When is a "simulated" lending arrangement tax evasion?

It happens that from time to time a taxpayer has to make decisions on how to treat a transaction for tax purposes. These decisions are taken by the taxpayer bearing in mind the circumstances of a transaction and the information at hand, the information often includes advice from top tax advisors.

As the law develops it can happen , that these decisions prove to have been wrong. At this stage, taxpayers may need to manage the risk and in the current dispensation should consider the use of the Voluntary Disclosure Programme (VDP).

Johan Kotze, head of tax dispute resolution at law firm Bowman Gilfillan, draws attention to a recently-concluded tax case involving the agricultural group NWK. In the wake of this case, SARS issued a note pointing out it was aware that "a number of other taxpayers have entered into simulated transactions, including compulsorily convertible loans similar to the one at issue in the NWK case, with the effect of artificially reducing their tax liabilities".

Kotze says NWK's ruling and SARS' note have sparked concern among borrowers and lenders that their perceived "fail-safe" structures could be at risk.

Kotze warns that the facts of the NWK case are very specific and its direct application would be limited. Very few 'compulsorily convertible loans' would be similar to the one in this case.

There is nonetheless good reason for concern. "Lenders and borrowers should ascertain whether their arrangements are substantially similar to NWK's and if so, the parties should certainly take note and should seriously consider making use of the VDP."

Taxpayers may have heard that their lawyers and tax advisors use terms such as 'substance over form' and, its stall mate, 'simulated (or sham) transactions'. It may be said that a distinction between the two is that 'substance over form' is when a *bona fide* transaction is construed in accordance with the substance rather than the form used to describe it. Simulated or sham transactions involve dishonesty.

The importance of the NWK case for other taxpayers may be the line drawn by Judge Lewis as to when a transaction will be simulated. He said: "If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation".

Kotze says that superficially this statement may seem fine, but is not without criticism. For instance the judges' contention that "an object that allows the *evasion* of tax ... will be regarded as simulated", makes it unclear whether all simulated transactions will be regarded as tax evasion. Could it onlyapply to the non-payment of tax due to an unlawful or illegal act? The Judge also held that NWK's transaction was a simulation, which does not necessarily mean that NWK was involved in tax evasion. It rather seems that the Judge used tax evasion as a high-water mark, which is in-line with the rest of her judgment.

Kotze says that the judgment is not all doom and gloom for taxpayers, because Judge Lewis did say that: "It is trite that a taxpayer may organise his financial affairs in such a way as to pay the least tax permissible. There is nothing wrong with arrangements that are tax effective."

The judgement, Kotze unsurprisingly concludes, obviously highlights a grey area in the extensive body of tax legislation.

"In effect, when does a taxpayer fall foul of the legislation and when not? When does the intention to achieve a tax benefit outweigh the commercial motivation? The answer, as is almost invariably the case, lies in considering the special circumstances of each case.

Kotze indicates that the NWK case contains a number of tax nuances that could distinguish it from other structured finance arrangements.