IN THE INCOME TAX SPECIAL COURT

HELD AT JOHANNESBURG

BEFORE THE HON MR JUSTICE P BORUCHOWITZ	President
M C VAN BLERCK	Commercial Member
R J HEFFER	Accountant Member

In the appeal of:

A B C LIMITED	Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE	Respondent

---

J U D G M E N T

BORUCHOWITZ, J:

INTRODUCTION

[1] This is an appeal against additional assessments raised by the Commissioner disallowing a portion of the interest claimed by the appellant as a deduction from income in terms of section 11(a) of the Income Tax Act 58 of

1962 ("*the Act*") in respect of the 1999 to 2003 years of assessment. The appeal is also directed against the refusal by the Commissioner to remit any part of the interest on the amounts so assessed in terms of section 89*quat*(3), and the imposition of additional tax and interest in terms of sections 76 and 89*quat* of the Act.

[2] The appellant is a public company which formerly operated as a Co-Operative Society under the Co-Operatives Act, 1981. In 1998 it accepted a funding proposal put to it by X Bank of Southern Africa Ltd (X BANK). This proposal led to the conclusion of six separate but interrelated written agreements which form the subject-matter of the appeal. Four of the agreements which will be referred to hereafter as the "*loan agreement*"; "*ABC forward purchase agreement*"; "*X BANK forward purchase agreement*" and "*DEF sale*" were concluded on 1 and 2 April 1998. And two further agreements described as the "*ABC cession*" and "*DEF cession*" were concluded on 29 June 1998.

[3] The following is a synopsis of the material terms of the said agreements.

[4] The parties to the loan agreement were the appellant, X BANK and DEF Trading Company (Pty) Ltd (DEF), a subsidiary of X BANK. In terms thereof the appellant purported to borrow a capital amount of R96 415 776,00 from DEF which was repayable by the appellant on 28 February 2003. The appellant was obliged to discharge its obligation to pay the capital amount by

delivering to DEF 109 315 tonnes of dried white maize intended for human consumption.

[5] In order to discharge the appellant's obligation to repay the capital amount in the manner contemplated it was provided that duly authorised representatives of the appellant and DEF would meet at a mutually convenient place and time in the presence of a Notary Public at which the appellant would deliver the maize to DEF by a recognised method of constructive delivery.

[6] It was furthermore provided that the appellant would not be entitled to cede any of its rights or delegate any of its obligations in terms of the agreement and that DEF would have the right, without the prior written consent of the appellant, to at any time cede any part or all of its rights or to delegate any part or all of its obligations thereunder to a company within the X BANK group. The appellant undertook to make payment to any cessionary of DEF and to effect delivery as contemplated to any such cessionary.

[7] The capital amount of the loan was subject to interest at a fixed rate of 15,2728% per annum, compounded monthly in arrear, payable 6-monthly in arrear and represented by a promissory note in respect of each interest payment. The aggregate face-value of the promissory notes to be provided amounted to R74 686 861,00. As will later appear this is the amount claimed by the appellant as a deduction from its income in terms of section 11(a) of the Act over the years of assessment in issue.

[8] The parties to the ABC forward purchase agreement were the appellant and Last Derivatives (LDV), an operating division of X BANK. In terms thereof the appellant bought forward the same quantity of maize as described in the loan agreement for an agreed purchase consideration of R46 415 776,00. The price was to be paid in cash on 1 April 1998 and ownership and delivery was to take place on 28 February 2003. As with the loan agreement, delivery was to take place in the presence of a Notary Public by means of a recognised form of constructive delivery. According to the appellant the avowed purpose of this transaction was to secure future possession of the maize in order to enable it to comply with its delivery obligation under the loan agreement.

[9] The parties to the X BANK forward purchase agreement were DEF and LDV. In terms thereof DEF sold forward to LDV the same tonnage of maize as referred to in the loan agreement for a purchase consideration of R45 815 776,00. The price was to be paid in cash on 1 April 1998 and ownership and delivery was to take place on 28 February 2003. Here also, delivery was to be effected in the presence of a Notary Public by means of a recognised form of constructive delivery. The appellant was not privy to the X BANK forward purchase agreement.

[10] It is common cause or not in dispute that on or about 2 April 1998 DEF entered into a sale agreement with X BANK (the DEF sale) in terms of which the promissory notes issued by the appellant in terms of the loan agreement

were sold by DEF to X BANK for the sum of R50 697 518,00. The appellant was also not privy to this agreement.

[11] The ABC cession is a cession *in securitatem debiti* executed by the appellant in favour of X BANK on 23 June 1998. The subject-matter of this cession was the appellant's right to delivery of the maize in terms of the ABC forward purchase agreement. It is unnecessary and beyond the scope of this judgment to consider whether the cession was to operate as a pledge or an out-and-out security cession. However, what is clear is that the appellant's right to claim delivery was ceded to X BANK as security and that in the result X BANK had an obligation to deliver the maize to the appellant on 28 February 2003 and with effect from 29 June 1998 the appellant had the obligation to deliver the maize to X BANK as opposed to DEF.

[12] In terms of the DEF cession which was finally executed on 29 June 1998 DEF ceded its rights under the loan agreement to X BANK in fulfilment of its obligations under the X BANK forward purchase agreement. There appears to be no dispute that the cession had the effect that DEF ceded to X BANK its rights in respect of the appellant's obligation to deliver the maize in discharge of the loan liability and that the cession was in full and final settlement of DEF's maize obligations pursuant to the X BANK forward purchase agreement. The effect of this cession was that with effect from 29 June 1998 DEF had no further claims against the appellant under the loan agreement and no further obligations to LDV under the X BANK forward purchase agreement. In this document which was signed by the appellant

the latter took note of the cession and agreed to deliver the maize in terms of the loan agreement to X BANK.

[13] It is common cause that in respect of each of its 1999 to 2003 years of assessment the appellant claimed and was granted a deduction from income in terms of section 11(a) of the Income Tax Act of the amounts paid to X BANK during that year. In each year of assessment the amount of the deduction was equal to the face-value of the promissory notes issued by the appellant in terms of the loan agreement, actually paid during that year. The aggregate amount claimed as a deduction amounted to R74 686 861,00 being the face-value of the promissory notes afore referred to based on a loan of R96 415 776,00.

[14] On 1 June 2003 the Commissioner issued additional assessments in terms of section 79 of the Act for the 1999 to 2002 years of assessment, disallowing the interest previously allowed as a deduction in respect of those years and imposing additional tax (200%) and interest in terms of sections 76 and 89*quat* of the Act on the amounts so assessed. And on 10 March 2004, the Commissioner issued an additional assessment in respect of the 2003 tax year disallowing the interest deduction claimed for that year and imposing additional tax at the rate of 200% and interest in terms of the aforementioned sections respectively. It is these disputed assessments that form the subject-matter of the present appeal.

THE ISSUES

[15] In terms of Rule 12 of the Regulations to the Act the issues in any appeal to this Court are those defined in the Statement of Grounds of Assessment read with the Statement of Grounds of Appeal. In order to avoid undue prolixity I will refer only to the essential issues that emerge from these documents.

[16] The Commissioner's principal contention is that whilst the loan to the appellant has been represented by all the parties to the transactions as a loan of R96 415 776,00, in substance and reality it is a loan of R50 million. It argues that in consequence the appellant should only be allowed an interest deduction based on interest on a capital amount of R50 million with any excess disallowed, and that interest and a 200% penalty should be levied on the consequent underpayment of tax, on the basis that the transaction involved deliberate simulation and intentional tax evasion. Accordingly the Commissioner requests that the court find that in the years of assessment 1999 to 2003 that the deductions of amounts equivalent to the portion of the promissory note payments constituted expenditure which was not actually incurred in the production of the appellant's income and were of a capital nature.

[17] In relation to the question of additional tax and interest in terms of sections 76 and 89*quat* of the Act, the Commissioner contends that the tax returns rendered by the appellant contained incorrect statements as

contemplated in section 76(1)(c) of the Act which were repeated at the hearing of the appeal, to the effect that the transaction was a genuine commercial transaction and that portion of the deductions claimed in the appellant's tax returns for the years of assessment ending 1999 to 2003 were represented to be in respect of interest payable in terms of the promissory note payments, when in reality they were in respect of repayments of capital. Consequently the additional tax and interest was leviable.

