A critical analysis of recent Supreme Court of Appeal judgments that have deviated from the *stare decisis* principle

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Abstract

The decisions and methodology used by the Judges in a higher court, such as the Supreme Court of Appeal is binding on the lower courts. It is therefore imperative that the principles established are sound and in line with the intention of the Legislator when hearing matters on tax cases on areas where the Income Tax Act No. 58 of 1962 (“IT Act”) is ambiguous or unclear.

In recent tax cases heard by the Supreme Court of Appeal, the tax community has been left puzzled and in some cases outraged by the comments made by the Judge(s) and for passing judgments which have deviated from the *stare decisis* principles that have become embedded in our Law and have been applied for many years.

In the cases reviewed the Judges have found that the *stare decisis* principle is not applicable to the case or needs to be expanded in order sustain its usability.

The objective is to determine if the reasoning and rationale followed by the Judge(s) are sound and whether or not it is in line with the conclusion that a reasonable man would reach if he was presented with the same facts.

We will delve into three recent court cases, and examine the reasoning of the Judge(s) for reaching a different conclusion and the reasons why the tax community was not impressed with the conclusions reached in the judgment handed down. Where possible, the principles determined by similar foreign cases have been mentioned, as well as how the new principles have been applied in cases heard since the judgments were handed down.

The dissertation is performed with the view of assisting the reader to ‘think outside of the box’ and to broaden their range when evaluating the facts and circumstances of the case and making their own conclusion based on the information presented. The basic principles of the IT Act should form the foundation on which you formulate your argument, and only the ambiguous portion which is open to interpretation should be the focus point of basing your arguments to the Judge. No ambiguity should exist in the case presented (i.e. no stone unturned) in order to avoid any curve balls to be thrown by the Judge deciding the outcome of the case.

Attestation

I understand the nature of plagiarism, and I am aware of the University's policy on this.

I certify that this dissertation reports original work by me during my University project except for the following:

- The commentary made by members of the tax community was based on publications in the Taxpayer namely -
  - The Taxpayer Volume 60 No 2 February 2011 p 23 to p 25
  - The Taxpayer Volume 60 No 5 of May 2011 p 83 to p 85
  - The Taxpayer Volume 60 No 6 June 2011 p 114 to p 120
  - The Taxpayer Volume 60 No 7 of July 2011. *Floundering Up Founders Hill.* P 123 and p 124
  - The Taxpayer Volume 60 No 8 of August 2011. *Raising the flag on Founders Hill – A rejoinder.* P 143
  - The Taxpayer Volume 60 No 9 September 2011 p 163 to p 167
  - The Taxpayer Volume 60 No 10 & 11 of October – November 2011. *The only flag for Founders Hill should be white*. P 182 and p 183
  - The Taxpayer Volume 60 No 10 & 11 of October – November 2011. *NWK and Founders Hill by Eddie Broomberg p 187 to p 207*
- The implication of the NWK case on recent court decisions made by Judge Allie. This was largely taken from Integritax March 2012 Issue No 150 dealing with anti-avoidance which was written by Advocate Cliffe Dekker Hofmeyr

Signature Lizl Pretorius 12 July 2012

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Abbreviations

CC – Constitutional Court

CIR – Commissioner for Inland Revenue

CSARS – Commissioner, South African Revenue Service

GAAR - general anti-avoidance rules

IT Act - Income Tax Act No. 58 of 1962

ITC – Income Tax Case

LAWSA – Law of South Africa

s. - section

SA – South African Law Reports

SARS – South African Revenue Service

SATC – South African Tax Cases Reports

SC – Senior counsel

SCA – Supreme Court of Appeal

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1 Introduction

Where disputes arise between the Commissioner and the Taxpayer in determining the tax consequences of a particular set and facts and they are unable to resolve the matter between themselves, the dispute could be brought before the Court for a decision.

Firstly the Tax Board will be approached where the amount in dispute is less than R 500,000. If either party is not satisfied with the outcome, they could appeal to the Tax Court[1], thereafter the High Court[2] for a decision. The case could be escalated to the SCA[3] should either party feel that the decision reached in the Tax Board and / or Tax Court did not reflect the tax position as set out in the IT Act.

It is important to note that judgments reached in the SCA are binding on lower courts (i.e. Tax Court and Tax Board). This is known as the *stare decisis* principle.

The *stare decisis* rule originates from English law which is accepted in South Africa. It is a Latin noun which literally means to 'stand by things decided'.[4] Explained differently it means that Judges are bound by the decisions reached in previous judgments where a set principle has been created.

It must however be borne in mind that unlike the High Court, the rules of *stare decisis* do not apply to the decisions of a Tax Court, in other words, the decisions of the Tax Court are not binding on itself or other Tax Courts.[5]

This is confirmed by the well-known income tax textbook called LAWSA 2 ed Vol 5 paragraph 122 which concludes that the Tax Court is an inferior or lower court.

Also in the *Commissioner for Inland Revenue v City Deep Limited* 1924 AD 298 at 306 case the court said that the Commissioner of Revenue ‘is not bound by the

[1] Previously called Special Court

[2] Previously called the Supreme Court

[3] Previously called the Appellate Division

[4] Definition obtained from http://oxforddictionaries.com/definition/stare+decisis

5 ITC 1806 (2005) 68 SATC 117 (G) at 139

reasoning of the Special Court (now called the Tax Court), which, though a competent court to decide the issues between the parties is not a court of law'.[6]

In essence the *stare decisis* principle has the effect that lower courts are bound by the judgments reached in higher courts. Therefore as mentioned above the judgments reached by the Tax Court and Tax Board are not binding on the SCA, but the judgments reached by the SCA are binding on the Tax Court and Tax Board.

Furthermore, it should be noted that the correct legal process should be followed where a party feels grieved by the decision reached of the other party. Furthermore it should be borne in mind that the Acts governing the circumstances would carry the authority as to how the matter should be dealt with.

This is based on the fact that the Constitution recognises the need to create specific and specialised legislation in order to deal with matters that could arise in a modern and complex society. This has given rise to legislation dealing with particular areas (for example taxation[7], labour relations[8] and equality[9]) in order to resolve matters in an effective and structured manner.

Therefore, once a set of carefully-crafted rules and structures has been created for the effective and speedy resolution of disputes and protection of rights in a particular area of law, it is preferable to use that particular system.[10]

This also confirms that the policies and procedures set by Law will govern how a matter should be dealt with and which court should be approached first for a decision on the matter in dispute.

Coming back to the *stare decisis* principle the following extracts were cited at paragraph [58] to [62] in *Gcaba v Minister for Safety and Security and Others* 2010 (1) SA 238 (CC) ("*Gcaba* case"):

> [58] …'it may be useful to keep the essential meaning of and the reasons behind the doctrine of precedent in mind.[11] Often expressed

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6 VAT 304, unreported decision by the Pretoria Tax Court, 7 November 2005 delivered by Southwood J

7 Income Tax Act No. 55 of 1962

8 Labour Relations Act No. 66 of 1995

9 See s. 9(4) of the Constitution and the Promotion of Equality and Prevention of Unfair Discrimination Act 4 of 2000

10 Gcaba v Minister for Safety and Security and Others 2010 (1) SA 238 (CC) par 56

in the Latin maxim *stare decisis et non quieta movere* (to stand by decisions and not to disturb settled matters), it means that in the interests of certainty, equality before the law and the satisfaction of legitimate expectations, a court is bound by the previous decisions of a higher court and by its own previous decisions in similar matters.'[12]

[59]…'Once the meaning of the words of a section in an Act of Parliament have been authoritatively determined by this Court, that meaning must be given to them, even by this Court, unless it is clear to it that it has erred. ... Particularly is it important to observe *stare decisis* when a decision has been acted on for a number of years in such a manner that rights have grown up under it.'[13]

[61] …'The sound jurisprudential basis for the policy that a court should adhere to its previous decisions unless they are shown to be clearly wrong is no less valid here than is generally the case.'[14]

In *Daniels v Campbell*,[15] it was said that …'the recognised exceptions to the *stare decisis* principle, namely "where the court is satisfied that its previous decision was wrong or where the point was not argued or where the issue is in some legitimate manner distinguishable.'

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[11] Hahlo and Kahn *The South African Legal System and its Background* (Juta & Co Ltd, Cape Town 1968) state at 214:

"In the legal system the calls of justice are paramount. The maintenance of the certainty of the law and of equality before it, the satisfaction of legitimate expectations, entail a general duty of judges to follow the legal rulings in previous judicial decisions. The individual litigant would feel himself unjustly treated if a past ruling applicable to his case were not followed where the material facts were the same. This authority given to past judgments is called the doctrine of precedent."

