TAX- ADVANTAGEOUS FINANCING ARRANGEMENTS OF GROUP COMPANIES

BY

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INTRODUCTION

Real rates of income tax in South Africa are extremely high, to such an extent that taxpayers are continuously spending a lot of effort, time and money on taxplanning in an attempt to minimise their tax liabilities.

Tax planning has been described;

" .... as .... the management and arrangement of the affairs of ...., so as to legally minimise as far as possible and as cost effectively as possible, all taxes payable, within the constraints imposed by commercial and other objectives of that and associated taxpayers"[1]

As a result of such taxplanning, large amounts of tax are avoided legitimately, every year, by various classes of taxpayers through numerous tax-saving schemes. The objective of this dissertation is to investigate one such scheme, viz. the structuring of the financing arrangements of group companies in such a way as to facilitate the claiming (as a deduction for tax purposes) of the repayment of loans as well as interest thereon (in a group context). This dissertation will explore the legality of the scheme and secondly, if this scheme is found to be legal, to determine how far legislation would have to go before the State could successfully combat it.

These company groups[2] are aggressively exploiting deficiencies of the Act for their own benefit and the question that can be asked is whether it is merely a case of them ordering their *"......... affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. .... "*[3], or whether they are morally obliged to make a fair contribution to the

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1 Gavin Urquhart, The Taxpayer, September 1987.

2 Participants in these schemes are not only unscrupulous companies but include companies of all sizes, including well-reputed major blue-chip companies listed on the Johannesburg Stock Exchange. Furthermore, these schemes are more widely used than is commonly believed, as was confirmed by two financial institutions consulted with.

3 Lord Tomlin in Duke of Westminster v IRC 51 tlr 467, 19 TC 490 at 520. The dictum continues ***"If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he can not be compelled to pay an increased tax."***

fiscus commensurate to their incomes. A company or group of companies have the right to taxplanning and thereby minimising the tax liability, but is there a limit to tax avoidance, a Rubicon that can not be crossed. In other words **is there a fair share of tax?**

This dissertation would indicate that unless a scheme can be successfully attacked under specific provisions or under the anti-avoidance provisions of the Income Tax Act, there is very little that can be done against the corporate entities participating in these schemes. This was borne out by MacDonald JP[4] who, despite his strong words below;

> *(" I endorse the opinion expressed that the avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the fiscus, but the effect must necessarily be to cast an additional burden on taxpayers who, imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice and set up the necessary tax avoidance-machinery, fail to do so. Moreover the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that 'good citizens' will always fare badly. While undoubtedly the short term effects of the practice are serious, the long term effects could even be more so.")*

held that;

" The underlying assumption of....... those who call tax-avoidance (not tax evasion) an evil is that there is some norm or other representing a taxpayer's fair share of or proper contribution towards tax. The truth of the matter is that there is no such norm. A fair share or contribution is what taxing statutes say what it is. No more, no less. And tax avoidance cannot occur except in the circumstances laid down in the statutes."

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4 C.O.T v Ferera. 1976, 2 SA 653 RAD. Rhodesian case dealing with Section 103 equivalent.

CHAPTER I

SELECTION OF CASE STUDY

A scheme, recently announced[5], was chosen as subject for this dissertation. The text of the press announcement reads as follows;

" Raising of R100 million secondary capital

*...... *Ltd* **(SubCo)** *a wholly owned subsidiary of ...... *Ltd* **(HoldCo)** *has raised R100 million in the form of a 5 year subordinated loan which is convertible into ordinary shares of SubCo at the end of the period. HoldCo has paid R43 million to acquire the right to receive the ordinary shares in SubCo on conversion of the loan at the end of the period and accordingly, the HoldCo shareholding will remain 100%."*

(* The names of the companies concerned have no relevance)

From the announcement it was furthermore clear that a Merchant bank (BANK) lent the money to SubCo and entered into an agreement with HoldCo to buy back the shares in SubCo for delivery after five years.

In schemes of this nature it is common practice to create structures, much more complex than the above, involving several subsidiary companies as well as trusts, interest rate swaps etc. For the purposes of this dissertation it was decided to analyse this more basic structure as;

- **a more complex structure should not materially change the tax position of the group.**
- **specific legislation designed to counter avoidance through such schemes would stop these schemes regardless of the number of intercessionaries.**

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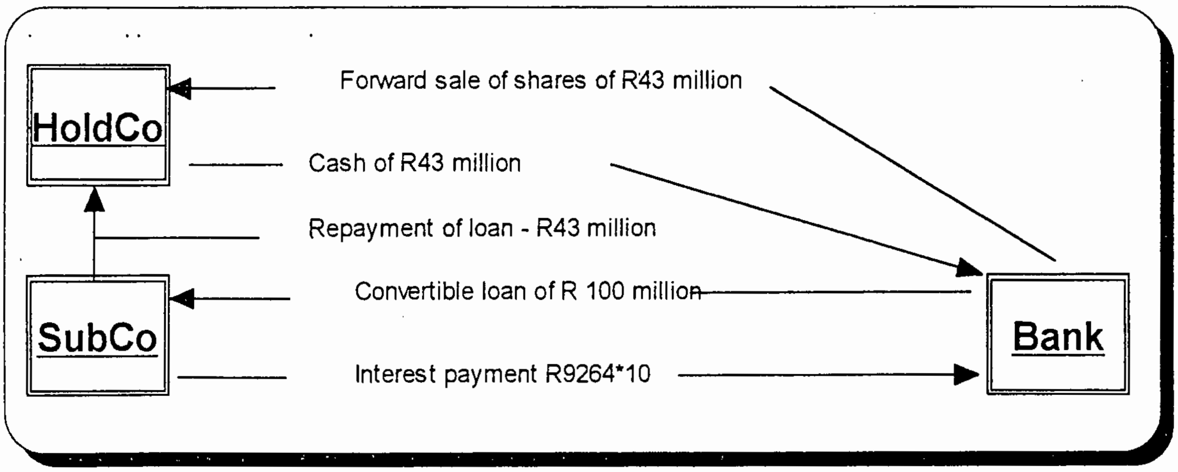
[5] Business Day of 4 March 1997.

1. Structure of financing scheme

From the above, subsequent investigations[6] and some conjecture it would appear that the financing arrangement was structured as follows;

- ◆ SubCo required funding of R57 million for working capital purposes.
- ◆ SubCo will be in a tax paying position for the duration of the loan.
- ◆ HoldCo has a loan into SubCo of at least R43 million.
- ◆ SubCo received a loan of R100 million from BANK. This loan is convertible into ordinary shares of SubCo at the end of the period.
- ◆ SubCo issues 10 promissory notes[7], on day 1 of the transaction, for R9.012.716[8] each, payable semi-annually, to facilitate the (purported) payment of interest on the amount of R100 million (whereas in fact to pay interest and capital in respect of the amount of R57 million).
- ◆ SubCo repays R43 million of its loan to HoldCo on day 1 of the arrangement.
- ◆ HoldCo pays R43 million on day 1 (discounted present value of market value) to BANK to acquire the right to receive the ordinary shares in SubCo on conversion of the loan at the end of the period.

2. Diagrammatic presentation of proposed structure



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6 Information received from Coronation Holdings Limited.
7 Promissory note is hereinafter referred to as PN or if in the plural PNs.
8 Amount estimated at 17.7851% NACM (nominal annual compounded monthly rate).

3. Tax effect of financing scheme

The effect of this scheme is that the group has effectively borrowed R57.000.000 at an after tax rate of 2.4% and tax of R19.950.000 is lost to the State as is indicated in the tabulation below.

Effect of scheme	Convertible Loan kR	Conventional loan kR	Difference kR
Net funding received	57000000	57000000	0
Repayments @ 17.51% NACM	90127155	90127155	0
Cash outflow before tax	33127155	33127155	0
Tax at 35%	31544504	11594504	19950000
	1582651	21532651	-19950000
After tax IRR (NACM)	2.40%	11.80%	9.40%

The tax savings of the individual group companies, under a structured convertible loan as compared with a conventional loan are as indicated in the tabulations below. As is illustrated, the tax saving under the convertible loan is very significant. Due to the fact that 'capital' as well as interest is deductible under the convertible loan the amount deductible from other trade income is three times higher than would have been the case under a conventional loan.

Group tax - conventional loan	Tax SubCo kR	Tax HoldCo kR	Total kR
HoldCo loan	43000000	-43000000	
Other loan	57000000		
MCM	0		
Total loans	100000000	-43000000	57000000
Interest @ 17.51% NACM	58117816	-24990661	33127155
Tax at 35%	-20341235	8746731	-11594504

Group tax - convertible loan

HoldCo loan	-43000000		
Other loan		0	
Bank	100000000	0	
Total loans	57000000	0	57000000
Repayment @ 17.51% NACM	90127155	0	90127155
Tax at 35%	-31544504	0	-31544504
TAX DIFFERENCE	11203269	8746731	19950000

4. Disclosure in the financial statements

Below is an analysis of the disclosure requirements of The Companies Act[9]. The 4th schedule of the Companies Act [10] as summarised by G. Everingham[11] prescribes *inter alia* that the following information in respect of **long term liabilities** be disclosed;

- para 15(b) - rates of interest or basis of determination thereof and dates and amounts of repayment.
- para 17 - liabilities secured by encumbrance over assets. - the amount, the liability and the asset.

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9 Companies Act, 1973 as amended.

10 Schoeman, T. Revising editor Geach, W.D. Guide to the Companies Act and Regulations. 1993. Juta & Co. Ltd.

11 Everingham, GR. Corporate Reporting. 1993. Juta & Co.

- para 15(c) - interest-bearing long term liabilities.
- capitalised leasehold liabilities.
- para 14 - convertible instruments and debentures.
    - amount and classes.
    - consideration received when issued.
    - dates and conditions of conversion.
    - details of convertible instruments and debentures granted during the year.

The 4th schedule subscribes that in relation to interest in subsidiaries there shall be shown;

Para 23

- Interest in shares.
- Indebtedness by subsidiaries

Para 58

- Group financial statements shall as far as possible comply with the above requirements.

The financial statements, the effect that the transaction in question has thereon and the relevant notes to the financial statements of SubCo, HoldCo and the Group Consolidated Financial Statements are reflected in the tabulation below.

HoldCo balance sheet	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Non-distributable reserves			-11	-22	-34	-46	-57
Loan to SubCo		43	0	0	0	0	0
Investment in SubCo	a		54	66	77	89	100
HoldCo income statement							
Interest on loan		-5	0	0	0	0	0
Tax payable		3	0	0	0	0	0
Notes to financial statements	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Investment in shares at valuation . Note that the number of shares need not be disclosed but only the value of the shares.	a		54	66	77	89	100
SubCo balance sheet	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Share capital	b						-100

Loan from HoldCo		-43	0	0	0	0	0
Short term loan		-57	0	0	0	0	0
Long term loan from Bank	c	0	-100	-100	-100	-100	0
SubCo income statement							
Interest on loan		12	12	12	12	12	12
Tax reduction		-4	-4	-4	-4	-4	-4
Notes to financial statements	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Increase in shares issued.	b						100
Convertible instruments;			100	100	100	100	
◆ Details of convertible instruments granted.	c						
◆ Consideration received when issued.							
◆ Dates and conditions of conversion.							
◆ Details of convertible instruments granted.							
Long term liabilities;	c		100	100	100	100	
◆ BANK has agreed to apply the proceeds of the loan redemption to the subscription of ordinary shares in the company at end of year 5.							

Consolidated balance sheet	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Non-distributable reserves			-6	-10	-19	-26	-32
Short term loan		-57	0	0	0	0	0
Long term loan	d	0	46	34	23	11	0
Consolidated income statement							
Interest on loan		7	7	7	7	7	7
Tax reduction		-1	-4	-4	-4	-4	-4
Tax reduction		-4	-4	-4	-4	-4	-4
Notes to financial statements	Note	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Long term liabilities;	d		X	X	X	X	
◆ Bank has agreed to apply the proceeds of the loan redemption to the subscription of ordinary shares in the company at end of year 5.							

Conclusion

As can be seen from the above, only certain of the elements of the scheme are required to be disclosed. Unless both group companies are registered at the same Revenue office and the same Assessor assesses both of the companies, it is unlikely that the full consequences of such a scheme will be detected from a reading of the financial statements. Although the above would appear to be the minimum disclosure requirements, in terms of the Companies Act, a perusal of the financial statements of two blue-chip companies (audited by big-5 auditing firms), participating in such schemes, revealed that much less information than the above was disclosed.

CHAPTER II

THE LEGALITY OF THE SCHEME IN TERMS OF THE INCOME TAX ACT[12]

THE DEFINITION OF GROSS INCOME AND THE GENERAL DEDUCTION FORMULA

It was held by de Villiers, CJ[13] that;

"A company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter. To say that a company sustains a separate persona and yet in the same breath to argue that in substance the person holding all the shares is the company is an attempt to have it both ways, which can not be allowed".

The tax positions of the two companies therefore have to be considered separately and independent of each other.

A. Position of HoldCo

The transaction

HoldCo acquires shares in SubCo from BANK on the first day of the contract for delivery after 5 years. HoldCo pays R43 million for the shares on day 1. The amount of R43 million represents the current market value of the shares discounted at 15.5% per annum which is presumably a reasonable rate. The current market value of the shares is R100 million.

Acquisition of shares

If the acquisition of shares, or any gain in relation to the purchase of the shares, has to be subjected to tax it has to fall within the ambit of the definition of gross income[14], which is defined as follows;

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12 Income Tax Act No. 58 of 1962 as amended, hereinafter referred to as the Act.

13 Ochberg v CIR. 1931, AD 215 5 SATC 93.

14 In section 1 of The Act.

"the total amount in cash or otherwise received by or accrued to ...... during such year of assessment ..... excluding receipts or accruals of a capital nature. .... Provided that where during any year of assessment the taxpayer has become entitled to any amount which is payable ...... after ..... such year, there shall be deemed to have accrued to him during such year .... such amount."

From the above it is, therefore, clear that the general rule is, that in the absence of either a receipt or an accrual[15], there can be no amount that can be subjected to tax, regardless of whether or not the taxpayer received a benefit. This accrual rule therefore determines that an amount to which the taxpayer is entitled, but which is payable after the end of the year of assessment, is deemed to have accrued during the year of accrual as opposed to the year in which the amount is actually received.

It was further held[16] that income must be ***"received by the taxpayer on his own behalf and for his own benefit."*** It is, furthermore, important to note that it is only an accrual relating to a specific tax year that is included in that tax year's taxable income.

If it is possible to tax any receipt or accrual in relation to the acquisition of the shares by HoldCo, it would have be the "gain" of R57 million between the R100 million market value of the shares and the amount of R43 million that HoldCo has paid for it.

The questions that need to be addressed in this respect of the <u>definition of gross income</u> are the following;

<u>1. Can the amount of R57 million be regarded as a receipt or accrual?</u>

The "gain" of R57 million will arise as a result of the effect of inflation on the value of money over time (time-value of money). Two logical arguments spring to mind in this respect;

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15 In CIR v Delfos. 1933, AD 242 6 SATC 92. De Villiers JA held that there ***"..... is, .. a 'necessary implication' that the same amount shall not be taxed twice in the hands of the same taxpayer, ..."***

16 Geldenhuys v CIR, 1947, (3) SA 256 (C) 14 SATC 419.

a) Contention 1. No benefit was obtained

No benefit was obtained as HoldCo's holding in SubCo, before and after the transaction, remained 100% of the total shareholding of SubCo. This argument is problematic as in Ochberg v CIR[17] it was held that; **whether a taxpayer received a benefit is immaterial, merely whether there was a receipt or accrual.** No further consideration will therefore be given to this proposition.

b) Contention 2. The shares were acquired at its full value and that there is, therefore, no receipt or accrual of income.

This proposition needs further consideration as it is factual that HoldCo will gain R57 million in current money terms at a pre-determined time in the future.

1.1. Does the Act accept the present/future value concepts ?

As contended earlier, the gain arises as a result of an increase in the value of an asset, due to the deterioration in the value of money over time, and the question that has to be answered in this respect is whether the Act recognises the time-value concept of money.

As is evident from the cases quoted hereunder, the ordinary consequence of the accrual rule in terms of the definition of gross income is that income will be recognised in the year when the;

- the taxpayer first becomes unconditionally entitled to it.
- the amount is payable after the year end.

According to Silke[18], as the "..... ***extraordinary consequence of the operation of the accrual rule shows, it is not merely a timing rule but also a valuation rule. Its further purpose is to include in gross income the full (nominal) value of any accrual outstanding at the end of the year, as opposed to some discounted value of such an accrual. This conclusion flows from the fact that the extraordinary consequence of the operation of the rule will be triggered only, if on or before 23 May 1990, a taxpayer has submitted a return. ...... In***

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17 Ochberg v CIR. 1931, AD 215 5 SATC 93. The taxpayer was, with the exception of a few minor shareholders, the only shareholder in a company. The unissued share capital of the company was issued to him for services to be rendered. He also pledged credit on behalf of the company and transferred a lease with the SA Railways at no cost to the company. It was the taxpayer's contention that as he virtually owned 100% of the company, he obtained nothing which can be taxed.

18 Silke on South Africa Tax edited by A de Koker. Butterworths. At 2.6.

other words, if the taxpayer discounted all his accruals ...... to their present value .... it is that present value - as opposed to their nominal value - that will be deemed to have accrued to him".

An early reference, in a prominent tax case, to the concept of the time-value of money was made in Lategan v CIR[19], in which case Watermeyer J held, with regard to money which accrued in one year but was received in a future year, that, " ***something must be deducted from their face value to allow for the fact that they were not payable at the close of the year assessment***".

In CIR v People's Stores (Pty) Ltd[20], a pre-eminent tax case in the sphere of receipts and accruals, this was confirmed and the Appellate Division of the Supreme Court, in effect, ruled that, if income receivable at a future date had accrued, the amount must be taxed at the net present (discounted) value.

The decision was based on the following propositions;

- ◆ Income, although expressed as an amount, need not be an amount of money but can include any kind of property, corporeal or incorporeal such as debts, rights of action and entitlements etc.
- ◆ All that is required is that the taxpayer has become *unconditionally entitled* to the amount, and any right to which a money value can be attached is an accrual regardless of when it becomes enforceable. This proposition is a practical application of the first.
- ◆ If the amount is received in future the value is affected. This principle is inseparably linked to the first two.

The time-value-of-money concept was, however, put beyond reproach in 1990, when the first proviso to the definition of gross income was enacted to include future "entitlements" at full value. In a press release[21] preceding this change in legislation the following was cited as reasons why discounting of an amount due had never been acceptable to Inland Revenue;

- ◆ practical problems in determining the present value of amounts payable in the future.

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19 Lategan v CIR. 1926, CPD 203 2 SATC 16).

20 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

21 Press release of the Deputy Minister of Finance dated 28 May 1990.

- subjective factors on which discounting is dependent making the requirement of certainty unattainable.
- the possibility that the difference between a subsequent payment and the original discounted amount might not be taxable at all.

For the sake of completeness, it must be mentioned that the first proviso to the definition of gross income is not the only indication that the time-value of money concept is not recognised by the Act. Further indications are that;

- Goods as trading stock. In terms of section 22 (1)(a) trading stock is included in taxable income at the lower of cost or net realisable value, i.e. cost less deterioration. An increase in the value of stock, due to monetary inflation over the period the asset was owned, will be disregarded for tax purposes.
- Shares as trading stock. Shares, being trading stock of a sharedealing company, carried forward to the next year shall be brought to account at the cost thereof. Again an increase in the value of stock will be disregarded for tax purposes and, furthermore, so will deterioration, in terms of section 22(1), if the market value of the shares is lower than cost.
- Other assets previously regarded as of a capital nature as trading stock. If land, for example, previously regarded as a capital asset, becomes trading stock as a result of a change of intention of the taxpayer, it is, in terms of section 22(2)(b), taken into account in the determination of taxable income at its cost at the time of acquisition. No allowance shall be made in terms of the Act for the increase in value since date of acquisition (regardless of the period of time) due to monetary inflation i.e. the increase in the value of the capital asset, before it became stock, will be disregarded for tax purposes.
- Capital assets such as plant or machinery used in the production of income.

Albeit for a different reason this is also the position with other capital assets such as plant or machinery used in the production of income. Para (n) of the Definition of Gross Income read together with section 8(4)(a) allows for recoupment of allowances which the taxpayer had previously deducted in terms of sections 11-20, 24D, 24F, 24G and 27(2)(b) and (d). The recoupment, however, can not be greater that the cost of the asset less the tax value. In other words if the proceeds from the sale of the asset, due to monetary inflation over the period of time the asset was owned, exceeded the cost price thereof, the difference between these two amounts is of a capital nature and not taxable.

