

A COMPARISON OF THE EFFECTIVENESS OF THE JUDICIAL DOCTRINE OF
“SUBSTANCE OVER FORM” WITH LEGISLATED MEASURES IN
COMBATTING TAX AVOIDANCE

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

MASTER OF COMMERCE (TAXATION)

of

RHODES UNIVERSITY

by

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JANUARY 2004

ABSTRACT

Taxation statutes often provide opportunities for tax avoidance by taxpayers who exploit the provisions of the taxing statute to reduce the tax that they are legally required to pay. It is, however, important to distinguish between the concepts of tax avoidance and tax evasion.

The central issue, especially where the contract has no business purpose, is whether it is possible for the substance and legal form of the transaction to differ to such an extent that a court of law will favour the substance rather than the legal form.

The debate is whether the courts should be encouraged to continue with their “judge-made” law or whether the tax jurisdictions should be supporting a legislative route as opposed to a judicial one, in their efforts not only to combat tax avoidance but also to preserve taxpayer certainty. The question is whether the Doctrine of “Substance over Form” as applied by the judiciary is effective in combating tax avoidance, or whether a legislated general anti-avoidance provision is required.

An intensive literature survey examines the changes which have occurred in the application of judicial tests from the 1930’s to date and investigates the different approaches tax jurisdictions follow in order to combat tax avoidance. The effect of the introduction of anti-avoidance provisions in combating tax avoidance is evaluated by making a comparison between the United Kingdom and South Africa. In the United Kingdom, the courts are relied on to create anti-tax avoidance rules, one of which is the Doctrine of “Substance over Form”. The doctrine is very broad and identifies various applications of the doctrine, which have been developed by the courts. In South Africa, the Doctrine of “Substance over Form” has been applied in certain tax cases; however the South African Income Tax Act does include anti-tax avoidance sections aimed at specific tax avoidance schemes, as well as a general anti-tax avoidance measure enacted as section 103.

The judicial tests have progressed and changed over time and the introduction of anti-avoidance legislation in the Income Tax Act has had an effect on tax planning opportunities. A distinction needs to be made between fraudulent and bona fide

transactions while recognising the taxpayer's right to arrange his or her affairs in a manner which is beneficial to him or her from a tax perspective. Judicial activism and judicial legislation in the United Kingdom has created much uncertainty amongst taxpayers and as a result strongly supports the retention of a general anti-avoidance section within an Income Tax Act. A general anti-avoidance provision, following a legislative route, appears to be more consistent and effective in combating tax avoidance.

TABLE OF CONTENTS

1	CHAPTER 1	
	<u>INTRODUCTION</u>	
	1.1 Context	1
	1.2 The research question and the goal of the research	3
	1.3 Research methodology	4
	1.4 The meaning of “Substance over Form”	5
	1.5 Brief outline of the research	6
2	CHAPTER 2	
	<u>THE DOCTRINE OF SUBSTANCE AND FORM AND OTHER JUDICIAL TESTS.</u>	
	2.1 Introduction	8
	2.2 The Sham Transaction	10
	2.3 The Principle of Fraus Legis and the Plus Valet Rule	12
	2.4 The Business Purpose Test	16
	2.5 Form and Substance in the pure sense	17
	2.6 The Step Transaction Rule	18
	2.7 Conclusion	19
3	CHAPTER 3	
	<u>SHAM OR ARTIFICIAL TRANSACTIONS AND THEIR RELEVANCE TO SUBSTANCE AND FORM.</u>	
	3.1 Introduction	20
	3.2 Sham or artificial transactions: United Kingdom and South Africa	20
	3.3 Conclusion	27
4	CHAPTER 4	
	<u>THE APPLICATION OF SUBSTANCE AND FORM TO TAX TRANSACTIONS; A COMPARATIVE ANALYSIS BETWEEN THE UNITED KINGDOM AND SOUTH AFRICA.</u>	
	4.1 Introduction	29
	4.2 United Kingdom	30
	4.3 Summary	41
	4.4 South Africa	41
	4.5 Conclusion	53

5	CHAPTER 5	
	<u>SOUTH AFRICAN TAX AVOIDANCE ISSUES RELATING TO</u>	
	<u>SUBSTANCE AND FORM.</u>	
	5.1 Introduction	55
	5.2 Judicial Attitude to Tax Avoidance	56
	5.3 Taxpayer's disclosure to Revenue	58
	5.4 Approaches by Revenue to Counter Tax Avoidance	59
	5.5 Conclusion	64
6	CHAPTER 6	67
	<u>CONCLUSIONS</u>	
7	BIBLIOGRAPHY	71
8	TABLE OF CASES	74

CHAPTER 1

INTRODUCTION

1.1 Context

The South African Revenue Services, which is regulated by the South African Revenue Services Act, 1997, is tasked with, inter alia, the collection of taxes levied under Acts administered by the Commissioner for Inland Revenue. Taxation statutes often provide opportunities for tax avoidance by taxpayers who exploit the provisions of the taxing statute to reduce the tax that they are legally required to pay. It is important to distinguish between the concepts of tax avoidance and tax evasion.

Tax evasion refers to all those activities deliberately undertaken by a taxpayer to free himself from the tax that the law charges upon his income. Tax avoidance on the other hand denotes a situation in which the taxpayer has arranged his affairs in such a perfectly legal manner that he has either reduced his income or that he has no income on which tax is payable (De Koker, 2000:19.1).

“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” (McLaughlin, 2000:1-2). This view was endorsed in the famous case, *IRC v Duke of Westminster [1936] AC 1*; there is, however, a thin dividing line between tax avoidance and tax evasion.

Taxation authorities may enact measures to prevent such tax avoidance. In the South African Income Tax Act, No. 58 of 1962 (referred to as the “Income Tax Act”), there are a number of anti-tax avoidance sections aimed at specific tax

avoidance schemes, as well as a general anti-tax avoidance measure enacted as section 103. Other tax jurisdictions, such as the British system, rely on the courts to create anti-tax avoidance rules, one of which is the Doctrine of Substance over Form. The doctrine is very broad and identifies various applications of the Doctrine of Substance and Form which have been developed by the courts, and which are discussed in this study. The Doctrine of Substance over Form is also applied by the courts in South Africa, even though section 103 is usually applied in combating tax avoidance and the Doctrine of Substance over Form is applied less frequently.

The Doctrine of Substance over Form usually implies that the courts should look to the substance of a transaction rather than to its form, particularly when the subject of avoidance is the central issue. The substance of a transaction can be of value where there is no clarity regarding the form of the transaction. Some countries have acknowledged the importance of a general anti-avoidance provision, in an effort to reduce tax avoidance, while other jurisdictions prefer to use the Doctrine of Substance over Form, or a combination of the two approaches.

The question, particularly where the contract has no business purpose, is whether it is possible for the substance and legal form of the transaction to be so far apart that a court of law will give effect to the substance rather than the carefully designed legal format thereof? The South African courts are slow to ignore the form of a contract, where the contract represents the honest intention of the parties. The debate however remains as to whether or not “judge-made” law should be encouraged. The Report of the Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa, advocates a legislative route as opposed to a judicial one, in combating tax avoidance, to preserve taxpayer certainty. This approach has found both support and opposition. (Government Report: paragraph 27.27).

The South African government has adopted the legislative route by the introduction of anti-avoidance sections in the Income Tax Act, with the aim of preventing the courts from going beyond the intention of the legislation.

William D Popkin in “Judicial Anti-Tax Avoidance Doctrine in England: A United States Perspective”, refers to

three phases in the evolution of the English judicial attitudes before the Craven case, which brought this evolution to a halt: firstly, pro-taxpayer liberalism, secondly when pro-taxpayer bias weakened in two types of cases and thirdly, the Ramsay/ Burmah / Dawson trilogy of cases, apparently beginning the evolution of a judicial anti-avoidance principle. Finally, the Craven case was heard, in which the majority decided that the courts had gone too far; several post-Craven decisions have shown an intention to contain judicial anti-tax avoidance doctrines (Popkin, 1991:289).

The Substance over Form Doctrine is used in the formulation of the facts and the application of the Statute to those facts. The judicial tests as well as the “sham transaction”, a transaction which is not genuine or bona fide, all have a bearing on the issue.

1.2 The research question and the goal of the research.

The aim of the research is to establish whether the approaches to the Doctrine of “Substance over Form” are effective in combating tax avoidance, or whether a general anti-avoidance provision is required. As discussed above, judicial anti-tax avoidance “law-making” is not always desirable. At the same time,

judicial interpretation of statutory anti-avoidance measures is essential as no legislative provision could adequately provide for all possible tax-avoidance schemes. The question addressed in the research is whether the various approaches to the doctrine of “Substance over Form” as applied by the judiciary to transactions entered into with the objective of avoiding tax, are effective in combating tax avoidance, or whether a legislated general anti-avoidance provision is required, or a combination of both. The goal of the research is therefore to attempt to establish the most effective anti-tax avoidance approach, based on a comparative analysis of the South African and United Kingdom approaches.

1.3 Research methodology

The research is qualitative in nature and consists of a critical evaluation and interpretation of taxing statutes, judicial decisions and authoritative articles relating to anti-avoidance measures. It includes a comparative study of two tax jurisdictions. The research has been conducted by means of an intensive literature survey which examined and analysed the changes which have occurred in the application of judicial tests from the 1930’s to date, to investigate the different approaches tax jurisdictions follow in order to combat tax avoidance. The effect of the introduction of anti-avoidance provisions in combating tax avoidance has been evaluated by making a comparison between the United Kingdom and South Africa. The discussion of the topic of substance over form encompasses various other judicial anti-tax avoidance doctrines. The investigation was based on a number of tax avoidance schemes where both parties to the transactions are well aware that the only reason for concluding what is often a complicated contract is the avoidance of tax.

The principle reference sources were the taxation legislation of the countries and the interpretation of these statutes by the courts. In addition various articles have been published from the 1980’s to date in the tax journals, dealing

with the topic of “Substance over Form”. The broad approach of these articles also includes various other judicial anti-tax avoidance doctrines, which is the approach that has been followed in this study. The journal content has been analysed as, on occasion, they have contradictory viewpoints. The reliability of the material collected and the objectivity of the writer has been assessed, based on factors such as the author’s reputation, the publisher and the type of magazine or journal in which the article is published. The date of publication was also taken into account to ensure more up-to-date content.

1.4 The meaning of “Substance over Form”.

Before examining the substance and form of tax transactions in the context of tax avoidance, it is necessary to have a clear understanding of what is meant when reference is made to the phrase “substance and form”. The substance of a transaction is of value in interpretation only if its form or the effect of its form cannot easily be categorised, but this does not mean that one prefers the substance over the form, merely that the substance may be of value in the determination of the form’s fiscal effect.

An examination of the substance of a transaction is different from a consideration of whether it is a sham. Sham transactions are simply ignored for tax purposes – not because the substance overrides the form but because the actual agreement of the parties takes a different form from that which is apparent on the face of it.

Other judicial tests often regarded as the Substance over Form Doctrine include the Sham Transaction, the Roman Dutch Law *Plus Valet* Rule and the Principle of *Fraus Legis*, the Business Purpose Test, the Step Transaction rule, and Form versus Substance in the pure sense. All of these approaches are discussed, based on tax cases decided in South Africa and the United Kingdom.

1.5 Brief outline of the research.

Chapter 1: Introduction.

Chapter One provides background information on issues related to tax planning and tax avoidance. The Doctrine of “Substance over Form” and other judicial anti-avoidance tests, as well as legislation combating tax avoidance are briefly discussed. The chapter outlines how the material is covered in the following chapters.

Chapter 2: The Doctrine of “Substance over Form” and other Judicial Tests.

Various other judicial tests are discussed which are often regarded as the Substance over Form Doctrine.

Chapter 3: Sham or Artificial transactions and their relevance to substance and form.