[12] A similar statement that a *stare decisis* means certainty, equality of law and legitimate expectations was made in *Van der Walt v Metcash Trading Limited* [2002] ZACC 4; 2002 (5) BCLR 454 (CC); 2002 (4) SA 317 (CC). Id at paragraph 39

[13] In *Robin Consolidated Industries Ltd v Commissioner for Inland Revenue* 1997 (3) SA 654 (SCA) Id at 666F-G

[14] *Certification of the Amended Text of the Constitution of the Republic of South Africa, 1996* [1996] ZACC 24; 1997 (1) BCLR 1 (CC); 1997 (2) SA 97 (CC). Id at paragraph 8

[15] *Daniels v Campbell NO and Others* [2004] ZACC 14; 2004 (7) BCLR 735 (CC); 2004 (5) SA 311 (CC). Id at paragraph 95

> [62] … 'Therefore, precedents must be respected in order to ensure legal certainty and equality before the law. This is essential for the rule of law. Law cannot "rule" unless it is reasonably predictable.
>
> The only exception as to when the CC may deviate from a previous decision is where …'earlier decisions have given rise to controversy or uncertainty, leading to conflicting decisions in the lower courts.'

Therefore, the principles as well as substantive tests developed through court cases and the respective conclusions reached in previous court cases serve as basis in determining the outcome of subsequent cases heard with similar facts and circumstances. However the facts and circumstances of each case will be assessed on its own merit and the applicability of the previous court cases will be scrutinised.

Judges will also bear in mind any changes in legislation which could lead to the previous judgment not applying to the set of facts before them.

There are instances where the judge identifies significant differences between the facts and circumstances in respect of the current case and previous cases and could highlight the differences in order to justify reaching a different conclusion than the precedence set in previous cases. This course of action is acceptable as long as it does not override legislation contained in the IT Act. Therefore, a judge cannot create new legislation, but can use his own judgment when deciding on an ambiguous portion of legislation pertaining to the case.

Recently some SCA Judges have been criticised for passing judgments which deviate from the *stare decisis* principles. This will now be discussed in more detail.

1.1 Background and Context

This dissertation will focus on three court cases, namely

- *Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd Supreme Court of Appeal,* 10 May 2011, Case No 509/10 ("*Founders Hill*")
- *CSARS v NWK* (27/10) [2010] ZASCA 168 (1 December 2010) ("*NWK*")
- *First South African Holdings (Pty) Ltd v CSARS* (372/10) [2011] ZASCA 67 (11 May 2011) ("*First SA Holdings*")

With respect to the first two court cases mentioned above, the Judges departed from the legal position (i.e. *stare decisis* principles) established by well-known previous court decisions. I will focus on the reason why the Judges deviated from the *stare decisis* principles, state reasons for the tax community agreeing or disagreeing with the judgment given and comment on whether or not these decisions are out of line with foreign cases on the same issues. This will be followed by my conclusion reached based on the information addressed in the case decided on.

The third court case mentioned above deals with the meaning attached to the word "assessment" as defined in s. 1 of the IT Act and how the interpretation of this word by the Courts have lead to the decision made by the Judge(s). Thereafter the comments raised by the tax community will be noted and addressed. This will be followed by my conclusion reached in examining these cases.

1.2 Scope and Objectives

The dissertation will focus on the reasons given by the Judge for reaching his / her conclusion and why he / she consider the judgment to be in line with the context of the IT Act.

Mention will also be made to comments published by the tax community and why they agree / disagree with the judgment reached in the court case.

The outcome of foreign cases on the same issues and how the judgments have affected court cases heard since then will be considered in order to conclude if the decision reached is considered to be in line with legislation of other countries and whether or not the new principles attached to these situations will carry any value in future cases to be heard.

Where a subsequent case have made use of the new principles laid down by the court cases discussed, this is included to show the how the new principles have been applied to the subsequent judgments handed down.

1.3 Achievements

While drafting new legislation or amending current legislation, the legislator should apply their mind and be ever conscious that any ambiguity in the IT Act which is open for interpretation could lead to different outcomes reached for various cases heard in the Court of Law.

It is also important to note that counsel for the Commissioner and Taxpayer should cover all of there basis in preparing for the hearing and ensure that they have thoroughly made use of all available avenues to support their case. Counsel should be able to first prove that the basic principles of the IT Act was applied to the case and that only the point(s) where ambiguity exists is presented to the Court for a decision. It is a well known fact that counsel representing the best case is most likely to win the case, while keeping in mind that no new grounds of appeal could be presented when the hearing has commenced.

Counsel should bear in mind that the Judges are not necessarily specialists in the tax field and therefore counsel should present their case and use corroborating evidence in such a way as to avoid the Judges from coming to their own conclusion when reviewing the principle of previous cases heard or making use of their own resources to reach a conclusion based on the facts presented where these principles have been decided on in a previous case.

1.4 Overview of Dissertation

The dissertation focuses mainly on three cases that were heard in the SCA, where Judges have made judgments which lead to criticism by the tax community.

I have set out the facts pertaining to the case, as well as the issue that had to be decided on by the Court. Reference has been made to the arguments raised by the Commissioner and counsel of the Taxpayer, together with the authorities relied on to support their argument(s).

Thereafter I included the conclusions reached by the Judge(s) hearing the case and some of the authorities relied on as well as new principles established by them in reviewing the facts of the case being discussed, which may include the Judge(s) own research and interpretation of that research.

Where possible, reference was made to foreign cases dealing with the same matters and the conclusions reached by their courts. Furthermore, commentary was made on whether or not the Judge(s) used the principles set in those cases.

In addition, where possible reference was made to subsequent cases where the cases being discussed was used by other Judges in passing their own judgment on cases brought before them for a decision.

This was followed by the criticism given by the tax community in presenting their view on how the Judge(s) may have overlooked some basics of the IT Act, and how even though the conclusion was correct it was not based on sound principles embedded in Law or judgments reached in previous court cases. In other words we will examine the reasons why the tax community concluded that the Judge(s) deviated from the *stare decisis* principle.

2 *Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd Supreme Court of Appeal*, 10 May 2011, Case No 509/10 ("*Founders Hill*")

The *Founders Hill* case firstly addressed the reason behind forming a realisation company for realising assets and secondly, whether or not the realisation of assets by the realisation company would be revenue or capital in nature.

2.1 Background and facts of the case[16]

AECI Ltd ("AECI") owned surplus land / property[17] that it wished to dispose of since it no longer formed part of the property portfolio required for its trade. The land was considered to be a capital asset since AECI originally acquired the property with a capital intention.

In a memorandum to the AECI board dated 2 March 1989, Mr J.C. von Solms recommended that the strategic plan which had been developed be accepted and that the surplus land should be disposed of. AECI made the decision to sell or develop the land according to the strategic plan devised, and executed the strategic plan on a step-by-step basis.

One of the steps proposed was to form a realisation company, namely Founders Hill (Pty) Ltd ("Founders Hill") with the purpose of realising the land to the best of its advantage.

The realization programme of AECI was vast, and Founders Hill was but one of six companies formed by AECI to sell its surplus property throughout South Africa. Founders Hill's sole purpose was to realise the property to best advantage and within a period of one year of completion of such realisation it would distribute the profits to its shareholder, AECI and to be voluntary wound up.

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[16] *Commissioner for the South African Revenue Service v Founders Hill (Pty) Ltd Supreme Court of Appeal*, 10 May 2011, Case No 509/10. The facts pertaining to the facts were summarized in my own words, but where the facts could not be phrased differently without losing the crux thereof extracts of the judgment was used to summarize the background and facts pertaining to the case

[17] The use of the word land / property or erven will be used interchangeably throughout this dissertation

AECI held the property as a capital asset and the property would retain its capital nature when it was taken over by Founders Hill.

Founders Hill was formed as a realization company for the purpose of facilitating the realization of property. Founders Hill did no more than act as the vehicle used to realise the property for the interests of its shareholder, namely AECI. Surpluses made from the disposal of the property would supposedly not be taxable as trading profits, since such surpluses would be capital receipts.[18]

In other words, AECI's view was that the sale of the land would be the realising of a capital asset and therefore any gain realised would be of a capital nature. Founders Hill followed the same line of thinking and maintained that it done no more than realise a capital asset advantageously.

2.1.1 Arguments presented by Commissioner and Taxpayer and the Judge's response thereto

The Commissioner agreed that AECI acquired the land as a capital asset, but argued that AECI later on changed its intention and held that Founders Hill crossed the Rubicon and therefore wanted to tax the profit received as being revenue in nature.

The Commissioner relied extensively on *The Natal Estates Ltd v Secretary for Inland Revenue 1975 (4) SA 177 (A)* ("*Natal Estates*") case by arguing that the intention has changed from holding the property as a capital asset to being held as trading stock and being realised as part of a profit making scheme.

