IN THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

Case Nr: 606/97

REPORTABLE

In the matter of:

THE COMMISSIONER FOR INLAND REVENUE Appellant

and

CONHAGE (PROPRIETARY) LIMITED
Respondent
(formerly **TYCON (PROPRIETARY) LIMITED)**

Coram: Mahomed CJ, Hefer, Olivier, JJA, Farlam et Madlanga AJJA

Date of hearing: 23 August 1999

Date of delivery: 17 September 1999

Income Tax - tax avoidance- agreements of sale and leaseback agreements not shown to be simulated transactions - s 103 of Act 58 of 1962 not applicable

J U D G M E N T

Hefer JA

HEFER JA

[1] Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If eg the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the court will give effect to the true nature and substance of the transaction and will not be deceived by its form. (*Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996(3) SA 942 (A) at 950I-952C.)

[2] At issue in the present case is the true nature and substance of two sets of agreements between the taxpayer ("Tycon") and Firstcorp Merchant Bank Ltd ("Firstcorp"). In form each set comprises a sale and leaseback of some of Tycon's manufacturing plant and equipment. The Commissioner's contention is that the agreements are not what they purport to be. The dispute arose when Tycon sought to deduct the rentals paid in terms of the leasebacks as expenditure in the production of income under s 11(a) of the Income Tax Act 58 of 1962, as amended. When the Commissioner refused to allow the deductions and in addition invoked s 103 of the Act, Tycon appealed to a Special Court. The appeal succeeded and the matter was remitted to the Commissioner for re-assessment on the basis that the rentals were deductible. With the necessary leave the Commissioner has now appealed directly to this Court. The first issue is the true nature and substance of the agreements. In the event of a finding

that they are indeed what they purport to be as the Special Court found, a further question will be whether the Commissioner correctly invoked s 103.

The true nature of the agreements

[3] In broad terms the Commissioner's contention is that, despite the form of the agreements, Tycon did not sell and lease back its equipment, but in substance borrowed the "purchase price" from Firstcorp. Both in the Special Court and in this Court his counsel expressly accepted that the parties did not act *in fraudem legis* by deliberately disguising their transactions. In the written heads of argument the agreements came under attack solely for lack of what was apparently regarded as essential elements of a sale (cf *McAdams v Fiander's Trustee & Bell NO* 1919 AD 207 at 223-224). On this basis it was submitted that there was no agreement on a *verum pretium* nor an intention to transfer and acquire ownership. At the commencement of his oral argument Mr Rubens for the Commissioner indicated that he would not press the argument relating to the price. When it was pointed out to him that the only remaining point would then be that the parties did not intend ownership to pass and that the passing of ownership is not an essential element of a sale, he informed us that he would argue that the agreements should not be applied according to their tenor because, **although Tycon and Firstcorp might honestly have believed that it would be sufficient to go through the formality of concluding that kind of agreement in order to procure tax benefits for themselves, they had no real intention**

to enter into agreements of sale and leaseback. Argument then proceeded on this basis.

[4] Despite the reference to the parties' honest belief, it seems to me that the logical effect of the submission is precisely what the Commissioner has constantly been disavowing, *viz* that they dishonestly concealed the true nature of their transactions. Certain *dicta* in cases like *McAdams v Fiander's Trustee & Bell NO supra*, *Goldinger's Trustee v Whitelaw & Son* 1917 AD 66, *Bank Windhoek Bpk v Rajie en `n Ander* 1994(1) SA 115 (A) (the minority judgment) and *Nedcor Bank Ltd v Absa Ltd* 1998(2) SA 830 (W) support the proposition that the true nature of a transaction will prevail where the parties enter into an agreement in the honest belief that they will achieve a particular purpose by doing so, but do not actually intend it to have effect according to its tenor. In *McAdams* eg the real transaction was found to be a loan even though the parties had deliberately cast their agreement in the form of a sale in the *bona fide* belief that it would provide security to the "purchaser". But even in such a case the agreement is plainly a simulation; and it may be a dishonest simulation depending on what use the parties want to make of it. In the present case Tycon required capital to expand its business. Firstcorp was prepared to make the funds available. Both parties were aware of the tax benefits to be gained from sales and leasebacks and decided to follow that course. If they did not genuinely intend ownership of the *merx* to pass upon signature of the agreement as each agreement of sale stipulated, the agreements would have been simulations and could only have been signed with the object of deceiving the Commissioner. The conclusion that this would indeed be a case of *fraus legis* cannot be avoided.

[5] This is not the only problem that I have with the submission. Although Mr Rubens assured us that the Commissioner's case was conducted on the same basis in the Special Court, he candidly confessed that he never suggested in his cross-examination of Tycon's witnesses that the agreements had been signed under the impression that the mere formality would be sufficient, or that the actual intention was that the agreements would

not have effect according to their tenor. The record leaves one with the firm impression that the cross-examination of Tycon's witnesses turned on the effect of the agreements rather than on the signatories' actual intentions. Tycon's case might well have been conducted differently had the argument in this Court been raised in the Special Court and in fairness we should really decline to entertain what is essentially a new point.