[18] In the alternative the Commissioner seeks to rely on an application of section 103 of the Act. The submission is that the series of transactions constituted a "*transaction, operation or scheme*" as contemplated therein which had the effect of avoiding, postponing or reducing the appellant's liability for income tax in the 1999 to 2003 years of assessment, and should therefore be set aside.

[19] The appellant's opposing contention, is that the sum it borrowed from DEF was R96 415 776,00, comprising an amount of R50 million which it required for its business purposes, plus an extra R46 million, which was used to purchase a hedge against the obligation to repay the capital.

[20] It contends that the terms and conditions recorded in the transaction documents correctly reflect the intention of the appellant in relation to its rights and obligations and were implemented and performed by the appellant in accordance with their tenor. And furthermore that there was no tacit understanding or unexpressed agreement on the part of the appellant which is

not recorded in the transaction documents. Accordingly the loan from DEF to the appellant was a loan for the full capital amount reflected in the loan agreement and no portion of the interest paid thereon constitutes expenditure of a capital nature or expenditure which is disqualified from deduction by either section 23(f) or section 23(g) of the Act.

[21] The appellant denies that the provisions of section 103 of the Act are applicable and that there is any justification for the imposition of the 200% additional tax and interest in terms of section 89*quat*.

[22] In terms of Regulation 10(3) of the Act the Commissioner is required to set out in the statement of grounds of assessment the grounds upon which the taxpayer's objection was disallowed and the material facts and legal grounds upon which the Commissioner relies for such disallowance.

[23] In para 6.3 of the statement of grounds of assessment the Commissioner sets out the material facts to support its contention that the substance and reality of the transaction is that the appellant did not receive nor did he intend to receive a loan in the sum of R96 415 776,00 which was repayable by the delivery of maize on 28 February 2003.

[24] In para 6.3.1 the assertion is made that the appellant did not intend to speculate, trade or sell any quantities of maize over a 5 year period, either before, at the time of or after the transactions were concluded. Reference is made to the following factors:

24.1 the value of maize five years into the future was completely uncertain (6.3.1.1);

24.2 the purchase price attributed to the maize in respect of the sale from DEF to X BANK was based on a clearly fictitious price of approximately R419,00 per ton in circumstances where, on the day the sale was concluded, the futures price quoted on the South African Future's Exchange (SAFEX) was R715,00 per ton (6.3.1.2);

24.3 the purchase price attributed to the maize in respect of the sale was determined without reference to the actual value of the maize on the relevant date (6.3.1.3);

24.4 the risks associated with sales of maize for delivery five years into the future are inordinate. No proper account was taken of the availability of maize at the time of delivery, price volatility or factors which are ordinarily taken into account when transactions of this nature are concluded (6.3.1.4);

24.5 the delivery date stipulated in the loan agreement for the delivery of the maize namely 28 February 2003, ignored the fact in South African maize which is harvested between May and August each year. The agreements failed to make any reference to obligations attaching to the relevant parties in regard to

storage and the costs associated therewith. Nor was there provision contained in the agreement relating to the consequences associated with the potential non-availability of the specified quantities of maize on the delivery date (6.3.1.5);

24.6 none of the agreements specified the physical location of the 109 315 tonnes of maize on 28 February 2003. Location of maize has a direct impact on storage and transport costs which were not referred to in the agreements or factored into the purchase price (6.3.1.6);

24.7 the manner in which the maize was described in each of the agreements was completely inadequate (6.3.1.7);

24.8 the DEF cession had the effect that the reciprocal rights and obligations of each of the appellant and X BANK were extinguished by way of set-off and there was consequently no obligation on either of the parties to deliver maize on the dates set out in the agreements or at all (6.3.1.8.3);

24.9 the series of transactions when considered as a composite whole rendered delivery of the maize impossible (6.3.1.9).

24.10 The purchase price payable in terms of the two forward sale agreements were atypical. In the normal course, in respect of conventional forward sales of maize and in relation to maize transactions effected on the SAFEX, the purchase price is payable on the date the maize is delivered in order to minimize the risk of non-delivery.

[25] In para 6.3.2 of the statement of grounds of assessment the Commissioner details a further five reasons as to why it alleges the transactions were specific designed to conceal the fact that in reality the actual loan amounted advanced to the appellant was R50 million:

"*6.3.2.1* *on the signature date, upon receipt of the amount of R96 415 776 from DEF, the appellant immediately paid R46 415 776 to X BANK in terms of the transaction referred to in paragraph 5.4 above. This amount was calculated by discounting the simulated loan amount in the sum of R96 415 776 over the loan period at the same rate purportedly levied on the said loan, namely, 15.2738% and adding thereto the sum of R697 518 which represented X BANK and DEF's fees for their participation in the series of transactions (see paragraph 6.3.2.3 below). The appellant was therefore, at the very outset, left with the sum of R50 000 000 at its disposal. As a result of the DEF cession, there was no obligation to deliver maize and consequently the 'payment' in respect of the purchase price of the maize is simulated;*

6.3.2.2 *on the signature date, DEF, simultaneously with the amount of R45 815 776, which it received from X BANK in terms of the transaction referred in paragraph 5.3 above, which amount was in any event not payable for the reasons mentioned above, received the sum of R50 697 518 from X BANK in payment of the promissory notes issued to DEF by the appellant. From the outset, DEF was placed in a completely neutral position and it is therefore clear that on the signature date, DEF had no role to play whatsoever either in regard to the purported*

loan or in relation to the obligation to deliver maize as more fully set out in paragraph 6.3.1.8 above. In this regard, the participation by DEF in the transactions referred to in paragraph 5 above, was artificially engineered and specifically designed to conceal the fact that the true loan amount was the sum of R50 000 000. DEF's sole purpose was therefore to facilitate the enhanced deduction claimed by the appellant in terms of section 11(a) of the Act;

6.3.2.3 X BANK immediately made a R600 000 profit pursuant to the transactions referred to in paragraphs 5.3 and 5.4 above. However, on the signature date, X BANK acquired the promissory notes as aforementioned from DEF, for the sum of R50 697 518 which resulted in a net outflow as far as X BANK was concerned in the sum of R50 097 518. This sum represented, at that stage, the actual loan made to the appellant in the sum of R50 000 000 and a fee in the sum of R97 518 which was payable to DEF for its nominal participation in the series of transactions. To the extent that X BANK paid the sum of R50 697 518 on the signature date to DEF, the R600 000 fee was built into the calculation which was undertaken to determine the face value of the promissory notes in the sum of R74 686 861. Accordingly, X BANK, over the loan period, purportedly received 'interest' on the simulated loan (R96 m) in the sum of R73 989 343 as well as the sum of R697 518, which together, constituted the face value of the promissory notes. Having regard to the substance and reality of the transaction, the face value of the promissory notes was actually determined by combining the capital value in respect of the actual loan in the sum of R50 000 000 together with interest thereon over the loan period in the sum of R23 989 343. The sum of these two amounts together with the fees payable to X BANK and DEF in the sum of R697 518, equate exactly with the face value of the promissory notes in the sum of R74 686 861;

6.3.2.4 the DEF cession referred to in paragraph 6.3.1.8 above, at the outset, extinguished the appellant's obligation to deliver 109 315 tonnes of maize in settlement of the purported capital portion of the loan in the sum of R96 m to any party to the series of transactions. Accordingly, no such loan ever existed.

6.3.2.5 it was contemplated from the outset that the one and only obligation that would exist between the parties was the one that remained between the appellant and X BANK in relation to the promissory note payments. Accordingly, it is clear that the promissory note payments were designed

> *to encompass the repayment of capital and interest based on an actual loan amount in the sum of R50 000 000.*"

[26] In para 7 of the statement of grounds of assessment the Commissioner contends that because the true substance of the transactions was a loan in the sum of R50 million the appellant is not entitled to a deduction of amounts equal to the portion of the promissory note payments which were not actually incurred in the production of the appellant's income.