Founders Hill argued, on the other hand, that its intention at all times were to realise the land held as a capital asset. That was the purpose of the company from inception. A taxpayer is entitled to realise an asset to best advantage, a principle recognised for nearly a century in South African law. Founders Hill cited in support of this proposition the cases of *Commissioner of Taxes v Booysens Estates Ltd*[19] and *Commissioner for Inland Revenue v Stott*[20] where Wessels JA said:

> 'Every person who invests his surplus funds in land… is entitled to realise such asset to the best advantage and to accommodate the

[18] Simon's Taxes, 3rd ed at p B 1. 214

[19] *Commissioner of Taxes v Booysens Estates Ltd* 1918 AD 576 at 595

[20] *Commissioner for Inland Revenue v Stott* 1928 AD 252 at 263

> asset to the exigencies of the market in which he is selling. The fact that he does so cannot alter what is an investment of capital into a trade or business for earning profits.'

Therefore, the question presented to the SCA was whether Founders Hill realised the erven to best advantage or whether it embarked upon the business of selling land?

Instead of addressing the question presented by the Commissioner and Taxpayer for a decision, Lewis JA took one step back and asked counsel for Founders Hill to substantiate why the land was acquired as a capital asset, and not as stock-in-trade from AECI, since Founders Hill engaged with professionals to develop and market the properties for sale.

Lewis JA acknowledged that the intention when the land was originally acquired and the intention at the time of disposal could impact the capital or revenue nature of the land. It was therefore possible that there had been a change in intention from the date of acquisition up to the date of disposal of the land.

Lewis JA however expressed that even if the taxpayer refers to an asset as being a capital asset, it does not necessary concludes it to be one. The intention of the taxpayer and the actions taken would reflect the true nature of the asset.

In response to the Judges' question, AECI stated that Founders Hill was formed as a 'realization company' based on legal advice obtained, namely that Founders Hill would realise the property to its best advantage and that in doing so it should not 'cross the Rubicon' if further activities were carried on in order to realise a higher gain upon disposal.

Lewis JA responded that merely acting on legal advice is not a conclusive reason to substantiate that the land was acquired as a capital asset. The SCA therefore deemed it necessary to scrutinize the facts leading to Founders Hill's incorporation, its memorandum and articles of association as well as its subsequent conduct to conclude whether or not the Rubicon had been crossed.

Lewis JA made reference to the *Malone Trust v Secretary for Inland Revenue*[21] ("*Malone*") and *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue*[22] ("*Berea West*") cases and came to the conclusion that both these cases had a real

[21] *Malone Trust v Secretary for Inland Revenue* 1977(2) SA 819 (A)

[22] *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue* 1976 (2) SA 614 (A)

justification for making use of a realisation company rather than the original owners disposing of the property itself as the original owners. The two distinctions made was that more than one person transferred the assets to the interposed entity and that without the interposition of the interposed entity, realisation would have been difficult if not impossible.

AECI had no other commercial reason for transferring the land to Founders Hill other than acting upon legal advice obtained. In addition, prior to transferring the property to Founders Hill, AECI had already applied to rezone Erven 25 and 28 for light industrial use, and had subdivided the land for the purpose of that zoning.

Furthermore, Founders Hill itself engaged professionals to develop these erven and incurred expenditure in ensuring that each subdivided stand could be sold with services such as the supply of water, electricity and sewerage by the local authority.

Based on the extended activities undertaken by Founders Hill and the fact that the land was acquired for development and resale Lewis JA concluded that Founders Hill changed its intention from capital to revenue over the years when the erven were sold.

Therefore, the SCA held that Founders Hill acquired the property as stock-in-trade and had embarked on a scheme of profit making thereby rendering the profit to be of a revenue nature.

2.1.2 Principles decided in previous cases

The *stare decisis* principles decided in previous cases –

a) A taxpayer may dispose of an asset to its best advantage (*Natal Estates*). Taxpayers may arrange their activities in a manner that makes the most sense to them.

b) Where a scheme of profit making is entered into or carried on in order to realise an asset to the taxpayer's best advantage, the taxpayer is said to have crossed the Rubicon. An asset previously held with a capital intention would become a trading asset and any amount realised would be included in gross income and the full amount would be subject to income tax. Furthermore there should be an intention to trade for profit. (*Natal Estates*).

Another principle which has developed from cases dealing with realisation companies is –

a) that a realisation company could be formed to merely realise certain assets without being liable for tax thereon, as long as the company does nothing more than realise the asset and does not trade (*Realisation Company,*[23] *Malone* and *Berea West*).

Therefore common practice followed by taxpayers when wanting to dispose of property was to incorporate a realisation company with the mandate of realising the property/(ies) to its best advantage, distributing the profits realised to its shareholders and thereafter cease to exist (liquidate, deregister or wind-up) as it served its purpose and it had no intention to exist long-term or to carry on a trade.

No other reason but the disposal of the property on behalf of the original owner was required in order for a company to be set up as a realisation company. Furthermore, it was accepted that the property would retain its nature as a capital asset where the original owner held the property with a capital intention. The transfer of the property from the original owner to the realisation company would not alter the original nature of the property nor the intention with which it was acquired by the original owner.

2.1.3 Judge's reasoning for deviating from *stare decisis* principle

Lewis JA did not merely address the question as to whether or not Founders Hill realised the erven to best advantage or if Founders Hill embarked upon the business of selling land in order make a profit that would be revenue in nature and taxable in full.

Lewis JA took the point of view that one should first determine if Founders Hill acquired the property with a capital intention or as trading stock to be sold as part of a profit making scheme. The reason behind the acquisition would form the foundation as to whether or not the property was acquired with a capital or revenue intention. This would cast a light on the subsequent actions followed to realise the erven.

[23] *Realisation Company v COT 1951 (1) SA 177 (SR), 17 SATC 139*

In her view, incorporating a realization company would not automatically bring the property acquired back into the capital net if Founders Hill's original intention was to acquire the erven as trading stock.

The fact that Founders Hill could not present any substantiation as to why it should be seen as a realisation company rather than a property developer and dealer, it served as the last nail the coffin for her to rule that the property was acquired as trading stock.

In her mind, based on the judgments reached in *Malone* and the *Berea West* case there should be a real justification for using a realization company rather than have AECI dispose of the property themselves and that normally more than one company would transfer their property to a realization company to be disposed of for its benefit.

As no real justification was given by Founders Hill other than acting on legal advice, Lewis JA held that Founders Hill acquired the property as trading stock as part of a scheme of profit making and the proceeds realised would be revenue in nature.

2.1.4 Implication of the Court's decision

The standpoint taken by Lewis JA has caused dismay amongst the business community for questioning the purpose of establishing a realisation company in the first place, since it is not the intention of a realization company to carry on a trade. The carrying on of a trade is one of the basic requirements to be met, prior to being subject to tax under the IT Act. By overlooking the legal methodology behind using a realization company and now having to prove or provide a commercial reason for following this route to dispose of assets would curb the business community from disposing of assets in a method that they deem to make the most commercial sense / practical approach to them at the time.

2.1.5 Criticism given by tax community

Davis responded to the *Founders Hill* case via articles which where published in *The Taxpayer.*[24] Davis said that Lewis JA misread the *Berea West* case thereby creating

[24] The Taxpayer since 1952. A monthly journal devoted to Tax Law and Practice

uncertainty with respect to the use of a realisation company to realise assets to the best of a taxpayer's advantage.[25]

Clegg however responded to Davis' article by indicating that he agreed with Lewis JA that an external influence or virtually insuperable problem that requires the property concerned to be taken out of the hands of its original owner[26] in order for the realisation to take place is sound, otherwise there would not be a need for a separate entity to realise the asset on their behalf.

Clegg concluded that since no apparent reason existed to create a realization company that Lewis JA was correct to say that the *Berea West* case did not apply to the *Founders Hill* case.

Broomberg's paper[27] on the case revealed the dismay he felt when Lewis JA raised the question as to whether or not Founders Hill acquired the land as capital assets or stock-in-trade. Both counsel for Founders Hill and the Commissioner agreed that Founders Hill acquired the land as capital assets. The SCA should therefore only have assessed if Founder's Hill crossed the Rubicon instead of raising additional points of concern that require clarification and be subject to further scrutiny. Founder's Hill's counsel was caught off guard when Lewis JA wanted evidence of whether the assets were acquired as capital assets or as trading stock to be put forward. Since Founders Hill responded that this was done based on legal advice received, Lewis JA failed to see the reason for making use of a realisation entity in the first place. In her view a real justification or commercial reason should exist and since none was given by Founders Hill's counsel, Founders Hill lost its case.

