

**THE IMPACT OF THE 'BUSINESS PURPOSE' TEST
ON SECTION 103(1)**

THE IMPACT OF THE 'BUSINESS PURPOSE' TEST ON SECTION 103(1)

Being a technical report submitted by

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to

the University of Natal

in part satisfaction of the requirements of the award of the degree of

Masters of Accountancy

February 1999

DURBAN

ABSTRACT

The aim of this collection of essays is to provide a detailed and critical commentary on and analysis of the legislation and case law relating to the impact of the 'business purposes test' on section 103(1) of the Income Tax Act.

The Income Tax Act No. 58 of 1962 and case law that are the subject of these essays were promulgated on or before 28 February 1999.

DECLARATION

I hereby declare that this report is entirely my own work.

ACKNOWLEDGEMENT

I would like to express my thanks to Professor Lindsay Mitchell, my supervisor, for his assistance and advice in the compilation and preparation for submission of this material. I would also like to thank him for his invaluable assistance over the years that I have studied taxation, and for all his efforts in assisting me in completing my Masters degree from Johannesburg.

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CHAPTER A : INTRODUCTION

**THE MEANING OF TAX AVOIDANCE AND THE CONCEPT DISTINGUISHED
FROM TAX EVASION AND SHAM TRANSACTIONS**

Tax evasion is and has always been an illegal activity and subject to heavy penalties. It is the situation where a taxpayer consciously tries to shrink the payment of a tax liability by fraudulent or devious means. In other words, by falsifying his returns or books, by not rendering returns etcetera.

Tax avoidance, on the other hand, is the refining or escaping from or the preventing of a tax liability. In other words, it is the organising of the taxpayer's affairs to reduce the tax payable before it has been imposed.

Lord Tomlin succinctly defined avoidance in the English case of *Duke of Westminster v IRC* as follows:¹

'Every man is entitled, if he can, to organise his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in organising them as to secure this result, then, however unappreciative the

¹ 51 TLR 467, 19 TC 490 at 520.

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Commissioners for Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.¹

Much South African case law and academic pronouncements have supported this statement, and tax avoidance continues as a basis of tax planning.

The taxpayer, however, is not entirely at liberty to order his affairs legally so that he remains immune from tax. The Income Tax Act contains a general provision, section 103(1), specifically designed to counter tax avoidance schemes. If the requirements of this section are fulfilled, the taxpayer may be taxed as if he had never entered into the particular scheme designed to avoid tax. The transaction remains legally valid and enforceable between the parties to it, but is ignored for tax purposes.²

This must be distinguished from the case of 'disguised' or 'sham' transactions, which the courts, in terms of common law, are entitled to disregard, giving effect to the true nature of the transaction. In these cases it is unnecessary to resort to statutory provisions, for example, section 103(1). This type of transaction is one where the taxpayer uses some fictitious device which cannot give rise to the normal rights and duties of a valid transaction, and which attempts to hide its real purpose. A 'sham' transaction is different

² See later for more detailed explanation on the mechanics of this section.

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to a valid transaction that has been entered into for improper purposes, which might fall foul of section 103(1).

THE LEGISLATION

Section 103(1) of the Income Tax Act, as amended, reads as follows:³

‘Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) -

- (a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
- (b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –
 - (i) was entered into or carried out –
 - (aa) *in the case of a transaction, operation or scheme in the*

³ The 1996 amendments are shown in italics, and come into effect on promulgation of the Income Tax Act 36 of 1996, 3 July 1996; and apply to any transaction, operation or scheme entered into or carried out on or after that date. The provisions of section 103 will, however, in relation to any transaction, operation or scheme entered into or carried out before that date, continue to apply as if the amendments had not been enacted.

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context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa) by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question;
or

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

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

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

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A definition of a 'tax benefit' has been introduced in a new subsection (7), which reads as follows:

'For the purpose of subsection (i) "tax benefit" includes any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or any other law administered by the Commissioner.'

The introduction of the definition of a 'tax benefit' seems to have little impact, the main thrust of the amendments being to better equip the Commissioner for the South African Revenue Service in attacking 'business' transactions that are structured in a manner that avoids taxation.

THE REQUIREMENTS TO BE MET BEFORE SECTION 103(1) CAN BE INVOKED

From the above it can be seen that section 103(1) contains four key requirements which must *all* be present before the anti-avoidance provisions can be invoked.⁴ Briefly, the requirements are:

⁴ *SIR v Geustyn, Forsyth and Joubert* 1971 (3) SA 567 (A), 33 SATC 113.

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- a transaction, operation or scheme;⁵
- a resultant tax saving;⁶
- tax avoidance as a sole or main purpose;⁷
- abnormality.⁸

The first three requirements are now dealt with.

Transaction, operation or scheme

There has been little dispute over the meaning of these words in the courts. Because they are framed so broadly, the Commissioner has little difficulty in bringing almost any arrangement into their scope.

After referring to arrangements made by the taxpayer in *Meyerowitz v CIR*, Beyer JA agreed with the judgment of the Special Court for Income Tax Appeals in which Watermeyer J said the following:⁹

⁵ The opening portion of section 103(1).

⁶ Section 103(1)(a).

⁷ Section 103(1)(c) and the definition of 'tax benefit'.

⁸ Section 103(1)(b).

⁹ 1963 (3) SA 863 (A), 25 SATC 287 at 300.

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'The word "scheme" is a wide term and I think that there can be little doubt that it is sufficiently wide to cover a series of transactions'

A resultant tax saving

The phrase 'effect of avoiding or postponing liability' was interpreted in the case of *Smith v CIR*,¹⁰ where Steyn CJ, after rejecting an earlier interpretation given in the case of *CIR v King*,¹¹ applied the literal rule of interpretation and said the following at 12:

'The ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability.'

These two requirements can easily be proved by the Commissioner, and are seldom in dispute. The final two requirements are the ones on which most case law hinges.

Tax avoidance as a sole or main purpose

In determining 'purpose', the courts have held that the test is a subjective one and that

¹⁰ 1964 (1) SA 324 (A), 26 SATC 1.

¹¹ 1947 (2) SA 196 (A), 14 SATC 184.

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because a transaction has the effect of avoiding tax, it does not necessarily mean that this was its purpose.¹²

Although the courts have indicated that a tax avoidance 'effect' should not cloud their judgment as to 'purpose', section 103(4) states that once the 'result', that is the 'effect', of a scheme is to avoid tax, it is presumed, until the contrary is proved by the taxpayer, that the main 'purpose' was to avoid tax.

This means effectively that the taxpayer has to show that his dominant purpose was some non-tax purpose, as was done successfully in *SIR v Geustyn, Forsyth and Joubert*¹³ and *CIR v Louw*,¹⁴ as far as incorporation was concerned.

¹² See in this regard *SIR v Gallagher* 1978 (2) SA 463 (A), 40 SATC 39 at 48.

¹³ 1971 (3) SA 567 (A), 33 SATC 113.

¹⁴ 1983 (3) SA 551 (A), 45 SATC 113.

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SCOPE AND OBJECTIVES OF THE REPORT

The discussion which follows centres on the 'abnormality' requirement and whether the introduction of the 'business purpose' test creates any significant impact, and whether in essence, the intention of the amendments is to look at the substance of the transaction, or series of interrelated transactions, rather than the simple form – a view which has already been adopted by the Republic courts in some instances.

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CHAPTER B : NORMALITY

Section 103(1)(b) of the Income Tax Act, as amended, reads as follows:¹⁵

‘having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –

(i) was entered into or carried out –

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

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa) by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or

¹⁵ The 1996 amendments are shown in italics.

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scheme of the nature of the transaction, operation or scheme in question.'

INTERPRETATION OF THE SECTION BEFORE THE 1996 AMENDMENT (INCORPORATING A HISTORY OF THE AMENDMENTS)

The test of normality was probably introduced into section 103 as a result of the remarks of Schreiner JA in *CIR v King* where he said the following:¹⁶

'The section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer's affairs which will result in him getting less income; it is designed to meet the Commissioner's objections to the creation of *abnormal or unnatural* situations to the detriment of the fiscus. Now normally and naturally the owner of an income-producing asset receives the income and the labourer receives the reward of his labour. Any departure from this order of things, if done with the object of prejudicing the fiscus, is the subject of a legitimate objection by the Commissioner, which is met by the machinery of the section.'

(Emphasis added.)

¹⁶ 1947 (2) SA 196 (A), 14 SATC 184 at 199. The facts of the case were basically that King entered into an agreement whereby he sold certain shares in private companies to his child. In assessing King the Commissioner had, in terms of section 90 (now section 103), disregarded the agreement, and taxed the dividend in the hands of King and not in the child's hands.

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Over the years the section has been refined in a number of ways with the latest amendment introducing the so-called business purpose test which will be dealt with in greater detail further on.

PARTIES DEALING AT ARM'S LENGTH

Dealing with the legislation before the introduction of the 'business purpose' test.

The approach to the normality or otherwise of a transaction was dealt with by the Appellate Division of the Supreme Court in *Hicklin v SIR*.¹⁷ This case involved a so-called dividend stripping operation. The shareholders of a dormant company sold their shares to a purchaser at a price equal to the net asset value less a percentage thereof. Once the dividend stripper had obtained control of the dormant company, it declared the distributable reserves as a dividend (to itself) and thereafter deregistered the company. Because the dividend stripper was a company, and therefore not liable for tax on the dividend, the Commissioner applied section 103(1) and taxed Hicklin and his co-shareholders on the dividend (which at that stage, being natural persons, was taxable in

¹⁷ 1980 (1) SA 481 (A), 41 SATC 179.

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their hands).

In his judgment Trollip JA stated the following about section 103(1)(b):¹⁸

'A few preliminary observations about paras (i) and (ii) of the subsection. When the "transaction, operation or scheme" is an agreement, as in the present case, it is important, I think, *to determine first whether it was one concluded "at arm's length"*. That is the criterion postulated in para (ii). For "dealing at arm's length" is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage of the transaction for himself. Indeed in the Afrikaans text the corresponding phrase is "die uiterste voorwaardes beding". Hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by para (ii). And the means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal in the sense envisaged by para (i). The next observation is that, when considering the abnormality of the rights and obligations so created or of the means or manner so employed, *due regard has to be paid to the surrounding circumstances*. Section 103(1) itself postulates that. Thus, what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the

¹⁸ 1980 (1) SA 481 (A), 41 SATC 179.

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same nature in another case because of the absence of such circumstances. The last observation is that the problem of normality or abnormality in such matters is mainly a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence produced therein by either party.'

(Emphasis added.)

The court held that the agreement between the dividend stripper and the shareholders was an arm's length transaction in which each party was striving to obtain the maximum possible advantage for himself. For this reason the abnormality requirement was not satisfied and section 103(1) was therefore not applicable.

From this case it can be concluded that if there is an arm's length transaction it will be difficult for the Commissioner to defend the abnormality requirement and apply section 103(1).

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PARTIES NOT DEALING AT ARM'S LENGTH

The concept of parties not dealing at arm's length was dealt with in *CIR v Louw*.¹⁹ In this case a civil engineering partnership was incorporated by means of the sale of the business from the partnership to a newly formed company. The shareholders and directors of this company were the partners in the partnership.

The features that the Commissioner contended were 'abnormal' were the following:

- The sale of the assets of the partnership to the company on credit without requiring the payment of interest.
- The provision of payment of the credit loans when the purchaser's financial circumstances permitted.
- And the conclusion of service contracts between the company and its shareholders (the erstwhile partners) in terms of which no set remuneration was stipulated and the fact that the respondent received a salary which was much smaller than the income which accrued to him for performing the same services while the partnership existed.

¹⁹ 1983 (3) SA 551 (A), 45 SATC 113.

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Corbett JA, after quoting from *Geustyn's* case²⁰ the passage that the court was *ex hypothesi* concerned with partners who have made over their practice, not to an independent third party but to a company of which they are the sole shareholders and directors, went on to say the following:²¹

'In such a case should the Court, in applying the "normality" yardstick, take account of the special relationship between the erstwhile partners and the company which they have formed, or ignore it and apply the yardstick as though the company were a stranger? I do not see how the court can ignore the special relationship and yet give proper effect to the concluding words of section 103(1), viz. "under a transaction, operation or scheme *of the nature of the transaction, operation or scheme in question . . .*" (My italics.) For it is of the very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as shareholders and directors the self-same partners and will be controlled by them. Those are the realities of the situation. Moreover, it must be borne in mind that in a case such as the present the transaction is a multipartite one to which all the partners and the company are parties; and each partner's contracts both with the company and his fellow partners and seeks to extract from the transaction the best advantage for himself. (Here I might point out that this case differs from *Hicklin's* case *supra* in that there the Court was considering (see 494H - 495F) an agreement which was

²⁰ The facts of this case are similar to those of *Louw*, however, the *Geustyn* case was decided on the basis that the avoidance of tax was not the sole or main purpose of the incorporation, and therefore the issue of abnormality was not addressed in detail.