Sham transactions with reference to tax cases and the various approaches by the different tax jurisdictions are discussed in depth. Reference is also made to the common law, aspects relating to piercing the corporate veil, as well as tax avoidance schemes.

Chapter 4: The application of Substance over Form to tax transactions: a comparative analysis of the United Kingdom and South Africa.

How the Doctrine of Substance over Form is applied to tax cases is discussed, focusing on the United Kingdom and South Africa. The discussion shows how the judicial tests have progressed and changed over time, by analysing decisions reached in the numerous decided tax cases. The research identifies where it appears that a general anti-avoidance rule was needed in order to

combat tax avoidance, and briefly outlines these provisions and their effect on tax planning.

Chapter 5: South Africa – Tax avoidance issues relating to Substance over Form.

Tax avoidance is briefly compared to tax evasion and a discussion of how the distinction between the two may have become blurred by the implementation of more aggressive tax schemes and by Revenue's attempts to attack the schemes is presented. The judicial attitude to tax avoidance is discussed including the effect on tax planning opportunities by the introduction, by the South African legislature, of anti-avoidance sections in the Income Tax Act.

Chapter 6: Conclusions.

Finally, conclusions are reached regarding the different approaches to the Doctrine of Substance over Form and tax avoidance. A distinction is made between fraudulent and bona fide transactions while recognising the taxpayer's right to arrange his affairs in a manner which is beneficial to him. A conclusion is reached regarding the need for a general anti-avoidance provision.

CHAPTER 2
THE DOCTRINE OF SUBSTANCE OVER FORM AND OTHER
JUDICIAL TESTS

2.1 Introduction.

There are various approaches to the Doctrine of “Substance over Form”, which have been applied by the judiciary to transactions, in an effort to reduce tax avoidance. In order to establish whether these judicial tests are effective in combating tax avoidance it is necessary to have a clear understanding of how the judicial tests are applied and the differences in the various approaches by the tax jurisdictions. Under the common law any person is entitled to arrange his or her affairs so that they fall within the provisions of a statute, where some benefit can be derived thereon.

No obligation rests upon a taxpayer to pay a greater tax than is legally due under the taxing act, and a taxpayer is not debarred from entering into a bona fide transaction which when carried out has the effect of avoiding or reducing liability to tax (De Koker, 2000:19.1).

This well known legal principle was adopted in various tax cases such as *Duke of Westminster v IRC* 51 TLR 467, 19 TC 490 and *Hicklin v SIR* 1980 (1) SA 481 (A), 41 SATC 179. The case of *Dadoo Ltd. And Others v Krugersdorp Municipal Council* 1920 AD 530 is authority for the principle that parties may genuinely arrange their transactions so as to remain outside the provisions of the taxing act. This is perfectly legitimate and cannot be rendered illegitimate

by the mere fact that the parties intend to avoid the operation of the law, and that the selected course is as convenient in its results as another which would proceed on other lines. It is common for taxpayers to arrange their affairs in the most tax efficient manner.

Tax law is superimposed on general law in the sense that transactions are made and agreements are entered into by persons in accordance with the general law. It is therefore necessary firstly to ascertain the general legal effect of the agreement and, secondly, by applying the various tax acts, to see whether there are any taxes leviable in respect of the transaction.

In the case of *Commissioner of Customs and Excise V Randles, Brothers and Hudson, 1941 AD 369*, it was established that, if a businessman creates a close corporation of which he is the sole member through which he intends to conduct his business in order to obtain a tax benefit, that corporation cannot be regarded as disguised or simulated merely because the corporation will receive a benefit in taxation which would not have accrued to the businessman, if he had conducted the same business in his own name. If there is a real or genuine intention for the corporation to exist and to do business itself, the courts will give recognition to it. As Watermeyer, JA stated in this case:

Firstly the law has to be construed to ascertain what type of transaction has been forbidden, and secondly the transaction has to be interpreted to ascertain whether it is a transaction of the kind which is forbidden or taxed. The substance and form doctrine should therefore be examined at two levels: firstly at factual level (the legal form of the transaction) and secondly, in the application of the statute to the form, in order to determine the tax implications.

The various other judicial tests that are often regarded as the “Substance over Form doctrine are the Sham Transaction, the Principle of *Fraus Legis*, the Business Purpose test, Form and Substance in the pure sense and the Step Transaction Rule. These various tests have been used by the courts and are often referred to as tests of substance or reality. It is important to discuss all the judicial tests which are applied by the judiciary, in the context of the Doctrine of Substance over Form, in order to establish the need for a legislated general anti-avoidance provision in combating tax avoidance.

2.2. The Sham Transaction

The approach of the English courts in favouring the economic effect or result, as opposed to the legal form was rejected by a House of Lords decision in *IRC v Duke of Westminster*, 51 TLR 467, 19 TC 490 in which Lord Tomlin stated that,

the substance of a transaction should be ascertained by looking at the legal effect of the contract which the parties have entered into using ordinary legal principles.

He was able to distinguish a genuine transaction from one where the documents are not bona fide and are used “as a cloak to conceal a different transaction.” This concealed transaction is also known as a sham transaction. 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, and not what in form it purports to be. In cases where disguised transactions are entered into for the purpose of tax evasion, a court will not hesitate to strip the transaction of its disguise and expose the true nature or substance of the contract (De Koker, 2000:19.1).

In the United States, the classification of a transaction as a sham is used in a different sense. The sham transaction is not seen as a doctrine of its own, but rather as a title given to a transaction by way of an application of one of the other general doctrines, such as the step transaction or business purpose test. In South Africa, the sham transaction has its origin in Roman-Dutch law, which is discussed under the next sub-heading.

John Tiley in his article, "Judicial Anti-avoidance Doctrines: Corporations and Conclusions", refers to the 'Myth of Substance' and questions why substance should be preferred to form:

Law, even tax law, is a set of rules which can contain more or less flexibility; the notion that form is important is fundamental to the application of these rules. Thus the issue is, not whether form should be decisive but when. Form itself has the merit of certainty, although this is not to say that it is always easy to determine, but, if one accepts the limited and functional view of form as being the legal rights and transactions effected by the parties, one is left with a premise that there ought to be some convincing reason to disregard those legal facts. In addition he adds that for all their invocation of substance the United States cases do not convince. When the court determines that the transaction presented to it is not genuine, but rather a sham, it is free to disregard the legal form of the transaction (Tiley, 1988:139-140).

2.3 The Principle of *Fraus Legis* and the *Plus Valet* Rule.

“*Fraus Legis*” means in fraud of the law, while the “*Plus Valet* Rule” refers to the situation where the law takes heed of that which is really done and not that which is merely put forward as being done. In *Dadoo, Ltd. V. Krugersdorp Municipal Council* 1920 AD 530, the court examined the doctrine of *fraus legis*. Dadoo and Dindar, as Asians, were forbidden to own land in the Transvaal. As a result they formed a company to purchase and own the land. Had they been partners, they could not legally have become owners, but by forming the company, managed to secure a result almost as convenient. In this case, Innes C.J. came to the following conclusion, “the rule is merely a branch of the fundamental doctrine that the law regards the substance rather than the form of things.” He went on to draw a distinction between genuine transactions which reflect the intention of the parties and are entered into to avoid the operation of the law, and transactions which may in truth be within the provisions of the statute, but which the parties cloak or disguise to escape the provisions. The former is quite legitimate, whereas the later would be in *fraudem legis* and the court would not hesitate to strip off its form and disclose its real nature.

This distinction was reiterated as follows by Watermeyer J.A. in the *Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd.* 1941 AD 369.

A transaction is not necessarily a disguised one because it is devised for the purposes 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.

In the *Randles* case, Watermeyer, J.A noted that: "Parties do not enter into a sham contract unless they are dishonest and unless the pretence brings them some advantage which they cannot get by entering into a real contract." On the facts of the case, "there was no material advantage to be gained by pretending to enter into a contract of sale which could not be gained by entering into a real contract of sale."

This can be contrasted with the position in *ERF 3183/ 1 Ladysmith (Pty) Ltd and Another v CIR, 58 SATC 229* or *Relier (Pty) Ltd v CIR, 60 SATC 1*, where there was the advantage of receiving a tax-free building.

The facts of the *Randles* case were briefly as follows. The taxpayer, Randles, imported clothing material, which was passed onto various clothing manufacturers, after which the completed garment was sold by Randles. After a change in regulations, Randles would only be able to benefit from a rebate if ownership in the materials passed to the manufacturers. The taxpayer, in order to get the benefit of the rebate, would sell the material to the manufacturers and once the garments were completed, would purchase them back for an additional price, which would include the cost of the work done by the manufacturers. The question before the court was whether there had been a genuine sale of materials to the manufacturers.

Watermeyer J.A. relied on an observation that was made by Innes C.J. in *Dadoo Ltd and Others v Krugersdorp Municipality 1920 AD 530*, to the extent that the *fraus legis* doctrine was concerned:

The blurring of this distinction between an honest transaction devised to avoid the provisions of a

statute and a transaction falling within the prohibitory or taxing provisions of a statute but disguised to make it appear as if it does not, gives rise to much of the confusion which sometimes appears to accompany attempts to apply the maxim quoted above.

Watermeyer J.A., in his analysis of simulated transactions, also quoted the case of *Zandberg v Van Zyl 1910 AD 302*. Innes J.A. had given the leading judgment. The comments so relied on were as follows:

The parties to a transaction endeavour to conceal its real character. They call it by name, or give it a shape, intended not to express but to disguise its true nature. And when the court is asked to decide any rights under such agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention (J.A. Innes). The parties to a transaction follow this course of action in an effort to secure some advantage which otherwise the law would not give or to escape some disadvantage which otherwise the law would impose.

In the *Zandberg* case Innes J.A. relied only on the Roman-Dutch *plus valet* rule, and made no reference to the *fraus legis* doctrine.

In the later *Dadoo* judgment however, Innes C.J. did not refer to the *Zandberg* case, but rather integrated the *plus valet* rule and the *fraus legis* doctrine into

one. Watermeyer J.A. then, in the *Randles* case, relied on this integrated approach and concluded that the transactions in question were not simulated and that the manufacturer had in fact taken ownership of the material.

A comment by De Villiers, J.A. in the *Dadoo* case, “But although all simulated transactions are in *fraudem legis* the converse does not always hold” was considered to be *obiter dicta* by Watermeyer, J.A. in the *Randles* case, who explained the position as follows:

A disguised transaction in essence is a dishonest transaction: dishonest, inasmuch as the parties to it do not really intend 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.

De Wet C.J. dissented in the *Randles* case and based his argument on the real as opposed to the simulated intention of the parties, (that is *plus valet*, rather than *fraus legis* principles.

In order to determine whether or not an agreement is in fraud of the law, the law must be interpreted according to the normal rules of interpretation (as in *Dadoo* case). The successful application of the *fraus legis* doctrine will enable the court to create an entirely new transaction in that a formally valid agreement can be nullified and replaced by a different one in accordance with the court’s assessment of the parties’ real intention.

2.4. The Business Purpose Test

In the case of *Commissioner of Customs and Excise versus Randles, Brothers and Hudson Ltd.* 1941 AD 369, Carlisle, J, in passing judgement referred to the “plain and business-like” manner of the transactions in question. This quasi business-purpose test was used in his evaluation of the bona fides of the parties involved and contributed to his conclusion that the transactions were not in *fraudem legis*. This business-purpose test is used as a means of evaluating indications of an intent to avoid the law in the application of the “true” *fraus legis* doctrine, and commercial implications as well as the normality of the transaction are taken into consideration.

Prior to 1984 Canadian courts had flirted with the adoption of a judicial business purpose test despite fundamental adherence to the principle of the Duke of Westminster case, that a person has a right to arrange his or her affairs so as to pay the minimum amount of tax. In 1984 the Supreme court of Canada expressly rejected the business purpose test, primarily because such a test was inconsistent with what the court characterised as a general statutory anti-avoidance rule in former sub-section 245(1) (Arnold, 1995:542).

