefore, unless the appellants have shown on a preponderance of probability that the agreements do indeed reflect the actual intention of the parties thereto, the Commissioner's decision cannot be disturbed. Apart from the agreements themselves, the only evidence placed before the special court on this part of the case was that of the two witnesses referred to earlier. The question is whether this is sufficient to discharge the onus.

2.2.2. Summary

Having regard to the judgments handed down in the cases discussed above, it is evident that, in determining whether a transaction is simulated or not, the courts have traditionally looked to the intention of the parties and in light of such intention, further investigated whether such intention has been given effect to. At no point did the courts deem it necessary to have regard to the commercial substance of the transaction, which is evidently vastly different from the approach seemingly adopted by the court in the *NWK* case.

The courts will not merely look at the form of the transaction, but at its real nature.¹⁸ In light of the judgments handed down in the cases set out above, our courts have reiterated that where the parties to a transaction *legitimately and honestly intend* for such a transaction to be given effect in accordance with the nature and meaning thereof, then the courts will, generally speaking, give effect to the transaction in accordance thereto. Conversely, if the parties do

¹⁷ Judgment . para 23.

¹⁸ *Ochberg v Commissioner for Inland Revenue* 1931 AD 215.

not intend to give effect to an agreement, and merely use it to disguise an agreement that they intend to give effect to, the court will give effect to the underlying agreement, not the simulated one. The cases above also show that the courts will focus on whether a transaction is simulated or not, before applying the Doctrine. The onus of proof will fall on the taxpayer to prove, on a balance of probability, that the transaction is an accurate reflection of actual intention of the parties.

2.3. INTENTION AND PURPOSE

Despite having these guidelines and aids to interpretation, the difficulty arises in the fact that intention by its very nature is subjective.¹⁹ In light of this difficulty, it often becomes challenging to differentiate between the related concepts of intention and purpose²⁰ as these concepts merge into each other.²¹

By way of example, in the case of *Plimmer v CIR*²² it was held that:

A man's purpose is usually, and more naturally, understood as the object that he has in view or in mind, but in ordinary language purpose connotes something added to intention and the two words are not ordinarily regarded as synonymous.

In *Hippo Quarries (Tvl) (Pty) Ltd v Eardley*,²³ the court confirmed this distinction, as stated by Nienaber JA:

Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all other things being equal, will be implemented.

In view of the above extract, it is evident that where a contract is unlawful, such a contract will have no force and effect as a result of the application of the general principles of the law of

¹⁹ Silke on South African Income Tax - Author: AP de Koker BCom (Cape Town) et al. - Last Updated: November 2014 - SI 53.

²⁰ Struwig, H. *Simulated Transactions: the requirement of "commercial substance" to determine simulation as enunciated in the NWK case – the established substance over form doctrine renovated or a mere indicator of a concealed transaction?* (LLM Tax Law Dissertation 2013 UP) page 22.

²¹ Ibid.

²² (1958) NZLR 147.

²³ [1992] 1 All SA 398 (A) at 405.

contract. Conversely, where a contract is simulated, such a contract will be ineffectual due to the application of the Doctrine.²⁴ The difference arises in respect of the consequences attached to each of unlawful and simulated transactions.

One of the elements of a valid contract is that the purpose and objective of the agreement must be lawful.²⁵ In the event that any one of the required elements is not present, the agreement will be of no force and effect. In other words, the contract will be null and void. It is a well-established principle that actions that are done contrary to the letter of the law will be void and will not have any effect.²⁶ As such, the parties to an agreement that is unlawful, will not be able to enforce any of the terms thereof, nor would either party be able to claim any sort of specific performance from the other. Consequently, the only conceivable tax related consequences that may arise from such an agreement, would be as a result of income tax principles (i.e. income tax implications arising due to the income received by either party, if any).²⁷

On the other hand, where an agreement is ineffectual due to the application of the Doctrine, the potential tax consequences that either party may face, would not be negated by the fact that the agreement was simulated.

Notwithstanding the judgments cited above, in deciding whether the parties to an agreement had *bona fide* or *mala fide* intentions, whether there was any fraud on their part or whether the agreement was a indeed genuine or simulated, one must take into account all the relevant facts and circumstances.²⁸

In this regard, the various factors that may be of importance in determining the question of simulation have been summarised below, although this is not an exhaustive list:²⁹

- a) inconsistencies between the recorded terms of the agreement on the one hand and the actual conduct of the parties, indicating a tacit agreement (see *Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue (supra)*);

²⁴ Struwig, H. *Simulated Transactions: the requirement of “commercial substance” to determine simulation as enunciated in the NWK case – the established substance over form doctrine renovated or a mere indicator of a concealed transaction?* (LLM Tax Law Dissertation 2013 UP) page 23.

²⁵ Nagel CJ (ed) (2006) *Commercial Law* (3rd ed.) Durban: LexisNexis Butterworths, para 3.8.1

²⁶ *Schierhout v Minister of Justice* 1926 AD 99 at 109.

²⁷ Uncertainty exists regarding the taxation of illegal receipts, as there have been many cases providing conflicting views in this regard. Clarification by the SCA would be welcomed. As discussed in Muller, E. 2007 The Taxation of Illegal Receipts: A Pyramid of Problems! *Obiter*: 166-181.

²⁸ *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd)* 1999 (4) SA 1149 (SCA).

²⁹ From an opinion prepared by the tax directors of Edward Nathan Sonnenberg Inc.

- b) irregular aspects in respect of the transaction (see *Relier (Pty) Ltd v Commissioner for Inland Revenue*)³⁰;
- c) implementation of all salient terms of the agreement (see *ITC 1625*)³¹;
- d) whether the agreement had been reduced to writing (thus serving as evidence) or whether any other evidence existed regarding the nature and details of the agreement between the parties (see *ITC 1663*)³²;
- e) the subsequent conduct of the parties in executing the agreement (see *Michau v Maize Board*)³³; and
- f) historical background of the transaction, including the nature of negotiations between the parties, the purpose that the parties sought to achieve by entering into the transaction and the various options available to the parties whereby their purposes could be achieved (see *Commissioner for Inland Revenue v Conhage (Pty) Ltd*)³⁴.

2.4. ANALYSING DIFFERENT APPROACHES ADOPTED INTERNATIONALLY

To establish whether the traditional application of the substance over form doctrine in South Africa is consistent with the treatment of simulated transactions in other countries, the position regarding simulation in other jurisdictions is briefly discussed hereunder as part of a comparative analysis. As part of the study being undertaken herein, a brief comparative analysis has been provided in respect of Australia and Canada and the manner in which each jurisdiction approaches simulated transactions compared to the common law approach adopted in South African³⁵ as well as the possible revision thereof as per the *NWK case*.

The aforementioned jurisdictions have been identified, primarily for two reasons, the first being that both these jurisdictions have, over time, developed their common law in order to address

³⁰ 1998 (1) All SA 183 (A).

³¹ 59 SATC 383.

³² 61 SATC 363.

³³ 2003 (6) SA 459 (SCA).

³⁴ 1999 (4) SA 1149 (SCA).

³⁵ As discussed in Chapter 2 above. Please see *Zandberg v Van Zyl, Commissioner for Customs and Excise v Randles Bros & Hudson Ltd* and *Erf 3183/1 Ladysmith and Another v Commissioner for Inland Revenue*.

anti-avoidance in light of simulated transactions. Secondly, both these jurisdictions common law developed from English common law, as both were previously under British rule.

2.4.1. Australia

In Australia, one of the most widely discussed judicial decisions regarding simulated or sham transactions, is that of *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation*.³⁶ In this case, the High Court of Australia³⁷ was required to consider the concept of simulated transactions specifically in an income tax scenario.

Briefly, from the facts of the case,³⁸ Raftland Pty Ltd formed part of a consolidated group of companies that were involved in property development and related activities (the Group). In an attempt to minimise its own income tax liability, Raftland Pty Ltd made use of an entity which had substantial accumulated losses and redirected its income through such entity. In addition, Raftland Pty Ltd acquired a loss-bearing unit trust, which was elected to be the tertiary beneficiary of a discretionary trust, namely the Raftland Trust. Notably, Raftland Pty Ltd was the trustee of the Raftland Trust. Superficially, the tertiary beneficiary was entitled to receive distributions from the Raftland Trust; however, during 1995, profits for the Group were distributed to Raftland Pty Ltd. The company then passed various resolutions to distribute its entire income to the loss bearing trust. Raftland Pty Ltd was assessed, in its capacity as trustee of the Raftland Trust, for the 1995, 1996 and 1997 years of assessment.

In this case, Kirby J held that:³⁹

Important to this description is the idea that the parties do not *intend* to give effect to the legal arrangements set out in their apparent agreement, understood only according to its terms. In Australia, this has become essential to the notion of sham, which contemplates a disparity between the ostensible and the real *intentions* of the parties. The courts must therefore test the intentions of parties, as expressed in documentation, against their own testimony on the subject (if any) and the available objective evidence tending to show what that intention really was. (own emphasis)

In order to fully understand the content of the above extract, it is important to determine what exactly is understood as being a sham, in the Australian context. In this regard, Kirby J

³⁶ 2008 ATC 8364.

³⁷ As an aside, it is worthwhile noting that the High Court of Australia is the highest court that is able to adjudicate on tax disputes.

³⁸ As per the summary provided by Judge Michael Kirby in *Of Sham and Other Lessons for Australian Revenue Law* (2008) 32(3) *Melbourne University Law Review* 861.

³⁹ Judgement . para 112.

mentions that the authorities on the concept of sham-transactions was revised in the case of *Sharrment Pty Ltd v Official Trustee in Bankruptcy*.⁴⁰ In the *Sharrment Pty Ltd v Official Trustee in Bankruptcy*, the court held that the concept of sham-transaction is defined as follows:

A sham is ... for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front. It is not genuine or true, but something made in imitation of something else or made to appear to be something which it is not. It is something which is false or deceptive. (own emphasis)

Although the ATO main argument in *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation*, was that the transactions between the parties were sham-transactions, it is not to say that Australia does not have legislated anti-avoidance provisions. Quite the contrary is true, as the Australians have gone to great lengths to put in place protective mechanisms to curb avoidance by taxpayers.⁴¹ This being said, the importance of this decision is noted by the ATO,⁴² which stated that same reinforces the Commissioner of the ATO's ability to challenge loss transferring arrangements, by ascertaining the true intentions of the parties. Essentially, this demonstrates that the ATO is not obliged to make use of complex anti-avoidance rules in order to combat tax avoidance arrangements.