²¹ *CIR v Louw* 1983 (3) SA 551 (A), 45 SATC 113 at 135-6.

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entered into by parties dealing with one another at arm's length and the remarks of Trollip JA, particularly at the top of 495, must be read in light of that fact.²²)

'With this in mind, it does not seem to me that the features stressed by the appellant's counsel constitute the creation of abnormal rights or obligations. As to the arrangement that the payment of the purchase price was to be made only as and when the company was in a financial position to do so, there is little else that the parties could have done. Initially the company had very limited capital and the idea was that it would pay off the purchase price out of profits. That it proceeded to do over a period of five to six years. Since the sellers were the persons mainly instrumental in earning those profits and were in complete control over the company, it was a perfectly sound and businesslike arrangement. It was not an arrangement which would not normally have been created by persons dealing at arm's length in this type of transaction. The same goes for the non-payment of interest on the purchase price. The non-payment of interest increased the profits of the company, and this directly benefited the erstwhile partners as the shareholders in the company for it enabled the company to pay off the purchase price more rapidly. Likewise, in the particular circumstances, there was, in my view, no abnormality in the fact that the erstwhile partners gave their services to the company for no previously stipulated salaries. As controllers of the company they were able from year to year to determine in their own interests what their salaries were to be. The fact that in the tax years under review - and in previous years, it would seem - respondent received

²² Most of these remarks in *Hicklin's* case are quoted above.

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a salary which was much smaller than his income as a partner had been was again a matter of his own choice, in consultation with his co-directors and co-shareholders.'

Subsequent to the incorporation of the company, but independently thereof, as the court found, the credit loans having been exhausted, the company lent the shareholders large sums of money out of its profits free of interest, and without security and without any definite conditions of repayment. In the circumstances of the case it was held that the directors' loans, seen in the context of the amounts allocated by way of salary and dividends, were abnormal both as to the means or manner employed in granting them and as to the rights and obligations created thereby.

From this case it can be concluded that the surrounding circumstances should be taken into account in determining whether the transactions are considered abnormal. That is, having regard to the circumstances, would the transaction be considered normal?

THE AMBIGUITY OF THE JUDGMENTS

From the above two cases it can be seen that the major difficulty with the normality test is its ambiguity, that is, whether there is an objective test despite the context of specific

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circumstances.²³

To assist in this problem it is worth looking at other decided cases on the issue of abnormality.

In some earlier decisions, the court appeared to place some emphasis on whether a transaction was one in common usage.

In ITC 963, Galgut J said the following:²⁴

'I should add that a taxpayer who changed his investments so as to have an investment, the income from which is not taxable . . . is not indulging in an abnormal transaction . . . his conduct, or the transaction, is not in the court's view abnormal. This is *all the more so* when we are told that this is a test case, which indicates that *several persons* have entered into *such* transactions.'

(Emphasis added.)

²³ See The Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (The Katz Commission) at 113.

²⁴ (1961) 24 SATC 705 at 709.

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In ITC 1113,²⁵ Watermeyer J used the concept of the actions of a '*normal businessman*', as a yardstick for assessing the normality of a transaction.

(Emphasis added.)

In *Meyerowitz v CIR*, Beyer JA agreed with the judgment of the Special Court in which it was stated that²⁶

'the scheme was carried out in a manner which would not *normally be employed* because, although the appellant was still doing the work and neither the trustee nor his children were competent to assist in the production of *The Taxpayer*, it was not the appellant but the trust that was made a partner.'

(Emphasis added.)

And in *Smith v CIR*, Steyn CJ said the following:²⁷

'If the means and the manner are those *normally employed* . . . and the rights and obligations are those which would normally be created . . . between persons dealing at arm's length, the section would not apply even if, of a set purpose, a liability for income tax is being avoided or postponed or the amount reduced.'

(Emphasis added.)

²⁵ (1967) 30 SATC 8.

²⁶ 1963 (3) SA 863 (A), 25 SATC 287 at 296-7.

²⁷ 1964 (1) SA 324 (A), 26 SATC 1 at 11.

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From these passages it can be concluded that a normal transaction is one which is in common usage. Therefore, presumably, if one adopts a common method of tax avoidance, one can pass the normality test.

Two judgments have dealt with this issue, both of which have been severely criticised.

The first was that of *COT v Ferera*,²⁸ where the Rhodesian Appellate Division decided against the taxpayer.

The facts of this case are briefly that in 1952 the respondent formed a private company, P, which acquired his shares in three trading companies. The P company was formed solely to avoid death duties payable on the respondent's death and not to avoid the payment of tax on undistributed profits or to reduce the liability of P's shareholders to super tax. In accordance with the usual practice prevailing during the years of assessment in issue, the P company distributed two-thirds of its profits and retained the remaining one-third, thus avoiding payment of undistributed profits tax and reducing the liability of its shareholders for supertax. In respect of the years of assessment ended 31 March 1967, 1968 and 1969 the Commissioner, invoking his powers under section 91,²⁹ ignored the above mentioned

²⁸ 1976 (2) SA 653 (RAD), 38 SATC 66.

²⁹ Income Tax Act 5 of 1967 (of Rhodesia), similar wording to the Republic section 103(1) before the introduction of the 'business purpose' test.

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retention of profits by P company and assessed the respondent as though he had received a share thereof as dividends accruing to him and his wife in respect of their shareholding in the company.

In his judgment Macdonald JP stated the following:³⁰

'Avoiding, postponing or reducing liability for tax is not in itself either a business or trade since it is not in any way concerned with earning income but only with the incidence of tax on income. It would be absurd to suggest that the legislature, in attacking this evil, could possibly have intended to leave unscathed taxpayers who frankly admit that the transaction, operation or scheme had as its sole or main purpose the avoidance, postponement or reduction of tax. The only consequence of such frank admission is that it is unnecessary in the light of it for the Commissioner to base his decision to interfere upon circumstantial evidence. This is a conclusion which arises by necessary implication from the terms of the section as a whole. Clearly it was not the intention of the legislature to reward frankness with exemption from the powers conferred by the section. It is equally absurd to suggest that the legislature intended, as has sometimes been suggested, that taxpayers would not be subjected to those powers if the means or the manner *employed to avoid, postpone or reduce tax* was a means and manner normally employed for this purpose. Paragraphs (a) and (b) of the section use the word "normally" in the context of

³⁰ *COT v Ferera* 1976 (2) SA 653 (RAD), 38 SATC 66 at 72.

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transactions, operations or schemes which are supposedly or *professedly business or trading transactions*, operations or schemes and not in the context of transactions, operations or schemes which are admittedly *not* concerned with trade or business but simply with avoidance, postponement or reduction of tax.'

(Emphasis added.)

It is evident from this judgment that a commonly used method of tax avoidance, which lacks the characteristics of a business transaction, will not be considered normal for tax purposes merely because of its regular use. This judgment seems to narrow the argument of normality. It almost seems to indicate that once a taxpayer is shown to have entered into a scheme for the purposes of tax avoidance, he will no longer have the defence of normality, because no tax avoidance scheme can be normal.

This judgment has been criticised in South Africa. *The Taxpayer* stated that the³¹ 'dichotomy between purpose and normality has . . . been blurred almost to the point of extinction', and that the interpretation put upon the section in this case is to 'stretch the terms of taxing Acts in order to improve on the effects of Parliament.' Broomberg states that hardly any aspect of this judgment could be accepted as good law in South Africa.³²

³¹ (1976) 25 *The Taxpayer* at 169 and 170.

³² E B Broomberg, *Tax Strategy* 3rd Edition, at 255.

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The second case was ITC 1496.³³

In this case the taxpayer entered into a farming partnership as part of a so-called plantation scheme. The scheme operated on the premise that interest due over a lengthy period in the future could, by being settled immediately by way of promissory notes, be deducted immediately. The other attraction of the scheme was that each participant would benefit by claiming as a deduction a proportionate share of a management fee that was payable in advance for the management of the farming activities necessary for the operation of the scheme. To succeed with this claim, the taxpayer had to show that it was a partner in a farming venture.

Melamet J held that the scheme was entered into and carried out in an abnormal manner, which was outlined by the³⁴ 'artificial structure . . . necessitated by the need to camouflage investors as partners.'

Although there was consequently no need to decide whether the rights and obligations created were abnormal in a partnership, Melamet J was able, effortlessly, to reel off

³³ (1990) 53 SATC 229.

³⁴ At 250-1.

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seventeen abnormalities, which, he indicated, were but part of a much larger population.

This case was also criticised for being³⁵ 'a clear example of the kind of judicial intervention, probably last seen in the approach in *Ferera v COT*,³⁶ where Macdonald JP said that "tax avoidance was an evil" which meant that the courts must not by interpretation of the avoidance provisions deprive them of their efficiency.'

The Taxpayer in dealing with the comparison between the House of Lords' approach to tax avoidance most recently expounded in *Ensign Tankers Leasing Co Ltd v Stokes*³⁷ and that developed in ITC 1496, commented as follows:³⁸

'Deciding this question in favour of the partnership, the court said that the question was not why the taxpayer was trading but whether he was trading. If the sole purpose of the transaction was to obtain a tax advantage, it was not logically possible to postulate the existence of a commercial purpose. However, it was possible to have a situation in which a taxpayer, whose sole motive was the saving of tax, invests with others in an ordinary trading activity conducted by them for a commercial purpose and with a view of making a profit. The court considered this test to be an objective one. The adoption of this approach helps to prevent the court

³⁵ See The Katz Commission Third Interim Report in paragraph 11.2.5.

³⁶ 1976 (2) SA 653 (RAD), 38 SATC 66 at 70.

³⁷ (1989) 1 WLR 1222.

³⁸ (1990) 39 *The Taxpayer* at 228.

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from collapsing the distinction between abnormality and purpose in order to conclude that it was not possible to have a genuine partnership once the purpose of the partners was to save tax rather than conduct a trade. Once the requirements of abnormality and purpose are distinguished, then it would appear that the Ensign Tankers judgments have application in Southern Africa, that is, that the activities of the partnership should be assessed objectively in order to decide whether the partnership is truly engaged in a trading operation.'

The above was quoted in *The Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (the Katz Commission), which concluded as follows:³⁹

'As the Act is presently drafted, it is submitted that the Court's construction in the aforementioned case [ITC 1496] does not provide a legally correct solution to a more efficacious tax anti-avoidance provision and the criticism of The Taxpayer is accordingly justified.'

The criticism indicates that these two cases went further than the legislation currently stood and cannot therefore be seen as judicial precedent.

The conclusion of these cases would appear to be that, if the scheme is created or adopted

³⁹ Paragraph 11.2.7.

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in such a way that it has no resemblance to a business transaction, and is merely a tax engineering device, it will be unlikely to pass the test of normality. On the other hand, if the scheme is created and operated for the purpose of avoiding tax but conforms to an established norm for the particular type of transaction, and is operated in the manner of a normal business operation, it should pass the test of normality.

This conclusion veers towards new the 'business purpose' test, to be discussed in Chapter C.

COMPARISON WITH OTHER COUNTRIES

There are two basic approaches to tax avoidance around the world, namely, the inclusion of a provision in the tax legislation, and the law as developed through the cases.

The Katz Commission investigated a number of jurisdictions in order to evaluate comparative legislation and case law to formulate the need for, and efficiency of, a general anti-avoidance provision.⁴⁰

⁴⁰ Katz Commission Third Interim Report paragraph 11.3.

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Those jurisdictions which have a general anti-avoidance provision are first discussed, and then the United Kingdom approach of substance over form is discussed.

New Zealand

New Zealand Income Tax legislation contains a general anti-avoidance provision, which provides the following:⁴¹

'[E]very arrangement made or entered into . . . shall be absolutely void as against the Commissioner for income tax purposes if, and to the extent that, directly or indirectly, its purpose or effect is tax avoidance.'

Therefore, tax avoidance need not be the sole or principal purpose, as long as it is not merely an incidental purpose or effect. Once tax avoidance is proved, the section provides that the Commissioner shall adjust the tax, as he considers appropriate, to counteract the tax advantage.