THE RELEVANT LEGAL PRINCIPLES

[27] By virtue of section 82 of the Act, the burden to prove that any amount is exempt from tax and the duty to show that the Commissioner's decision to disallow the objection to the assessments was wrong, rests on the appellant (see *Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (A) at 953D-E).

[28] The general principles to be applied where simulation is relied on are well-settled. Parties are free to arrange their affairs so as to remain outside the provisions of a particular statute, including a taxing provision. What they cannot do is arrange their affairs through or with the aide of simulated transactions. Where parties attempt to conceal the true nature of a transaction by giving it a form different from what they really intend, the courts will give effect to the true nature and substance of the transaction. See *Ladysmith supra* at 952A-953C. In *Ladysmith* Hefer JA writing for the court

referred with approval to *Zandberg v Van Zyl* 1910 AD 302 at 309 in which it was held that the form of an agreement will be ignored and effect given to the substance thereof only if "*there is a real intention, definitely ascertainable, which differs from the simulated intention*". He also referred of approval to *Commissioner of Customs and Excise v Randles, Bros and Hudson Ltd* 1941 AD 369 at 395-6 to the effect that before a court will hold a transaction to be simulated or dishonest it must be satisfied that there is some unexpressed or tacit understanding between the parties to the agreement which has been deliberately concealed. Hefer JA concluded at 953C-D that the real question is whether the parties "*actually intended that each agreement would inter partes have effect according to its tenor. Simulation will be established if be shown that the parties do not intend to be bound by all the terms of their contract*".

See also in this regard *Relier (Pty) Ltd v Commissioner for Inland Revenue* [1998] 1 All 183 (SCA); *Commissioner for Inland Revenue v Conhage formerly Tycon (Pty) Ltd* 1999 (4) SA 1149 (SCA); *Mackay v Fey NO and Another* 2006 (3) SA 182 (SCA).

[29] The law on the subject of simulated transactions also includes the principle that notwithstanding that the parties may honestly intend to enter, and may *bona fide* think that they are entering into a contract of a particular nature and in no way are fraudulent or have an improper claim and the agreement is not designedly disguised, the court may nonetheless, on an analysis of the relevant facts conclude that in fact the agreement is not what it

purports to be but that there is some other agreement. See Kroon J in *ITC 1636* 60 *SATC 227* at 313. This principle does not appear to apply to the present case as it is not the Commissioner's case that the parties, acted honestly and in good faith and that they misconstrued the true legal nature of the transaction. The contentions *in casu* are that the appellant acted dishonestly and intentionally disguised the true transaction. The transactions in issue are said to be a "*mere paper exercise and/or simulation*".

[30] In determining the true substance of the transactions the court must have regard to all the relevant circumstances. This would include the historical background to the transaction; the nature of the negotiations between the parties; the purpose which the parties sought to achieve by entering into the transactions; any inherent, abnormal and improbable features which militate against a genuine or normal commercial transaction; the manner of implementation of the agreement as well as any indications that the parties did not intend to implement the agreement as recorded or that the agreement did not reflect their true intention (*ITC 1636* 60 SATC 267). Where, as in the present case, the transaction is comprised of a number of separate but interrelated or interdependent agreements, each one must be considered in the context of the others in order to determine their total effect (*Ladysmith* at 954C-D).

[31] Whether each agreement would *inter partes* have effect according to its tenor can only be determined on an objective review of all of the relevant facts and circumstances. The uncorroborated *ipse dixit* of the taxpayer as to

the purpose and intention of the transaction is not necessarily conclusive. Such evidence must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts. Direct evidence of intent and purpose must be weighed and tested against the probabilities and inferences normally to be drawn from the established facts (*ITC 1185* 35 SATC 122; *Malan v Kommissaris van Binnelandse Inkomste* 1981 (2) SA 91 (C) at 96F-G and on appeal 1983 (3) SA 1 (A) at 18C-H). The *onus* would be discharged if a court has no reason to disbelieve the taxpayer and his evidence is not contradicted by objective facts. *CIR v Middelman* 1991 (1) SA 200 (C) at 203G-204A.

[32] The sufficiency of the evidence adduced by the appellant must be measured against what the appellant is required to prove to discharge its section 82 *onus*. In the light of the allegation by the Commissioner that the appellant with dishonest intent signed documents which do not reflect its true intention the appellant is required to show on a balance of probabilities that its true intention was to contract with DEF and X BANK on the terms reflected in the agreements to which it is a party.

[33] The Commissioner's decision cannot be disturbed unless the appellant shows on a balance of probability that its true intention was to contract with the relevant parties to the agreement on the terms therein stated. What is critical to this enquiry is the appellant's true intention. The appellant need only establish that its true intention was to contract with DEF and X BANK on the terms reflected in the agreements to which it is a party. It is of no assistance

to the Commissioner that DEF or X BANK might not have had a reciprocal intention. See in this regard *Mackay v Fey NO and Another supra* at paras 26, 27 and 28.

[34] In the light of the specific allegation by the Commissioner that the appellant with dishonest intent signed documents which do not reflect its true intention, it is the true intention of the appellant which is in issue. What is critical to the enquiry is the appellant's true intention; in other words was it established on a balance of probabilities that its true intention was to enter into a disguised or simulated transaction as contended for by the Commissioner or was the true intent to contract with X BANK and DEF on the terms reflected in the agreements to which it is a party. As I have already pointed out it is of no assistance to the Commissioner that DEF or X BANK might have had no reciprocal intention. For this reason it was not necessary for the appellant to lead evidence of what DEF or X BANK might have intended. This approach found favour with the court in *Mackay v Fey NO and Another supra* at paras 27 and 28.

[35] Finally in seeking to establish the parties' intentions to a contract regard may be had to the parties' conduct in executing their obligations. It is appropriate in cases when a third person such as the Commissioner seeks to question the meaning of a contract. This approach was endorsed in *Rane Investments Trust v Commissioner, South African Revenue Service* 2003 (6) SA 332 (SCA) at para 27 and cases there cited.

THE EVIDENCE

[36] The appellant called two witnesses Mr B who in 1998 was the Deputy General Manager : Finance of the appellant and Mr J an Agricultural Economist in the employ of X BANK.

[37] The Commissioner relied on two expert witnesses Prof W a specialist in accounting and auditing matters and Mr J B, an attorney specialising in legal issues affecting the South African agricultural industry.

[38] B testified that the appellant was one of the largest agricultural cooperative societies before its conversion into a public company. It is a major corporate entity having approximately 2 000 shareholders. The appellant is governed by a board of 16 directors 12 of whom are non-executive directors. There are various sub-committees of the board of directors. In March/April 1998 he was the Deputy General Manager : Finance of the appellant. At the end of May 2005 he retired from his position as Financial Director of the appellant. In 1998 the appellant had a turnover of R1,5 billion and a nett operating profit of R103 million. Its main business being that of a grain trader providing agricultural inputs to its members.

[39] B was the person who was primarily responsible for negotiating the loan agreement and the ABC forward purchase agreement. He outlined the circumstances leading to the conclusion of these agreements.

[40] B explained that appellant had an established relationship with several banks including the Land Bank, Absa and X BANK. In January and early February 1998 representatives of X BANK visited the appellant at its offices in Lichtenburg where an unsolicited proposal to provide finance was put to the appellant. The proposal was described by X BANK as a "*kommoditeitsgebaseerde termyn fasiliteit*". At the meeting which was held on 28 January 1998 the appellant's representatives questioned the accounting and tax implications of the structure and these were subsequently explained to the appellant in an undated telefax addressed by a Mr M of X BANK in early February 1998. A copy of an explanatory memorandum provided to the appellant is to be found in the appellant's additional discovery bundle as also an opinion given by Adv P J J Marais SC dated 26 January 1998, explaining the tax implications of its proposed structure.