Broomberg continues by saying that Lewis JA misinterpreted the IT Act by overlooking the fact that there cannot be a trade, without the intention to trade. Also that the taxpayer cannot be said to trade if there is no intention to trade for profit. Therefore, the fact that Founders Hill acquired the land for resale to the best

[25] The Taxpayer Volume 60 No 7 of July 2011 p 123

[26] The Taxpayer Volume 60 No 8 of August 2011 p 143

[27] The Taxpayer Volume 60 No 10 & 11 of October – November 2011 published with the permission of Eddie Broomberg SC, a paper recently given at seminars presented under the auspices of the SA Fiscal Association p187 to p 197

advantage of its holding company does not automatically bring Founders Hill's activities into the trading net. Furthermore, he supports his comment by saying that

> 'the Court in Founders Hill seems to have ignored the fact that the *ratio decidendi in Pick 'n Pay*[28] was to the effect that it is not enough that a taxpayer acquires an asset intending to resell it, to make the asset floating capital. The asset must have been resold as an operation of business in a scheme of profit making: the purpose of the transaction must have been to trade for profit.'

Therefore agreeing with Davis that the only question which should have been addressed by the SCA was whether or not Founders Hill embarked on a profit making scheme by 'crossing the Rubicon', which would lead to the proceeds being revenue in nature and thus taxable.

Broomberg mentioned the Rhodesian case of *Realisation Company v COT* 1951 (1) SA 177 (SR), 17 SATC 139 ("*Realisation Company")* case which carried a lot of weight in the *Berea West* judgment and was the leading case on realisation companies.

Per the *Realisation Company* case, Judge Beadle and concurring Judge Tredgold accepted the concept of a realisation company and concluded that a company could be formed to merely realise certain assets without being liable for tax thereon, as long as the company does nothing more than realise the asset and does not trade.

Although the *Balstone Farms Limited v Minister of National Revenue [1968] SCR 205* ("*Balstone*") case made reference to a realisation entity the transaction fell outside the scope of a realisation entity since the property was disposed of to a third party, and no benefit was received by the original owners of the property.

Therefore, Lewis JA incorrectly relied on the sale being subject to income tax. Although Lewis JA did mention the *Realisation Company* case in a footnote, she ignored the principles discussed in the judgment. The principle being that there could be no trade if there was no intention to trade for profit.

Lewis JA referenced to the judgment reached in the *Balstone* case which was heard in the Supreme Court of Canada. Balstone was held to be liable for tax and

[28] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 46A-52B

Lewis JA said that there was no difference between the *Balstone* and *Founders Hill* case. Broomberg frowned on this comment since the facts of the *Balstone* case clearly reflected an outright sale of property by a couple to a company. The couple did not own any shares in the company which acquired the property and the realisation of the property would not be for the couples' benefit, but for the benefit of the shareholders of Balstone. Balstone was held not to be a realisation company since the property was not realised for the benefit of the original owners. Therefore Lewis JA comment that there was no difference between the *Balstone* and *Founders Hill* case was incorrect.

2.2 Conclusion

Since a realisation company is not defined in the IT Act or in the Interpretation Act No. 33 of 1957 the Court places reliance on case law to attach a meaning to the word. The definition of the word as defined in a trust worthy dictionary could also assist in clarifying the meaning, but the judgments reached in case law would carry more weight.

Lewis JA made use of court cases as well as published works of authors pertaining to tax matters in order to conclude that a realisation company could only be used if more than one person transferred the assets to the interposed entity and that without doing so it would be difficult, if not impossible to realise the assets.

However, Lewis JA overlooked the basic requirements for a company to be taxed, i.e. the taxpayer must be carrying on a trade with the intention of making a profit.

The purpose of a realisation company is merely to dispose of the assets acquired by it, and thereafter distributing the profits to the shareholders of the company which was the original owner of the asset. This was Founders Hill's intention all along as a realisation company and was used to obtain the same effect as the *Berea West* case, in that the profits upon the sale of the property would be distributed to the original shareholders (i.e. original owners of the property).

Also of concern to me is that counsel for Founders Hill was unable to conclude that the trade requirement would not be met and therefore the sale of the land would be capital in nature when questioned by Lewis JA. One would imagine that counsel and management of Founders Hill would have asked why forming a realisation company would be required and how it would affect the tax position of AECI as well as Founders Hill.

I agree with the conclusion reached by Broomberg in that would be interesting to see how and if this case would be used in future cases heard dealing with realisation companies and if it would have any authority at all[29] since the trading requirement needs to be met first prior to questioning whether or not the asset is capital in nature or forms part of trading stock.

Therefore, the basis of concluding that the proceeds would be revenue in nature should have been based on the Commissioner's argument that Founders Hill 'crossed the Rubicon' which brought the sale of the erven into the revenue net, rather than merely realising the asset to AECI's best advantage due to the extended activities undertaken to develop and sell the land.

[29] Comment is similar to the comment raised by Eddie Broomberg in The Taxpayer Volume 60 No. 10 & 11 October – November 2011 p 197

3 *CSARS v NWK* (27/10) [2010] ZASCA 168 (1 December 2010) ("*NWK*")

The *NWK* case dealt with a structured finance deal which was questioned to be a simulated transaction in order to gain a tax benefit which NWK would not otherwise have been entitled to. The SCA found that NWK was not entitled to claim a deduction in respect of interest paid on amount not actually borrowed. In addition it was concluded that where a simulated transaction took place, the Commissioner may not be able to invoke s. 103(1) of the IT Act. Thus s. 103(1) of the IT Act can be invoked where it is shown that a transaction is not simulated.[30]

3.1 Background and facts of the case[31]

NWK claimed an interest deduction over a period of five years (1999 to 2003) in respect of a loan extended to it by Slab Trading Company (Pty) Ltd ("Slab"), which is a subsidiary of First National Bank ("FNB"). In terms of the agreement the capital amount of the loan would be settled by the delivery of 109,315 tons of maize. The interest was payable every six months, and NWK claimed the deduction under s. 11(a) of the IT Act.

The deduction of the interest was initially allowed by the Commissioner, but in 2003 the Commissioner issued new assessments disallowing the deduction of interest. The Commissioner raised interest and a 200% penalty under s. 89*quat*[32] and s. 76[33], and refused to remit any part of the interest levied.

The revised assessments were issued by the Commissioner on the basis that the loan formed part of a series of transactions entered into between NWK, FNB and its subsidiaries with the intent of NWK avoiding or reducing its liability for tax.

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[30] Paragraph cited as the "Summary" of the *NWK* case per the published Judgment of *CSARS v NWK* (27/10) [2010] ZASCA 168 (1 December 2010) on page 1

[31] *CSARS v NWK* (27/10) [2010] ZASCA 168 (1 December 2010). The facts pertaining to the facts were summarized in my own words, but where the facts could not be phrased differently without losing the crux thereof extracts of the judgment was used to summarize the background and facts pertaining to the case

[32] Interest on underpayment of provisional tax

[33] Maximum additional tax that may be imposed in the event of default or omission

3.1.1 Arguments presented by Commissioner and Taxpayer and the Judge's response thereto

The Commissioner argued that if all the agreements / transactions were viewed together, the loan was simulated to appear that R 96,415,776 was granted instead of R 50 million which was repayable over 5 years and interest bearing at 15.41%. This was done with the intention that a greater interest deduction could be claimed by NWK.

The Commissioner contended that the agreements entered into between NWK, FNB and its subsidiary Slab did not reflect the substance of the real transaction.

In the alternative the Commissioner wanted to invoke s. 103(1) arguing that the Commissioner was satisfied that the transaction, operation or scheme in question was entered into for the purpose of evading tax.

Financial director Mr E. Barnard represented NWK and argued that NWK had an honest intention to execute the transactions in accordance with its tenor and that the claims for deductions were valid. Although he was aware that agreements were entered into between Slab and FNB, NWK was not a party to them. Furthermore, NWK contended that its tax returns over the years of assessment contained full and accurate information, thereby denying being liable for the additional tax or additional interest.

The Tax Court ruled in favour of NWK and commented that if the Commissioner concluded that the transaction was simulated, he could not be "satisfied" that the transactions were entered into for the purpose of evading or reducing a liability for tax. Thus s. 103(1) had no application to the case.

The question before the SCA was whether or not the transactions reflected the real intention of the parties and had any commercial backing[34], or whether it was simulated in this way in order to evade or avoid tax? Therefore the Court would

[34] S v Friedman Motors (Pty) Ltd 1972 (1) SA 76 (T), upheld on appeal, 1972 (3) SA 421 (A) ("*Friedman*") and Commissioner for Inland Revenue v Conhage 1999 (4) SA 1149 (SCA). In the *Friedman* case although the goods remained with the purchaser when the full amount owed had been paid there was a genuine change of ownership, delivery being constructive and commercial reason for entering into the agreement.

examine the substance over form in order to determine the true nature and substance of the transaction.

