

# Synopsis

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Tax today\*

All smoke and mirrors or genuine  
commercial venture?

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Editor: Ian Wilson

Written by R C (Bob) Williams

Sub-editor and layout: Carol Penny

Tax Services Johannesburg

Distribution: Elizabeth Ndlangamandla

Tel (011) 797-5835

Fax (011) 209-5835

www.pwc.com/za

## Tax avoidance schemes

# Smoke and mirrors or genuine commercial venture?

There are places in the world where a tourist can scarcely walk a dozen steps without being accosted by a shifty-looking individual offering to sell a "genuine" Omega watch or something similar for a fraction of the usual price.

The Australian equivalent in the 1990s was what the press in that country called the "white shoe brigade" of snake oil salesmen touting tax schemes with the "guarantee" that the taxpayer would get a tax deduction equal to a multiple of the fee payable to the promoter of the scheme.

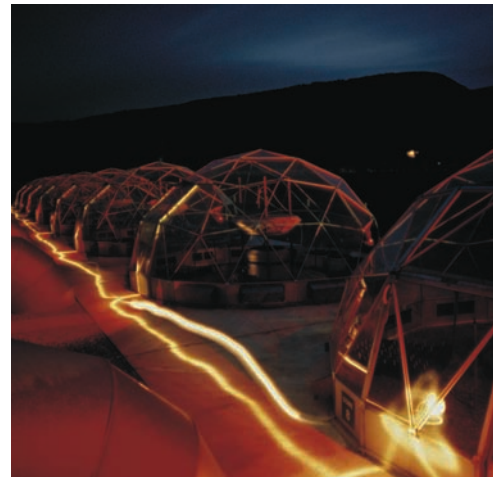
The recent judgment of the Australian Federal Court in *de Simone v Federal Commissioner of Taxation* 2009 ATC 20-101 concerned such a mass-marketed tax scheme.

### A venture ostensibly to finance a theatrical production

In this particular case, the promise of the tax promoter was that, in return for an outlay of A\$100 000 the taxpayer would get a tax deduction of five times that amount, namely A\$500 000. Such a deduction would diminish the taxpayer's overall taxable income, and reduce the tax payable by him by up to about A\$200 000.

The attraction of the tax scheme was thus the prospect of outlaying \$100 000 and getting about \$200 000 back from the tax authorities.

How did it work? Bruce, the gullible taxpayer, would be invited to "invest" \$500 000 in a partnership that would finance a proposed "theatrical production". The invitation came (so the judgment tells us) from "a lawyer experienced in the entertainment industry". The partnership was to be managed by a company, and a second company would produce the show.



The theatrical production was to be financed, initially, by the contributions of the partnership in which Bruce would be a partner and thereafter by the profits to be generated by the production itself.

Of the \$500 000 to be contributed by Bruce and each of his fellow investors, \$100 000 was to be provided upfront by each of them in cash, and for this they would become a partner together with the other Bruces who put money into the scheme.

Each partner would be under a legal obligation to provide the balance of \$400 000, but this sum would be advanced "on their behalf" by a finance company, on terms whereby the finance company could only claim repayment from the investors out of the income they received from the theatrical production. Hence, Bruce could never, even if the theatrical production was a complete flop, be called on to pay more than the \$100 000 he had contributed.

It was no doubt explained to Bruce and his fellow investors by the promoter of the scheme that they would each be entitled to a tax deduction, not merely of the \$100 000 they had contributed in cash, but also of the \$400 000 that had been advanced “on their behalf” by the finance company, on the basis that the arrangement was a commercial venture in respect of which any non-capital outgoing (such as their \$500 000 contribution to the venture) would be a tax-deductible expenditure or loss.

Sadly, but not unexpectedly, in the tax year in which all of this happened, the partnership of Bruce and his fellow investors received not a cent in income from the theatrical production. Indeed, it is uncertain whether any theatrical production eventuated.

This did not deter each of them from claiming the full \$500 000 of their investment as a tax deduction, in respect of a “loss” they had incurred from a money-making venture that, regrettably, had not yet produced any income.

The Australian tax authorities allowed Bruce a deduction of \$100 000 in respect of the moneys actually outlaid by him, but refused to allow him a deduction for the other \$400 000.