[41] The discussions between the parties centered around the provision of a structured finance facility of R50 million which would be repayable over five years. On 23 February 1998 X BANK submitted two documents to the appellant. The first, a letter of approval of the facility (Evidence bundle volume 1 p 711) and the second a proposal detailing the structure which eventually formed the basis of the transactions in issue (Evidence bundle volume 2 pp 962-976). The proposal was discussed at board and management level and after due consideration was accepted by the appellant. The parties then entered into the loan agreement and the ABC forward purchase agreement.

[42] According to B the parties implemented the said agreements in accordance with their tenor. DEF paid the full amount of the loan (R96 415 776,00) to the appellant and the purchase consideration in respect of the hedge (R46 415 776,00) was paid to LDV in accordance with the ABC forward purchase agreement. The promissory notes were duly delivered in terms of the loan agreement and paid on their due dates. The capital amount of the loan was discharged by the delivery of maize. The appellant received delivery of the maize as contemplated in the ABC forward purchase agreement and made delivery to X BANK as contemplated in the loan agreement.

[43] The following occurred in regard to delivery of the maize. On 29 January 2003 Mr P of X BANK addressed a letter to the appellant reminding it that the tenth interest repayment in terms of the loan agreement was due on 28 February 2003. The appellant was asked in addition to "*please indicate where the 109 315 tonnes of dried white maize is kept and arranged for a Notary Public to be on site at the appropriate time of delivery*". B informed P that the appellant did not then have in its possession the aforesaid quantity of maize sufficient to fulfil its delivery obligation and that it expected to receive such maize under the ABC forward purchase agreement. At that stage B was informed by X BANK that no delivery need take place as X BANK had elected to apply set-off. The appellant insisted that constructive delivery take place as agreed and accordingly a written document entitled "*Confirmation of Delivery*" dated 28 February 2003 was entered into between the appellant and X BANK reflecting the proper sequence of delivery. See Exhibit "A". The relevant silo certificates were duly executed on 28 February 2003.

[44] During his evidence in chief and cross-examination B was questioned in regard to the following matters: the role of DEF; the facility required by the appellant; the composition of the loan amount and the terms relating to repayment of the loan; the description of the maize; the absence of security; the failure by the parties to take account of storage and transportation costs in determining the purchase price of the maize; the effect of the ABC forward purchase agreement and DEF cession; the accounting treatment of the transactions in the financial records of the appellant and the genuineness of appellant's hedge.

[45] B admitted that he was aware as early as 23 February 1998 when the presentation was made that DEF's role would only be "*momentary*" and that DEF would dispose of its rights to the promissory notes and of its rights to delivery of the maize, to X BANK. He conceded that apart from the loan agreement there was not one single communication between DEF and the appellant and that he at no stage spoke to a representative of DEF. He assumed however that X BANK's representatives were also DEF's representatives.

[46] In cross-examination B conceded that the appellant had not requested a loan of R96 415 776,00 and that the discussions during February 1998 centred around a funding requirement of R50 million. He also conceded that X BANK based its decision to grant the appellant a facility of R50 million based on financial information furnished to them by the appellant and that the

appellant had not communicated to X BANK that it required a facility of R96 415 776,00.

[47] B was also cross-examined in regard to the manner in which DEF was to fund the loan but stated that this was of no real concern to the appellant. He admitted that the discounting of the promissory notes in terms of the DEF's sale were an integral part of the transactions but pointed out that the appellant was not privy to these transactions. The appellant was aware that these transactions were the sources from which the loan was to be derived.

[48] B indicated that although the appellant had not asked for a loan amount of R96 415 776,00 the fact that such loan was offered was of no concern to the applicant as the appellant's capital requirements were in the region of R200 million, a figure in excess of that which was offered.

[49] It was suggested to B that the transactions in issue were not genuine, as no security was asked or given in respect of the loan and nor was any contingency made for an increase or decrease in the price of maize. Storage and transfer costs which have a material bearing on the actual value of the maize which will be received were also not taken into account.

[50] So far as the absence of security was concerned B testified that he did not consider it to be unusual that DEF was prepared to advance the substantial amount of R96 million without security. The appellant seldom gave security to banks and there is nothing unusual in this feature. It had

never given security to Absa in respect of the substantial loans made by it to the appellant. To the criticism that the loan agreement failed to make any provision for the eventuality of the price of maize on 28 February 2003 may not have approximated the forecasted price of R882 per ton was that it had sought and obtained the forecast of J an expert in the field and was satisfied that it would not be exposed. The J forecast was R882 per ton.

[51] It was put to B that the description of the maize namely "*dried maize fit for human consumption*" was completely inadequate for the purposes of such transactions. B disputed this. He contended that the description that was adopted was that contained in the Value-Added Tax Act, 89 of 1991 in order to ensure compliance for the zero-rating provisions of that Act. The precise description was not of major concern to the appellant because it had to receive delivery of the maize from LDV for re-delivery to X BANK.

[52] It was also put to B that there were a number of unusual features in the ABC forward purchase agreement when compared to a genuine transaction in maize such as one concluded in terms of a SAGOS agreement or an OTC (over-the-counter) transaction or on the South Africa Futures Exchange (SAFEX). In the case of these transactions there would be provisions governing transportation and storage costs and the physical location of the maize would be specified and the quality of the maize would not be described in the language used in the Value-Added Tax Act, 1992. B conceded that the ABC forward purchase agreement differed materially in content from a SAGOS, OTC or SAFEX contract but he explained that the

transactions in issue did not have to comply with these requirements as physical delivery of the maize was never contemplated by the parties. What was contemplated was a form of constructive delivery. The elements referred to were thus not important considerations. B explained that the appellant was not concerned about physical location of the maize as delivery would be "*through silo and SAFEX receipts*" and the same maize would be re-delivered by the appellant. Physical delivery was never contemplated.

[53] B further testified that the appellant did not regard the DEF cession as extinguishing the appellant's delivery obligation by means of set-off. The appellant considered throughout that it was obliged to effect delivery of the maize to X BANK by means of constructive delivery as has been provided for in the loan agreement. That set-off was to apply was only contended for by X BANK for the first time in about February 2003.

[54] According to B he never appreciated the real purpose of the DEF cession but simply signed it upon the request of X BANK. That this would have given rise to an extinguishment of the loan obligation by means of set-off did not occur to the appellant or B until 13 February 2003 when a letter was addressed by X BANK to the appellant detailing their understanding that the appropriate manner in which the respective obligations were to be discharged was by way of set-off. The appellant merely took note of the cession. He at all times understood that the appellant was required to deliver 109 315 tonnes of

maize to X BANK. This was to be done by means of constructive delivery by the exchange of materially certified silo certificates.

[55] So far as the appellant was concerned it had an effective "*hedge*" against its obligation to deliver maize to DEF in its possession in the form of the ABC forward purchase agreement. It was put to B that he knew from the outset that the source of the "*hedge*" would be the appellant itself as it was apparent from the schematic structure put to the appellant on 23 February 1998 and that the origin of the hedge would depend on the delivery first by the appellant of the identical maize to DEF which X BANK depended upon in order to effect its delivery obligation to the appellant. B disputed this. According to B that is not how the appellant understood how the hedge was to operate. The appellant's understanding was that LDV was first to deliver the maize under the ABC forward purchase transaction. B denied, as was suggested by the Commissioner, that the appellant was to be the source of the hedge or that it was to kick-start the transaction. B vehemently disputed the suggestion that the hedge was not a genuine one. He pointed out that it mattered not that the hedge was obtained from a subsidiary of or division of X BANK. For as far as he was concerned the X BANK was one of the largest agricultural commodity traders in South Africa and there was no reason to think that they would not be able to deliver upon the ABC forward purchase transaction.

The aforegoing is a summary of the main aspects arising from B's evidence.

[56] The second witness called on behalf of the appellant was Mr J. J is an agricultural economist employed by X BANK. He has been involved in trend analysis for the last 23 years in the agricultural sector and one of his functions is to forecast price tends of agricultural products. J's forecasts are used by X BANK to manage its significant exposure to the agricultural sector which is about R5,8 billion and represents 33% of the bank's total assets. J testified that lending decisions are affected by these forecasts. The whole purpose of the data and forecasts is to give some indication of what the market would look like in the future. In March 1998 J compiled a forecast in regard to the projected average price per tonne of maize for the 2003 year. He forecasted a price of R882 per tonne. According to J a projection within 20% for a 5 year forecast is considered to be relatively accurate.

