REPUBLIC OF SOUTH AFRICA

IN THE INCOME TAX COURT OF SOUTH AFRICA

HELD IN JOHANNESBURG

CASE NO: **13065/13**

(1) REPORTABLE: YES / NO
(2) OF INTEREST TO OTHER JUDGES: YES/NO
(3) REVISED.

....
SIGNATURE **DATE**

BEFORE

JUDGE NP MALI **PRESIDENT**

MS GN JIYANE **ACCOUNTANT MEMBER**

MR I NKAMA **COMMERCIAL MEMBER**

In the matter between:

X (PROPRIETARY) LIMITED APPELLANT

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE RESPONDENT

J U D G M E N T

MALI, J:

INTRODUCTION

[1] This matter concerns the analysis of supply agreements entered into between the appellant and some of its foreign subsidiaries. It thus brings to fore, *inter alia* the application of the South African developing fiscal legal principles, namely, residence based taxation, section 9D of the Income Tax Act 58 of 1962 ("the Act") and other established principles of tax law, such as anti-tax avoidance provisions and substance over form. Tax avoidance is the use of legal methods to modify taxpayer's financial situation to reduce the amount of tax that is payable. As Learned Judge Hand said the following in ***HELVERING v GREGORY***:[1]

> Anyone may arrange his affairs so that his taxes shall be as low as possible, he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.

[2] The appellant is a juristic person, a taxpayer who may be chargeable to tax in terms of section 151 of the Tax Administration Act 28 of 2011 ("TAA"). The taxpayer is registered and incorporated as a company in the Republic of South Africa and carries on business in the petrochemical industry. It has some of its subsidiaries in foreign jurisdictions. The appellant's business activities include the importation and refinement of crude oil.

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[1] Judge Learned Hand, *Helvering v Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934), aff'd 293 U.S. 465 (1935).

[3] The respondent is the Commissioner for the South African Revenue Service ("SARS"), appointed in terms of section 6 of the SARS Act 34 of 1997 ("SARS Act") by the President of the Republic of South Africa, or the Acting Commissioner designated by the Minister in terms of section 7 of the SARS Act.

[4] This appeal was heard from 3 August 2016 to 19 August 2016. On 19 August 2016 the court heard an application by the South African Revenue Service's ("CSARS") to call a foreign law expert. The application was opposed by the appellant. It was agreed by both parties that the calling of further witnesses by the appellant was dependent on the outcome of the application by the respondent. The judgment was handed down on 16 September 2016 dismissing CSARS's application. The hearing of the appeal then proceeded from 10 to 21 October 2016.

BACKGROUND FACTS

[5] In April 2010 SARS issued additional assessments against the appellant for 2005, 2006 and 2007 years of assessment. The assessed amounts were included in the taxable income of the appellant. Additional tax was levied in terms of section 76 of the Act. The said assessments amounts are as follows:

5.1 For 2005: Assessed amount is R29 573 094

Additional tax is R8 576 197 and interest is R7 475 821

5.2 For 2006: Assessed amount is R113 521 961

Additional tax is R32 921 369 and interest is R24 587 141

5.3 For 2007: Assessed amount is R93 610 407

Additional tax is R27 147 018 and interest is R540 647

[6] On 14 July 2010 the appellant objected to the assessments and the respondent disallowed the objection in a letter dated 24 June 2011, hence this appeal. In order to appreciate the issues involved the appellant's group structure is set out.

[7] **X GROUP**

7.1 X Ltd held all the shares of the appellant prior to 1 December 1997 in XYZ and X International Holdings (Pty) Ltd, ("XIH").

7.2 XIH held all the shares of X Trading International Ltd ("XTI"), a company incorporated in the Isle of Man ("IOM").

7.3 During the relevant years, XYZ had the following subsidiaries:

7.3.1 XX International Ltd ("XYZIL") was incorporated in May 2004 as a wholly owned subsidiary in IOM;

7.3.2 X International Services Ltd ("XIXL"), incorporated in 1999 in the United Kingdom ("UK"). The shares in XIXL were owned by XIH until 2004 when they were transferred to XYZ.

THE AGREEMENTS

[8] On 28 September 1998 XYZ and XTI concluded a written agreement (the **"Original Supply Agreement"**). Prior to the effective date of the Original Supply Agreement and since 1 December 1997 X Oil has purchased crude oil from XTI in terms of an oral agreement. It was recorded in clause 2 of the Original Supply Agreement that the parties wished to record the oral agreement in writing.

8.1 **The Original Supply Agreement** included the following clauses:

Clause 3.1 defined the "Effective Date" to mean

"1 December 1997, notwithstanding the date of signature of this agreement".

Clause 4

"This agreement came into force on the Effective Date and shall continue to be of full force and effect until 25 June 1999, from which date either Party shall be entitled to give the other 6 (six) months' written notice of termination."

Clause 5

"XTI undertakes to supply Crude Oil to [XYZ and [XYZ undertakes to buy such Crude oil from XTI according to the terms and conditions contained in this Agreement."

Clause 7.1

"All Crude Oil purchased by [XYZ] hereunder shall be delivered by XTI either at Durban or in the Port of Durban in lots scheduled in accordance with clause 7.2. Risk and ownership in the Crude Oil shall pass to [XYZ] at the time the Crude Oil passes the ship's manifold at discharge port."

Clause 8.2

"The destination of the Crude Oil to be delivered to [XYZ], shall for Bill of Lading purposes be Durban, unless agreed in writing by the Parties to the contrary...."

8.2 **First XTI Supply Agreement**

On 1 December 2001, XTI and XIXL signed a written document (the **"First XTI Supply Agreement"**) which included the following clauses:

Clause 3.1 defined the *"Effective Date" to mean*

"1 July 2001, notwithstanding the date of signature of this Agreement".

Clause 4

"This Agreement came into force on the Effective Date and shall continue to be of full force and effect until 30 June 2003, from which date either Party shall be entitled to give the other 6 (six) months' written notice of termination."

Clause 5

"XTI undertakes to supply Crude Oil to XIXL and XIXL undertakes to buy such Crude Oil from XTI according to the terms and conditions contained in this Agreement."

Clause 7.1

"All risks in the Crude Oil purchased by XIXL hereunder shall pass to XIXL at the loading vessel's permanent hose connection points at the load port…"

Clause 8.2

"The destination of the Crude Oil to be delivered to XIXL, shall be Durban, unless agreed in writing by the Parties to the contrary"

Clause 8.3

"XIXL shall assume all risks and costs associated with taking delivery of a cargo of Crude Oil FOB loadport, to the extent that such costs are not recoverable from the loadport, to the extent that such costs are not recoverable from the loadport terminal…"

8.3 **XIXL supply Agreement**

In April 2004, XIXL and XYZ signed a written document (the **"XIXL Supply Agreement"**) which included the following clauses:

Clause 3.1 defined the *"Effective Date"* to mean

"1 July 2003, notwithstanding the date of signature of this Agreement".

Clause 4

"This Agreement came into force on the Effective Date and shall continue to be of full force and effect until termination.

Either party is entitled to give the other 6 (six) months' written notice of termination or at any time after 30 June 2004."

Clause 5

"XIXL undertakes to supply Crude Oil to [XYZ] and XYZ] undertakes to buy such Crude Oil from XIXL according to the terms and conditions contained in this agreement."

Clause 7.1

"All Crude Oil purchased by [XYZ] hereunder shall be delivered by XTI either at Durban or in the Port of Durban in lots scheduled in accordance with clause 7.2. Risk and ownership in the Crude Oil shall pass to [XYZ] at the time the Crude Oil passes the ship's manifold at discharge port"

Clause 8.2

"The destination of the Crude Oil to be delivered to [XYZ], shall for Bill of Lading purposes be Durban, unless agreed in writing by the Parties to the contrary"

Clause 8.3

"XIXL shall assume all risks and costs associated with shipping the Crude Oil. Such risks and costs include, but are not necessarily limited to:

- *Crude oil losses (the difference between Bill of Lading quantities and final outturn at disport).*
- *Demurrage*
- *Dead freight*
- *Ship freight costs*
- *Insurance*
- *Inspection*
- *Loss Control*
- *Negotiating crude oil ship pricing with other South African refiners."*

Clause 6.1

"Unless otherwise agreed upon in writing by the Parties, XIXL shall supply 11,000,000 barrels (eleven million barrels) plus/minus 1% of Crude Oil during the year 2003/2004 and every subsequent year thereafter to [XYZ]. The Crude Oil shall be delivered in cargos lots according to a delivery schedule as determined in accordance with clause 7 below."