Aggrieved by this decision, Bruce appealed against the assessment.

**An egregious error by the court of first instance, but the Federal Court disallowed the deduction in terms of Australia’s GAAR**

When the matter was heard by Australia’s Administrative Appeals Tribunal (the counterpart to our tax

court), the tribunal held that, since there was no evidence that Bruce had actually outlaid the \$400 000, he was not entitled to a deduction for this amount.

On further appeal, the Federal Court accepted that this was an egregious error of law by the Tribunal.

The reason was that, in terms of Australia’s income tax legislation (as with our own), a taxpayer is entitled to a deduction in respect of expenditure which has been “incurred” – that is to say, in respect of which the taxpayer has, during the tax year in question, become subject to a legal obligation to pay, even if the money has not yet been actually paid. Hence, the fact that Bruce had not actually paid the \$400 000 did not, of itself, bar him from claiming it as a deduction, so long as he had come under a legal obligation in respect of that amount.

However, said the Federal Court, this error of law by the Tribunal did not resolve the matter in favour of the taxpayer.

The Federal Court then proceeded to hold that Bruce was not entitled to the claimed deduction of \$400 000 because his obligation to pay that amount was an element of a tax-avoidance scheme that fell within the general anti-avoidance provision of Australia’s income tax legislation, namely part IVA of Australia’s Income Tax Assessment Act of 1936.

These provisions are similar to South Africa’s new general anti-avoidance rule contained in part IIA of our Income Tax Act 58 of 1962.

## How would a similar situation be dealt with by a South African court?

**A South African tax lawyer may be somewhat bemused by the immediate resort by Australia’s Federal Court to the complexities of that country’s general anti-avoidance provisions, and by the conclusion that Bruce was indeed entitled to a tax deduction of \$100 000.**

For, surely, there was an antecedent question that should have been asked, namely, were these transactions (the partnership, the loan, and the theatrical venture as a whole) genuine or a mere sham? For, if they were a sham, then the court could simply dismiss the claim for a tax deduction without needing to invoke any statutory anti-avoidance rules.

Thus, was any “theatrical production” ever mounted? If not, was there even any genuine intention to mount such a production?

The judgment tells us that no evidence was laid before the court that the middleman financier had ever actually advanced the amount of \$400 000 per “partner” to finance the theatrical production.

This inevitably raises the suspicion that the agreement whereby the financier ostensibly agreed to advance the sum of \$400 000 on behalf of each partner was a mere pretence, and that

*It is hoped that if a similar case were to come before a South African court, that it would apply the straightforward common law principle that the courts disregard disguised or sham transactions.*

what really happened was that the promoter of the scheme simply pocketed the \$100 000 that Bruce had paid, gave the latter some documents which professed to establish a partnership and a venture to finance a theatrical production, and then gave the financier his cut.

If that was what had really happened behind the scenes – in other words if the various bits of paper that professed to record a partnership agreement, and a contribution by the partners of \$500 000 to the venture were just smoke and mirrors to conceal the reality that the whole elaborate “theatre production venture” was a complete sham – the court could simply have ruled that the whole scheme was an elaborate hoax, with no tax consequences, except, perhaps, prosecution for an attempted fraud on the revenue.

In which event, (contrary to the decision of the Australian Federal Court) Bruce may not have been entitled to a deduction even for the \$100 000 he had contributed to the venture, since that too may have been part of the sham, and may not have qualified as expenditure outlaid for the purpose of producing income.

In short – the Australian tax authorities in this case (as SARS has done on several occasions in reported judgments of our own courts) responded to a highly suspect tax scheme with a knee-jerk invocation of the complex anti-avoidance provisions of the tax legislation.

What a court should do (it is submitted) is first apply the common law (in this

case, the straightforward principle that the court will ignore a sham transaction) and resort to the statutory anti-avoidance provisions only where common law cannot resolve the matter.

### Sham and disguised transactions

There is clear authority in judgments of the South African courts on what constitutes a sham or disguised or simulated transaction.

The *locus classicus* is Innes CJ's judgment in *Zandberg v Van Zyl* 1910 AD 302 in which he said that –

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

But, as was emphasised in *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369 –

[a] transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly

intend it to have effect according to its tenor, is interpreted by the court according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax.