The business purpose test is best known in the United States and found its origin in the case of *Helvering versus Gregory* 293 US 465, 469 (1935). In this case the taxpayer, instead of receiving a dividend of marketable securities from her original corporation, received the same securities tax-free by forming a second corporation, transferring the securities to that corporation, then liquidating the second corporation. The Supreme Court decided that the transaction lacked any business purpose and violated the tax laws, notwithstanding the fact that it literally complied with the liquidation provisions. This case was confirmation that the courts will not recognise a transaction that lacks any business or corporate purpose, but is a mere device for dodging the taxpayer’s taxes (Sommers, 1998:3).

2.5. Form and Substance in the pure sense.

Form and Substance in the pure sense refers to genuine transactions as opposed to sham transactions. The doctrine proposes that one should ignore the form of a transaction, whatever it might be and by whomsoever put forward, and instead, levy tax by reference to the substance. Substance, being substantial, will be the same whatever the form (Tiley, 1988:138). There is, however, a weak link in that the doctrine is founded on the fallacy that the primary facts and consequent legal rights can be disallowed. The doctrine has a role to play in the 'classification of facts' to which the tax code can apply. However, the courts have experienced problems when asked to re-characterise facts. The United States courts have struggled with the doctrine of substance, and Tiley's statement that "tax law must live in the real world", is summed up by Justice Harlan in *Commissioner versus Brown 380 US 563 in 1965*: "were it not for the tax laws, the respondent's transactions would make no sense.... A tax dollar is just as real as one derived from any other source" (Tiley, 1988:143).

Assuming that one is dealing with a contract which represents the honest intention of the parties, the South African courts are slow to ignore the form of the contract. The South African courts have, however, occasionally given preference to the substance over the legal form of a transaction, even though the transaction is an honest one. The traditional approach of the South African courts is that only where the courts are satisfied that the agreement is a sham or dishonest transaction, will the words in the agreement be disregarded. They could reach such a conclusion by investigating issues such as the object of the contract, the surrounding circumstances, and be aware of any other unusual provisions in the contract. Innes C.J. felt that this "was the substance of the transaction." It is submitted that the case of *CIR v Collins 1923 AD 347* is an example of what Tiley described as a "classification of the facts" by using the substance and form doctrine. The income versus capital debate in the *Collins* case was a factual test and was not affected by the structure of the transaction, which gave rise to the receipt. It is submitted that it was in this sense that the

court in both *Lace Proprietary Mines Ltd. V CIR 1938 AD 267, 9, SATC 349* and *Ochberg v CIR 1931 AD 215, 5, SATC 93* referred to the “true intention of the parties” and “the substance of the transaction” respectively (Williams, 1995:112-115).

2.6. The Step Transaction Rule.

The case which bears the most relevance to the step transaction rule is that of *Furniss v Dawson, 1984 HC 152*, where it was held that the intermediate company, “Green-jacket” should be ignored for tax purposes, as its existence served no purpose other than the avoidance of tax. The governing principle was that the tax should be imposed in accordance with the end result when preordained steps are carried through with the insertion of a step, having no commercial purpose apart from the avoidance of a liability to tax, regardless of whether there is a legitimate commercial end (Popkin, 1991:296). In other words, the court must apply the tax law to the end result of a series of transactions rather than to take each step separately. In its widest formulation the doctrine is similar to the pure substance and form doctrine dealt with above and consequently suffers from the same limitations.

Provided that the parties to a transaction have a bona fide business purpose, they are entitled to arrange their affairs in a manner which is to their greatest advantage from a tax point of view. Whilst not necessarily condoning or approving of tax avoidance, on a number of occasions the courts have ruled in favour of a taxpayer’s attempts to minimise his liabilities. An example was that of the case of *Ayrshire Pullman Motor Services and Ritchie v CIR (1929) 14 TC 754*, where Lord Clyde remarked that,

No man is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property so as to enable the Inland

Revenue to put the largest possible shovel into his stores.... The taxpayer is entitled to prevent, so far as he honestly can, the depletion of his means by the Revenue (McLaughlin, 2000:1).

The business purpose rule or the step transaction rule, was not part of the South African Law until the amendment to section 103(1) of the Income Tax Act in 1996. The South African courts were disinclined under the old section 103(1) to ignore the substance of a transaction, since it was strongly believed that it is the function of the judge to state the law and not make it. Since the amendment, the court may look only at the end result of a transaction, if there are steps within the transaction which have no commercial purpose other than the avoidance of tax.

2.7 Conclusion.

There are a variety of approaches to the Doctrine of “Substance over Form” which have been applied to tax avoidance cases by the judiciary. Each situation or tax case has unique issues or features which will have an influence on which test should be applied. No one test on its own could adequately resolve all tax avoidance issues. The various tests used together as a doctrine of ‘Substance over Form’ is more successful in dealing with the issue of tax avoidance, than judging each test separately. An understanding and knowledge of the judicial tests is essential in understanding how the courts apply them in their efforts to counteract tax avoidance. The application of the tests to specific tax cases is discussed in detail in Chapter Four of the report.

CHAPTER 3

SHAM OR ARTIFICIAL TRANSACTIONS AND THEIR RELEVANCE TO SUBSTANCE AND FORM

3.1 Introduction.

A court will not give effect to a sham transaction. This is a fundamental principle of our law, which has been applied in all areas of the law. The decision in *ERF 3183/ 1 Ladysmith (Pty) and Another v CIR, 58 SATC 229* is an example of the application of this principle in income tax law. As it appeared that the parties were involved in a disguised transaction, the court further investigated the agreements and surrounding circumstances. The court ignored the disguised transaction and considered the true intention of the parties. It provides a further avenue for the Commissioner to attack tax avoidance schemes beyond the provisions of section 103 or the other specific anti-avoidance provisions of the Income Tax Act. When section 103 is invoked, the Commission is admitting that the form of the agreement as presented reflects the genuine intention of the parties. In a sham transaction case there is a division between the form of the agreement and how the parties really intend that their agreements will operate. The form of the agreement is a disguise which attempts to mask the true intention of the parties (that is the substance of the agreement). The substance of the agreement is the true intention of the parties. A discussion of the approach of the judiciary to sham transactions in the United kingdom and South Africa, confirms the principle that the court will not be deceived by the form of a transaction if it does not reflect the true intention of the parties concerned.

3.2 Sham or artificial transactions: United kingdom and South Africa.

In English law, both sham transactions and tax avoidance schemes can be attacked through the extended interpretation, which their courts give to the

substance and form of a transaction. The English courts have manipulated the concept of substance and form to counter tax avoidance schemes, as they do not have the benefit of a general anti-tax avoidance provision, such as section 103 of the Income tax Act, and the cases are thus not relevant to the question of the sham transaction, in South African Law. The English development further brings to issue the correct relationship between the legislature and the judiciary. The question is whether the judicial role should be limited to a neutral one between the taxpayer and Revenue or whether it should play an active role in preventing tax avoidance schemes.

In a sham transaction there is the element of dishonesty or the attempt to hide the true intention of the parties. Piercing the corporate veil applies where there has been an abuse of the separate personality of a company. As a result there is the possibility of an overlap between sham transactions and piercing the corporate veil, in cases where the separate corporate personality of a company has been abused to mask the intentions of a party to an agreement. In South Africa, the concept of sham transactions has most often been dealt with in relation to pledge agreements. As De Villiers, C.J. stated in *Hofmeyr v Gous* (1893) 10 SC 115, "There is not a more common device than that by which a pledge is effected under the guise of a sale". An example was the case of *Zandberg v Van Zyl*, 1910 AD 302, where Watermeyer, J.A. summarised the case as follows:

One party to a transaction owed a debt to the other, for which he wanted security. The other owned a wagon which was essential to her. The first party did not want the wagon. If the second party had to remain in possession of the wagon, no valid pledge of it to the first party could be constituted. The parties, therefore, in order to enable the second party to remain in the possession of the wagon,

purported to enter into contract of sale with a right to repurchase. In the circumstances the court held that this contract was a dishonest pretence entered into for the purpose of making it appear that ownership of the wagon had passed to the first party, whereas the parties never really intended the contract to have effect according to the tenor.

In South Africa, the sham transaction was referred to in *Hicklin v Sir 1980 (1) SA 481 (A)*, where Hicklin and his two co-shareholders sold their dormant company to a dividend-stripping company. The company was purchased for an amount equal to the net asset value of the company, less ten percent of the distributable reserves. The dividend-stripper, after obtaining control of the dormant company, declared the distributable reserves as a dividend and then proceeded to deregister the company. The dividend-stripping operation was attacked by Revenue under section 103(1) of the Income Tax Act, as it then was. In dealing with the effect and purpose of the share sale agreement, Revenue's counsel contended that in reality the distributable profits were received by the shareholders.

In his judgment J.A. Trollip stated the following:

So in effect and reality, said counsel, the shareholders received these distributable profits... counsel's argument wrongly ignored the form, substance, and the legal effect of the loans to the shareholders and the RN agreement. After all, the loans and the RN agreement were not simulated or sham transactions. On the contrary, they were genuine and bona-fide. The taxpayer succeeded on the requirements of section 103(1) relating to normality. On the facts the rights and obligations

created by the agreement which was clearly entered into at arm's length, were normal in the sense envisaged in S103(1)(b)(ii) (Silke, 2000:19.11).

Each party was striving to obtain the maximum possible advantage for himself. In an arm's length transaction there is a presumption that the rights and obligations created are normal. As a result the court held that the abnormality requirement was not satisfied and that section 103(1) was not applicable to this case.

In *CIR v Berold 1962 (3) 748 (A), 24 SATC 279*, the Appellant had formed a company ("Luzen") and had sold shares to the company, the purchase price remaining outstanding as an interest-free loan. The taxpayer then donated shares in "Luzen" to his children's trusts. In an attempt to avoid tax, an intermediate company "Zenlu" was formed by the taxpayer's mother who donated its shares to the trusts. The trustees then sold the shareholding in "Luzen" to "Zenlu" for its nominal value. The point of the scheme was that once "Luzen" declared the dividend it would be received by "Zenlu" which, in turn would declare a dividend received by the trusts. Thus technically the trust income after the "double dividend declaration" was received as a result of the donation of the children's grandmother and not as a result of the taxpayer's donation. The Appellate Division however, applied a "substance over form approach" and held that:

Although in form the dividend in question is derived from Zenlu, in fact it is derived from the taxpayer's donation, and the Court should not allow the forms of company law to cancel the effective causal connection between the taxpayer's donation and the income accumulated for the benefit of the children (Williams, 1995:135-139).

Hoexter, J.A. quoted sub-section 9 of the Income Tax Act [now section 7(3)] which was relevant to this case:

Any income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child - it has been received by or accrued to, or in favour of, or has been deemed to have been received or accrued to or in favour of that child, or has been expended for the maintenance, education or benefit of that child; or, it has been accumulated for the benefit of that child.

In *Elandsheuwel Farming (Edms) Bpk. V Sekretaris van Binnelandse Inkomste 1978(1) (101) (A)*, a property had been held by a company as an investment. Before the asset was sold, the shareholding in the company had changed. The new shareholders (the De Villier's group) who had caused the sale of the assets were speculators. Individual shareholders benefited from the proceeds of property owned by a company which would have been unlikely to have sold the property were it not for the change in shareholding. The substance of the transaction was thus speculative and the taxpayer would need to convince the court that there was an important legal distinction between the intention of the company and the intention of the shareholders. As Corbett, J.A. stated in a dissenting judgement in the *Elandsheuwel* case:

Where a taxpayer wishes to realise a capital asset he may do so to best advantage.... There are however limits to what a taxpayer may do in order to realise to best advantage. The manner of realisation may be such that it can be said that the taxpayer has in reality gone over to the running of a business or

embarked upon a profit-making scheme. The test is one of degree (Silke, 2000:3.1).

