




# Synopsis

March 2009

Tax today\*

When is a transaction a  
“disguised” transaction for tax  
purposes?

\*connectedthinking

PRICEWATERHOUSECOOPERS 

## In this issue

When is a transaction a “disguised” or “simulated” transaction for tax purposes? . 2

Mining operations - taxing stockpiles . . . . . 4

Taxability of unlawfully derived income and deductibility of fines, penalties, etc. . . . . 6

Travel expenses – new deduction tables . . . . . 8

Official rate of interest . . . . . 8

Interest - outstanding taxes and tax refunds . . . . . 8

### Regional offices

<i>Bloemfontein</i>	<i>(051) 503-4100</i>
<i>Cape Town</i>	<i>(021) 529-2000</i>
<i>Durban</i>	<i>(031) 250-3700</i>
<i>East London</i>	<i>(043) 707-9600</i>
<i>Johannesburg</i>	<i>(011) 797-4000</i>
<i>Port Elizabeth</i>	<i>(041) 391-4400</i>
<i>Pretoria</i>	<i>(012) 429-0000</i>

*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*

# When is a transaction a “disguised” or “simulated” transaction for tax purposes?

One of the most common forms of tax avoidance is where the parties to a contract attempt to disguise its true nature in order to qualify for a tax benefit that would not be available if the true contract between them were revealed.



A South African court requires no statutory powers to ignore a pretence of this kind, and the law will always give effect to the real transaction between the parties.

The classic exposition of the law in this regard is the judgment of Innes CJ in the 1910 Appellate Division case of *Zandberg v Van Zyl*, where 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.’

In recently reported judgments, there have been numerous occasions where SARS has attempted to deny a taxpayer a claimed tax benefit on the grounds

that the transaction in question is not what it purports to be, but is a “disguised” or “simulated” transaction, and that the real transaction entered into between the parties does not give rise to the claimed tax benefit.

### The defining characteristics of a simulated or disguised transaction

In the 1941 case of *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* the Appellate Division ruled that –

‘[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.’

In the 1993 decision in *Michau v Maize Board* the Supreme Court of Appeal made the point 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 "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.'

In determining whether a transaction is 'disguised' or "simulated", a crucial and often decisive question is whether the parties to the contract in question intended to give effect to it "according to its tenor" – in other words, in accordance with its apparent terms, or whether there was some secret understanding between them that they would not do so.

## Recent experience

SARS successfully raised the principle that transactions were simulated in the matter of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR 1996 (3) SA 942 (SCA)*, in which the Supreme Court of Appeal stated the fundamental issues in the following terms:

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

parties did indeed deliberately cast their arrangement in the form mentioned, must of course be accepted; that, after all, is what they had been advised to do. The real question is, however, whether they actually intended that each agreement would inter partes have effect according to its tenor. If not, effect must be given to what the transaction really is."

The fundamental issue therefore is whether the parties actually intended that the agreements that they had entered into should have effect. In this matter, the Court found that there was another, unexpressed, intention and that the legal substance of the agreements was other than reflected in the agreements.

SARS has used this approach in two subsequently reported matters, without success.