[6] I will nevertheless deal with the argument because I am of the view that it is in any event not supported by the facts. In view of the analysis of the evidence and the submissions for the Commissioner in the Special Court's reported judgment (ITC 1636 in 60 (1998) SATC 267) only a brief discussion is required.

[7] The Special Court found (on the strength of the presumption in s 82 of the Act) that the onus was on Tycon to prove the authenticity of the agreements and that the onus had been discharged. The signatory on Tycon's behalf and two Firstcorp officials who had negotiated the transactions testified that the parties intended to give effect to the transactions according to their terms. The Special Court accepted their evidence on the point.

[8] The Court's judgment was vigorously criticized in the written heads of argument for the Commissioner. In some respects the criticism is valid; in others not; and in still others it is no longer relevant in view of the limited scope of the argument. It is not necessary to go into the details because it is quite clear to me that Mr Rubens is clutching at straws. The real point of his submission is that neither Tycon nor Firstcorp actually intended to enter into agreements of sale and leaseback. One way of testing its validity is to ask: If the parties did not intend to deceive, how did it come about that they entered into agreements which they knew would have no effect *inter se* as sales and leasebacks? The problem facing the Commissioner is that he has discarded the

possibility that the agreements were deliberately disguised. The only other explanation which he is able to suggest is that the parties might have believed that the formal instruments would gain them the desired tax benefits. But this is sheer speculation which finds no support in the evidence and is against the probabilities. I say this particularly in view of

> the consideration which Tycon's staff and financial director in consultation with the financial directors of affiliated companies gave to the advantages and disadvantages of sales and leasebacks;
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> the fact that the disadvantage which the loss of the ownership of part of Tycon's plant would bring about, was expressly mentioned and considered;
>
> the fact that offers by other banks to make funds available by way of sales and leasebacks were received and considered by the company;
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> the extensive negotiations which were conducted at arms length with Firstcorp; and
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> the expertise of the people involved in the negotiations and the signing of the agreements.

All this goes to show that the parties were not merely going through the motions of concluding agreements. And if they were not, the very foundation of the submission crumbles.

[9] The fact of the matter is that the evidence that the parties had every intention of entering into agreements of sale and leaseback and of putting the agreements into effect was not contradicted. The result was that the Special Court had no option but to accept it unless the witnesses were not reliable, or all the available information and such inferences as might justifiably be drawn, were cogent enough to cast sufficient doubt thereon. I have not been persuaded that the Court erred in finding the witnesses reliable; or that there is sufficient reason to doubt the authenticity of the agreements. Mr Rubens referred us to certain provisions of the agreements which, he submitted, are not usually found in

agreements of sale and agreements of lease and militate against an intention to buy and sell and to lease back. But it is by no means unusual to find provisions in a sale and leaseback which do not typically appear in a contract of purchase and sale or in a contract of lease. On the contrary, as Professor Nereus Joubert points out in "*Asset-based financing, contracts of purchase and sale, and simulated transactions*" 109 (1992) SALJ 707 at 708,

> "[d]espite the fact that new asset-based financing transactions are often carefully drafted to reflect contracts of purchase and sale or contracts of letting and hiring, **they almost invariably contain provisions which are not typically found in such types of contract** ..." (Emphasis added.)

Moreover, although a sale and leaseback comprises an agreement of sale as well as an agreement of lease, it must be treated as one composite transaction. This is why Mr Rubens's reliance on the fact that Tycon could not do without the equipment sold to Firstcorp because it was in daily use in Tycon's factory, is misplaced. If we were to look at the agreement of sale separately this would be a valid point, but, viewed in the context of the whole transaction, the argument loses its sting: as lessee Tycon would be assured of the use of the equipment for the duration of the lease. It is really the provisions dealing with their fate at the end of the lease that count. In this regard Mr Rubens stressed clause 5 of the each lease. It is to the effect that the equipment would on the expiry date remain Firstcorp's property. But there is also clause 10 which grants Tycon the option to renew the lease on that date and annually thereafter. In effect the company was entitled to the indefinite use of the equipment. Admittedly it lost its ownership. But this was a considered and accepted disadvantage for which the capital generated by the transactions more than compensated. All in all

the transactions made perfectly good business sense.
[10] In my view the Special Court was correct in deciding the first issue in Tycon's favour.

Did the Commissioner correctly invoke s 103?