⁴¹ Section 99 of the New Zealand Tax Act of 1976.

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Australia

The South African system was modelled on Australia's general anti-avoidance clause,⁴² which is similar to that of New Zealand. It provides that, upon meeting three preconditions, a scheme may be assessed as though it was never effected. Essentially, the requirements are as follows:

- a scheme;
- resulting in a tax benefit;
- entered into with the purpose of gaining such a tax benefit.

Eight alternative tests are provided to assist Revenue in deciding whether the scheme was entered into for the purpose of enabling the taxpayer to obtain a tax benefit. These eight tests are as follows.⁴³

- '(a) The manner in which the scheme was entered into or carried out.
- '(b) The form and substance of the scheme.
- '(c) The time which the scheme was entered into and the period of time during which the scheme was carried out.
- '(d) The result which would be achieved by the scheme.

⁴² Part IVA of the Australian Income Tax Assessment Act.

⁴³ Paragraph (b) of section 177D (as summarised under paragraph 11.3.8 of the Katz Commission Third Interim Report).

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- '(e) Any change in the financial position of the relevant taxpayer arising out of the scheme.
- '(f) Any change in the financial position of any other person.
- '(g) Any other consequences for the relevant taxpayer or any other person connected with him.
- '(h) The nature of any connection between the relevant taxpayer and a person contemplated by test (f).'

Interpreted literally, this legislation deprives the taxpayer of his choice in selecting the most tax efficient route. In enforcing the law, however, Australian courts have determined that, where the purpose of the total scheme or series of transactions is of a commercial nature or is commercially justifiable, the anti-avoidance clause would not apply.⁴⁴

This 'commercial purpose' could be likened to the South African 'business purpose', to be discussed in Chapter C.

⁴⁴ See *FCT v Peabody* 28 ATR 344.

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Hong Kong

The Hong Kong anti-avoidance legislation was also modelled on the Australian legislation, and provides as follows:⁴⁵

'This section shall apply where any transaction has been entered into or affected . . . and that transaction has . . . the effect of conferring a tax benefit on a person . . . and, having regard to –

- (a) the manner in which the transaction was entered into or carried out;
- (b) the form and substance of the transaction;
- (c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;
- (d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;
- (e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;
- (f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and

⁴⁵ Section 61A of the Hong Kong Ordinance.

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(g) the participation of the transaction of a corporation resident or carrying on business outside Hong Kong;

it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.’

Once again, the application of the section has the effect of setting aside the transaction or taxing it in the most appropriate manner.

Although the Hong Kong legislation goes a step further than the Australian legislation, ‘the test for the manner in which the transaction was entered into does not appear to have met the difficulties of the normality test of section 103(1). See in particular paragraph (f).’⁴⁶

⁴⁶ The Katz Commission Third Interim Report in paragraph 11.3.19.

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Canada

Finally, the Canadian Legislation provides that⁴⁷

'no disbursement which artificially reduces the income of a taxpayer shall be taken into account in determining the tax liability; and in computing income for the purposes of the Act no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that if allowed would unduly or artificially reduce the income.'

In interpreting the section, the Canadian court, in *Stuart Investment v The Queen*⁴⁸ adopted a *business purpose* approach. (Emphasis added.)

Shortly after this case, the Canadian legislature introduced a general anti-avoidance rule commonly known as *gaar*. *Gaar* basically states the following:

- A transaction or series of transactions which results directly or indirectly in a tax benefit will be considered to be an avoidance transaction unless the transaction may reasonably be considered to be undertaken or arranged primarily for *bona fide* purposes other than the purpose of obtaining a tax benefit.
- Where a transaction is carried out for a combination of *bona fide* non-tax purposes

⁴⁷ Section 137 of the Canadian Income Tax Act.

⁴⁸ (1984) 10 DLR1.

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and tax avoidance, the primary purposes of the transaction must be determined.

- Where a transaction results in a tax benefit and has been carried out primarily for tax purposes, *gaar* is only applicable if it may reasonably be considered that the transaction or series thereof would result directly or indirectly in a misuse or abuse of the particular provision.

Therefore *gaar*, essentially, relies upon the business purpose cum abuse of rights doctrine.

THE MARGO AND KATZ COMMISSIONS

Over the past ten years the South African government has requested two commissions to investigate the question of tax avoidance. The first was *The Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (the Margo Commission) in 1986. The second, the Katz Commission, was a result of the Minister of Finance's 1995 Budget speech, where he drew attention to the high level of tax avoidance.

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The Margo Commission

The Margo Commission adopted the view that anti-avoidance legislation was beneficial in countering tax avoidance schemes and hence both general anti-avoidance measures and specific provisions should be included within the South African legislation.⁴⁹

It noted, however, that the normality requirement, to a large degree, pulled the teeth out of section 103(1), among other reasons because, if a particular type of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its use becomes normal.

The Katz Commission

The Katz Commission proposal attempts to solve this problem by suggesting that, where the transaction occurs in the normal business context, the normality test should be a comparison to what is 'normal' for transactions of a similar nature.

This proposal was accepted by the legislature and enacted in 1996.

⁴⁹ Report of the Margo Commission, in paragraph 27.27.

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CHAPTER C : THE NEW 'BUSINESS PURPOSE' TEST

INTERPRETATION OF THE NEW LEGISLATION

Section 103(1)(b) - the 'normality' requirement now reads as follows:

'[H]aving regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –

- (i) was entered into or carried out –
 - (aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and
 - (bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa) by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
- (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; '

The amended section now requires that transactions, operations or schemes must be

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divided into those, which apply 'in the context of business', and those that do not.

Schemes applying 'in the context of business' must, in order to avoid meeting the requirements of the extended section 103(1)(b)

- have a '*bona fide* business purpose, other than the obtaining of a tax benefit'; and
- not create rights or obligations that would not normally be created between persons dealing at arm's length under schemes of the kind in question.

Schemes that do not operate 'in the context of business' must, in order to avoid falling within the requirements of section 103(1)(b), in the same way as prior to the extension

- not have been entered into or carried out in a manner not normal in relation to the scheme in question; and
- not created rights or obligations that would not normally be created between persons dealing at arm's length under schemes of the kind in question.

In applying the extended provisions the two new phrases that must be considered are 'business context' and '*bona fide* business purpose'.

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'Business context'

There is no definition of the term 'in the context of business' and the phrase does not appear to have been judicially interpreted.

The word 'context' has been judicially interpreted but only in relation to language and the interpretation of statutes and rules. When used with reference to 'business' the only dictionary definition which can realistically apply is that set out in *Chambers 20th Century Dictionary New Edition 1983* which gives the word 'context' the meanings 'associated surroundings' or 'setting'. Perhaps the most useful interpretation would be to give the word 'context' (in the context of the phrase 'business context') the common sense meaning of 'in relation to'. What does seem clear is that the phrase 'in the context of business' is very wide-ranging and is likely to be so interpreted.

The word 'business' has been judicially defined as 'anything which occupies the time and attention and labours of a man for profit'.⁵⁰ In subsequent judicial considerations it has, however, been suggested that the profit motive is not vital and that there appears to be no definitive explanation of the word 'business'.

⁵⁰ *Smith v Anderson* (1880) 15 ChD 247.

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There have been several cases dealing with the interpretation of the phrase 'carrying on business' and it would be reasonable to suggest that the view adopted by the courts can be summarised by the dicta of Beadle CJ in *Estate G v Commissioner of Taxes*,⁵¹ which reads as follows:

'The sensible approach, I think, is to look at the activities concerned as a whole, and then ask the question: Are these the sort of activities which in commercial life, would be regarded as "carry on business"? The principle features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired. This list of features does not purport to be exhaustive nor are any of these features necessarily decisive, nor is it possible to generalise and state which feature could carry the most weight in determining the problem. Each must depend on its own particular circumstances.'

It seems likely that in interpreting the word 'business' as used in the phrase 'business context', the courts will adopt a similar approach.

No matter how general the interpretation may be, it could be difficult in some instances to establish which schemes fall into the category of 'in the context of business'. For

⁵¹ 1964 (2) SA 701 (SR), 26 SATC 168 at 173.

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example, business type transactions entered into for domestic purposes, for example domestic, private or family loans.

'Business purpose'

The phrase 'business purpose' has in itself not been subject to judicial interpretation.

On reading the amended section, it can be seen that when testing for the normality requirement, the issue is not the taxpayer's purpose or intention of effecting a transaction for *bona fide* business purposes. The criterion is merely whether the chosen transaction is generally applied for business purposes. If so, he may freely declare having entered into that transaction essentially for the purpose of gaining a tax benefit.

This conclusion is also indicated by the fact that if the reference point here was the taxpayer's own purpose, there would be little or no difference between this test and the subjective test as to the purpose.⁵² This distinction is important because there may be a tendency to disregard this aspect and thus inadvertently allow the subjective test to

⁵² Section 103(1)(c): 'was entered into solely or mainly for the purpose of obtaining a tax benefit.'

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contaminate what is clearly an objective nature test.

There can, therefore, be more than one 'normal' and non-tax motivated manner in which any given transaction, operation or scheme may be entered into. If it can be shown that a 'reasonable business person' would have used the same manner as that employed by the taxpayer, and would have done so (in those circumstances) for reasons other than a tax benefit, the taxpayer's defence would not be obviated by the fact that there may have been other valid, non-tax motivated manners or ways in which to have achieved the same end. It would be going too far to suggest that a court would in each instance have to settle on one exclusive manner as the most common, so that no other perfectly normal, totally non-tax motivated (but perhaps less common) manner could serve as a reference for judging the normality.

As with the subjective test as to the taxpayer's purpose, the test as to the manner must be related to the full totality of the scheme, individual transactions within it, and sub-combinations of transactions forming part of it – that is, in order to enjoy this defence, generally the taxpayer would have to show the non-tax motivated normality as regards the manner of the whole or any part of the transaction, operation or scheme.

In the new test, therefore, one has to separate out transactions done to achieve a business purpose from those done to obtain a tax benefit. As the tax benefit is part of the business

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transaction, the two may be difficult to separate. In most cases the taxpayer's recourse will lie directly in the purpose test in paragraph (c), as opposed to the normality test which was generally used in the past.

COMPARISON TO THE VALUE ADDED TAX ACT

Section 73 of the Value Added Tax Act provides that

' . . . whenever the Commissioner is satisfied that any scheme (whether entered into or carried out before or after the commencement of the Act, and including a scheme involving the alienation of property):

- (a) has been entered into or carried out which has the effect of granting a tax benefit to any person; and
- (b) having regard to the *substance* of the scheme;
 - (i) was entered into or carried out by a means or in a manner which would not normally be employed for *bona fide business purposes*, other than the obtaining of a tax benefit; or
 - (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length; and
- (c) was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit;

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the Commissioner must determine the liability of any tax and the amount thereof as if the scheme had not been entered into or carried out or in such a manner as in the circumstances of the case be deemed appropriate for the prevention or diminution of such tax benefit.'

(Emphasis added.)

There has been only one case to date dealing with this section, *Amor van Zyl Trust v KBI*.⁵³ Here the appellant contended that section 73(1) was not a tax-levying provision. The case did not deal with the issue of the 'business purpose', and therefore this case provides no assistance as regards the 'business purpose' test.

Section 73(1) is obviously an improvement on the old section 103(1) of the Income Tax Act, and is worded in a similar way to the 'new' section 103(1), with the exception of the use of the word 'substance' which does not appear in the 'new' section 103(1). This is a significant omission, as will be seen in the discussions on substance over form.

⁵³ 1995 (4) SA 1007 (T), 58 SATC 77.

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IMPACT OF BUSINESS PURPOSE TEST

The new 'business purpose' test adds some venom to section 103(1) against taxpayers, particularly with regard to those who, in the past, used to reward tax avoidance of enormous proportions.

Compared to the position in the United Kingdom, Australia and Canada, among others, the South African taxpayer would still have the advantage of exercising his right to a tax saving by entering into a transaction purely for tax purposes, but would have to ensure the transaction is one normally applied for business purposes.

There is still a risk of the court reaching the point where it may decide 'enough is enough' and take into account the taxpayer's own aim for entering into the transaction. The court's decision could therefore reflect the fact that the transaction was, under the circumstances, not entered into for business purposes.

Looking at the cases decided on normality in the past, the issue to be decided now is whether the chosen transaction is generally applied for business purposes, or merely to obtain a tax benefit.