Reference was made to the *Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue 1996 (3) SA 942 (a) at 953A-F* ("*Ladysmith*") case and *IRC v Duke of Westminster [1936] AC 1 at 19* ("Duke") case which said that a taxpayer may organise his financial affairs in such a way as to pay the least tax permissible. However, it is wrong to dress up or disguise a transaction to make it appear to be something that it is not, especially if it has the purpose of tax evasion, or the avoidance of a peremptory rule of law.

The Commissioner contended that NWK had deliberately disguised its agreement to borrow R 50 million from FNB as a transaction in terms of which R 96,415,776 would be repayable via the delivery of maize to Slab, which was never intended. Also of concern was why R 96,415,776 was borrowed when NWK only required R 50 million? The description of the maize to be delivered was vague since it could make reference to three different qualities of maize all of which would have a different value. Furthermore, no security was required to be given by NWK to Slab in respect of this loan as would normally be expected for a loan transaction.

Barnard testified that NWK was aware of the forward sale agreement between Slab and FNB and that the promissory notes would be sold by Slab to FNB. Barnard therefore admitted that Slab had no real role in the transaction. Slab would sell its right to receive delivery of the maize to be effected five years later almost immediately after the loan had been concluded. The loan agreement indicated that Slab had the option to cede any of its rights.

Slab sold its right for delivery of the maize by NWK to First Derivates, an FNB subsidiary on the day the loan was concluded. No provision was made to secure the payment price of R 45,815,776. Barnard understood that the cession which was envisaged in the proposal, that NWK's liability to deliver the maize to FNB would be cancelled. From the outset the Commissioner contented that there was no intention to deliver the maize at all and that there was no genuine exchange of ownership of the maize. Thus this was in contrast with the *Friedman* case and that simulation took place between NWK and FNB and its subsidiaries.

The Commissioner argued that the evidence given by Barnard was not credible and the SCA agreed with the Commissioner in that Barnard provided conflicting responses regarding the Slab cession, by first saying he was not aware thereof and then later admitting that it had been contemplated at the outset as part of the structure of the FNB proposal. Barnard also refused that the FNB forecast of the maize to be delivered did not take important factors that could influence the price of the maze into account and that NWK was not required to provide security to banks when requesting loans, as security was provided to the Land Bank in the past. Lastly that Barnard knew that Slab would not be able to provide NWK the funds if Slab had not discounted the promissory notes of R 96,415,776 with a face value which equalled the capital sum of R 50 million and interest at the rate agreed with FNB. The SCA therefore said that the Tax Court erred in finding Barnard as a credible witness.

So the real question to be asked was if this was a simulated transaction or whether there was a real and sensible commercial purpose for the transactions other than to claim a higher interest deduction for income tax on a greater capital amount than R 50 million?

No other reason could be found and it was concluded that NWK wished to achieve a tax advantage. Therefore NWK reflected the loan amount to be R 96,415,776 instead of the actual amount of R 50 million. In addition, Barnard was not deceived by FNB since he knew how the contracts, even the ones to which NWK was not a party were to be structured and that the delivery of the maize was simulated. NWK bore the onus of showing that the transaction was not simulated and by merely presenting the contracts was insufficient to discharge that burden.

The SCA found in favour of the Commissioner in that the transaction was disguised as a loan for R 96,415,776 instead of the actual amount of R 50 million. Therefore the assessments of the Commissioner were correct in that the interest pertaining to the capital amount in excess of R 50 million was not deductible.

In addition the SCA said that additional tax of 200% was excessive since extenuating circumstances existed, namely NWK was approached by FNB and the structure was set up by FNB which FNB proposed was legally sound. However, NWK was made aware of the risk that the Commissioner could want to apply s. 103

to the structure proposed. The SCA did however agree that the interest was properly levied.

3.1.2 Principles decided in previous cases

The *stare decisis* principles decided in previous cases –

a) A taxpayer is allowed to enter into agreements in a manner which would result in the least tax consequences. In other words, a taxpayer may arrange its affairs in a way which would lead to the minimal amount of tax being due to the Commissioner (*Ladysmith* and *Duke*[35]).

   This is referred to as tax avoidance and is a legal way of reducing a taxpayer's liability for paying tax. As long as the transaction, scheme or operation or represents the true intention of what the taxpayer wanted to achieve, no simulation would have taken place. (*Randles*)[36]

Tax avoidance could be questioned by the Commissioner under the general anti-avoidance provisions contained in s. 80A to 80L of the IT Act, whereas tax evasion will be subject to the provisions of s. 103 of the IT Act.

Under the general anti-avoidance provisions the taxpayer would have to prove that no simulation has taken place and that the taxpayer had no intention to deceive the Commissioner.

b) The commercial reality of the transaction, scheme, or operation is normally used as a substantive test to analyse the intention of the taxpayer, but does not serve as the determining factor for a transaction, scheme or operation to be simulated. It merely forms part of a number of considerations to be taken into account when determining if the taxpayer is merely arranging his affairs in order to avoid unnecessary taxes being due as opposed to following another alternative which would have the same end result, but lead to a higher amount of tax being due to the Commissioner. (*Randles* and *Zandberg*)

c) Tax evasion on the other hand is an illegal act whereby the taxpayer purports a transaction, scheme or operation to be something that it is not in order to avoid or postpone taxes owing to the Commissioner from being paid or being

[35] *IRC v Duke of Westminster* [1936] AC 1, [1935] All ER Rep 259, HL

[36] *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 AD 369 at 395-6

paid later than when it is actually due. (*Kilburn v Estate Kilburn* 1931 AD 501 at 507)

With respect to tax evasion, the taxpayer had the intention to deceive the Commissioner and participated in an illegal act to avoid or postpone the payment of taxes owing to the Commissioner. The transaction, scheme or operation was deliberately performed in such a manner in order to defraud the Commissioner from receiving taxes owing to him. No commercial reason was required for choosing the specific course of action, merely the intention to circumvent taxes being triggered.

3.1.3 Judges reasoning for deviating from *stare decisis* principle

No argument was raised in the *NWK* case as to why Lewis JA chose to deviate from the *stare decisis* principles laid down in cases and quoted over more than a century in subsequent cases,[37] namely that no commercial reason was required to make a transaction fall within the scope of tax evasion. The lack of commercial substance would be questioned under tax avoidance which is governed by s. 80A – 80L of the IT Act and not tax evasion.

Lewis JA appears to have lacked the understanding between tax avoidance and tax evasion which as lead to un-precedent consequences when considering if tax has been evaded. This was done by Lewis JA using the lack of commercial substance subjective test as an objective test in order to prove tax evasion, rather than being a subjective test as originally intended and interpreted to understand if tax avoidance was effectively achieved by the taxpayer.

3.1.4 Implication of the Court's decision

The *NWK* case introduced a "commerciality" requirement when deciding on whether a transaction is subject to simulation. Although the *NWK* case acknowledges that a taxpayer may structure his affairs in such a way as to attract the least amount of tax the method chosen should also have a commercial reason behind it.

In a recent series of Tax Court Cases (Western Cape High Court, Cape Town) Cases No *12760, 12828* and *12756,* judgment delivered on 14 September 2011 by

[37] The Taxpayer Volume 60 No 10 & 11 of October – November 2011 published with the permission of Eddie Broomberg SC p 197 at 13

Judge Allie[38], she applied the commerciality requirement introduced by the *NWK* case when rendering her judgment pertaining to tax appeals dealing with share incentive schemes. In terms of the schemes, the employee would almost immediately after the grant of an option to take up shares, exercise the option, thereby eliminating any "gain" in the value of the shares for purposes of s. 8A of the IT Act.

This was based on the assumption that the tax would arise on the exercise of the option and not the subsequent actual delivery of the shares to the employee (referred to as "deferred delivery"). Taking into account the true substance of the transaction, Judge Allie held that there was still some "conditionality" when the employee exercised the option and, therefore, there was no "complete sale" at the time of exercising the option.

Therefore it was held that: *'Section 8A is triggered when a gain is made. In the case of deferred delivery schemes, the gain can only be quantified once delivery occurs as that is when acquisition of the shares is complete.'* And further: *'It is clear from the scheme and the way appellants understood its purpose, that it is the right to take delivery against payment at a later date at a price less than the market value of the shares at that later date that created the substantial financial gain which serves as an incentive to employees.'*

In essence Judge Allie's application of simulation based on the outcome of the *NWK* case has led her to conclude that the exercise of the employee of the share option gave rise to a "conditional" purchase of the share and not the actual acquisition thereof which will trigger the taxes as set out in s. 8A of the IT Act.