The only instance where Revenue practice differs in this respect is that they use the present value (discounted at 11%) of future benefits under insurance policies ceded by employers to employees or where insurance policies are surrendered.

According to Silke[22] ***".... the proviso*** (to the definition of gross income) ***looks to the taxpayer's 'entitlement' at the year-end to an amount payable after the year-end. Why entitlement and not simply 'accrual'? No good reason is obvious other than a need to pay respects to the Lategan principle. ...... It cannot be that it prohibits the valuation of non-monetary accruals: an amount will always include both money and money's worth ..... and the proviso makes no specific reference to amounts expressed in money.***

If this argument is accepted the two requirements of the accrual rule (unconditional entitlement and payment at a future date) does not make provision for all possible outcomes and overlooks the meaning of the word "amount" which include money and money's worth. Silke goes on to say: ***The only possibility remaining that it represents a different type of timing rule; one governing not the time of inclusion (a trite question) but the time of valuation. But if this view is correct, important problems arise .... The second is the 'amount' payable at the future date .... This, if expressed in money .... would clearly be valued at its face value, ... But if the amount is money's worth, the odd outcome is that, at the year-end, the taxpayer would be required to look ahead to payment date to find some valuation. In other words, he would be required to discount forward under a provision intended to stop him from discounting backwards.***

In the Delfos[23] case it was determined that a non-cash accrual must have an ascertainable money value before it can be regarded as an accrual, and in the Lace[24] case the court held that

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22 Silke on South Africa Tax edited by A de Koker. Butterworths. At 2.11.

23 CIR v Delfos. 1933, AD 242 6 SATC 92.

24 Lace Proprietary Mines Ltd v CIR. 1938, AD 267 9 SATC 349. The court held that in order to determine the value of a significant number of shares one can not throw it all on the Johannesburg Stock Exchange on a specific date. That would seriously impact on the share

a reasonable method must be adopted to value shares which formed part of an accrual in terms of the definition of gross income. In determining a reasonable value of an asset with money's worth. Silke's contention above that a taxpayer must, by necessity, discount the value of an asset forward is contentious, there are too many other factors which plays a role in this respect.

In a commentary on the People's Stores case [25] Income Tax Cases and Materials[26], referring to the proviso with regard to future entitlements, contends that;

" It is considered that, notwithstanding the deeming provision in the first proviso ......, a different interpretation could be founded on the argument that the taxpayer is not 'entitled' to an amount payable in the future but merely to the (present) right to claim payment of that amount in the future. If such argument were sustained, then the right to which the taxpayer is entitled would, it is considered, have to be valued along the lines adumbrated by Hefer JA. "

This is a very interesting and logical argument, but until tested in the courts, it has no validity in law.

Conclusion

In the writer's opinion, as the law now stands, HoldCo would have a very serious problem if the transaction is found to be an accrual of a revenue nature. As part of the face value of the shares the amount of R57 million will then be taxable.

1.1.1. Is there a receipt or an accrual?

In the transaction under discussion, the taxpayer has acquired a right to purchase shares with a current market value of R100 million for R43 million. This right has vested in the taxpayer and it is furthermore possible that HoldCo may turn the shares into money by alienating its right to the shares, although this is inconsistent with the facts in the transaction under discussion and with the intention of the taxpayer at the time of entering into the transaction. Can the

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price. What has to be looked for is a person who is willing to buy wholesale at a price which will be less than the retail price, being the listed price.

25 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

26 Emslie, TS: Davis, DM; Hutton, SJ. Income Tax Cases and Materials. 1995. 2nd Ed. The Taxpayer, Cape Town.

transaction, because of the aforegoing, be classified as a receipt or accrual and if so in which year of assessment?

In Lategan v CIR[27] it was held that the words "***has accrued to or in favour of any person***" means to which a person became entitled to. The principle that emerged from this case and which was later referred to as the 'Lategan principle' is, that an **amount** of gross income **accrues** to a taxpayer **in** the **year** of assessment **in which he acquires the right** to claim payment in the future **and not in the year** in which **he** eventually **is entitled to** claim **payment**. This principle was later enshrined in the Act by the first proviso to the definition of gross income. In this case Watermeyer J held that the taxpayer "..... ***has acquired a right to claim payment of a debt in future. This right has vested in him, has accrued to him in the year of assessment, and is a valuable right which he could turn into money if he wishes to do so***" and "**.... *provided that a money value could be attached to it, then, on the premise of the first proposition the right formed part of his 'gross income'*** "

In terms of the Lategan rule, it is therefore important to determine that vesting of the right in a taxpayer has occurred and whether the right can be valued, and in the Mooi v SIR[28] it was held that an ***'amount .... accrued to'*** a taxpayer may constitute a right to which the taxpayer has become entitled. It was further held that although a taxpayer was entitled to a right all along it will only be taxable in the year the right becomes an **unconditional entitlement**.

The "Lategan principle', expanded on in the Mooi case remained somewhat controversial - as a result of cases such as Delfos, mentioned above, where this was not endorsed by the majority view - until confirmed by the Appellate Division in the People's Stores case[29]. In this case it was determined that an amount or a right is taxed in the year of assessment that it is received in or when it accrues, whichever event occurs first. The term 'accrual' was confirmed to mean to become **unconditionally entitled** to an amount.

In this case counsel for the taxpayer contended that in terms of section 7(1) the word **accrual** means **due and payable**. Section 7(1) provides that income " ..... ***shall be deemed to have***

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27 Lategan v CIR. 1926, CPD 203 2 SATC 16. At 209 - 210.

28 Mooi v SIR. 1972, (1) SA 675 (A) 34 SATC 1.

29 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalised by him or that such income has not been actually paid over to him but remains** <u>**due and payable**</u> **to him or has been credited in account or reinvested or accumulated or capitalised or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act." In an editorial article of <u>The Taxpayer</u>[30] discussing this case it was submitted that "..... ***Section 7(1) does not enlarge the meaning of the word accrue for it does not say that there shall be deemed to be an accrual in the circumstances set out but that there shall be deemed to be an accrual notwithstanding these circumstances.***" Hefer JA in <u>People's Stores</u> held that it is "...... ***not readily ascertainable what the purpose of..... Section 7 is.***" it "... ***merely list a number of situations in which the accrual of income is deemed not to be affected. But it seems to be clear, by virtue of the definition of 'gross income', that there would in these situations be an accrual in any event. Be that as it may, however, the Legislature plainly dealt ...... with postulated factual transactions, one of which is where income is not paid over to the taxpayer but remains due and payable to him. This does not justify the conclusion that the test of an accrual is that the income is due and payable.***"

<u>Conclusion</u>

From the above it is clear that a right is taxable when it becomes an unconditional entitlement for the taxpayer's benefit and not when it is due and payable. The settlement of the loan between <u>BANK</u> and <u>SubCo</u> by issuance of the shares to Bank becomes unconditional on the first day of the transaction, and so is <u>HoldCo</u>'s right to the shares. It is immaterial (in terms of the above) that the shares will only be delivered after 5 years.

It is therefore argued that a right has accrued to <u>HoldCo</u>, which if it conforms to all the requirements of the definition of gross income is capable of being taxed.

It needs mentioning, however, that one would normally expect, with a receipt or accrual, that an underlying asset has been sold or otherwise disposed of, and as a result that there has been

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30 The Taxpayer, April 1990 at 62.

a realised gain. In this instance the shares have not been sold but were purchased by HoldCo for the purpose of retaining 100% control in SubCo.

1.1.2. Is there an amount?.

A receipt or accrual must be capable of being valued and it must be noted that whereas, in terms of section 82 of The Act, the onus of proof with regard to all elements of the definition of gross income is on the taxpayer[31], the onus of proving an amount, in terms of cases such as CIR v Butcher Bros. (Pty) Ltd[32] and ITC 1545[33], is on the Commissioner.

An amount need not be an actual amount of money but, per Watermeyer J[34], can be ***"every form of property earned by the taxpayer, whether corporeal or incorporeal which has money value ..... including debts and rights of action"*** and according to Hefer JA[35]; ***"It must be emphasised that income in a form other than money must in order to qualify for inclusion in "gross income", be of such a nature that value can be attached to it in money. As Wessels CJ said in the Delfos case[36] ....***

> ***' The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money's worth or cannot be turned into money, it is not regarded as money' "***

1.1.2.1. Does the gain have a money value?

The general rule is that if an asset or right has accrued the value to be placed thereon is the value that could be obtained for it on the open market under a reasonable method of sale. (Refer the Delfos[37] and Lace[38] cases). Inland Revenue can not place an arbitrary or

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31 The reason for the onus being placed on the taxpayer is that he knows how his business transactions and how it relates to his income tax obligations.

32 CIR v Butcher Bros. (Pty) Ltd. 1945, AD 301, 13 SATC 21.

33 ITC 1545. 54 SATC 464.

34 Lategan v CIR. 1926, CPD 203 2 SATC 16.

35 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

36 CIR v Delfos. 1933, AD 242 6 SATC 92.

37 CIR v Delfos. 1933, AD 242 6 SATC 92.

38 Lace Proprietary Mines Ltd v CIR. 1938, AD 267 9 SATC 349. The court held that in order to determine the value of a significant number of shares one can not throw it all on the Johannesburg Stock Exchange on a specific date. That would seriously impact on the share price. What has to be looked for is a person who is willing to buy wholesale at a price which will be less than the retail price, being the listed price.

near-arbitrary value on the transaction, and even where it is Revenue's practice to place a value on certain accruals, (such as applying a formula in the case of cessions of insurance policies) if the taxpayer can demonstrate that the true market value is different the latter value must take precedence.

In the Lategan case[39] Watermeyer J held that if the taxpayer *"... **has acquired a right to claim payment of a debt in future. This right has vested in him, has accrued to him in the year of assessment, and is a valuable right which he could turn into money if he wishes to do so**"* In Mooi v SIR[40] it was held that for a right to be regarded as income it has to have money value. The fact that *"....... **the valuation may sometimes be a matter of considerable complexity (cf The Lace Proprietary Mines case[41] ...... at 279-281) does not detract that all income having money value must be included. How the valuation is done depends ..... on the nature of the income and the circumstances of the case.**"* [42]. In AJ Stander v CIR[43] it was held that an amount *"..... **had no 'value' in Stander's hands which brought it within the terms of ...... the definition of gross income**"* as there was no basis on which money's worth could be attributed to the amount.

From these cases it is clear that unless an amount can be valued, i.e. unless money or money's worth can be attached to it, it is not competent of being taxed. In the transaction under discussion the taxpayer has an unconditional right to the shares on the first day of the arrangement although it will only be delivered after 5 years. In the intervening period can it be

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39 Lategan v CIR. 1926, CPD 203 2 SATC 16.

40 Mooi v SIR. 1972, (1) SA 675 (A), 34 SATC 1.

41 The Lace Proprietary Mines (Pty) Ltd v CIR. 1938, AD 267 9 SATC 349. At 279-281.

42 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

43 AJ Stander v CIR. Case no A1264/95 CPD. Stander was employed by a Delta Franchisee as bookkeeper and received an overseas holiday as prize for submitting the best monthly financial returns to Delta. The court held that the trip could not be taxed under the general definition of gross income because it was of a fortuitous nature and therefore capital. It could also not fall under para (i) because Delta was not Stander's employer. For para (c) to apply there had to be an amount which had to be in respect of taxpayer's employment i.e. there have to be a causal link with services rendered. The court held that **an amount can be other than in cash** such as a right to which monetary value can be attached. There was no written contract of donation which the taxpayer could enforce and he could therefore not be said to have acquired a right. Even if a monetary value could be placed on the trip. Stander furthermore **did not receive property which could be turned into money's worth** and therefore had not received an amount which constituted gross income.

turned into money? The possibility exists that HoldCo may alienate its right to the shares (although inconsistent with the facts in the transaction under discussion and with the present intention of the taxpayer). The taxpayer can also use the asset for other purposes such as security for further borrowings.

In the event that the Commissioner contends, that, in view of the above, there is a gain that is capable of being taxed he would be called upon, as contended above, to place a value on the gain. As argued above it is the true market value that is relevant and an arbitrary valuation by Revenue will not suffice. If the following facts are considered;

- the taxpayer has become unconditionally entitled to a right in respect of an asset which will be delivered in future, i.e. the right has accrued to the taxpayer.
- the taxpayer paid a true market value, determined between unrelated parties, for the assets.
- in the fullness of time the asset will be delivered and at that stage the value thereof will be higher than what it was when the right to the asset was acquired i.e. a gain will be made.
- any gain must be taxed in the year it accrues and Revenue has no right to elect to tax a gain in a later year when more tax would be payable. (SIR v Silverglen Investments[44])

it would be very difficult for Revenue, if they disagree with the value placed on the transaction by unrelated parties, to determine the true market value. There is no apparent market for the share in which such a transaction can be tested.

No other possible method can be conceived that Revenue could use in determining the value, other than to discount the end-value of the transaction back to the present value (under an Act, and a section thereunder, which does not recognise the time-value-of-money concept), which is in any case exactly the basis used to determine the market value in the first place, meaning that there is no gain.

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44 SIR v Silverglen Investments. 1969, (1) SA 365 (A) 30 SATC 199.

Conclusion

In view of the above it is submitted that it will not be possible for Revenue to determine an amount that can be taxed.

1.1.3. Has the taxpayer become 'entitled' to a gain on which tax will become payable in a later year?

As argued above an amount can only be taxed in the earlier part of the year in which it is has first been received or it has first accrued. The Appellate Division of the Supreme Court has held in the Caltex case[45] that "***It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received and accrued .... during the year of assessment....*** ". Accruals other than in cash must therefore be valued on the last day of the tax year. The Appellate Division in the Silverglen case[46] held that an amount must be taxed in the year it is received or it accrued, whichever happens first. Revenue has no right in respect of disclosed accruals to elect to tax a person in a later year when more tax would be payable.

In the Lategan case[47], confirmed by the People's Stores Case[48] the court held that words "***has accrued to or in favour of any person***" merely mean to which he has become unconditionally entitled. In this respect it must be mentioned that the proviso to the definition of gross income was enacted to nullify the finding in the later case as regards the present valuing of an accrual that is receivable in the future. The proviso determines that where a taxpayer has become "***entitled to***" an amount there shall be "***deemed to have accrued***" the face value of the amount.

The words 'entitled to' is not defined in the Act and the question arises as to whether it has a different meaning than the word 'accrual' , and consequently represents an independent tax charging provision as opposed a qualification for the inclusion of future accruals. The latter seems more probable as is evidenced by the wording of the proviso which continues; "***there shall be deemed to have accrued***". It also bears mentioning that in a press release of the

45 Caltex Oil (SA) Ltd v SIR. 1975, SA 665 (A) 37 SATC 1.

46 SIR v Silverglen Investments (Pty) Ltd. 1969, SA 365 (A) 30 SATC 199.

47 Lategan v CIR. 1926, CPD 203 2 SATC 16.

48 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

Deputy Minister of Finance (dated 23 May 1990)[49], announcing the abovementioned change, it was stated that it was parliament's intention to submit legislation which will have the effect that: " ***The full value of a debt which becomes payable after the end of the year of assessment is included in ' gross income' in the year of accrual"*** It therefore seems unlikely that it was parliament's intention to create another tax charging device.

Conclusion

From the above it is clear, that as the amount accrued in the first year of the transaction it can only be taxed in that year and not in a later year.

1.1.3.1. Can the gain be regarded as realised and can it be turned into money?

HoldCo will receive the shares after 5 years. An increase in the value of an asset due to the passing of time (difference between the present and future values of the transaction) can not constitute gross income until such time as the asset has been disposed of and the gain has been realised. In this instance, HoldCo is not entitled to the gain and it will remain unrealised until the shares are eventually sold.

According to Silke[50] " ***.... an unrealised appreciation in the value of .... assets ..... can not lead to an inclusion in ... gross income, since the benefit arising does not constitute a receipt or accrual."*** Silke[51], illustrating examples in relation to the Lategan Principle, also held an "... ***unrealised appreciation in the value of stock-in-trade*** (an asset similar to the shares in this instance) ***is therefore not taxable until the seller has an enforceable right to claim payment of the proceeds (ITC 110 - 4 SATC 59)"***

1.2. Is the amount of a capital nature?

For income tax purposes income can only be of a revenue or of a capital nature. In Pyott v CIR[52] it was held that an amount can not be non-capital and non-revenue. Except for certain exceptions allowed for by the Act, amounts of a revenue nature are usually taxable and those of a capital nature are not taxable.

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49 Reproduced in The Taxpayer of May 1990 at 81.

50 Silke on South Africa Tax edited by A de Koker. Butterworths. At at 2.1.

51 Silke on South Africa Tax edited by A de Koker. Butterworths. At at 2.14.

52 Pyott v CIR. 1945, AD 128 13 SATC 121.

To distinguish the nature of a receipt or accrual, one has to look at the generally accepted test for amounts of a capital nature as laid down in CIR v Stott [53] and confirmed in CIR v Pick 'n Pay Employee Share Trust[54]. In these cases it was determined that the principal question to be established is whether it was the intention of the taxpayer to be involved in a scheme of profit-making, in which case any gain is of a revenue nature, alternatively it is of a capital nature.

The test employed by the court is, in the light of all relevant circumstances surrounding the acquisition, with what intention did the taxpayer acquire or hold the asset and whether the taxpayer has, for any reason changed his intention. In the first mentioned case the court held that it is ".... ***sufficient to say that the intention is an important factor and unless some other factor intervenes to show that when the article was sold it was sold in pursuance of a scheme of profit-making, it is conclusive in determining whether it is capital or gross income.***"

Conclusion

It is inconceivable that a profit motive could be ascribed to the transaction under discussion and the amount is therefore clearly not of a revenue nature and not taxable.

1.3. Can the amount of R57 million be regarded as compensation for the use of HoldCo's capital, i.e. as finance charges?

Can the 'gain' of R57 million be regarded as taxable compensation (finance charges) for the use of HoldCo's capital which would be settled by the delivery of the shares.

If Revenue was in a position, or had discretion, to change the nature of a transaction the position of taxpayers would be absurd. What would, for example, stop them from reclassifying dividends as interest. In CIR v Leydenburg Platinum Ltd[55] it was indeed held that the 'true

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53 CIR v Stott. 1928, AD 252 3 SATC 253.

54 CIR v Pick 'n Pay Employee Share Trust. 1992, (4) SA 39(A), 54 SATC 271.

55 CIR v Leydenburg Platinum Ltd. 1929, AD 137 4 SATC 8.

nature' of a transaction is a determining factor and Revenue cannot be allowed to reclassify a transaction in order to tax amounts which should not ordinarily be subjected to tax.

Conclusion

In the transaction under discussion the 'gain' represents an increase flowing from the value of money over time as a result of monetary inflation and the true nature of the transaction is the purchase of an asset for delivery after five years and not a loan. The amount is, therefore, not taxable in the hands of HoldCo.

1.4. Can it be said that there has been an allotment of rights or was there a sale of shares?

Has there been a realisation of allotment shares and does the realisation of such rights represent a disposal of the asset? It would seem that regardless of the answer to this question there has been an acquisition of shares by means of the exercising of the right and not a disposal.

1.5. If there is a gain, will it be taxed if the shares are sold after 5 years?

A gain will only be taxed if the amount thereof is not of a capital nature in terms of the basic test laid down in CIR v Stott[56]. The requirements for capital and revenue have been discussed above[57]. It would appear that the intention of HoldCo at the time of acquisition is to hold the shares. If the shares were sold after 5 years the amount would therefore not be taxable unless the taxpayer changed his intention in the intervening period.

1.6. Conclusion

It view of the above, it is submitted that there has not been a receipt or an accrual and, additionally the amount is not of a revenue nature and therefore is not taxable.

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56 CIR v Stott. 1928, AD 252 3 SATC 253.

57 Refer paragraph 1.1 of this chapter.

B. Position of SubCo

The transaction

BANK lends an amount of R100 million to SubCo on the first day. The loan is convertible into shares after 5 years. SubCo utilises R43 million of this amount to repay its loan from HoldCo on day 1 of the transaction and the balance will be utilised for working capital purposes.