From the above, it is apparent that the Australian concept of sham-transactions and the manner in which the ATO may seek to defeat such transactions may be likened to the approach adopted and implemented in South Africa, as per the case law discussion in this chapter, provided the proposed amendments to the Doctrine, as per Lewis JA's judgment in the NWK case, do not stand.

2.4.2. Canada

Not unlike the position in Australia, the sham concept is well understood in Canada. In Kirby J's judgment, he noted that judges elsewhere have indicated some degree of willingness to consider the development of a broader and more robust approach to the identification of sham. Such willingness demonstrates the disinclination of judges to accept, at face value, documents devised and executed by the parties in purported expression of their legal rights, where there

⁴⁰ (1988) 18 FCR 449 at 454 cited (2006) 227 ALR 598 at 615 [76].

⁴¹ Please see Part IVA of the *Income Tax Assessment Act 1936, Act 27 of 1936*.

⁴² <http://law.ato.gov.au/atolaw/view.htm?Docid=LIT/ICD/B39/2007/00001&PiT=99991231235958> . accessed on 24 June 2015.

is reason, as a matter of evidence and common sense, to believe that their real intentions lie elsewhere.⁴³

Given that Canadian law developed from English common law, in the case of *Minister of National Revenue v Cameron*,⁴⁴ the court opted, as regards sham transactions, to follow the approach articulated in *Snook v London and West Riding Investments Ltd*,⁴⁵ which provided as follows:

[I]f it has any meaning in law, [sham] means acts done or documents executed by the parties to the sham which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. ... [F]or acts or documents to be a sham with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations, which they give the appearance of creating. No unexpressed intentions of a shammer affect the rights of a party whom he deceived (own emphasis).

Nevertheless, and not unlike the *NWK* judgement, in the case of *Minister of National Revenue v Leon*,⁴⁶ the court held that where an agreement or transaction lacks a *bona fide* business purpose, it will be regarded as being a sham. This business purpose element was not accepted without criticism and was soon rejected by the Supreme Court of Canada in the case of *Stuart Investments Ltd v The Queen*.⁴⁷ In this case, Estey J held that a lack of business or commercial purpose was not sufficient on its own to imply proof of a sham and further indicated that an additional subjective element would be required. Despite several failed attempts to revive the business purpose element, the court finally eliminated any doubt which may have arisen in this regard, in the case of *McClurg v Canada*,⁴⁸ by endorsing the approach adopted in *Snook v London and West Riding Investments Ltd*, Dickson C.J stating:

In *Champ v. The Queen*, 83 D.T.C. 5029 (F.C.T.D.), for example, a dividend payment was found to be invalid in law, and the form of the payment was disregarded for tax purposes. In that case, the taxpayer and his wife held two-thirds and one-third of the shares of the corporation respectively. While the Articles of Association of the company specifically stated that "dividends may be declared and paid according to ... the number of shares held", dividends were paid to only one class of shares, which were held exclusively by the wife. The court found that the taxpayer diverted his *pro rata* share of the dividends, and included this indirect payment in his income by way of s. 56(2). The approach adopted by the Federal Court in *Champ* is in keeping with the

⁴³ See para 113 of the *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation judgment*.

⁴⁴ (1974) SCR 1062 at 1068 per Martland J.

⁴⁵ (1967) 2 QB 786.

⁴⁶ (1977) 1 FC 249 at 256.

⁴⁷ (1984) 1 SCR 536.

⁴⁸ (1990) 3 SCR 1020.

"ineffective transaction" test for denying a taxpayer the benefit of a particular transaction, which was articulated by this court in *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536.

2.4.3. Conclusion

Having considered the approach adopted in the jurisdictions set out above, with regard to determining simulation, one may conclude that emphasis is to be placed on the intention of the parties to a transaction and thus a test as to such parties' intention, by having regard to their expressed intention in the transactional documentation versus the available objective evidence, is required. This approach is very much in line with the approach traditionally adopted in South Africa, as discussed above.

Arguably, attempt to modify such approach in the aforementioned foreign jurisdictions have been unsuccessful.⁴⁹ It has been held that the rejection of business purpose element in determining simulation, as per the *Stubart Investments Ltd v The Queen* case, was the precursor to the introduction of the Canadian GAAR in 1988.

2.5. CONSEQUENCES OF SIMULATED TRANSACTIONS

In summary, where it is found that the Doctrine applies to a transaction, as stated in *Kilburn v Estate Kilburn 1931 AD 510*, the courts will *do not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance*.

It is important to discern between legal and economic substance in the context of simulated agreements. Regard will be given to the legal substance of an agreement as this is what will govern the tax treatment thereof in terms of South African law. The economic substance of an agreement may assist in determining the intention of the parties.⁵⁰

Should SARS successfully attack a transaction based on the Doctrine, the parties will be obliged to pay such taxes as may be due to SARS as a result of the legal substance of the agreement.

⁴⁹ As may be seen from the rejection of the decision handed down in *Minister of National Revenue v Leon*. Discussed above.

⁵⁰ From an opinion prepared by the tax directors of EY Advisory Services Proprietary.

Given the successful application of the Doctrine for over a century, it begs the question why the Doctrine would require any further development and if it is found that the court in the *NWK* case did revise the existing common law principles, what motivating factors were put forth in order to substantiate the need for such alteration. In addition, having regard to the international approach adopted by Australia and Canada, it seems evident that these jurisdictions are in agreement that there is no need for creating the economic substance doctrine as a broad anti-avoidance rule, particularly where a jurisdiction already has legislated broad anti-avoidance provisions.

CHAPTER 3

THE *NWK* CASE AND THE REQUIREMENT OF COMMERCIAL SUBSTANCE

3.1. INTRODUCTION

Corporates are constantly inundated with news reports of multinational corporations downsizing, industries being brought to their knees because of financial difficulties and forced to retrench thousands of employees. In view of such dire economic environment, parties are seeking to structure their affairs in such a manner so as to take full advantage of creative structuring opportunities and thus minimising their possible tax liability as far as is legally permissible. One of the principles of the right to avoid tax is the right to choose a transaction that attracts the least tax, from a number of alternative transactions. This principle was described in *ITC 1636* as follows:

Where there are alternative ways in which a transaction may be effected, or, more accurately, where there are alternative ways in which a specific purpose may legally be achieved, one of which would attract a certain liability for the payment of tax and the other(s) of which would result in either the reduction or even the elimination of such liability, then provided that the adoption of one of the latter ways is both *bona fide* and factually genuine from a commercial and legal point of view, there is no reason why the adoption thereof should not receive the sanction of the courts. It is not the function of the courts to widen the net of tax liability (emphasis added).⁵¹

It is interesting to note the above extract in light of the judgment delivered in the *NWK* case. Given the discussion that will unfold below, it is thought-provoking to note that, in terms of the above, taxpayers are entitled to structure transactions in such a manner so as to reduce or eliminate a tax liability, provided such structuring is both *bona fide* and factually genuine from a commercial standpoint, as the courts do not have the mandate to unjustifiably widen the net of tax liability.

Moreover, when determining whether a transaction is simulated or not, the courts will analyse the intention of the parties thereto, and in doing so determine whether they legitimately and honestly intended for the transaction to be implemented in accordance with the nature and meaning thereof. As discussed in the previous chapter, this enquiry has been established in case law over many years. In addition, a similar approach is adopted in many other jurisdictions, particularly those jurisdictions that already have an existing statutory GAAR.⁵² It

⁵¹ *ITC 1636* 60 SATC 267.

⁵² Please see discussion under Chapter 2 and 4.

is against this backdrop that one must analyse the judgment in the *NWK* case and the perceived significant departure thereof from the existing jurisprudence on the matter of simulation.

3.2. ANALYSIS OF THE *NWK* CASE

On 1 December 2010, the SCA delivered its landmark judgment in the *NWK* case, which ostensibly changed the landscape of the Doctrine by adding an additional requirement, namely that of commercial substance. The judgment sparked much debate in the tax community amongst commentators and practitioners, as many people believed that the SCA took it upon itself to expand the established interpretation of the Doctrine.⁵³

On the other hand, many people were of the view that the SCA merely modernised the existing principles forming the basis of the Doctrine.⁵⁴

As such, what stands to be determined is whether the commercial substance requirement is merely indicative of simulation or rather is a standalone requirement, which must be present before a transaction can be said to be simulated.⁵⁵ For this reason, one must analyse the facts and judgment handed down in the *NWK* case.

3.2.1. Facts

Briefly summarised, the facts were as follows:⁵⁶

- a) *NWK Limited* (*NWK*) is a public company which formerly operated as a cooperative society trading in maize. *Slab Trading Company Proprietary Limited* (*Slab*), a subsidiary of *First National Bank* (*FNB*), which dealt in financial instruments, entered into a series of agreements whereby *Slab* advanced a loan in the amount of R96,415,776 to *NWK*.

⁵³ Dachs (2011) The interpretation of substance over form. *In Practice – Edward Nathan Sonnenberg*. Available at: http://www.ens.co.za/images/news/14_02_11%2001%2001r1402LAW_AL_2.pdf.

⁵⁴ Legwaila (2012) Modernising the Substance over Form Doctrine: Commissioner for the South African Revenue Service v *NWK Ltd*. *SA Mercantile Law Journal* (Vol 24) 115-127, at p117.

⁵⁵ Struwig, H. *Simulated Transactions: the requirement of “commercial substance” to determine simulation as enunciated in the *NWK* case – the established substance over form doctrine renovated or a mere indicator of a concealed transaction?* (LLM Tax Law Dissertation 2013 UP) page 27.

⁵⁶ The facts have been summarised as they appear in the SCA judgment from paras 5 . 41, Legwaila (2012) Modernising the Substance over Form Doctrine: Commissioner for the South African Revenue Service v *NWK Ltd*. *SA Mercantile Law Journal* (Vol 24) 115-127, at p117 and Broomberg E *NWK* and Founders Hill *The Taxpayer* 2011 (Vol 60) p197.