In *Relier (Pty) Ltd v CIR, 60 SATC 1*, the obligation to effect improvements was placed on the sub-tenant and not on the tax exempt-body (as in the *Ladysmith* case). J.A. Harms noted that ‘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. The Relier decision was based on the outcome of factual and legal issues that were considered in *ERF 3183/1 Ladysmith (Pty) Ltd and Another v CIR, 58 SATC 229*. The Supreme Court of Appeal was clearly of the opinion that the issues raised in this case had already been dealt with in the *Ladysmith* case.

The scheme in the *Ladysmith* case was so poorly drafted that the evidence did not exclude what was thus a real likelihood that the written agreements did not reflect the true or full intention of the parties. If the contracts had been signed on a different date by non-related parties who each intended to be a true lessor or lessee the judgment might have been different. It does not make commercial sense to enter into a lease agreement and on the same day enter into another agreement in terms of which it is stipulated that no rent is payable in terms of the first agreement. The court had no choice but to find that the documents did not reflect the intention of the parties.

Hefer, J.A, who delivered the unanimous judgement of the Appellate Division of the Supreme Court, did not apply the “Substance over Form” Doctrine. Instead he relied on issues developed in the cases of *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* and *Zandberg v Van Zyl, 1910 AD 302*, which dealt with sham or disguised transactions. The 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 (Silke, 2000: 19.12F).

Tax-motivated agreements may be entered into provided that they reflect the true intention of the contracting parties. When an agreement that is not commercially viable is made it is more difficult for the taxpayer to prove that the agreement is genuine. However, irrespective of how commercially viable an agreement may be, if it does not reflect the true intention of the parties it will be considered a sham.

The case of *Relier* gives support to the view that the use of terminology ‘substance versus form’ is of secondary importance, as it can lead to confusion, judging by the English courts approach to tax avoidance schemes. Harms, J.A. (in the *Relier* case) in summarising the *Ladysmith* decision stated that:

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. 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.

Such a transaction is in *fraudem legis*, and is interpreted by the court in accordance with what is found to be the real agreement or transaction between the parties. It is submitted that any sham transaction case can and should be approached without using the terminology “substance” and “form” as they do not assist the inquiry. The form of the agreement is how the agreement is

portrayed and should coincide with the intention of the parties. If the intention of the parties differs from the form of the agreement, then one can say that the form of the agreement is sham. In a sham transaction case the concept of “substance” is synonymous with the real intention of the parties.

3.3 Conclusion.

In sham cases, once a conclusion has been reached that the real intention of the parties has been disguised, one can state that the substance of the transaction was the real intention between the parties and the form was the apparent or disguised intention.

The element of dishonesty which exists in both sham cases and piercing the corporate veil cases, forms a link between the two concepts. There is however a difference in the approach of the enquiries of each concept. A sham transaction revolves around finding, and applying the real intention of the parties. In piercing the corporate veil, the court is focused on the abuse of the corporate entity. There is however a possibility for overlap between the two concepts, specifically where a corporate personality has been abused to mask the true intention between the parties involved in a transaction. In the *Ladysmith* and *Relier* cases, for example, the question arose whether the separate corporate personality of that entity had been abused, as a result of a tax exempt entity being used for the purpose of allowing a tax advantage to flow to the companies.

The approach of the judiciary in dealing with sham cases has proved to be effective in combating tax avoidance. The courts made it clear that although taxpayers are entitled to arrange their tax affairs to obtain the maximum tax benefit, the agreement will be considered a sham if it does not reflect the true intention of the parties concerned. A similar approach was followed in many

cases where other judicial tests were applied by the courts, in both the United Kingdom and South Africa.

CHAPTER 4

THE APPLICATION OF SUBSTANCE AND FORM TO TAX TRANSACTIONS, A COMPARATIVE ANALYSIS BETWEEN THE UNITED KINGDOM AND SOUTH AFRICA.

4.1 Introduction

In order to establish the effectiveness of the various approaches to Substance and Form, it is necessary to discuss how the judicial tests have progressed and changed over time, as a result of decisions reached in the numerous tax cases. A detailed discussion and analysis of decisions reached in decided tax cases, in both the United Kingdom and South Africa, addresses the question of the effectiveness of the various approaches of the Doctrine of "Substance over Form". In addition the need for a general anti-avoidance provision will be established. Taxpayers are constantly attempting to reduce their tax liability, resulting in decisions being made by the taxpayer which are often a fine line between legal tax avoidance and tax evasion.

With rising tax burdens, taxpayer cooperation has declined even in countries where traditionally it has been quite good....in the U.K. tax fiddling is a national pastime...(Doggart, 1997:5).

Taxpayers need to adjust their tax planning so as to be in line with tax legislation.

Acceptance of tax laws is widespread because the law offers loopholes as well as compulsions thus making it possible for many people liable to pay high taxes to avoid doing so through legal methods of tax avoidance (Karran,1987:183).

While this was generally the view taken by taxpayers, the move toward stricter legislation and judicial attitudes has closed many of the loopholes previously available to taxpayers.

In the case of *The Commissioners' of Inland Revenue v The Duke of Westminster (1936) A.C. 1*, the Duke of Westminster formed agreements with his employees whereby he agreed to pay them an annual amount by weekly payments for several years. The purpose of the Duke's scheme was to enable him to deduct the annuity amounts payable in terms of the agreement for tax, which would as normal wages not be deductible. The question before the court was whether the amounts paid in accordance with the agreement were annual payments in terms of the Income tax Act, 1918. The CIR argued that the amounts paid in terms of the agreement were in substance the same as a salary as long as the recipients remained in the appellant's service and thus were not annual payments. Lord Tomlin had the following to say about what was called the "substance of the matter":

Every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.... The substance must be ascertained by consideration of the rights and obligations of the parties to be derived from a consideration of the whole agreement (McLaughlin, 2000:1).

4.2 United Kingdom.

Lord Russell found that unless the transaction was a sham, he was unable to distinguish between the substance and form of a transaction. However the parties were unanimous in regarding the Duke's agreements as bona fide. This case has generally been regarded as authority for the English courts preferring

form to substance. However it has been suggested that this case is incorrectly so regarded and that it has given rise to the dangerous belief that in tax cases, form prevails over substance. "Clearly the scope of the Westminster Doctrine is in some state of uncertainty and confusion" (Ashton, 1988:498).

In *W.T. Ramsay Ltd v IRC*. (1981) *STC 174*, the Law Lords took the next step of adopting a judicial anti-tax avoidance doctrine. Ramsay dealt with a scheme to create tax losses, with no economic risk, to offset taxable gains on unrelated transactions. The taxpayer created a controlled corporation, the investments in which were represented by two debt instruments. One debt paid no interest and the other paid substantial interest above market rates. The rates were fixed so that the values of the debt produced off-setting gains and losses on their disposition. The taxpayer disposed of the low interest debt and claimed a tax loss.

While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in tax loss to the prejudice of other taxpayers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting approach which the parties themselves may have negated would be a denial rather than an affirmation of the true judicial process... The capital gains tax was created to operate in the real world, not that of make believe... [To look at the transaction at the end of integrated steps is] within the judicial function (Popkin, 1991:295).

Inland Revenue invited the court to regard the capital loss created as a nullity. Lord Wilberforce went on to say:

Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of *Inland Revenue Commissioners v. Duke of Westminster (1936) A.C. 1*. 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, the courts are not under an obligation to look at a document or transaction in isolation to any other factors which may be relevant.

The next important case after the *Ramsay* case, was *I.R.C. v. Burmah Oil Co. Ltd (1982 STC 30)*, which was involved in a complex scheme to convert a non deductible bad debt loss on a claim by a parent corporation against a subsidiary into a deductible loss on stock. On disallowing the loss, Lord Diplock affirmed that *Ramsay* was no “judicial sport”:

It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax avoidance schemes to assume, that *Ramsay*’s case did not mark significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have commercial purpose apart from the avoidance of the liability to tax...(Popkin, 1991:295).

In one respect, the *Burmah* decision was a significant step for the Law Lords to take. The *Ramsay* scheme was a pre-packaged commercially marketed tax scheme whereas the *Burmah* case rejected a scheme which was not pre-packaged for sale to customers. “The Ramsay principle had been confined to tax avoidance in the form of artificial schemes containing steps that were, in effect, self cancelling” (Mclaughlin, 2000:3).

The situation in which the court may reject the form is when the primary facts are not established, where the court determines that the transaction presented to it is not genuine but a sham or where the taxpayer fails to establish that the facts although genuine fit into the legal category sought. Failures such as these are beyond dispute; the taxpayer has simply failed to establish the form required (Tiley, 1988:140).

In the *Ramsay* case the court did not lay to rest the *Westminster* doctrine of form prevailing over substance. Lord Wilberforce applied the *Westminster* principle in its broadest sense and Lord Tomlin’s statement in this regard was brought to the fore: “Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it would otherwise be.”

What was fresh and new about *Ramsay* was the realisation that such an approach need not be confined to well recognised accounting concepts such as profit and loss but could be the appropriate construction of other taxation concepts as well (The Taxpayer, 2002: 84).

In *Furniss v Dawson* 1984 AC 474, the taxpayers wished to sell their family company shares to an independent purchaser. As part of a prearranged plan to defer their capital gains tax liability, the taxpayers exchanged their shares in that company for shares in a newly formed investment company (Greenjacket) incorporated in the Isle of Man. On the same day Greenjacket sold the family company shares at the previously negotiated price. The taxpayers relied on a capital gains tax exemption in respect of the company amalgamation and a no gain no loss disposal of the family company shares by Greenjacket.

The series of English cases from the *Furniss* case onwards have entrenched the legal principle that where a taxpayer enters into a pre-ordained series of transactions consisting of two or more steps and those steps are inserted for no commercial business purpose apart from the avoidance of a liability for tax, the court will determine the tax consequences of the series by looking at the end result and ignoring the intervening steps. The *Furniss* principle makes up for the fact that the English tax legislation does not contain a sweeping anti-avoidance measure enabling the court to strike down artificial transactions. In all the cases from *Duke of Westminster v IRC* 51 TLR, 19 TC 490 to the most recent decision in the *McGuikan* case the transactions reflected the genuine intention of the parties. They were not sham transactions. The judgment in the *Westminster* case is authority for the principle that every person is entitled to arrange his affairs so as to fall outside the provisions of a statute. In *McGuikan* [1997] S.T.C. 908, the United Kingdom court showed a willingness to revisit the boundary between capital and income. In this case the sum received for the sale of a right to dividends over a period of three years was characterised as income (Tiley/Jensen, 1998:169).

The approach of the Lords to 'linear' tax avoidance in the case of *Furniss v Dawson* marked a significant extension of the Ramsay principle, which had been founded upon 'circular' or 'self-cancelling schemes'. Lord Brightman redefined the necessary conditions for the Ramsay principle to apply:

A preordained series of transactions (or one single composite transaction); into which there must be, steps inserted which have no commercial (business) purpose, (as distinct from a business effect) apart from the avoidance (or deferral) of a liability to tax (McLaughlin, 2000:3).

Lord Bridge contrasted the *Dawson* case with the *Westminster* case, in that the *Dawson* case dealt with “a series of interdependent transactions designed to produce a given result” as opposed to the single agreement entered into between the Duke and his employee. This series of transactions he felt now entitled him to look to the substance as opposed to the form of the composite transaction. He mentioned the fact that the substance over form doctrine is used in the United States and felt that the “precise boundaries will need to be worked out on a case by case basis.”

Lord Roskill in the *Dawson* case spoke of the “ghost of Westminster” and hoped that the House would set it’s soul at rest. However, he admitted to uncertainty regarding the outcome had the *Westminster* case been heard in 1982 instead of 1936. It has also been noted that a broad anti-avoidance principle effectually overruling the *Duke of Westminster* decision and denying the fiscal efficacy of artificial transactions has found little support (Ashton, 1988:498). Based on the majority judgment, the Dawsons were ordered to pay the capital gains tax on the unrealised gain.