2. Will interest be deductible in terms of sections 11(a) and 23(g)?

SubCo borrowed the amount of R100 million, for the purposes of obtaining additional working capital and replacing existing working capital. On the amount borrowed interest is payable and, for that to be deductible, it needs to pass the following requirements of section 11(a) read with section 23(g) of the Act. In terms of section 11(a) there shall be allowed; ***"expenditures and losses actually incurred in the Republic in the production of income, provided that such expenditure and losses are not of a capital nature"***. Section 23(g) determines that no deductions shall be made in respect of; ***"any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expensed for the purposes of trade"***

2.1. Expenditure and losses

The Appellate Division[58] of the Supreme Court has held that the distinction between the words expenditures (voluntary expenses for the purpose of trade) and losses (involuntary expenses such as bad debts, money stolen etc.) has no significance in itself as far as the deductibility thereof is concerned. Interest is paid for the use of money borrowed and is likened to rent paid for the use of someone else's asset and is inherently of a revenue nature (CIR v Genn & Co (Pty) Ltd[59]). It does not matter whether it is paid on funds borrowed to finance a capital asset or not.

2.2. Actually incurred in the year of assessment

In Caltex Oil (SA) Ltd v SIR[60] it was held that expenditure actually incurred meant ".... ***all expenditure for which the liability has been incurred during the year, whether the liability***

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58 New State Areas Ltd v CIR. 1946, AD 610 14 SATC 155.

59 CIR v Genn & Co (Pty) Ltd. 1955, (3) SA 293(A) 20 SATC 113.

60 Caltex Oil (SA) Ltd v SIR. 1975, (1) SA 665 (A) 37 SATC 1.

has been discharged in that year or not". Incurred during the year of assessment does not mean incurred in respect of the year of assessment e.g. deductible property rates which were incurred and were paid during a tax year can be deducted in full, in that year, even though part of it relates to the next fiscal year.

In Port Elizabeth Electric Tramway Co. Ltd v CIR [61] it was held that **actually incurred** does **not** mean **necessarily incurred** (The Commissioner can not impute income which he is of the opinion that the taxpayer should have earned had he conducted his business to the satisfaction of Revenue) or **actually paid but,** what it does **mean** is, that an **absolute and unconditional liability** must exist **in the year claimed**.

It was held that where the liability is conditional[62] on a future event or contingent[63] it will not have been "actually incurred" until the happening of that future event. With an amount, however, for which an unconditional liability exists but which cannot be quantified until after the end of the tax year, it would appear that an estimate would be in order. Where the actual expenditure is in excess of the estimate this excess will not be deductible in a future year as it will not have been "actually incurred" in that year. Unfair though it may seem, where an over estimate occurred this will be included in income in terms of section 8(4).

Amounts carried to a reserve fund has not been actually incurred and cannot be deducted. Furthermore, amounts capitalised or carried to reserves cannot be deducted in terms of section 23(e).

A taxpayer is therefore allowed to deduct amounts actually paid during the tax year or amounts still owing at the end of the tax year, provided that an unconditional liability exists. Actually incurred does not mean amounts that are due and payable (the taxpayer may have incurred a liability which is only payable after the year of assessment). In terms of the Definition of Gross Income an amount received in advance (before it has accrued) is taxable.

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61 Port Elizabeth Electric Tramway Co. Ltd v CIR. 1936, CPD 241 8 SATC 13.

62 Nasionale Pers v KBI. 1986, (4) SA 549 (A) 48 SATC 55.
ITC 1495, 1990. 53 SATC 216.

63 CIR v Edgars Stores. 1988, (3) SA 876 (A) 50 SATC 81.

This is not the case in terms of the General Deduction Formula and voluntary payments in advance are not deductible.

In order for expenditure to have been incurred, a clear legal liability must exist for the payment thereof in a particular tax year, (ITC 1094[64]) and such liability must not be the subject of any dispute, in which case it lacks the unconditionality required (ITC1499[65]).

In the transaction under discussion the position is quite straightforward. SubCo has a contractual and unconditional liability to pay the interest in question. The fact that PNs were issued to cover the original obligation will not detract from the fact that there is an unconditional underlying obligation and it shall also not effect the timing of the obligation. A PN is merely an instrument to facilitate payment of an obligation and a PN also settles the interest obligation. Refer to paragraph 2.2 of this chapter.

2.3. In the production of income

In terms of sections 11(a) and (b) only expenses incurred in the production of income is deductible and section 23(f) prohibits the deduction of expenses in relation to amounts received, which do not constitute income as defined in section 1 (gross income less exempt income and excluding amounts of a capital nature and amounts not from a South African source)

Schreiner, JA[66] held that ***" Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of income of the business, whether the loan was for the acquisition of fixed or floating capital"***

The test is not whether a ***"..... particular item of expenditure produced any part of the income"*** but ***".... whether the item was incurred for the purpose of earning income."*** [67]

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64 ITC 1094. 28 SATC 275.

65 ITC 1499. 1989, 53 SATC 266.

66 CIR v Genn & Co (Pty) Ltd. 1955, (3) SA 293 (A) 20 SATC 113.

67 Sub-Nigel v CIR. 1948, (4) SA 580 (A) 15 SATC 381.

In the Port Elizabeth Electric Tramway case[68] it was determined that the questions which must be asked in this respect are;

- Was the act to which the expense relates, performed in the production of income.
- Are the expenses so closely linked to the income earning act (of the business operation) as to be regarded as part of the cost performing it. According to Watermeyer, AJP *" .....all expenses attached to the performance of a business operation, bona fide, performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance, or are, bona fide, incurred for the more efficient performance of such operation, provided that they are so closely connected with it, that they may be regarded as part of the cost of performing it."*
- Expenses payable out of income after it has been earned, such as income tax, is not deductible.

As regards the closeness of the connection the Appeal Court[69] held that if it is *" ..... proper, natural or reasonable to regard the expenses as part of the cost of performing the operation"* it can be so regarded. In Joffe & Co. v CIR[70] the Appellate Division held that the expenditure have to be a *"necessary concomitant"* of the business operation before it can be regarded to be in the production of income.

In CIR v Allied Building Society[71] the court held that it was not the ultimate use or destination of funds borrowed that is the determining factor, as regards the deductibility of interest, but the true nature of the transaction, i.e. the purpose of the borrowing. It was also held in CIR v Standard Bank of South Africa Ltd[72] that the vital enquiry is the general purpose for which the money borrowed was utilised and what it actually effects.

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68 Port Elizabeth Electric Tramway Co. Ltd v CIR. 1936, CPD 241 8 SATC 13.

69 CIR v Hickson. 1960, (1) SA 746 (A) 23 SATC 243.

70 Joffe & Co. v CIR. 1946, AD 15 13 SATC 354.

71 CIR v Allied Building Society. 1963, (4) SA 1 (A) 25 SATC 343.

72 CIR v Standard Bank of South Africa Ltd. 1985, (4) SA 485 (A) SATC 179.

If the expenditure has been incurred with more than one purpose in mind certain courts[73] determined that the dominant purpose was the determining factor, whereas in other[74] courts apportionment was applied.

In terms of Practice Note 22 the following recurrent expenses, which is not in the production of income, such as cost of publication of financial statements, Johannesburg Stock Exchange fees and fees of the transfer secretaries are allowed in the ratio of income to gross income. In addition Revenue practice allows recurrent expenses, not incurred in the production of income, such as audit fees and accounting fees.

In the case under discussion the closeness of expenditure to the income earning operations and what it actually effects must be examined. It would appear that SubCo had a dual purpose for lending the money viz.

- to finance working capital requirements.
- to repay the HoldCo loan.

The first instance is undoubtedly in the production of income. In the second instance the money borrowed would replace money previously used for purposes of trade. In CIR v Sunnyside Centre (Pty) Ltd[75] the court confirmed that interest on a loan raised to repay an existing loan, used for business purposes, was deductible. If the interest on the existing loan was therefore allowed as a deduction, due to it being in the production of income (it is assumed that the loan did not arise as a result of unpaid dividends, in which case deductibility could be a problem), so also should the interest on any loan which replaced it. The interest payable on the borrowing in question is, therefore, clearly for the purpose of producing income and SubCo should have no problem in deducting it for tax purposes.

2.4. Not of a capital nature

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73 CIR v Allied Building Society. 1963, (4) SA 1 (A) 25 SATC 343.

74 SIR v Guardian Assurance Holdings (SA) Ltd. 1976 (4) SA 522 (A) 38 SATC 111.

75 CIR v Sunnyside Centre (Pty) Ltd. 1993, (3) SA 940 (T) 55 SATC 150. It must be noted that in appeal of this case, CIR v Sunnyside Centre (Pty) Ltd. 1996, SA 68 (A) 58 SATC 319, the appeal court held that the interest loss (less interest was paid than what was charged) was not deductible under the old section 23(g). The deductibility of interest up to the amount charged, however was never in contention.

As receipts of a capital nature is excluded from the definition of gross income, so is expenditure of a capital nature in terms of the general deduction formula. The Act does not define the term 'of a capital nature' and in Sub-Nigel v CIR[76] it was held that it actually is impossible to have a general definition that would cover all possible instances. In Tuck v CIR[77], it was determined that there is no halfway house between capital and revenue and that the apportionment of expenditure between capital and revenue is therefore possible.

The pre-eminent principal test for expenses being of a capital (or revenue) nature, determined in New State Areas (Ltd) v CIR [78], is the inquiry whether the expense or loss should properly be regarded as part of the cost of performing the income-earning operations of the taxpayer (i.e. of a revenue nature), or whether it is to enhance the income-earning structure of the taxpayer, in which case it is of a capital nature. In determining the nature of the expense the court first has to assess the closeness of connection between the expenditure claimed and the income-earning operations, having regard to the purpose of the expenditure and what it effects.

There are also other generally accepted tests for determining the capital nature or otherwise of an expense such as the enduring benefit test, the once and for all expenditure test. Such tests are, however, not as reliable as the New State Areas test.

The court held in CIR v George Forest Timber[79] that if a source of future profits is acquired or created the expense is of a capital nature. The cost of working the source is of a revenue nature. In the first instance it is spent to enable the concern to yield profits in the future and, in the second instance, for the present production of profits. Cost incidental to the performance of income producing operations was held[80] to be of a revenue nature.

In the case under discussion, the loan was incurred for the purpose of financing ongoing operations of SubCo. It is, therefore, clearly not of a capital nature.

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76 Sub-Nigel v CIR. 1948, (4) SA 580 (A),15 SATC 381.

77 In Tuck v CIR. 1988, (3) SA 819 (A) 50 SATC 98

78 New State Areas (Ltd) v CIR. 1946, AD 610 14 SATC 155

79 CIR v George Forest Timber. 1924, AD 516 1 SATC 20

80 COT v Rhodesia Congo Border Timber Co. Ltd. 1961, 24 SATC 602. It was held that roads constructed for the exploitation of timber was not of a capital nature.

2.5. For the purpose of trade

Trade is defined in section 1 of the Act as to include " ***every profession, trade, business, employment, calling, occupation or venture ..... "***. Section 11(a) determines that ***'amounts laid out or expended for the purpose of trade'*** is deductible from income. Section 23(g) limits such deduction ***'to the extent to which such moneys were not laid out or expended for the purposes of trade.'***

The United Kingdom courts[81] have held that ***'for the purposes of trade'*** means ***'for the purposes of earning the profits'***.

In the transaction under discussion SubCo's claim for interest, on a loan incurred for the purpose of providing working capital for the company is clearly for the purpose of trade.

An expense is only deductible if incurred in the taxpayer's own trade. In Solaglass Finance Co (Pty) Ltd v CIR[82] it was held that the provision of benefits to other companies in a group is not trade-related. In the case under discussion, however, it is not the capital repayment to the group company that is claimed but the interest on the loan paid to the financial institution. Part of the funds received will be used to repay funds that are currently being used for the purposes of SubCo's trade. Interest was presumably payable on the loan from HoldCo , which would have been deductible, and so should the loan that replaced it.

It must also be noted that even if it could be held that the whole transaction was for the purpose of securing a fiscal advantage it was decided Burgess v CIR[83] that if ***"...... a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not , in my view, cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage. If he carries on a trade, his motive for doing so is irrelevant. ...... the position***

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81 Inter alia Strong & Co of Romsey Ltd v Woodifield (Surveyor of Taxes). 1906, AC 448,5 TC 215.

82 Solaglass Finance Co (Pty) Ltd v CIR. 1991, (2) SA 257 (A) 53 SATC 1.

83 Burgess v CIR. 1933, (4) SA 161 (A) 55 SATC 185.

would be different if a transaction: ' is so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading section. [84] *".*

2.6. Conclusion

The interest is from a South African source, actually incurred, in the production of income, of a revenue nature and trade-related, and as long as the loan is used for SubCo's normal income earning trade interest on the loan will not attract tax.

3. Does the payment of interest by PN have relevance with regard to the deductibility of interest, taking into account the possibility that BANK may discount the bills with another financial institution?

PNs are used primarily to pay debts, give credit or make donations and give creditors an easily enforceable right of action against the debtor.

A PN is described in the Bills of Exchange Act[85] as *"An unconditional promise in writing made by one person to another, signed by the maker, and engaging to pay .... at a fixed .... future time, a sum certain in money, to a specified person or his order... "*

In an old but authoritative work on the subject Malan,FR[86] (at 21-22) held that PNs are " *delivered solvendi credendi donadi causa. In each of these instances the contract on the instrument is concluded with the intention of executing one or another underlying obligation between drawer and payee .... The contract on an instrument which is delivered for such purpose is an auxiliary agreement because it executes or reinforces the original or underlying obligation. The underlying obligation constitutes the causa of the contract on the instrument .... Although the contract on the bill is expressed unconditionally, and is directed solely at the payment of a certain unqualified sum of money, the parties do not usually intend their relationship to be governed only by the terms*

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84 FA & AB Ltd v Lupton (Inspector of Taxes). 1972, AC 634 (HL) 1971 3 All ER 948.

85 Act number 34 of 1964

86 Malan, FR assisted by de Beer, CR: Bills of Exchange, Cheques and Promissory Notes in South African Law. 1983: Butterworths. Durban.

of the instrument. .... the parties intend merely to execute or reinforce the underlying obligation, not to supplement it. For this reason the obligation between two immediate parties on a bill is called a formally abstract .... or dependent obligation."

Malan goes on to say *"The cambial obligation does not replace the underlying obligation. The two obligations co-exist and are cumulative because both are directed at payment of the same debt. Delivery of the bill in payment of a debt constitutes no novation of the original obligation because the parties do not as a rule intend to replace the original obligation by the contract on the instrument. ..... Payment of a debt by ..... note does not constitute a 'datio in solutionem', or performance by way of acceptance of a substitute, namely the instrument."*

This was confirmed in Adams v SA Motor Industry Employer's Association where it was held that "*There can be little doubt that - unless novation is intended...... - two obligations then co-exist.*"

3.1. Conclusion

From the above it is clear that in the circumstances of the case under discussion the cambial obligation has not replaced the underlying contractual obligation and therefore has no tax effect.

4. Will the conversion of the loan have any tax consequence?

On conclusion of the term of the loan BANK will be obliged to take up the shares in SubCo and, in doing so SubCo's liability of R100 million will be liquidated in full. The conversion of the loan into shares can therefore merely be regarded as the settlement of the loan, and circumstance under which it is likely that the conversion would have any tax consequences for SubCo in terms of the Act can not be forseen.

CHAPTER III

THE LEGALITY OF THE SCHEME IN TERMS OF THE TAX ACT (CONTINUED)

OTHER PROVISIONS OF THE ACT

1. Section 24J

The provisions of section 24J have no effect on the source or the capital and revenue provisions of the Act and regulates the deduction of 'interest' (interest, finance charges and discounts or premiums payable or receivable in terms of a financial arrangement) expenses with regard to various types of financial 'instruments'.

Section 24J(1) defines the term 'instrument' as any interest-bearing arrangements, including *inter alia*, loans, advances, debt, debentures promissory notes, rights to receive interest, and an 'instrument' would therefore require:

- A debtor creditor relationship.
- Interest payable on the debt.
- Interest in the nature of sub-section 1.

The applicability of section 24J is considered in relation to the following;

1.1. Loan agreement between SubCo and BANK

There is an obligation on the part of SubCo to pay interest on the loan of R100 million from BANK. According to the provisions of section 24J this interest-bearing loan will qualify as an instrument and the deductibility of interest payable on this loan will therefore be determined under the provisions of this section.

SubCo is the 'issuer' in terms of section 24J(2) and the interest liability incurred and ranking as a deduction for tax purposes or 'accrual amount' will be determined by section 24J(1) in terms of a prescribed formula provided for under the definition of 'accrual amount'. The result of this formula is that both the incurral and accrual of interest is on a day-to-day (yield-to-maturity) basis.

At the end of 5 years SubCo will settle the loan by the allotment of shares.

1.2. PNs issued by SubCo in favour of BANK

PNs are specifically included as a financial instruments in terms of section 24J. The PNs were issued to facilitate payment of the underlying obligations in respect of the abovementioned loan agreement which is deductible on a yield-to-maturity basis.

A question which arises is whether issuance of the PNs can be regarded as a 'redemption' in terms of section 24J? From the discussion above it is clear that the underlying liability and the contract on the PN co-exist and the liability is not redeemed by the issuance of a PN.

1.3. Repayment of the loan

The 'redemption' of the loan after 5 years will be at full value (i.e. shares to the value of R100 million) and the provisions of section 24J with regard to the settlement of a loan at a discount or premium will not be applicable.

1.4. Issuance of shares

Ordinary shares are not interest instruments in terms of this section. If preference shares were to be allotted the same would apply as there is no interest bearing arrangement present. Furthermore there is no element of financing to which interest could apply, as the amount of R100 million is the full value of the loan at the market value of the shares and there is therefore no "discount" or "premium" which could be deemed to be an accrual of 'interest' in respect of SubCo in terms of section 24J. Subsection (4) determines that where a gain is realised on 'redemption' of an instrument (the loan) the gain shall be deemed to have accrued to the taxpayer in that year of assessment (year 5).

It is unlikely that the sale of the shares can be regarded as a financing arrangement and growth in the value of shares as compensation for the provision of finance, furthermore the indebtedness for the sale of the shares was settled on the first day of the arrangement and there is no amount outstanding which could bear interest.

There would appear to be no decided cases or other authority in this regard as section 24J is a newish addition to the Act.

1.5. Can the conversion of the loan be regarded as convertible debentures and if affirmative will there be any tax consequence?

1.5.1. Definition of and general attributes of debentures

Debentures form part of the external equities of a company are usually procured for the purpose of obtaining long term finance. In Coetzee v Rand Sporting Club[87] the Judge held that "***I think the word imports, an acknowledgement of debt.***"

The Companies Act does not define debentures but merely states that debentures include "**.... *debenture stock, debenture bonds and other securities of a company, whether constituting a charge on the assets of the company or not.*"** [88] and "***...... embraces all debt issues whatever the name, by a company, and that the statutory provisions governing debentures can now not be avoided by calling the debt issue by another name, for example notes, bonds or loan stock. .... In ordinary commercial usage the term debenture denotes a document or certificate issued by a company designating itself a debenture, which acknowledges the indebtedness of a stated sum of money , and specifies the rate of interest and the repayment date(s) and conditions of repayment***"[89]

Debentures can only be created if authorised by a company's memorandum and articles of association and normally flow from a contract between the company issuing the debentures and investors via a debenture trust. The debenture contract will specify interest rates and terms of redemption. Convertible debentures are convertible into other securities such as shares or preference shares.

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87 Coetzee v Rand Sporting Club. 1918, WLD 74.

88 Section 1 of The Companies Act of 1973 as amended.

89 Celliers, HS; Benade, ML; Henning, JJ; Du Plessis, JJ: Corporate Law. 1992. 2nd Ed. Butterworths Durban. At 230.

1.5.2. Position of SubCo

There would be no difference between the tax treatment of loans and debentures. Interest is deductible on a yield-to-maturity basis over the period of the instrument.

1.5.3. Position of HoldCo

Is it possible that any court, on the basis of the substance-over-form doctrine, can disregard the role of Bank and hold that what HoldCo, in effect, has bought for R43 million, was not the right to obtain shares to be issued in 5 years, but compulsory convertible debentures and that the amount of R57 million represents interest thereon?

It is inconceivable that the above could be held to be the true nature of the transaction (which is the determining factor - CIR v Leydenburg Platinum Ltd[90]).