- b) In terms of the loan agreement, NWK would repay the loan to Slab over a period of five years and the capital would be repaid by NWK delivering 109,315 tons of maize at the end of the loan period.⁵⁷
- c) In addition, interest was payable by NWK, every six months, at a fixed interest rate of 15.41% per annum. In this regard, NWK would issue ten promissory notes to Slab, with a total value of R74,686,861.
- d) In order to fund the loan, Slab sold the promissory notes to FNB, for an amount less than the face value thereof. In addition, Slab sold its rights to receive the maize from NWK to FNB for the sum of R45,815,776.
- e) NWK also contracted with First Derivatives, a division of FNB (~~First Derivatives~~), to acquire the right to receive 109,315 tons of maize, for the sum of R46,415,776. The aforementioned sum was payable immediately, but NWK would only take delivery of the maize in five years⁵⁸time.
- f) Over a period of five years, from 1999 to 2003, NWK claimed deductions from income tax, to the sum of the face value of the promissory notes, in respect of the interest payments it had made to FNB. Originally, the deductions claimed by NWK were allowed; however in 2003, the Commissioner issued new assessments disallowing the deduction of the interest and also imposed additional tax and interest on the underpayment of provisional tax. The amount payable in terms of the additional assessments, including additional tax, was R47,360,583.

3.2.2. Commissioner's arguments

The Commissioner held the view that the agreements concluded between the parties, was not a true reflection of the actual agreement between them.⁵⁹ The Commissioner contended that the arrangements were put in place by the parties to conceal the fact that in essence a loan of only R50,000,000 was made instead of the purported amount of R96,415,776.

⁵⁷ Interestingly, as pointed out by Lewis JA at para 13, the agreement between the parties in this regard takes the form of a sale agreement rather than a lease; however, for purposes of this analysis; same will be referred to as a loan agreement.

⁵⁸ As noted by the Court, in essence, this circular arrangement meant that NWK's right to receive the maize and the right to deliver the same amount of maize was cancelled during 2003.

⁵⁹ Judgment - para 26.

The Commissioner contended that Slab had no real part to play in the transaction and was only interposed to conceal the true loan amount by concluding an additional transaction for the sale and purchase of maize. Thus the only reason Slab was a party to the transaction was to facilitate NWK's enhanced interest deduction.⁶⁰

Importantly, the Commissioner further noted that the value of the promissory notes covered not only the loan amount, but also the interest payable thereon, as such, the portion of the promissory notes which covered the capital amount was not deductible.⁶¹

In the alternative, the Commissioner contended that the arrangements between the parties constituted impermissible tax avoidance, which could be impugned in terms of section 103(1) of the Act, the applicable general anti-avoidance provisions.⁶²

3.2.3. NWK's arguments

In its grounds of appeal, NWK alleged that the contracts which the parties had been concluded, were given effect to in accordance with each agreement's terms.⁶³ NWK thus contended that no portion of the payment made by NWK would be of a capital nature.⁶⁴

In addition, as regards the Commissioner's alternative argument regarding section 103(1) of the Act, NWK unequivocally stated that no part of the arrangement (i.e. the contracts) had the effect of postponing or avoiding altogether any tax liability. The only reason NWK elected to enter into the agreements with Slab and FNB was to secure loan financing.⁶⁵

⁶⁰ Judgment . para 30.

⁶¹ Judgment . para 32.

⁶² Judgment . para 33.

⁶³ Five reasons were put forth by NWK in this regard, namely: NWK received the loan amount from Slab, as contemplated in the loan agreement and further noted that delivery of the promissory notes had occurred; the price of the maize, in terms of the forward sale agreement, had been paid by NWK to First Derivatives; NWK was not party to the agreements between Slab and FNB; the provisions of the loan agreement were an accurate reflection of the NWK's intention and effect was given thereto in accordance with their tenor; and there was no tacit understanding or unexpressed agreement of NWK, which had been omitted from the terms of the agreements.

⁶⁴ Judgment . para 35.

⁶⁵ Judgment . para 36.

3.2.4. Decision of the SCA⁶⁶

In delivering the judgment, Lewis JA⁶⁷ firstly confirmed that in tax appeals, the onus of proof rests with the taxpayer, by virtue of the Act, and the taxpayer is required to show that the transaction in question is not simulated, i.e. that the parties honestly and legitimately intended for the transaction to be implemented in accordance with the nature and meaning thereof.⁶⁸ However, as NWK argued that the agreements, which the parties had concluded, served as *prima facie* evidence of the parties' true intention, the onus thus rested on the Commissioner to disprove NWK's insinuation.

The Court then delved into the matter of simulation and started off by confirming the following:⁶⁹

It is trite that a taxpayer may organise his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective. But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not, especially if that has the purpose of tax evasion, or the avoidance of a peremptory rule of law.⁷⁰

Lewis JA then discussed several cases that have contributed to the formation of the principles underlying the Doctrine. Of importance, were the decisions handed down in *Zandberg case* and *Randles Brothers case*, where the courts held that the intention of the parties was of paramount importance in establishing where a transaction is indeed simulated. The Court, however, went on to discuss different approaches put forth in each of the majority and the minority judgments of the *Randles Brothers case*.

⁶⁶ Although for purposes of this analysis, the decision of the SCA is being scrutinised, for the sake of completeness, it is important to note the decision of the Tax Court. The Tax Court, finding in favour of NWK, held the view that NWK had acted in accordance with the terms of the contracts, which it had concluded and found that the parties had intended to fulfil all the contractual terms agreed between them. At no point did this intention change. In this regard, the Tax Court's focus was where the parties legitimately and honestly intended for such a transaction to be given effect to in accordance with the nature and meaning thereof. There was no investigation or concern regarding the commercial substance of the agreements, or lack thereof.

⁶⁷ The remaining judges, Harms DP; Cachalia JA; Shongwe JA and Bertelsmann AJA concurred with the decision.

⁶⁸ Section 82(b) of the Act.

⁶⁹ Judgment . para 42.

⁷⁰ In this regard, the judge stated that notwithstanding the above principle, a distinction should be made between being permitted to *arranging one's affairs in such a way as to pay the least tax* and the principle that *a court will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance* (as stated by Wessels ACJ in the *Kilburn v Estate Kilburn* case at p 507).

The majority judgment turned on the fact that cognisance must be had to the true intention of the parties to a transaction, regardless of the terms of the agreement between them. In this case, Watermeyer JA considered the subjective intention of the taxpayer and stated that there was no requirement that the right being transferred be unrestricted.⁷¹

The dissenting judgments were delivered by De Wet CJ and Tindall JA, both placing emphasis on the substance of the transactions as opposed to what the stated intention was.

In addition, the Court also referenced the case of *S v Friedman Motors (Pty) Ltd*⁷² and Lewis JA quoted the following passage from the judgment of Colman J:⁷³

If two people, instead of making a contract for a loan of money by one of them to the other, genuinely agree to achieve a similar result through the sale and repurchase of a chattel, there is no room for an application of the maxim *plus valet quod agitur quam quod simulate concipitur*. The transaction is intended to be one of sale and repurchase, and that, at common law, is what it is.

The Court further noted that in the cases of *S v Friedman Motors (Pty) Ltd*⁷⁴ and *CIR v Conhage (Proprietary) Limited*,⁷⁵ the courts held that the respective parties did, in fact, intend to give effect to their agreements in accordance with the terms thereof; however, in addition, such agreements were commercially sound and there was a legitimate purpose for the agreements to be structured in that particular manner.⁷⁶

The statement above, regarding sound reasons for structuring an arrangement in a particular manner, gave rise to the crux of the judgment in the *NWK* case. The following statements by Lewis JA are the basis for the discussion at hand:

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

⁷¹ Judgment . para 47.

⁷² 1972 (1) SA 76 (T).

⁷³ Judgment . para 53.

⁷⁴ 1972 (1) SA 76 (T).

⁷⁵ 1999 (4) SA 1149 (SCA).

⁷⁶ Judgment . para 54.

It is correct that FNB and NWK outwardly performed in terms of the various contracts, as indicated earlier⁷⁷ and the Tax Court should have considered this. It should have asked whether there was actually any purpose in the contract other than tax evasion. This is not to suggest that a taxpayer should not take advantage of a tax-effective structure. But there must be some substance . commercial reason . in the arrangement, not just an intention to achieve a tax benefit or to avoid the application of a law. A court should not look only to the outward trappings of a contract: it must consider, when simulation is in issue, what the parties really sought to achieve.⁷⁷

After having examined the facts before the Court, the decision was made in favour of the Commissioner and the Court held that the loan transactions were simulated for various reasons.⁷⁸ The Court found that the transaction fundamentally lacked commercial substance. The judgment was promptly followed by a statement released by SARS on 15 December 2010 (**Media Statement**), in which SARS welcomed the SCA's clarification of the important principles regarding the Doctrine, as considered in the judgment.⁷⁹ In the Media Statement, SARS specifically states that, inter alia, the following principles received clarification:

- a) In order to determine simulation, one cannot simply have regard to whether the parties had an intention to give effect to the contract in accordance with its terms, but instead, one should further regard whether the transaction lacks commercial sense; and
- b) section 103(1) of the Act, may be applied as an alternative to SARS's argument that a transaction is simulated.

3.2.5. Deviating from legal principles

The Doctrine of judicial precedent⁸⁰ requires courts to take into account judicial decisions handed down in similar instances. Previous judgments create a binding precedent that must

⁷⁷ Judgment . para 80.

⁷⁸ At paragraph 89 of the judgment, the following reasons were put forth by the Court: the sale of maize by NWK to FNB was dressed up as a loan; NWK and FNB concluded two contracts of loan on the same day, one for an amount of R50,000,000 and the other for an amount of R96,415,776; virtually the same amount in excess of that which was required by NWK (R46,415,776) was paid by FNB to NWK and then essentially repaid by NWK to FNB; the amount lent in the impugned loan was determined not by reference to what was needed, but by reference to a capital sum needed to generate a particular sum of interest; the description of the maize in the various contracts was vague; no security was afforded to Slab for repayment of the loan and lastly, NWK concluded the loan knowing that Slab would sell its right to delivery of the maize to FNB and that Slab would sell the promissory notes at a discount to FNB all on the same day: Slab's role in the transactions was momentary.

⁷⁹ SARS Media Release (15 December 2010). Available on <http://www.sars.gov.za>. Accessed on 4 April 2015.