Clause 9.2

"The price of Crude Oil per barrel delivered by XIXL to [X] in terms of this Agreement will be calculated as follows:

FOB Price plus Other Costs Elements plus/minus Variation Margin (if any) = Price per barrel delivered in Durban"

Clause 9.1.5 which defined for the purposes of clause 9, the term "Other Costs Elements" to mean:

"the following costs elements with values as agreed between the Parties for the period 1 July 2003 to 30 June 2004:

Freight:	*Freight costs…*
Losses:	*0.5% of CIF value*
Insurance:	*0.07% on CIF value of Crude Oil plus 10%*
Surveying and Loss Control:	*US$0.01/barrel*
Demurrage:	*US$0.03/barrel*

…"

8.4 **Second XTI Supply Agreement**

In April 2004, XTI and the XIXL concluded agreement (the **"Second XTI Supply Agreement"**) which included the following clauses:

Clause 3.1 defined the *"Effective Date" to mean*

"1 August 2003, notwithstanding the date of this signature of this Agreement."

Clause 4

"This agreement came into force on the Effective Date and shall continue to be of full force and effect until termination. Either party is entitled to give the other 6 (six) months' written notice of termination at any time after 30 June 2004"

Clause 5, 7.1, 8.2 and 8.3 contained the same provisions as those contained in the XIXL Supply Agreement quoted in paragraph 8.2 clauses 5. , 7.1 ,8.2 and 8.3 above.

Clause 6.1, is the same as clause 6.1 of the XIXL Supply Agreement (quoted in paragraphs 8.3 above), save that the 11 million barrels referred to in this clause of the Second XTI Supply Agreement were to be supplied by **XTI to XIXL** (in contrast, the 11 million barrels referred to in clause 6.1 of the XIXL Supply Agreement were to be supplied by **XIXL to XYZ**).

Clause 9.2, which was the same as clause 9.2 of the XIXL Supply Agreement (quoted in paragraphs 8.3 above), save in the following respects:

"*In terms of this clause of the Second XTI Supply Agreement, the price was determined in respect of a barrel of crude oil to be delivered by **XTI to XIXL** "in FOB load port" (in contrast, in terms of clause 9.2 of the XIXL Supply*

*Agreement, the price was determined in respect of a barrel of crude oil to be delivered by **XIXL to XYZ** "in Durban")."*

In terms of this clause of the Second XTI Supply Agreement, the price did not include the *"Other Costs Elements"* (in contrast, in terms of clause 9.2 of the XIXL Supply Agreement, the *"Other Costs Elements"* was included in the price).

Clause 15.1

"This Agreement read together with the Annexures thereto constitutes the entire and whole Agreement between the Parties in regard to the subject matter thereof and supersedes all prior and contemporaneous negotiations, offers, discussions, promises, representations, agreements and understandings of the Parties with respect thereto....."

The *"prior…agreements"* contemplated in clause 15.1 included the first XTI Supply Agreement.

8.5 **Assignment Agreement**

In October 2004 XIXL, XTI and XYZIL signed a written document (The **"Assignment Agreement"**).

The Assignment Agreement included clause 1, which reads as follows:

"1.1 [XTI] herewith assigned all of its rights, duties and obligations under the Oil Agreement to [XYZIL] and [XYZIL] hereby accepts all of [XTI's] rights and assumes all of [XTI's] duties and obligations under the Oil Agreement.

1.2 [XIXL] hereby consents to the above assignment, pursuant to Paragraph 19 of the Oil Agreement. The "Oil Agreement" referred to in clause 1 was the Second XIXL Supply Agreement."

[9] Because of the implementation of the above supply agreements the appellant excluded the amounts received or accrued to XYZIL, a Controlled Foreign Company ("CFC") from the sales of crude oil, in breach of the provisions of section 9D.

SECTION 9D

[10] Section 9D of the Act provides:

> **Net income of controlled foreign companies.—**
>
> **"Controlled foreign company"** means any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that—
>
> (*a*) no regard must be had to any voting rights in any foreign company—
>
> (i) which is a listed company; or
>
> (ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;
>
> (*b*) any voting rights in a foreign company which can be exercised directly or by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and
>
> (*c*) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—

(i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (*e*)(ii) of the definition of "company" in section 1 or foreign "company" in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(*aa*) holds less than five percent of the participation rights of that scheme or arrangement; and

(*bb*) may not exercise at least five per cent of the voting rights in that scheme or arrangement, unless more than 50 per cent of the participation rights or voting rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other;

"country of residence", in relation to a foreign company, means the country where that company has its place of effective management;

"foreign business establishment", in relation to a controlled foreign company, means—

(*a*) fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where-

(i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;

(ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conducted the primary operations of that business;

(iii) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and

(v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere or government in the Republic;

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—

(*aa*) if that company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(*bb*) if that other company forms part of the same group of companies as the controlled foreign company; and

(*cc*) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company;

(*b*) any *place* outside the Republic where prospecting or exploration operations for natural resources are carried on, or any place outside the Republic where mining or production operations of natural resources are carried on, where that controlled foreign company carries on those prospecting , exploration, mining or production operations;

(*c*) a *site* outside the Republic for the construction or installation of buildings, bridges, roads, pipelines, heavy machinery or other projects or a comparable magnitude which lasts for a period of not less than six months where that controlled foreign company carries on those construction or installation activities;

(*d*) *agricultural* land in any country other than the Republic used for bona fide farming activities directly carried on by that controlled foreign company;

(*e*) a vessel, vehicle, rolling stock or aircraft used for purposes of transportation or fishing, or prospecting or exploration for natural resources, or mining or production of natural resources, where that vessel, vehicle, rolling stock or aircraft is used solely outside the Republic for such purposes and is operated directly by that controlled foreign company and that forms part of the same group of companies as that controlled foreign company;

"participation rights" in relation to a foreign company means -

(*a*) the right to participate in all or part of the benefits of the rights (other than voting rights attaching to a share, or any interest of a similar nature, in that company; or.....

(2A) For purposes of this section the **"net income"** of a controlled foreign company in respect of a foreign tax year is an amount equal to the taxable income of that company determined in accordance with the provisions of this

Act as if that controlled foreign company had been a taxpayer, and as if that company had been a resident for purposes of the definition of “gross income”,

As part of its overall effort to reduce South African tax rates by widening the tax base, the Minister of Finance introduced the Revenue Laws Amendment Act 59 of 2000. The amendments contained in the Act widened South Africa’s tax base by shifting the tax system from a “source plus” system to a “residence-minus” tax system. Under the former “source plus” system, South Africa taxed items arising only from South African sources plus a limited category of foreign source items. Under the current “residence-minus” system, South Africa imposes taxes on a worldwide basis less a limited category of foreign source items. One key element of the current “residence-minus” system is section 9D which provides for South African taxation of certain foreign sourced income generated by South African controlled foreign companies. South African tax applies where failure to tax foreign controlled company income will likely lead to an artificial flow of funds offshore, not where taxation will likely damage South African international competitiveness…Section 9D mainly applies to foreign companies that are mostly owned by South African residents. South African residents owning 10 per cent or more of the shares in these foreign companies must include a proportional ownership percentage of the net income earned by that foreign company. Lastly, only limited forms of net income of a foreign company create an inclusion for South African residents. These limited forms of foreign company income mainly involve objective forms of income that represent a potential threat to the South African tax base while presenting few international competition concerns.[2]

[2] www.treasury.gov.za National Treasury's Detailed Explanation of Section 9D of Income Tax Act page 1-3.