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In the case of *Hicklin v SIR*,⁵⁴ it is unlikely that a normal businessman would sell a dormant company to a dividend stripper for less than its net book value when he could deregister the company himself at a small administrative cost and receive the full net asset value. The only reason that a normal businessman would enter into a transaction of this nature would be to avoid the tax payable on the deregistration dividend. It would seem that, therefore, *Hicklin* would not succeed under the new business purpose test.

In the case of *CIR v Louw*,⁵⁵ one could conclude that a normal businessman would enter into the series of transactions undertaken by Louw to incorporate a civil engineering partnership. On the issue of the debit loan accounts, a normal businessman would not reduce his salary in order to owe the company funds unless the purpose was the saving of normal tax. The conclusions reached by the Appellate Division in *Louw's* case would remain unchanged with the introduction of the 'business purpose' test – that is – the incorporation would not be regarded as abnormal whereas the creation of the debit loan accounts would be regarded as abnormal.

The other four cases⁵⁶ basically conclude that a normal transaction is one in common usage, even if only as a common method of tax avoidance. These decisions would alter on

⁵⁴ The facts and decision of this case are detailed in Chapter B.

⁵⁵ The facts and decision of this case are detailed in Chapter B.

⁵⁶ ITC 963, ITC 1113, *Meyerowitz v CIR*, and *Smith v CIR*. The facts and decisions of these cases are detailed in Chapter B.

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the basis that common usage would have to be a method that would be used by a normal businessman for reasons other than the obtaining of a tax advantage.

The cases⁵⁷ dealing with this issue of a common method of tax avoidance were both criticised for going further than the legislation currently stood.

COT v Ferera seemed to steer towards the 'business purpose' test before its enactment. In this regard Macdonald JP stated the following:⁵⁸

'Paragraphs (a) and (b) of the section use the word "normally" in the context of transactions, operations or schemes which are supposedly or *professedly business or trading transactions*, operations or schemes and not in the context of transactions, operations or schemes which are admittedly not concerned with trade or business but simply with avoidance, postponement or reduction of tax.'

(Emphasis added.)

A company's dividend policy is by its nature a matter of discretion, based on a number of issues, only one of these being taxation. The retention of profits is not an abnormal way of carrying on a business. On the contrary, it is quite normal for profits to be retained for expansion, future expenditure and so on. In fact, the secondary tax on companies was

⁵⁷ *COT v Ferera* and ITC 1496. The facts and decisions of these cases are detailed in Chapter B.

⁵⁸ 1976 (2) SA 653 (RAD), 38 SATC 66 at 72.

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introduced into the Republic legislation specifically to encourage companies not to distribute their profits.⁵⁹

What had to be decided in *Ferera's* case was whether, under the circumstances, a normal businessman would have retained one-third of the profits for reasons other than tax avoidance. This issue was only briefly dealt with in the following phrase:⁶⁰

'To retain the profits was, in the circumstances, an abnormal way of transacting the company's business.'

This issue is no longer difficult to decide. Different companies transact their businesses in different ways and a company may well retain its profits for sound business reasons. It would therefore seem that it is unlikely that the Commissioner could prove that the retained profits were not required in the business, and for this reason it is likely that this case would succeed under the 'business purpose' test.

Again in the case of ITC 1496⁶¹ it would have to be decided whether a normal businessman would enter into the plantation scheme for reasons other than tax avoidance.

⁵⁹ See the Budget speech for the 1993/94 financial year presented by the Minister of Finance DL Keys on 17 March 1993.

⁶⁰ *COT v Ferera* 1976 (2) SA 653 (RAD), 38 SATC 66 at 73.

⁶¹ (1990) 53 SATC 229.

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An example would be a high return on the 'investment'.

It could be argued that if the sole purpose of the transaction is to obtain a tax advantage, it is not logically possible to postulate the existence of a commercial purpose. This is not the case, as it is possible to have a situation where a taxpayer, whose sole motive is the saving of tax, invests with others in an ordinary-trading activity conducted by them for a commercial purpose and with a view of making a profit. As stated previously, when testing for the normality requirement, the issue is not the taxpayer's own purpose but merely whether the chosen transaction is generally applied for business purposes.

It is implied in the judgment that this would not be the case, and therefore the scheme would not pass the 'business purpose' test.

In conclusion, the 'business purpose' test adds clarity to the 'normality' provision of section 103(1).

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CHAPTER D : SUBSTANCE OVER FORM

United Kingdom

British income tax legislation does not contain any general anti-avoidance clauses, and therefore guidance must be sought from case law.⁶²

For approximately forty years the English courts followed the approach adopted by the House of Lords in *IRC v Duke of Westminster* which stated the following:⁶³

'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'

Then in 1981 in *IRC v Ramsay*, Lord Wilberforce laid down four general principles to be applied to tax avoidance schemes, namely the following:⁶⁴

- When interpreting fiscal legislation, the courts are not confined to literal interpretation. The taxpayer will be taxed according to the clear statutory words, but the Act itself must be placed in context and the purpose of the Act should be taken into account.

⁶² Refer to the Katz Commission Third Interim Report in paragraph 11.4.

⁶³ 51 TLR 467, 19 TC 490 at 520.

⁶⁴ (1981) STC 174 (HL).

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- The taxpayer can arrange his affairs to reduce his liability to tax. He is still to be taxed according to the legal effect of the transactions into which he has entered.
(Lord Wilberforce was here reaffirming the ratio of the *Westminster* decision.)
- The Courts should find as a matter of fact whether the transaction is a genuine one or a sham.
- If the document or transaction is genuine, the court should not look for some underlying substance (citing *Westminster's*⁶⁵ case). One should, however, not look at the transaction distinct from its context; it may be an ingredient of a wider transaction as a whole. When the Court is deciding whether the transaction is a genuine one or a sham it may look at the series of transactions and determine their effect as a series. In other words this constitutes a limit imposed by the *Ramsay*⁶⁶ court on the *Westminster* doctrine.

Ramsay's case concerned a scheme by means of which a series of loan and share transactions were entered into for the purpose of manufacturing a paper loss to offset an otherwise taxable gain on the sale of land. In this regard Lord Wilberforce said the following:⁶⁷

⁶⁵ *IRC v Duke of Westminster* 51 TLR 467, 19 TC 490.

⁶⁶ *IRC v Ramsay* (1981) STC 174 (HL).

⁶⁷ At 323.

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'Given that a document or transaction is genuine, the court cannot go behind it so some supposed underlying substance. This is the well known principle of *IRC v Duke of Westminster* This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. It can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.'

A similar approach was applied in the *Burmah Oil*⁶⁸ case, in which the House of Lords was confronted by a series of transactions aimed at converting a bad debt by a subsidiary into a loss on the winding-up of the subsidiary which would be tax deductible. The House of Lords again looked through the transaction to what they perceived to be the real transaction. In so doing, Lord Diplock warned that it would be dangerous to assume that the *Ramsay*⁶⁹ case did not make significant changes in the approach adopted by the

⁶⁸ *IRC v Burmah Oil Co Ltd* [1982] STC 301 (HL).

⁶⁹ *IRC v Ramsay* [1981] STC 174 (HL).

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House of Lords in dealing with a pre-ordained series of transactions, into which were inserted steps having no commercial purpose apart from the avoidance of a liability for tax, which, in the absence of those particular steps, would have been payable.

It was against this background, and relying on these authorities, that Lord Brightman delivered his judgment in *Furniss (Inspector of Taxes) v Dawson*.⁷⁰ The facts in the *Dawson* case were that the taxpayers in two manufacturing companies agreed to sell their shares for £152 000. In order to defer the payment of capital gains tax, a scheme was instituted whereby the shares in the two manufacturing companies were sold to Greenjacket Investments (Pty) Ltd ('Greenjacket'), a company incorporated in the Isle of Man. The consideration for the sale of the shares in the two manufacturing companies was settled by the allotment of shares in Greenjacket to the taxpayers. Greenjacket then sold the shares in the manufacturing companies to the ultimate purchaser for a cash sum of £152 000. This £152 000 cash then constituted the sole asset of Greenjacket. The taxpayers were assessed for capital gains tax in respect of the disposal of the manufacturing companies but the lower court upheld their appeal.

After a series of unsuccessful appeals by the Crown, the matter eventually came before the House of Lords, which held the taxpayers liable to capital gains tax. The House of Lords

⁷⁰ [1984] STC 153 (HL).

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criticised the reluctance of the judges in the lower courts to depart from the *Duke of Westminster*⁷¹ decision. Lord Bridge of Harwich remarked⁷² that the *Duke of Westminster* case still seemed to be authority for the proposition that only if the transaction were a sham would it be legitimate to draw a distinction between substance and form in considering the tax consequences of the transaction. He said, however, when moving from a single transaction to a series of interdependent transactions designed to produce a given result, it is perfectly legitimate to draw a distinction between the substance and the form of the composite transaction without in any way suggesting that any one of the single transactions which makes up the whole is other than genuine.

His conclusion can be summed up by the following extract from the judgment:⁷³

'My Lords, in my opinion the rationale of the new approach is this. In a pre-planned tax-saving scheme, no distinction is to be drawn for fiscal purposes, because none exists in reality, between (i) a series of steps which are followed through by virtue of an arrangement which falls short of a binding contract, and (ii) a like series of steps which are followed through because the participants are contractually bound to take each step seriatim. In a contractual case the fiscal consequences will naturally fall to be assessed in the light of the contractually agreed results *Ramsay* says that the fiscal result is to be no different if the several steps are pre-ordained rather than pre-

⁷¹ *IRC v Duke of Westminster* [1936] AC 1 (HL) 19.

⁷² At 535.

⁷³ *Furniss (Inspector of Taxes) v Dawson* [1984] STC 153 at 526-7.

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contracted. For example, in the instant case, tax will, on the *Ramsay* principle, fall to be assessed on the basis that there was a tripartite contract between the Dawsons, Greenjacket and Wood Bastow under which the Dawsons contracted to transfer their shares in the operating companies to Greenjacket in return for an allotment of shares in Greenjacket, and under which Greenjacket simultaneously contracted to transfer the same shares to Wood Bastow for a sum in cash. Under such a tripartite contract the Dawsons would clearly have disposed of the shares in the operating companies in favour of Wood Bastow in consideration of the sum of money paid by Wood Bastow, with the concurrence of the Dawsons, to Greenjacket. Tax would be assessed, and the base value of the Greenjacket shares calculated, accordingly. *Ramsay* says that this fiscal result cannot be avoided because the pre-ordained series of steps are to be found in an informal arrangement instead of a binding contract. The day is not saved for the taxpayer because the arrangement is unsigned or contains the magic words "this is not a binding contract" Secondly there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax – not "no business effect".'

It can be seen that the attack was aimed at schemes characterised by a series of transactions, in which some steps had no commercial purpose but were aimed simply at the avoidance of tax.

From these rulings, the British courts have formulated the following principles on which current decisions are based.

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Even though the person liable for tax may choose legally to manage his business in such a way that he obtains maximum tax benefit for himself, the courts shall,

- first, upon interpreting the legislation, consider the purpose and scheme of the Act as a whole; and
- secondly, shall have the right to, in a series of transactions, ignore the steps serving no commercial purpose.

Thus, substance takes precedence over form.

South Africa

There have been a few cases in South African law which have adopted a 'substance over form' approach. The most significant was *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd*⁷⁴ where the court followed an earlier judgment of Innes CJ in *Zandberg v Van Zyl*.⁷⁵

The facts of *Randles Brothers* were briefly that the defendant imported goods and

⁷⁴ 1941 AD 369.

⁷⁵ 1910 AD 302 at 309.

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transferred them to a manufacturer to be made up into shorts and pyjamas for the defendant. Under the customs regulations that existed at the time, imported goods enjoyed a customs rebate. In 1936 new regulations were promulgated requiring that in order that the goods might enjoy a rebate the manufacturer to whom the importer transferred the goods should make a declaration that the goods were his own property. The defendant, with the intention of complying with these regulations, changed its procedure and sold the goods to the manufacturer, and at the same time agreed to purchase the garments at the price of the sum at which the goods had been sold, plus the cost of manufacture. The goods were delivered to the manufacturer, who signed the appropriate form declaring that the goods were his own property. When the manufacturer delivered the goods, he was paid. The Commissioner of Customs and Excise contended that, notwithstanding the procedure adopted by the defendant, the defendant remains at all times the owner of the goods, and that it was liable to pay full duty upon the goods.