2. Section 103(1)

Whenever, in the opinion of the Commissioner for Inland Revenue, any transaction, operation or scheme is regarded as having been carried out in a manner which has the effect of postponing, reducing or avoiding tax[91], there is a possibility of section 103(1) being invoked. It is immaterial whether the tax liability is unconditional or anticipated[92]

2.1. Commissioner's powers under section 103(1)

In the event that this section is invoked the Commissioner can not impute rights and obligations that did not exist under an agreement but the Commissioner can;.

- disregard the transaction, operation or scheme in determining the taxpayer's taxable income on the basis that it did not take place at all. It must, however fall within the general scope of the Act (ITC963[93]).
- in his own discretion, do this in such a manner as to minimise the loss to the fiscus (Smith v CIR[94]).

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90 CIR v Leydenburg Platinum Ltd. 1929, AD 137 4 SATC 8.

91 All taxes administered by Revenue.

92 Hicklin v SIR. 1980, (1) SA 491 (A) 41 SATC 179.

93 ITC963. 1961, SATC 705.

94 Smith v CIR. 1964, (1) SA 324 (A) 26 SATC 1.

- disregard the whole transaction rather than just the parts that are objectionable (Meyrowitz v CIR[95]).
- disregard the transaction, operation or scheme in determining the taxpayer's taxable income, not only for the current year but for all future years on which it has an effect.

2.2. Requirements of section 103(1)

In order for section 103(1), as amended by the 1996 Income Tax Amendment Act[96] to apply, and in addition to the precondition that there must be an amount, it is essential that all of the following distinct requirements must be present[97];

1. there must be a transaction, scheme or operation.

2. the transaction (et seq.) must have the effect of postponing, reducing or avoiding tax.

3. the transaction (et seq.) must have an element of abnormality in that;

- the scheme was carried by a means or a manner which would not normally be employed in *bona fide* business transactions other than for the obtaining of a tax benefit.
- the scheme has created rights not normally created in arm's length transactions between unrelated parties.

4. the transaction, scheme or operation must be solely or mainly for the purpose of avoiding tax.

In terms of the section the four requirements are conjunctive to each other, i.e. all four must co-exist and if one is absent Revenue is precluded from invoking the section. According to Kroon, J[98] the normality requirement is set disjunctively and if abnormalcy is present it would be enough for Revenue to invoke this section.

2.2.1. Onus of proof

In terms of section 82, the burden of proof with regard to any claim, exemption from tax, non-liability of tax, deduction, abatement, or set-off rest on the taxpayer and, on any appeal

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95 Meyrowitz v CIR. 1963, (3) SA 863 (A) 25 SATC 287.

96 1996 Income Tax Amendment Act No 36 of 1996

97 This principle was confirmed in SIR v Geusteyn, Forsyth and Joubert 1971(3) SA 567 (A), 33 SATC 113 and a number of other cases.

98 Case No. 10229. 1997, Income Tax Special Court, Port Elizabeth.

of any decision the decision shall not be reversed unless it is proved, on the balance of probabilities, by the appellant that it was wrong. Section 103(4) determines that a decision of the Commissioner, in terms of sections 103(1), (2) and (3) is subject to objection and, if it is proved that the transaction operation or scheme would result in avoidance, it shall be subject to a **presumption**, that until the contrary is proved, it was carried out mainly for the purpose of tax avoidance. This presumption is rebuttable and the onus is on the taxpayer to rebut the transaction to the satisfaction of the court

Therefore, there is an onus on Revenue to proof that there has been a transaction, operation or scheme entered into or carried out by means or in a manner which would not normally be employed in entering into or carrying out of a transaction, operation or scheme, or which created rights or obligations which would not normally be created in arm's length transactions, or which has resulted in avoidance or postponement of tax.

In ITC1155[99] it was held that the onus of proof was on the Commissioner, however, "....... *goes somewhat further than establishing the existence of a scheme which has or had the effect of avoiding the tax concerned or reducing the amount thereof. He must also establish that the scheme was entered into or carried out by means of or in a manner which would not normally be employed in the operation of a scheme ..... or has created rights and obligations which would not normally be created between persons dealing at arm's length ......*"

Kroon, J[100] held that; " *In my judgment, looking fairly at section 103 in its entirety , and in particular subsections (3) and (4), the correct interpretation of the section is the following: The section, being a particular provision, is removed from the application of the general provision contained in section 82; the primary onus of proving fulfilment of the four requirements posed in section 103(1) rests on the Commissioner; the provision relating to proof that the effect of a transaction was tax avoidance contained in subsection (4) (a burden, as explained earlier, rests on the Commissioner), did not effect an incidence of onus that would otherwise not have been there, but rather recognised where the onus*

99 ITC 1155. 1971, 33 SATC 1133.

100 Case No. 10229. 1997. Income Tax Special Court. Port Elizabeth.

already lay; the presumption in subsection (4) was an aid in proof to assist the Commissioner to establish one of the matters he is required to establish."

The deeming provision in subsection (3) is not as harshly stated as the presumption in subsection (4) in that it is not inconsistent with the argument that the onus in this respect was on the taxpayer, and the argument that the onus can not be discharged unless the taxpayer also established that the transacting parties were dealing at arm's length.

Kroon, J held in this respect: *"It seems to me, however, that in the light of the interpretation of subsection (1), i.e. as regards onus, flowing from the provisions of subsection (4), it would be more consistent to view the deeming provision as an aid in proof for the assistance of the Commissioner and the provision concerning proof by the taxpayer of the independence of the parties and the arm's length nature of their transaction as being tantamount to requiring the rebuttal of presumption. The question may also be asked why, if the onus of disproving abnormality rests on the taxpayer, subsection (3) did not provide that in relation to the circumstances referred to in the section, that onus would not be discharges unless the taxpayer also proves the independence of the parties and the arm's length nature of their dealings. There is therefore no room for placing the onus on the taxpayer to disprove the existence of any one of the four requirements"*

This approach is consistent with the ruling in Guestyn, Forsythe and Joubert[101].

2.2.2 The substance of the composite transaction

Zulman, J[102] held that; "*In the instant case it seems to me that it is totally artificial to truncate the four contracts in each of the two sets of contracts and to look only to the lease contracts between the appellants and the pension fund. To do this is to view the matter with blinkers on and to lose sight of the reality of the matter and to introduce what is an artificial construction of what is one transaction only.*"

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101 SIR v Guestyn, Forsythe and Joubert. 1971, (3) SA 567 (A), 33 SATC 113.

102 Cases No. 9592 and 9593, 1993. Income Tax Special Court. Transvaal.

The substance of a transaction, as opposed to its form is important and in the words of Mellamet J[103]. ***"Dit is 'n bekende beginsel in die inkomstebelastingreg dat die klem gelê word op die substansie van die transaksie en nie die regsvorm waarin dit geklee word nie".***

In an attempt to address this the 1996 Tax Amendment Act[104] introduced the business test to section 103(1), ostensibly it would seem, to look at the substance of a transaction or series of transactions rather than the form.

2.2.3. The effect of the transaction is avoidance of the liability for tax

The meaning of the word avoidance, would include legal avoidance of the person who orders his affairs in such a way as to pay the least amount of tax, subject thereafter to the purpose and normality requirements.

In the second Ferera case[105] McDonald, JP in relation to the Rhodesian equivalent of section 103 held that it ***" would be absurd to suggest that the legislature, in attacking this evil, could possibly have attended to leave unscathed taxpayers who frankly admit that the transaction ..... has its sole purpose the avoidance ...... of tax"***

This view has not found support in South African courts.

In the Louw case[106] Justice Corbett adopted a "but for" test and his enquiry was, but for loans (received by shareholders of a company in place of salaries previously received in a partnership which was converted into a company) which had some abnormal characteristics, equivalent amounts would probably have been received in a taxable form. The conclusion that, but for the loans the taxpayer probably would have received a taxable amount is sufficient to show that the effect of the transaction was the avoidance or postponement of the liability for tax.

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103 ITC 1518. 1989, 54 SATC 113. Mellamet cited as authority SIR v Sidley. 1977, (4) SA 913 (A) 39 SATC 153 CIR v General Motors SA (Pty) Ltd. 1982, (1) SA 196 (T) 43 SATC 249.

104 Act no. 36 of 1996.

105 COT v Ferera. 1976, (2) SA 653 R.AD.

106 CIR v Louw. 1983, (3) SA 551 (A) SATC 113.

2.2.4. Purpose requirement

The words "solely" is defined[107] as "alone, only, exclusively" and "mainly" as "chiefly, principally". These two words are adversative, as "solely" denotes fullness, whereas "mainly" denotes a measure of more than half. This is addressed in the Lourens Erasmus case[108] in which it was held that the word "mainly" lays down a quantitative standard of more than 50% and the use of the alternative, "solely" does not derogate therefrom, but is in fact superfluous and meaningless, disrespecting a cardinal rule of interpretation that a statute should be constructed in such a way that no clause, sentence or word shall be superfluous, void or insignificant.

According to Meyerowitz and Spiro[109] ***"...... even where tax avoidance is one of two or more purposes in entering into or carrying out a transaction, section 103(1) will not apply unless tax avoidance was the dominant purpose."***

Furthermore in IRC v Brebner [110] it was held that ***"........ when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out, - one by paying the maximum amount of tax, the other by paying no, or much less, tax - it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course, one of the main objects is for the purpose of this section, avoidance of tax. No commercial man in his senses is going to carry out a commercial transaction except on the footing of paying the smallest amount of tax involved."***

In ITC1307[111] it was held that to qualify as the main purpose, the purpose in question must preponderate over the other purpose or at least be as important as the other purpose. Furthermore it is the purpose at the time of implementation that is important and not the

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107 Chamber's Etymological English Dictionary edited by A.M.Macdonald; 1963: W&R Chambers: London.

108 SBI v Lourens Erasmus (Eiendoms) Bpk. 1966, (4) SA 434 at 442. This case dealt with profits derived solely or mainly from dividends in terms of section 51(f) of Act 43 of 1955.

109 Meyerowitz an Spiro on Income Tax, Copyright authority No. 3006 of 16/5/1962 ISBN 0 620 14668 0

110 IRC v Brebner, 1967, 1 ALL E.R. 779 HL at 784.

111 ITC1307. 42 SATC 147.

purpose at conception of the scheme[112]. In the Brebner case, referred to above, it was held that the subjective intention of the taxpayer in entering into the transaction is the determining factor.

In Case 10229[113] Kroon, J determined that the *fons et origo* of a transaction determines the purpose thereof. If tax evasion is one of two or more purposes, the question is, which was the principal or more important one or which preponderated over the other.

2.2.5. Normality requirement

The normality requirement is an objective test and is to my mind the most important requirement of section 103(1). According to Broomberg[114] ***"........ a taxpayer can nakedly confess that a transaction was entered into solely for the purpose of avoiding tax, and yet he can pip the Commissioner. If the taxpayer can demonstrate that the transaction which he entered into did not manifest any abnormalities, either in respect of rights or obligations which were created, or in regard to the manner in which it was entered into or carried out"***

There is no general test as regards normality or abnormality. The facts must be judged in relation to the following elements viz.

- was the transaction normal in the business context of the taxpayer in question. This business test refers to the purpose in a reasonable business context and not necessarily to the purpose of the taxpayer.
- was it an arm's length transaction between independent parties?
- has the transaction created rights or obligations which would not normally have arisen in arm's length transactions between independent parties? The second proviso is conditional on the third provision as it would not be impossible to conclude normal transactions between related parties. It is also important to note that the section specifically refers to a specific scheme as carried out by specific taxpayer. The scheme must therefore be examined as to the facts in every individual case as there can be different circumstances in similar cases.

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112 Ovenstone v SIR. 1980, (2) SA 721 (A) 42 SATC 55. At 732.

113 Case No. 10229. Income Tax Special Court. Port Elizabeth.

114 Broomberg, E.B. 1983, 2nd Ed.: Tax Strategy . Butterworths at 213.

2.2.5.1. The business purposes test.

The normality of a transaction must be measured against the specific circumstances present in a transaction or series of transactions and the manner in which they were implemented. What is found to be abnormal in one transaction may be considered normal in another.

The 'business purposes test' introduced with the 1996 amendment to the Act amended the 'abnormality test'. It has been held that the standards against which 'normality' is judged is set outside the intent of the taxpayer, and that it is therefore an objective test that has nothing to do with the subjective state of mind of the taxpayer.

It is contended that where reference is made to a business purpose in the normality provisions of the section 103(1), purpose refers to the manner and method by means of which the transaction, operation or scheme has been carried out in relation to normal non-tax business practices, and not to the purpose of the taxpayer. The clear and precise wording of the revised section would seem to indicate that if non-tax motivated business practices are followed a taxpayer should succeed under this defence even if he admits to having subjective main tax purpose. It is further contended that Revenue or the courts should not be allowed to prescribe to business by which method a transaction, operation or scheme must be entered into if there is more than one valid non-tax business related way, even if the one is more commonly used than the other.

In the transaction under consideration the business purposes test should not present any problem as the following non-tax business motivated objectives are present;

Bank

- in pursuance of business objectives of satisfying customer needs, markets structured financing packages to corporate borrowers with substantial funding requirements.
- provides loan capital on a long term basis, linked to promissory notes.
- provides capital at very competitive interest rates, lower than the prime overdraft rate.

SubCo's business objectives are;

- the obtaining of low cost financing for working capital purposes.
- the strengthening of its balance sheet.

and HoldCo has no tax objective.

2.3. Evaluation of possible tax triggers against section 103

According to Broomberg[115] ; *"If a transaction is proposed, which will have the effect of avoiding tax, and the planner is relying on the normalcy test to defeat ..... the Commissioner, the planner should be able to account for each right and each obligation created by the transaction, by way of providing a sound business purpose for such right or obligation. The planner should test his proposed contract by asking the following question : leaving side altogether ..... the tax effects ..... , can the provisions of this clause be justified on commercial grounds." .... If the transaction cannot be defended on the grounds of normalcy of the rights or obligations, ... the taxpayer can retreat to his second line of defence. This relates to the purpose of the taxpayer in entering the transaction."*

In the light of the above the different elements of the transaction must be considered in order to determine whether there is a possibility of the invokement of section 103.

2.3.1. The loan

The dominant purposes are the securing of working capital on a long term basis and the repayment of the loan from the holding company. The interest rates will be market related and consistent with normal commercial practices. Interest will furthermore be claimed on a day-to-day basis as required in terms of section 24J. These circumstances meet both the normality and purpose requirements.

2.3.2. Promissory notes

The issuing of PNs is a normal every day occurrence and has no relevance to the tax deductibility of the interest.

115 Broomberg, E.B. 1983, 2nd Ed.: Tax Strategy . Butterworths at 213.

2.3.3. Conversion of the loan to shares

The conversion of loans into shares may not be an everyday financial occurrence but the capitalisation of debt is done at one time or another by most companies and, by converting the loan into shares, the company will obtain the following *bona fide* commercial advantages;

- ◆ the enhancement of the financial structure and capital base of the company.
- ◆ the improvement of the financial gearing of the company, which amongst other things would improve the availability of borrowed funding to the company.
- ◆ the improvement of the risk profile for investors.

furthermore the price of the shares was negotiated at arm's length between unrelated parties.

2.3.4. Gain on conversion of the loan to shares

As stated above the price of the shares were negotiated in an arm's length transaction between unrelated parties and the price is based on market value. In Hicklin v SIR[116] it was held that;

"when the 'transaction, operation or scheme' is an agreement ...... it is important ...... to determine first whether it was concluded 'at arm's length'. .... For 'dealing at arm's length' is a useful and often easily determinable premise from which to start the inquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. .... Hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal ...... The next observation is that, when considering the normality of rights or obligations so created or of the means or manner so employed, due regard has to be paid to the surrounding circumstances. "

The normality of the conversion is clearly demonstrated by the commercial benefit in securing a permanent long-term source of funding, in place of short-term finance with which there is the inherent risk of it being called up at short notice. Further the incurring of debt in the form of convertible loans is commonly used as a manner to raise funds. This is borne out by the fact that certain countries such as Australia have special provisions in their taxing act to regulate such transactions.

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116 Hicklin v SIR. 1980, (1) SA 481 (A) 41 SATC 179. At 494-5.

This leg of the transaction therefore meets both requirements. The only question remaining in this respect is as regards the time value of money referred to in paragraph 1.1 of chapter II above.

2.3.5. Forward sale of shares

HoldCo acquires the shares after the expiry of the loan to ensure that it remains the sole shareholder of SubCo, whilst at the same time strengthening its capital base. Such transactions are not common but are after all for a non-tax business reason. The purchase of the shares were determined in an arm's length transaction with BANK at its market value, discounted at a competitive market-related rate.

2.3.6. HoldCo and SubCo's relationship

Although these companies are connected persons, no non-arm's length transactions were concluded between these companies. The Appellate Division of the Supreme Court[117] has held that ***"I do not see how the court can ignore this special relationship and yet give proper effect to the concluding words of section 103(1)(b)(ii).. "*** The mere fact that the two companies are related persons should not detract from the normalcy of the transactions. Furthermore it is normal that SubCo, as the trading company of the group, which has the working capital requirements, should incur the borrowings.

2.3.7. Issuance of debentures

If the loan between Bank and SubCo can be classified as compulsory convertible debentures (refer 3.5 above) would such a transaction be normal, i.e. would a bank normally invest in preference shares of its clients? The following would indicate the normalcy of the transaction;

- the transaction is an arm's length transaction between unrelated parties.
- the transaction is most certainly not an isolated transaction but a structured financing package which is available to group company clients of Bank.
- Bank is seeking to do no more than to lend out money, as is indicated by the fact that, the rights to the shares have been sold on the date the transaction was entered into and, on conversion, the shares will not be kept by the bank.

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117 CIR v Louw. 1983, (3) SA 551 (A) 45 SATC 113.

2.4. Possibility of retrospectively

Although retrospective legislation is a possibility, it is unlikely. The last time that retrospective legislation was introduced was in the late 1980's. The legislature seems to have ceased this practice due to the fierce criticism from organised business and the rest of the tax-paying community.

2.5. Conclusion

Although there is a transaction operation or scheme, it would seem that there is no tax benefit as contemplated in this section of the Act, and it is therefore unlikely that the Commissioner will be able to invoke section 103 successfully. There was nothing abnormal in the transactions *per se* and no abnormal rights were created. Furthermore, both SubCo and HoldCo have *bona fide* business purposes for the transaction and the dominant purpose of the transactions was not the avoidance of tax.

Despite the above it needs to be remembered that the newly introduced business test has not as yet been tested by the courts.

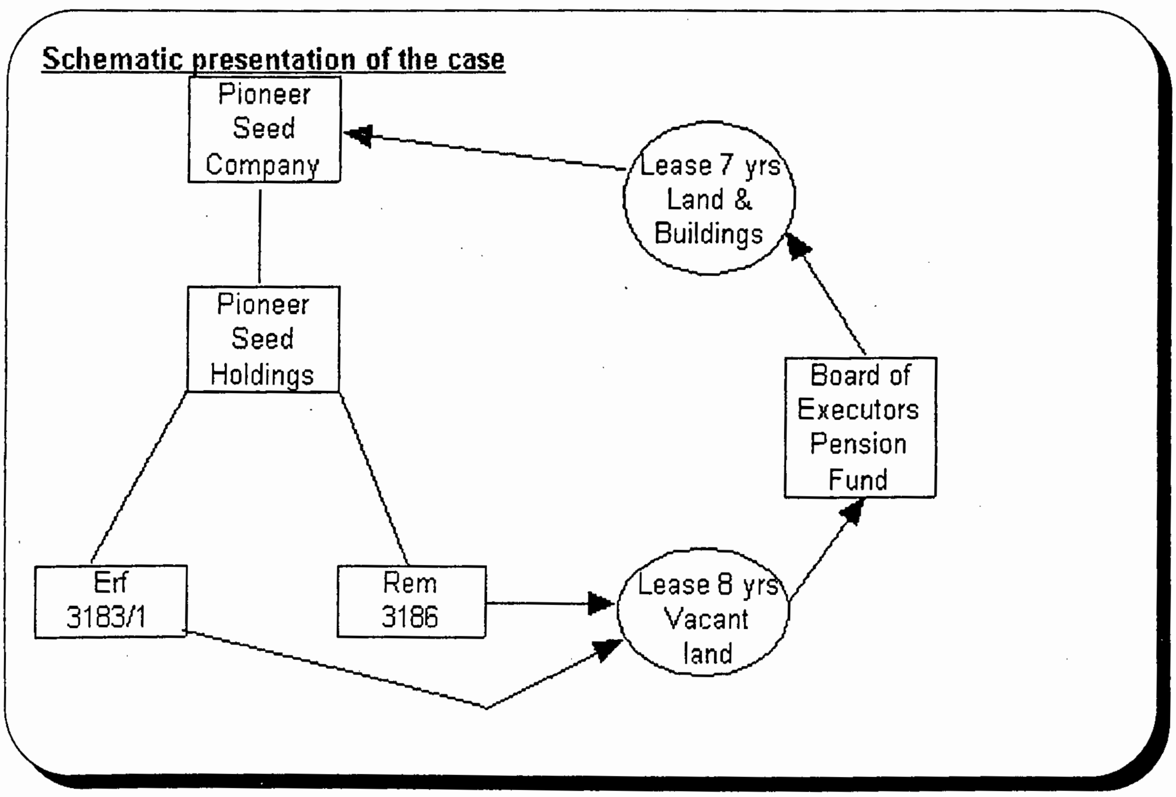
CHAPTER IV

RECENT SUBSTANCE-OVER-FORM AVOIDANCE CASES AND THE RELEVANCE THEREOF ON THE PRESENT FACTS

Revenue has of recent shown an aggressive propensity to attack taxpayers under the form over substance doctrine in situations where taxpayers arranged their affairs so as to attract the least tax. The following are two such prominent cases.