[57] The defendant sought to rely upon the evidence of two experts Prof W, an expert accountant and JB, a specialist in legal issues affecting the South African agricultural industry.

[58] The evidence of Prof W who was the first witness called on behalf of the Commissioner touched upon six issues: (1) the basis upon which the capital amount of R96 415 776,00 was determined; (2) the basis upon which the purchase price of the maize was determined in terms of the X BANK forward purchase agreement; (3) the basis upon which the maize price was determined in the X BANK forward purchase agreement; (4) the effect of the performance by the parties in terms of the loan agreement, the X BANK

forward purchase agreement and the ABC forward purchase agreement; (5) the role played by DEF in the series of transactions; (6) the commercial reality of the transactions.

[59] The appellant objected to the admissibility of Prof W's opinion evidence on the ground that he was not by reason of any particular special knowledge or skill better equipped or qualified than to the court to draw inferences from the admissible evidence as to the true intentions of the parties to the relevant transactions. It was also submitted that his evidence could be of no appreciable or material assistance to the court. The objection was overruled.

[60] In relation to the first issue Prof W expressed the view that the capital amount of R96 415 776,00 was artificially computed. W explained how utilising certain given factors such as the nett finance required (R50 697 518,00); the loan period (5 years) and the given interest rate to be applied to such loan (15,2728% per annum) and utilising and accepted financial annuity formula one was able to derive an artificial capital value. Put differently the capital amount was determined, colloquially speaking, "*backwards*" using the given factors as a basis for the calculation. In this way the periodic payments which ordinarily would have covered a portion of capital and interest were transformed and treated as a payment of interest only. This conclusion was derived by W after an examination of the spreadsheets used by X BANK in relation to the transactions in question.

[61] As regards issues 2 and 3 here too it was W's view that the maize prices stipulated in the X BANK forward purchase agreements flow a consequence of the calculation of the artificial loan account in the loan agreement and is determined backwards that is not by agreeing a tonnage to be delivered multiplied by an agreed price but rather by the total rand amount derived from the artificial calculations.

[62] In regard to the fourth issue it was W's view that the transactions in issue, from a financial perspective, are entirely circuitous. The loan agreement provides for the appellant to pay the capital amount of DEF via delivery of 109 315 tonnes of maize. The same tonnage of maize was to be delivered by DEF to X BANK under the X BANK forward purchase agreement which in turn is to be provided to the appellant under the ABC forward purchase agreement.

[63] As regards issue 5 it was W's view that DEF was simply an intermediary in respect of the loan from X BANK to the appellant. The effect of the various agreements is that the nett position of DEF is that it carried no asset or liability in respect of the transactions but was simply left with an amount of R97 518,00 to cover duty and its fees. DEF was simply the conduit through which the loan funding from X BANK was provided to the appellant. As regards the commercial reality of the transactions (issue 6) it was W's contention that the true transaction was a loan by X BANK to the appellant of R50 million and that the additional R697 518,00 relates to up-front fees payable for the structuring of the transaction and stamp duty, so that the initial loan amount increased to R50 697 518,00.

[64] In summary W expressed the view that the form of the transaction was to create a simulation where the payments which comprise capital plus interest were simulated as interest only, thereby creating an artificial loan amount. The effect of this was that the payments made by the appellant (being, in reality, capital plus interest) were, in form, reflected as only interest.

[65] To support his view as to the effect of the transaction and its commercial reality reference was made to the accounting treatment applied in the financial statements of the appellant. In his view the appellant did not account for the transaction properly.

[66] JB who is an expert on legal issues affecting the South African agricultural industry was asked to comment in regard to the genuineness and authenticity of the transactions in issue. JB testified, among other things, that the series of agreements entered into between the parties did not, in his opinion, create rights or obligations which would normally be created between persons dealing at arm's length under a transaction of the nature in question. The following were in his view features of the agreement which were unusual when compared to a genuine transaction in maize such as one concluded in terms of a SAGOS agreement and OTC (over-the-counter) transaction or on the South African Futures Exchange (SAFEX). In the case of these transactions the type of grain and grade of grain required to be delivered would be specified in sufficient detail and the quality of the maize were not to be described in the language used. The practice in the grain industry is to

distinguish between three grains of white maize, white maize 1, 2 and 3 in terms of the South African Grading Regulations. In the present contract there is no specification as to what percentage was to be white maize 1 or white maize 2. In a genuine maize transaction the percentage deviation in relation to the tonnage specified which will be tolerated and if so, whether the deviation would be allowed at the option of the seller or the purchaser would be indicated. There would also be a specification whether any statutory duties were payable by the purchaser or seller and most importantly the physical location of the maize would be identified.

[67] In JB's view there were inadequate security arrangements to safeguard contracting parties against counterparty default on insolvency. The ABC cession would not address the problem caused by the absence of security. For approximately the three month period from the date of the loan to the execution of the ABC cession on 23 June 1998 DEF would have been exposed in the event of the appellant's insolvency. The absence of adjustment provisions was particularly important as the loan agreement failed to make any provision for the eventuality that the price of maize on 28 February 2003 may not have approximated the forecasted price of R882 per tonne. The volatility of the maize price could have had a substantial impact on the recoverability of the loan amount by DEF.

[68] According to JB the delivery obligation as evidenced in the agreements is circular and not genuine. The agreements make provision for the delivery of maize by the appellant to DEF, from DEF to X BANK and from X BANK

back to the appellant, thereby effectively distinguishing the obligation on the part of the appellant to deliver the maize.

[69] In cross-examination JB conceded that he was familiar with the SAGOS and SAFEX contracts which applied to grain transactions, however, he was not familiar with loan agreements in terms of which the capital was to be redeemed in specie. He further conceded that his views as to typicality of the various provisions were based on a comparison of the transactions in issue with SAGOS and SAFEX contracts which are ordinarily used in grain trading. JB further stated that the failure to make reference to storage costs, transportation costs and the location of the maize in the agreements in issue was probably because the parties realised that there was to be no physical delivery of the maize. He also conceded that in order to avoid the risk of price volatility it would have been appropriate to have hedged the risk in terms of a forward purchase transaction, as occurred in the present case. So far as the absence of security was concerned his concerns were to be viewed from the point of view of the lender (X BANK or DEF) rather than the appellant. There would in his view had been a risk to DEF or its successor-in-title that despite the appellant having received maize under the forward purchase agreement it will be unable to deliver this maize to DEF or its successor-in-title. JB conceded under cross-examination that this risk was eliminated when the appellant's rights under the forward purchase agreement were ceded on 23 June 1998 and that at worst X BANK or DEF would have been exposed for some three months after the loan agreement was entered into.

THE OPPOSING CONTENTIONS

[70] In argument the following contentions were advanced on behalf of the Commissioner:

70.1 The evidence and probabilities established that the transactions in issue involved deliberate simulation and intentional tax evasion. The loan which had been represented by the parties to the transactions as a loan of R96 415 776,00 was in substance and reality a loan of R50 million. In consequence the appellant should only be allowed an interest deduction based on interest on a capital amount of R50 million with any excess disallowed and that interest and a 200% penalty should be levied on the consequent underpayment of tax.

70.2 The evidence of Prof W convincingly established that the capital amount of R96 415 776,00 in the loan agreement was artificially computed and that the true loan was R50 million. On the evidence the appellant had never indicated to X BANK that it required a loan in such sum and that all discussions and negotiations with the representatives of X BANK centered around a loan of R50 million.

70.3 The maize component of the transaction was not genuine and there was never an intention to extinguish the capital amount of

the loan by the payment of maize. The relevant agreements, properly construed show that the maize obligation was circular. To provide for the delivery of 109 315 tonnes of maize from the appellant to DEF, from DEF to X BANK and from X BANK to back to DEF thereby effectively distinguishing the obligation on the part of the appellant to deliver the maize.