The Appellate Division found that the transaction between the company and the manufacturer was genuine and that it was entitled to the customs rebate. Delivering the judgment Watermeyer JA cited the following well-known passage from the judgment of Innes J in *Zandburg v Van Zyl*:⁷⁶

‘Not frequently, however (either to secure some advantage which otherwise the law

⁷⁶ 1910 AD 302 at 309.

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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 by 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 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.⁷⁷

Commenting on this passage Watermeyer JA in *Randles, Brothers & Hudson Ltd* said the following:⁷⁷

‘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 of tax.

⁷⁷ 1941 AD 369 at 395.

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'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 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.'

The court found that the consequences of the arrangement between the company and the manufacturer were fully intended and that ownership did pass. In other words, both parties had intended the consequences of the agreement.

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The approach of the South African Appellate Division in *Randles, Brothers & Hudson Ltd*⁷⁸ is completely different from that of the House of Lords in *Furniss (Inspector of Taxes) v Dawson*.⁷⁹ In the *Dawson* case, the House of Lords accepted that the transactions between the parties were completely genuine; the parties intended the transactions to have full effect in accordance with the tenor of the agreement. There was no suggestion of a 'tacit' or an 'unexpressed' agreement between the parties. The House of Lords was concerned to set aside the transaction only on the basis that it made no commercial sense other than avoiding tax. In *Randles, Brothers & Hudson Ltd* on the other hand, the Appellate Division was at pains to point out that if the parties genuinely arranged their affairs to avoid tax then the courts would not interfere. Only if the parties purported to enter into one transaction, whereas in reality and by tacit understanding they were entering into a completely different transaction, would the courts assail the disguised transaction.

In *Zandberg v Van Zyl*,⁸⁰ Innes CJ held that, where the court is satisfied that the real intention of the parties could be ascertained and that it differed from the simulated intention, the court would give effect to the real agreement. In *Randle Brothers* the court accepted the principle that a transaction that was in reality devised to avoid liability for tax imposed could be classed as being in *fraudem legis*, so that 'the transaction is interpreted

⁷⁸ 41 AD 369.

⁷⁹ (1984) STC 153 (HL).

⁸⁰ 1910 AD 302.

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by the courts in accordance with what is found to be the real agreement or transaction between the parties'.⁸¹ On the facts, however, the court found that the parties honestly intended to give effect to the legal consequences as set out in the agreement and that on the evidence there was a clear intention to transfer ownership.

Some other cases dealing with 'substance over form' are now discussed.

In *CIR v Saner*,⁸² a case bearing certain similarities to the *Dawson* case, the shareholders in a company wished to sell the assets of the company and also to avoid tax on the profits derived from the sale, that would have to be distributed by way of a dividend. Accordingly the company sold its undertaking to a new company in consideration for shares in the new company. The shares in the new company were then sold to the four directors at a low price. They, in turn sold the shares in the new company to the ultimate purchaser at a proper market price. The four directors then distributed the proceeds of the final sale amongst the shareholders of the original company. The Commissioner assessed Saner, one of the four directors, to tax upon a quarter of the profits derived from the proceeds of the second sale. The court held that the various transactions should be regarded as a whole and therefore the transaction was in substance a realisation of the assets of the

⁸¹ *Zandburg v Van Zyl* 1910 AD 302 at 396.

⁸² 1927 TPD 162 (1927) 2 SATC 199

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original company for the benefit of its shareholders.

Tindall J, in delivering judgment in *Saner’s* case, said the following:⁸³

‘The substance and not the form of the transaction must be looked at [I]n my opinion the facts stated by the Special Court in the present case show that neither the intention to sell to Saner and his associates nor a genuine purchase price were present. As was pointed out by *De Villiers JA in McAdams v Fiander’s Trustee and Bell* (1919 AD 207 at 224), there can be no contract of purchase and sale without the *animus emendi* on the part of the purchaser and the *animus vendendi* on the part of the seller, and it must be a genuine animus of the one to sell and of the other to buy.

It is not enough for the parties to think that they have the intention; the intention must be proved as a fact apart from what they thought and the price must be real and serious.’

In essence, the transaction has to be genuine; that is, the parties have to intend the consequences on which they purported to agree. In other words, in *Saner’s* case, although the transaction was described as a sale, the consequences of a sale were never intended; the true understanding between the parties was in fact something other than that expressed in the true transaction.

⁸³ *CIR v Saner* 1927 TPD 162 (1927) 2 SATC 199 at 207.

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In ITC 260⁸⁴ the taxpayer carried on one business, and a second business was purportedly carried on in the name of his son. The taxpayer sought to deduct a bad debt, being an amount lent by him to his son. On an examination of the situation, however, the court came to the conclusion that there was, in essence, only one business and that was carried on by the taxpayer. His son was merely working under his supervision and had no real interest in the so-called second business. The amount was therefore deductible, not as a bad debt owed by the other business, but as a loss incurred in the overall business of the taxpayer.

This case should be compared to ITC 463,⁸⁵ a case in which the taxpayer sold his shares to a third party for £2 000 in cash and also resigned as managing director of the company. In consideration for the resignation, the company undertook to make a payment to him of £25 per month for ten years. Despite the ambiguity of the wording of the arrangement and the fact that payments were made on a periodic basis, the court examined the real nature of the transaction and found that the payment was made for the taxpayer's 'ceasing to have an interest in the company'.⁸⁶ The court found that, although the monthly payment had the external appearance of an annuity, it was in fact nothing more than a portion of the principal sum, being the consideration payable to the taxpayer for his sale of his entire

⁸⁴ (1932) 7 SATC 73.

⁸⁵ (1940) 11 SATC 196.

⁸⁶ At 197.

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interest in the company.

On the other hand in ITC 333,⁸⁷ a lump-sum payment received for the cancellation of an agency agreement was found to be a 'commutation of the monthly income to which the company was entitled under the agreements' and a substitution for that income.

A good example of the court's looking to the underlying relationship between the parties, rather than the form of the transaction, is ITC 124.⁸⁸ In this case the taxpayer, a partner in a business, entered into a deed of sale in terms of which the business was sold to a new partnership. A major proportion of the consideration for the sale was allocated to the transfer of the leasehold rights to certain premises. The taxpayer's capital account in the new partnership, of which he was also a member, increased as a result of the value placed on the leasehold rights. The Commissioner sought to tax the increase in the value of the leasehold rights on its disposal from the old partnership in the hands of the taxpayer, but the court found that the taxpayer held the same interest in both partnerships, that there had been no disposal of his interest in the leasehold rights to a third party and that no consideration had been received in respect of the transfer of the leasehold rights. The transaction amounted, as far as the taxpayer was concerned, simply to a revaluation of his

⁸⁷ (1935) 8 SATC 333.

⁸⁸ (1928) 4 SATC 119.

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interest in the partnership.

In ITC 436⁸⁹ a taxpayer was the owner of two properties, both of which were let to a company of which the taxpayer was the principal shareholder. The Commissioner adopted the attitude, amongst other things, that the taxpayer and the company were one and the same person. The court refused to pierce the corporate veil and found, that to do so 'would be to ignore the distinction between the appellant and the company as separate *personae*. The court cannot possibly ignore such a distinction. The company, as a separate *persona*, is the tenant of the appellant in his individual capacity'.⁹⁰ It was recognised that the transaction between the taxpayer and his company was a genuine transaction. The consequences were fully intended, there was no reason to suppose that the lease was a disguise or a sham and there was, underlying the transaction of lease, some other tacit or other unexpressed arrangement. The validity of the lease and the separate corporate identity of the company were therefore upheld.

In *Baily v CIR*⁹¹ there are some striking similarities the *Dawson*⁹² case. Bailey, a financier, expected to receive large profits from his interest in the HM Association. These profits would clearly have been taxable in his hands and, in an attempt to avoid the tax, he

⁸⁹ (1939) 10 SATC 453.

⁹⁰ At 454.

⁹¹ 1933 AD 304, (1934) 6 SATC 69.

⁹² *Furniss (Inspector of Taxes) v Dawson* [1984] AC 494 (HL).

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formed a separate company, to which he sold his interest in the HM Association for £7 750. This amount was the par value of the shares that had been allotted to him on the formation of the company. The price for the issue of the shares and the consideration for the sale of the interest in the HM Association were then offset. The profits from the HM Association were distributed in due course to the company, which was placed under voluntary liquidation, and the profits were distributed to Bailey by way of a non-taxable liquidation dividend. The Commissioner sought to tax these dividends and the Appellate Division upheld this assessment, finding that the liquidation dividends were not receipts of a capital nature and were properly included in Bailey's gross income.

The court explained⁹³ that the mere fact that the amounts were called 'liquidation dividends' did not necessarily prove that they were of a capital nature. In order to decide whether they were of a capital nature it had to be determined, in effect, what the real transaction between the appellant and Bryanston (Prop) Limited was. The court found that it was not reasonable to conclude that the appellant intended to sell his valuable rights in the HM Association for £7 750. The scheme was a single and indivisible transaction; its true nature was a sale in consideration of the allotment to the appellant of all the shares in the company, which would hold precisely the same interests previously held by the appellant in the HM Association, and by means of which shares the appellant hoped to be

⁹³ *Baily v CIR* 1933 AD 204, (1934) 6 SATC 69 at 78.

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able to receive the profits of the HM Association in an indirect manner, thereby escaping taxation. It was found that the shares so acquired from the company could in no sense be regarded as an investment of capital, nor could the proceeds of those shares, 'the liquidation dividends', be regarded as a return of capital.

In both *Bailey*⁹⁴ and *Dawson*⁹⁵ the courts ignored the interposition of a company. In *Dawson* the court taxed the Dawsons as if Greenjacket Investments (Pty) Ltd had never existed and in *Bailey* the court acted similarly. It is interesting, however, to note the difference in approach between the courts. In *Dawson* the court said that, although the transaction was completely genuine and fully intended, it had no purpose other than tax avoidance and since the whole structure was directed at that end, it had to be struck down. In *Bailey* the court adopted the view that the transaction had never really been intended. The sale of Bailey's interest in the association to the company had been a fiction, the lack of an appropriate consideration clearly weighing heavily with the court.

It is clear from an analysis of the court's reasoning that, if Bailey had sold his interest for a reasonable amount and had not immediately wound up the company to take out the profits, the transaction might have succeeded in avoiding liability for tax. Yet, in *Dawson*,

⁹⁴ *Baily v CIR* 1933 AD 204, (1934) 6 SATC 69.

⁹⁵ *Furniss (Inspector of Taxes) v Dawson* [1984] AC 494 (HL).

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where the sale was for true value and the shares in Greenjacket Investments (Pty) Ltd were not immediately disposed of, the House of Lords nevertheless taxed the Dawsons directly.

In two similar cases ITC 21⁹⁶ and ITC 690⁹⁷ the taxpayer contended that the true transaction was something other than that recorded in the agreements. In both cases that taxpayer has purchased assets, including goodwill, as well as rights under a lease. In both cases the taxpayer contended that the payment for goodwill was not, in fact, truly a payment for goodwill but should be regarded as a lease premium, which would have been deductible. In neither case did the taxpayer succeed. The courts found no reason to suppose that the agreements did not correctly reflect the intention of the parties.

Another important decision in the field of substance versus form is that of the Appellate Division in *CIR v Collins*.⁹⁸ Here, a company decided to increase its capital and in so doing it capitalised undistributed profits of £16 000, issuing them as bonus shares to its existing shareholders. The Commissioner sought to levy tax on the shares that had been so issued as bonus shares on the basis that this was simply a distribution of profits. Innes CJ reasoned as follows:⁹⁹

'The profits referred to were vested in the company; no member could claim any

⁹⁶ (1922) 1 SATC 206.

⁹⁷ (1950) 16 SATC 503.

⁹⁸ 1923 AD 347, (1970) 32 SATC 211.

⁹⁹ At 361-5.

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portion of them; but the shareholders could by resolution compel their distribution as dividends. They resolved not to exercise that power, but authorised the conversion of the amount into share capital, - the resulting shares to be distributed on a specified basis. And the directors, representing the company, gave effect to that resolution But if we have regard to the real substance of what was done there was no intention on the part of the company to distribute any portion of assets, nor did any such distribution take place The transaction was to my mind whole and indivisible, - the capitalisation of profits covered by the issue of shares representing those profits The governing facts are that the company never intended to part with the profits, and that the shareholders never obtained any right to them. That was the substance of transaction, and I agree with Rowlatt J thinking that the means employed to carry it out were machinery only; they cannot affect the character of the capitalised profits.'