[11] The interpretation of section 9D is intertwined with residence-based taxation. With effect from tax years commencing on or after 1 March 2001, South Africa moved from a source -based system of taxation to a residence basis of taxation in respect of which all income, subject to certain exclusions, is subject to normal tax. The effect is that all worldwide income of a natural person who is resident is subject to normal tax. Thus, in respect of resident companies tax is levied on the net income of the CFC.

[12] In essence the respondent contends that XIXL had been interposed to divert the ownership of crude oil in the original supply chain. The respondent's case is that it was the intention of the appellant and its group of companies that the sale of crude oil would remain between XYZIL and XYZ. The interposition of XIXL provides tax benefit to the appellant's group. The benefit is secured by virtue of XYZIL being resident in IOM. This continued after the introduction of the residence -based taxation, as the Group continues to pay 0% tax on profits of XYZIL both in IOM and South Africa.

[13] In the alternative SARS's ground of assessment is that the appellant's structure constituted a transaction, operation or scheme as contemplated in section 103(1) of the Act. The structure had the effect of avoiding liability for the payment of tax imposed under the Act.

[14] In summary the respondent's case is based on the principle of substance over form, in which event the provisions of section 9D will be applicable. Alternatively the respondent's case is based on the application of section 103 of the Act.

[15] Section 103 of the Act provides:

> **Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.—** (1). . . . .
>
> (2) Whenever the Commissioner is satisfied that—
>
> (*a*) any agreement affecting any company or trust; or
>
> (*b*) any change in-
>
> (i) the shareholding in any company ; or
>
> (ii) the members' interests in any company which is a close corporation; or
>
> (iii) the trustees or beneficiaries of any trust,
>
> as a direct or indirect result of which-
>
> (A) income has been received or accrued to that company or trust during any year of assessment; or
>
> (B) any proceeds received by or accrued to or deemed to have been received by or to have accrued to that company or trust in consequence of the disposal of any asset, as contemplated in the Eight Schedule, result in a capital gain during any year of assessment,
>
> has at any time been entered into or effected by any person solely or mainly for the purposes of utilizing any assessed loss, any balance of assessed loss, any capital loss, or any assessed capital loss, as the case may be, incurred by the company or trust, to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof—
>
> (*aa*) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;
>
> (*bb*) the set-off of any such assessed loss or balance of assessed loss against any taxable capital gain, to the extent that such

taxable capital gain takes into account such capital gain, shall be disallowed; or

(*cc*) the set off of such capital loss or assessed capital loss against such capital gain shall be disallowed…

(4) If in any objection and appeal proceedings relating to a decision under subsection (2) it is proved that the agreement or change in shareholding or members' interests or trustees or beneficiaries of the trust in question would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner , or in the reduction of the amount thereof, it shall be presumed until the contrary is proved in the case of any such agreement or change in shareholding or members' interests or trustees or beneficiaries of such trust, that it has been entered into or effected solely or mainly for the purpose of utilising the assessed loss, balance or assessed loss, capital loss or assessed capital loss in question in order to avoid or postpone such liability or to reduce the amount thereof.

[16] The appellant denies that the substance of the relevant agreements differed from their form and accordingly denies that in substance the amounts which were received by or accrued to XYZIL from sales of crude oil were from sales of crude oil by XYZIL to X Oil. It contends that both in form and substance the relevant amounts were received by or accrued to XYZIL from sale of crude oil by XYZIL to SISIL. For that reason, XYZ is the argument, those amounts were excluded from the net income of XYZIL in terms of section 9D(9)(*b*) on the basis that they were not attributable to amounts derived from the sale of goods by XYZIL to a connected person who was a resident.

[17] In the alternative, the appellant contends that even if the relevant amounts were attributable to amounts derived by XYZIL from sales of goods by XYZIL to any connected person in relation to XYZIL, which was a resident, by virtue of the provisions of paragraph (A) of section 9D(9)(*b*), (ii)(*aa*), such amounts were not included in the net income of XYZIL, for the purposes of section 9D.

[18] The appellant denies that the requirements of section 103(1) and the requirements of section 89*quat* interest are satisfied. It further denies that it became liable for penalties in terms of section 76 of the Act and contends in the alternative that respondent should have remitted such penalties in terms of section 76(2)(*a*) of the Act.

[19] In support of the appellant's argument Counsel for the appellant referred to several authorities, *inter alia*, ***COMMISSIONER OF CUSTOMS AND EXCISE v RANDLES, BROTHERS AND HUDSON LTD***,[3] ***MCKAY v FEY NO AND ANOTHER***.[4] The argument raised by the appellant is based on the principle enunciated in the abovementioned cases. The principle stipulates that in order to treat a transaction as simulated or a sham, it is necessary to find that there was dishonesty. The parties did not intend the transaction to have effect in accordance with its terms but intended to disguise the transaction. The transaction should be intended to deceive by concealing what the real agreement or transaction between the parties is.

[20] The appellant's counsel also referred to the perceived confusion which arose as a result of the judgment in ***CSARS v NWK LTD*** ("*NWK*").[5] The XYZ called confusion resulted to the view that the effect of the judgment was that it was

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3 1941 AD 369 at 395-396.
4 2006 (3) SA 182 (SCA) para 26.
5 2011 (2) SA 67 (SCA).

no longer necessary to prove dishonesty or an intention to deceive in order to treat a transaction as simulated.

[21] It is common cause that in ***BOSCH AND ANOTHER v COMMISSIONER, SOUTH AFRICAN REVENUE SERVICE***;[6] learned Davis J rejected the view that the effect of the judgment in *NWK* was to dispense with the requirement of dishonesty.

[22] Wallis JA in ***CSARS v BOSCH***[7] clarified the perceived misunderstanding that occurred in *NWK* judgment. He stated the following:[8]

> [40] That submission involved a misunderstanding of the judgment in NWK, as was pointed out in Roshcon. "There I stressed that simulation is a question of the genuineness of the transaction under consideration. If it is genuine then it is not simulated, and if it is simulated then it is a dishonest transaction, whatever the motives of those who concluded the transaction. The true position is that „the court examines the transaction as a whole, including all surrounding circumstances, any unusual features of the transaction and the manner in which the parties intend to implement it, before determining in any particular case whether a transaction is simulated. Among those features will be the income tax consequences of the transaction. Tax evasion is of course impermissible and therefore, if a transaction is simulated, it may amount to tax evasion. But there is nothing impermissible about arranging one's affairs XYZ as to minimise one's tax liability, in other words, in tax avoidance. If the revenue authorities regard any particular form of tax avoidance as undesirable they are

6 2013 (5) SA 130 (WCC).
7 2015 (2) SA 174 (SCA).
8 *CSARS v MARIANA BOSCH AND ANOTHER* ZASCA 171 (19 November 2014).

> free to amend the Act, as occurs annually, to close anything they regard as a loophole. That is what occurred when s 8C was introduced. Once that is appreciated the argument based on simulation must fail. For it to succeed, it required the participants in the scheme to have intended, when exercising their options to enter into agreements of purchase and sale of shares, to do XYZ on terms other than those set out in the scheme.
>
> **(OWN UNDERLINING)**

[23] Wallis JA's judgment above is in line with the reasoning in ***NATAL JOINT MUNICIPAL PENSION FUND v ENDUMENI MUNICIPALITY***[9] ("*Endumeni*") wherein the same learned Judge of Appeal developed a regularly applied principle to interpretation of documents. The examination of all surrounding circumstances seems to be a key and a common factor. Both judgments unambiguously state what the court is required to do.

[24] Before determining whether the transaction is simulated the court is enjoined to follow the true position by examining the transaction as a whole. Whilst I agree that if the transaction is genuine then it is not simulated, I do not understand that the enquiry ends with the interplay of "genuine is equal to no simulation". My view is that even if the agreements are considered to be genuine, the matter cannot be closed without a thorough examination of the relevant agreements. The court should follow the entire chain as stated above. The court's appreciation of the breakdown is as follows: **(i) look at all surrounding circumstances (ii) any unusual features of the transaction and the manner in which the parties intend to implement it. (iii) Of great**

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[9] 2012 (4) SA 593 (SCA) (16 March 2012).

importance in looking at the features will be the income tax consequences of the transaction.