Hofmeyr in commenting on Judge Allie's judgment in Integritax[39] said that 'The SCA's NWK approach in relation to simulation and its requirement of "commercial reason" shows remarkable overlap with the "business purpose" test found in the USA.

[38] Integritax March 2012 Issue No 150 dealing with anti-avoidance written by Advocate Cliffe Dekker Hofmeyr

[39] Integritax March 2012 Issue No 150 dealing with anti-avoidance

Gregory v Helvering [1934] (69F 2d 809)*;* affd [1935] 293 U.S. 465 US SC essentially held that the taxpayer's corporate "re-organisation" completely lacked any business purpose. The tax relief in respect of same was bluntly denied. In *CIR v Transport Trading & Terminal Corp. 176 F2nd 570 (2nd Cir. 1949)* Judge Hand described the "business purpose" requirement as follows: *"The doctrine of Gregory v Helvering ...has a much wider scope: it means that in constructing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."*

Interestingly, the US *Gregory v Helvering and the* UK *IRC v Duke of Westminster* [1936] AC 1, [1935] All ER Rep 259, HL, cases were decided almost simultaneously on different sides of the Atlantic.

Lord Tomlin's statement from *Duke of Westminster* is oft-quoted*: "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."*

Whereas almost 80 years ago *Gregory v Helvering* dashed taxpayer hopes in the USA, the *Duke of Westminster* in the UK (and locally) became the cornerstone for many tax planning strategies.

The *NWK* case and the apparent enthusiasm with which it is being applied locally could be indicative that the newly introduced "commercial reason" requirement might be taking SA towards some convergence with the "business purpose" test as applied in the USA.

To be on the safe side requires that there should always be a demonstrable non-fiscal financial, business or economic driver for any transaction.'

3.1.5 Criticism given by tax community

Emslie[40] disagrees with Lewis JA in asking how simulation was obtained through an unexpressed agreement or tacit understanding between the parties?

Emslie makes the point that it was inherent in the written agreements that the repayment of the loan via the delivery of Maize would never take place. The fact remains that this was clear from the agreements themselves, and that it did not form

[40] The Taxpayer Volume 60 No 2 February 2011 p 23 to p 25

part of any unexpressed agreement or tacit understanding. It merely indicated that both obligations to deliver maize would disappear due to *confusio*.

The legal effect of the contract would merely extinguish the liability to deliver the maize, but the real problem was then that NWK claimed a deduction to which it knew it was not entitled to, not that the agreements were simulated (i.e. disguising the real intention of the transaction).

Since no delivery of maize would take place, this would rule out a simulated transaction (under the general anti-avoidance provisions of the IT Act) and thus give rise to having explore the commercial reason for entering into the transaction to determine if the real intention was to evade tax (under s. 103 of the IT Act).

Testing for simulation is a subjective test to question whether the parties had and intention to deceive. The court could examine the 'commercial sense of the transaction' and 'the real substance and purpose', but this should be done to better understand the parties' intention and not to prove simulation.

Lewis JA appeared to have used the substance over form test as an objective one to determine if tax evasion took place which is an illegal act, instead of testing simulation as part of legally avoiding paying the maximum amount of tax as allowed in the IT Act.

This is why Emslie concludes that in order for simulation to take place there must be an 'unexpressed intention' or 'tacit understanding' between the parties which does not accurately reflect the intention expressed in the written agreements.

Emslie agrees that the outcome of the NWK was correct in that NWK claimed an interest deduction it was not entitled to, but does not agree that this was due to any simulation as claimed by the Commissioner and the SCA.

Vorster[41] pointed out the interchangeable use of the words 'evasion' and 'avoidance' in the *NWK* case will now cast doubt to what extent a taxpayer could take advantage of a 'tax-effective structure" in order to limit its tax liability as allowed by the IT Act. This concern is raised since previous cases regarding evasion dealt with taxpayers conducting its affairs in an illegal manner which had nothing to do with the principles governing the doctrine of substance over form, or disguised or

[41] The Taxpayer Volume 60 No 5 of May 2011 p 83 to p 85

simulated transactions which was generally understood to be governed by s. 80A to 80L of the IT Act.

In Vorster's view, there was no need to consider the presence or absence of a commercial reason since the real intention was to obtain a loan of R 50 million and not R 96,415,776 and NWK knowingly deducted interest on a higher amount than was actually borrowed.

Broomberg[42] pointed out that Lewis JA used the words 'evasion' and 'avoidance' interchangeably and that the two words carry a different meaning when interpreting the IT Act. Evasion is an illegal act to deliberately conceal information in order not to be liable for tax, whereas avoidance is the mere arrangement of a taxpayer's affairs in order to pay the least amount of tax payable within the provisions of the IT Act.

In the case of avoidance, the Commissioner may want to attack the transaction if it falls within the ambit of the general anti-avoidance rules ("GAAR") of the IT Act contained in s. 80A to 80L. If the transaction falls within the GAAR, then only interest becomes payable on the amount of unpaid tax. Whereas in the case of evasion it means that the taxpayer entered into a simulated transaction, which is a criminal offence punishable in terms of s. 104(1) of the IT Act by a fine, or imprisonment or both.

Broomberg furthermore, commented that

> 'In regard to the alleged simulation, the bedrock common law principle that applies in South Africa is more familiar. A transaction will not be regarded as simulated if the parties genuinely intended that their contract will have effect in accordance with its tenor, and that rule applies even if the transaction is devised solely for the purpose of avoiding tax'

He also quoted the following per Watermeyer JA in *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 AD 369 at 395-6 ("*Randles*") which has been a principle that has been

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[42] The Taxpayer Volume 60 No 10 & 11 of October – November 2011 published with the permission of Eddie Broomberg SC p 197 to 207

applied for over a century by most of the well-known judges that have given judgments in SA:

> 'A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Court according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax'

Lewis JA however in her judgement said at paragraph [55] that

> 'the test to determination simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms … The test should … go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.'

By interchanging the words "evasion" and "avoidance" the meaning intended by the Court becomes misleading. In Broomberg's view Lewis JA meant to use the word "avoidance".

> 'If paraphrased, the new rule would read: *If the purpose of the transaction is only to allow the avoidance of tax then the transaction will be regarded as simulated.'*

However, if the judgment given is to be interpreted in this way, then the rule would be in conflict of the decisions of the Appeal Court reached in *Randles*, *Zandberg v Van Zyl* 1910 AD 302 at 309 and *Ladysmith (Pty) Ltd v* CIR 1966 (3) SA 942 (A), 58 SATC 299 and a non-tax related court case *Michau v Maize* Board 2003 (6) SA 459 (SCA) at 464A, 66 SATC 288 at 292 which held a transaction will not be regarded as simulated if the parties genuinely intended that their contract will have effect in accordance with its tenor, and that the rule applies even if the transaction is devised solely for the purpose of avoiding tax.[43]

Broomberg commented that

> '… what the new *NWK* common law rule presumably intends to prescribe is that if the purpose of the transaction is to avoid tax, then, even though the transaction is genuine, it must not be annihilated, but must be treat as a simulated one, i.e. the parties must be taxed as if they had created some other rights and obligations which would have attracted tax.'

He later on continues at [48] and [49] of his paper saying that

> 'The Court in *NWK* refers to four other cases dealing with the issue of simulated transactions, *vis Vasco Dry Cleaners v Twycross, Skjelbreds Rederi A/S v Hartless (Pty) Ltd, Hippo Quarries (Tvl) (Pty) Ltd v Eardley,* and *CIR v Conhage*, and the impression one forms is that the Court discerned, in these four cases a pattern, *vis* that where a transaction had some other purpose, in addition to tax avoidance, the courts had not treated the transaction as simulated where there was no purpose other than tax avoidance.
>
> It was but a small step, it seems, for the Court in *NWK* to deduce from this rather modest sample, a general principle that if tax avoidance was the only purpose, then the transaction must be treated as simulation.'

3.2 Conclusion

In terms of common law principles, taxpayers may arrange their affairs in such a manner as to pay the least amount of tax. However, based on the judgment given by Lewis JA in the *NWK* case, taxpayers are advised to have a non-financial as well as a commercial reason for doing so and not just merely wanting to decrease the tax consequences that would follow.

[43] The Taxpayer Volume 60 No 10 & 11 of October – November 2011 published with the permission of Eddie Broomberg SC p 197 to 207 at 4

It must however be borne in mind that Parliament has the right and have accordingly set limits in order to disregard the 'tainted elements' of a transaction where the genuine rights and obligations have been disguised by implementing a simulated transaction. Therefore tax avoidance schemes would be governed under the provisions of s. 80A – 80L of the IT Act, whereby the Commissioner should disregard the actual rights and obligations created by parties and impose tax as if the parties created different rights and obligations. In other words, the Commissioner should ignore the disguised portion of the transaction and levy the taxes according to the true intention of the transaction.