Thus, in *Michau v Maize Board* 2003 (6) SA 459 the Supreme Court of Appeal said that

parties are free to arrange their affairs so as to remain outside the provisions of a particular statute. Merely because those provisions would not have been avoided had the parties structured their transaction in a different and perhaps more convenient way does not make their transaction objectionable. What they may not do is to conceal the true nature of their transaction or, in the words of Innes JA in *Zandberg's* case at 309, “call it by a name, or give it a shape intended not to express but to conceal its true nature”. In such an event the court will strip off its ostensible form and give effect to what the transaction really is.

It is to be hoped that, if a case involving facts similar to *de Simone v Federal Commissioner of Taxation*, discussed above, were to come before a South African court, that the court would apply the straightforward common law principle that the courts disregard disguised or sham transactions, rather than resorting immediately to our own complex and convoluted statutory anti-avoidance provisions.

## Legal disputes

# Be careful what you wish for

It may happen in a legal dispute that a party becomes so focused on the contested issue that he loses sight of the bigger picture and fails to foresee consequences that might lie in wait in the event that he succeeds in the action. This might just be the case of the respondents in *Registrar of Pension Funds and another v Angus NO and others 2007 2 All SA 608 (SCA)*.



The case dealt with whether certain bargaining council retirement funds fell within the ambit of the Pensions Funds Act 24 of 1956 (PFA) and the oversight of the Financial Services Board (FSB). The subject of the dispute was a R9 billion rand actuarial surplus which the respondents did not want to have apportioned in terms of the detailed provisions of the PFA. The Supreme Court of Appeal concluded that the funds were indeed created “in terms of” an industrial agreement and were therefore not subject to the PFA.

It appears that the respondents in contesting the issue may have overlooked a vital question, namely, **“what will happen to my tax status should I win this case?”**

Pension funds are afforded a special tax dispensation which means that the income that they receive is exempt from normal tax. Moreover, employers and employees enjoy deduction in respect of contributions to a pension fund, subject to certain limitations. This special tax dispensation is only available if the fund falls within the ambit of the definition of “pension fund” in section 1 of the Income Tax Act 58 of 1962 (ITA) which includes only the following types of funds namely:

Funds established by law;

Funds established for the benefit of employees of any local authority or for municipal entities created in terms of the Municipal Systems Act;

Funds established for the benefit of employees of any control board or the Development Bank of Southern Africa; Municipal Councillors Pension Fund; Any other fund approved by the Commissioner and registered in terms of the PFA.

In this instance, the Court determined that the fund was established “in terms of” an agreement that was effected in terms of the Industrial Conciliation Act 28 of 1956 and thus was not established by law. Furthermore the requirements of all the other specific types of funds are narrowly prescribed and would not apply in the case of a union fund serving a type of industry. The only possible way in which the fund could otherwise obtain a tax status as a pension fund is under the general requirements that apply in respect of a fund registered as a pension fund under the PFA. The Court at 614 dealt with this issue and concluded that if the respondents were to win the primary question in the appeal it would mean that the PFA was not applicable and the fund’s existing registrations were void and of no effect.

The fund registrations under the PFA were therefore ab initio void, which means that they did not qualify for the exemption under the ITA from their inception.

In consequence of this finding, it would appear that the funds were not pension funds for the purposes of the ITA, but some other type of entity whose income

is fully taxable. It is difficult to imagine how the unions would react to the loss of employees’ pension entitlements to tax.

This however is not the end of the tax saga as the contributions paid by the employers for the benefit of the employees were also claimed as a deduction for corporate tax purposes under section 11(l). It would appear that, as a consequence of the Court’s ruling, the employer contributions would be classified instead as a taxable fringe benefit, and that the employers would therefore still enjoy deduction, although under section 11(a).

Employees on the other hand would have deducted their contributions under s11(k). As the requirement for deduction would have been void, these amounts should not have been allowed as a deduction, but should have been taxed.

The position then is that PAYE should have been deducted and paid in respect of the employer contributions and the employee contributions made to a non-qualifying fund. These amounts would appear to be recoverable by SARS from the employers, who in turn are entitled to recover same from the employees, but, in light of the obvious labour relations risks, would be reluctant to do so.