70.4 The rights and obligations purportedly created in terms of the agreements comprising the series of transactions were clearly unusual and did not encompass rights and obligations which would have been incurred by the parties dealing on an arm's length basis in the context of a normal maize transaction. JB pointed to the following atypical provisions contained in the agreements. These include:

70.4.1 the vague and inadequate description of the maize;

70.4.2 the failure to indicate the percentage deviation in relation to the tonnage specified which would be tolerated;

70.4.3 the failure to make provision for storage and transportation costs and inadequate security

arrangements to safeguard contracting parties against default on insolvency.

70.5 It was clear from Prof W's evidence that the manner in which the purchase price of the maize in terms of the ABC and X BANK forward purchase transactions was calculated was contrived and not based on genuine commercial considerations. The appellant clearly did not intend to contract with DEF. DEF's involvement in the transaction was intended to be momentary. According to Prof W the effect of the various agreements was that the nett position of DEF was that it carried no asset or liability in respect of the series of transactions but was simply left with an amount of R97 518,00 to cover duty and its fees. It is clear that DEF was merely the conduit through which the loan funding from X BANK was provided to the appellant.

70.6 Because there was no true intent to deliver maize the hedge purportedly created by the ABC forward purchase transaction was more apparent than real. The ABC forward purchase agreement did not constitute a genuine hedge. The appellant's "*hedge*" was self-created. The source of the hedge was the appellant itself which had to supply the maize. The hedge would have been genuine if the maize came from a completely independent source.

70.7 B, the pivotal figure in the series of transactions on his own admission did not understand essential and vital aspects of the composite transaction. In so doing B sought to distance himself from them. It was submitted that B's evidence that he believed that the appellant had incurred a liability of R96 415 776,00 to DEF ought to be rejected.

70.8 The production of the agreements coupled with the evidence of B and J was insufficient to discharge the requisite *onus*. The countervailing evidence adduced by the Commissioner's witnesses were cogent enough to cast sufficient doubt on the authenticity of the agreements.

70.9 The court ought to draw adverse inferences against the appellant as a result of its failure to call X BANK which was subpoenaed to give evidence as a witness. The representatives of X BANK would, if called, have been able to cast light on the true nature of the transaction.

70.10 In the result the appellant had failed to discharge the requisite *onus* in terms of section 82 of the Act.

[71] It is as well, to at this stage, dispose of the contention that an adverse inference ought to be drawn against the appellant as a result of its failure to

call X BANK, which had been subpoenaed and whose representatives were available to give evidence.

[72] There are no hard and fast rules to when an adverse inference is to be drawn. Such inference is usually drawn in circumstances where they are before the court opposing versions or explanations and the evidence is equally balanced. See *Galante v Dickinson* 1950 (2) SA 460 (A) at 465 and *Brand v Minister of Justice and Another* 1959 (4) SA 712 (A) at 716D-G; or where it is clear that the failure to call the witness stems from a failure that such evidence would expose facts unfavourable to such party. *Elgin Fireclays Ltd v Webb* 1947 (4) SA 744 (A) at 749-750.

[73] There is no duty on a party to call all the available evidence in order to discharge its *onus*. The position that obtains is summarised by Marais J in the following passage in *Rand Cold Storage and Supply Co Ltd v Alligianes* 1968 (2) SA 122 (T) at 124D-G:

> "*It is axiomatic that a party need not, and cannot be blamed if he does not, call all the witnesses who may give pertinent evidence; he is entitled to take the risk of offering less than all the evidence available to him if he is of the opinion that what he has offered would suffice to win. He may of course in the result be shown as having been too confident but that is something different from being found to have deliberately suppressed evidence unfavourable to him – which is the conclusion sought to be drawn here.*"

[74] There is no justification for the drawing of an adverse inference against the appellant as a result of its failure to call the subpoenaed representatives of X BANK as witnesses. As previously stated, the critical enquiry for present purposes is the appellant's state of mind and whether it intended to enter into a disguised or simulated transaction. It is of no assistance to the Commissioner that DEF or X BANK might or might not have had a reciprocal intention. See *Mackay's* case *supra*. It is unlikely that the appellant's failure to call X BANK was motivated by the fear that to call the bank's representatives would have damaged the appellant's case. If anything the opposite is true. X BANK would probably have supported the appellant in its version. All of this obviated the need for the appellant to call X BANK. In any event the subpoenaed witnesses were equally available to both the appellant and the Commissioner but neither elected to call such witnesses.

[75] The following submissions were advanced on behalf of the appellant. It was argued that the production of the agreements to which the appellant was a party coupled with the evidence of B and J was sufficient to create a *prima facie* case that the agreements were genuine and intended to have effect according to their tenor. The countervailing evidence adduced by the Commissioner and inferences to be drawn therefrom were not cogent enough to cast doubt on the authenticity of the agreements. The inferences which the Commissioner has asked the court to draw are not justified and its contentions are replete with bald allegations, speculative assertions and comparisons to transactions far removed from the realities of the present case.

[76] The approach postulated by the appellant found favour with the court in *ITC 1636* 60 SATC 267 and on appeal in *Conhage supra.* In *ITC 1636* Kroon J accepted that in terms of section 82 of the Act, the taxpayer bore the overall *onus* of proving that the Commissioner's decision to allow its objection to the assessment was wrong. Because the taxpayer was armed with agreements which on the face of it appeared to be genuine that the Commissioner bore the burden of rebutting the *prima facie* case constituted thereby (the "*weerleggingslas*"). This approach to the burden of adducing evidence in rebuttal has been followed in a number of cases. See for example *Zandberg v Van Zyl* 1910 AD 302 at 314 (per Solomon J); *Vasco Drycleaners v Twycross* 1979 (1) SA 603 (A) at 615H *in fin* to 616A; *Parton and Colam NNO v G M Pfaff (SA) (Pty) Ltd* 1980 (4) SA 485 (N) at 489F-G and *Skjelbreds Rederi a/s and Others v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at 733F-G.

[77] In *Conhage* Kroon J's approach to the *onus* of proof in *ITC 1636* and his analysis of the evidence appears to have been accepted. (See paras 6 to 9 of the judgment.) The fact that the *prima facie* evidence of the taxpayer stood uncontradicted was decisive of the matter. Hefer JA writing for the court stated the following in paragraph 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. …*"

[78] It was submitted that the same approach should be followed in the present matter and that we should find that the *prima facie* case resting on the formal agreements, supported by the evidence of B, stands uncontradicted.

[79] It was submitted further that the evidence of B as to the circumstances leading to the conclusion of the agreements to which the appellant was a party and the fact that the parties implemented the relevant agreement in accordance with their tenor was not seriously challenged in cross-examination or otherwise contradicted and ought to be accepted. Accordingly there is no reasonable basis for suggesting that B is an untruthful witness.

EVALUATION

[80] In our assessment B was a credible and satisfactory witness. He was heavily cross-examined by counsel for the Commissioner and gave reasonable and plausible answers to the propositions that were put to him. The following aspects of his cross-examination bear mention.

[81] In an endeavour to demonstrate that the appellant had no intention to contract with DEF it was put to B that DEF was not independently represented during the negotiations and that there was not one single communication between DEF and the appellant. B accepted this but explained that as far as he was concerned DEF was part of the X BANK group and that the representatives of X BANK to whom he spoke (M and L) spoke for both X

BANK and DEF. The suggestion that B was untruthful in this regard cannot be accepted. The aforesaid answer is in our view perfectly plausible.

[82] B was pressed to explain why DEF did not take any security from the appellant and did not conduct its own credit assessment. He was also asked to explain why DEF was interposed as a party. It was suggested that he was aware as early as 23 February 1998 when the presentation was made that DEF's role would only be momentary. B was also pressed to admit that DEF did not have the financial wherewithal to make the loan. As regards the question of security B testified that the appellant seldom gave security to banks and that DEF is a subsidiary of X BANK. He was unable to fully explain the role of DEF in the transaction. These answers are in our view reasonable. It cannot reasonably have been expected of B to explain why DEF was interposed as a party to the transactions. X BANK was perceived by B and his colleagues as a major South African bank with expert knowledge in the structuring of financing transactions and the appellant had no hand in the drafting of the structure. The proposal to the appellant in fact incorporated a confidentiality undertaking which required the appellant to acknowledge X BANK's trade secrets.