The Appellate Division held, therefore, that the issue of the bonus shares was not intended as a guise for the distribution of profits in a non-taxable form. The company and the shareholders could elect either to capitalise the profits or to distribute them as dividends. There was no reason to suppose that the election to capitalise the profits and issue shares was in any way not a genuine transaction that did not reflect the true intention of the parties. On the contrary, there were sound commercial reasons to support the election that had been made. It should be noted, however, that although the court took the commercial soundness of the decision into consideration, its finding was not based solely on this

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ground but on the proposition that there were two routes open to the parties and they had validity and intentionally chosen a route which had specific tax consequences.

More recently the courts have looked at the substance of a series of interrelated transactions to determine the true intention of the parties.

A recent case dealing with this issue is the Appellate Division case of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*.¹⁰⁰

The case deals with a scheme designed to use the benefits of section 11(f) in respect of lease premiums without creating gross income in the hands of the lessor (under paragraph (h)). The facts of the case were briefly, that a company in a group owned land that it wished to develop. The land was let to a pension fund that erected the buildings thereon, and sublet the land and buildings to another company in the group that paid an up-front lease premium. This was done before section 11(f) was amended to require a deductible lease premium to be taxable in the lessor's hands. The pension fund enjoyed an exemption from normal tax in terms of section 10 while the sub-lessee obtained a section 11(f) deduction.

¹⁰⁰ 1996 (3) SA 942 (A), 58 SATC 229.

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Relying on the principle that '[e]very man is entitled, if he can, to order his affairs in such a way that the tax attaching under the appropriate Acts is less than otherwise would be',¹⁰¹ the appellant's counsel argued that effect must be given to the agreements according to their terms despite their underlying purpose.

The Commissioner's argument was based on the principle that was succinctly explained by Wessels ACJ in *Kilburn v Estate Kilburn* as follows.¹⁰²

'Courts of law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance.'

The Commissioner argued that the documents did not reflect the real intention of the contracting parties because the entire purpose of the transaction was to evade tax. The agreements were concluded in a form that concealed the fact that the appellants did have the right to have the buildings erected. He argued that the entire purpose of the transaction was to evade tax.

The court in this case was faced with arguments from opposing parties that were based on

¹⁰¹ Per Lord Tomlin in *IRC v Duke of Westminster* 1963 (A) 1 at 19. This principle was adopted by Centlivres CJ in his minority judgment in *CIR v Estate Kholer and Others* (1953 (2) SA 584 (A) at 591E – 592H and affirmed in subsequent judgments of the Supreme Court.

¹⁰² 1931 AD 501 at 507.

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two well-known legal principles. The interaction between these two principles was referred to by Lord Russell of Killowen in the *Duke of Westminster's* case when he said the following:¹⁰³

'If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non-taxability in accordance with the legal rights, well and good If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine.'

In the South African case of *Dadoo Ltd and Others v Krugersdorp Municipal Council*, Innes CJ said the following:¹⁰⁴

'[A] transaction is in *fraudem legis* when it is designedly disguised so as to escape the provisions of the law, but falls in truth within these provisions. Thus stated, the rule is merely a branch of the fundamental doctrine that the law regards the substance rather than the form of things - a doctrine common, one would think, to every system of jurisprudence and conveniently expressed in *the maxim plus valet quod agitur quam quod simulate concipitur*.'

¹⁰³ *IRC v Duke of Westminster* [1963] AC 1 at 25.

¹⁰⁴ 1920 AD 530 at 547.

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In the *Ladysmith* case Hefer JA in referring to the two principles said the following.¹⁰⁵

‘Provided that each item 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.’

Hefer JA quoted sections from the judgments in *Zandburg v van Zyl*¹⁰⁶ and *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd*¹⁰⁷ in order to reveal the fundamental flaw in a submission that tinged the entire argument for the appellants. The following quote from the case is of relevance:¹⁰⁸

‘I have quoted the relevant passages from the leading cases in full in order to reveal the fundamental flaw in a submission which tinged the entire argument for the appellants. It is to the effect that, once it is found that the parties to the present agreements actually intended to structure their arrangement in the form of a lease coupled with a sub-lease and a building contract, there is really an end to the matter, because in that event effect must be given to each agreement according to its tenor. This is plainly not so. That the parties did indeed deliberately cast their

¹⁰⁵ *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* 1996 (3) SA 942 (A), 58 SATC 229 at 239.

¹⁰⁶ 1910 AD 302 at 309.

¹⁰⁷ 1941 AD 369 at 395-6 and at 58 SATC 239.

¹⁰⁸ 1996 (3) SA 942 (A), 58 SATC 229 at 240-1.

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arrangement in the form mentioned, must of course be accepted; that, after all, is what they have been advised to do. The real question is, however, whether they actually intended that each agreement would *inter partes* have effect according to its tenor. If not, effect must be given to what, the transaction really is. I must also point out that, by virtue of the provisions of section 82 of the Act, the burden to prove that any amount is exempt from tax and the duty to show that the Commissioner's decision to disallow their objection to the assessments was wrong, rest on the appellants 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.

'Regarded separately and without reference to the others, there is nothing unusual about the terms of the main leases or of any of the other documents except for one remarkable feature. Since the same signatories signed the main leases, the sub-leases and the building contracts simultaneously on behalf of the appellants, the Fund, Pioneer and the contractor respectively, we must infer that they signed each agreement with full knowledge of the terms of the others which were either awaiting their signature or had already been signed. In view of the terms of the variation agreements the signatories must have known full well that the main leases did not correctly reflect the arrangement in respect of the payment of rent for the period 1 April to 31 July 1984. Yet they signed them. The witness did not explain why the

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relevant terms had to amended or why there had to be separate documents. I am unable to accept the suggestion put forward by the appellants' attorney that the variation agreements might have been prepared simply to correct a mistake by the draughtsman. There is no reason to assume in appellants' favour that a mistake had been made and it is in any event highly unlikely that additional documents, replete with definitions and recitals and running into three pages each, would have been prepared instead of redrafting a few lines in the leases. It is significant that payment of rent was in effect suspended in the variation of agreements until 1 August 1984 which was the date on which the sub-leases would commence and the day after the buildings were expected to be completed under the building contract. But this only becomes clear once all the agreements are read together: a reader who was not aware of the existence of the variation agreements would not know that the Fund would not be paying rent for the first four months. This he could only discover upon being shown the variation agreements; and even then he would be unaware that the reason for the apparent indolence was that the buildings would only be completed at the end of the fourth month. The impression is irresistible that the parties sought to give to each agreement a semblance of self-sufficiency which it did not in reality possess.

'Be that as it may, the agreements cannot be regarded separately; they were all signed simultaneously and were plainly interdependent to the extent that none of them would have been concluded unless all the others were also signed; as appellants attorney conceded, each one must be considered in the context of all the others in order to discover their total effect.'

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Hefer JA then concluded that the nature of the agreements was such that all of the parties must have clearly understood what was really intended.

The following quote from the judgment is telling:¹⁰⁹

'Can it in these circumstances be said, particularly taking account of what I have said about the appellants' interests in the terms of the sub-leases relating to the erection of the buildings, that as a matter of probability the directors intended to confer the sole right to have the buildings erected on Pioneer, thereby precluding the appellants from taking steps to enforce compliance with the relevant terms? In my view not. I have no doubt that the directors were aware of the need for the appellants to protect their own interests themselves. There is a real likelihood that there was an unexpressed agreement or tacit understanding between the appellants and Pioneer that the appellants would be entitled if need be to enforce compliance with the relevant terms of the sub-leases, either against Pioneer or possibly against Pioneer and the Fund jointly. Of this the Fund could not have been unaware: as stated earlier, it could not have been kept in the dark about the purpose of its intervention; indeed, on the available evidence, there is no reason to believe that the Fund was not unaccustomed to the role it was required to play in this kind of transaction. On this basis the Fund too could well have been a party to the agreement or understanding referred to. The evidence does not exclude what is thus

¹⁰⁹ *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR 1996 (3) SA 942 (A), 58 SATC 229 at 242.*

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a real likelihood that the written agreements do not reflect the true and full intentions of the parties. Appellants' entire case rests on the provisions of clause 7.1 of the main leases. However, it is those very provisions that, on the foregoing analysis, bear the stamp of simulation. The purpose could well have been to conceal the real or complete terms of what the parties truly intended but chose not to express.'

The court held that the substance of the transaction was merely a lease between the lessor and the sub-lessee and ignored the insertion of the pension fund. The lessor was taxed in terms of paragraph (h) of the definition of 'gross income' on the value of the improvements. The court then found it unnecessary to examine the Commissioner's alternative grounds under section 103(1).

The appeal was dismissed with costs.

It would be incorrect to conclude that the court had infused the Republic's law with the English 'substance over form' approach. Instead the court applied itself to the real intention of the parties to a series of contracts, this application having been derived from an examination of the written agreements as read together and the purpose for which these agreements were entered into. In this, the judgment derives its justification from principles of the Republic's law of contract. This distinction between, on the one hand, finding that a transaction is a sham and on the other hand distinguishing substance from

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form can be fine. Where the substance of the transaction is different to the sum of the parts, the court should accept the reality of the transactions (they are not shams) but consider whether their cumulative effect is such that, in substance, they make up a different transaction for income tax (and indeed commercial) purposes.

The test of the commercial rationale for the transaction is perhaps the safest approach for the determination of the tax effect of any transaction. For this reason the actual intention of the parties as opposed to a 'constructed' disguise by means of written agreements will be the key determinant of the nature of the transaction. From the true nature of the agreements, a taxpayer can determine whether rights that accrue have been created. It is here that the true significance of the *Ladysmith* judgment must be located.

Another recent judgment dealing with lease premiums was ITC 1606 delivered by Tebbutt J in the Cape Special Court.¹¹⁰

The facts were that a transport company wished to acquire new premises for one of the group's operating companies – the appellant – as the existing premises were too small. The land was acquired by a third party property broker (H), a dealer in property, who developed the premises to the taxpayer's specifications. In order to finance the acquisition

¹¹⁰ (1995) 58 SATC 328.

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of the property and its development, H raised a loan of R1,65 million from a bank. A bond secured the loan over the property. In addition guarantees were given by the shareholder of the appellant's holding company and his three sons. The premises were let by the broker to the taxpayer for a period of eight years with a lease premium of R1,5 million payable up front and an annual rental of R1 000. In order to pay the lease premium the appellant borrowed R1,65 from the same bank. The broker used the lease premium to settle its indebtedness to the bank and as a result the bond was cancelled. The bare dominion was then sold to a sister company of the taxpayer for R502 000.

It should be noted that the total cost of the land and improvements was approximately R2 million. Approximately four to five years later the property was sold for R4,1 million as the appellant was no longer doing well and wished to move to smaller premises.

The taxpayer claimed a deduction, in terms of section 11(f), of the premium paid over the period of the lease. The Commissioner disallowed the deduction in terms of section 103(1) against which the taxpayer appealed.

'H' was taxed on the lease premium as well as the bare dominion sale proceeds. Being a speculator, it was also able to deduct the costs of acquisition. Had the broker not been interposed the property-owning company would have been taxed on the lease premium without any corresponding deductions, hence the tax saving gained by interposing the

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third party broker.

The court noted that there were four preconditions laid down in section 103(1) and that all four had to be fulfilled before the Commissioner could apply the provisions of the section.

They were as follows:

- The transaction or scheme must lead to tax avoidance, reduction or postponement.
- It must be entered into or carried out wholly or mainly for the purposes of avoidance, reduction or postponement of tax.
- It must be entered into or carried out in a way which would not normally be used in carrying out such a transaction or scheme.
- Rights or obligations must be created which would not normally be created between parties acting at arm's length.

The court observed that, in order to determine the purpose of a particular agreement, it was necessary to look at the subjective intent of the parties at the time the agreement was entered into and that, in so far as the present transaction was concerned, it was clearly to reduce tax. The central question was therefore whether the transaction was one that would normally be entered into between persons acting at arm's length.

A distinction must be drawn between an unusual transaction and an abnormal one and it is in the nature of things that where a taxpayer uses his ingenuity to reduce his tax liability

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through the medium of a scheme, it will be unusual but the abnormality of the scheme will usually depend on whether it creates rights or obligations which would not normally be created by the parties to the transaction.

Where a scheme consists of separate transactions, which together in substance make up one composite transaction, it would be artificial only to look at each independent step and not have regard to the transaction as a whole.