⁸⁰ This is also known as the *stare decisis* principle and literally means to 'stand by previous decisions'.

be followed.⁸¹ In delivering the judgment, Lewis JA did not put forth any reasons for her decision to deviate from the Doctrine of judicial precedent. This being said, Lewis JA did discuss some of the leading authorities regarding the principle of simulation and how it ought to be determined.⁸² Nevertheless, as discussed above, at paragraph 55 of the judgment, Lewis JA essentially put forth that the standard test for simulation is inadequate, thus one should not only probe and enquire whether parties to a transaction intended to give effect thereto in accordance with the terms; in addition, one must examine ~~the~~ the commercial sense of the transactionq its ~~real~~ substance and purposeq⁸³

Aside from the ostensible inclusion of an additional requirement in respect of the test for simulation, what is truly important to determine is whether the controversial paragraphs in the judgment formed part of the *obiter dictum* or rather the *ratio decidendi* of the judgment. The difference is vital, as any person in the legal fraternity will confirm, not everything covered in a judgment is binding. *Obiter dicta* are not binding, but may have persuasive value whereas the *ratio decidendi* of a case is binding and creates a precedent.⁸⁴

Many authors, including Vorster, are of the view that the lengthy legal analysis included in the *NWK* judgment, had been expressed as an *obiter dictum*, meaning that it would only hold persuasive value. This view is based on the fact that, as part of the *ratio decidendi* of the judgment, Lewis JA relied on the established legal principles regarding the test for simulation, to conclude whether the transactions at hand were indeed simulated. Indeed, many share this view, in particular, Broomberg submits that the ~~%emarks of the Court to the effect that, if the purpose of the transaction is only to avoid tax, 'then it will be regarded as simulated', were made obiter, and are not binding on other courts in the future.~~⁸⁵ Furthermore, this view is echoed by Vorster⁸⁶ and Mazansky.⁸⁷ Vorster having stated that, in his view, the Court did adhere to the Doctrine of judicial precedent as the Court did not overrule the existing judicial precedent, which was in place prior to the case being heard. This, according to him, suggests that the commerciality requirement formed part of an *obiter dictum*.

⁸¹ *Duard Kleyn Beginner's Guide for Law Students* (2002) Third Edition, Juta Law . page 60.

⁸² Please see the discussion in Chapter 2.

⁸³ Emslie (2011) Simulated transactions . a new approach? Cape Town: *The Taxpayer* (Vol 60)(No1) at p3.

⁸⁴ *Duard Kleyn Beginner's Guide for Law Students* (2002) Third Edition, Juta Law . page 60 - 61.

⁸⁵ Broomberg, E.B. 2011. The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd* (27/10) [2010] ZASCA 168, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 59.

⁸⁶ Vorster (2011) *NWK* and Purpose as a test for Simulation. Cape Town: *The Taxpayer* (Vol 60) at p85.

⁸⁷ Mazansky (2012) And you thought an *obiter dictum* was not binding! Cape Town: *The Taxpayer* (Vol 61)(No 3) at p45.

Despite the fact that the contentious portions of the judgment may, likely, not form part of the *ratio decidendi* thereof, it is truly doubtful whether a court of lower hierarchy will dare to deviate from any decision, including an *obiter dictum*, of the SCA.⁸⁸ As Mazansky notes,⁸⁹ taking this point even further, it does seem quite puzzling that in a relatively short period of time, the SCA handed down several judgments that required analysis of legislative provisions contained in the Income Tax Act, three of which potentially have far-reaching commercial and tax consequences.⁹⁰

3.2.6. Broomberg criticism

As mentioned above, the decision of the SCA in the *NWK* case, left many puzzled, among them Advocate Eddie Broomberg, who contends that the SCA in possibly attempting to overturn the common law principle at hand, which has formed a part of our law for over a century, conflated the concepts of ~~tax avoidance~~ and ~~tax evasion~~.⁹¹ In the judgment, it is stated that *if the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated*.⁹²

The importance of correctly distinguishing between these two concepts lies, *inter alia*, in the consequences that flow from each, being vastly different. There is a definite distinction between instances where a taxpayer, through legitimate means reduces its income, thus reducing its potential tax liability and on the other hand, instances where a taxpayer arranges its affairs in such manner so as to escape a liability to pay tax, despite taxes being due on the taxpayer's income received. The former scenario amounts to tax avoidance whereas the latter is tax evasion.⁹³ In other words, ~~tax avoidance~~ implies the use of schemes and planning mechanisms, which are not in conflict with any legal provisions, whereas ~~tax evasion~~ implies

⁸⁸ Mazansky (2012) And you thought an *obiter dictum* was not binding! Cape Town: *The Taxpayer* (Vol 61)(No 3) at p45.

⁸⁹ Mazansky (2012) And you thought an *obiter dictum* was not binding! Cape Town: *The Taxpayer* (Vol 61)(No 3) at p45.

⁹⁰ In addition to the *NWK* judgment, see *Commissioner for South African Revenue Service v Sprigg Investment 117 CC t/a Global Investment* 2011 (4) SA 551 (SCA) and *Commissioner for South African Revenue Service v Founders Hill* 2011 (5) SA 112 (SCA).

⁹¹ Davis, DM. 2010 Simulated Transactions. Cape Town: *The Taxpayer* (Vol 59)(No 11 & 12) November-December 2010.

⁹² Broomberg, E.B. (2011). The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd* (27/10) [2010] ZASCA 168, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 7.

⁹³ Emslie *et al.* (2001) Income Tax: Cases and Materials. Cape Town: *The Taxpayer* (3rd Edition) at p895.

inherently unlawful means of evading a tax liability (e.g. the non-disclosure of income/falsifying tax return) and sham or disguised transactions.⁹⁴

Judge Dennis Davis has stated that *tax evasion is a term of tax art; its performance constitutes a criminal offence and it has its own requirements, one of which is an act that can best be described as fraudulent*.⁹⁵

Broomberg is of the view that the Court likely intended to refer to *avoidance* of tax rather than *evasion* and thus suggested that the *new rule* should read as follows: *if the purpose of the transaction is only to allow the avoidance of tax, then the transaction will be regarded as simulated*.⁹⁶ He goes on to state that even such an interpretation would result in a *new rule*, which departs from the principles announced in previous Appeal Court decisions.⁹⁷

In addition, Broomberg points out that this change would have an impact on the existing rule of law that where a transaction gives rise to legitimate rights and obligations, which by virtue of their nature do not give rise to a tax liability in terms of the Income Tax Act, despite having taken into account the general anti-avoidance provisions set out therein, then the transaction in question does not attract tax. Simply put, this is a declaration of the legislature and it is not for a Court to deem such a transaction to be simulated by virtue of the fact that same avoids the imposition of tax.⁹⁸

Broomberg is of the view that Lewis JA considers it improper for taxpayers to be permitted to structure transactions in such a manner so as to avoid the imposition of tax, despite having created legitimate rights and obligations in terms thereof. This view, nonetheless:

[D]oes not justify the Court in overriding the basic common law principle, and in creating a new common law rule to counter such tax-avoidance. One reason is that, quite apart from the fact that it breaches the

⁹⁴ De Koker (2015) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version) at para 19.

⁹⁵ Davis D (2014) NWK: Can it be saved? Cape Town: *The Taxpayer* (Vol 63)(No 4) at p63.

⁹⁶ Broomberg, E.B. (2011). The Founders Hill and NWK cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 10.

⁹⁷ See decisions in the *Zandberg v Van Zyl* and *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* cases.

⁹⁸ Broomberg, E.B. (2011). The Founders Hill and NWK cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 17.

Rule of Law, there was no need for the judiciary to intervene. The fact is that the Court in *NWK* has sprung into action some 70 years too late.⁹⁹

Furthermore, Broomberg makes mention of the fact that the legislature introduced the statutory anti-avoidance provisions, which empowers the Commissioner to attack a transaction that has, as its sole or main purpose, the avoidance or reduction of a tax liability.¹⁰⁰

This begs the question of how a scenario would be dealt with, where a taxpayer enters into an agreement, creates legitimate rights and obligations, but because such a transaction avoids the imposition of a tax liability, same is regarded as being simulated. In respect of which rights and obligations should such a taxpayer be taxed?¹⁰¹ Commonly, there are many ways to achieve the same objective and, in this regard, in many instances there may be various scenarios of attaining a specific economic outcome, each of which may have a different tax outcome. Consequently, one must wonder how the Commissioner will decide in respect of which rights and obligations a taxpayer is to be taxed. Broomberg notes that this cannot be what was intended.

Lastly, in his criticism of the *NWK* judgment, Broomberg makes mention of the judgments in the *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* case, as discussed by Lewis JA, and notes that in his view, the judges came to opposing conclusions, as a result of their different interpretations of the wording of the Regulations, not because of a difference in approach to simulated transactions.¹⁰²

3.3. CONCLUSION

Subsequent to the judgment of the *NWK* case being handed down, a clear distinction arose between those authors who were in support of the judgment and those who firmly stood against it. Having considered the historical position as regards the approach to determining

⁹⁹ Broomberg, E.B. (2011). The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 18.

¹⁰⁰ Broomberg, E.B. (2011). The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 20.

¹⁰¹ Broomberg, E.B. (2011). The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 38.

¹⁰² Broomberg, E.B. (2011). The Founders Hill and *NWK* cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 46.

simulation as well as the views of respected such authors as Broomberg and Mazansky, it is submitted that the SCA, and notably Lewis JA, indeed deviated from the established and traditional approach to determining simulation by introducing an additional element, namely that of commercial substance. The question to follow is thus whether this deviation can be said to be a justifiable development of the existing principles of the Doctrine.

CHAPTER 4

THE PERCEIVED IMPACT OF THE *NWK* JUDGMENT ON THE STATUTORY GENERAL ANTI-AVOIDANCE PROVISIONS

4.1. INTRODUCTION

As mentioned previously, as an alternative argument to the allegation of simulation, the Commissioner contended that the arrangements between the parties constituted a transaction, scheme or operation that avoided tax impermissibly and could be challenged in terms of section 103(1) of the Act.¹⁰³

In the judgment, Lewis JA correctly noted that the section being relied on had, in fact, been repealed by the anti-avoidance provisions in sections 80A - 80L of the Act.¹⁰⁴ These provisions apply to all transactions entered into on or after 2 November 2006, but as these transactions occurred between 1999 and 2003, the Commissioner correctly relied on section 103(1) of the Act.