[25] Furthermore from the judgment of ***ROSHCON (PTY) LTD v ANCHOR AUTO BODY BUILDERS CC AND OTHERS***[10] I do not discern any requirement for SARS to plead fraud. I reiterate that what is necessary is the scrutiny and close examination of the transaction by the court. In any event the NWK decision referred to by the appellant was decided sometime after the assessments in this matter were issued.

ISSUES

[26] The issues to be determined are the following:

26.1 Whether the substance of the relevant agreements differed from their form, in the manner contended by the respondent;

26.2 If so, whether the relevant amounts were excluded from XYZIL's net income, for the purposes of section 9D, on the basis that the requirements of paragraph (A) of section 9D(9)(*b*)(ii)(*aa*) were satisfied;

26.3 Whether the requirements of section 103(1) were satisfied;

26.4 Whether the appellant should be liable for the section 76 Penalties;

26.5 Whether the appellant should be liable for the section 89*quat* Interest.

SUBSTANCE OVER FORM

[27] The law on substance over form has evolved over the century. In ***ZANDBERG v VAN ZYL***[11] Innes CJ said the following:

> Not infrequently, however, (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law

[10] ZASCA 40 [2014] ALL SA 654.
[11] 1910 AD 202 at 209/302 at 309.

> would impose), the parties to a transaction endeavour to conceal its real character. They call it by name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do XYZ by giving effect to what the transaction really is, not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur. But the words of the rule indicate its limitations. The Court must be satisfied that there is a real 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 obtained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact; for the right solution of which no general rule can be laid down.

[28] In determining a matter regarding principle of substance over form, the well established law is that the court should conduct the factual enquiry. The court is enjoined to establish the actual intention of the contracting parties. In ***COMMISSIONER OF CUSTOMS AND EXCISE v RANDLES, BROTHERS & HUDSON LTD***[12] it is held at page 395-6:

> (a) transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Court according to its tenor, and then the only question is whether XYZ interpreted, it falls within or without the prohibition or tax.
>
> A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction:

[12] 1941 AD 369.

dishonest, inasmuch 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 XYZ they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. Such a transaction is said to be *in fraudem legis*, and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties. Of course, before the Court can find that a transaction is *in fraudem legis* in the above sense, it must be satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not XYZ, it could not find that the ostensible agreement is a pretence. The blurring of this distinction between an honest transaction devised to avoid the provisions of a statute and a transaction falling within the prohibitory or taxing provisions of a statute but disguised to make it appear as if it does not, gives rise to much of the confusion which sometimes appears to accompany attempts to apply the maxim quoted above.

[29] In ***ERF 3183/1 LADYSMITH (PTY) LTD AND ANOTHER v CIR***[13] the Court was faced with the issue of the accrual of income to the taxpayers. The income was arose from a lease and sublease arrangements. The Commissioner successfully relied on the principle that the Courts should not be deceived by the form of a transaction but should examine its substance. The court held at page 8 the following:

> …one is immediately struck by the cumbrous arrangements for its construction. Affiliated companies are of course at liberty to structure their mutual relationships in whatever legal way their directors may prefer; but when, for no apparent commercial reason, a third party is interposed in what might equally well have been arranged between affiliates, it is not unnatural to seek the motive elsewhere.

[30] Almost all tax jurisdictions are desirous to lay hands on taxes arising from profits belonging to their residents. Even developed countries are concerned with the rise of sophisticated and complex tax avoidance schemes resulting in tax base erosion. The same can be said for South Africa. One of the most cited example is the recent case of Google Company in the UK.

[31] In the report of House of Commons-Committee of Public Accounts published on 13 June 2013 at page 5, the following is stated:

> 1. **The UK is a key market for Google but the enormous profit derived is out of reach of the UK's tax system.** Google generated US 18 billion revenue from revenue from the UK between 2006 and 2011. Information on the UK profits derived from this revenue is not available but the company paid the equivalent of just US $16 million of UK corporation taxes in the same period. Google defends its tax position by claiming that its sales of advertising space to UK clients take (XIH) place in Ireland-an argument which we find

[13] 1996 (3) SA 942.

> deeply unconvincing on the basis of evidence that, despite sales being billed by Google from Ireland, most sales revenue is generated by staff in the UK. It is quite clear to us that sales to UK clients are the primary purpose, responsibility and results of its UK operation, and that the processing of sales through Google Ireland has no purpose other than to avoid UK corporation tax. This elaborate corporate construct has damaged Google's reputation in the UK and undermined confidence in the effectiveness of HMRC. In contrast to evidence given to us previously, Google has also conceded that its engineers in the UK are contributing to product development and creating economic value in the UK…
>
> 2. **MRC has not been sufficiently challenging of multinationals' manifestly artificial tax structures**. We accept that HMRC is limited by resources but it is extraordinary that it has not been more challenging of Google's corporate arrangements given the overwhelming disparity between where profit is generated and where tax is paid. Inconsistencies between the form of the company's structure and the substance of its activities only came to light through…Any common sense reading of HMRC's own guidance and tests suggests HMRC should vigorously question Google's claim that it is acting lawfully... .

[32] In ***ENSIGN TANKERS (LEASING) LTD v STOKES (INSPECTOR OF TAXES)***[14] the House of Lords stated:

> Unacceptable tax avoidance [which] typically involves the creation of complex artificial structures by which, as though by the wave of magic wand, the taxpayer conjures out of the air a loss or a gain , or expenditure, or whatever it may be, which otherwise would never have existed. These structures are designed to achieve an adventitious tax benefit for the taxpayer, and in truth

[14] [1992] 2 ALL ER 275 (HL) at 295.

are no more that raids on the public funds at the expense of the general body of taxpayers, and as such are unacceptable.

[33] Section 102(1)(*a*) and (*f*) of the TAA, provides that a taxpayer bears the burden of proving that an amount, transaction, event or item is exempt or otherwise not taxable; or that a *"decision"* that is subject to objection and appeal under a tax Act is incorrect. The predecessors of section 102 of the TAA is section 82 of the Income Tax Act 58 of 1962 ("the Act"). Section 82 of the Act also burdened the taxpayer to prove that any amount is exempt from tax and to show that the Commissioner's decision to disallow its objection to the assessment was wrong.[15] In the present case the appellant bears the burden establishing that the agreement is as contented by it true. Thus proving that the assessed amounts by SARS are not taxable.

[34] I turn now to examine the transaction as a whole. In doing so I will summarise the evidence of the witnesses called by the appellant. They are, Mr D; Mr E; Mr P, Mr F; and Mr G The appellant also cited an expert witness, Mr Q. It is not convenient to deal with the summary of the evidence of the witnesses in sequence.

[35] The respondent did not call witnesses and the appellant called six (6) witnesses.

SURROUNDING CIRCUMSTANCES

[36] Mr D testified that he joined X Oil on 1 October 1991 and he moved through the ranks. On 7 August 2000, he was appointed a director of XIXL to oversee

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[15] *Erf 3183/Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (SCA) at 953 D.

its operations. He also sat in the Crude Oil Product and Trading Committee ("COPAT").

[37] From December 1997 to the end of June 2001, XTI took over XYZ's offshore trading functions and procured crude oil from the suppliers and shipped to XYZ and marketed solvents for the chemical companies. From July 2001 to July 2004, crude oil was procured by XYZ from XIXL in turn procured it from XTI. From August 2004 onwards, crude oil was procured by XYZ from XIXL and XIXL in turn procured it from XYZIL, instead of XTI.

[38] The appellant embarked on a globalisation programme and one of the programmes was a bid to acquire an international entity called T Group. This acquisition which required restructuring XIH group was resolved in a meeting held on 16 November 2000. Mr D was instructed to conduct a review of XTI's and XIXL's operations, as he had an intimate understanding of their businesses.