In a time of economic recession and SARS budget deficits it would be interesting to see the approach to this dilemma which on the one hand could ensure a few billion rand tax windfall but on the other hand create “organised” labour chaos.

## Tax paid on fictitious income

# Taxpayer's right to interest on SARS refund?

Strange as it may seem, some corporate frauds involve paying tax to SARS on fictitious income, where no tax was in fact payable.

If and when such frauds come to light, the company will naturally seek a refund from SARS of the capital amount unnecessarily paid, plus interest. This raises issues of some legal complexity since, not unnaturally, tax legislation does not provide for the situation where a taxpayer deliberately pays tax that is not due.

Most recently, this scenario occurred in the case of *KNA Insurance and Investment Brokers (Pty) Ltd v SARS* (2009) 71 SATC 155 which was heard by the North Gauteng High Court.

In this case, the fraudster was one Alexander, the managing director of the taxpayer company. His objective seems to have been to arrange for the company to pay a "dividend" of some R10 million, not to the company's sole shareholder, but to the company's directors and relatives, including himself.

This of course was wholly improper. It is only shareholders of a company who are entitled to be paid dividends. Moreover, the company in question was not in a financial position to pay any dividend at all.

What happened was theft, pure and simple, of the company's money.

The company's sole shareholder put the company into liquidation, and the details of the fraud then came to light.

By this time, the company had paid some R1.2 million to SARS by way of secondary tax on companies in respect of a professed R10 million "dividend", and had also paid provisional tax in the



sum of R6.3 million in respect of the company's profits.

In reality, the company had made a loss of over R4 million, and was therefore not liable for any corporate income tax.

SARS refunded the amounts paid by the company in respect of provisional tax and secondary tax on companies.

The argument concerned whether SARS had to pay interest on these amounts and, if so, from what date. The amounts in question were substantial. Interest on the provisional tax unnecessarily paid by the company amounted to R1.5 million.

### The basis of the taxpayer's claim to interest on the provisional tax unnecessarily paid

The Income Tax Act 58 of 1962 provides in section 89quat for the payment of interest on over-payments of tax.

The court held, however, that the amount of R6.3 million paid by the company could not be regarded as an over-payment of provisional tax for the purposes of this provision.

This was because no provisional tax was in fact payable by the company, and the money was paid only because of the fraudulent misrepresentations made by Alexander, the company's managing director, to the company's auditor.

Since Alexander was the "directing mind" of the company, his fraudulent intent was imputed to the company.

In procuring the company to make the payment, Alexander had no genuine intent that it was to be in respect of provisional tax – his intention was to cover up his theft by setting up fictional profits which would necessitate provisional tax payments.

Consequently, the court held that section 89quat which provides for interest on over-payments of

## Identity crisis

# Changing from being a share investor to being a share dealer

Since income tax is levied at a relatively high rate and capital gains tax at a relatively low rate, where a taxpayer sells shares at a profit, he has an incentive to deny that he was a share-dealer, and try to show that the shares were capital assets in his hands and that the gain on resale is subject to CGT, not income tax.

Conversely, where a taxpayer sells shares at a loss, he has an incentive to portray himself as a dealer in shares, so that the loss is deductible for income tax purposes, thereby diminishing his overall taxable income and reducing his income tax liability.

Thus, as the share market waxes and wanes through its periodical booms and busts, the law reports reflect taxpayers arguing in boom times that they are investors in shares and in downturns, that they are share-dealers.

It is interesting that the Australian Tax Office has recently issued a “taxpayer



alert” highlighting the telltale signs that alert the revenue authorities in that country that the taxpayer may be trying to “re-characterise” a capital loss on the resale of shares as a revenue loss in order to gain an income tax deduction.

The telltale signs, says the Australian Tax Office, include –

- purchasing or selling shares on a more regular basis with small net volumes;

- creating a trading plan for share transactions with a newly-stated goal of maximizing profits, even though the shares sold will generate a loss rather than a profit;

- increasing the amount of recorded time spent per week on the investment process, without any significant change in the value of transactions;

- maintaining additional records to evidence share transactions including additional reliance on guidance from others without any significant value in the total value of transactions;

- the taxpayer subsequently deciding to dispose of shares to realize a net loss;

- these changes being applied on a prospective basis, such that only future transactions are affected, even though there has been no substantive change in the objective facts between the current tax year and previous years.