After reviewing the issues in broader perspective, Tebbutt J, President of the Special Court, returned to the facts at hand and said that it appeared from those facts that, although the scheme was made up of three separate steps, each one of which could be seen as genuine, it was clear that they were all parts of one composite transaction. It was also clear that although there were three entities with independent legal personalities, two of them took part as members of a single company group and the third acted purely as an agent for that group in the transaction.

Tebbutt J was of the view that¹¹¹

‘where H was brought into the picture purely to give effect to the reduction of tax, the transaction should be seen in its entirety, in our view, as not normal or arm’s

¹¹¹ ITC 1606 (1995) 58 SATC 328 at 338 (translated).

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length'.

Although the evidence was that the group's chief purpose was to procure suitable premises for the taxpayer's business, the scheme which was actually entered into was, however, not to acquire the properties but was so constructed as to give effect to a tax reduction and, therefore, the scheme's chief purpose was to reduce tax.

He then went on to say, after discussing the United Kingdom case of *Furniss v Dawson*, that¹¹²

'[A]lthough the opinion has been expressed that any principle flowing out of the *Furniss* case should not be adopted by our courts (see article by Anton Derkson in August 1990 South African Law Journal at 416) the learned author of that article nonetheless indicates that the thought process in the *Furniss* case is in line with the statutory anti-avoidance provisions of the South African Act. In the light of this, it is our opinion that common sense holds that when one of the transactions included in a series of transactions, has no commercial purpose, and is there exclusively to attempt to obtain a tax advantage, it cannot be seen as a normal transaction between persons acting at arm's length.'

(Emphasis added.)

¹¹² ITC 1606 (1995) 58 SATC 328 at 339 (translated).

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This conclusion appears to steer towards the 'business purpose' test by disregarding transactions with no commercial (business) purpose other than the obtaining of a tax benefit.

Another case involving a leasehold improvement scheme along the lines of the scheme in *Ladysmith was Relier (Pty) Ltd v CIR*.¹¹³ This is an appeal against the judgment in the Special Income Tax Court (ITC 1611).¹¹⁴

The facts were that Hollard (H) who owned a computer company (EDP) sold two vacant stands to the appellant, Relier (Pty) Ltd (a dormant company belonging to a provident fund (the Fund)). Relier let the property to the provident fund, which was included in the arrangement because its income was exempt from tax in terms of section 11(d) of the Income Tax Act. The lease was for a minimum period of ten years. The rental during the initial and any extended period amounted to R1 750 a month, which represented a return of 21% on R100 000.

The property had to be used for the erection of office buildings, the buildings had to be insured by the tenant, the insurance policy had to be ceded to Relier (Pty) Ltd and the

¹¹³ 60 SATC 1.

¹¹⁴ 59 SATC 126.

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tenant had to pay all expenses concerning the property. The tenant was not entitled without the prior consent of Relier to sublet or make structural alterations or additions and at the termination of the lease all improvements were to become the property of Relier without any compensation.

The Fund lent Relier R100 000 to pay for the purchase of the properties. The loan bore interest at 21%, equivalent to the rentals received by Relier.

The Fund sub-let the properties to EDP and although identical to the main lease in most respects, it differed in that there was an obligation on EDP to effect improvements to the property costing not less than R820 000. At the termination of the sublease the improvements were to become the property of Relier, without any compensation.

The effect of this was that because the amount of interest and rentals were the same, no rentals flowed between Relier and the Fund. EDP's rental payment was in effect the interest payment on the loan.

The R100 000 lent by the Fund to Relier to pay H was then 'pledged' by H to the Fund and this amount had to be invested for the benefit of H. It was to be released once the loan had been repaid to the Fund by Relier or the value of the properties as improved exceeded R1,2 million.

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Although Relier became the owner of the property, it was the intention that this would be a temporary arrangement and an option was granted to the H Family Trust to purchase all the shares in Relier at their nominal value.

What the parties sought to achieve was a tax deduction of the cost of the building in EDP in terms of section 11(g) of the Act without a corresponding gross income inclusion in terms of paragraph (h).¹¹⁵ Relier would obtain the building as a capital gain without any tax liability because neither the Fund nor EDP had any contractual obligation towards it to erect the building. The H Family Trust would eventually hold the shares in Relier, and therefore the property including the improvements.

Alerted to the arrangement by a note to Relier's annual financial statements the Commissioner taxed an amount of R988 425 in Relier's hands. (It is not clear how the Commissioner arrived at this amount.)

Relier objected to the inclusion of this amount on the ground that no right accrued to it to have the improvements effected to its land as contemplated in paragraph (h) of the 'gross income' definition. In terms of the agreements the right to have improvements effected to

¹¹⁵ Section 11(g) was subsequently amended to counter arrangements of this nature.

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the property accrued to the Fund.

The issue before the court *a quo* and the Supreme Court of Appeal was whether the value of this right had accrued to Relier in terms of paragraph (h) of the 'gross income' definition.

The Special Court concluded that the scheme had not been entered into to be 'tax driven', but rather that 'the impelling consideration of the transactions was not to avoid or reduce tax but to enable EDP and the trust, both controlled by Hollard, to acquire the use and then the ownership of a property with a building on it in what was conceived to be a tax efficient way. It was the structure of the transactions that was designed to achieve a favourable tax result'.¹¹⁶

Wunsh J, President of the Special Court, said the following:¹¹⁷

'It is not the function of our courts to remedy or augment the power of the legislature to counteract tax avoidance. We do not have the weapons to counter-act parliamentary inaction or ineptitude or to avoid parliamentary congestion.

...

It is common cause that the transactions were interdependent and that none of them

¹¹⁶ ITC 1611 59 SATC 126 at 134.

¹¹⁷ At 145-6.

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would have been concluded without the others. We have rejected the submission that there were tacit terms in the sense of what are also sometimes called implied terms to be added to the agreements. What we have to examine is what the actual (even if not all recorded) terms of the agreement of lease between the taxpayer and the provident fund were. Did the lease confer the taxable right on the taxpayer?

The Special Court concluded as follows:¹¹⁸

'We conclude, therefore, that the appellant had a right, which accrued during the year of assessment, to compel the provident fund to procure the erection of a building on its property to a value of at least R820 000, that this right fell within the ambit of para (h) and that the respondent correctly assessed the appellant to tax on its value.'

It was against this decision that an appeal was lodged.

In the Supreme Court of Appeal Harms JA, who delivered the unanimous judgment of the court, noted that the issue in the present instance was not whether the scheme fell foul of section 103(1), but whether Relier had established, on a balance of probabilities, that the building costs were not part of its gross income because no right had accrued to it, in terms of an agreement relating to the grant to any other person of the right of use or

¹¹⁸ ITC 1611 59 SATC 126 at 152.

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occupation of the land, to have improvements effected on the land by that other person.

The taxpayer's representative argued that because the scheme was structured with full knowledge of the tax provisions and since the parties intended not to attract tax, there could be no question of a simulated agreement or of unexpressed terms. He had made the same submission in the *Ladysmith* case where Hefer JA responded as follows:¹¹⁹

'That the parties did indeed deliberately cast their arrangement in the form mentioned, must of course be accepted; that, after all, is what they have been advised to do. The real question is, however, whether they actually intended that each agreement would *inter partes* have effect according to its tenor.'

He summarised the main conclusions of Hefer JA in the *Ladysmith* case as follows:¹²⁰

'In the main this court concluded that although the law permits people to arrange their affairs so as to remain outside the provisions of a particular statute including a taxing provision, the question in the end remains whether the arrangement was one of substance and not one of form. More to the point, it was held that parties cannot arrange their affairs through or with the aid of simulated transactions and effect will be given to unexpressed agreements and tacit understandings.'

¹¹⁹ *Ladysmith (Pty) Ltd and Another v CIR* 1996 (3) 942 (A), 58 SATC 229 at 240.

¹²⁰ *Relier (Pty) Ltd v CIR* 62 SATC 1 at 6.

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Harnes JA observed that¹²¹

'[i]f the agreements are taken at face value, the appeal must succeed. The interposition of the Fund as tenant and lessor, however, has unusual and unreal aspects to it and the question that immediately springs to mind is whether the Fund actually intended to lease and then to sublet the property.

'It was readily conceded that the Fund never had the intention to use the property as tenant by occupying it or otherwise. To rent in order to sublet is not unusual in itself, but one would have expected that in such circumstance some advantage would accrue to the tenant. In this case there was none. The rental received by the Fund from EDP was the same as the rental payable by the Fund to Relier, which in turn was equal to the interest due by Relier to the Fund. All the obligations of the Fund as tenant were, according to the sublease, placed upon EDP. The Fund had no interest in the increase in the value of the property, whether in its capacity as tenant, sublessor or as sole shareholder of Relier.'

He went on to say the following:¹²²

'The Fund, in fact, incurred obligations which one would not have expected a trustee (Anderson) to have entered into. One such was the warranty given to Holloway concerning the tax effectiveness. In addition, in terms of the option, Relier was no longer effectively under the control of the Fund because Relier could no longer be

¹²¹ ITC 1611 59 SATC 126 at 127.

¹²² At 127-8.

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involved in any business beyond that agreed with Holloway.

'The Fund, as sublessor, imposed a contractual obligation upon EDP to erect a building to the value of R820 000, not on its own behalf, but in the sole interests of Relier. No other reason for the term was suggested. Relier, the owner of the property and the Fund's landlord, who, in terms of the scheme was not supposed to have any interest in the imposition of the obligation upon the subtenant, EDP, stood surety for the loan incurred by EDP to erect the building and passed a surety mortgage bond over its property. As was the case in the Special Court, "[n]o basis was suggested on which, bearing in mind their fiduciary duties, the directors of the appellant could have undertaken this liability without a corresponding obligation on the part of the principal debtor (EDP), which had no contractual nexus with the appellant, to improve the appellant's property which could be enforced, directly or indirectly, by the appellant."¹²³

'Holloway, a pivotal figure in the scheme, did not understand what the scheme involved and was thus a party to agreements, the import of which escaped him. From this one can fairly deduce that the written agreements did not reflect his true intentions. Nevertheless, the effect of the considerations mentioned is that the interposition of the Fund as tenant was not truly intended and amounted to a simulation. They also lead me to conclude that Relier had an enforceable right to have the improvements effected in terms of and as set out in the sublease. It is inconceivable in the scheme of things that the parties intended that Relier could not

¹²³ ITC 1611 59 SATC 126 at 147.

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enforce the obligation incurred by EDP. If one poses the question whether the Fund and EDP could have cancelled or amended the obligation to erect a building by agreement without the consent of Relier, the answer must perforce be in the negative. Similarly, it is unthinkable that the Fund could have elected not to enforce the obligation of EDP to erect without the permission of Relier. The submission by Mr Vorster that since the Fund controlled Relier this could not happen does not take account of the fact that a taxpayer must accept the consequences of the separate legal personalities involved.'

As a result the Supreme Court of Appeal held that the Commissioner had correctly assessed the taxpayer to tax on the value of its right to compel the Fund to procure the erection of a building on its property within the ambit of paragraph (h) of the definition of 'gross income'.

Harmes JA flatly rejected any attempt by the appellant to distinguish the facts in *Relier's* case from those in the *Ladysmith* case. In this regard he stated the following.¹²⁴

'An attempt was made to distinguish the present facts from those in *Ladysmith*. I have some difficulty in appreciating how the differences endure to the benefit of the appellant. In any event, the effect of my conclusion set out earlier is that the Commissioner's case in case is stronger than what it was in *Ladysmith*.'

¹²⁴ *Relier (Pty) Ltd* 60 SATC 1 at 8.

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The appeal was dismissed with costs.

It is clear from this case and from the *Ladysmith* case that the courts are going to view schemes of this nature with a more critical eye than they might have done in the past.

Both the *Relier* and *Ladysmith* cases provide significant support for the following statement made by *Silke*:¹²⁵

'As regards disguised transactions entered into for the purpose of tax evasion, the fiscus is sufficiently protected by common law, in that a court will not hesitate to strip the transaction of its disguise and expose the true nature or substance of the contract.'

The case of *CIR v Cactus Investments (Pty) Ltd*¹²⁶ deals with interest but there is an element of *Wunsh*'s judgment that deals with the true intentions of the parties.

The case dealt with interest dividend swaps. In terms of the arrangement *Cactus* (a taxpayer) ceded its right to interest income (which would have been taxed in its hands) to tax exempt entities in return for a cession by the tax-exempt entities of their right to tax-free dividends.