[83] Much of the cross-examination was taken up by comparing the maize obligation in the loan agreement and ABC forward purchase agreement with features in a conventional maize transaction. He was asked to explain the alleged inadequacy in the description of the quality of the maize, why the fact that the physical location of the maize was not specified and why there was

no provision for transport costs or storage such as one would normally find in SAFEX transactions. B conceded that the ABC forward purchase agreement differed materially in content from a conventional maize transaction, however, he pointed out that this was not intended to be a SAFEX transaction. The ABC purchase agreement was linked to the loan agreement which provided for the capital to be settled in specie and the agreement was intended to provide forward cover. In his view it was unnecessary to have specified the physical location of the maize or to make provision for transport costs or storage as physical delivery of the maize was never contemplated; it was at all times contemplated that the maize was to be delivered to the appellant by LDV in terms of the ABC forward purchase agreement by means of a form of constructive delivery. B also testified that he did not see anything untoward in the fact that the hedge was taken out with a company associated with X BANK especially since X BANK was the largest agricultural commodity trader in the Republic. So far as the alleged inadequacy in the description of the maize is concerned (the failure to distinguish between white maize 1 and white maize 2) there is no evidence that either X BANK, DEF or the appellant regarded the description as inadequate for purposes of the transaction. B's explanation to the effect that the description of the maize was not a major concern to him because the same maize that the appellant was to receive in terms of the ABC forward purchase agreement had to be re-delivered to X BANK was not challenged.

[84] The aforesaid answers given by B are in our view acceptable and reasonable. It is of significance that the Commissioner has not contended or

sought to lead evidence to suggest that, inherently, a loan cannot by agreement be repaid in specie or such specie cannot be in the form of grain or further, or if a loan were repayable in specie that the borrower cannot take measures to reduce its exposure to fluctuations in the cost of purchasing the specie at the loan repayment date through a hedge transaction. Nor is it contended that such arrangements would affect the tax deductibility of the interest on the loan. Nor has the Commissioner contended or sought to lead evidence to show that such a hedge cannot be taken out with the lender or an entity associated with the lender, and that inherently such an arrangement would affect the tax deductibility of the interest on the loan.

[85] The evidence of JB in relation to the above aspects was of little probative value. JB testified that while he was aware of the existence of loans repayable in specie in the form of shares or commodities he had no personal experience in dealing with such transactions. The thrust of JB's evidence was to compare the transactions in issue with SAGOS and SAFEX contracts used in grain trading. This basis of comparison is irrelevant if one accepts that a loan repayable in specie was in fact entered into.

[86] Neither Professors JB or W appeared to have had any inherent difficulties with the concept of loans repayable in specie and with the borrowers hedging the resultant risk. That was hardly surprising as specie-based financial transactions appear to be common.

[87] The evidence of Prof W is in our view irrelevant to the question of the appellant's true intentions in concluding the agreements which it did and did little to disturb B's evidence as to the appellant's true intentions in entering into the agreements to which it was party. Prof W, who is a specialist in accounting gave evidence to the effect that the correct accounting disclosure of the combined loan and hedge transaction would be to show it as a loan of R50 million, as this was the "*economic substance*" or "*commercial substance*" of the combined transactions. Prof W made it clear that his opinion in this regard was from a financial and accounting point of view and conceded in cross-examination that his opinions on artificiality are informed by his training as an accountant in search of the economic substance of the transactions.

[88] It was argued on behalf of the appellant, and we are largely in agreement therewith, that the opinion of Prof W on the economic substance or financial reality as understood and explained by him is largely irrelevant to the question of the appellant's true intentions in concluding the agreements which it did. The reason therefore is that the purposes of the exercise undertaken by Prof W 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. See for example *Commissioner for Inland Revenue v Felix Schuh (Pty) Ltd* 1994 (2) SA 801 (A) where Corbett CJ commented at 813F:

"*… As has frequently been pointed out, the court is concerned with the deductions permitted in terms of the Act and not with debits or other provisions made in a taxpayer's accounts, even though these may be regarded as prudent and proper from an accounting point of view.*"

The relevance of the evidence of Prof W must thus be seen in this context.

[89] Prof W made much of the fact that the financial calculations were, in his view, "*artificially determined*"and "*determined backwards*". By this he meant that the following factors were known: the amount of nett finance required (R50 million); the loan period (5 years); and the market-related interest rate that would have been applied to such a loan, (15,2728%). By applying a standard financial formula to these factors, the repayments could be recalculated, covering both capital and interest. He demonstrated that if such payments only covered interest, leaving the capital unpaid, this would service a capital loan of approximately R96 million. In cross-examination Prof W conceded that "*backward calculations*" involve simple financial maths and that not all such calculations are artificial. Reference would have to be made to other factors and that he had in fact looked at more than the calculations themselves. Apart from the spreadsheets to which he refers he also had regard to the agreements between the parties and from the totality of all that came to the conclusion that the economic substance as perceived by accountants was not R96 million but R50 million. In our view no inference adverse to the appellant with regard to the true intention of the parties to the relevant agreements can be drawn from the fact that the loan amount was determined on the basis of the so-called backward calculation. Artificiality

would depend on other factors and more particularly whether the parties intended to implement the structure proposed by X BANK to the appellant. See in this regard what is stated in paras [96] and [97] below.

[90] Prof W admitted that loans repayable in specie were not inherently abnormal. His concern related to the fact that the future quantum of maize that was required to repay the capital amount of the loan was determined by dividing the capital amount of approximately R96 million by an X BANK theoretically determined 2003 maize price of R882,00 per ton resulting in requirement to repay the loan with some 109 000 ton of maize. This in his view was an entirely artificial exercise. We are not in agreement with this proposition. Had the parties made no effort at all to estimate the future maize price, the quantum of maize required to be delivered would in turn have been artificial. On the undisputed evidence however X BANK and the appellant made their best efforts to determine the estimated forward price of maize. According to B it was critical that the future price of maize be determined with as much accuracy as possible. B's unchallenged evidence is that the J forecast was presented to the appellant as a forecast by an X BANK expert and that he considered the forecast price to be reasonable. X BANK had expressed no uncertainties about the forecast to B and the actual price per ton in February 2003 was within 20% of the R882,00 forecast by J. In the circumstances we do not accept the Commissioner's contention that the purchase price attributed to the maize in the X BANK forward purchase agreement was based on a clearly fictitious price.

[91] Whatever criticisms Prof W has in regard to the compilation of the maize price in terms of the X BANK forward purchase agreement cannot be laid at the door of the appellant. The appellant was not privy to the agreement between DEF and X BANK, was not consulted on the provisions thereof and was indeed, according to B, never presented with a copy of that agreement.

[92] We do not agree with the Commissioner's contentions concerning the effect of the DEF cession. The Commissioner contends that there was no need for the appellant and X BANK to have exchanged SAFEX and silo certificates on 28 February 2003 because the reciprocal delivery obligations were extinguished by set-off. On the evidence only X BANK insisted that set-off was to apply. The appellant, according to B at all times insisted that delivery should take place in accordance with the ABC forward sale agreement and the loan agreement. To the extent that set-off was to apply it is clear from B's evidence as to what took place on or about 28 February 2003 that the parties agreed that set-off was not to take place and that their respective obligations were to be fulfilled by delivery of the maize. It is an established principle that parties can contract out of the operation of set-off. See *Herrigel v Bon Road Construction Co (Pty) Ltd* 1980 (4) SA 669 (SWA).

[93] In the course of argument counsel for the Commissioner referred to several English cases which involved what are termed self-cancelling transactions within the context of sophisticated tax avoidance schemes. See for example *Matrix-Securities Ltd v Inland Revenue Commissioners* [1994] 1 All ER 769. The allegedly "*self-cancelling*" obligations in the present

transaction are the obligation on X BANK to deliver the maize to the appellant in terms of the ABC forward purchase agreement and the obligation of the appellant to re-deliver the same maize to X BANK. It would be incorrect in our view to characterise the reciprocal delivery obligations of X BANK and the appellant as self-cancelling. On the Commissioner's version the effect of the DEF cession was to create a set-off of obligations. Set-off is a legally valid mechanism for the discharge of legal obligations. The term "*self-cancelling*" referred to in the English cases implies that the obligations in question did not exist or were a pretence. In the present case there was a valid reciprocal delivery obligation with effect from 29 June 1998.