1. The Ladysmith case

3183/1 Ladysmith (Pty) Ltd and Rem 3186 Ladysmith (Pty) Ltd v CIR[118] caused real concern amongst company groups and will have to be taken into consideration in all future agreements where more than one group company is involved.



[118] 3183/1 Ladysmith (Pty) Ltd and Rem 3186 Ladysmith (Pty) Ltd v CIR. 1996, S.A. Law Reports vol. 13.

The court followed the approach (first adopted by Zulman, J[119] during 1993 in the special court hearing of this case and later during 1995 in another case by Wunsh, J[120]) of completely ignoring the form of a set of inter-related agreements between group companies in favour of the combined substance thereof, and ruled as to the REAL INTENTION of the contracting parties, which in this case was held to be the obtaining of a tax advantage. The **fundamental question** that was addressed by the court **was whether the taxpayer received a benefit or right in terms of paragraph (h) of the definition of gross income and** the decision hinged on the fact that the **taxpayer** had not discharged the onus of **proof showing** that the **right** envisaged under that paragraph **had not accrued to them.**

In short the facts were as follows;
A group of companies wished to erect a furniture factory. Two property holding companies (Appellants), owned by a subsidiary of a holding company, owned vacant land which was leased to a Pension Fund. The Pension fund (under no contractual obligation to do so) erected a factory and leased it to the holding company for the purpose of trade. Various agreements were signed (it is important to note the agreements were signed at the same time and any one would not have been signed on its own had the others not been signed) between the parties to give effect to this arrangement.

The Appellants' financial statements reflected the stands at cost and no disclosure was made of the buildings erected. The effect of this scheme was that;

- Appellants would pay nominal tax on the rental received from the Fund.
- The holding company would receive a deduction for the lease premium over the term of the lease in terms of section 11(f) (entered into before the amendment to section 11(f)(dd) to the effect that premiums shall not be deductible in the hands of the lessee unless taxed in the hands of the lessor).
- The fund would not be taxed on the rental and lease premium received from the holding company.
- The group would, through the property-companies, own the buildings after 8 years.

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119 Unreported case 9592 and 9593. 1993 Transvaal Special Income Tax Court.
120 1995 Case number 9660.

The Commissioner raised additional assessments for normal and additional tax, on the basis that the erection of the properties was an accrual of income in terms of paragraph (h) of the definition of gross income in section 1 of the Act.

The relevant part of paragraph (h) reads; ***"in the case of any person to whom, in terms of any agreement relating to the grant to any other person of the right of use or occupation of land or buildings, ... there has accrued in any such year or period the right to have improvements effected on the land or to the buildings by any other person - (i) the amount stipulated in the agreement as the value of the improvements or as the amount to be expended on the improvements ......"***

The Appellants argued that;
"effect must be given to the agreements according to their tenor despite their underlying purpose. They submitted that, whatever their purpose might have been, a right envisaged in paragraph (h) of the definition of gross income in Section 1 of the Act did not accrue to the Appellants in terms of the main leases". The Appellants further contended that paragraph (h) deals with the right to have improvements effected and not with the benefit accruing to the taxpayer. The fund may have been obliged, in terms of the agreement with Pioneer, to erect a building but there was no obligation under the agreements with the Appellants.

The court held unanimously that;

- Every group has the right to arrange its affairs as it chooses, but if a third party is interposed for no apparent sound commercial reason the motive should be looked for elsewhere.
- A deduction in terms of section 11(f) could not have been a major consideration for the group, for had the agreements been between the Holding company and the Appellant companies the group (through the Appellants) would have been taxed on the premium. In view of the above the appellants' tax positions must have been a dominant consideration.

◆ The opening words of the definition of gross income determines that an amount received or accrued, in cash or otherwise, shall be taxed and sub-section (h) is but a discrete application of this principle.

◆ That it is important for the court to determine the real intention of the contracting parties and, in this respect quoted the dictum of Wessels ACJ[121] viz.; ***"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."*** and that in Zandberg v Van Zyl[122] :

" .... the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. .... The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall give effect in accordance with its tenor, the circumstances, that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down."

◆ The agreements, on their own are standard except that the same signatories signed the leases simultaneously in the full knowledge of the terms of the other agreements. The agreements can not be regarded separately, they were signed simultaneously, were interdependent, and would not have been concluded unless all were signed. The contracts, or certain clauses therein, were distinctly artificial in relation to the purpose thereof to give it a self-sufficiency that it did not have.

◆ A disguised transaction will fall foul of the doctrine of fraudem legis if the parties to the contract hide their true intention. As authority for substance over form the Judgement in Dadoo Ltd and Others v Krugersdorp Municipal Council[123] was quoted.

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121 Kilburn v Estate Kilburn. 1931, AD 501 at 507.

122 Zandberg v Van Zyl. 1910, AD 302 at 309.

123 Dadoo Ltd and Others v Krugersdorp Municipal Council. 1920, AD 530.

1.1. Conclusion

The above, however, does not mean that the Ladysmith judgement can be applied to future tax-avoidance in all cases, as pointed out by Dr. Lynette Olivier[124] in an article on this case. In her words; "***Some tax lawyers are of the opinion the effect of the judgement is that all tax-motivated agreements will be ignored if the substance of the agreement does not correspond with the form thereof. This is reading to much into the judgement.***"

She is of the opinion that the documentation was so badly drawn that the court had no option but to decide the case on the substance-over-form doctrine. This interpretation of the case is correct but I, respectfully, am of the opinion that Dr. Olivier is playing down the importance of para (h) of the definition of gross income in her article. In an article in The Taxpayer[125] it was held that the court examined all the contracts " ***and their terms in order to determine what the true arrangements between the parties were. It concluded that there was a real likelihood that there was an unexpressed agreement or tacit understanding between the taxpayer and its holding company (the sub-lessee) that the taxpayer would be entitled, if need be, to enforce compliance with the terms of the sub-lease, namely the erection of the improvements by the lessee (the fund) ....*** " The article goes on to say that it was not necessary for the court to find that the lessor was so entitled as the taxpayer had failed to discharge the onus of proof that a right had not occurred to it in terms of para (h) of the definition of gross income.

It is particularly revealing that;

- **specific legislation** (para (h) - referring to the right of use or occupation of buildings) was **necessary for the fiscus** to succeed in the Ladysmith case. This point of view was confirmed by an article in the The Taxpayer[126]. I believe that if this section was not in existence, there would have been no basis for the court to have held as it did as the Act presently stands.

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124 De Rebus, April 1997, page 243 and 244.

125 Article by Dr. D. Meyerowitz in the February 1997 issue of the Taxpayer.

126 Article by Prof. D. Davis in the February 1997 issue of the Taxpayer. In his words "Ladysmith turned on the determination of the existence of a right in terms of paragraph (h) of the definition of gross income"

◆ that the court recognised the fact that **avoidance** would **not** have been **possible, had it not been for the interposition of a third party**.

◆ that the Commissioner **chose not to attack this scheme under section 103**.

1.2. Could the court have found for the Commissioner in the absence of specific legislation?

1.2.1. By giving the law a wider application?

The court would then have to find that the gain of HoldCo would be taxable under the normal provisions of the definition of gross income or that part of the interest claimed by SubCo would not be deductible under the general deduction formula. In other words the court would have to give a wider meaning to the abovementioned sections and hold that it was not the intention of the legislator that tax should be avoided.

This would be consistent with;

> Wessels J, in the court a quo in Dadoo Ltd v and others v Krugersdorp Municipal Council[127] where it was held that, " ..... *every enactment is expressed in words, and it is only from the words used that we can ascertain the intention of the legislature. When however we wish to ascertain the exact scope of a prohibition we must not confine ourselves to the particular words of a particular section , but we must take into consideration the whole Act so as to arrive at what exactly the legislature intended to prohibit. In order to determine the wish of the legislator we must see what acts he did not wish to be done even though he did not prohibit them in special terms. ...... When we have ascertained the exact intention of the legislature from the whole scope of the legislation we must not allow anything to be done either directly or indirectly against the legislator's real intention. ...... when we therefore speak of evading a law we use an ambiguous term. In one sense the law can never be evaded, for once you have ascertained the voluntas of the Legislature any act done contra voluntum ejus is void.* "

and centres around the following passages from the Corpus Juris (Monro's translation);

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127 Dadoo Ltd v and others v Krugersdorp Municipal Council. 1920, AD 530.

"A man who does what the statute forbids, transgresses the statute: a man who contravenes the intention of a statute, without disobeying the actual words, commits fraud on it."

"A fraud is committed on a statute when something is done which the statute desired should not be done, but did not actually forbid: the difference between fraud on the law and transgression of it, is the same as that between speech and intention"

"Without doubt he contravenes the law who, observing its letter, opposes its spirit. Nor will man escape its penalties who fraudulently shelters himself by a strained use of language contrary to the spirit of the law"

(The acts to which the passages refer came within the operation of the law, but was disguised by design to evade its language.)

In this same (Dadoo) case , however, the Appellate Division (per Innes, CJ) rejected the argument of the court a quo and held as follows;

" Speaking generally, every statute embodies some policy or is designed to carry out some object. When the language employed admits doubt, it falls to be interpreted by the Court according to recognised rules of construction, paying regard in the first place, to the ordinary meaning of the words used , but departing from such meaning under certain circumstances, if satisfied that such departure would give effect to the policy and object contemplated. ..... But there must, of course, be a limit to such departure. A Judge has authority to interpret, but not to legislate, and he cannot do violence to the language of the lawgiver by placing on it a meaning of which it is not reasonably capable, in order to give effect to what he may think to be the policy object of the particular measure. Now when the recognised canons of construction have been applied to a statute the concrete transaction with which the court is concerned must fall either inside or outside its provisions. ...... I know of no case in which the unexpressed intention of the lawgiver has been clothed with authority to affect a transaction which could not under ordinary rules of construction be brought within the written statute. Such a principle would be dangerous and difficult to apply to the meticulous provisions of modern legislation."

Lord Normand went further than this and held in the case Vestey's (Lord) Executors and Another v IRC [128] held that ;

" ..... the court will not stretch the terms of the taxing Acts in order to improve the efforts of Parliament and stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to over-stretch the language of the statute in order to subject to taxation people of whom they disapprove".

This principle has been recognised by South African Courts in prominent anti-avoidance cases such as CIR v King[129].

This has also been confirmed by Clegg;

" the courts are not at liberty to make their own law and are restricted to interpreting the law laid down in either a more or less restrictive fashion. " [130]

1.2.2. Because the transaction was a sham transaction?

A sham transaction which disguised the true nature transaction was defined CCE v Randles Bros. & Hudson[131] as;

> *"A disguised transaction ...... something different. In essence it is a dishonest transaction: dishonest, in as much as the parties to it do not really intend to it to have, inter partes, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be in fraudem legis , and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties. .... before the Court can find that a transaction is in fraudem legis ...... it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties"*

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128 Vestey's (Lord) Executors and Another v IRC. 1949, 1 All ER 1108 at 1120.

129 CIR v King. 1947, (2) SA 196 (A) 14 SATC 184.

130 Clegg, D.J.M. 1991, Tax Law Through The Cases. Juta. Page 536

131 CCE v Randles Bros. & Hudson. 1941, AD 369, 33 SATC 48.

In Dadoo Ltd v and others v Krugersdorp Municipal Council[132] Wessels J, in the court a quo, held that;

> ***"It is an undoubted principle of our law that if a Statute prohibits a particular act you can not circumvent the Statute by doing that act in an indirect manner."***

The transaction under discussion can hardly be classified as a dishonest transaction entered into for the purpose of disguising the real agreement.

1.2.3. Because SubCo required additional capital of R57 million, and the group as a whole only received that amount interest on the amount of R43 million can not be regarded to be incurred to the extent laid out for the purpose of trade in terms of section 23(g)?

The express reference in section 23(g) to the words ***"..... to the extent to which"*** makes it possible to apportion deductible expenses between that incurred for the purpose of trade and that not so incurred. The courts have found in cases such as Solaglass Finance Co (Pty) Ltd v CIR[133] that it was indeed possible to have more than one distinguishable purpose for a transaction.

Can it be held, a la Ladysmith, that as only R57 million was required for additional working capital purposes the amount or R43 million has been borrowed not for the purpose of trade and the interest thereon is therefore unproductive interest and not deductible.

It is my contention that, in order to hold so, a court would have to disregard the true nature of the transaction and find that the transaction constituted a sham transaction for the purpose of avoiding tax, as in Burgess v CIR it was held that if "***......a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not, ..., cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage.***"

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132 Dadoo Ltd v and others v Krugersdorp Municipal Council. 1920, AD 530.

133 Solaglass Finance Co (Pty) Ltd v CIR. 1991 (2) SA 257 (A) 53 SATC 1.

1.2.4. Difference between the Ladysmith case and the transaction between SubCo and HoldCo.

Differences between Ladysmith and the transaction under discussion.	**Ladysmith**	**Sub/HoldCO**
Company required funds of a capital nature?	yes	no
Company required funds of a revenue nature?	no	yes
The company approached a bank?	yes	yes
The bank offered a structured financial package?	yes	yes
Is there a tacit understanding between the parties not contained in the agreement?	yes	**no**
Is there a group tax benefit?	yes	yes
Is it the intention that the transaction should have effect according to its tenor?	no	**yes**
Is there a specific provision in the Act under which the scheme can be attacked?	yes	**no**

The three important differences between the two cases (indicated in bold type) is what makes Ladysmith a sham transaction (If the court indeed held so). No complete investigation into the true nature of the contract was required as the Appellants neglected to discharge the onus of proof that the amount in question was exempt from tax and what does not make the transaction under discussion a sham transaction?

2. Case number 10229[134]

The taxpayer required funds to finance future expansion and, in order to raise these funds sold a considerable number of its assets to a financial institution for R96 million on a sale and leaseback basis. The amount were paid on fulfilment of the conditions of the agreement, and ownership passed to the bank on the same day. The agreement was subject to a suspensive condition that the seller and the bank entered into the lease agreement in respect of the goods on such terms and conditions as may be agreed upon by the seller and the bank. On termination date the lessee will retain possession of the goods and thereafter enjoyment of the goods in terms of a new 1 year lease.

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134 Case 10229. 1997, Income Tax Special Court, Port Elizabeth.

To gain the maximum tax advantage fully depreciated assets were selected for the transaction, especially items with a low initial value and a high current value because of technology updates. These items were valued at current market values including a notional cost of transportation to and installation in taxpayer's factory.

By entering into a sale and leaseback agreement the capital portion borrowed and interest thereon was deductible for tax purposes. As a result of these payments tax deductions were accelerated and tax savings and cashflow benefits were obtained. In other words a lower cost of after-tax finance was obtained. Furthermore, the concept became more viable with the phase-out of General Sales Tax and the phase-in of Value Added Tax.

Revenue disallowed the capital component of the lease payments because of its capital nature and it not being in the production of income in terms of section 11(a), on the basis that;

- no additional production activity was obtained.
- the leaseback agreement can not be looked at in isolation from the sale agreement and the one would not have been entered into without the other.
- the assets, as installed at the taxpayer's factory, were not physically saleable.
- the operation could not be sustained without the sale of the assets.
- Alternatively if the application of section 11(a) would prove not to be successful, the transaction will be pursued in terms of section 103(1) on the grounds that the sale and leaseback was financing a transaction entered into;
    - which had the effect of avoiding tax, as capital profits from the sale of fixed assets were translated into lease payments and claimed under section 11(a).
    - which had created rights and obligations not normal in financing transactions. The sale was not a stand alone arm's length transaction. The value of the assets were grossly overstated.
    - It had been chosen above less tax effective alternatives.

The taxpayer objected to the assessments on the grounds that;

- the agreements were genuine and substance was identical to form.
- there was no tacit agreement that varied from the written agreements.

- the amounts disallowed for the reason of it being regarded as being of a capital nature constituted rental payable in terms of the leases.
- the equipment was leased for the purposes of the taxpayer's income earning operations and was therefore non-capital and in the production of income in terms of section 11(a) and for the purpose of trade in terms of section 23(g).

During testimony it was conceded, either directly or indirectly, that the benefit of a sale and leaseback agreement, as opposed to a conventional loan, was the substantially greater tax benefit. From the bank's point of view, taking the section 11(e) allowances into consideration, the tax position would be similar to that of a loan. It was also confirmed that the reason for raising the money was for the purpose of expansion. The reason for choosing the specific type of transaction was because of its obvious tax advantages.

Kroon J held that ".....

- The sales and leaseback agreements must be construed as a single composite agreement.
- The agreements contained certain nonsensical clauses which would usually be included in certain standard agreements which were used as a guide. The inclusion of these inappropriate provisions can not be seen as an indication that the contracting parties merely went through the motions of putting a formal agreement in place.
- The fact that a pointing-out exercise was undertaken goes in support of the genuineness of the transaction.
- The fact that the transaction was disclosed in the financial statements in a similar manner as would have been the case as had the transaction been a loan cannot be used adversely against the taxpayer. ***" In short .... from an accounting point of view the transaction had the same effect as a loan, i.e., when regard was had to their economic substance. Whether or not their legal substance was that of a loan would have to depend on not only their economic substance but also all the other relevant circumstances viewed in their entirety."***
- The conventional manner of raising finance is by way of a loan. That does not mean that if a taxpayer has recourse to other means of raising finance, an intention to procure a loan is necessarily imputed to him.

◆ Sale and leaseback transactions are commonplace in the market and is recognised by the Act in section 23D. **The court can not perceive any reason why a manufacturing plant, albeit an integral part of the manufacturing process, should not properly form the subject of a sale and leaseback agreement for the purpose of raising finance and why the stigma of abnormality should be attracted. The fact that the taxpayer is otherwise able to obtain a conventional loan does not render the transaction abnormal and does not point to the genuine substance of the transaction being that of being a loan.**

◆ The taxpayer was fully aware of the tax benefits, which was the reason why the transaction was so structured instead of a conventional loan. Sight must however not be lost of the fact one can structure your tax affairs so that it attracts the least amount of tax.

◆ The argument of Revenue was that the taxpayer had no intention to sell the assets, and intended to retain the assets after the lease had terminated. This contention that the transaction was, therefore, in essence, a loan was not without merit, however, the following arguments that goes against this.

- Although the assets formed an integral part of taxpayer's operation, Taxpayer can not as of by rights acquire the goods.
- The purchase price fell within the ambit of a verum pretium.
- The bank envisaged no beneficial interest in the assets.
- Financial institutions do not regard sale and leasebacks as loans but as leases and it was usual not to retain any interest in the asset after the lease had expired.

◆ The provision that the taxpayer carried the risk in the assets is commonplace in leases.

◆ The intention or otherwise of the taxpayer to sell the assets can not be looked to in isolation in the context thereof that the purpose of the sale was for the assets to form the subject of the leaseback which is a recognised financing technique.

◆ The fact that a transaction has the same practical result as that of a loan *".... does not entitle the court to disregard the genuine intention of the parties and the genuine nature of the transaction, and to categorise the transaction as a loan, even*

if the recognition of the former transaction results in tax benefits for the lessee that would be denied to it in the case of the latter transaction".

◆ With regard to Revenue's argument that the assets were not realistically valued with regard to age and outdated technology, the court rejected the testimony of Revenue's expert witness.