The next important case in this saga was *Craven v. White* [1988] S.T.C. 476 HL, the facts of which are briefly as follows. The taxpayers exchanged their shares in a trading company (Q Ltd) for shares in an Isle of Man holding company (M Ltd), in anticipation of a potential sale or merger of the business. Meanwhile, the taxpayers had abandoned negotiations with one interested

party, and later concluded a sale of Q Ltd's shares with another. M Ltd. subsequently loaned the entire sale proceeds to the taxpayers, who appealed against assessments to capital gains tax (McLaughlin, 2000:1). The leading judgment in the House of Lords was delivered by Lord Oliver, (who had delivered the Court of Appeal judgment in the Dawson case, which was later overturned in the House of Lords). Lord Oliver's judgment consisted essentially of three parts, each of which is summarised separately below.

Firstly, he considered what the *Dawson* case actually decided. He held that the *Dawson* case merely extended the *Ramsay* doctrine from encompassing only self-cancelling transactions to also including linear transactions, that is transactions that have enduring legal consequences.

Secondly, he disagreed strongly with Lord Scarman's reference to "unacceptable tax evasion" in the *Dawson* case and rejected a moral dimension in the evaluation of tax transactions.

Thirdly, and most importantly, he considered what Lord Brightman meant when he referred to a "preordained" series of transactions. He emphasised that the importance of the *Ramsay* doctrine lay in the concept of a composite or preordained series of transactions, rather than the tax minimisation motive. An important feature of the *Dawson* decision was therefore the "tripartite agreement" referred to by Lord Brightman in that case. Lord Oliver had the following to say with regard to the word 'preordained':

In my opinion, that must mean more than simply planned or thought out in advance. It involves a degree of certainty and control over the end result at the time when intermediate steps are taken.

Lord Oliver then summarised the law as it currently stood and set out the 'essentials emerging from *Dawson*', which were as follows:

The court can be justified in linking the beginning with the end so as to make a single composite whole to which the fiscal results of the single composite whole are to be applied,

(a) that the series of transactions was, at the time when the intermediate transaction was entered into it preordained in order to produce a given result;

(b) that the intermediate transaction had no other purpose than tax mitigation;

(c) that there was at the time no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and

(d) that the preordained events did in fact take place (Mclaughlin, 2000:4).

In these circumstances the court can be justified in linking the beginning with the end so as to make a single composite whole to which the fiscal results of the single composite whole are to be applied. It could not be said that the sale which actually took place was actually then 'preordained' although no doubt it was preconceived, nor can it be said that there was then 'no likelihood that it would not take place'. Although the result was a victory for the taxpayer, the case only succeeded by means of a slight majority and was thus not entirely convincing in its outcome. Lord Templeman delivered the strongest dissenting judgment, which is summarised briefly below.

(a) Despite agreeing that the court in the *Dawson* case was searching for the "real" disposal for the purposes of the taxing statute, the underlying

principle was more that “an artificial tax avoidance scheme does not alter the incidence of tax.”

- (b) He held that two transactions can form part of a scheme even though it is completely uncertain at the time of the first transaction whether the taxpayer will succeed in procuring the second transaction to be carried out at all.
- (c) He felt the “knife-edged” majority in the *White* case had no power to limit the Dawson principle that had been developed in four decisions in the House of Lords.
- (d) He disagreed with the contention that the Dawson principle interfered with the taxpayer’s freedom. All the transactions in the *Dawson* case, he said were carried out at the taxpayer’s own free will.
- (e) He voiced his concern that a victory for the taxpayer would result in the revival of the tax avoidance industry in the United Kingdom.

It has been submitted that the *White* case shows a willingness by the House of Lords to put limits on the *Ramsay* doctrine (Ashton, 1988:497). “Ramsay at least would remain, to knock out self-cancelling off the peg schemes” (Mansfield, 1989:19). The move towards judge-made law in the *Dawson* case has been halted by the majority decision in the *White* case that the approach is merely one of statutory construction. A logical extension of this approach is that the taxpayer is now also able to argue that his series of transactions should be treated, as a matter of construction as a single composite disposal (Tiley, 1989:20). There can be little question about the House of Lord’s logic in *White*, that there would be no intellectually-defensible stopping place this side of strategic tax planning had it followed the line begun with *Dawson*:

Whereas the decision contains the new approach after *Dawson*, the route may also curtail the effects of *Ramsay*. There is no general judicial doctrine of

rejecting tax avoidance schemes on the basis of substance rather than form or a lack of business purpose; there is no ill-defined doctrine of a shame. The correct approach is one of ordinary construction of the statute (Mansfield, 1989:19-20).

John Ward stated that the general test of taxability under Schedule E, effectively hinges on whether the employee receives a profit from his employment. According to Ward the general test combines elements both of “form” and “substance”, and that, contrary to suggestions by some commentators, the doctrine of “form over substance” has been consistently upheld in the cases concerning the general test (Ward, 1992: 39-40).

The relevance of the doctrine has inevitably been cut down by various provisions designed to reduce the taxpayer’s scope for manoeuvre. If there is a move in England towards a more purposive interpretation of statutes, it might be explained in part by membership of the European Economic Community (EEC). EEC statutes must be interpreted in the “European” fashion by English courts – that is, in light of legislative purpose and legislative history.

There are three phases in the evolution of English judicial attitudes before *Craven*, which brought this evolution to a halt. First, the pro-taxpayer literalism symbolised by the famous Westminster case. Secondly, pro-taxpayer bias weakened in two types of cases – those interpreting statutory language implying a requirement that the taxpayer have something more than tax avoidance purpose, and those dealing with statutory provisions aimed specifically at tax avoidance. Thirdly the House of



Lords in the early 1980's decided the *Ramsay/Burmah/Dawson* trilogy of cases, apparently beginning the evolution of a judicial anti-avoidance principle. Then came *Craven*, where the majority decided that the courts had gone too far (Popkin, 1991: 288-289).

“*Craven* brought to a head the conflict over statutory interpretation which the *Ramsay/ Burmah/ Dawson* trilogy had initiated” (Popkin, 1991: 299), while the *Westminster* doctrine received little attention in the *White* case. It is submitted that the crux of the court's application of the *Dawson*-type doctrine to tax avoidance schemes is whether there is a composite transaction or not in the sense of a series of acts which can be distinguished into separate legal transactions but which in substance all contribute to and comprise a single result. Although the doctrine applies not only to self-cancelling transactions but to linear ones as well, there is less likelihood of there being a composite transaction in the latter case.

Lord Scarman made several statements in the *Dawson* case reaffirming an aggressive judicial role. He emphasized that the law in this area is in an early stage of development and that the evolution of an emerging principle was suited to the judicial process, and that the solution to tax avoidance was beyond the power of the blunt instrument of legislation. This inverted the traditional perspective that preventing tax avoidance was more suited to legislative than judicial solution. Lord Roskill even hinted that *Westminster* might no longer be good law and Lord Bridge referred favourably to the United States substance versus form approach (Popkin, 1991: 297).

The substance over form concept may be described explicitly in law, or it can be adopted by the courts as a principle of interpretation. In the U.K. it

has been up to the courts to look beyond the form of the transactions to find their tax avoiding substance (Doggart, 1997:113).

4.3 Summary

For several decades the English courts followed the approach adopted in the *Westminster* case, in which payments were made by the taxpayer to domestic employees in the form of deeds of covenant, but which in substance were payments of remuneration. The House of Lords refused to disregard the legal character (form) of the deeds merely because the same result (substance) could be brought about in another manner (McLaughlin, 2000:1). In 1981, in the *Ramsay* case, Lord Wilberforce laid down several principles to be applied to tax avoidance schemes. This tougher approach to tax avoidance schemes continued in the *Burmah Oil* case and culminated in the case of *Furniss v Dawson*. The House of Lords decision came as a shock to those taxpayers who were of the opinion that the *Burmah Oil* and *Ramsay* cases decisions would be restricted to the facts of those cases. However, in 1988, in the case of *Craven v White*, the House of Lords began to retreat from the *Furniss v Dawson* approach.

4.4 South Africa

The South African courts have to date used the “Substance over Form” doctrine in various forms. It is necessary to examine various cases in order to ascertain the broad principles regarding the application of the “substance and form” approach.

The fusion of English law doctrines has been substantial and the doctrine of the substance as opposed to form has been used in English law to counter what would be regarded in South African law as tax avoidance schemes.

The court in *CIR v George Forest Timbers Co Ltd 1924 AD 516 (SATC 20)* took a literal approach by quoting with approval from the English case of *Partington v The Attorney General 21 LT 370*:

If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

However, a more intention-orientated approach has been put forward, indicated by a quote from *Dadoo Ltd v Krugersdorp Municipal Council 1920 AD 5 30*:

It is a wholesome rule of our law which requires a strict construction to be placed upon statutory provisions which interfere with elementary rights. And it should be applied not only in interpreting a doubtful phrase, but in ascertaining the intent of the law as a whole.

This more functional approach was advocated in *CIR v Delfros 1933 AD 242 (6 SATC 92)*, when Wessels, C.J., after referring to the approach put forward in the case of *Partington v Attorney General*, said:

I do not understand this to mean that in no case in a taxing act are we to give a section a narrower or wider meaning than its apparent meaning, for in all cases of interpretation we must take the whole statute into consideration and so arrive at the true intention of the legislature.

In *Dibowitz v CIR 1952 (1) SA 55 AD*, Centlivres CJ, supported this intention-orientated approach by saying that:

When that citation was made it was assumed that the rule should be qualified by saying that even in taxing statutes something may have to be implied by necessity.

Further support for the intention-orientated approach to interpreting fiscal statute was put forward by Botha J.A. in *Glen Anil Development Corporation Ltd. v SIR 1975 (4) 715(A) 37 SATC 319*, who delivered the judgement of the Appellate Division of the Supreme Court:

Apart from the rule that in the case of an ambiguity a fiscal provision should be construed contra fiscum which is but a specific application of the general rule that all legislation imposing a burden upon the subject should, in the case of an ambiguity, be construed in favour of the subject, there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation.

The Court held that no reasonable court could, on the facts set out in the stated case, have come to any other conclusion than that the sole or main purpose of the agreement was not the utilisation of the assessed loss incurred by the taxpayer, to avoid liability for the payment of income tax or to reduce the amount thereof (De Koker, 2000: 19.22).

In so far as the interpretation of general anti-tax avoidance statute is concerned the *Glen Anil* case is authority against applying the contra fiscum rule in interpreting such legislation, as the court did not consider section 103 of the Income Tax Act to be a taxing measure.

Various court cases have differed in their acceptance or rejection of this broader and more equity-based approach to the interpretation of statutes. In *CIR v Nemojim (Pty) Ltd 1983 (4) SA 935 (A), 45 SATC 241*, the taxpayer, a private company, (Nemojim) was a dealer in shares. The company carried out a series of dividend-stripping operations, in which it purchased all the shares of dormant companies. It then caused the company to distribute all its accumulated profits by way of a dividend, all of which accrued to Nemojim, and then sold the shares. The dividends were exempt from tax in Nemojim's hands in terms of section 10(1)(k) of the Income tax Act. Nemojim included the proceeds of the sale of the shares in its gross income and claimed a deduction for the purchase price of the shares. The question was whether Nemojim was entitled to deduct the full purchase price of the shares or was a portion thereof not deductible by reason of section 23(f) of the Income Tax Act. The court held that Nemojim had purchased the shares for a dual purpose, that is, to gain exempt income in the form of dividends and to gain income by selling the shares after receiving the dividend. Therefore in terms of section 23(f) of the Income Tax Act only a proportion of the cost of the shares was an allowable deduction (Williams, 1995: 407-411).