Where the transaction is performed in such a way as to evade tax, this represents an illegal act on the part of the taxpayer and the Commissioner may invoke the provisions of s. 103 of the IT Act.

Lewis JA has made use of the words 'tax avoidance' and 'tax evasion' as if they are synonyms rather than having the effect of avoidance being a legal route to reduce the taxes owing and tax evasion being an illegal act on the part of the taxpayer.

This creates uncertainty as to whether or not transactions with the intention of only leading to a lower tax liability would also be subject to being questioned as being an illegal act.

Rather than creating new precedence based on similarities in previous cases by adding a commerciality requirement to simulation, it should rather have been found that the intention was to evade tax or gain a benefit not legally entitled to by stating that the loan amounted to R 96,415,776 rather than R 50 million.

Therefore although we agree that the interest payable on the loan exceeding R 50 million is not deductible the rationale behind it was not firmly founded in the interpretation of the Law or previous judgments made.

4 *FIRST SOUTH AFRICAN HOLDINGS (PTY) LTD v CSARS* (372/10) [2011] ZASCA 67 (11 May 2011) ("*First SA Holdings*")

The *First SA Holdings* case dealt with the definition of 'assessment' and the interpretation thereof when additional or reduced assessments are issued by the Commissioner when assessing First SA Holdings' taxable income.

4.1 Background and facts of the case[44]

The Commissioner disallowed First SA Holdings' request for the issue of a reduced assessment to income tax in respect of the 2002 year of assessment. The request was based on the provisions of s. 79A of the IT Act. Since the request to the Commissioner was disallowed, First SA Holdings appealed to the High court to overrule the Commissioners decision, but the appeal was dismissed with costs.

First SA Holdings rendered an income tax return for the 2002 year stating that its taxable income amounted to R 15,892,978. First SA Holdings wanted to set off this taxable income against an assessed loss of R 34,978,418 which has been carried over from the previous tax year (2001). This meant that First SA Holdings wanted to carry over an assessed loss of R 19,085,440 (R 34,978,418 minus R 15,892,978) to the 2003 year of assessment.

First SA Holdings incorrectly accounted for certain foreign exchange gains which were not fully taxable in terms of s. 24I(7A) of the IT Act. Instead of including 10% in taxable income, it included 100% thereof. First SA Holdings accordingly overstated its taxable income. The same mistake was not made in the subsequent tax years, but First SA Holdings did not inform the Commissioner of the mistakes in the prior years, because it was not unaware of it at that time.

The Commissioner also oblivious of the error accepted First SA Holdings' figures and issued an income tax assessment for the 2002 year of assessment on 17 July

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[44] *First South African Holdings (Pty) Ltd v CSARS* (372/10) [2011] ZASCA 67 (11 May 2011). The facts pertaining to the facts were summarized in my own words, but where the facts could not be phrased differently without losing the crux thereof extracts of the judgment was used to summarize the background and facts pertaining to the case

The Taxpayer Volume No 9 September 2011 p 163 to p 167

2003 accordingly. The Commissioner assessed the income of First SA Holdings at R 15,892,978 and he allowed the carrying over of the assessed loss of R 34,978,418 from 2001. Therefore no tax liability arose in respect of the 2002 year.

On 12 April 2006 the Commissioner issued an additional assessment in respect of the 2002 year, disallowing the 2001 assessed loss. The Commissioner was entitled to do so in terms of s. 79(1) of the IT Act, since the three year period, which began to run on 17 July 2003, had not yet expired.

This meant that First SA Holdings' income for that year, namely R 15,892,978, became fully taxable. With interest added in terms of s. 89*quat* the sum of R 6,681,010 became due to the Commissioner.

It is important to note that the Commissioner did not reassess First SA Holdings' income, but only the set-off of the 2001 assessed loss.

First SA Holdings lodged an appeal against the refusal of the Commissioner to set off the balance of this assessed loss. The matter was settled and First SA Holdings withdrew its appeal relating to the particular additional assessment.

First SA Holdings thereafter realised that it had overstated its income for the 2002 year by not taking into account s. 24I(7A) of the IT Act, and therefore submitted a letter dated 24 July 2007, to apply for a reduced assessment for the 2002 year to be issued by the Commissioner in terms of s. 79A of the IT Act.

4.1.1 Arguments presented by Commissioner and Taxpayer and the Judge's response thereto

First SA Holdings argued the following:

a) The 2006 assessment was based on information provided by First SA Holdings for the 2002 year;
b) It is not in dispute that First SA Holdings had overstated its taxable income for that year;
c) Tax was accordingly calculated on an incorrect amount;
d) The Commissioner should have accepted that he had a discretion to reduce the assessment under s. 79A(1); and
e) The Commissioner was consequently incorrect in assuming that he was not entitled to consider the application for reduction.

The Commissioner in turn argued that:

a) Section 79A did not apply to the 2002 year since s. 79A only came into operation as from the commencement of years of assessment ending on or after 1 January 2003; and
b) Alternatively, the three year period began to run when the original assessment was issued on 17 July 2003 and not on the date of the additional assessment, namely 12 April 2006, as was submitted by First SA Holdings.

The meaning attached to the word assessment was the turning point in the case.

Deputy President Harms quoted the definition of 'assessment' as defined in s. 1 of the IT Act saying at [15] to [16] that

'assessment' means the determination by the Commissioner, by way of a notice of assessment (including a notice of assessment in electronic form) served in a manner contemplated in s.106(2) –

a) Of an amount upon which any tax leviable under this Act is chargeable; or
b) Of the amount of any such tax; or
c) Of any loss ranking for set-off; or
d) Of any assessed capital loss determined in terms of paragraph 9 of the Eighth Schedule.

The 2006 assessment was a re-assessment of a loss ranking for set-off under par (c). It did not re-assess the income of R 15,892,978 under par (a). First SA Holdings wanted to appeal against the assessed income and not the assessed loss which the Commissioner was contesting. The appeal was dismissed.

First SA Holdings then said that he would like to seek a re-assessment of the tax payable under par (b) and that it is entitled to do so because that amount was assessed for the first time in 2006 in the additional assessment and that the three (3) year period had not lapsed. The problem was that the amount under par (a) had to be reassessed first, before the amount under par (b) could be contested.

If the appeal of First SA Holdings was upheld it would mean that if a new assessment is raised after the Commissioner's original assessment the prescription time would be extended by a further three years which would be unthinkable bearing the judgment held in *Commissioner, South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA 601 (SCA) ("*Brummeria")*.

4.1.2 Principles decided in previous cases

The *stare decisis* principles decided in previous cases –

a) A return would prescribe after three years if the Commissioner and taxpayer had no objection to the assessment issued based on the return that was submitted. (Section 79(1) of the IT Act)
b) It was generally accepted that if one assessment on a subsequent IT34 (whether it be a reduced assessment or additional assessment) was questioned, that another assessment on that subsequent IT34 could also be subject to objection. Once the taxpayer and Commissioner had resolved the amounts under dispute the last IT34 would prescribe following a three year period of no further objection. (*Brummeria)*

The interpretation as noted in b) above was however not in line with the strict interpretation of the definition of 'assessment' as defined in s. 1 of the IT Act.

In practice the Commissioner would issue an IT34 as his assessment of the various components pertaining to the return.

4.1.3 Judge's reasoning for <u>not</u> deviating from *stare decisis* principle

The principle that the prescription of an assessment commence on the date of the original assessment, could be applied in favour of the taxpayer (the *Brummeria* case) or the Commissioner (the *First SA Holdings* case) depending on the facts and circumstances of each case.

In the *Brummeria* case, the Commissioner had made a determination which it changed by issuing a revised assessment, and then later on re-instated the first determination by issuing another revised assessment. The Commissioner argued that the 'prescription' only started to run from the date of the further revised assessment.[45]

Cloete JA said the following in paragraph [26] of his judgment:

> 'It seems to me that these competing contentions must be resolved by having regard to the purpose underlying section 79(1) and 81(5), which is obviously to achieve finality. To uphold either of the Commissioner's contentions would undermine that purpose. It is

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obviously in the public interest that the Commissioner should collect tax that is payable a by taxpayer. But it is also in the public interest that disputes should come to an end – *interest reipublicae ut sit finis litium;* and it would be unfair to an honest taxpayer if the Commissioner were to be allowed to continue to change the basis upon which the taxpayer were assessed until the Commissioner got it right – memories fade; witnesses become unavailable; documents are lost. That is why section 79(1) seeks to achieve a balance: it allows the Commissioner three years to collect the tax, which the legislature regarded as a fair period of time; but it does not protect a taxpayer guilty of fraud, misrepresentation or non-disclosure. If either of the Commissioner's arguments were to be upheld, this balance would be unfairly tilted against the honest taxpayer.'