◆ From a security point of view for the bank the ownership of assets is an important consideration. This would not come into play had the transaction been a loan.

◆ The fact that the bank did not verify the valuation of the assets is not important as the taxpayer in effect guaranteed the valuation.

◆ The contracts were what they purported to be and the commercial standing of the bank and the taxpayer as well as the quality of their witnesses were taken into account in this regard. It was unlikely that they would be party to a bogus agreement.

◆ The sole purpose of the rentals were in respect of the taxpayer's income earning activities and therefore bona fide in production of its income, meeting the criteria laid down in the Port Elizabeth Electric Tramway[135] case.

◆ The rentals are not of a capital nature in terms of the principles laid down, *inter alia*, in the New State Areas [136]and George Forest Timber[137] cases.

◆ ***" The fact that the transactions were in essence finance transactions and that in determining the rental profile the bank had regard to the capital amount of the finance provided and the profit that it was to secure on the deal does not mean that from taxpayer's viewpoint any portion of the rental payment was of a capital nature."***

◆ ***" Having dispossessed itself of ownership therein and in order to utilise the assets for the purpose of producing income it was obliged to pay the whole amount of the rentals and no portion thereof related to the acquisition of the means of production. The position is no different from that which would have obtained had taxpayer in fact borrowed the funds for capital expansion and, in a separate transaction, leased assets for use in its manufacturing process - the payment of rentals in respect of the latter would not have been of a capital nature and the fact that in casu the capital***

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135 Port Elizabeth Electric Tramway Co. (Pty) Ltd v CIR, 1936, CPD 241 8 SATC 13.

136 New State Areas Ltd. v CIR. 1946, AD 610 14 SATC 155.

137 CIR v George Forest Timber Co. Ltd. 1924, AD 516 1 SATC 20.

funds came from the sale of the assets that were thereafter leased does not import any difference."

◆ As far as tax avoidance in terms of section 103(1) is concerned the court held that in the transaction not all four of the requirements (as shown below) determined by section 103 were present, and that there was therefore no avoidance;

- The taxpayer has entered into a transaction, operation or scheme as envisaged by this section.
- The second requirement, viz. that the effect of the transaction was the avoidance, reduction or deferment of tax, was also present. Although the objective fact of avoidance is sufficient to bring section 103(1) into play the taxpayer furthermore subjectively intended the avoidance of tax . It remains avoidance despite the fact that the taxpayer was legally entitled to avoid tax. If the "but for test" (refer to discussion of section 103(1) above) is applied it is clear that, but for the transaction, conventional loans would have been incurred which would have resulted in increased tax.
- As far as the normality requirement is concerned the transaction was an arm's length transaction between unrelated parties, and it also passed the business purposes test.
- As far as the purpose requirement is concerned the sole or main purpose was not the avoidance of tax. There was an established business need to raise finance. This purpose was the *fons et origo* of the transaction, the sale and leaseback structure was chosen because of its by-product, the avoidance of tax.

2.1. Conclusion

Contrary to the Ladysmith case, where Revenue ignored the tax avoidance and proceeded on the basis of the general deduction formula, tax avoidance was used as alternate grounds in this case. The following conclusions can be drawn from the case which is not inconsistent with Ladysmith;

◆ As regards tax avoidance, suffice to say, as pointed out above, that tax evasion will not succeed where a claim originated with a *bona fide* business need.

◆ There was no specific provision of the Act under which the transaction could be attacked.

◆ As in Ladysmith the separateness of the agreements were ignored by the court, in this case, however, it must be remembered that the agreements were between the same parties in that no group companies were involved.

◆ As in Ladysmith the agreements contained some nonsensical clauses but these were not seen to be an indication of abnormalcy in this case. There was nothing to indicate that the agreements did not reflect the real intentions of the contracting parties. The substance of the agreements were, therefore, seen to be the same as the form of the contracts.

◆ The real intentions of the parties were important. What makes it easier to determine the real intention, in contrast to Ladysmith, is that in the transaction under discussion no subsidiary of the taxpayer was involved.

CHAPTER V

CONCLUSION AS TO LEGALITY OF THE SCHEME UNDER DISCUSSION

1. Summary of previous chapters

In the foregoing chapters the transaction under consideration and the tax positions relative to the two group companies are considered. In chapter II the question is raised whether the increase of R57 million in the value of shares in the subsidiary company, resulting from the effect of inflation on the value of money over time, represents a receipt or an accrual. It was concluded that although a right has accrued to HoldCo, in the first year of the arrangement, there is no receipt or accrual as;

- no monetary value can be ascribed to this right and no amount can be determined which is capable of being taxed.
- there is also no gain which can be taxed in future years.
- the gain is of a capital nature and not taxable.

Other questions addressed are whether;

- the amount of R57 million can be regarded as finance charges.
- there has been an allotment of rights.
- if the gain can be taxed when the shares are sold.

The conclusion as regards HoldCo is that there is no basis on which this company can be taxed.

As far as the tax position of SubCo is concerned the chapter looks at the deductibility of interest in relation to sections 11(a) and 23(g) of the Income Tax Act and concludes that the claim for interest conforms with all requirements of the general deduction formula, and that it is therefore fully deductible. The chapter also the reviewed position with regard to the issuing of promissory notes and the conversion of the loan into shares and found no tax relevance.

Chapter III reviews the applicability of;

- section 24J. The conclusion reached is that SubCo will claim interest on a yield-to-maturity basis prescribed by this section. The section has no applicability as far as HoldCo is concerned.
- section 103(1). The individual elements of transaction under consideration is investigated and it was found not to contain any abnormalities. The dominant purpose is, furthermore, not the avoidance of tax. Tax avoidance is unlikely to succeed where a claim originated with a *bona fide* business need.

Finally, chapter IV considers the composite transaction in the light of the recent substance-over form tax cases. No specific legislation is applicable in this case, as in the Ladysmith case, and there is no tacit understanding between the two companies not contained in agreements. It is the intention that the transaction should have effect according to its tenor. These sections therefore have no tax relevance in the transaction under consideration.

2. Final conclusion

There would not appear to be any basis on which the Fiscus can successfully attack this scheme in terms of the provisions of the Act and thereby recover this "loss" to the state. The group of companies have therefore, through effective tax planning, successfully avoided R19.950 million in tax.

The only possible danger for the taxpayers is that they may acquire the reputation. with Revenue, as having an aggressive and creative approach towards tax planning. Such a reputation could mean a closer scrutiny of the day-to-day operations of the companies and all future claims for tax purposes. Such a reputation can be the cause of endless Revenue queries and inspections, which can be very awkward and time consuming. Credibility with Revenue is important and Public Officers will usually go out of their way not to tarnish the reputation of their companies with Revenue.

CHAPTER VI

HOW WOULD THE INCOME TAX ACT HAVE TO BE CHANGED BEFORE IT WOULD STOP SUCH SCHEMES

1. Government's intent to eradicate major avoidance schemes

Government seems committed to address major tax avoidance schemes. During the course of the 1995 budget speech the Finance Minister had the following to say[138] about legal and illegal tax avoidance schemes;

" These schemes can be challenged in terms of the anti-avoidance provisions of the Income Tax Act, but they are deliberately engineered in such a complex manner that detection is difficult. The success of these schemes as avoidance measures would seem to rely to a large extent on non-disclosure to the tax authorities"

In the 1997 budget speech the new Minister of Finance reiterated this point of view by making the following statement.[139]

" Should SARS[140] become aware of transactions or operations of this nature, the real essence of such transactions will be thoroughly investigated and the transactions or series of related transactions will be dealt with in accordance with the substance of the matter. Furthermore, the authorities will not hesitate to apply the general anti-avoidance provisions contained in section 103 of the Act or to introduce further legislation to counter schemes of this nature"

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138 Text of the 1995 budget speech.

139 Text of the 1997 budget speech.

140 South African Revenue Services.

1.1. Has changes to the Act since 1995 been effective?

Between the 1995 and 1997 budget speeches, section 103 was amended and section 24J was introduced. As argued above, these changes have not been effective in combating schemes such as the one under discussion.

1.2. Can a change to section 103(1) be effective to combat schemes of this nature?

I, respectfully, differ with the Minister of Finance if he believes that changes to the general anti-avoidance provisions will be successful in combating these schemes.

These schemes usually start with a *bona fide* business need and it is only once that business need is established that the most tax effective method of achieving the business need is looked for. Avoidance is usually a secondary and not the sole or main purpose of the scheme, furthermore the schemes are conducted in such a manner that each of the elements of the scheme, broken down, complies with the normality and purpose requirements. It therefore makes it difficult to successfully attack these schemes under the general anti-avoidance provisions of the Act.

2. Developments in the pipeline

In the Budget Review 1997[141] the following statement is made;

" As the aforementioned section" (24J) ***"only covers interest-bearing arrangements, a subcommittee of the Tax Advisory Committee is at present investigating the international status of the taxation of derivative .... instruments. A paper***[142] ***issued .... by the Australian Commissioner of Taxes on the taxation of financial arrangements will be taken into consideration .... in formulating its proposals."***

From the above document it would seem that the fiscus is looking closely at existing provisions and new developments in Australia. These developments are;

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141 Budget Review 1997 Paragraph 7.7.5.

142 Consultative document, entitled " Taxation of Financial Arrangements: A consultative Document dated 23 December 1993.

2.1. Convertible notes

Capital Gains Tax (CGT) provisions of the Australian Income Tax Assessment Act[143] makes provision for financial instruments named convertible notes (conversion of loans into shares). The convertible note is a hybrid instrument between debt and equity. The note carries the right (but not an obligation) to be converted to equity after a pre-determined period of time. Interest is deductible until conversion. This arrangement is beneficial to both the investor (higher interest rates, the option to convert and the possibility of a capital gain) and the company (the interest is deductible which dividends would not have been).

There are strict regulations controlling convertible notes, but what is of particular interest is that if the holder of the note elects a conversion fully paid shares must be allotted or transferred to the holder and the value placed on the shares for CGT is an amount not less than the greater of the nominal value or 90% of the market value.

Convertible loans are not recognised by our Act and until such time as South Africa implements a capital gains tax it will probably not be recognised.

2.2. Taxation of derivative instruments

In the process of *'financial engineering'* various new financial instruments have been developed in recent years, mainly for the corporate finance market. These instruments are called *'derivative instruments'* and include various combinations of shares, preference shares, convertibles, debt, futures, options, etc.

According to the book Financial Management[144] the rationale for this financial innovation is,

- Tax asymmetries
- Transaction costs
- Agency costs
- Risk hedging
- Increasing the assets' liquidity
- Price volatility
- Interest rate volatility
- Accounting reasons
- Technological advances

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143 Information from, Taxation Law in Australia by Lehmann, G; Coleman, C.:1989: Butterworths ISBN 0409494704

144 Correia, C.; Flynn, D.; Uliana, E.; Wormald, M.: Financial Management: 1993. Juta & Co. Ltd. Cape Town.

The basic building blocks of all derivative type instruments are;

Options

The right, but not the obligation, to buy an asset at a future date at a predetermined price.

Forward contract

A commitment to buy an asset at a future date at a predetermined price.

Futures

A commitment to buy an asset at a future date at a predetermined price. The difference being that this usually involves the selling of a standardised contract on a formal regulated futures exchange such as SAFEX.

In view of the above the scheme under discussion can be classed as a derivative instrument.

The consultative document (referred to above) makes specific provision for the following financial arrangements;

- Hedging transactions.
- Fixed return debt instruments.
- Variable return debt instruments.
- Foreign exchange gains and losses.
- Swaps, futures and forward contracts.
- Financial options and convertible securities. The instruments will be broken down in its debts and equity elements and only the debt element will be subject to this proposed tax regime.
- Adjustment on sale or redemption.
- Dealings with liabilities.
- Assignments of income.
- Linked transactions.

The proposed regime of taxing derivatives, however, according to the Australian Tax Handbook - 1996[145], " .... ***is not intended to apply to flows to and from equity based arrangements and accordingly it will not apply to equity arrangements or equity and commodity derivatives not based on an index made up of a number of commodities or equities."***

A new document[146], (of which the Minister of Finance would appear to be unaware of) in which the original proposals were significantly modified, was published by the Australian Treasury during December 1996. The issues paper is available on the Internet[147] and is also discussed in the Australian Tax Handbook 1997 [148] these modifications include the following;

- the scope was broadened to include all derivatives.
- Gains and losses from traded equity are to be taxed, because, according to the Issues Paper (Section 2 page 75) there is sometimes little or no principled distinction between debt and equity. Debt and equity assets both represent investments which the investor hopes will be recouped together with a return commensurate with the risk undertaken in outlying funds.
- hedging derivatives are to be taxed in terms of a market value trading regime. Investing/financing derivatives will not be subject to tax.

The issues paper defines derivatives as " ..... ***contractual arrangements the value of which is contingent on and derives from the value, or changes in value, or assets and revenue streams***" which is proposed to be taxed under a new tax regime. The paper proposes consistent tax treatment of all taxpayers for similar instruments. The guidelines, laid down in the paper, for distinguishing between assets and derivatives are the following;

- The purchase or sale of an asset typically involves the transfer of an amount of actual principal - the value of which is both established and transferred at the outset of the arrangement. Ordinarily asset ownership involves both legal and economic ownership.

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145 Deutch, RL; Gates, SJ; Gibson, MM; Hanley, PJ; Payne, GL; Plummer, WS. Australian Tax Handbook - 1996; Australian Tax Practice; 1996. at 594.

146 Issues Paper on the "Taxation of Financial Instruments - published December 1996.

147 Internet address http://www.ato.gov.au/ search97cgi/ et seq.

148 Deutch, RL; Gates, SJ; Gibson, MM; Hanley, PJ; Payne, GL; Plummer, WS. Australian Tax Handbook - 1997; Australian Tax Practice; 1997. at 676.

◆ Derivatives primarily focus on the future change in value of particular risk variables. In broad terms, the payment of rights and obligations under a derivative are contingent; they derive from a specified variable such as the future level of an interest rate, a foreign exchange rate, a commodity price or an equity price.

◆ The tax system will encompass all derivatives including;

- swaps.
- options.
- forwards.
- futures.
- debt.
- equity.
- Hybrid instruments including debt and non-debt.

The tax treatment of financial instruments must by design balance the following principles;

- certainty.
- tax neutrality.
- flexibility.
- clarity

The taxation of derivatives is a complex matter. This is borne out by the fact, after 4 years, Australia is still grappling with this issue and has still not been able to enact provisions for the taxing of derivatives. In fact, because of this complexity, the Australian authorities have recently again, in a media release, postponed the dead-line for receipt of comments, proposals and objections on the paper. If and when such legislation is introduced it will have to be seen whether that legislation would counter such avoidance schemes and whether South Africa will follow the Australian model.

2.3. Taxation of company groups

In South Africa every company within a group is assessed as a separate entity and there are no provisions for taxation of company groups with one minor exception viz., Section 14(1D), in terms of which a wholly owned ship-owning subsidiary may elect to be taxed as a single entity with its holding company. As in South Africa the United Kingdom and Australia have no group taxation but these countries have provisions allowing for the transfer of trading losses between companies in a group. In the United Kingdom it is required that at least 75% of the shareholding must be held by the parent company and in Australia 100%. In the United States of America certain groups are allowed to elect to file consolidated tax returns.

The Katz Commission[149] recently investigated the vexed issue of the taxation of company groups, in a South African context. This was first investigated by the Margo Commission[150] and the majority decision of that commission was against group taxation. The Katz Commission, however, disagreed with this point of view and felt strongly that, by not allowing for group taxation, South Africa was out of sync with the industrialised countries of the world.

The Katz Commission **recommended** the **consolidation basis** of **group taxation** on the basis that;

- group should initially be defined as wholly owned (throughout the year of assessment) and limited to South African companies but excluding close corporations and companies subject to a special tax regime such as insurance and mining companies.
- only current year losses should initially be allowed.
- sections 24 and 24C allowances must not be consolidated.
- specific anti-avoidance measures be introduced.

The method of consolidation would be simple and would work as follows;

- the taxable income for all companies in the group is calculated as under the present tax regime with the exception that;
    - assets transferred within the group must be deemed to be transferred at tax value and subject to recoupment in the transferee up to the original cost in the group.
    - allowances i.t.o. sections 24 & 24C, and allowances on intra-group bad debts should not be allowed.

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149 Third Interim Report Of The Commission Of Inquiry Into Certain Aspects Of The Tax Structure Of South Africa: Government Printer. at 96 to 111.

150 Report Of The Commission Into The Tax Structure Of The Republic Of South Africa, chaired by Justice Cecil Margo, RP 34/87, Government Printer. ISBN0621106887, at 109-202.

- unrealised losses on trading stock will be eliminated.
- section 23(g) will be allowed in group context.

- assessed losses brought forward from the previous year for each company will be added back.

The consolidation results for each year of assessment will be determined as follows;

- an assessed loss brought forward of an individual group company will first be utilised to set off current year assessed losses in other group companies before the balance available can be set off against current year income of the individual company.
- A current year assessed loss would first be set off against current year income in other group companies before it can be carried forward to the next year.

The existing connected person and anti-avoidance procedures will protect the fiscus against the transferring of profits from profitable companies in the group to unprofitable ones. Group members would be jointly and severally liable for tax.

The Commission started off by listing as advantages;

"10.2.5 In a culture of intra-group manipulations, such as ...... arises when there is no recognition in the law of the reality of group economic interest, tax avoidance and .... evasion do not stop at merely trying to match profits and losses. .... it becomes possible to manipulate cost bases, ... timing or capital/revenue mismatches ...... ?"

and more significantly;

" 10.2.6 Under the current system the fiscus is at a serious disadvantage in combating these practices. .... In an appropriate group system, a full audit trial of any intra-group transaction is available to the authorities. In a full group system, moreover, the transactions that have tax effects are those with parties outside the group, who have an independent commercial interest. That independent commercial interest, in a group system, becomes a powerful ally to revenue authorities in policing the system."

The fact that a full audit trail will be available to the SARS of transactions with group companies and independent parties is very important as it will force disclosure of certain transactions.

Despite the remarks above the Commission was more concerned about assessed losses brought forward and failed to address the question of additional anti-avoidance measures where more than one group company and independent outside parties are concerned.

Will the recommended taxation of groups eliminate gains by company groups as a result of schemes such as the one under discussion? The answer to this question would appear to be - NO!

3. Specific Legislation to counter major tax avoidance

Specific anti-avoidance legislation to include income or deduction categories, which would otherwise not have been covered under the definition of gross income and the general deduction formula, is not a foreign concept in the Act. This despite the numerous anti-avoidance provisions[151] in the Act. The following are examples of such specific legislation;

Definition of gross income

Sub-sections (a) - (n) of the definition of gross income deals with income not included under the general provisions, section 7 (deemed amounts), 7A (antedated salaries, pensions and retirement gratuities) 8 (travel allowances), 8A (rights to acquire marketable securities), 8E (dividends deemed to be interest), Schedule 2 (lumpsum benefits), Schedule 7 (fringe benefits), etc.

General deduction formula

In addition to the General Deduction Formula covered by sections 11(a), 11(b) and 23 there are specific deductions in term of sections 11(k)&(n) (retirement fund contributions), 11(u) (entertainment), **18** (medical expenses), 21 (alimony), 21*ter* (undertakings in economic development areas), 22 and 22A (trading stocks), 23A (ringfencing) deductions of lessors) 23B (double deductions), 23C (assets and VAT), 23D (limitation of allowances on certain assets), 23E (leave pay), 24 (debtor's allowance), 24A (exchange of certain assets), 24B (foreign exchange transactions), 24C (future expenditure on contracts), 24D (security

[151] Sections 103(1)-(5), paragraph (c)(ii) of the definition of gross income in section 1, 7(1)-(7), 8A, 8E, 9, 9A, 10(1)(nE),20(1), 22(8), 23B, 23F, 31(2)&(3),76, 79(1), 89quat, para 11(c)(iii) of the First Schedule.

measures), 24F (film owners), 24G (toll operators), 24H (partners), 24I (foreign exchange), 25 (deceased estates), 25A (separated spouses), 25B (trust and beneficiaries), 26 (farming), 27 (co-operatives), 28&29 (insurance companies), 36 (mining) etc.