[39] Mr D's review resulted in a proposal he prepared on 8 February 2001 and later presented on 20 February 2001 by his line Manager Mr G to the XYZ board. One of the problems was with the functions performed by X Ltd Group of companies in respect of the crude oil supply to XYZ. The main finding was that the structure involving XTI and XIXL had been relatively successful, however the business had not grown as originally expected. This is due to amongst other things some disappointing developments in the Gas to Liquid business and in opportunities anticipated in the West Africa. The essence of the problem was that the duplication of costs between XTI, XIXL and XYZ was no longer justified.

[40] It was therefore recommended that the oil and product trading function be relocated from XTI in the IOM to XIXL in London. The Southern African product trading to be relocated from XTI in the IOM to X Oil in Johannesburg.

[41] In his testimony he emphasised that the motivation for the proposal was to strip the chemicals and everything from XTI which was based IOM purely for commercial reasons. One of the statements in the proposal reads:

> Unavoidably there is a duplication of effort between XTI, XIXL and X Oil on the international oil and products trading side. The cost to these parties to maintain their offices and business contacts in the international oil and products market is simply too high in view of the lack of growth in business as discussed above. It should be mentioned that the cost of an air ticket between Johannesburg and UK is not much higher than a ticket from the Isle of Man to London. It is estimated that rationalising the trading activities could save around R3 million per year cost duplication.

[42] The XYZ board of directors approved the original proposal subject only to the approval of the Group Executive Committee ("GEC") and any UK tax implications. Mr D on behalf of XYZ, requested L & L, a firm of solicitors, to advise on the UK tax consequences of the Original Proposal. The advice contained in a letter dated 7 March 2001 was that, the transfer of the oil trading function from XTI to XIXL would not have any adverse UK tax consequences other than an increase in the liability of XIXL to UK corporations tax; as a result of the increased business it conducts in the UK. The advice presented two major problems namely; the termination of XTI's crude oil supply contracts with third party suppliers involved a great risk of losing the term contracts and challenges to transfer XTI's employees from the

IOM to London. One of the employees was Mr K who was a crude oil trader and Managing Director of XTI at the time. The L & L advice was not followed.

[43] As a result of the abovementioned challenges the revised proposal was discussed with Mr K. The revision was mainly about allocation of functions. Mr K made a presentation to the XTI board on 23 June 2001 and they were approved on the same day. Under cross-examination Mr D stated that the presentation could not be traced and was considered missing for good.

[44] According to Mr D subsequent to the approval of the abovementioned presentation he prepared a revised proposal as well as the draft agreements. They were sent to Ms M for tax advice and sign off by the Tax Department of XYZ. The tax advice sought from Ms M was finally outsourced to MnM.

[45] The only change from the first proposal sent to L & L was that the term crude oil contracts with the third party suppliers and the related hedging functions were to remain in XTI. The procurement function was relocated to XYZ, where it could be managed closer to the needs of the refinery. There were no skills in XIXL to procure crude oil.

[46] Although L & L's advice never raised problems with the relocation of shipping functions to XIXL and XIXL purchasing crude oil, instead a different approach based on a different structure suggested by MnM was adopted. MnM described the manner in which the X Ltd Group would implement the structure as follows:

46.1 XYZ orders the oil required by it from XIXL;

46.2 XIXL places back -to-back orders with XTI;

46.3 XTI purchases the oil from third parties;

46.4 XTI immediately on-sells the oil to SIS on a FOB basis;

46.5 XIXL then on-sells the oil to X Oil on a CIF basis and arranges for the shipment of the oil from the source directly to Durban harbour;

46.6 X Oil takes delivery of the crude oil once delivered in Durban;

46.7 XTI then invoices XIXL, XIXL invoices X Oil;

47.8 X Oil pays XIXL, XIXL pays XTI and makes a profit;

46.9 XTI pays the third party suppliers of the oil and also makes a profit.

[47] MnM advised that no net income would be imputed to XIH if the structure was implemented. This was because XTI had a business establishment in the IOM and would not be transacting with connected resident companies.

[48] Mr D stated that when the MnM structure or review was proposed he never thought about tax implications at all. This is despite the undisputed fact that Ms M from the Internal Tax Department of the appellant sought advice from MnM. The effect of MnM structure is the opposite of the motive of the original proposal. Instead of simplifying the structure it added another layer in the business, XIXL. MnM described the manner in which the X Ltd Group would implement the structure as follows; that no net income would be imputed to XIH if the structure was implemented. This was because XTI had a business establishment in IOM and would not be transacting with connected resident companies.

[49] In cross examination Mr D insisted that he did not draft the agreements based on the advice he obtained from MnM. The MnM opinion was a later event as he wanted to confirm tax compliance of the agreements. He further admitted

that he was aware from February 2001 of the tax changes and that they would affect X Group though he did not have detailed knowledge of the impact.

[50] Mr D had difficulty in explaining the reasons for not following the L & L proposal. When asked, in the context of the MnM structure, whether there was sufficient commercial justification for XIXL to sell the crude oil to XYZ, he replied that there was, for the reasons which he had testified on. The reasons related to the Original Proposal and were based on cost savings.

[51] Mr D also testified about the issue of transfer pricing policy of XIXL. He stated that in the transfer pricing document for 2002/2003 prepared by KPMG the primary activities of XIXL from 2001 – 2007 were defined as shipping. The profits of XIXL were derived from shipping activities. In the transfer pricing document it is also stated:

> XIXL takes on a small level of risk in connection with the provision of these services.... it also provides market research services.... XIXL only has one employee who is based in the UK and who is responsible for facilitating the shipment of oil to South Africa.

[52] In cross examination he stated that the activities were incorrectly recorded because the activities of XIXL were crude oil trading. This is despite the transfer pricing document making no mention made of any employee responsible for any trading function of XIXL.

[53] Mr D is a doubtful and unreliable witness who with his position and experience in the appellant's group struggled to explain obvious issues. It is highly probable that the actions of the appellant group were not commercially driven. A savings of R3 million even then, for an institution of the appellant's stature does not make commercial sense.

[54] Mr G's evidence in some respects was corroborated by Mr D's evidence. Mr G also attempted to explain the sudden decision to abandon the Original Proposal. In amplifying Mr D's testimony he stated that L & L recommended that Mr K, the undisputed key man intended to drive operations in XIXL move from IOM to London. Mr K's move was difficult to implement. It is apparent from paragraph 2 of the letter from L & L that L & L did not advise the relocation of Mr K. The correct position is that Mr K's relocation was at the instance of Mr D in his proposal to L & L. Mr D had conceded to the above contention. Mr G's evidence that he had not contemplated Mr K's move before receiving the letter from L & L is rejected because it is not in dispute that he worked hand in hand with Mr D, therefore he would have known the true position.

[55] Furthermore Mr G went to great lengths in trying to justify the poor performance of shipping services by XTI as one of the commercial reasons for moving the shipping transactions to XIXL. In cross-examination he conceded that the alleged poor performance of shipping service was not documented anywhere.

[56] Mr G like Mr D denied that the change of structure anticipated the new tax legislation. In cross examination it was put to Mr G that the change in legislation was a concern to X Group. In that regard he was invited to comment on the minutes of the Group Executive Committee meeting ("GEC") held on 1 February 2001. The said minutes *inter alia* recorded the following:

> 3.3. <u>Residence Tax Legislation and the effects on the X Group and X's globalisation</u>
>
> Mr N from MnM made a presentation on Residence Tax Legislation, which would be introduced for X on 1 June 2001.

> The presenter also introduced the topics of Foreign Dividends and Capital Gains Tax. Capital Gains Tax still appears to be on track for 1 April 2001, despite rumours to the contrary.
>
> Mr O stated that X is currently very weak on tax planning and that urgent actions are required to remedy the situation. Mr O will take the issue further.

[57] Mr G's response to the above was that he knew that the Residence-based legislation would have an effect on X Group and that urgent actions were required to remedy the situation. When he was cross-examined about the MnM report of 3 April 2001 he stated that he did not know about the report then. When he was pressed for answers, he then stated that there was a chance that Ms M, could have mentioned the report. He later conceded that Ms M explained to him and Mr D the impact of the new regulations in April 2001, that if XTI continued to sell to XYZ there would be imputation of tax to the appellant.