[94] On a proper conspectus of the evidence and probabilities it appears that the series of transactions entered into between the appellant, X BANK and DEF had the two-fold purpose of enabling the appellant to borrow the funding that it required for its immediate business purposes and to obtain the maximum tax benefit. The structure of which the agreements entered into by the appellant form part were deliberately planned in order to achieve these objectives. There is in principle nothing wrong in entering into such an arrangement provided that the transactions entered into or structures devised are a true reflection of the taxpayer's intent and not a simulation. Taxpayers are permitted, subject to the provisions of section 103 of the Act, to arrange their affairs so as to legitimately avoid the payment of tax. The *Conhage* case *supra* serves as a good example of the application of these principles. There the court accepted that agreements of sale and leaseback sought to be impugned by the Commissioner served the dual purpose of providing the

taxpayer with capital and to take advantage of the tax benefits to be derived from the type of transaction (see *Conhage* at para 15). The court in *Conhage* accepted that the transactions were genuine and that the parties intended to give effect to the transactions according to their terms and that the provisions of section 103 of the Act were inapplicable.

[95] Inherently, there would appear to be nothing objectionable in taking out a hedge with the lender, or a company associated with the lender. B's uncontradicted evidence was that LDV was part of the X BANK banking group which was a major player in the South African agricultural market. There would appear to be no question therefore as to the normality of their writing agricultural hedge transactions with clients. The Commissioner did not seek to adduce any evidence to establish that there was anything unusual in the fact that the same banking group provided the loan as well as the hedge. There is also no evidence before the court that the tax advantage to the appellant would have been any different had they dealt with an independent third party in relation to the hedge, or that the terms of the hedge differed materially from those that would have applied with the involvement of such independent third party. B's unchallenged evidence that he saw nothing unusual in the fact that the same banking group provided the loan and the hedge must in the circumstances be accepted.

[96] It is clear from B's evidence that the appellant only required R50 million in funding for its immediate business purposes. X BANK however proposed a

structure in terms of which the appellant was to borrow a higher sum (R96 million) which was to be repaid in 5 years in specie by the delivery of a fixed quantity of maize. The additional amount of R46 million to be used to purchase a hedge in order to secure the repayment of the capital. The appellant had a choice it could either borrow R50 million or accept the proposed structure which afforded it the additional tax advantage. The appellant was not obliged to choose the less tax-effective route.

[97] What is critical in our view is the manner in which the alternative structure was implemented and whether the implementation was simulated or not. Given the apparent tax benefit of the alternative structure, it is difficult to see why in the present case the appellant would have tried to *simulate* entering into the alternative structure (given the relative simplicity in *actually* entering into it), while in reality entering into a conventional R50 million loan. There seems no reason on the probabilities why the appellant would have wanted to simulate the alternative structure. There was no financial or other disadvantage to actually implementing the alternative structure as opposed to pretending to do so.

[98] We are in agreement with the appellant's submission that the appellant had no motive for deception. It would not have mattered to the appellant whether the lender was DEF or X BANK. There is no discernible reason why the appellant would have wished to connive with DEF or X BANK to disguise the true identity of the lender under the loan agreement.

[99] In considering the probabilities we are mindful of the well-established principle that criminality or other dishonest conduct will not lightly be inferred. See *Gates v Gates* 1939 AD 150 at 155. It is highly unlikely that the directors and responsible officials of the appellant, a public company would have acted in collusion with bank officials of a major banking institution and the appellant's external auditors in perpetrating a fraud. For this reason more persuasive evidence is genuinely required if the inherent improbability is to be overcome. See *Kelleher v Minister of Defence* 1983 (1) SA 71 (E) at 75F.

[100] We find, on the basis of the undisputed evidence and probabilities that the parties intended to and implemented the relevant agreements in accordance with their tenor. DEF paid the full amount of the loan to the appellant and the appellant utilised a portion of the loan (R46 415 776,00) to purchase the hedge in terms of the ABC forward purchase agreement. When the time came for delivery the appellant received delivery of the maize as contemplated that is by means of constructive delivery and made delivery to X BANK as contemplated in the loan agreement. The accounting treatment of the transaction in the appellant's audited annual financial statements accords with the terms of the relevant agreements and is consistent therewith.

[101] Adopting the approach postulated in *Conhage supra*, we find that the countervailing evidence adduced by the Commissioner and justifiable inferences to be drawn from the established facts are not of sufficient cogency to cast doubt on the authenticity of the agreements and the *prima facie* case established by the appellant.

[102] The appellant has in our view discharged the *onus* of showing that its true intention was to contract with DEF and X BANK on the terms reflected in the agreements to which it is a party. The appellant has established on a balance of probabilities that the agreements to which it was a party were not simulated and that it was the appellant's intention to give effect thereto in accordance with their tenor.

SECTION 103 OF THE ACT

[103] In the Statement of Grounds of Assessment the Commissioner seeks to rely, in the alternative, upon the anti-avoidance provisions contained in section 103 of the Act. The section empowers the Commissioner to determine a taxpayer's liability for income tax by disregarding any abnormal transaction which the taxpayer has entered into for the purpose of avoiding or postponing tax liability or reducing the amount thereof. On the present wording of the section there are several jurisdictional prerequisites that must co-exist before the Commissioner is entitled to invoke the section. One of these is that the Commissioner must be satisfied that the transaction in issue had a tax avoidance effect.

[104] It was argued that as the Commissioner's main ground of assessment and contention is that the transaction was simulated it was not open to the Commissioner to at the same time have been satisfied that the transaction

had a tax avoidance effect. Reliance for this proposition is placed on the judgment of Wunsh J in *ITC 1625,* 59 SATC 383 at 395 where the following is stated:

> "*This is not the first case in which I have expressed my difficulty with the reliance by the Commissioner on s 103 when at the same time he says that tax has not been avoided. A pre-condition to the invocation of s 103 is that the Commissioner has to be satisfied that tax has been avoided. Unless he demonstrates that he is of the opinion that tax has been avoided, he is not entitled to issue an assessment in terms of s 103. He obviously cannot demonstrate that unless he is, in fact, satisfied that tax had been avoided. If he says that the taxpayer is not entitled to a deduction which gives rise to the avoidance of tax because, for example, he contends that expenditure which it is sought to deduct was not incurred in accordance with s 11(a) and 23(g), he has deprived himself of the jurisdiction of saying that tax was avoided. He, therefore cannot rely on s 103.*"

[105] In my view the appellant's contention is not without merit. The Commissioner's satisfaction with regard to the tax avoidance effect of a transaction is clearly a precondition to the Commissioner's right to apply his extraordinary powers under the section. As the main ground of assessment is that the transaction is a simulated one it follows that the Commissioner could not at the same time have been satisfied that such transaction had a tax avoidance effect. To have been so satisfied presupposes the validity of the transaction. In the present circumstances the Commissioner may not invoke section 103 in the alternative.

[106] I would accordingly uphold the appellant's contentions in regard to the applicability of section 103(1) of the Act.

[107] For these reasons we are of the view that the appeal should be upheld and that the additional assessments for the 1999 to 2003 years of assessment should be set aside.

ORDER

[108] The following order is made:

108.1 The appeal is upheld with costs including the costs consequent upon the employment of two counsel.

108.2 The additional assessments for the 1999 to 2003 years of assessment are set aside.

ON BEHALF OF MR M VAN BLERCK (COMMERCIAL MEMBER)
ON BEHALF OF MR R J HEFFER (ACCOUNTING MEMBER)

____

P BORUCHOWITZ – PRESIDENT

This judgment should be reported **YES NO**

Appellant's representatives Mr H Vorster
Mr E Brincker

Commissioner's representatives	Adv D M Fine SC Adv G D Goldman Adv T Molokomme