3.1. Recognising avoidance by company groups

It would seem that a tax avoidance scheme such as the one under discussion can only take place where **two** or more **group companies** together **with** an **independent** party or independent parties are involved. This view with regard to the involvement of an independent party is confirmed by paragraph 10.26 of the Katz report (albeit from a different perspective) and by the appeal court in the Ladysmith case (see my concluding remarks (1) to Chapter IV of this dissertation)

The Act would therefore have to recognise the connection between the group companies and, additionally, the fact that the group companies and an independent party have entered into a transaction, operation or scheme that will have the effect of reducing the taxable income of one or more group companies.

The concept of "connected persons" was introduced into the Act with the promulgation of 1993 Income Tax Amendment Act[152] and was further amended by the 1994 Tax Amendment Act[153], ostensibly for the purpose of limiting tax avoidance resulting from the transfer of assets at amounts higher than cost to a connected persons. Deductions under sections 11(e) (wear and tear), 12B&C (machinery, plant etc.), 11gA (patents, trade marks etc.), 14 (ships), 14*bis* (aircraft) etc. are subject to this enactment..

Group companies (holding companies subsidiaries, fellow-subsidiaries etc.) were included in the definition of connected persons. The Act therefore already recognises the relationship between group companies and this concept could easily be expanded to facilitate the prevention of schemes, such as the one under discussion.

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152 Act number 113 of 1993.

153 Act number 21 of 1994.

3.2. The first hurdle viz. disclosure?

Should Revenue be determined to eradicate major tax avoidance by company groups, it is conceivable that they will adopt the strategy[154] as was followed with the so called "lease improvement schemes", in which case Revenue adopted the following modus operandi;

- firstly questionnaires were sent to merchant banks to ascertain whether they were involved in financing such schemes and who their respective customers were in this respect.
- thereafter amendments to the Act were introduced.

Another method by which full disclosure can be forced by Revenue relatively easily and cheaply is by posing unambiguous questions to the taxpayer in Part 5 of the tax form IT14 (for companies). Paragraph 5.28 of the tax return[155] already poses the following question;

- ***"Was any transaction concluded with a connected person, in respect of intellectual property or any other asset ?"***

The following additional questions, or questions to similar effect, in part 5 of the tax return (with a request for full details) would force full disclosure;

Is the taxpayer a connected person, as defined by the Act, in relation to any other person or entity ?	☐ ***Yes***	☐ ***No***
Has the taxpayer or any connected person in relation to the taxpayer entered into any transaction, operation or scheme, irrespective whether the transaction operation or scheme is of a capital or revenue nature with;	☐ ***Yes***	☐ ***No***

- ***a connected person and an unrelated party***
- ***a third party with which a connected person***

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[154] The Taxpayer. February 1997.

[155] Form IT14 for the 1996 tax year.

<u>has entered into a transaction.</u>
<u>and as a result of which transaction operation or scheme the tax liability of the taxpayer or the connected person or the combined tax liabilities of the taxpayer and the connected person have diminished?</u>

3.3. Problems with amendments to the Act

The Income Tax Act is so complex and has been amended so many times since 1962 that, with any revision to the Act such as would have to be instituted to stop avoidance through financing schemes of company groups, the biggest problem that has to be faced is that the wrong taxpayers could be affected, namely those taxpayers which it is not intended for. Specific legislation should only be applicable if there is a third party involved[156] and should exclude trade related arm's length transactions, repayment of loans etc. The transfer of assets and taxable income between group companies are already covered by the provisions of the Act and it is therefore not necessary that it be included in any new specific provisions to counter avoidance by company groups .

There would appear to be two possible ways of preventing this, viz.:

3.3.1. To insert a purpose clause

To prevent the taxing of trade related transactions, which should not be affected by such legislation as it is already covered by the normal provisions of the Act, a purpose clause would seem to be a possibility. Any purpose clause, however, would bring about the same problems that <u>section 103(1)</u> currently presents making it ineffective in preventing these avoidance schemes. Such a purpose requirement would have to make a determination whether the transaction, scheme or operation was conducted solely or mainly for the purpose of avoiding tax or not . In the event of a dual purpose there would have to be a quantitative measure determining whether the avoidance of tax was the main purpose or a secondary purpose. If avoidance is found not to be the sole or main purpose, the avoidance would be allowed, hardly the result which the fiscus would want to achieve by implementing such legislation.

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156 This is consistent with Hefer, JA's view in the Ladysmith case (op cit). Refer to my conclusion in sub-paragraph of chapter 4.

A purpose clause would therefore not be ideal, in fact it would be unnecessary as, whatever the provision of such a new section, if the purpose or normalcy clauses are not satisfied a transaction can still be subjected to section 103(1).

3.3.2. Control over the effect of the legislation

Control over the effect of such legislation would therefore be a preferable option for the following reasons;

- tax avoidance will be addressed regardless of whether the purpose is the avoidance of tax or not.
- the wrong classes of taxpayers can be excluded.

3.4. A possible way of changing the existing Act to combat tax avoidance schemes by group companies

The following amendments to the Act are possible;

An additional provision to the definition of gross income

Gross income definition could be changed to include amounts (whether of a capital nature or not) received or accrued in terms of any agreement or agreements between;

- a "person", a "connected person(s)" and an unrelated party, or
- a "connected person" and an unrelated party,

the effect of which is a reduction in "income" of the "person" or of the combined incomes of the "person" and the "connected person(s)", to the extent that would have applied in the absence of such agreement.

An additional provision in the general deduction formula, possibly under section 23.

The formula can be changed not to allow deductions in the event that the taxpayer is a "connected person" to any other "person", if any expense is incurred in respect of any agreement or agreements;

- between that "person", a "connected person(s)" and an unrelated party or
- between a "connected person" and an unrelated party,

to the extent that the deduction or combined deductions of the taxpayer and the "connected person(s)" exceeds the amount that would have applied in the absence of such agreement or agreements.

From the comparison in Chapter I of this dissertation it can be seen that SubCo's tax liability, as a result of the transaction, has been reduced by R11.2 million and HoldCo's tax liability by R8.8 million. In that the tax regime is changed, as above, the companies in question will be assessed to these amounts.

An additional provision to the anti-avoidance provision under section 103.

It would also be possible to legislate a specific anti-avoidance provision, determining that where any transaction, operation or scheme conducted between a "person", a "connected person(s)" and an unrelated party has the effect of a reducing "income" of the "person" or of the "connected person(s)" or the combined incomes of the "person" and the "connected person(s)", the Commissioner shall determine the liability income tax.

Such sections will subject schemes such as the one under discussion to tax and at the same time prevent further avenues of tax avoidance, such as the possibility of the holding company having a tax loss.

CHAPTER VII

RADICAL TAX REFORM

1. Expenditure-based taxation

The ***"... objective of the (business) tax system is primarily to ensure an equitable sharing of the tax burden within the business sector."*** This was the view expressed by the New Zealand Task Force on Tax Reform[157] and would be the main objective of any change in our system of taxation if the tax-advantageous financing arrangements of groups companies were to be addressed with a view of eradicating it.

Taxation, of any form or nature, can only be levied on a clearly defined tax base. Traditionally income, as a tax base, has been the backbone of the system of taxation in South Africa, and has accounted for the largest proportion of all taxes levied by the State. It has, however, been held that taxation on the basis of receipts and accruals is an obstacle in the eradication of tax schemes (of the nature of the transaction under discussion or otherwise), and that expenditure or consumption as a tax base could overcome many of the problems and disadvantages associated with an income-based tax system for direct taxation, i.e. company and personal income tax.

Taxation using expenditure as basis has up to now mainly been used for indirect taxes such as customs duties, Regional Services Tax and Value-added Tax. There is an exception in our present income tax system, which would closely resemble the workings of an expenditure based tax, and that is the tax treatment of pension funds and retirement annuities (ignoring for this purpose the tax of 17% on interest and rental income of these funds recently instituted). The taxing Acts allow income of retirement funds to accumulate untaxed until it is consumed.

1.1. What is an expenditure or consumption based tax?

An expenditure tax works on the supposition that a taxpayer should be taxed on his consumption of the community's resources. In the United Kingdom a tax reform committee

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157 Report of the New Zealand Task Force on Tax Reform. 1982. At 169.

under the Chairmanship of Professor J.E. Meade[158] favoured a direct consumption or expenditure tax, using, as a tax base, income minus net savings, and was of the view (at 33) that;

" A strong case can be made for this base in that it levies a tax on the claims which a taxpayer makes, at any one time, on the community's resources which he uses up for his own consumption purposes. If he saves his income in stead of consuming it, he is putting resources back into the productive pool; if he dissaves he is taking resources out of the productive pool in addition to his other income. His relatively low consumption in the case of savings and his relatively high consumption in the case of dissavings are measures of what he is appropriating at any one time for his own personal use "

Although a flat rate expenditure-based tax is preferable, a progressive tax will ensure that the wealthy, who are financing high levels of consumption, will carry the brunt of the tax burden. If the tax effects of a progressive expenditure tax and a progressive income tax of equal rates are compared, the former is more burdensome on the wealthy. An expenditure-based tax, however, gives the wealthy taxpayer the opportunity of saving tax by investing his income for the betterment of the community, as such investment would stimulate enterprise and encourage economic development. At the same time it would tax consumption expenditure financed out of capital which under an income based tax regime goes untaxed.

The Margo Commission had the following to say with regard to an expenditure-based tax;

> ***"5.30 The proponents of an expenditure tax suggest that many problems associated with the income tax base could be overcome by basing taxes on cashflow."***
>
> ***"5.31 Because expenditures by definition relate to the current year, the problem caused by inflation in comparing the purchases and sales of businesses in different years would not arise. Similarly, because the funds used for investments would be deductible under a cash flow system, the problems experienced in calculating economic depreciation would not arise."***

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158 Meade, J.E.: The Structure and Reform of Direct Taxation. 1978. Allen & Unwin. Boston.

It is not clear from the Margo Commission report whether the commission envisaged direct tax on expenditure as replacing the current income-based tax or whether this was considered in conjunction (as paragraph 5.36 would indicate) to the income based tax.

1.2. Problems and inherent difficulties associated with an expenditure tax.

The Margo Commission listed the following as problem areas;

- Definition of consumption;
  - The use of expenditure as proxy for consumption.
  - The inclusion of household expenditure.
  - The exclusion of housing expenses. (If this important form of saving and investing becomes taxable it would be to the detriment of economic development in general.
  - The determination of imputed rent on owner occupied housing.
  - Windfall receipts. (With an income-based tax system a windfall receipt - of a revenue nature - will be taxed in the year it has accrued or is first received. With an expenditure-based tax it is possible to spread the consumption of a windfall over a number of years and thereby also possible to avoid high progressive rates of tax.)
  - The decision as to what return is required to maintain an asset.
- Ability to pay. Both income and expenditure based systems of direct taxation can be progressive. (see earlier remarks). Furthermore this could also be achieved by allowing a large initial tax exempt bracket, by having different rates for different expense categories.
- Taxing of savings. Saving provides resources required by society for investing in and growing the economy. Many of the proponents of a consumption tax therefore are of the opinion that it should not be taxed.
- Tax and inflation including the concept of matching income expenditure incurred for the purchasing of assets with the income generated therefrom. Inflation also complicates the issue with regard to interest incurred in the production of income. If inflation exceeds the nominal rate of real interest the return becomes negative, and as a result funding is biased in favour of debt as opposed to equity.

- Income and depreciation. The inflation on the cost of the asset, its economic life-span and future technological developments.
- Expenditure tax and the norm of equity.
  - Savings. The proponents of expenditure as a basis for taxation maintains that a person consuming less of the economy's resources should pay less tax and the amount not consumed, i.e. savings should be excluded from tax and, on the other hand, dissavings should be taxed. (It is clear that if a person, as a result of higher consumption, pays more tax than another person of equal means, at some time during the life cycle of the second person something will happen to bring the wealth that is accumulated, due to the present lower consumption, into the tax net.) As mentioned above this is consistent with the recommendations of the Meade Commission.
  - Life-time income. It is believed that this more accurately reflects the ability to pay and that annual expenditure mirrors this more adequately than annual income.
- Transitional problems
  - Whether to tax expenditures from existing accumulated funds in which case double taxation may occur.
  - Whether to tax only expenditures from funds accumulated after the introduction of the new tax base. If it is excluded, the temporary reduction in the tax base would necessitate higher rates of taxation. It would be regarded as preferential treatment for the rich as those who had accumulated large assets prior to introduction of the tax would maintain high levels of untaxed expenditure without having to pay income tax.
  - Combined systems of income and expenditure based taxes can not, ideally, co-exist as it creates possibilities for tax sheltering and tax trafficking. Ad hoc measures, such as ring-fencing, creates its own problems.
  - The transitional problem in changing from an income to an expenditure based tax system would appear to be particularly onerous and it is possibly for this reason that, according to the Margo Commission Report, no country has successfully introduced expenditure as a tax base for direct taxation. It would appear that this is still the position 12 years after the report was published.

1.3. How does the expenditure basis work?

For the purposes of this dissertation and the comparison of the effect of an expenditure-based tax on the tax positions of SubCo and HoldCo it is assumed hereinafter that savings will be excluded from the tax base.

The basic difference between income-based and expenditure-based taxes is the effect on return on savings of the taxpayer. The difference between returns on savings in income and an expenditure based tax system is illustrated below;

		Income tax	Expenditure tax
Earnings spent	+	150	150
Less: Tax at 30.33%		-50	-50
Savings		100	100
Add back tax		0	50
Savings invested		100	150
Annual yield at 10%	+	10	15
Less: Tax at 30.33%	-	-3.33	-5
Savings at year end	=	106.66	160
Return on postponed consumption		6.66%	10%

As is illustrated above and according to the Meade Report (at 37) it is the " ***characteristic feature of an expenditure tax as contrasted with an income tax that, at any given constant rate of tax, the former will make the rate of return to the saver on his reduced consumption equal to the rate of return which can be earned on the investment which his savings finances, whereas income tax will reduce the rate of return to the saver below the rate of return the investment will yield.*** "

The yield to the saver will remain equal to the yield on the investment if the rate of tax remains constant. If the tax rate at the time of saving is lower than at the time of dissaving, the net yield to the saver will be reduced below the yield on investment as can be seen in the tabulation below.

	Constant rate	Tax @30%	Changed rate	Tax 30-32%
Earnings	150	45	150	45
Earnings invested	-150	-45	-150	-45
Interest at 10%	15	4.5	15	4.5
Earnings divested	150	45	150	48
Sub total	165	49.5	165	52.5
Less: Tax	-49.5		-52.5	
Net earnings	115.5		112.5	
Return on after tax earnings	10.5		7.5	
Original after tax earnings	105		105	
% Return on after tax earnings	10		7.14	

1.4. How is an expenditure-based tax computed?

The following is a comprehensive computation of the tax liability under an expenditure tax system. (adaptation of example of Meade report at 151)

ADD	R	R
1. Personal income		
Salaries	150,000	
Dividends	35,000	
Interest	25,000	
Rent	24,000	
Profits	50,000	
Royalties	1,000	285,000
2. Capital receipts		
Realisation of assets (property sold)	400,000	
Amount borrowed	200,000	
Receipt of payment of past loans	20,000	
Reduction in money balances	0	620,000
3. Windfall inflows		
Inheritances	50,000	
Gifts	20,000	70,000

Total chargeable items		975,000
DEDUCT		
4. Non-consumption outgoings		
Acquisition of assets (property purchased)	-500,000	
Amount lent	-50,000	
Repayment of past borrowings	-100,000	
Increase in money balances (savings)	-50,000	
Gifts made (?*)	-50,000	
Direct taxes paid (?*)	-20,000	-770,000
5 Allowable deductions		-100,000
TAXABLE EXPENDITURE ON CONSUMPTION		105,000

* There is uncertainty whether direct taxes paid should be included in item 4 (in which case consumption expenditure in item 5 can be regarded as exclusive of tax and on the other hand it will be regarded as inclusive of tax) The basic outcome is not affected by the choice between the two methods.

1.5. Tax effect of an expenditure-based tax regime on the transaction under discussion.

If the above principles are applied to the facts of the transaction under consideration and is compared with the figures shown in the tabulated comparison between the conventional and the convertible loan, on page 14 of chapter 1, it is clear that the tax that would be payable on the conventional and convertible loans, although radically different than either under an income tax regime, are exactly the same. The comparison reflects all entries during the 5 year period including the incurral and the repayment of the loan.

ADD	Conventional loan	Conventional loan	Convertible loan	Convertible loan
1. Income	SubCo	HoldCo	SubCo	HoldCo
Interest		24,990,661		
2. Capital receipts				
Amount borrowed	100,000,000		100,000,000	
Receipt of payment of past loans		43,000,000		43,000,000
DEDUCT				
4. Non-consumption outgoings	-100,000,000			
Repayment of past borrowings			-43,000,000	
5 Allowable deductions	-58,117,816		-90,127,155	
TAXABLE EXPENDITURE ON CONSUMPTION	-58,117,816	67,990,661	-33,127,155	43,000,000
TOTAL		9,872,845		9,872,845

2. Change in basis of revenue recognition under the accrual system.

In the Margo Commission Report[159] it was held that;

> *" 9.3 The existing tax system in South Africa is, in a sense, artificial. The system does not tax either profits or cash flow, but instead seeks to tax - in accordance with a statutory formula - an amalgamation of both. Briefly stated, gross income - which is the starting point in the determination of taxable income - consists of all receipts and accruals with an actual or deemed South African source, but excluding those of a capital nature. Gross income also includes certain specified receipts and accruals, whether of a capital nature or not. From gross income is deducted exempt income, and the resulting amount constitutes income. In order to determine taxable income there must be deducted from income all expenses incurred in the production of income .... The artificiality of the tax base has been subject to criticism in numerous legal decisions ...... and has itself resulted in certain controversial judicial decisions. "*

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159 Report Of The Commission Into The Tax Structure Of The Republic Of South Africa, chaired by Justice Cecil Margo, RP 34/87, Government Printer. ISBN0621106887.

2.1. Financial accounting versus tax accounting

The Commission went on to say;

> ***" 9.4 In theory, taxable income could be exactly equated with accounting income .... but in practice there is no country ..... which has adopted this approach in its purest form. "***

Although financial accounting and reporting and taxing systems have the same objective, i.e. the determination of income, their respective purposes can be defined as follows;

- **Financial accounting and reporting as regards income** - to provide information to management, shareholders, creditors and the taxing authorities with regard to the true income of the business entity and to protect these parties from being misled.
- **Taxing systems** - the equitable collection of revenue and the protection of the public fisc. Additionally, a tax system is part of the overall wealth distribution system and can, furthermore, be used as one of a number of tools to control the national economy.

Generally Accepted Accounting Principles (GAAP) usually recognises income and expenses at the time of "economic performance", which seems logical and more compatible with ability to pay. This can, however, vary widely with taxable income computed under our present income tax principles. On the basis of their income for financial accounting purposes, many companies would appear to have a significant ability to pay, yet have, proportionately, very low or no tax provisions. "Economic performance" as a basis of revenue recognition will eliminate such anomalies.

The question is now; can these two systems, each with a different purpose, be reconciled? The Margo Commission (at 169) felt that a greater extent of reliance could be placed on it in the South African taxing system. The New Zealand Task Force on Tax Reform[160], however, was of a different view and felt it was appropriate that the accounting and tax methods of determining income should differ.

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160 Report of the New Zealand Task Force on Tax Reform. 1982.

In the United States Of America and Australia the accrual method of revenue recognition (described below) is used as one of a number of tax options open to the taxpayer. Under this method of computing tax, taxable income would be much closer to accounting income than as would be the case with the South African accrual system. In terms of section 446 of the "Internal Revenue Code" (IRC) taxable income is determined using the regular accounting method by which income is determined. However, if in the opinion of the "Internal Revenue Service" (IRS) this does not clearly reflect income the IRS may adopt a method which does. The courts, in order to determine the timing of an accrual, have developed the 'all events' test to determine if certain items clearly reflect income regardless of its accounting treatment. In Australia some courts have used accounting standards to make determinations with regards to tax, but the 'Australian Income Tax Assessment Act' does not make reference to the accounting method used by the taxpayer.

There has been ongoing concern that, if there was to be mandatory conformity between tax accounting and financial accounting, it would practically mean that all development of GAAP would have to be sanctioned by the tax authorities, which could stifle such development and have the effect that Government would practically determine GAAP instead of the accounting profession. In the U.S. this idea was conclusively rejected by the U.S. Supreme Court in the Thor Power Tool case[161].