Lewis JA proceeded to state the following:

In summary, if satisfied that a transaction has been entered into, which has the effect of avoiding or reducing liability for tax, and would not normally be employed for bona fide business purposes, the Commissioner shall determine liability for tax as if the transaction had not been entered into.¹⁰⁵

There appears to be no reason why an invalid transaction cannot also be abnormal and concluded for the purpose of avoiding tax. Had the Commissioner not proved that the loan was a simulated contract, it would have been open to the Tax Court to consider the soundness of an assessment under s 103.¹⁰⁶

Assuming that the new rule regarding commercial substance would be applied going forward, one must ask what would be the need for the statutory anti-avoidance provisions, which empower the Commissioner to attack a transaction that has, as its sole or main purpose, the

¹⁰³ In light of the fact that the Court found in favour of the Commissioner, on the basis that the transactions were simulated, there was no need for the Court to further analyse, in detail, whether s 103(1) of the Act could have been applied; however, same was briefly touched on, as set out above.

¹⁰⁴ As inserted by section 34(1) of the Revenue Laws Amendment Act 20 of 2006.

¹⁰⁵ Judgment - para 91.

¹⁰⁶ Judgment - para 93.

avoidance or reduction of a tax liability.¹⁰⁷ Given the vastly different consequences, which would arise should a transaction be simulated versus the consequences, which would ensue if the transaction fell foul of the statutory general anti-avoidance provisions,¹⁰⁸ as Broomberg notes, it would be utterly undesirable should substantially the same test be applied in both scenarios.¹⁰⁹ In essence, the new rule regarding commercial substance would broaden the scope of the Doctrine to such an extent that it would be comparable to a judicially created GAAR, as has been the case in the USA.¹¹⁰

Consequently, an analysis of the GAAR is necessary to determine the interaction between these provisions and the common law test for simulation as advanced in the NWK case.

4.2. ANALYSIS OF THE GAAR

4.2.1. General

The Commissioner is empowered, in terms of the Act, to determine the tax consequences of any impermissible avoidance arrangement.¹¹¹

The Act provides that an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose is to obtain a tax benefit.¹¹² An avoidance arrangement is defined in Section 80L of the Act as any arrangement that results in a tax benefit. The definition of tax benefit includes any avoidance, postponement or reduction of any liability for tax.

¹⁰⁷ Broomberg, E.B. (2011). The Founders Hill and NWK cases under the spotlight. *Comment on CSARS v NWK Ltd. (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 20.

¹⁰⁸ Section 80B of the Act provides that, in the case of an impermissible avoidance arrangement, the Commissioner may determine the tax consequences by, *inter alia*, disregard or characterising any steps in or parts of the impermissible avoidance arrangement; characterise any gross income, receipt or accrual of a capital nature or expenditure or treat the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

¹⁰⁹ Broomberg, E.B. (2011). The Founders Hill and NWK cases under the spotlight. *Comment on CSARS v NWK Ltd (27/10) [2010] ZASCA 168*, Cape Town, 30 August 2011. Cape Town: South African Fiscal Association . para 28.

¹¹⁰ See discussion below.

¹¹¹ Section 80B(1) of the Act.

¹¹² Section 80A(1) of the Act.

4.2.2. Requirements of the GAAR

There are four requirements of an impermissible tax avoidance arrangement, each of which will be briefly discussed below. All four requirements must be present in order to apply the provisions of sections 80A - 80L can be applied,¹¹³ namely:

- a) there must be an arrangement;
- b) a tax benefit must exist (i.e. the arrangement must result in some or other tax benefit);
- c) the sole or main purpose of the avoidance arrangement must be to obtain a tax benefit; and
- d) the avoidance arrangement, (which can either be in the context of business, in a context other than business or in any other context), must be characterised by at least one so-called ~~st~~ainted element^q
 - i. the arrangement was entered into or carried out by abnormal means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit¹¹⁴ or
 - ii. the arrangement lacks commercial substance¹¹⁵
 - iii. the arrangement creates rights or obligations that would normally not be created¹¹⁶ or
 - iv. the arrangement would result in the misuse or abuse of the provisions of the Act.¹¹⁷

¹¹³ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p788.

¹¹⁴ Section 80A(a)(i) of the Act.

¹¹⁵ Section 80A(a)(ii) of the Act.

¹¹⁶ Section 80A(c)(i) of the Act.

¹¹⁷ Section 80A(c)(ii) of the Act.

Arrangement

An arrangement is defined to mean, *inter alia*, any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof.¹¹⁸ Presumably, an arrangement may also be construed to include a scenario where parties elect, prior to conclusion of their transaction, to depart from the original manner in which they had intended to transact, so as to achieve a different result.¹¹⁹

Tax benefit

A tax benefit¹²⁰ is defined to include any avoidance, reduction or postponement of any liability for tax¹²¹ and the term tax¹²¹ is further defined to include any tax, levy or duty imposed by the Act or any other Act administered by the Commissioner.¹²² In respect of the GAAR, a tax liability is understandably a foreseen liability¹²³ as opposed to being a current liability.¹²⁴

Case law supports the argument that in determining whether a transaction results in a tax benefit, the enquiry undertaken in this regard cannot be done in isolation, rather one would be required to determine, from the facts and circumstances, whether the transaction in question avoids, postpones or reduces an expected liability for tax.¹²⁵

Sole or main purpose of the avoidance arrangement must be to obtain a tax benefit

The meaning of mainly¹²⁶ has previously been held in case law to mean more than fifty per cent.¹²⁶ Quoting Louw (2007), *'solely or mainly' means 'for the most part; principally; chiefly', and that the phrase conveys the idea of dominance, i.e. to ascertain the weighting of each purpose of an avoidance arrangement.*¹²⁷

¹¹⁸ Section 80L of the Act.

¹¹⁹ From an opinion prepared by the tax directors of EY Advisory Services Proprietary Limited.

¹²⁰ Although the statutory definition thereof would take precedence, *Smith v CIR* 1964 (1) SA 324 (A) the SCA held that the normal meaning of the term tax benefit should prevail, namely to avoid, escape, or prevent an anticipated liability.

¹²¹ Section 1 of the Act.

¹²² Section 80L of the Act.

¹²³ In *Hicklin v SIR* 41 SATC 179, it was held that the liability was not referenced in respect an accrued liability, as same could not be escaped by entering into a transaction.

¹²⁴ *CIR v King* 1947 (2) SA 196 (A). Quoted from Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 20.

¹²⁵ From an opinion prepared by the tax directors of EY Advisory Services Proprietary.

¹²⁶ *Sekretaris van Binnelandse Inkomste v Lourens Erasmus (Eiendoms) Bpk* 1966 4 SA 444 (A).

¹²⁷ Meyerowitz, D, Meyerowitz on Income Tax+ 2006-2007 edition, *The Taxpayer*. Refer also Meyerowitz reference to *CIR v King* 1947 (2) SA 196 (A).

Previously, in terms of section 103(1) of the Act, in determining the sole or main purpose of the transaction, the South African courts repeatedly held that the subjective test ought to be applied in order to determine the sole or main purpose.¹²⁸

This being said, if regard has had to the provisions of section 80G(1), one may safely assume that this position has in fact changed. The section reads as follows:

An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

From the above, in order to avoid falling foul of a GAAR, a taxpayer will not only be required to provide persuasive reasons for the decision to enter into a transaction, but will also be required to show that the sole or primary purpose of entering therein was not to obtain a tax benefit.¹²⁹

The result is that now, objective criterion will be employed in determining whether a transaction passes scrutiny of the GAAR, whereas, in establishing the new rule Lewis JA also opted to consider the objective criterion.¹³⁰

This being said, our courts have frequently confirmed that taxpayers are entitled to structure their affairs in a tax efficient manner;¹³¹ however, this does not afford a taxpayer the opportunity of avoiding a tax liability in respect of income that is in reality such taxpayer's income.¹³² In *CIR v King* (1947 (2) SA 196 (A)) the Court held that:

[T]here is a real distinction between the case of a man who so orders his affairs that he has no income that would expose him to liability for income tax, and the case of a man who so orders his affairs that he

¹²⁸ *SIR v Gallagher* 1978 (2) SA 463 (A) and *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A). Referenced from Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 23.

¹²⁹ Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 25.

¹³⁰ Emslie stated as follows: 'We agree that, in testing whether a transaction is a simulated transaction, a court can examine the commercial sense of the transaction and its real substance and purpose, but this should be done through the eyes of the parties to the transaction. The test for simulation is necessarily a subjective one, for the question whether parties have an intention to deceive can only be subjective. However, Lewis JA appears to have opted for an objective test.' Emslie, T *Simulated Transactions – NWK revised*, The Taxpayer (Vol 60)(No 2).

¹³¹ *CSARS v LG Electronics* (428/09) [2010] ZASCA 79.

¹³² From an opinion prepared by the tax directors of EY Advisory Services Proprietary.

escapes from liability for taxation, which he ought to pay upon the income that is in reality his. Similarly there is a distinction between reducing the amount of tax from what it would have been if he had not entered into the transaction and reducing the amount of tax from what it ought to be in the tax year under consideration.

One or more of the “tainted elements” must be present

The phrase *in the context of business*, in light of the discussion above, means entering into an avoidance arrangement in the ordinary course of a taxpayer's business dealings.¹³³

As regards the onus of proof, section 82 of the Act places the burden of proof, in all tax disputes, on the taxpayer and this holds true for the GAAR as well. However, Meyerowitz makes the observation that in respect of establishing the existence of a tainted element, the onus rests with the Commissioner.¹³⁴ As a result, the taxpayer is required to prove that the sole or main purpose of the transaction was not to obtain a tax benefit, conversely, the Commissioner is required to establish at least the presence of one of the tainted elements.

Abnormality for a bona fide business purpose element

Certain authors are of the view that this requirement would be met if the means or manner in which the transaction was entered into would, in normal circumstances, not be undertaken for legitimate business purposes.¹³⁵

In determining whether this element is met, it is suggested that one applies established business principles, common sense and bears in mind the choice principle as discussed and set out in *IRC v Duke of Westminster*.¹³⁶

¹³³ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p790.

¹³⁴ Meyerowitz, D, Meyerowitz on Income Tax+2006-2007 edition, *The Taxpayer*, at 29-11. Referenced from Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 25.

¹³⁵ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p790. Also see SARS (2011) *Draft Comprehensive Guide to the General Anti-Avoidance Rule*

¹³⁶ 1936, 19 TC 490. Referenced from Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 28.