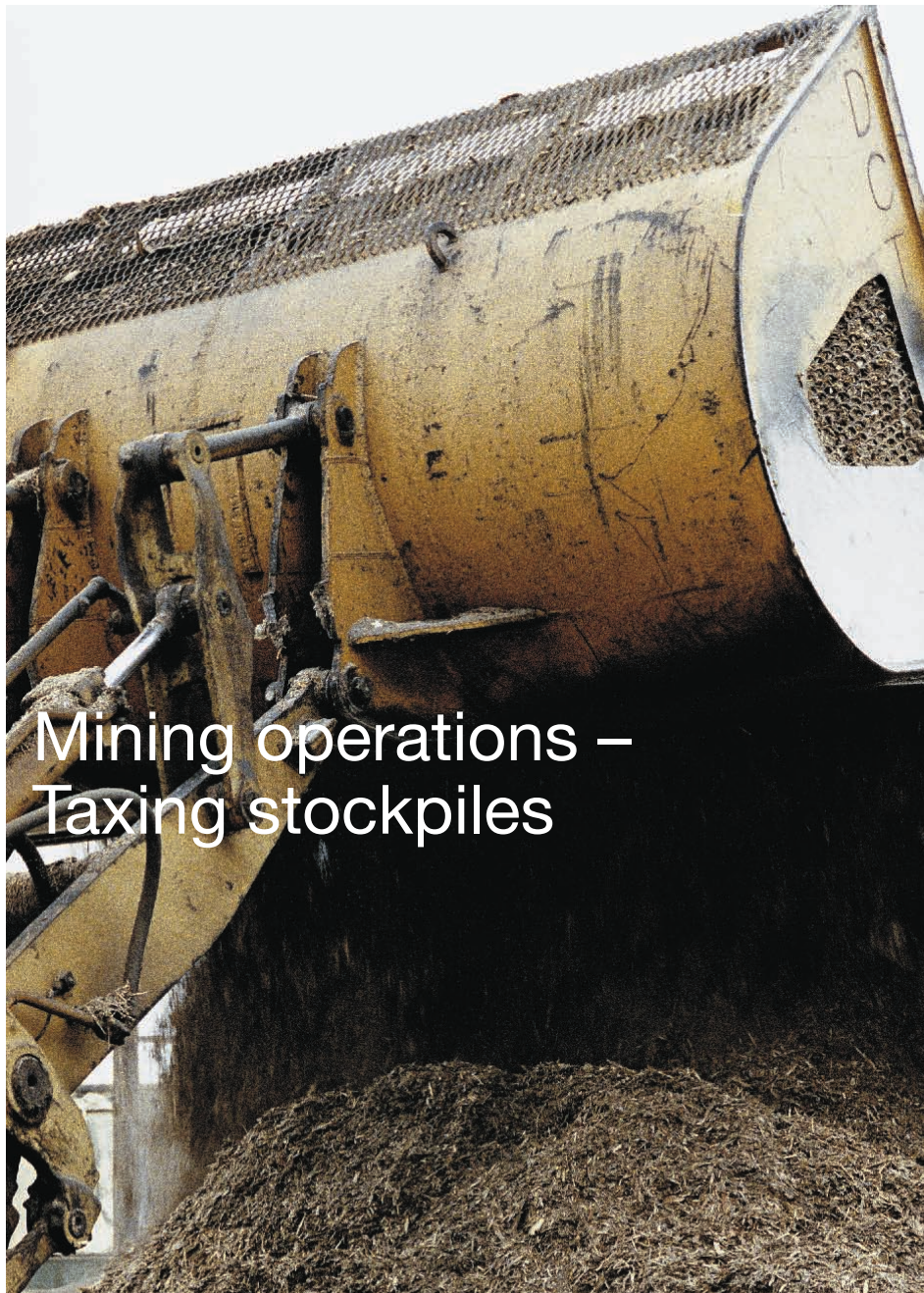
In the most recently reported matter in which the substance over form argument was raised by SARS, the Court was able to point to a clear misconception on the part of SARS that legal substance is the same as economic substance. In that matter, a loan at interest was repayable on maturity date by the delivery of an equivalent value of a commodity in specie secured by a forward purchase of the commodity from a connected party in relation to the lender. The economic substance of the transaction was demonstrated by SARS to be equivalent to a loan of a lower amount (represented by the difference between the funds advanced and the receipt under the forward purchase agreement) at the stipulated interest rate, such that the interest payments over the loan period

(calculated by reference to the funds advanced) were, in effect, equal to the repayment of the lower amount plus interest thereon at the stipulated rate of interest. Based on this, SARS asserted that the agreement was, in substance, a loan for the lower amount and that the interest claimed as a deduction was, in substance, not interest but a combination of repayment of the lower amount of principal plus interest.

The Tax Court dismissed the submissions of SARS' representative that the taxpayer should be taxed on the basis of economic substance on the following basis:

"... the purposes of the exercise undertaken by [SARS' expert witness] and the one to be undertaken by this Court differ. In the search for economic substance the purpose is to give a fair reflection of the taxpayer's financial position at the end of the financial year and then the other the purpose is to establish the true agreement on the basis of which the taxpayer's liability for income tax has to be determined in accordance with the provisions of the Act. Our case law is liberally sprinkled with judicial comment that tax treatment has no necessary connection with accounting treatment."

It was found that the parties intended to enter into the arrangements and to give effect to them according to their tenor. This underlines the fundamental difference between substance in an economic sense and substance in a legal sense. In the former, the economic effect is crystallised by reference to the receipt and payment of cash, whereas in the latter, the law looks to the rights and obligations created, and whether these were intended by the parties in entering into and carrying out their transaction.



## Mining operations – Taxing stockpiles

In the Budget Review, published 11 February 2009, reference was made to a decision of the Tax Court that mining stockpiles are not trading stock for income tax purposes. SARS informed the public that the decision was under appeal and gave notice that it was considering amendment to the legislation “*with immediate effect, to prevent other taxpayers engaged in mining from taking this position while the appeal is under way*”.