The route taken by the court was more in accordance with the “intentional approach” with regard to which Corbett J.A. said:

It has been said that there is no equity about a tax. While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus. And it may be fairly inferred that such a result is in conformity with the intention of the legislature.

This broad approach to the interpretation of tax statute was repeated in *De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A)*, where the question before the court was the deductibility of the cost of the shares in a company which had been stripped of its reserves by way of a capital reduction scheme. In relation to this case, Ungood-Thomas, remarked that, “all these transactions were completely out of character with the rest of the company’s trading operations and the way in which it conducted its trade, and cry aloud for an explanation”. The Commissioner concluded that in the absence of evidence to the contrary, that the company deliberately set out to make a substantial loss (Williams, 1995:194-195).

Apart from the courts adopting a more “intentional” approach in the interpretation of the tax statutes, there has also been a hint of a “business purpose” test being adopted in such interpretation. In *De Beers Holdings v CIR* the court also considered whether the expense in question was “wholly or exclusively laid out for the purposes of trade”, as required by section 23(g) of

the Income Tax Act. This approach may indicate a new and more participatory approach by the courts in combating tax avoidance.

A further example of this wide interpretation of the tax statutes is contained in *CIR v Berold 1962 (3) SA (A), 24 SATC 279*, where Steyn, C.J., in his interpretation of section 7(3) of the Income Tax Act, did not allow the imposition of a company to conceal the real cause of income accruing to a minor child. In this case the court looked for the 'effective cause' of the income and made it clear that it would not allow the forms of company law to cancel an effective causal connection. It was established that the effective cause of the dividend was a donation by the taxpayer, the father of the minor children, for whose benefit the dividend had been accumulated. The elements of section 7(3) of the Income Tax Act were therefore satisfied and the dividend was deemed to have been received by the taxpayer (Williams, 1995: 135-138).

At the other end of the spectrum, the courts have also interpreted the tax statutes restrictively. In *Hicklin v SIR 1980 (1) SA 481*, the court had to deal with the application of section 103(1) of the Income Tax Act to a dividend stripping operation. The decision in *Hicklin v SIR* gave the definitive ruling on the interpretation of the "normality" requirement of section 103(1)(c) (i) and (ii) of the Income Tax Act. The Appellate Division stated that "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 arms length". In an at arms length agreement the rights and obligations it creates are more likely to be normal than abnormal. When considering the normality of the rights or obligations created or of the means or manner so employed, due regard has to be paid to the surrounding circumstances. 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 same nature in another case because of the absence of such circumstances. *Hicklin's* case was obviously a great triumph for taxpayers as

tax planners could now plan their schemes around the abnormality requirement by ensuring that the parties are at arms length (De Koker, 2000: 19.13).

A rule of interpretation of statutes that is often referred to in the courts is the “ejusdem generis” rule which means that the word in question must be interpreted in the light of the words that go before it where the preceding words form a class or genus. This principle was applied in *Ovenstone v SIR 1980 (2) SA 721* where the court interpreted the word “disposition” as used in section 7 of the Income Tax Act in relation to the words that went before it. This principle of interpretation is generally restrictive. The court confirmed the taxation in the taxpayer’s hands of the dividends that passed, through a new company and a trust which was formed, to his children, for he failed to discharge the onus of establishing that the avoidance of tax was not one of his main purposes at the time he carried out the scheme (De Koker, 2000: 19.12).

Apart from the courts adopting a more “intentional” approach in the interpretation of the tax statutes, there has also been a hint of a “business purpose” test being adopted in such interpretation. In *De Beers Holdings PTY (Ltd) v CIR 1986 (1) SA 8 (A)* the court also considered whether the expense in question was wholly or exclusively laid out for the purposes of trade, as required by section 23(g) of the Income Tax Act.

The possible application of the English ‘substance over form jurisprudence’, particularly to the interpretation of section 103(1) of the Act was raised by number of commentators as well as in certain judgments. In *Erf 3183/1 Ladysmith(Pty)Ltd v CIR 1996(3) SA 942(A)*, the Appellate Division followed the doctrine of simulated transactions as initially set out in two early decisions of *Zandberg v Van Zyl 1910 AD 302* and *CIR v Randle Brothers and Hudson Ltd 1941 AD 369*. In the analysis of the approach adopted by Hefer J.A. (as he then was) in the *Ladysmith* case it was said as follows in relation to the court’s

application of the simulated transaction doctrine as set out in the *Randle Brothers* case:

The passage illustrates a difference between the English substance over form doctrine which focuses a purposive interpretation of the legislation to curb that which is defined as tax avoidance, and the *Randle Brothers* approach which concerns the actual interpretation of the agreements, such that if the actual agreement is set out accurately in the written contracts even the existence of a tax avoidance purpose does not allow these agreements to be ignored. *Ramsay* is about purposive legislative interpretation whereas *Randle Brothers* concerns the analysis of the true intention of the parties to an agreement(The Taxpayer, 2002:83).

Watermeyer, J.A. in *Commissioner of Customs and Excise v Randles, Brothers and Hudson, Ltd, 1941 AD 369, 33 SATC 48*, expressed the traditional approach as follows:

... dishonest, in as much as the parties to it do not really intend it to have 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 facts and the judgments of recent court cases illustrate how the principle is applied in practice.

In *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*, 58 SATC 229, a group of companies required a furniture factory to be built for the use of the group. A subsidiary company was incorporated to acquire the land which was thereafter leased to a pension fund at a relatively nominal rental. In terms of the lease agreement the lessee was entitled, but not obliged, to erect such buildings and other improvements on the land at its expense. The buildings would become the property of the lessor and the lessee had no claim against the lessor for compensation. A sub-lease was then entered into between the pension fund and an operating company for the same period as the initial lease. The operating company was required to pay a monthly rental and a lease premium which would equate to the cost of the buildings. This meant that the group acquired the land and buildings while the expense to the operating company, which was deductible, would fund the cost thereof. The issue was whether a right as envisaged in paragraph (h) of the definition of “gross income” in section 1 of the Income Tax Act had accrued to the subsidiary company. The taxpayer’s contention was that in the absence of an obligation enforceable by the subsidiary, a right to have the buildings erected did not accrue to it (Williams, 2000:para. 19:12F). There was a real likelihood that there was an unexpressed agreement or tacit understanding between the subsidiary and operating company that the subsidiary would be entitled, if need be, to enforce compliance with the relevant terms of the sub-leases, either against the operating company or possibly against the operating company and the pension fund jointly. Accordingly, the approach of the court was based upon ascertaining the real intention, as opposed to the simulated intention, of the parties to the contracts. The written agreements did not reflect the true or full intention of the parties. Hefer, J.A. relied on the *Randles* and *Zandberg* cases which dealt with sham or disguised transactions. It was clear that the courts of law would not be deceived by the form of a transaction but would examine its true nature and substance (De Koker, 2000: 19.12F).

The same principle was applied in *Relier (Pty) Ltd v Commissioner for Inland Revenue 60 SATC 1*, where the interposition of the fund as tenant and lessor has unusual and unreal aspects to it and where it is questionable whether the fund actually intended to lease and then to sublet the property. The interposition of the fund as tenant was not truly intended and amounted to a simulation.

However in *CIR v Conhage (Pty) Ltd, 61 SATC 391*, the taxpayer entered into two sets of agreements with a bank and in form each set comprised a sale and leaseback of some of its manufacturing plant and equipment. The question was whether such agreements were simulated transactions. The Commissioner for Inland Revenue contended that despite the form of the agreements, the taxpayer did not sell and lease back its equipment, but in substance borrowed the “purchase price” from the bank. The question was whether the Commissioner for Inland Revenue had correctly invoked section 103 of the Income Tax Act. The court held that there was not sufficient reason to doubt the authenticity of the agreements in issue and that the provisions of section 103 were not applicable. In addition, although the agreements of sale and leaseback had served the dual purpose of providing the taxpayer with capital and allowing it to take advantage of the tax benefits to be derived from the type of transaction, the raising of finance was the underlying and basic purpose of the transactions in question.

In *ITC 1618, 59 SATC 290*, the aspect of artificiality was examined. The question was whether certain income was to be regarded as having accrued to sole member of close corporation or having accrued to his close corporation. The taxpayer, a draughtsman, had entered into an agreement with a labour broker whereby he performed professional services for a particular venture and then invoiced the labour broker who, in turn made payment to him. Thereafter the taxpayer formed a close corporation which was substituted as the service provider in terms of the existing agreement with labour broker, although the

taxpayer continued to physically carry out the work. It must be remembered that a transaction is not necessarily a simulated or disguised one because it is devised for the purpose of gaining a tax benefit. If there is a real and genuine intention for the corporation to exist and to do business itself, the courts will give recognition thereto. In this case the appellants discharged the onus they bear under section 82 of the Income Tax Act in showing that the Commissioner for Inland Revenue was incorrect in regarding the agreement, where under the second appellant provided services on the venture as a simulated agreement disguising a real agreement to which First Appellant was a party.

The sequel to this case was the announcement by the Minister of Finance in his budget speech on 23 February 2000 that employment companies (that is labour brokers without an exemption certificate) and personal service companies will be subject to tax at the rate of 35% and any remuneration paid to them by a client will be subject to employees' tax with effect from 1 August 2000. This announcement was translated into legislation.

In *ITC 1625, 59 SATC 383*, in regard to "Substance over Form", there was no merit whatsoever in the Commissioner for Inland Revenue's contentions that the real intention of the parties was not that appellant should acquire the property from the existing close corporation, D, but that the members of D should derive the benefit of the enhanced market value of the property and that appellant did not have an honest intention of purchasing the property and that D did not have an honest intention of selling it. The court held that the documents honestly reflected the agreement and achieved that which the parties thought they were achieving. In regard to sections 11(a) and 23(g) of the Income Tax Act, appellant had discharged the onus of proving that the interest was incurred by it in the production of its income and was wholly and exclusively laid out for the purpose of trade.

If a taxpayer has a commercial or a family purpose for entering into an agreement which is not itself a tax avoidance purpose and chooses a method to achieve his or her objective which is tax effective, that does not convert the transaction into one for the avoidance, reduction or postponement of tax. Our courts have adopted the approach of the House of Lords in *IRC v Brebner* [1967] 1 All ER 779, where it was found that the interest incurred by appellant in respect of the loans obtained by it from Syfrets was incurred in the production of income and was not of a capital nature for the purposes of section 11(a) of the Income Tax Act and was wholly and exclusively laid out for the purpose of trade as required by section 23(g) of the Income Tax Act.

In *ITC 1663, 61 SATC 363*, a salary sacrifice system in return for tax efficient fringe benefits, was the core issue. The judgment indicates that it is important to remember that the form of the contract on its own is insufficient. In reality there must be substance to the agreement, especially a valid offer and acceptance by the contracting parties. The court held that there was no proof that the appellant as employer, had entered into an enforceable agreement with any of its employees in terms of a salary sacrifice system.

The South African courts will not lightly disregard what the parties say. The traditional approach is that only where the court is satisfied that the agreement is a sham or is a dishonest transaction, will the words in the agreement be disregarded.

It is important to take account of where the onus lies in regard to the burden of proof on a balance of probabilities. Section 82 of the Income Tax Act places the burden on the taxpayers' shoulders. The court in the Randles case, however, put the burden of proof, in the case of an alleged sham transaction, on the party contending that the transaction was a sham.

In an Income Tax case, it is necessary to bring witnesses to discharge this onus. Thus, should the Commissioner of Inland Revenue dispute whether an agreement presented genuinely reflects the intention of the contacting parties, it would be for the taxpayer to lead evidence to prove this. This is understandable considering that this information would be peculiarly within the knowledge of the taxpayer. In a sham transaction case, for the Commissioner to succeed, it is not necessary for a court to find that the agreements were in fact a sham.

