When can SARS re-characterise contractual arrangements for taxation purposes?

Tax planning structures normally involve multiple parties. Sometimes the individuals and/or legal entities involved are inter-connected. The tax benefits generated through such structures, almost without exception, annoy revenue authorities. SARS, in setting out to extract the tax it believes to be owing, occasionally runs into a “little problem”. The individual or entity in the structure that should really be the “target taxpayer”: might not have any assets (eg it is a tax-neutral once-off Special Purpose Vehicle); might be inconveniently situated (eg it is located off-shore or in a tax haven); might have a tax-exempt tax profile (eg a long-term insurer’s policyholder fund); or might have an assessed loss.

The attack on the structure will therefore be completely futile, alternatively, yield no cash payment. Then the temptation arises “to follow the money”. That is, SARS might try and pin the tax consequences on the individual or entity in the structure that does have a substantial balance sheet.

The question is to what extent SARS can shove aside contractual relationships between parties, thereby determining the tax liabilities on the basis of what SARS perceives to be the “real transaction”?

Legal precedent indicates that SARS’s ability to simply pursue the taxpayer who happens to have the money to meet the alleged tax liability might be rather limited.

In Rane Investment Trust v CSARS [2003] 3 All SA 39 (SCA), the Supreme Court of Appeal (the SCA) dealt with the tax consequences of a so-called “film scheme”. The SCA pointed out: “… we are not concerned in this matter with a dispute between the parties. It is a third person – the Commissioner – who seeks to place a different interpretation on the agreements.”

The SCA held that “… when a third party is questioning the meaning of a contract, regard may be had to the parties’ conduct in executing their obligations.” Despite certain “obscure” clauses in the parties’ contract, the SCA gave effect to same since the parties’ subsequent conduct was aligned with what they really intended to achieve.

There you have it: it is not that easy for SARS to gate-crash the taxpayers’ (contractual) party. SARS must first jump certain hurdles before it can re-characterise a transaction for taxation purposes.

In Zandberg v Van Zyl 1910 AD 302 it was that held: “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 object might have been attained in another way will not necessarily make the arrangement other than it purports to be.” (emphasis added)

In Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd a “disguised transaction” was explained as follows:

“In essence it is a dishonest transaction: dishonest, in as much as the parties to it do not really intend 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." (emphasis added)

[Many more recent cases like Conhage, Ladysmith, Relier, and NWK are in the same vein. The older cases are specifically cited to show just how far back these principles go in South African law.]

SARS can therefore only re-characterise a transaction where, among others: there exists a "definitely ascertainable" intention at odds with the wording of the contract; an element of "dishonesty" or "deceit" is present in so far as parties intended to conceal their real agreement; parties' subsequent actions were out of sync with the terms of their contract.

[ITC 1816 69 SATC 62 gives a comprehensive list of indiciae that a court will consider in determining the true substance of a contract.]

Often the Zandberg and Randles Bros criteria would be insurmountable for SARS, or it might not be able to procure the necessary evidence. SARS might then seek to invoke the "piercing the corporate veil" doctrine in order to tax the party SARS feels should actually be the target taxpayer (and who incidentally happens to have deep pockets).

That doctrine also has limitations. In ITC 1611 59 SATC 126, Wunsch J held that there was no established principle of law that justified the "radical step" of piercing the corporate veil:

"… a court can lift the veil only if that is legitimate by application of established doctrines, such as the plus valet rule or the fraus legis rule (or in other cases of fraud or dishonesty) or, possibly, the actio pauliana, that is if the requirements for such application are present, or a finding of a true relationship of principal and agent. There is, we consider, no self-standing doctrine of piercing the veil." (own emphasis)

Where does that leave SARS?

SARS could always turn to section 80B(1) of the Income Tax Act, 58 of 1962 (the Act). Under that section, the Commissioner may determine the tax consequences of any impermissible avoidance arrangement for any party by: disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement; disregarding any accommodating or tax-indifferent party; deeming connected persons to be one and the same person for taxation purposes; re-characterising any gross income of a capital nature; treating the impermissible avoidance arrangements as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate to eliminate the offending tax benefit.

This gives SARS extensive powers to re-characterise the whole transaction, or a step or part thereof (refer to section 80H of the Act). But first SARS would have to properly navigate the complexity of Part IIA of the Act. Furthermore there are certain notice requirements (section 80J of the Act). Consequently, in practice, attempts by SARS to re-characterise a transaction in terms of sections 80A-L have, so far, been few and far between.

Taxpayers are often made to sleep in the beds they make. In CIR v Sunnyside Centre (Pty) Ltd 1997(1) SA 68 (A) it was held:

“When a scheme works, no tears are shed for the Commissioner. That is because a taxpayer is entitled to order his affairs so as to pay the minimum of tax. When he arranges them so as to attract more than the minimum he has to grin and bear it.”

Surely, what is good for the goose is good for the gander?

SARS’ determination to “follow the money” by simply re-characterising taxpayers’ contractual arrangements could in certain instances result from the drive for revenue collections.

Taxpayers should be aware that SARS’ powers to re-characterise taxpayers’ contractual arrangements are by no means unfettered.