In the case referred to, the taxpayer (A) was conducting a mining operation on a piece of land. An adjacent miner (X), which mined different minerals than A, entered into an agreement with A whereby it (X) would extend its open cast mine over the land mined by A. By reason that X would in the course of its operations remove earth which held deposits mined by A in order to extract earth bearing the minerals mined by X, it was agreed that X would dump the earth containing A’s minerals on the property. A agreed to pay to X part of the cost of creating the stockpile which it would later systematically exploit to extract the minerals. The amounts paid to X were claimed as deductions by A in the years in which they were incurred.

SARS issued a substantial assessment to A asserting that A was required to include the cost of the stockpile of earth in its income as the value of trading stock for tax purposes. SARS relied on the decision in *Richards Bay Iron & Titanium (Pty) Ltd and Another v CIR* 1996 (1) SA 311 (A), 58 SATC 55 in which certain stockpiles of a taxpayer in the mining industry were held to be trading stock.

A argued that the stockpiles were capital in nature and were created for the purposes of mining, thus not falling within the extended definition of trading stock in section 1 of the Income Tax Act. SARS argued that the stockpile was the same as or similar to the stockpiles in the Richards Bay case and thus should be included in trading stock.

The Tax Court held that the facts in A’s case were distinguishable from those in the Richards Bay case in the following respects:

*The matter is unlikely to be solved by simply extending the definition of “trading stock” to include “mining stockpiles”, without introducing detailed rules relevant to the method of valuation and subsequent deduction for diminution on processing of the stockpiles.*

The stockpiles were created or acquired for the purpose of mining, not for the purpose of manufacture;

The stockpiles were not for sale by the taxpayer and in fact could not be sold.

The Court confirmed that mining is a process different and separate from manufacture, and cited with approval the statement from the Richards Bay case that:

“the words “for purposes of manufacture... by him or on his behalf” in the definition [of ‘trading stock in section 1] can only mean ‘for use in manufacture’.”

The judgment emphasised that the terms “mining” and “mining operations” are specifically defined in the Income Tax Act, whereas the term “manufacturing” is not defined. The Court quoted at length from Income Tax Case 1455 51 SATC 111 at 115 to demonstrate the essential difference between mining and manufacturing, comparing the processes to derive gold bullion (a mining process by which gold particles are liberated from the soil) with those to produce pig iron (a manufacturing process by which the mineral iron oxide is turned into iron). The conclusion was that the essence of A’s processes:

“is the extraction or winning of the [minerals] without a different finished product emerging. What is sold to customers is the [mineral] originally found in the ...ore, and ... no different substance with different qualities has been produced. All that occurs is a process that

liberates the mineral particles from the earth and that separates the mineral particles.”

The Court found that it had been conceded in the Richards Bay case that the stockpiles were acquired for the purpose of manufacture, and that the decision in that matter was therefore clearly not of application in this matter where no such concession had been made by A or on its behalf. It accordingly ruled that the stockpiles were not trading stock for income tax purposes.

### Will amendment open a Pandora’s box?

How is SARS going to amend the legislation, which it clearly intends to do, to tax unmined stockpiles, and how does it intend to apply the amendment?

The following considerations will need to be addressed:

The earth itself is unlikely to have value as a marketable commodity. The Commissioner is bound to reduce the value of trading stock below cost for any reason satisfactory to the Commissioner. Logically, if the earth cannot be sold in that state the stockpile value must be reduced to zero.

The quantity and quality of minerals that may be won from the stockpile may affect the value of the stockpile. Value would typically depend on factors such as yield, cost and price.

The price of the minerals on world markets will determine whether the stockpiles have any value. Prices will direct whether stockpiles are viable for further mining processes. The value of a stockpile could therefore fluctuate significantly from year to year given the volatile nature of commodity prices.

As the stockpiles are mined, the taxpayer will diminish the stock. How will the deduction for diminution be calculated?

Waste dumps may be exploited to extract further or other minerals, as technology develops and as prices of commodities make further processing of mining waste viable. Will a portion of the excavation cost have to be deferred indefinitely in case of possible secondary exploitation of the waste dumps?

Taxpayers in the mining industry are placed in a state of uncertainty by the announcement in the Budget Review. The matter is complex and unlikely to be solved by simply extending the definition of “trading stock” to include “mining stockpiles”, without defining what is a mining stockpile and without introducing detailed rules that are relevant to the method of valuation and subsequent deduction for diminution on processing of the stockpiles.