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provisional tax was not applicable, and that any liability on the part of SARS to pay interest would have to be based on common law principles.

The court held that the common law principles in respect of liability for unjustified enrichment were applicable – in other words, that SARS would be unjustifiably enriched at the expense of the company if it did not repay, with interest, the moneys in question.

### The Income Tax Act is not a code

This decision is a useful reminder that, despite its considerable volume, the Income Tax Act is not a code – that is to say, it is not an encyclopaedia that embodies the entire law.

In respect of issues not covered by the Income Tax Act, common law principles will apply – in this case, the common law principle that where one person is unjustifiably enriched at the

expense of another, the latter is entitled to claim the amount of such enrichment.

It is well established (see *BAT v CoT* 57 SATC 271 at 281) and the court in the present case accepted, that the fiscus is not immune from the payment of interest *ex mora*, that is to say, interest from the date on which an amount ought to have been paid but was not.

# Tax experts give their views on tax avoidance and evasion and South Africa's new GAAR

The *South African Institute of Tax Practitioners* held an international conference in Johannesburg on 8 – 9 September this year, where one of the topics under discussion was tax avoidance and evasion and the likely effectiveness or otherwise of the general anti-avoidance provisions contained in part IIA of our Income Tax Act 58 of 1962 which came into effect on 2 November 2006 and replaced section 103(1).

In his conference paper, *Tax Avoidance, Morality and the Devil's Sermon on Sin*, Professor Henry Vorster made the point that, just as sin means different things to different people, so too does tax avoidance, and that the attitudes of the courts in regard to the dividing line between legitimate and illegitimate tax avoidance has changed over time.

For example, he said, in at least two reported decisions of the South African courts, the fiscus had taken the view that, for an unincorporated professional practice to incorporate (that is to say, to become a company) was a transaction that fell within the scope of the statutory anti-avoidance provisions of the Income Tax Act.

Professor Vorster also pointed out that, in England, over the course of the past thirty or so years, the courts have, at different times and under the influence of different judges, come to diametrically opposite conclusions in cases involving substantially identical facts, as to whether the transactions under scrutiny had crossed the line between legitimate and illegitimate tax avoidance.

In this regard, he said, under the influence of Lord Templeman, the English courts had found impermissible tax avoidance in factual

scenarios that had previously been held by the courts to be unobjectionable. But, since the retirement of Lord Templeman, the English courts had reverted to their earlier view, and now eschewed a moralistic approach to tax avoidance and have explicitly cautioned against the "sweeping generalizations" regarding tax avoidance that had characterized Lord Templeman's judgments.

In South Africa, said Professor Vorster, the courts have adopted the philosophy propounded in the celebrated case of *IRC v The Duke of Westminster* which asserted that a taxpayer is entitled to arrange his affairs so as to minimize his tax liability. Our courts, he said, have also been restrained in expressing views on the morality or otherwise of tax avoidance.

However, said Professor Vorster, we have now seen in the enactment of South Africa's new GAAR (that is to say, the general anti-avoidance provisions contained in part IIA of our Income Tax Act) provisions which –

"could only have been drafted by a Templemanian [and] are riddled with Templeman-speak of the type now avoided by the enlightened and well-informed in the land of its origin. They include sweeping generalizations of undefined scope and

imprecise meaning. I refer to Templemanian phrases such as "impermissible tax avoidance", the "absence of commercial substance", elements which "have the effect of off-setting and cancelling each other" and the "misuse or abuse of provisions in the statutes".

In essence, Professor Vorster's criticism is that our new GAAR has engrafted onto our Income Tax Act provisions which are seriously at odds with the philosophical position that has been taken by our courts in regard to a taxpayer's right to arrange his affairs so as to minimize his tax liability.

Professor Vorster points out that there are those who argue that tax avoidance performs a positive role, in that tax is one of the major costs of production and that enterprising and intelligent schemes are made possible only by enlightened tax planning.

In this regard, he said, the words of Hand J are often quoted –

"Over and over again, courts have said that there is nothing sinister in so arranging one's affairs so as to keep taxes as low as possible. Everyone does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."