4.1.4 Criticism given by tax community

The tax community was upset about the fact that the Commissioner was allowed to disallow the assessed loss carried forward, but that the taxpayer was not in an equal position to argue the reduction of the taxable income for the year on which the Commissioner determined the amount upon which tax is leviable.

In general it was assumed that where a reduced / additional assessment was raised, both the taxpayer and the Commissioner could object to any of the assessments reflected on the new reduced / additional assessment.

This interpretation was found to be incorrect in both the *Brummeria* and *First SA Holdings* case, since the definition of an assessment is linked with the word 'or' and not 'and'. Therefore if a reduced / additional assessment is raised in respect of one of the determinations made by the Commissioner within the prescription period, then after the prescription period no other determination 'assessment' would be open for objection if it was not previously raised during the period when the assessment was open for objection.

Although it appeared that the tax community was shocked by the interpretation of the meaning of assessment, it now seems that they are in agreement with the conclusions reached in both the *Brummeria* as well as the *First SA Holdings* case.

4.2 Conclusion

An assessment is defined in s. 1 of the IT Act as a determination by the Commissioner as an amount upon which tax is leviable, or an amount of tax owing, or a loss available for set off, or an assessed capital loss as determined in terms of paragraph 9 of the Eighth Schedule. (*Words underlined for emphasis*)

A taxpayer may object to any of the abovementioned assessments within a period of three years from the due date of the assessment. The Commissioner may also issue a revised assessment if he deems it necessary in the three years prior to prescription. After the three year period the assessment prescribes. Then neither the taxpayer nor the Commissioner may object to any of the assessments made.

It should however be borne in mind that were the taxpayer is guilty of fraud, misrepresentation or non-disclose, the assessment will never prescribe and remains open for scrutiny or re-assessment by the Commissioner.

The Commissioner generally makes use of an IT34 to communicate the value of each of the assessments raised but this can be communicated to the taxpayer in any other form.

It is important to double check the assessments received from the Commissioner to ensure that no errors or mistakes have been made by either the taxpayer or the Commissioner.

If a difference arises, the taxpayer should object to the respective assessment which he does not agree with within the three years allowed. The taxpayer cannot just say that he objects against the assessment as a whole, he needs to object to one of the specific determinations by the Commissioner for re-assessment.

After the three year period has lapsed the return will have prescribed with no further objections being entertained, unless the taxpayer is guilty of fraud, misrepresentation or non-disclose. In those instances the assessment will never prescribe and will be open for scrutiny by the Commissioner.

5 Conclusion

5.1 Summary

As the tax legislation and principles laid down by court cases evolve it may not always be certain that the principles that applied in a previous case would apply to a current case being heard in the Court of Law.

The Commissioner and counsel for the taxpayer should remember that the Judge presiding over the case does not necessarily have the same knowledge of the IT Act and would scrutinise the arguments presented by both the Commissioner and counsel based on how the Court and counsel for both sides interpret the applicability of the facts of a previous case to apply to the current case, as well as how the principles arose and whether this is still in line with the tax legislation as it stands when the current case is being presented.

Relying on the outcome of previous cases should not be the main focus point of your argument. Your argument should be based on the tax legislation as it currently stands and the court cases with similar facts should form part of your substantiation for how the IT Act is to be interpreted. Emphasis should be placed on how these cases discussed in your argument applies to the facts of the current case as well as why the other cases relied on by the Commissioner is not applicable to your set of circumstances.

The *stare decisis* principles as communicated by the CC in the *Gcaba case* has to form the foundation upon which the Court will base its conclusion since the Court is bound by the previous decisions of the CC and furthermore, deviating from these principles would lead to inequality, disregard of the rule of Law and uncertainty of how the law is to be applied.

Therefore the Court may not deviate from the principles previously decided on unless the IT Act has been amended which lead to the previous principles no longer being applicable.

5.2 Evaluation

The SCA is obliged to stand by decisions previously made unless it is clear that the decision reached was wrong.

In the *Founders Hill* case, both the Commissioner and Founders Hill agreed that the property acquired by Founders Hill from its shareholder, AECI was acquired as a capital asset. The only point of uncertainty which required examination by the SCA was whether or not Founders Hill subsequently 'crossed the Rubicon' by not merely disposing of the property to its shareholders best advantage, but rather entered into a scheme of profit making. If a scheme of profit making was entered into the profits realised would fall into the revenue net and Founders Hill would have to pay tax on all the profits made as the amount received would no longer be of a capital nature.

It was previously established by other decisions that a realisation company would acquire the assets to be disposed of on behalf of its shareholder in the same capacity as the original owner (i.e. the shareholder) held the asset. In other words if the shareholder held it as capital asset, the realisation company would acquire it as capital asset. On the other hand if the shareholder acquired it as trading stock (i.e. floating capital) then the realisation company would acquire it as trading stock and the disposal thereof would be subject to tax in full. Therefore the justification for using a realisation company, rather than AECI disposing of the property itself did not change the property from a capital asset to trading stock.

The SCA erred in questioning the capacity in which Founders Hill acquired the property and by overlooking the fact that a realisation company is not a company as defined, i.e. it has no intention to carry on trade with the intention of making a profit or having a continued existence. The SCA should have focused on whether or not the subsequent actions of Founders Hill lead to a change in intention and would bring the capital assets into the revenue net. This would be the case as it could be proven that Founders Hill did more than just dispose of the property to the best advantage in its current state, but engaged with professionals to develop the properties further and thus embarked on a scheme of profit making.

Although the SCA's conclusion that the profits realised where of a revenue nature was correct, the basis upon which this conclusion was based was flawed and in contradiction with the previous decisions of the SCA.

With respect to the *NWK* case the SCA was unable to distinguish between a transaction which leads to avoiding tax in a legal way which is governed by s. 80A to 80L of the IT Act and tax evasion which is the illegal act of structuring your affairs in such a way to avoid or postpone the liability of paying the tax legally due to SARS which is subject to s. 103 of the IT Act.

The SCA misinterpreted the two terms ‘avoidance’ and ‘evasion’. This lead to the SCA using the substantive test of considering the commercial reasoning behind structuring the transaction in one way as opposed to another as an objective test to proof simulation, rather than using the commercial reasoning to obtain more background on the reason for structuring the transaction in that particular way. The NWK decision now adds an additional safeguard to be put into place by taxpayers in that they now need to demonstrate a non-fiscal, financial, business or economic driver for electing a certain course of action as opposed to another.

In addition, if a transaction was simply performed in a certain manner only to decrease its liability for tax, the transaction will now be seen as a simulated transaction and SARS could tax the transaction as if other rights and obligations were created and determine the tax consequences for the transaction based on the rights and obligations that the Commissioner attached to the transaction. This new requirement creates uncertainty as to whether or not transactions with the intention of merely leading to a lower tax liability would be questioned as being an illegal act on the part of the taxpayer.

The SCA should rather have concluded that there as an outright intention to claim interest on a higher amount than was actually borrowed which lead to the evasion of tax, rather than adding an additional requirement to disprove simulation and possibly curb taxpayers from arranging its affairs in a tax effective manner.

First SA Holdings which at first sight appeared to be controversial in the end proved to be an accurate interpretation of the IT Act and pointed out how easily the intention of the legislator can be misapplied.

The SCA correctly applied the definition of an assessment and emphasised the importance of both the Commissioner and taxpayer to review and recalculate each assessment determined by the Commissioner upon receipt of an IT34. Where an objection is raised the Commissioner and taxpayer should ensure that it is raised in respect of each balance assessed which requires reassessment within the three year prescription period. It also confirms that the different assessments will prescribe after the prescription period lapsed irrespective of the fact that the Commissioner would disclose each assessment made in subsequent correspondence with the taxpayer even though it was not subject to reassessment.

The tax legislation evolves continuously and we need to follow a ‘learning-for-life’ approach if we want to remain on top of our game and set precedents to be followed by the next generation or ensure that the precedents already set remain steadfast against future examination if scrutinised by subsequent cases being decided on.

5.3 Future Work

Due to the recent nature of the cases it is yet to be seen how these cases will be applied in future cases to be heard and whether the rational followed by the Judge(s) hearing these cases would be applied by other Judges.

Judges should be cautious in following their own interpretation of what they think to be right, and consider the whole rational behind the Judges reaching the conclusions in the previous court cases as well as the principles which have been established from them. This would then assist them in coming to an appropriate conclusion for the current case being presented to them.

In addition, the Commissioner and counsel for the Taxpayer should ensure that they in turn would be able present valid counter arguments which are embedded on the foundation and interpretation of the IT Act, the Law and previous court cases in order to substantiate the principles / arguments on which they base their case to the Judge(s) of the Court.

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