[58] Mr G further testified that the record of the minutes of the GEC of 5 July 2001 attributed to him is incorrectly captured. The essence of the abovementioned minutes is that Mr G emphasised the need to review X's structures in light of certain legislation changes. He stated that he would not have advised about legislative changes. In bolstering his statement in this regard, he stated that he was a Chemical Engineer by profession, XYZ he was not qualified to do advise on legal issues.

[59] Mr G further stated that he had sight of the abovementioned minutes only when preparing to testify for the appeal hearing, because of the appellant's strict confidentiality provisions. No one in the appellant's company or group structures was or is entitled to read the minutes after the meetings. This is a

very unusual business practice indeed, particularly for a reputable international organisation of the stature and size of the appellant.

[60] A key circumstance related to the impugned agreements is that residence-based taxation came into effect in 2001. The appellant's group structure was reviewed around the same period. The appellant's witnesses failed to persuade the court as to the coincidence of the great panic in reviewing the structure with the introduction of residence-based taxation.

[61] I cannot accept Mr D and Mr G's evidence that the utilisation of XIXL was a commercial intervention. I find that they were both not truthful, were evasive and denied the obvious. For example, the July minutes attributed to Mr G are explained as being incorrectly captured, even worse that Mr G had never had sight of them. In the closing heads of the appellant it is submitted that the court cannot reach this finding because it was not put by the respondent in cross-examination. The court's findings are based on the examination of the agreement coupled with the surrounding circumstances as enjoined by the law regulating the interpretation of agreements.

[62] Furthermore the court finds Mr D to be a doubtful and unreliable witness. Amongst other examples he conceded the Mr K issue. He even conceded that there was one agreement involving the supply of oil by XTI/XYZIL to XYZ. It is highly probable that the actions of the appellant group were not commercially driven. The only quantified amount the court heard about is a savings of R3 million. By any standards even in year 2001, a savings of that amount does not make commercial sense for an institution of the appellant's stature.

[63] Ms F testified that she joined X in 2003 as the head of Legal and Advisory. She corroborated Mr D's evidence that the presentation of 2001 was made by

Mr G and the subsequent minutes of 5 July 2001 were missing. She tried to find the documents from the participants but to no avail. Ms F's corroboration of Mr D in a single issue does not really take the matter further. There are various elements to be considered in order to reach the conclusion.

[64] Mr E is a Chartered Accountant ("CA") who has tax experience. His testimony contradicted that of Mr D in respect of the tax advice sought from MnM. He stated that from 1997 to 2004 he was employed by MnM. He worked with one Mr N who later joined X as a head of the Tax Department. Mr N died in 2002. He was tasked to provide tax advice to the appellant's group around the time of the announcement of residence-based taxation by the Minister of Finance. He stated that when he provided his opinion to the appellant's group he was not aware that the appellant's group had made the same request to L & L.

[65] Mr E further testified that he received a letter from Mr N who was working for the appellant at the time. In the letter Mr N proposed a structure and requested tax opinion on the structure. He testified that he provided tax opinion with an emphasis on commercial justification as a caution. His advice was purely tax based and not on the commercial implications. At the time XTI and X contract was stIll in force. He assumed that there was nothing wrong with the contract.

[66] In cross examination he testified that the instructions he received from Mr N carried a specific instruction that he was expected to advise regarding the reduction of tax with the advent of residence-based taxation.

[67] Mr E was found to be honest and reliable witness. His evidence trumped the evidence of the supposedly key witnesses, Mr D and Mr G.

[68] The court cannot help but to conclude that in the circumstances the interposition of XIXL was found convenient by the appellant to avoid residence-based tax legislation which would apply to the group with effect from 1 June 2001

UNUSUAL FEATURES AND THE INTENDED IMPLEMENTATION OF THE TRANSACTION

[69] From the evidence it transpired that XIXL did not genuinely perform oil trading function because little or no risk at all was attributed to XIXL. This is unusual in the business environment. XIXL did not truly buy and sell crude oil. According to Mr G the real value contribution and risk carried by XIXL was in its capacity as a shipping entity of crude oil and in the performance of its other shipping function. Mr G's evidence supports the respondent's case that XIXL was not involved in crude oil trading. It is apparent that XIXL made profit from the cost elements of shipping services.

[70] The appellant's own admission that XIXL did not assume real risk in the shipping and sale of crude oil to XYZ is also found in the financial statements, where the following is stated:

> The price paid on purchase and sale is the same XYZ that XIXL is not exposed to any risk in respect of movements in ship prices, any risk associated with XIXL's ownership of the oil during the voyage is covered by insurance", although there is some risk taken on from ownership of the oil for the period of the voyage to South Africa, this risk is mitigated.

[71] In the financial statements of XTI, the oil trading margins are recorded and analysed, whereas in XIXL's financial statements XIXL's profit margins are based on shipping services. In all probabilities XIXL was not trading in crude oil. It is reasonable to expect uniformity reporting from the same group of

companies. Simply put, in the event that XIXL was trading in crude oil the oil trading margins would have been analysed in the financial statements as had been done in XTI.

[72] Furthermore Mr D's statement in his submission of 22 November 2001 that XYZ had approached XIXL with the view to negotiate a crude oil supply agreement due to XIXL's prime location in London's crude oil trading and shipping cannot be accepted. He contradicted himself when he admitted that XIXL had neither independent nor sophisticated procurement function and nor procurement skills. In fact, he stated that there were no lengthy negotiations because the contracts had been drafted, XYZ what remained was just agreeing on those terms as already covered in the contracts.

[73] Mr D's contented that the quantity of crude oil which XIXL sold to XYZ was not the same quantity that it purchases from XTI/XYZIL. This was contrary to the invoices issued by XIXL and XYZIL, which generally showed the same type, quantity and value of crude oil purchased by XIXL being on-sold by it to XYZ. It was also contradicted by Mr G.

[74] There is compelling evidence that XIXL's requirements for crude oil were in fact XYZ's requirements. Everything was predetermined, including pricing structure. It was business as before the introduction of XIXL. Mr G struggled to explain the physical sale of oil by XIXL to XYZ. In fact under cross examination he conceded that the placing of orders by XIXL from XYZIL was not independent at all. Quantities and the needs were informed by what was required by XYZ. The invoice pricing was based on the same amount in respect of crude oil. The only difference was in other costs related to shipping. The begging question is why XIXL?

[75] Mr P testified that the intention behind the procurement chain from XTI to XIXL and from XIXL to XYZ was to ensure a security of supply of crude oil for the X refining system in South Africa on a term basis. However Mr G stated that under the new agreements XYZ had the security of the oil supply from the same source on the same terms and conditions. From this material contradiction it is not difficult to conclude that there was no need for XIXL to have crude oil at all other than to avoid attribution of net income of XYZIL to XYZ, a resident company. Furthermore, Ms F made similar admissions to those of Mr D and Mr G. Those admissions pertaining to the fact that there was one agreement involving the supply of oil by XYZIL to XYZ. Ms F is found to be unreliable witness.

[76] The expert witness, Mr. Q, testified that the common industry practice is to have one procuring entity that concludes the master agreement with the crude-oil producer for the entire group, and on sell to shipping and logistics companies within the group. In cross examination he stated that he was aware that XIXL's activities were shipping and that in certain circumstances it would be crude oil trading. He did not proffer evidence as to those circumstances.