¹²⁵ *Silke on South African Income Tax* 11 Mem Ed in §19.1.

¹²⁶ 59 SATC 1.

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Wunsch J cited a number of cases dealing with the issue and concluded as follows:¹²⁷

‘In the present case the respondent did not enter into an agreement to acquire dividends on shares selected by it. It did not receive the dividends “of its choice”.

The choice of the dividends was left entirely to the institutions and they made their elections shortly before the cessions had to be effected, i.e. on the construction which I place on the agreement, before payment was to be made.

Applying *Zandberg v Van Zyl*,¹²⁸ the court has to determine what the actual intention of the parties was, taking into an account “all the circumstances”, which must include the method used by the parties to implement the master agreements. In *Lawson & Kirk v SA Discount (Pty)*¹²⁹ Davis J said:

“But the court has to determine the true meaning and intent of this covering contract, which took the outward form of an arrangement for purchases and sales, by what was said at the time and subsequently, and by what is of greater importance, namely what was done under it. Above all, what sorts of contracts were entered into in pursuance of this general covering agreement? It will consequently be necessary to examine the different types of contract purported to have been entered into under the original covering agreement, and in great measure to judge its true nature by them.”

‘Although his judgment was a dissent as to the outcome of the appeal, I consider that the approach of our courts with regard to ineffective transactions was correctly stated by De Wet CJ in *Commissioner of Customs and Excise v Randles, Brothers and*

¹²⁷ *CIR v Cactus Investments (Pty) Ltd* 59.SATC 1 at 42-3.

¹²⁸ 1910 AD 302 at 310.

¹²⁹ 1938 CPD 273 at 278-279.

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*Hudson Ltd*¹³⁰ indicating that dishonesty does not have to be present for a purported agreement to be regarded as simulated or a sham, when he said, after citing a passage from a judgment of De Villiers AJA in *MacAdam v Flander's Trustee*:¹³¹

"I think the learned judge intended to emphasise in the last sentence that, if the court on a consideration of all the circumstances comes to the conclusion that the transaction was not what it purported to be, it follows that however honestly the parties thought that their intention was in accord with the simulated transaction, that was not their real intention."

The quoted word of De Villiers AJA included the following:

"Parties may honestly think that they are entering into a contract of purchase and sale, which turns out to be one of pledge. Whether it is the former depends upon whether the essential elements of such a contract are present. To go back to first principles. There can be no contract of purchase and sale without *the animus emendi* on the part of the purchaser and the *animus vendendi* on the part of the seller. And it must be a genuine animus of the one to sell and of the other to buy. It is not enough for the parties to think that they have the intention, the intention must be proved as a fact apart from what they thought."

An example of the application of this approach is *Tucker v Ginsberg*, where the court was concerned of the question whether the discounting of a bill of exchange was a money lending transaction. Trolip J said:¹³²

¹³⁰ 1941 AD 369.

¹³¹ 1919 AD 207 at 383.

¹³² 1962 (2) SA 58 (W).

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“As each party has given the transactions a different label, I think that it is appropriate to add here that the label used is not decisive. Despite the label, the court must look at the nature of the transaction and not its object because, as stated above, the object is the same in both cases – see *Olds Discount Co Ltd v John Playfair Ltd* [1938] 3 All ER 275 at p 277, and in ascertaining its nature the court must have regard mainly to its substance and not merely its form.”

‘In the present case the respondent was not prepared to look exclusively to the rights to the dividends for payment of the consideration for the rights to the interest – the institutions were clearly the primary obligors. The cession were, to adopt the expression used in the American Restatement supra, used as “a device” for the settlement of the monetary obligations to the respondent. If the dividends ceded to it failed to materialise, others had to be substituted. Similarly the institutions looked to the respondent for payment and the cessions of rights to interest were used as a device for the settlement of the monetary obligations of the respondent.

‘On the basis of the above reasoning it was put to Mr Solomon that the true transaction between the parties to each of the agreements was reciprocal undertakings to pay each other money amounts which they were to implement by transferring to each other interest and dividends respectively.’

When this contention was accepted by counsel for the respondent ‘that was the end of the respondent’s case’ according to Wunsh J.

Once again it can be seen that the courts look at the true intention, rather than the stated

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intention, of the parties.

A recent Eastern Cape Special Court decision¹³³ also deals with the issue.

In this case, the taxpayer wished to raise R95 750 000 for future capital expansions. The most obvious way to secure the necessary funds would be to obtain a loan from a financial institution. As the amount involved was substantial, the bank required security. It was not an option to offer income-producing assets as security, as the assets would have had to be in the possession of the pledgee for a pledge to be valid. From a tax point of view the transaction was not beneficial to either the borrower or lender, as the borrower could only deduct the interest payable on the loan, in terms of section 11(a), and not the repayment of the loan itself, while the lender would be taxed on the interest received, as it is part of its gross income.

An alternative route was for the taxpayer to sell some of its income-producing assets to the financial institution and then to lease them back. For the seller the scheme did involve a risk that the ownership of the assets would pass to the financial institution with the effect that, if the latter went insolvent, the assets will fall into its insolvent estate. This was, however, not much of a risk as,

¹³³ ITC 1636 60 SATC 267.

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- first, the chances of a reputable financial institution going insolvent were slight and.
- secondly, the purchase price of the goods, which are sold at market value, was paid in cash.

The tax consequences of the sale and leaseback route, unlike the loan, were that the full rental expenditure – that is, the interest and capital portion – was deductible in the hands of the lessee. Although the rentals received were taxable in the hands of the financial institution, a depreciation allowance could be claimed under section 11(e) of the Act. As a result of this allowance, the rental charged was based on the lower interest rate than it would have been under a conventional loan.

This particular method of financing is no longer viable as a result of the amendments made to sections 23D and 23G of the Income Tax Act, which limit the allowances available to lessors.

In ITC 1636¹³⁴ the taxpayer decided to follow the sale and lease back route as the present value of the after-tax lease versus the loan benefit, at a discount rate of 18% a year, was R29 247 796.

¹³⁴ 60 STAC 267.

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The agreements between the parties were carefully recorded. The sale agreement was made subject to the suspensive condition that the seller and buyer enter into a lease agreement. The parties thus did not conceal the fact that the two transactions were interrelated. Due to the high cost involved in appointing an independent valuer, an employee of the taxpayer was appointed to identify and value the assets that were to be sold. It was not only important for the seller that the assets were sold at market value, but also for the purchaser, as the section 11(e) allowance was based on the market value.

The lease agreement provided that if the Commissioner did not accept the purchase price as the basis on which the allowance might be claimed, the rental would be adjusted upwards to compensate the financial institution.

On the day the agreements were signed, representatives of both the seller and the purchaser proceeded to the seller's factory where, in the presence of an attorney, delivery took place by way of *constitutum possessorium*, the exercise of which was recorded by the attorney in a notarial certificate.

The Commissioner questioned the validity of the scheme on the following two grounds:

- First, that the transactions were simulated, and
- secondly, that they may be ignored under section 103(1) of the Act.

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Kroon J, President of the Special Court, approached the question of simulation on the premise that the sale and lease back transaction should be construed as a single composite transaction. It was decided that the transaction was not disguised, as both parties agreed on the assets to be sold and a genuine price was paid. One party had the true intention to buy and the other party the true intention to sell.

Although some of the assets that were sold formed an integral part of the taxpayer's manufacturing process, without which it could not operate, these were sold subject to the buyer leasing them back to it. The fact that the bank had not seen the plant and machinery until legal delivery (by *constitutum possessorium* – i.e. a legal, not a physical handing over of ownership, because the assets stayed in the possession of the taxpayer), was not an issue.

Even though, for accounting purposes a sale and leaseback transaction is treated as a finance lease, this treatment is not decisive in determining the tax treatment. For accounting purposes the financial and economic substance of an agreement is taken into account and not the legal form of the contract. For tax purposes, the legal form of the transaction is taken into account unless it is proved that the transactions were a sham.

Having established that the contracts reflect the true intentions of the parties, Kroon J turned to the applicability of section 103(1). It was decided that the first two requirements

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of section 103(1) had been complied with, a transaction had been entered into; the effect of which was to reduce tax.

The transactions were, however, not abnormal, either in the means or manner in which they were entered into or carried out, nor in terms of the rights or obligations that they created.

The court also found that the sole or main purpose of entering into the arrangement was not the avoidance of tax, but the raising of finance for future capital expansions.

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The applicability of substance over form in South Africa

It is not generally accepted that the substance over form doctrine should be adopted in South African law. Two examples where the form of a transaction is recognised over its substance are as follows:

- Finance leases – the substance of the transaction is the acquisition of ownership of the asset, however, the lessor and the lessee are taxed on the form of the transaction, that is a lease.¹³⁵
- Sale and leaseback transactions – the substance of the transactions is that the sale proceeds are in effect loans on the security of assets and the lease instalments are in effect repayment of the loans. The introduction of section 23D in the Income Tax Act, to limit the deduction of allowances by financiers in sale and leaseback situations, would not have been necessary if the substance of the transaction was the basis for the imposition of tax.¹³⁶

It is submitted that, if substance is the basis for assessment, the enactment of section 103(1) would not have been necessary. Section 103(1) was enacted, and amended,

¹³⁵ Lessors are taxed in terms of section 23A of the Income Tax Act which clearly supports form over substance.

¹³⁶ See also ITC 1636 60 SATC 267.

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because the basis of assessment is that the form of the transaction predominates.

Had the legislature intended this, the word used in section 103(1) would be 'substance', as is the position in section 73 of the Value Added Tax Act.¹³⁷

The South African courts are, however, steering towards the United Kingdom doctrine of substance over form as a basis for their decisions, although the English decisions have gone much further.

The United Kingdom approach, which culminated in the decision in *Dawson's case*¹³⁸, is that where a series of transactions has been entered into with the purpose of avoiding tax, and some of the steps in the series have no commercial purpose other than the avoidance of tax, then that entire series of transactions may be disregarded and the 'true substance' may be invoked.

The South African courts, on the other hand, have adopted the view that, if a transaction is genuinely intended, and if the parties truly intend the rights and obligations which flow from the agreement or for agreements actually to exit, the court would have no reason to

¹³⁷ Refer Chapter B.

¹³⁸ *Furniss (Inspector of Taxes) v Dawson* [1984] AC 494 (HL).

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go behind the 'form' of the transaction, even if invited to do so by the taxpayer, because the form and the substance in that instance would be one and the same. It is only where the court suspects that there may be an underlying, unexpressed or secondary agreement or intention and that the formal agreement is intended merely as a cover for the real agreement, that the courts may strip away the façade in order to discover the nature of the real agreement.

It has been stated that '[i]n essence, it would seem that the intention of the "business purpose" test is to look at the substance of a transaction, or series of interrelated transactions rather than the simple form'.¹³⁹

It is submitted, however, that this overstates the position of the South African courts and that, although the lack of a commercial purpose may be an indication that the 'formal agreement' does not truly reflect the 'real agreement', this cannot be elevated to a principle of law and should be regarded as no more than one of many factors which the court would take into account.

In conclusion the so-called substance over form doctrine is not of direct relevance in South African tax avoidance other than in establishing the true intention of the parties.

¹³⁹ 'Anti-avoidance – s103 fights back' in *Taxgram* Issue No. 6 June 1996.

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Basically, where there is no business purpose for a particular transaction other than the obtaining of a tax advantage, that transaction will be ignored for tax purposes giving effect to the 'business substance' of the scheme.

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CHAPTER E : CONCLUSION

In conclusion, the introduction of the 'business purpose' test gives more venom to the Court under section 103(1)(b) – the normality test.

It assists in preventing taxpayers from using the defence that a common method of tax avoidance, which gains commercial acceptance, is normal. Compared to the position in the United Kingdom, Australia and Canada, among others, the South African taxpayer still has the advantage of exercising his right to a tax saving by entering into a transaction purely for tax purposes, as long as it is one normally applied for business purposes and as long as it is not regarded as a sham transaction.

The 'business purpose' test does not go as far as to favour the substance of a transaction, or series of interrelated transactions, over their simple form. Where, however, the circumstances indicate that there is abnormality, it will be of assistance to look at the substance of the transaction over its form in order to determine the true intention of the parties.

In essence, where there is no 'business purpose' for a particular transaction other than the obtaining of a tax advantage, that transaction should be ignored for tax purposes giving effect to the overall 'substance' of the scheme.

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