# Taxability of unlawfully derived income and deductibility of fines, penalties, etc

On 10 February 2009 SARS issued a draft interpretation note regarding the prohibition, in terms of section 23(o) of the Income Tax Act, of the deductibility of expenditure in respect of corrupt payments, fines and penalties.

Section 23(o) reads as follows –

No deductions shall in any case be made in respect of ...any expenditure incurred –

(i) where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No.12 of 2004); or

(ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic.

The draft interpretation note begins by saying that corruption hampers democratic processes, good governance, sustainable development and fair business practices, and that many countries, including South Africa, prohibit the tax-deductibility of bribes.

The draft interpretation note goes on to say that s 23(o) was enacted in 2005 and took effect from 1 January 2006, and that, before the enactment of this sub-section, the Income Tax Act did not specifically address the non-deductibility of expenses incurred in respect of illegal activities.

The draft interpretation note says that some commentators had argued that bribes, fines and penalties were deductible if they satisfied the criteria for deductibility laid down in the general deduction formula (that is to say, s 11(a) read with s 23) of the Income Tax Act, in other words, if the expenditure was incurred for the purpose of producing income.

Thus, for example, prior to the enactment of section 23(o), it was arguable that a taxpayer who carried on a road haulage business ought to be able to deduct fines

paid for overloading his trucks, on the grounds that his purpose in overloading them was to earn income.

Section 23(o) now rules out any deduction being granted for expenditure falling within its scope.

The draft interpretation note observes that the common law crime of bribery committed by state officials was abolished by the enactment of the Corruption Act of 1992 which created a new offence called “corruption” which subsumed both the common law crime and the offences created by previous legislation.

This situation is now covered by the Prevention and Combating of Corrupt Activities Act of 2004.

The draft interpretation note says that examples of corrupt activities which now fall under the last-mentioned Act, and where any payment for such activities is accordingly not tax-deductible include –

pharmaceutical corporations rewarding doctors with gifts for prescribing their drugs to patients;

businesspeople providing gifts to potential clients to secure contracts for themselves;

sports referees being paid to fix the outcome of a match;

money paid by record companies to radio and television stations to secure air time for the music they are promoting; and

public officials being bribed to secure a particular result, for example, a state prosecutor being bribed to arrange a plea bargain.

## Enforceability and proof

The strength of the case for prohibiting tax-deductions for bribes and other corrupt payments is undeniable.

However, there are problems of proof, particularly where a dubious fee is paid to a middle-man to secure a particular result.

For example, a fee may be paid to a “lobbyist” to persuade a politician to do something or refrain from doing something, where there may or may not be a tacit understanding that part of the fee will be used to pay a bribe.

The proposition, expressed in the draft interpretation note, that an example of a corrupt activity is that of “businesspeople providing gifts to potential clients to secure contracts for themselves” is fraught with difficulty.

What of a businessperson who takes a potential client out to lunch? Or who invites a potential client to his luxury private viewing box to watch a cricket match?

It surely cannot be suggested that such conduct, of itself, falls within the scope of chapter 2 of the Prevention and Combating of Corrupt Activities Act of 2004.

## Interpretation note addresses only one side of the problem

The real weakness of the draft interpretation note, however, is that it fails to acknowledge the obverse issue, namely, whether illegal income is or should be subject to income tax.

To put the issue in sharp focus, take the hypothetical case of a businessperson paying a corrupt bribe to a government official to induce the latter to grant a favour. Is the receipt subject to income tax in the official's hands?

It would be the height of cynicism and double standards for a tax system to deny a tax-deduction for a corrupt payment, yet take a slice of that payment by taxing the recipient.

Yet, it would seem that this may indeed be the way our law stands at present.

### The Supreme Court of Appeal decision in *MP Finance Group*

In the 2007 decision of the *Supreme Court of Appeal in MP Finance Group CC (in liquidation) v CSARS*, the court held that the proceeds derived from carrying on an illegal pyramid scheme had been "received" for income tax purposes as from the date when the individuals in question (the fraudsters) know that the scheme is insolvent and fraudulent and that it would be impossible to pay the investors what they had been promised. From that date, said the court, the amounts contributed by investors formed part of the fraudster's gross income.

The decision does not articulate the principle that amounts derived from illegal activities have the character of "income" but such a finding, it is submitted, appears from the court's conclusion that, as from the aforesaid crucial juncture, the entities in question "made their money by swindling the public. That was their income."

There are two disconcerting aspects to the judgment.