[77] Mr Q stated that to put XIXL in any location other than London to perform its functions would have been inefficient. This is based on the position that XIXL was trading in crude oil. When Mr Q was asked to compare the oil supply chain under the Original Agreement and under the subsequent supply chain, he said that the structure was the same or consistent *"apart from the cost element".* He said that while under the Original Agreement, XYZ placed an order with XTI, and XTI then placed an order with the Middle East suppliers, under the subsequent supply chain:

> ...you've now got another entity involved in the chain XYZ it is what is known in the industry as a 'daisy chain' and you could have multiple entities in the daisy chain XYZ this has just got maybe five in the chain whereas the previous one there was three. You could have twenty. You could have thirty in the chain and everybody is **just** passing information from one to the other and XYZ there is nothing unusual with five people being the chain of this daisy chain.
>
> **[OWN EMPHASIS]**

[78] Mr Q conceded that the Original Agreement and the subsequent supply chain agreement were the same or consistent apart from the cost element. He did not dispute that the difference in cost element was made by shipping cost elements and not by oil trading elements.

[79] Mr Q tried hard to support the appellant's position in that XIXL was trading in crude oil. He was forced to concede that his evidence was based on the understanding that XIXL was in shipping business. Mr Q is found to be a defensive witness determined to support the position of the appellant at the expense of contradicting himself. His conduct is not akin to the role of an expert witness.

[80] It is trite than an expert witness gives independent evidence, without taking the side of the party that called the expert to testify. In my view Mr Q created the impression that he was taking the side of the appellant. Therefore his evidence is rejected.

FURTHER ANALYSIS OF THE UNUSUAL FEATURES

[81] There are several material inconsistencies alluding to the business of XIXL. To mention a few: in a management document XIXL was described as providing services and not as trading and as not bearing any real risk in respect of the crude oil in respect of which it provided shipping services. Other clear inconsistencies are that the documents indicate that the crude oil was procured by XYZIL for XYZ (not XIXL). The 2003 and 2004 X Ltd filings with the United States Security and Exchange Commission, consistently refer to XIXL as a "service company" in contrast to XTI, which is referred to as a "trading company").

[82] Other examples are firstly, minutes of the meeting of the XIH board of directors of 22 November 2002 and 28 February 2002. Those minutes state that the main business of XIXL is "to act as an international advisory services company mainly for the X Group of Companies". In contrast, Annexure C of the minutes of 22 November 2002 states that the main business of XTI is "to act as an international trading company mainly for the X Group of Companies". Secondly, the XIXL transfer pricing report (2002/2003) prepared by KPMG. The report states that XIXL's "primary function is to provide shipping services". XIXL takes on a small level or risk in connection with the provision of these services and it also provides market research services".

[83] Thirdly the X Ltd transfer pricing study (30 June 2003) prepared by Ernst and Young, states that “XIXL’s primary function is that of arranging shipping of oil to XYZ”. In the study XIXL is characterised as a “limited risk distributor” and as “shipping agent” in contrast to XTI, which was characterised as a” wholesale crude oil trader”. This is also in contrast to XTI whose net margin for oil trading is analysed as stated earlier. Analysis of XIXL’s net margin is limited to shipping. In the study it is also stated: “The return that XIXL enjoys on its shipping activities is to be determined with reference to the extent to which XIXL is able to pay less for insurance, Surveying & Loss Control, Losses, Demurrage that it charges XYZ”.

[84] To the above, all the witnesses failed to proffer clear explanation as to the reasons for these significant inconsistencies except to trivialise the inconsistencies as mere mistakes. In fact, Mr D agreed with the proposition that XYZ paid XIXL for insurance, the cost of surveys, loss of control, losses demurrage and ship freight. It is apparent that the true position is that XIXL was providing services and did not bear significant risk in respect of crude oil - a very unusual feature for a purportedly trader in crude oil. Therefore, the court concludes that the features and the implementation of the transaction as discussed above do not serve any real commercial justification.

[85] Lack of intention on the part of XYZIL and XIXL to pass ownership of the oil to XIXL is another unusual feature. This is apparent from the fact that there was no agreement as to when or how any such transfer of ownership would occur. When Mr G was probed about the details of the physical delivery of the oil he equated the physical delivery of the oil by XYZIL/XTI by the Middle East Suppliers bought by XYZIL/XTI as also being physical delivery of that oil by XTI /XYZIL to XIXL.

[86] The appellant's submission to the above is that the application of the principle in *"Endumeni"* should be the answer. The court must look at surrounding facts and circumstances under which the contract between XTI and XIXL was concluded. That includes the other contracts like the Middle East suppliers to XTI. The intention to pass ownership from XTI to XIXL is clearly established. In the event that the court is prepared to accept the appellant's contention the matter goes further than that.

[87] The relevant International Commercial Terms ("INCO") terms do not support the appellant's case. XYZIL/XIXL agreement does not have the provisions which would be expected in Free on Board ("FOB") contracts. The agreement does not oblige the buyer to arrange transport of the oil or to submit to the seller (XYZIL) a nomination of a ship to which XYZIL must deliver the oil. Furthermore, the agreement is silent as to the load port and there is no requirement for the seller to deliver a bill of lading in the name of the buyer. There was no physical delivery as envisaged by the normal FOB. The appellant's witnesses took time testifying about the endorsed bills of lading in favour of XIXL to support passing of ownership. Endorsement of bills of lading is not relevant to the passing of ownership. See ***GOLDEN MEATS AND SEAFOOD SUPPLIERS v BEST SEAFOOD IMPORT CC AND ANOTHER.***[16]

THE INCOME TAX CONSEQUENCES OF THE TRANSACTION

[88] The consequences of the transaction are that XYZIL's net income has not been imputed to XYZ. It is apparent from the overwhelming evidence above that this was planned from the onset. This happened at the time the tax regime changed from source to residence- based legislation. The MnM structure as alluded to above was intended to optimise the tax regime

[16] 2011 (2) SA 491 (KZD) 498 H-I.

according to the undisputed minutes of the GEC of 5 July 2001. On the same day X Ltd addressed a letter to MnM describing the MnM structure and enquired whether it would avoid XTI's net income being imputed to XIH. MnM indeed confirmed on 16 July 2001. As it turned out XTI became XYZIL and XIH is currently XYZ.

[89] The question is whether the substance of the relevant agreements differs from form. The interposition of XIXL and the separate reading of "back-to-back" agreements take XIXL out of the equation. The original commercial purpose was maintained by achieving the objectives of XTI/XYZIL selling the crude oil to XYZ and, in particular, ensuring that the material rights and obligation to XTI/XYZIL and XYZ were the same as those that existed under the Original Agreement. Again this demonstrates that XIXL's interposition in the value chain raised further questions about its commercial justification. The "daisy chain" nature of the oil supply chain referred to in expert's testimony also demonstrates how the interposition of XIXL between the seller (XYZIL) and the buyer XYZ was artificial and did not serve any real commercial purpose.

[90] Furthermore important documents of the group, one of them being the transfer pricing policy was prepared without taking into account the provisions of section 9D. Most of the significant documents filed with tax and banking authorities defined the activities of XIXL as shipping services. This is in contrast of the tendered evidence. In the evidence of the appellant's witnesses they insist that the activities of XIXL involved trading in crude oil.

[91] Regrettably no matter how the appellant's witnesses try to dress the contracts and their implementation, the surrounding circumstances; implementation of the uncharacteristic features of the transaction point to none other than

disguised contracts. The court can only read one thing not expressed as it is; **tax avoidance**. Based on the evidence the court concludes that the purpose of relevant supply agreements was to avoid the anticipated tax which would accrue to XYZIL, a CFC if it sold the crude oil directly to XYZ.

[92] The question to be answered is whether the relevant amounts were excluded from XYZIL's net income, for the purposes of section 9D, on the basis that the requirements of paragraph (A) and (D) of section 9D(9)(*b*), proviso (ii)(*aa*) were satisfied.

[93] Wallis JA's principle in *Endumeni* supra is still applicable in the interpretation of paragraphs (A) and (D). The paragraphs must be interpreted in the context of the Act, as a whole, and in the context of the relevant provisions of section 9D. The relevant extract in *Endumeni* at page 604 reads as follows: paragraph 18:

> The 'inevitable point of departure is the language of the provision itself',[17] read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.