Complete conformity between tax and financial accounting can only be achieved if existing rules for both disciplines are scrapped, and are replaced with a common set of rules for both, or. alternatively, if tax accounting can be changed to conform completely with financial accounting[162]. This would have the following advantages:-

- It will reduce complexity and uncertainty as there will be one set of rules, provided that no exceptions are allowed.
- Equity will increase as one set of rules will lead to greater uniformity.
- Compliance cost will be lower and compliance levels will improve.
- Perceptions of fairness will improve.

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161 Thor Power Tool. 1979, 439 US 522.

162 Consistent with the views of Porcano, TM: Shull,DM: Tran, AV: Alignment of Taxable Income with Accounting Profit. (1993) 10 Australian Tax Forum.

- Tax administration will improve. The need for tax specialists and their services will decline.

There will however also be disadvantages viz.;

- Potential for conflict between government and financial accounting bodies.
- Distortion of accounting policy development.
- Greater reliance will have to be placed on the auditor, with consequent cost implications.
- Financial statements will be subject to review by Revenue.
- It may result in the method of taxation overriding the ability-to-pay concept, i.e. if income is received before funds are earned and the Government does not obtain tax when cash is available, it may find when the amount is earned the taxpayer may not have the money to pay tax.
- Government's ability to control the economy will diminish.

The abovementioned article concluded that ***" .... a complete alignment of the two systems does not appear to be feasible because of the institutional arrangements. There are too many differences between the two systems: differences in underlying concepts, in methods and practices and in governing agencies. These differences should exist because they have different constituencies and different objectives. The effect of such differences is the preclusion of a complete alignment. Is complete alignment beneficial? It is probably in the public interest that the two systems be kept separate. The Distortions to both systems, and therefore the impact on the audience they serve, would be too great if complete conformity were imposed. "***

2.2. Recognition of futurity of rights

The Margo Commission, under the heading "Recognition of Income and Expenditure" reviewed the recognition aspect and specifically referred to the "due and payable" test (paragraph 9.7), which is basically one of recognising income on a cash basis. The Commission could not see the justification for deferring income until the debt was received. A cash basis of taxation, as a consequence of income being recognised in a later year, taxes an amount at what can be considered as the future value of the same amount if it is taxed at face value under the present receipt or accruals basis. The Commission specifically held that where a taxpayer "***has become entitled to a right in terms of which an amount is payable in a future year ......, due allowance should be made in the valuation thereof for the futurity of the right beyond twelve months.***" This would appear to be a valuation as envisaged in the Lategan[163] case and the later People's Stores[164] case. (In chapter II of this dissertation these cases were discussed and mention was made that both courts held that, if an amount is received in the future, its face value should be reduced to its present value.)

The Commission's then recommended (paragraph 9.10 (a) page 170) that;
"***Income should be recognised when all events have occurred which fix the right to receive it and that the amount thereof can be determined with reasonable accuracy; but due allowance should be made for the futurity of a right beyond twelve months.***".
(As can be seen from the discussion, below, of the "all events" method of revenue recognition, recommended by the Commission, also can lead to deferment of the payment of tax (if compared with the South African receipt or accrual basis), and allowing for futurity does not always go hand in hand with that system.)

"Estimation" aside, which is commonly used in many countries especially to counteract tax avoidance, only two methods of revaluation are possible, viz.;

- revaluation to present value. The present value is merely a discounted value at a given percentage, computed mathematically. Provided that a reasonable and acceptable rate is used, there is nothing contentious about it .
- revaluation to market value. If an asset does not have a readily determinable market value, such as shares listed on a stock exchange, the market value can be difficult to determine. The concept of "fair market value" will take into account factors such as the soundness of a company's financial position but also intangibles such as its management, markets, competitors, etc.

The People's Stores case addressed this issue but it is not clear what ruling was made. Hefer, JA referred to the Special Court's finding that the present value must be included in income. The Special Court, however, held that the objective market value must be included in

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163 Lategan v CIR. 1926, CPD 202 2 SATC 16.

164 CIR v People's Stores (Pty) Ltd. 1990, (2) SA 353 (A) 52 SATC 9.

income[165]. The value of an amount receivable in the future, especially in the longer term, however, is more often than not determined by discounting it back to the present value.

Subsequent to the Commission report and the People's Stores decision the first proviso to the definition of gross income (discussed in earlier chapters) was brought into the Act, which determined that the tax value of a receipt is equal to the face value.

If the "all events" method of accrual, recommended by the Margo Commission as solution, should be implemented in South Africa, the first proviso would not necessarily counteract the concept of allowing for futurity, it will, to the contrary, prevent revaluation in the event where payment of tax is deferred (which this system of tax can result in as can be seen below). In such an event the method in itself, takes care of the futurity concept, as is contended in the following paragraph.

2.3. The "all events" accrual method of revenue recognition

In the United States Of America, in terms of the 1984 tax legislation, there is not, as is in South Africa, a single method for the computation of taxable income. A taxpayer has the right to elect the basis of tax accounting and may compute his income under any of the following methods of accounting.

- Cash receipts and disbursements method. Under this method all items which constitute gross income must be included in the year in which it is actually or constructively received and expenditure must be deducted for the year of assessment in which they are actually incurred.
- The accrual method (discussed below in detail). According to Sommerfeld[166] large businesses have little alternative but to use the accruals method for the reason that the IRC determines that a taxpayer must compute his taxable income using the same accounting method, subject to certain limitations, as used for keeping his books of account. The accruals method is usually insisted on by accountants as it is the method that most accurately reflects income for financial reporting purposes. The essence of the accrual method is the belief that revenue recognition should take place when

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[165] See Emslie, TS: Davis, DM; Hutton, SJ. Income Tax Cases and Materials. 1995. 2nd Ed. The Taxpayer, Cape Town. At 42.

[166] Sommerfeld, RM: Federal Taxes and Management Decisions. 1974. Homewood, Illinois.

income is earned, regardless of when cash is received, and that expenses should be matched against the revenues they produce i.e. in the year the revenue is recognised and not in the year the expense is paid. In the U.S.A. it is therefore the prerogative of the taxpayer to elect the tax accounting method provided that such method clearly reflects income, in the opinion and to the satisfaction of the Commissioner. If generally accepted accounting principles are used by the taxpayer for financial reporting purposes and in accounting for tax, and this basis is applied consistently, it will normally be acceptable to the U.S. tax authorities.

. This system has the following advantages;

- the ease of taxpayer compliance once accrual system of accounting is maintained.
- accelerated deduction of deductible items not paid.

and the following disadvantages:

- reduction of taxpayer's control over timing of tax payable.
- the need to recognise income prior to receipt in cash.

- Other permissible methods such as the crop method, instalment method, long-term contract method etc.

It was held that;

"On an accrual basis, as distinguished from a cash basis, a taxpayer makes a complete accounting or return for the taxable year of every transaction which determines net or taxable income; in other words, all obligations incurred and all accounts receivable growing out of transactions in such a taxable period are reflected in the return for that year, whether payable within such taxing period or later. .... it has been said that the accrual method .... is purely an economic and bookkeeping procedure whereby it is the right to receive, and not the actual receipt of an income item, which determines the propriety of its inclusion in income for tax purposes. The basic consideration in determining whether or not income has accrued depends on whether or not all of the events creating the liability have occurred. Whether a taxpayer is entitled to or bound to accrue an item of income in a certain year depends upon whether there was justification for a reasonable expectation that payment of the item would be made in due course. Thus, if ..... the taxpayer's accounts contain all the basic data and facts from which he may,

within reasonable limits, determine an amount which he has a fixed right to receive, such amount is accruable."[167]

It must be stressed that it is not the actual receipt of an amount but the right to receive it that governs.

It is interesting to note that the Australian Tax Assessment Act also allows taxpayers to be taxed under a number of methods, the main methods also being the cash and the accruals basis. In that country, however, it is neither the Commissioner's nor the taxpayer's prerogative to chose the method. The method is derived from principles laid down by the courts.

As far as accrued expenses and losses are concerned under the U.S. system, these are also deductible when 'all events' occurred which established the fact of the liability giving rise to the deduction. (A similar test applies in Australia to determine the timing of deductions). As can be seen from the above quotation, U.S. tax legislation basically provides an all events could not have occurred before the time of "economic performance"[168]. An example of the application of the "economic performance test" is that the deduction of prepaid expenses will be deferred until economic performance occurred (even under a cash basis)[169].

In an American case Challenge Publications Inc. v Commissioner[170] the court held that the "all events" test provides that an expense is deductible in a given year if;

- it is sufficiently fixed.
- it is absolute and unconditional.
- the amount is determinable with reasonable accuracy.

The U.S. tax regulations define the manner in which liabilities incurred are taken into account. For example; a liability that relates to the creation of an asset with a useful life extending beyond the end of the year of assessment is taken into account in the year of assessment, through capitalisation, and will later have an effect on the computation of taxable income

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167 American Jurisprudence. 1973 as updated. Volume 71. Bancroft-Whitney Co. San Francisco. At 845. Writer's underlining.

168 IRC Code Sec. 461(h).

169 IRC Code Sec. 461(i).

170 Challenge Publications Inc. v Commissioner. 1988.

through depreciation or otherwise over a period, including subsequent years of assessment, in accordance with applicable IRC.

The term "liability" includes allowable deductions, costs and expenses, allowable capitalised costs, costs in relation to long-term contracts, cost of goods sold etc., provided that a legal liability to pay existed in the year of assessment. Prepayments for goods and services or any other payments for which no legal obligation existed during the tax year, are not included in "liability" and can not be taken into account in determining the tax liability under the accrual method.

The U.S. definition of gross income includes all income from whatever source, except items specifically excluded by the IRC, and the supreme court held that "***Income may be defined as the gain derived from capital, from labor, or from both combined, provided that it be understood to include profit gained through a sale or conversion of capital assets***"[171]. Common types of gross income enumerated by the Code include gains from dealing in property, dividends, etc.

The tabulation below reflects a (simplistic) comparison between the tax treatments of an accrual under such a system and under our present income based tax system:

	Year 1	Year 2	Year 3
Unconditional liability	X		
Economic performance		50%	50%
Payment	100,000	900,000	1,000,000
Deduction for tax purposes			
Present income based tax system	2,000,000		
Economic performance		1,000,000	1,000,000

2.4. Comparison between the South African system and an "all events" accrual system.

If money is received after the year of "economic performance" the "all events" method of accrual suffers the same fate as under the South African system as regards allowance for the

171 U.S. Master Tax Guide. Commerce Clearing House Inc. Chicago.

futurity of money. As in South Africa the U.S. Internal Revenue Code also makes no provision for a valuation in respect of amounts to be received in the future.

The **important difference** is that in South Africa an amount is taxed in the year it is first received, regardless of whether it has accrued. This is not the case in America.

The tabulation below clearly illustrates the fact that when an amount received and taxed under our present receipt or accrual system is compared with the same amount taxed at the time of "economic performance" in a later year, the real worth of the accrual and the tax paid thereon, although equal in face value, will naturally be higher.

	Year 1	Year 2	Year 3
Accrued income			
Income - date of receipt	2,000,000		
Present value of receipt	2,000,000		
Present value of tax @ 35%	700,000		
Income - date of economic performance		1,000,000	1,000,000
Present value of receipt: Inflation 10%		900,000	810,000
Present value of tax @ 35%			598,500

2.5. Will an "all events" accrual system have any relevance to the transaction under discussion?

If, as a result of the "all events" method of accrual, the transaction under discussion is to be subjected to tax, it would mean that as its value increases from R43 million in year 1 (a price determined at arm's length by unrelated persons) to R100 million in year 5, the portion of the value that is "realised" of R11.4 million per year will be taxable (For illustrative purposes this value was calculated on a straight-line basis (R57 million divided by 5) rather than the yield to maturity basis.). Alternatively the full R57 million will have to be taxed after 5 years.

As the principle to be established, in the transaction under discussion, clearly deals with income that will accrue over a period of time, or after 5 years, it must be noted that from this point onwards, for the purpose of this dissertation, **only amounts received in the future will be given further consideration.** The fact that the "all events" system makes no allowance for

the futurity if an amount of money is received after the year of "economic performance" will be disregarded.
It is important to note that if the "all events" accrual system, as was advocated by the Margo Commission[172], is implemented in South Africa and it leads to deferment of taxation on a receipt, no valuation of the asset would be required. The reason for this proposition with regard to "all events"/valuation is made on the basis that the deferral of taxation to a later year, as a natural consequence thereof is taxed in the future at the then present value of the amount.

It must also be noted that the Commission made no recommendation that the other elements of the "Definition of Gross Income" i.e. amount, source, revenue nature (the Commission recognised the difficulty in distinguishing between capital and revenue, which impairs the ability of a taxpayer to plan with certainty. The tests laid down by the courts involve, for the most part, subjective criteria relating to the intention of the taxpayer. The Commission recommended that the subjective criteria be substituted with objective criteria but that the distinction for tax purposes remain) and the "General Deduction Formula" (expenditure or losses, in the year of assessment, in the production of income, trade related, revenue nature) be changed, but merely that the timing for inclusion of income and expenses be matched with the time of "economic performance".

Deferment therefore, by its very nature, makes valuation unnecessary. It is possibly for this reason that the recommendation in paragraph 9.10 of the Margo Commission report, which seems inconsistent if compared to paragraph 9.7, do not contain the words *"..... in the valuation thereof ....."* appearing immediately before the words *"....for the futurity of ......"*. The omission, insofar as it does not refer to income received at a later date, is, however, puzzling because if a valuation was not intended, what other way could the Commission possibly have envisaged that allowance be made for futurity?

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172 The proposal of the Commission (at paragraph 9.8 - page 170) was mainly envisaged as an anti-avoidance measure and it was of the opinion that the "economic performance" test would defeat certain tax schemes where a company entered into a contract for large expenses over a number of years and claiming the full contract value upon making a small down payment in the first year.

If, in the transaction under discussion, it can be contended that the gain of R57 million "received" by HoldCo (and resulting from the time value of money difference between the amount for which the shares were purchased and the "value" that will be received after 5 years), would be taxable, at some stage, under an "all events" accrual system, will the allowance for futurity, resulting from such a system, have any effect on the taxability of the gain? To determine this the questions posed in Chapter 11 have to be revisited in the light of the aforegoing and the Margo Commission recommendations.

2.5.1. Present value/future value concepts?

For the purposes of this paragraph it is assumed that an increase in the value of an asset, owned by a group company can, for some reason, be classified as being of a Revenue nature. Capital assets, used in the production of income, are currently treated under our Act as shown below (See chapter II for a more detailed discussion);

- Goods as trading stock - section 22(1)(a). Stock carried forward to the next year is included in taxable income at cost less deterioration. An increase in the value of stock, will be disregarded for tax purposes.
- Shares as trading stock - section 22(1)(a). Shares held by a sharedealing company, carried forward until the next year, is valued at the cost thereof.
- Assets previously regarded as of a capital nature which became trading stock - section 22(2)(b). Capital assets which have been converted to trading stock are valued at its cost at the time of acquisition, and no allowance is made for any increase in value whilst it was held a capital asset.
- Capital assets such as plant or machinery used in the production of income - Para (n) of the Definition of Gross Income together with section 8(4)(a). Recoupment of allowances previously deducted in terms of Sections 11-20, 24D, 24F, 24G and 27(2)(b) and (d) limited to the cost of the asset less the tax value. If the proceeds from the sale of the asset exceeded the cost price thereof the difference between these two amounts is of a capital nature and not taxable.

As argued and illustrated above, the "all events" method of accrual, by its very nature, recognises the time value of money concept due to the deferment of income or expenses until the year of "economic performance". The fact that the closing stock value of assets such as shares, with a determinable market value can, under the present tax regime, not be increased to above its cost to a company is logical and compatible with principles of taxation. With unsold shares there is clearly no income which can be taxed. As was contended earlier one of the objectives of a closer alignment between financial and tax accounting - which the "all events" accrual method to some extent achieves - is ability to pay. Recognising the increase in the value of the shares for income tax purposes will not enhance ability to pay, to the contrary.

Following from this, can unrealised gains flowing from the growth in value of an asset, under an "all events" accrual tax regime, be regarded as being tantamount to "economic performance" and is it, therefore, capable of being taxed? From the above it would appear that the answer remains no.

If the same argument is followed through to shares held as investment in a subsidiary (which for some reason could be regarded as being of a revenue nature) it would seem that the increase in the face value of the shares can not be regarded as "economic performance" and that there is, therefore, no income capable of being taxed until the shares are sold.

2.5.2. Is there an accrual and if so is there a determinable amount?

In Chapter II it was contended that an unconditional right accrued to HoldCo in relation to the shares purchased for future delivery but that it would not be possible for Revenue to determine a value to be attached to it. As mentioned above the "all events" test has similar provisions in that an expense is deductible in a given year if;

- the liability is absolute and unconditional.
- the amount is determinable with reasonable accuracy.

The arguments in chapter II would therefore be equally valid in respect of the "all events" system.

As far as the third requirement, viz.,

- the liability must be sufficiently fixed;

is concerned, it seems unlikely that increases in the value of shares, proportionately determined over 5 years, can be regarded as sufficiently fixed until HoldCo sells the shares. More concrete circumstances are required as is borne out in the Challenge Publications case[173]. In that case a U.S. court held that a publisher could not accrue, as a deductible business expense, an estimate of the credit it will be required to pass to its distributor for unsold magazines, even though this estimate was based on past history and conformed to industry standards. The court held that the expense was not sufficiently fixed, nor absolute and unconditional and, as the taxpayer failed to pass the these two requirements, the court did not deem it necessary to rule on whether an amount was determined.

An estimate of a credit which will be realised in the immediately succeeding tax year, based on past history and industry standards, would appear to be more concrete than an increase in value of shares, over five years, in the circumstances of the transaction under discussion.

2.5.3. Is the amount of a capital nature?

In the U.S.A income of a capital nature is taxable in terms of their definition of gross income. The Margo Commission Report (page 225), however, contained no recommendation that South Africa should tax gains of a capital nature (and furthermore rejected capital gains tax) The amount under discussion, therefore, remains to be of a capital nature and is therefore not taxable.

2.5.4. Conclusion

The transaction under discussion will, in view of the above not be taxable under the "all events" method of recognising accruals.

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173 Challenge Publications Inc. v Commissioner. 1988.

CHAPTER VIII

FINAL CONCLUSIONS

1. Conclusion

If the eradication of tax-advantageous group financing arrangements becomes a priority of the State, there would appear to be 3 possible ways of achieving this through tax reform.

1.1. Changes to the existing Act

Tax avoidance by company groups, flowing from tax-advantageous financing arrangements of group companies could, relatively easily, be countered by changing the existing Income Tax Act. This is subject to the proviso that the necessary care is exercised to ensure that such changes would not result in leaving other loopholes open and that it would not subject amounts to tax which it is not the intention of the fisc to tax. Such change may, for this reason necessitate changes to other sections of the Act.

1.2. Expenditure-based taxation

There is no question that this tax system will be successful in combating tax-advantageous financing arrangements of group companies. Such a system, however, is not a practical solution in so many other respects, that it is unlikely that it will ever be implemented in any country. These difficulties were considered by the Margo Commission and led the Commission to the conclusion that, whilst recognising the obvious advantages of such a tax system, the time was not ripe to introduce an expenditure-based tax system in South Africa.

The unequal distribution of wealth in the South African society was mentioned as one reason for this conclusion. Although the country now has a democratically elected government this unequal distribution remains. The enormous transitional problems, that such a change will present, is another factor that can not be easily overcome.

There is good reason why, despite the advantages, no country has ever instituted an expenditure-based system of direct taxation and it is hoped that South Africa will not be the pioneer in this respect.

1.3. An all-events accrual system

The Margo Commission (9.9) was of the opinion that an "all events" accrual system will combat certain tax schemes. It would, however, have no effect on group financing schemes.

2. Final conclusion

It would be far simpler and more logical to find a solution within the existing income based system of taxation along the lines suggested in Chapter VI, rather that to change the basis of taxation.

Tax is not an exact science, as the many dissenting judgments amongst High Court Judges would indicate, but as is contended in Chapter V, there is very little doubt that group companies can successfully avoid tax with schemes such as the one under discussion.

The fact that it is not impossible to eradicate these schemes must be a cause concern of the companies participating in these schemes, but there is, however, very little downside for these companies. Should legislation to counter the schemes be introduced it is unlikely that it will be retro-active. Usually all that can be lost is part of the initial fee paid to the bank. The eradication of tax-advantageous financing arrangements of group companies is such an obvious way to swell the state coffers, with such a high return in additional tax for the fisc that it is hard to fathom why nothing is done by the State in this regard.