Thus in the *Ladysmith* case, Hefer J.A., commented that “a problem facing the appellants is that there is a paucity of evidence relating to the events after the acquisition of the land”. The court concluded that the evidence did not exclude what was thus a real likelihood that the written agreements did not reflect the true or full intention of the parties. In other words the Appellants in the *Ladysmith* case had not brought sufficient evidence to discharge the onus in terms of section 82 of the Income Tax Act.

4.5 Conclusion.

Although the South African courts have shown a willingness to depart from the clear words of the statute in the interests of equity, there remains little legal basis for doing so. The *Randles* case has not been overruled and remains good law in SA. In the case of bona fide transaction, unless the SA courts give effect to the pure *fraus legis* principle, there is little basis for adopting a *Ramsay*- type step transaction approach.

It is submitted that the most likely approach by the courts in combating tax avoidance is along the lines of the *De Beers* case where the court found that the section 23(g) trade requirement had not been met for the purposes of a section

11(a) deduction. This means of attack is however still largely restricted to the words used in the statute.

While the principle underlying all sham transaction cases are the same, it should be noted that a policy consideration underlying a certain field of law will differ from another. Innes, J.A. noted in the *Dadoo* case that:

It is a wholesome rule of our law which requires a strict consideration to be placed upon statutory provisions which interfere with elementary rights. And it should be applied not only in interpreting a doubtful phrase but in ascertaining the intent of the law as a whole.

The English courts followed the route of taxpayer liberalism for several decades until the *Ramsay/Burmah/Dawson* trilogy of cases, where it became apparent that a judicial anti-avoidance principle had developed. The evolution towards the judicial anti-avoidance principle was stifled by the *Craven* decision where the majority decided that the courts had overstepped their boundaries. Decisions after the *Craven* case showed a tendency to contain the judicial anti-avoidance doctrine. While many of the cases where judicial interpretation of anti-avoidance measures was applied have proved effective in combating tax avoidance, the outcome of the various tax cases also led to some confusion for the taxpayer, as the same principles were not always applied. The various approaches by the courts from the 1930's to date leave much room for uncertainty as far as planning one's tax affairs is concerned. It also raises the question whether a legislated general anti-avoidance provision is required or a combination of both judicial tests and legislation.

CHAPTER 5: SOUTH AFRICA – TAX AVOIDANCE ISSUES RELATING TO SUBSTANCE OVER FORM

5.1 Introduction

In order to understand exactly what is meant by the term ‘tax avoidance’, it is important to distinguish between ‘tax avoidance’ and ‘tax evasion’.

Tax avoidance is the arrangement of activities so that an individual is liable for less tax than would otherwise be the case. It is of the essence of tax avoidance that the arrangements are within the law, and known, to appropriate revenue authorities. If the taxpayer’s definition is disputed, it is adjudicated, and if a claim for tax avoidance is wrongly founded, then payment can be collected. Tax evasion is the non-reporting of a tax liability for activities in which money or taxable benefits change hands. (Rose/Karran, 1987:196)

Evasion involves the use of illegal means to reduce tax liability. The capacity of an individual to practice tax avoidance is contingent upon circumstances. An individual must first have an income sufficient enough to justify the additional effort required to reduce or avoid taxation. A taxpayer must also be organised to manage money in ways which are suited to minimise taxation. Of importance is also the fact that tax avoidance often requires co-operation between two parties, a payer of money and the recipient. A taxpayer most often will require professional advice due to the technicalities of the system, in order to be adequately informed of the means of arranging activities to reduce tax liabilities.

The distinction may have become blurred by the implementation of more aggressive tax schemes and by Revenue's attempts to attack the scheme. If a taxpayer enters an arrangement with the dominant or substantive intention of producing a tax advantage and cannot show that he has a reasonably arguable position, then the taxpayer will have displayed the essential characteristics of taking an abusive tax position. Saunders (1993) in observing that the United Kingdom does not have a general statutory anti-avoidance rules focuses on the need for both the judiciary and the revenue to continue to keep pace with tax avoidance techniques. Ward (1995) observes that one of the major failures with United Kingdom anti-avoidance efforts is the strong emphasis on the wording of the legislation, even if this may be contrary to a clear purpose of the legislation. Ward also explores the changes in judicial approaches to tax avoidance over the past few decades, emphasizing the uneasiness of allowing judge-made law to exist in a culture of resolute adherence to the language of statutes (Sawyer, 1996: 484-486). A useful point to commence the process of distinguishing between avoidance and evasion is the question of the legality of the transaction or underlying activities. Avoidance is involved when the activity or arrangement is unquestionably legal, evasion when it is illegal. The judicial attitude to tax avoidance, the taxpayers' disclosure to Revenue as well as the approaches by Revenue to combat tax avoidance, are discussed in order to establish the need for a general anti-avoidance provision in the Income tax Act.

5.2 Judicial Attitude to Tax Avoidance

A debate remains as to whether "judge-made" law should be encouraged or not. The Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa had the following to say:

In the United Kingdom there has been an 'activist' judicial policy against tax avoidance. Where there

are specific legislative anti-tax avoidance provisions the role of the courts may be limited to applying and interpreting those provisions, which could act as a brake on a judicial approach such as that adopted in the case of *Ramsey, Burmah Oil and Furniss v Dawson* (Government Printer: para.27.15).

The Commission of Inquiry made it clear that it favoured the legislative route as opposed to the judicial one, as the concern was that it made it difficult for the taxpayer to plan with certainty, without the relevant legislation. This approach has found both support and opposition in the courts. Lord Wilberforce in the *Ramsay* case condemned a strict legislative approach as opposed to Lord Oliver who supported this by stating in the *White* case:

So it is, but judges are not legislation and, if the result of a judicial decision is to contradict the express statutory consequences which have been declared by Parliament to attach to a particular transaction which has been found as a fact to have taken place, that can be justified only because, as a matter of construction of the statute, the court has ascertained that that which has taken place is not within the meaning of the statute!

The legislative approach has been adopted in Canada by the introduction of a new general anti-avoidance section 245. According to the Canadian government a general anti-avoidance rule was necessary to prevent taxpayers from engaging in aggressive tax planning. Judicial anti-avoidance doctrines were perceived to be inadequate to discourage or prevent offensive transactions (Arnold, 1995: 541). This process was chosen as the Government believed that the judicial process would develop too slowly and was inadequate to cope with

the aggressive tax industry. The South African government too has embarked on the legislative route by the introduction of anti-avoidance sections. With this growing amount of anti-avoidance legislation in the Income Tax Act, there seems little chance of the SA courts adopting a *Dawson* type approach in the combating of tax avoidance. Instead, an approach along the lines of the Australian courts seems more likely, where the presence of anti avoidance legislation precluded the courts from going beyond the intention of the legislation.

5.3 Taxpayer's disclosure to Revenue

Should the taxpayer be disclosing the substance or the form of the tax transactions to Revenue? On the one hand a 'full and true' disclosure requirement could mean only amounts received by or accrued to the taxpayer and not include details of tax avoidance schemes that could fall foul of section 103 of the Income Tax Act. However, on the other hand, it has also been submitted that the 'full and true' disclosure requirement is broad enough to encompass the disclosure of tax avoidance schemes.

If the income tax return forms issued by Revenue constitute an attempt by them to gather 'true and fair' information, then by implication it may be possible to argue that any information which is not requested in these forms is not necessary in arriving at the 'true and fair' state of affairs. The taxpayer's duty to disclose would then be restricted to the information asked for on the income tax return form. Alternatively the statutory reference to 'true and fair' could be unrestricted by the administrative procedures in gathering the information and could therefore encompass all information, whether asked for or not on the return forms.

In the *Relier* case, the Supreme Court of Appeal emphasized that the issue in the present instance is not whether the scheme falls foul of the anti-avoidance

provisions of section 103(1) of the Act, but whether *Relier* has established on a balance of probabilities that the building costs were not part of the 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 occupation of the land, to have improvements effected on the land by that other person. In order to prevent the taxpayer's successful avoidance of tax, the legislature introduced section 103 of the Income Tax Act. If the provisions of the section are fulfilled, a taxpayer will have to pay the tax. Section 103 only becomes applicable when the Court has concluded that the agreement reflects the genuine intention of the parties. If the agreements in the *Ladysmith* and *Relier* cases had reflected the genuine intention of the parties, the application of section 103, would most likely have been avoided as the main purpose of both the taxpayers in these cases was to build premises, and not to receive a tax benefit.

5.4 Approaches By Revenue To Counter Tax Avoidance

5.4.1 Possibilities for Revenue authorities to combat Tax Avoidance

Section 103 in the Income Tax Act is an example of a general anti-avoidance measure. Section 103(1) acts as the safety net in respect of certain transactions which are not dealt with by the specific anti-avoidance provisions. Specific anti-avoidance measures can also be included to restrict tax avoidance. Under this method, legislation is introduced which is aimed at curtailing particular schemes or closing loopholes in the system. Examples of this type of avoidance measure are paragraph (c) of the definition of "gross income", in section one of the Income Tax Act, which deals with the receipt or accrual by a person of amounts for services rendered or to be rendered by another person; section 7(2) - section 7(7), dealing with income derived by a person in consequence of donations by another person; section 8E, which deems certain dividend accruals to be interest; sections 9A, 9C and 9D, which deal with certain investment income; section 22(8), dealing with the donation or private

consumption of trading stock or sections 54 – 64 dealing with donations tax (Arendse et al, 2001:494-495).

Another example is the announcement by the Minister of Finance in his budget speech on 23 February 2000 that the deduction of expenditure incurred in terms of any agreement will be limited to goods supplied, services rendered or other benefits received during the relevant year of assessment. Where such goods, services or benefits are to be supplied, rendered or enjoyed within six months after the end of the year of assessment in which the expenditure was incurred or where the total amount limited by this provision does not exceed R50 000, the expenditure will be allowed as a deduction. Any deduction in respect of trading stock disposed of by the taxpayer in the ordinary course of trade will be limited to the extent that the consideration paid is included in gross income. This announcement has been translated into legislation in terms of section 23 H of the Income Tax Act.

5.4.2 Requirements of Section 103 (1)

Section 103(1) gives the Commissioner for Inland Revenue important remedies against the avoidance of tax at which it is directed. In order to apply section 103(1), the Commissioner is required to be satisfied that four sets of circumstances exist, each one of which must be present. Any decision of the Commissioner under section 103(1) is subject to objection and appeal by the taxpayer, and if the taxpayer can show that any one of the circumstances described is not of application, his liability for tax may not be determined under section 103(1) (De Koker, 2000:19.12).

The court in *SIR v Geustyn, Forsyth and Joubert 1971 (3) SA 567(A), 33 SATC 113*, categorised the four requirements (which must all be satisfied) for the successful application of section 103 (1).

(1) A transaction, operation or scheme must have been entered into or carried out.

(2) The transaction entered into or carried out had the effect of avoiding, postponing or reducing liability for tax. To avoid liability in this sense is escape or prevent an anticipated liability. Any transaction, operation or scheme by which income, which otherwise would have accrued to the taxpayer, accrues to another, can be regarded as having the effect of voiding, postponing or reducing a liability to tax although the taxpayer has no right to and will receive no benefit from the income.

(3) Abnormality having regard to the circumstances under which the transaction was entered into or carried out, must be present.

Prior to amendment of section 103 (1)(b) in 1996, as long as the taxpayer complied with requirement of normality as laid down, he could carry out any transaction for the avowed purpose of avoiding, postponing or reducing the amount of tax he has to pay. It was of utmost importance that the transaction was judged not only in relation to the means or manner in which it was entered into or carried out but also in relating to the rights and obligations it created. Normality was not to be judged solely by the questioning whether the parties were independent persons dealing at arms length, as the Commissioner must also take into account the circumstances under which the transaction was entered into or carried out. It is possible that in relation to a specific transaction between parties who were not independent persons dealing at arm's length, the means or manner adopted may have been the normal procedure for that particular transaction, in line with the provisions of section 103(1) (b) (ii).