The first is the complete silence of the court on the moral and ethical dimension of the case, and the question whether SARS (as an organ of state) makes itself



*The proposition that an example of a corrupt activity is that of "business-people providing gifts to potential clients to secure contracts for themselves" is fraught with difficulty.*

complicit in fraud by taxing the proceeds of fraudulent activities and, if so, whether this is inconsistent with the constitutional values that underpin South Africa's legal order.

The answer to this multi-faceted question is far from self-evident, but it is suggested that it is unfortunate that the Supreme Court of Appeal chose to remain silent on an issue of such importance.

The second, and related issue, is that the effect of the judgment in *MP Finance* was that SARS, by virtue of its statutory preferential claim to the residue of the proceeds of the now-insolvent pyramid scheme, had first claim to the depleted proceeds of the scheme.

In other words, the payment of income tax to SARS depleted the meagre funds available for reimbursement to the innocent and cheated investors.

Given the public concern about the prevalence of crime and corruption in South Africa, it is unfortunate that the Supreme Court of Appeal confined its decision to the particular facts of the case, and did not give the country the benefit of its view on the larger question of the taxability of the proceeds of crime.

It is believed that SARS takes the view that the proceeds derived from (for example) illicit sales of liquor and from drug-dealing are taxable. There is nothing in the Supreme Court of Appeal's judgment in *MP Finance* to suggest that the court would regard this practice as not sanctioned by the tax laws.

Would SARS take the same view – and would the courts view with approval – taxing the proceeds of (say) car hijacking, robbery or hit squad activity?

In the 1963 decision of the English Court of Appeal case of *Griffiths (Inspector of Taxes) v JP Harrison (Watford) Ltd* Lord Denning squarely confronted the issue of whether criminals are entitled to be taxed on the basis that they are "carrying on a trade" in the following words:

'[T]ake a gang of burglars. Are they engaged in trade or an adventure in the nature of trade? They have an organisation. They spend money on equipment. They acquire goods by their efforts. They sell the goods. They make a profit. What detail is lacking in their adventure? You may say it lacks legality, but it has been held that legality is not an essential characteristic of a trade. You cannot point to any detail that it lacks. But still it is not a trade, nor an adventure in the nature of trade. And how does it help to ask the question: If it is not a trade, what is it? It is burglary and that is all there is to say about it.'

It is implicit in Lord Denning's view that the consequences of crime should be dealt with by the criminal law (which may, inter alia, decree that the proceeds of crime are to be forfeited to the State) and that the fiscus should not allow itself to be tainted by taxing the proceeds of crime.

Our courts have yet to confront this issue, and it is a pity that SARS's interpretation note on the deductibility of corrupt payments does not, at least, acknowledge the issue and put it squarely on the table for debate.

## Travel expenses – new deduction tables

Persons in receipt of allowances for out-of-town travel have for a number of years been permitted to claim deduction of subsistence and incidental expenses against such allowances without the necessity of producing evidence of expenditure on the basis that a daily amount is deemed to have been expended during such absences from the place of residence.

New scales were gazetted on 27 February 2009, applicable to the year of assessment commencing 1 March 2009.

For travel within the Republic, where the allowance is granted to defray incidental costs only, a deduction of R80 per day is permitted. In the case of an allowance to defray the cost of meals and incidental expenses, the deduction permitted is R260 per day. In relation to accommodation costs, if these are borne by the employee, it will be incumbent on the employee to claim specific deduction against proof of expenditure.

For travel outside the Republic, the previous blanket amount for all destinations (of US\$215 per day) has been changed. Now the per diem amount in respect of meals and incidental costs is determined by reference to a table that lists nearly 190 destination countries and prescribes a daily rate for each destination, with a default amount of US\$215 per day for any country not listed.

The information may be found in Government Notice No. 171 of 2009 published in Government Gazette No. 31915 of 27 February 2009.

## Official rate of interest

The “official rate of interest” is a rate prescribed by the Minister of Finance as a benchmark against which the taxable value of loans to employees may be measured and as a minimum reference for determining whether a low interest loan by a company to a shareholder may be deemed to be a dividend.

In terms of powers vested in him, the Minister has announced in Government Notice No. 180 of 2009 published in Government Gazette No. 31931, dated 20 February 2009 that the official rate of interest, with effect from 1 March 2009, will be set at 11,5% (previously 13%).

## Interest - outstanding taxes and tax refunds

The rate of interest on outstanding taxes and refunds will also reduce in harmony with the recent reduction in market rates by 1,5% with effect from 1 May 2009. The rate in respect of outstanding taxes will reduce to 13,5% while the rate in respect of refunds of tax will be 9,5%. The relevant information is found in Government Notice No. 179 of 2009 published in Government Gazette No. 31893 of 20 February 2009.