Commercial substance element

Section 80C(1) of the Act provides that an avoidance arrangement lacks commercial substance if such an arrangement would have the result that a taxpayer would benefit from a significant¹³⁷ tax advantage, but such arrangement does not have a significant effect upon either the business risks or net cash flows of that taxpayer, apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this section).

Section 80C(2) lists certain indicators that are indicative of a lack of commercial substance, including:

- a) the legal substance of the avoidance arrangement differs significantly from the legal form of the individual steps;
- b) round trip financing;¹³⁸
- c) an accommodating or tax indifferent party;¹³⁹ or
- d) elements that offset or cancel one another.

Rights and obligations not usually created between persons dealing at arm's length

This requirement would be met if a transaction involving parties dealing at arm's length would not give rise to the same rights and obligations.¹⁴⁰ In the judgment handed down by Trollip JA,¹⁴¹ the following was stated regarding what would constitute parties dealing at arm's length:

[I]t connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself.¹⁴²

¹³⁷ Although significant is not defined in section 80C, it is suggested that same may be viewed either subjectively (from the taxpayer's standpoint) or objectively (from the man in the street's standpoint), with the objective approach likely being preferred by the courts. Please see Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p790.

¹³⁸ As contemplated in section 80D of the Act.

¹³⁹ As contemplated in section 80E of the Act.

¹⁴⁰ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p790.

¹⁴¹ *Hicklin v SIR* 41 SATC 179.

¹⁴² Louw *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT) p 37.

Misuse or abuse of statutory provisions

The purpose of this requirement is to ensure that cognisance is had to the purpose and intention of the legislative provisions set out in the Act, including the specific provisions in sections 80A - 80L.¹⁴³ In essence, this reaffirms that the purposive approach should be followed in interpreting legislation.

SARS explains this concept as follows:¹⁴⁴

The misuse or abuse concept in the GAAR is not aimed at replacing or codifying the common law, but is rather aimed at creating a separate and new concept that exists alongside these well-established doctrines. The introduction of the misuse or abuse concept is intended to reinforce the emerging trend in South Africa (which mirrors similar trends in other jurisdictions) towards a contextual and purposive approach to tax statutes to find a meaning that harmonises the wording, object, spirit and purpose of [their] provisions. As there is no overriding presumption as to misuse or abuse, the onus of proof rests on the Commissioner to show on a balance of probabilities that such misuse or abuse exists.

4.3. COMPARISON OF THE GAAR AND THE 'REVISED' TEST FOR SIMULATION

Having compared the requirements for simulated transactions and that of impermissible avoidance arrangements in terms of GAAR, a taxpayer would bear the onus of proving certain elements for each.¹⁴⁵

4.3.1. Defences for simulation of a transaction

To avoid a transaction being regarded as being simulated, a taxpayer will have to prove that the substance of the transaction does not differ from the form; the transaction was not entered into for the avoidance of incurring a tax liability and neither party to the transaction had the intention of disguising the transaction and the primary purpose thereof was not to avoid tax. Should Lewis JA's judgment in the *NWK* case hold true, an additional requirement will, of course, be the commerciality of the transaction in question.

¹⁴³ Stiglingh M, Koekemoer AD, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2012. *SILKE: South African Income Tax 2013*. 15th ed. LexisNexis. Johannesburg . p790.

¹⁴³ *Hicklin v SIR* 41 SATC 179.

¹⁴⁴ SARS (2011) Draft Comprehensive Guide to the General Anti-Avoidance Rule

¹⁴⁵ Marais *Simulation discussed: Tax avoidance in the common law* (MCom Dissertation 2012 UCT) 46.

In light of the extensive case law discussed in this study,¹⁴⁶ it would be accurate to say that the existing jurisprudence on the matter has been applied successfully and any deviation therefrom, particularly as contemplated in the *NWK* case judgment, would amount to a judicially created GAAR because of its wide applicability. Had South Africa not already had statutory anti-avoidance provisions in place, which specifically target arrangements that lack commercial substance, such as the United States of America (~~%USA+~~), the purported expansion may well be required. However, this is not the case.

4.3.2. Defences for the GAAR

To ensure that a transaction does not fall foul of the statutory general anti-avoidance provisions, a taxpayer will have to prove that there is no arrangement or tax benefit; the sole or main purpose of the transaction was not to obtain a tax benefit and at least one of the tainted elements do not apply to the transaction (e.g. the transaction has, by way of example, commercial substance).

4.3.3. Comparison to the approach adopted by the USA

The approach to simulation as adopted by Lewis JA, may be likened to the current approach followed by the courts in the USA, by creating an economic substance doctrine as a broad anti-avoidance rule. It is submitted that the USA Courts have, over time, developed several subcategories of the Doctrine, including the ~~business purpose test~~¹⁴⁷. One must, however, consider the reasons for the development and in this regard, it would be most appropriate to consider the case of *Gregory v Helvering*,¹⁴⁸ being the landmark case in the USA regarding the formulation of the ~~business purpose test~~.

Briefly, the taxpayer, being the sole shareholder of an entity that transferred a portion of its shareholding in another entity to a newly incorporated company (~~%Newco+~~), received transfer of all of the newly issued shares, from the Newco. The Newco was shortly thereafter dissolved and liquidated by the distribution of the newly issued shares to the taxpayer. The taxpayer immediately elected to sell the shares acquired for her individual profit. Ostensibly, the only reason for the incorporation of Newco was to give effect to the proposed transfer and it was never intended to conduct any additional business activities through Newco. Essentially, the

¹⁴⁶ See chapter 2.

¹⁴⁷ Fraser (2011) The ~~New~~ Economic Substance Doctrine: The Three Cs: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011).

¹⁴⁸ 293 U.S. 465 (1935).

taxpayer implemented the transaction in such a manner so as to ensure that every legislated requirement to obtain the tax benefit being sought, was complied with. The taxpayer's argument was based on the contention that the mere fact that the very purpose of the transaction was to obtain a tax benefit, in and of itself, was insufficient to deem the transaction a sham.

The Court held the following:

In these circumstances, the facts speak for themselves, and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule, which excludes from consideration the motive of tax avoidance, is not pertinent to the situation, because the transaction, upon its face, lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.¹⁴⁹

For many years, the Commissioner of Internal Revenue of the USA sought to investigate and determine taxpayers' true business related motives,¹⁵⁰ often with the assistance or condonation of the courts.¹⁵¹ Certain authors are of the view that this is the reason for the eventual development of the business purpose test in the USA in the *Gregory v Helvering* case.¹⁵² In addition, it is important to note that the USA does not have any legislated anti-avoidance provisions and for this reason, the judiciary of the USA sought to counteract avoidance by implementing several judicial anti-avoidance rules, one of which is the business purpose test.¹⁵³

A distinction most certainly exists between the approach taken by the USA versus South Africa, primarily due to the fact that prior to the *NWK* judgment, South Africa already had legislated GAAR, whereas the USA did not have such rules in existence and for that reason, the USA required a judicially created economic substance doctrine.

In addition, the consideration of the court in *NWK* was of a doctrine that has been in existence for a number of years and has been applicable to all transactions, not exclusively tax

¹⁴⁹ Page 293 U. S. 470.

¹⁵⁰ Waizer, H. Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability, *Fordham Law Review* (Vol 49)(Issue 6).

¹⁵¹ See *TSN Liquidating Corp. v United States* 624 F.2d 1328 (1980); *Quinlivan v Commissioner* 444 U.S. 996 (1979).

¹⁵² Waizer, H Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability, *Fordham Law Review* (Vol 49) (Issue 6).

¹⁵³ Ault HJ (1997) *Comparative Income Taxation: A Structural Analysis* The Hague: Kluwer Law International.

avoidance transactions. In this regard, the requirement for commercial purpose, which appears to be tailor made for tax avoidance transactions, might render the Doctrine difficult to apply to non-tax related simulated transactions. In other words, the modification of the Doctrine as contemplated in the *NWK* case, renders the Doctrine more of an anti-tax avoidance measure than a general doctrine against simulated transactions. It would most certainly be undesirable to have one set of principles to determine substance over form in the case of tax avoidance transactions and a different set of principles to determine substance over form in the case of non-tax simulated transactions.

4.4. CONCLUSION

As stated, should the new rule be given effect to, the requirements for simulation under the common law and the test for an impermissible tax avoidance arrangement in terms of the GAAR would be substantially the same and would be curbing the same mischief.¹⁵⁴

Given the vastly different consequences that would apply in each scenario, would it mean that the Commissioner would have the discretion regarding which route to pursue in questioning the true nature of a transaction? Such discretion would essentially circumvent the limitation of the Commissioner's powers in terms of the GAAR as the Commissioner could instead contend that an irrefutable presumption of simulation arises as a result of the tax avoidance purpose of a transaction.¹⁵⁵

Vorster explains the consequences of such powers perfectly. If one were to look at the transaction in the *Randles Brothers* case, same would have to be regarded as being simulated, based solely on the fact that the parties entered into the agreement to avoid the imposition of customs duties,¹⁵⁶ without at any point having considered the intention of the parties or the legal effect of their agreement. Surely, this could not possibly be what the SCA had intended when delivering the now controversial judgment.

¹⁵⁴ Vorster (2011) *NWK* and Purpose as a test for Simulation. Cape Town: *The Taxpayer* (Vol 60) at p84.

¹⁵⁵ *Ibid.*

¹⁵⁶ Please refer to Chapter 2 for detailed facts of the *Randles Brothers* case.

CHAPTER 5

JUDICIAL CLARITY ON THE SUBSTANCE OVER FORM DOCTRINE AFTER *NWK*

5.1. INTRODUCTION

Amidst all of the confusion and discussion regarding the true meaning, and resulting consequences, of the judgment handed down in the *NWK* case, the tax community, and presumably the larger legal fraternity, welcomed the clarification brought about initially by *Bosch* case and finally in the case of *Roshcon*. This clarification was most necessary, particularly in view of the fact that the court in the *NWK* case deviated substantially from the existing principles regarding the determination of simulation and in doing so, introduced an additional element, namely that of ~~æ~~commercial substance~~q~~. Having considered the interplay between the revised principles of the Doctrine, as contemplated in the *NWK* judgment, and the test for an impermissible tax avoidance arrangement in terms of the GAAR, it would not appear as though one would be able to justify the development of the existing principles of the Doctrine so as to validate the ostensible revision.