[11] Although s 103 was no doubt designed to enable the Commissioner to deal effectively with tax avoidance schemes, it operates only in the circumstances stipulated in the section itself. As Watermeyer CJ observed in *Commissioner for Inland Revenue v IHB King* 1947(2) SA 196 (A) at 209,

> "if a transaction is covered by the terms of the section its provisions come into operation, if it is not then its provisions cannot be applied."

Broadly speaking the section empowers the Commissioner to determine a taxpayer's liability for income tax and other taxes by disregarding any abnormal transaction which the latter has entered into for the purpose of avoiding or postponing his tax liability or reducing the amount thereof. I need not list all the requirements that must co-exist before the power may be exercised because we are only concerned with the abnormality requirement and the purpose requirement. A transaction is regarded as abnormal if it was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction of the nature of the transaction in question; or has created rights or obligations which would not normally be created between persons dealing at arms length under a transaction of the nature of the transaction in question. An abnormal transaction may be disregarded if it was entered into or carried out **solely** or **mainly** for the purposes of the avoidance or the postponement of

liability for the payment of any tax or the reduction of the amount of such liability.

[12] From the judgment in *Secretary for Inland Revenue v Geustyn, Forsyth & Joubert* 1971(3) SA 567 (A) at 571E-H and other reported judgments of this Court the following emerges:

(a) Although the Commissioner may invoke the section whenever he is satisfied of the presence of its requirements, a Special Court may re-hear the whole case and, if necessary, substitute its own decision for that of the Commissioner. When *Geustyn* was decided appeals against decisions of Special Courts were limited to questions of law. The Act has since been amended to do away with this limitation and this Court may now exercise the same powers as a Special Court.

(b) The effect, purpose and normality of a transaction are essentially questions of fact. The onus is on the Commissioner to prove that its effect was to avoid or postpone the liability for tax or to reduce the amount thereof. Upon proof that this was the case it is presumed (in terms of ss (4)) that the effect of the transaction was also its sole or main purpose.

(c) What has to be determined in every case is the subjective purpose of the taxpayer.

[13] In the present case the Special Court found that the Commissioner had not established the abnormality of the sales and leasebacks and that Tycon had established the absence of the purpose requirement. Both findings were attacked in this Court, but a decision in Tycon's favour on either will dispose of the appeal. I proceed to deal with the purpose of the transactions.

[14] The enquiry is limited to a single question. I have already

mentioned that Firstcorp was prepared to make the capital available which Tycon needed to expand its business. The financing could be structured either as a loan or as a sale and leaseback; but from an income tax point of view the latter was preferable and mainly for this reason Tycon decided on a sale and leaseback. The Commissioner's contention is that this is all that counts; the sole purpose of the transaction was to reduce the company's tax liability; and it matters not that Tycon needed the capital to finance its expansion programme. Tycon's argument is precisely the opposite: the purpose of the whole exercise was to obtain capital, not to reduce tax; and if the reduction of its tax liability can be regarded as a purpose of the transactions as envisaged in s 103 at all, it was not the main purpose.

[15] I share the Special Court's view that the agreements of sale and leaseback served the dual purpose of providing Tycon with capital and to take advantage of the tax benefits to be derived from that type of transaction. The following passage in the Court's judgment (at 393) neatly describes the situation:

> "[The raising of finance] was the *fons et origo* of the transactions and it remained the underlying and basic purpose thereof ... This whole arrangement ... was to achieve the predominant purpose of raising finance but, because of the welcome by-product of the tax benefit, the vehicles chosen were the sale and leaseback transactions."

It is submitted on behalf of the Commissioner that the only reason why sales and leasebacks were preferred to a straightforward loan was that a loan would not bring about such advantageous tax deductions. This is not entirely correct because there were other commercial reasons too. But, even if the particular type of transaction was chosen solely for the tax benefits, it would be wrong to ignore the fact that, had Tycon not needed capital, there would not have been any transaction at all. Tycon did not approach Firstcorp in order to alleviate its tax burden; it did so because it was in need of capital and this plainly remained the main purpose of the transactions. It is not necessary to deal with the case of

Commissioner of Taxation of the Commonwealth of Australia v Spotless Services Limited [1996] 186 CLR 404 on which the Commissioner relies because it is clearly distinguishable both on the facts and in respect of the applicable legislation.

[16] In view of this conclusion it is not necessary to deal with the Special Court's finding that the abnormality of the transactions had not been established. Suffice it to say that what the Commissioner had to establish, was the abnormality of the transactions **as sales and leasebacks.** To decide whether he had done so, the Court rightly took all the circumstances of the case into account and did not content itself with an examination of the typicality of the terms of the agreements.

[17] I conclude therefore that the Special Court correctly found in Tycon's favour on the second issue as well.

The appeal is accordingly dismissed with costs including the costs of two counsel.

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HEFER JA

Concurred:

Mahomed CJ
Olivier JA
Farlam AJA
Madlanga AJA