[94] We pause to reiterate the purpose of the provisions and its background. Section 9D is an anti- tax avoidance provision. As alluded to earlier the context and purpose of section 9D is to prevent South African residents from avoiding tax simply by shifting their income to foreign entities owned by them. The simple application of section 9D is to bring home the income diverted by the CFC to the FBE in the country of the CFC's residence. More often than not CFSs are resident in tax havens with low tax jurisdictions or zero tax.

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[17] Per Lord Neuberger MR in *Re Sigma Finance Corp* [2008] EWCA Civ 1303 (CA) para 98. The importance of the words used was stressed by this court in *South African Airways (Pty) Ltd v Aviation Union of South Africa & others* 2011 (3) SA 148 (SCA) paras 25 to 30.

[95] In maintaining the balance the legislature provides for Foreign Business Establishment Exclusion ("FBE"). The exclusions are provided for in paragraphs (A) – (D) of section 9D(9). In the event the CFC has a genuine FBE to which income is attributable, the FBE exclusion may apply to such income.

[96] In terms of section 9D(9)(*b*)(ii), such net income does not include any amount attributable to any FBE of that CFC. The purpose and context of the relevant provisions of section 9D appear from a document issued by National Treasury in June 2002[18] (the "Treasury Explanation").

[97] According to the Treasury Explanation not all of a CFC's income is attributed to its South African owners. In terms of the FBE exclusion, if the CFC has an FBE to which income is attributable, the FBE exclusion may apply to such income. The FBE exclusion applies if the business is truly active, has some nexus to the country of residence and is used for bona fide non- tax business purposes.[19]

[98] The appellant contends that the income earned by XYZIL falls under Diversionary Income Exclusions in paragraphs (A) to (D) hence it was not included in its net income. Diversionary income comprises amounts derived from any sale of goods by the CFC to any connected person who is a resident.

[99] In the present matter it is not in dispute that XYZIL is the CFC resident of IOM. XYZIL has sold crude oil to XIXL a non-resident in relation to South Africa. However, from the findings above that XIXL's interposition is a sham it follows that XYZIL has sold goods to XYZ, a South African resident.

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[18] www.treasury.gov.za.

[19] ibid page 53.

[100] According to the appellant the contracts of purchase of term crude oil were concluded by XYZIL in IOM, alternatively were concluded mainly in IOM. In terms of South African law, the place where a contract is concluded is the place where the last step required for the completion of the contract takes place. No evidence was led as to the place where the agreement was concluded. The appellant relied on ***JAMIESON v SABINGO***[20] where Farlam JA held the following:

> Parties who communicate by telephone, telex, or telefacsmile transmission are "to all intents and purposes in each other's presence" (to use an expression used by Parker LJ in *Entores Ltd v Miles Far East Corporation* [1955] 2 QB 327 (CA) at 337) and the ordinary rules applicable to the conclusion of contracts made by parties in each other's physical presence apply, viz, the contract comes into existence when **and where** the offeree's acceptance is communicated and received to the offeror. This has been held to be the legal position in the case of contracts concluded over the telephone.....By parity of reasoning the same principle must apply where the parties are in communication with each other by telefacsimile transmission (see *Gunac Hawks Bay (1986) Ltd v Palmer* [1991] 3 NZLR 297 (HC)).

[101] The principles established above are not applicable because there is no evidence tendered in support of the principles. The only documentary evidence regarding the completion of the relevant sale agreements, other than the agreements themselves was in respect of XYZI/NICO agreements. Those documents comprised of NICO telexes referred to by Mr F in his testimony. Mr F did not commit to the place of execution of agreements except for the facsimile received in IOM offices. He could not even provide the

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[20] 2002 (4) SA 49 (SCA) at 54.

name of the person who received documents in his absence except to state that he would arrange a substitute, with the necessary signing authority.

[102] The appellant therefore did not establish that IOM was the place where the last step required for the completion of the contract occurred as prescribed by South African Law. See ***KERGEULEN SEALING & WHALING CO LTD v CIR***[21] and ***R.D. MS. M N.O. v SANLAM LEWENSVERSEKERING BEPERK***.[22]

[103] Although XYZIL is resident in IOM, it is clear from the evidence that the crude oil was bought from the Middle East being the product of Middle East. Taking into account the totality of the evidence and in the absence of all other stops between Middle East and Durban, XYZ would still had bought crude oil from Middle East. The oil never went anywhere near IOM because it was shipped directly from the Middle East to Durban. There was nothing prohibiting XYZ to procure oil directly from Middle East.

[104] The court has concluded that the whole scheme and or the implementation of supply agreements is a sham. The court, therefore cannot consider the facsimile argument in isolation to support the averment that the contracts were concluded in IOM. Furthermore there is nothing before court to the effect that XYZIL has an FBE with a truly active business with connections to South Africa being used for bona fide non- tax business purposes. There is not even a shred of evidence alluding to the existence of an FBE.

[105] The Act does not provide for definition of the words **"mainly within"** or **"within"** for purposes of section 9D and in respect of paragraph (D). The court has to defer to the ordinary meaning of the words. The word **"mainly**

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[21] 1939 AD 487.

[22] 2865/2006 Free State High Court.

within" means the place or a position in the place or something affording little opportunity to go outside the position or place. The word **"within"** is understood to mean strictly in the place or in the position without room for deviation.

[106] Having regard to the above, the appellant's CFC does not qualify for FBE exclusion. There are 0% tax on the profits of XYZIL paid in IOM. Therefore, there protection of IOM's tax base does not arise.

[107] The relevant XYZIL sales were to XYZ and paragraphs (A) and (D) did not apply in respect of such sales. Therefore, SARS was correct in including the assessed amounts in determination of XYZIL's net income for the purposes of section 9D. In the circumstances it is unnecessary to consider the alternative ground of assessment, section 103(1).

INTEREST AND PENALTIES

[108] Section 89*quat* of the Act provides for the payment of interest at the prescribed rate on the taxable amount resulting from underpayments and overpayments of provisional tax.

[109] Having concluded that the appellant is liable for tax on the assessed amounts it follows that the appellant must pay interest on the assessments. The appellant underpaid tax when it excluded the net income attributed to XYZIL as alluded above. Furthermore, the appellant did not provide any reasonable grounds that it should not be liable for interest.

[110] Section 76(1) of the Act provides as follows:

> A taxpayer shall be required to pay in addition to the tax chargeable in respect of his tax income—

(*a*) if he makes default in rendering a return of any year of assessment, an amount equal to twice the tax chargeable in respect of taxable income for that year of assessment; or

(*b*) if he omits from his return any amount which ought to have been included therein, an amount equal to the difference between the tax as calculated in respect of the taxable income returned by him and the tax properly chargeable in respect of his taxable income as determined after including the amount omitted; or

[111] Section 76 (2) empowers SARS with a discretion to remit a portion or all of the additional tax assessment in terms of section 76 (1). Additional tax prescribed in Section 76(1) is 200% of the relevant tax amount. CSARS has already exercised its discretion and reduced the penalties to 100%. 100% reduction is found to be appropriate, in this regard NWK above is relevant, where the transaction was found to be simulated and 100% additional tax was levied.

COSTS

[112] The general principle in the tax appeal, heard by the tax court is that the successful party is not automatically granted costs; unless the order is applied for by the aggrieved party.

[113] Section 130 of the TAA provides as follows:

(1) The tax court may, in dealing with an appeal under this Chapter and on application by an aggrieved party, grant an order for costs in favour of the party, if—

(*a*) the SARS grounds of assessments or ‘decision’ are held to be unreasonable;

(*b*) the appellant’s grounds of appeal are held to be unreasonable;

(*c*) the tax board’s decision is substantially confirmed;

(*d*) the hearing of the appeal is postponed at the request of the other party; or

(*e*) the appeal is withdrawn or conceded by the other party after the ‘registrar’ allocates a date of hearing.

[114] Neither party applied for the costs order.

[115] In the result, the following order is made:

1. The appeal is dismissed.

2. The assessments by the South African Revenue Services for 2005, 2006 and 2007 tax years as well as interest and penalties, are confirmed.

3. There shall be no order as to costs.

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N.P. MALI

JUDGE OF THE HIGH COURT