5.2. ANALYSIS OF THE BOSCH CASE

On 20 November 2012, a full bench of the Western Cape High Court handed down the judgment in the case between *Mariana Bosch and Ian McClelland vs the Commissioner*, which upheld the appeal in respect of an order of the Income Tax Court, which was delivered on 14 September 2011.

5.2.1. Facts

Briefly summarised, the facts were as follows:¹⁵⁷

- g) The appellants (i.e. Mariana Bosch and Ian McClelland), being employees of the Foschini Group of companies, partook in an employee share incentive scheme (~~%Scheme~~), implemented by their employer.

¹⁵⁷ The facts have been summarised as they appear in the Western Cape High Court judgment paras 1 . 17 and Louw (2012) High Court Interprets NWK Judgment. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (23 November 2012) at p1.

- h) According to the mechanisms of the Scheme, the appellants were given the option to purchase shares. Such option had to be exercised within a set period of time after the offer was made to the appellants and both appellants elected to exercise same within the required timeframe.
- i) In respect of the shares, delivery and payment was delayed and would occur in three tranches, on the second, fourth and sixth anniversaries of the notice date (each being an **implementation date**). Essentially, all risk and benefit in the shares would be transferred to the appellants only once payment and delivery had occurred.
- j) In terms of the Scheme, the appellants were entitled to sell their shares back to the employer if the price in respect of such shares fell below the price payable on the implementation date. Furthermore, the Scheme provided certain instances in which the employer would be entitled to repurchase the shares.
- k) The effect of the aforementioned provisions of the Scheme was that same bypassed the provisions of section 8A of the Act, in that the full gain arising from the date of the notice containing the option until the date of delivery and payment, would not be taxable as income in the appellants' hands.
- l) The Commissioner raised additional assessments on the difference between the cost of the shares on the date when they exercised the options and the market value on each implementation date. The Commissioner held that the operation of the Scheme amounted to a simulated transaction due to the fact that the parties did not intend for a sale to occur at the time of exercising the option, but rather that the sale ought to be subject to the suspensive condition that the appellants were to remain in the employ of the employer until such time as payment and delivery of the shares had occurred.

5.2.2. Findings of the Western Cape High Court

In delivering the main judgment, Davis J (Baartman J concurring), seized the opportunity to examine the judgment in the *NWK* case, as the finding therein formed the basis of the Commissioner's argument at present. Davis J indicated that in his view, and having had regard to the facts of the case, the SCA was clearly presented with several simulated transactions in

the *NWK* case. As regards the judgment delivered by Lewis JA, Davis J was not of the view that Lewis JA intended to alter the existing principles of the Doctrine.¹⁵⁸

In his view, Davis J stated that the judgment handed down in the *NWK* case, and in particular paragraph 55 thereof,¹⁵⁹ must be read within the context of previous judgments regarding the Doctrine, such as *Commissioner for Customs and Excise v Randles, Brothers and Hudson Ltd*, *Zanberg v van Zyl and Erf 3138 / Ladysmith (Pty) Ltd v CIR*.¹⁶⁰ Essentially, he was of the opinion that the judgment in the *NWK* case and the existing case law on the matter, ought to be read as a whole, rather than interpreting the former in such a manner so as to deviate from the existing jurisprudence.¹⁶¹

The interpretation put forth by Davis J, as regards the test for simulation in light of the judgment in the *NWK* case, is that an examination of the commercial rationale of a transaction is required,¹⁶² meaning that where a transaction purports to have, as a basis, commercial rationale, yet no such rationale can be established and the single reason for the transaction is to avoid incurring a tax liability, then the approach adopted by Lewis JA would be defensible.¹⁶³

Holding quite the contrary view, Waglay J, writing the dissenting judgment, states that the SCA did drastically depart from the existing jurisprudence on simulated transactions.¹⁶⁴ Waglay J states:

NWK, considered in its entirety, not by extraction of words and phrases out of their real context, does in fact lay down the rule that any transaction that has as its aim tax avoidance will be regarded as a simulated transaction irrespective of the fact that the transaction is for all purposes a genuine transaction.

¹⁵⁸ Judgment - para 78: %b]eyond this finding, there is nothing in the careful judgment of Lewis JA which supports the argument that the reasoning as employed in *NWK* was intended to alter the settled principles developed over more than a century regarding the determination of a simulated transaction for the purposes of tax.+

¹⁵⁹ As delivered by Lewis JA: %tThe test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably, where parties structure a transaction to achieve an object other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that the parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.+

¹⁶⁰ Please refer to detailed discussion in chapter 2.

¹⁶¹ Judgment - para 84. Davis J states that %a without an express declaration to that effect, *NWK* should be interpreted to fit within a century of established principle, rather than constituting a dramatic rupture.+

¹⁶² Louw (2012) High Court Interprets *NWK* Judgment. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (23 November 2012) at p2.

¹⁶³ Judgment . para 86.

¹⁶⁴ Judgment . para 4.

Notwithstanding, Waglay's interpretation of the judgment as stated above, he goes on to set out the requirements that are to be met for a precedent to be created, namely that the judgment must be *clear and unequivocal, it must be plain, unmistakable and explicit in its rejection of previous judgments that it seeks to reverse and it must be applicable to the facts in the matter before the court confronted with its possible application*.¹⁶⁵ In his view, the judgment in the *NWK* case did not expressly depart from previous binding judgments, nor was this intention evident from the reasoning set out therein.¹⁶⁶

In addition, Waglay J pointed out the SCA's confusion regarding the distinct concepts of *tax avoidance* and *tax evasion* and notes that the decision cannot serve as being the authority on the matter of simulated transactions, should the purpose of the transaction be tax evasion as opposed to tax avoidance, the latter being a criminal offence thus resulting in the transaction in question being set aside due to illegality.¹⁶⁷ For these reasons, Waglay J held the view that the judgment cannot be used as binding precedent on lower courts.

5.3. ANALYSIS OF THE ROSHCN CASE

Despite the attempts by the High Court in *Bosch and another v Commissioner for the South African Revenue Service* to settle the controversy arising as a result of the judgment in the *NWK* case, a measure of confusion persisted. On 31 March 2014, the debate sparked by the *NWK* case was finally put to rest in the SCA judgment of *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC*.

5.3.1. Facts

Briefly summarised, the facts were as follows:¹⁶⁸

- a) Due to business requirements, the appellant sought to purchase five trucks, which required bespoke modification, to be fitted with cranes. The trucks were ordered by the appellant from Toit's Commercial Proprietary Limited (**Toit's**), who in turn, procured the trucks from Nissan Diesel (SA) Proprietary Limited (**Nissan Diesel**).

¹⁶⁵ Judgment . para 7.

¹⁶⁶ Davis J also made reference to Broomborg's analysis of the *NWK* case and stated: *Broomborg thus views NWK as a new and unjustified rule, which replaces the previous jurisprudence. In my view, without an express declaration to that effect, NWK should be interpreted to fit within a century of established principle, rather than constituting a dramatic rupture.*

¹⁶⁷ Louw (2012) High Court Interprets *NWK* Judgment. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (23 November 2012) at p2.

¹⁶⁸ The facts have been summarised as they appear in the SCA judgment paras 3 . 8.

The financing thereof was provided by Firstrand Bank Limited (trading as Wesbank) (~~Wesbank~~).

- b) Nissan Diesel and Wesbank had concluded a supply agreement in terms of which the former provided the trucks to the latter. Similarly, Wesbank and Toit~~s~~ had concluded a ~~floor plan agreement~~ according to which Wesbank provided financing to the authorised Nissan dealer (i.e. Toit~~s~~). The trucks, purchased by Wesbank from Nissan Diesel, were delivered directly to Toit~~s~~.
- c) The trucks, on instruction from Toit~~s~~, were delivered to Anchor Auto Body Builders CC (~~Anchor~~) so that the required modifications could be undertaken. Two modified trucks were delivered to the appellant on 19 November 2008; however, the appellant took ownership of the remaining three trucks on 21 November 2008 by signing the handover sheet. These trucks were not physically delivered to the appellant, as Anchor needed to finalise additional modifications thereto.
- d) On 28 November 2008, Roshcon made payment for all five trucks to Toit~~s~~; however, as Toit~~s~~ had not yet paid Anchor for the work done, Anchor would not release the three remaining trucks.
- e) Roshcon settled payment with Anchor for the modifications; however, by this time, Toit~~s~~ had commenced with liquidation proceedings and, on instruction from Wesbank, Anchor did not release the trucks, as it claimed ownership of the trucks as Toit~~s~~ had not yet paid for them.
- f) Several months later, Anchor released the trucks to Wesbank, which sold two of the vehicles to Unitrans Supply Chain Solutions Proprietary Limited. Roshcon held that the supply and floor plan agreements amounted to a disguise or simulation. According to Wesbank, the onus of proving in respect of a simulated agreement rested with the party alleging simulation (i.e. Roshcon) and in the case at hand, Roshcon failed to discharge such onus.

5.3.2. Findings of the SCA

In a separate judgment, with which the full Court concurred, Wallis JA took the opportunity to provide welcome clarification in respect of the judgment in the *NWK* case. As a point of first departure, Wallis JA confirmed that the foundation of South African law, as regards simulation,

is contained in the statement made by Innes J in the *Zandberg v Van Zyl* case, namely that in determining whether a transaction is simulated, the Court must have regard to the real intention of the parties and subsequently determine whether such intention differs from the intention created by their agreement.

After briefly going on to discuss the principles established in existing jurisprudence regarding simulation, Wallis JA went on to say that ~~nothing~~ nothing said subsequently in any of the judgments of this Court dealing with simulated transactions alters those original principles in any way or purports to do so~~+~~

Wallis JA emphasised the fact that it would be fundamentally incorrect to attach such an interpretation to the judgment in the *NWK* case so as to suggest that any transaction,¹⁶⁹ which has the avoidance of a tax liability as its sole purpose, is a simulated transaction. Doing so would mean that the interpreter failed to read the judgment in the correct context¹⁷⁰ and would further result in mass condemnation of several suites of transactions, merely due to the fact that such transactions have the avoidance of a tax liability as their sole purpose. Wallis JA summarised this as follows:¹⁷¹

Whether a particular transaction is a simulated transaction is, therefore, a question of its genuineness. If it is genuine, the court will give effect to it and if not, the court will give effect to the underlying transaction that it conceals. And whether it is genuine will depend on a consideration of all the facts and circumstances surrounding the transaction.