The recent amendment to section 103 (1) (b) (i) of the Income Tax Act in 1996 splits schemes between those carried out in the context of business and all other schemes. For schemes in the context of business, the scheme must be entered

into or carried out in a manner which would not normally be employed for bona fide businesses purposes, other than the obtaining of a tax benefit. For all other schemes, they must have been entered into or carried out 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. The test of abnormality for “other schemes” is thus identical to that which up to the 1996 amendment, applied to all schemes. The Third Interim Report of the Commission of Inquiry into certain aspects of the tax structure of South Africa stated that:

While transactions which the section is designed to catch are in their developing stages, they might readily accede to the description of abnormal and so fall with the provisions of the section, but once they become firmly established business practices, the applicability of the section is more doubtful (Government printer: para. 11.5.2).

Furthermore the report equates “business” to “course of trade” and recommends that the definition of trade as defined in Section 1 of the Income Tax Act, should be used as the test. In *Estate G v Cot 26 SATC 168*, Beadle, CJ, stated that the sensible approach was to look at the activities concerned as a whole and then to ask the question:

Are these the sort of activities which commercial life would regard as “carrying on business? The principal features of the activities must be examined, such as their scope and magnitude, their object or the continuity of the activities concerned.

(4) The transaction was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit. When it is proved that the transaction would result in the avoidance or the postponement of liability for payment of any tax, or the reduction of such liability, it will be presumed, until the contrary is proved, that the transaction was entered into or carried out solely or mainly for the purposes of the avoidance, postponement or reduction of such liability. If the sole or main purpose of a transaction is not the avoidance of any of the specified taxes, section 103(1) may not be applied. Accordingly, a scheme designed solely or mainly to achieve business objectives, other than the avoidance of these taxes, would be safe from the application of the provision, even if incidental savings of taxes were achieved.

Should the Commissioner not be satisfied that any of the circumstances about which he is required to be satisfied are present, section 103(1) may not be applied. Once he is satisfied on the four sets of circumstances listed above, the Commissioner may determine liability for and the amount of any tax, duty or levy imposed by the Act, as if the transaction 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, the avoidance, postponement or reduction of liability for the payment of any tax, duty or levy imposed by the Act.

In *Ovenstone v SIR, 1980 (2) SA 721 (A), 42 SATC 55*, it was stated that reference should be made to the effect and purpose of the transaction as well as the circumstances surrounding it at the time it is implemented or carried out as against the time it was formulated. Trollip JA who delivered the judgement of the Appellate Division stated that:

Even if the purpose or effect of a scheme when it is formulated is not to avoid liability for tax, it may

have that effect or that may become one of the taxpayer's main purposes when he subsequently carries it out, thereby rendering section 103(1) applicable if its other requirements are fulfilled (De Koker, 2000: 19.12).

In another case, *Glen Anil Development Corporation Ltd. V SIR 1975 (4) SA 715 (A)*, 37 SATC 319, Botha JA, rejected the view that section 103 should be restrictively interpreted, and held that it should be interpreted in a manner that will achieve the intention of the legislature in enacting it.

Section 103(1) of the Act is clearly directed at defeating tax avoidance schemes.... It should not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed.... The discretionary powers conferred upon the Commissioner should therefore, not be restricted unnecessarily by interpretation (De Koker, 2000: 19.2).

The invocation of section 103(1) is not necessarily to nullify sham transactions as the Courts will treat a simulated transaction as the nullity it really is. However, the section may be used to attack a bona fide transaction if it is entered into for the sole or main purpose of tax avoidance, especially if abnormal rights or obligations are created.

5.5 Conclusion

In terms of section 82 of the Income Tax Act the burden of proof as to exemptions, deductions, abatements, disregarding or exclusions shall be upon

the person claiming such exemption. The onus of proof in terms of section 103 appears to override section 82 as, before any onus rests upon the taxpayer, the Commissioner has first to establish a *prima facie* case of tax avoidance.

Avoidance is thus an attempt to minimise a tax liability using legal means as opposed to evasion where illegal methods are used to reduce liability.

Whilst laws heavily constrain what must be paid as taxes, they do not determine the way in which people arrange their affairs to take account of tax laws (Karran, 1987: 182).

The Income Tax Act does provide for interest and penalties to be charged, however where tax has been evaded, section 75 of the Income Tax Act also provides for a fine or imprisonment if the taxpayer is found guilty of an offence. Tax evasion constitutes an illegal offence and thus the fiscus does not require a statutory law to cope with this type of misdemeanour (Huxham/Haupt, 1999: 308-309).

In terms of section 103(6) of the Income Tax Act, the commissioner is obliged to impose interest on outstanding taxes avoided or postponed in terms of section 89 quat, if he applies section 103. Practice Note 20 of the Income Tax Act deals with section 103(1) and (2) and states that that these two provisions, as well as section 103(5) (a), have given rise to the concern that the South African Revenue Services might have the right and perhaps even the obligation, when applying them, to reopen any assessment, irrelevant of the period that has expired since the date of assessment. In South African Revenue Service's view, in raising additional assessments under section 103, it is constrained by the restrictions to be found in section 79. In other words, the ordinary three year period of prescription, after which assessments become final, applies even to tax avoidance schemes susceptible to the application of

section 103. However, by the same token, if the operation of this period is interrupted by the acts identified for this purpose by section 79, such as inadequate disclosure, past assessments will remain open to attack under section 103 (Arendse et al, 2001: 502).

While it is clear that the various judicial tests of the Doctrine of Substance over Form can play a significant role in limiting tax avoidance, the South African government has shown a preference to follow a legislative route as opposed to a judicial one.

The Fifth Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa, sums it up:

Anti-avoidance rules should be sufficiently detailed to be effective, but should not become so complex as to become counter-productive and inhibiting of international trade and investment (Government printer, para. 9.38).

CHAPTER 6: CONCLUSION

The aim of the research was to establish whether the various judicial tests, known as the Doctrine of “Substance over Form”, are effective in combating tax avoidance or whether a legislated general anti-avoidance provision is required, or perhaps a combination of both.

The “Substance and Form” doctrine varies significantly between the various tax jurisdictions, with the main issue being the presence or absence of a statutory general anti-avoidance provision. The main area of consistency between the jurisdictions is the distinction between a fraudulent transaction which is set aside almost immediately and a bona fide one where the court recognises the taxpayer’s right to plan his or her affairs in the most efficient manner possible. There are a variety of approaches to the Doctrine of “Substance over Form” and the combination of judicial tests used together is more effective in dealing with the issue of tax avoidance than any one test on its own. In sham transactions, the real intention of the parties is disguised, revealing an element of dishonesty. The courts have proved effective in handling these cases by ignoring the disguised transaction and instead considering the true intention of the parties.

For approximately forty years the English courts followed the approach adopted by the House of Lords in the *Westminster* case, where the principle that parties may genuinely arrange their transactions so as to remain outside the provisions of the Taxing Act, was established. In 1981, however, the courts showed a tendency to adopt a stricter approach in the *Ramsay* case. This stricter trend continued with the *Burmah Oil* case, and finally the House of Lords confirmed in the case of *Furniss v Dawson*, the new approach to the interpretation of anti-avoidance measures in the United Kingdom. The courts now seemed unsympathetic to the pro-taxpayer literalism of *Westminster* and paying a fair share of taxes seemed to be a more important national value than

in prior decades. However, in the case of *Craven v White* the House of Lords showed a reluctance to continue with this approach and decided that the courts had gone too far. The history of the United Kingdom tax avoidance issues reveals the extent to which judicial activism creates substantial uncertainty.

In the South African Income Tax Act there are a number of anti-avoidance sections aimed at specific tax avoidance schemes, as well as a general anti-tax avoidance measure enacted as section 103. The British system relies on the courts to create anti-tax avoidance rules, one of which is the Doctrine of "Substance over Form". The doctrine is very broad and identifies various applications developed by the courts in response to tax avoidance issues. In South Africa, unless the courts are willing to give effect to a pure *fraus legis* doctrine, there seems little legal basis for the court recharacterising a bona fide transaction, based on some degree of non-business purpose. The South African approach in combating tax avoidance seems to be following Australia and Canada along the legislative as opposed to the judicial route and which will, it is submitted, leave little room for the courts to adopt a *Dawson* doctrine.

There is no difference in approach to sham transactions in South Africa or English law courts as both countries will ignore simulation and give effect to the real intention of the parties. South African law still adopts the approach that every person is entitled to arrange his or her affairs so as to pay the least amount of tax. The *Dadoo* case and the *Duke of Westminster* case which have been adopted in South Africa are clear authority for this view. In order to discourage taxpayers from arranging their affairs to the detriment of the fiscus, the legislature has enacted specific anti avoidance provisions as well as the general anti-avoidance provisions in section 103. English taxpayers, before the *Ramsay* and *Furniss* line of cases, were free to arrange their affairs so as to fall outside the provisions of a statute, and could rely on the Courts adopting a literal interpretation to the statutory provision in question. The English courts are now taking a purposive approach to the interpretation of statutes, and

further do not confine themselves to a step by step dissection of a transaction, but will look at the composite transaction.

Unlike the courts in the United Kingdom, South African courts have played a minor role in the battle against tax avoidance. The South African courts, however are compelled to limit their law making. They cannot simply ignore the substance of a transaction in order to determine the tax consequences according to the tax results achieved. Applying the South African approach, a different decision may have been reached, had the facts in *Furniss v Dawson* been decided by a South African court.

Avoidance is not to be equated with evasion. A general tax anti-avoidance provision has been included to allow Revenue to counter tax avoidance practices which would otherwise fall within the form of the Income Tax Act. The principle that a taxpayer is entitled to plan his or her affairs within the context of existing law in order to minimise tax liability should be respected as a fundamental principle. Anti-avoidance legislation is only intended to operate where the specific legislation contained in the Income tax Act is ineffective. The existence of a general anti-avoidance rule promotes equity and certainty and facilitates orderly and systematic planning of the taxpayer's affairs. There is an important relationship between statutory interpretation and the control of tax avoidance. A strict or literal interpretation of statutes should be rejected in favour of a "modern approach":

Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of parliament (Arnold, 1995:543).

The modern approach gives courts considerable latitude to scrutinise transactions with a view to determining whether they are within the object and spirit of a particular statutory provision.

A statutory general anti-avoidance rule, is far more methodical and therefore ultimately more predictable, than a judicial anti-avoidance principle. A judicial anti-avoidance principle entails the additional uncertainty of unpredictable changes in the principle itself, in the hands of the judges, changes that are only announced after the fact. In the United Kingdom this phenomenon has been seen at a higher level in the changes in the direction in the House of Lords from *Furniss v Dawson* to *IRC v McGuigan*. In contrast a statutory general anti-avoidance rule may require judicial interpretation but the words of the statute still provide a firm foundation upon which the interpretation must be built (Roxan, 1998:148).

The aim of identifying the effectiveness of the judicial tests known as the Doctrine of “Substance over Form”, in combating tax avoidance was achieved in various stages. Firstly an analysis of the various judicial tests was undertaken to establish how they were applied and the level of success achieved by their application. A comparative analysis of the judicial approach to tax avoidance between the United Kingdom and South Africa revealed the differences and similarities between the tax jurisdictions and their effectiveness in dealing with tax issues. The preference of the general anti-avoidance rule in the South African Income Tax Act, where a more legislative route was undertaken by the South African government, showed how the provision can assist in reducing tax avoidance and limiting taxpayer uncertainty.

This study has shown that the uncertainty created in the United Kingdom by judicial activism and judicial legislation supports strongly the retention of a general anti-avoidance section, to act as a control measure on uncontrolled judicial activism. While the various applications of “Substance over Form”

used by the English courts have played a significant role in tax avoidance issues, they have also created much uncertainty for taxpayers when planning their tax affairs. A general anti-avoidance provision, following a legislative route, appears to be more consistent and effective in combating tax avoidance.

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