The SCA's position, as delivered by Wallis JA, regarding the test for simulation is:

For those reasons, the notion that *NWK* transforms our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains that the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated (own emphasis).

¹⁶⁹ In his judgment, Wallis JA states with particular reference to paragraph 55 of the judgment delivered by Lewis JA in the *NWK* case, that people have misunderstood the judgment and in particular the statement that ~~if~~ if the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated~~+~~ to mean that all contractual arrangements that enable the parties to avoid tax will be seen as being simulated. That was not Lewis JA's intention.

¹⁷⁰ Louw (2014) Supreme Court of Appeal Revisits Simulation. *DLA Cliffe Dekker Hofmeyr: Tax Alert* (4 April 2014) at p3.

¹⁷¹ Judgment . para 27.

5.4. CONCLUSION

It is indeed noteworthy that even honourable and experienced judges, having regard to the majority and dissenting judgments in the *Bosch* case, differ in their interpretation of the judgment handed down by Lewis JA in the *NWK* case and this illustrates how vitally important clarification regarding the meaning thereof was.

Should the enquiry as per the *NWK* case have prevailed, it would have been an enormous deviation from the established principles forming part of the Doctrine, which has been considered and applied in a plethora of different cases. In other words, one can determine conclusively that the Court in the *NWK* case did not expand the existing Doctrine, but rather sought to revise the traditional understanding of the common law principles encompassed in the Doctrine. The revision of the Doctrine as contemplated in the *NWK* case, would have rendered the Doctrine an anti-tax avoidance measure rather than a general doctrine against simulated transactions.

Despite those who showed support for the judgment in the *NWK* case, the clarity brought about by the *Bosch* and *Roshcon* cases was welcomed by most. With specific reference to Wallis JA's judgment in the *Roshcon* case, the judiciary can now accept that there are no deviations from the established principles forming part of the Doctrine and indeed an enquiry as to simulation will place emphasis on the manner in which the parties to a transaction intend to implement such transaction. In other words, the uncertainty and inconsistencies brought about as a result of the *NWK* case have indeed been relegated to history and the traditional approach to simulation, as set out in the cases of *Zandberg v Van Zyl, Commissioner for Customs and Excise v Randles Bros & Hudson Ltd* and *Erf 3183/1 Ladysmith and Another v Commissioner for Inland Revenue*, stand.

CHAPTER 6

CONCLUSION

6.1. CONCLUDING REMARKS

As has been discussed above, the Doctrine has been applied to simulated transactions, in general, for over a century and has been repeatedly considered and affirmed by South African courts. By having regard to the three crucial judgments of the SCA, namely the *Zandberg v Van Zyl* case, the *Randles Bros* case and the *Ladysmith* case, it is clear that, in determining whether a transaction is simulated or not, the courts will consider the intention of the parties and, depending on the nature of such intention, possibly further investigate whether such intention has been given effect to. Prior to the SCA judgment in the *NWK* case, the courts did not deem it necessary to have regard to the commercial substance of the transaction.

Rather, our courts have reiterated that where the parties to a transaction *legitimately and honestly intend* for such a transaction to be given effect in accordance with the nature and meaning thereof, then the courts will, generally speaking, give effect to the transaction in accordance thereto.

This approach seems to align with the approach adopted in several international jurisdictions, including Australia and Canada, both of which jurisdictionsqcommon law developed from English common law. In the aforementioned jurisdictions, with regard to determining simulation, one may conclude that emphasis is to be placed on the intention of the parties to a transaction and thus a test as to such partiesqintention is required. As set forth in this study, attempts, in Australia and Canada, to modify such established have proved to be unsuccessful.

In light of the analysis undertaken above, it is apparent that many authors, including Bloomberg, held the view, as does the author of this study, that the SCA judgment in the *NWK* case sought to revise the enquiry as to whether a transaction is simulated or not, by requiring focus to be placed on the transaction itself rather than having regard to the intention of the parties.

Should this interpretation and ostensible ~~new rule~~ have been given effect to, the requirements for simulation under the common law and the test for an impermissible tax avoidance arrangement in terms of the GAAR would have been substantially the same.

Importantly, taking into consideration that such a scenario would be addressing the same mischief, and given the different consequences that would apply in each scenario, the Commissioner would possibly have the discretion to choose which route to follow and such a broad discretion would circumvent the limitation of the Commissioner's powers in terms of the GAAR.

The approach to simulation as adopted by Lewis JA, may be likened to the approach followed by the courts in the USA, by creating an economic substance doctrine as a broad anti-avoidance rule. However, having considered the reason for the approach taken by the USA, one can safely conclude that a distinction exists between the approach taken by the USA versus South Africa, primarily due to the fact that prior to the *NWK* judgment, South Africa already had legislated GAAR, whereas the USA did not have such rules in existence and for that reason, the USA required a judicially created economic substance doctrine.

6.2. RECOMMENDATIONS

Taxpayers are entitled to structure transactions in such a manner so as to reduce or eliminate a tax liability, provided such structuring is both *bona fide* and factually genuine from a commercial standpoint and, very important to note, is that the courts do not have the mandate to unjustifiably ~~widen the net of tax liability~~.

Notwithstanding the various interpretations adopted in respect of the SCA judgment in the *NWK* case, the clarity provided in the judgments of the *Bosch* case and *Roschon* case was not only welcomed, but settled any lingering interpretational questions. Having concluded that the traditional approach to determining simulation stands, in other words, one must determine whether the parties to a contract truly intended to act in accordance with the tenor of the agreement, irrespective of what their purpose for entering into that transaction was, there is no longer uncertainty regarding the correct manner in which to determine whether a transaction is simulated nor whether the SCA established a new judicial anti-avoidance principle.

This affords taxpayers the opportunity to continue implanting creative structuring opportunities, complex or not, so as to optimise tax savings and to minimise tax liability,

without having to show that there is a commercial purpose for such structuring. Of course, this does not mean that taxpayers' structuring opportunities may fall foul of the statutory general anti-avoidance provisions.

The Commissioner is empowered to continue investigating simulated transactions, using the existing guidelines and principles, discussed at length in Chapter 2 as well as investing transaction which ostensibly fall foul of the GAAR. The important distinction is that the Commissioner will not be using a judicially created GAAR in order to combat and strike down simulated transactions.

(Word count: 21 724)

LIST OF REFERENCES

BOOKS

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

De Koker (2015) *SILKE on South African Income Tax* (Vol 1-4) LexisNexis (Online Version).

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

Nagel CJ (ed) (2006) *Commercial Law* (3rd ed.) Durban: LexisNexis Butterworths.

Stiglingh M *et al.* 2012. *SILKE: South African Income Tax 2015*. LexisNexis.

CASE LAW

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

Commissioner for Inland Revenue v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA).

Commissioner for Inland Revenue v King 1947 (2) ALL SA 155 (A).

Commissioner for Inland Revenue v Saner 1927 TPD 162.

Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd 2011 (5) SA 112 (SCA).

Commissioner for the South African Revenue Service v LG Electronics (428/09) [2010] ZASCA 79.

Commissioner for the South African Revenue Service v NWK Limited 2011 (2) SA 67 (SCA).

Commissioner for the South African Revenue Service v Sprigg Investments 117 CC t/a Global Investment 2011 (4) SA 551 (SCA).

Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd 1941 AD 369.

Dadoo Ltd v Krugersdorp Municipal Council 1920 AD 530.

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

Gregory v Helvering 293 U.S. 465 (1935).

Hofmeyer v Gous 10 SC 115.

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

IRC v Duke of Westminster [1936] AC 1.

ITC 1625 59 SATC 383.

ITC 1636 60 SATC 267.

ITC 1663 61 SATC 363.

Kilburn v Estate Kilburn 1931 AD 501.

McClurg v Canada (1990) 3 SCR 1020.

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

Minister of National Revenue v Cameron (1974) SCR 1062.

Raftland (Pty) Ltd v Commissioner of Taxation (2008) HCA 21.

S v Friedman Motors (Pty) Ltd 1972 (3) SA 421 (A).

Sharrment Pty Ltd v Official Trustee in Bankruptcy (1988) 18 FCR 449.

Snook v London & West Riding Investments Ltd (1967) 2 QB 786.

Stuart Investments Ltd v The Queen (1984) 1 SCR 536.

Vasco Dry Cleaners v Twycross 1979 (1) SA 603 (A).

Zandberg v Van Zyl 1910 AD 302.

JOURNAL ARTICLES

Broomberg, E (SC) (2011) NWK and Founders Hill. Cape Town: *The Taxpayer* (Vol 60).

Dachs, P (2011) The interpretation of substance over form. *In Practice – Edward Nathan Sonnenbergs*.

Davis D (2014) NWK: Can it be saved? Cape Town: *The Taxpayer* (Vol 63)(No 4).

Davis, DM. 2010 Simulated Transactions. Cape Town: *The Taxpayer* (Vol 59)(No 11 & 12) November-December 2010.

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

Emslie (2011) Simulated transactions . a new approach? Cape Town: *The Taxpayer* (Vol 60)(No1).

Emslie (2011) Simulated Transactions . NWK revised. Cape Town: *The Taxpayer* (Vol 60)(No 2).

Fraser (2011) The New Economic Substance Doctrine: The Three Cs: Consistency, Clarification and Claws. *TaxTalk* (March/April 2011).

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

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

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

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

SARS Media Release (15 December 2010). Available on <http://www.sars.gov.za>.

Surtees, P and Millard, S (2004) Substance, Form and Tax Avoidance *Accountancy SA* (November . December).

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

Waizer, H. Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability, *Fordham Law Review* (Vol 49)(Issue 6).

LEGISLATION

Constitution of the Republic of South Africa, 1996.

Income Tax Act 58 of 1962.

Tax Administration Act 28 of 2011.

PUBLICATIONS

Louw. *The new General Anti-Avoidance Rule: A Comprehensive Discourse on this Statute* (Dissertation 2007 UCT).

Marais. *Simulation discussed: Tax avoidance in the common law* (MCom Dissertation 2012 UCT).

Struwig. *Simulated Transactions: the requirement of “commercial substance” to determine simulation as enunciated in the NWK case – the established substance over form doctrine renovated or a mere indicator of a concealed transaction?* (LLM Tax Law Dissertation 2013 UP).