DRAFT

South African Revenue Service

DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT 58 OF 1962

SECTION : SECTION 23D AND SECTION 23G

SUBJECT : SALE AND LEASEBACK ARRANGEMENTS AND RELATED SIMULATED TRANSACTIONS

Contents

Preamble

In this Note unless the context indicates otherwise –

- **"section"** means a section of the Act;
- **"the Act"** means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All interpretation notes referred to in this Note are available on the SARS website at **www.sars.gov.za**. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides guidance on the application of sections 23D and 23G to certain sale and leaseback arrangements. The Note does not address sale and leaseback arrangements in general and takes into account simulated transactions where loan agreement may be concealed and it is necessary to consider the true nature of such transactions.

2. Background

Taxpayers in need of financing, generally for business equipment and assets, can structure the financing arrangement in different ways. The taxpayer could either obtain loan funding from a financial institution or alternatively could enter into a sale and leaseback arrangement. A sale and leaseback arrangement is a transaction in which the owner of an asset sells the asset to the financier and then enters into a use agreement whereby the hires the asset back from the financier. In this way the taxpayer raises the required funding through the proceeds on the sale of the asset and the repayment of the financing takes the form of rent.

The perceived benefits of entering into a sale and leaseback arrangement are that one party is generally entitled to deduct the full rental expenditure associated with the lease (both interest and capital portions), while the second party, usually a financial institution, is entitled to claim an allowances on the asset, and so shield the gross income arising from the receipt of the rentals. Financial institutions may in some cases utilise this ‘tax benefit” created through the claiming of the capital allowances to offer a lower interest rate, reflected in the rentals to the client, on the funding made available.[1] By contrast, under a loan, only the interest is deductible by the borrower and only the interest is taxable in the hands of the financier.

In *CIR v Conhage (Pty) Ltd*[2] the taxpayer had entered into two sale and leaseback transactions in respect of its manufacturing plant and equipment with a bank. The taxpayer had required capital to expand its business and the bank was prepared to make the funds available. Both parties had been aware of the tax advantages of sale and leaseback arrangements. The Commissioner had refused to allow the rental payments as deductions on the basis that the transactions fell foul of the general anti-avoidance provisions of section 103, and argued that the true nature of the transactions was a loan. Hefer JA noted the following:[3]

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

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1 Emil Brincker *Taxation Principles of Interest and Other Financing Transactions* (2004) LexisNexis Butterworths at GG-2.

2 1999 (4) SA 1149 (SCA), 61 SATC 391.

3 At SATC 393.

In the result, the court held that the transactions made perfectly good business sense and their true nature and substance was one of authentic sale and leaseback agreements. The court was also not persuaded that section 103 applied. This case highlighted the need for specific anti avoidance legislation to address sale and leaseback arrangements.

The Act contains two sections which target sale and leaseback arrangements, namely, sections 23D and 23G.

Section 23D is aimed at arrangements in which an asset, which has substantially increased in value owing to currency depreciation or inflation, is sold at market value to another party, such as a financial institution, which then in turn lets or licences the asset back to the seller. In this way, the seller is able to claim a deduction for the lease rentals determined on the increased value of the asset. Section 23D[4] is aimed at restricting the allowance which the lessor may claim on the leased asset.

Section 23G[5] treats targeted sale and leaseback transactions as financial arrangements. The objective of section 23G is to prevent one entity from using the tax base of another to obtain a tax benefit.[6] This situation can arise when a tax-exempt person or institution is introduced as lessor or lessee. Section 23G has the effect that these arrangements are treated as financing arrangements.

3. The law

The relevant sections of the Act are quoted in the **Annexure**.

4. Application of the law

4.1 Leased assets previously held by the lessee or a connected person (section 23D)

Section 23D was introduced as an anti-avoidance measure to limit specified allowances available to a lessor on certain assets acquired under a sale and leaseback arrangement. As mentioned briefly above, transactions of this nature effectively allowed a taxpayer to claim increased capital allowances on assets which had increased in value.[7]

Section 23D applies when a depreciable asset, which is let or licenced by a taxpayer to a lessee or licensee, was held within a period of two years before the start of the transaction by –

- the lessee or licensee, or by any sublessee or sublicensee in relation to the asset; or
- by a person who was at any time during that period a connected person in relation to the lessee, licensee, sublessee or sublicensee.[8]

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4 The section came into effect on 21 June 1993.

5 The section was introduced with effect from 5 June 1997.

6 Section 1(1) broadly defines a tax benefit to include any avoidance, postponement or reduction of any liability for tax.

7 *Explanatory Memorandum on the Income Tax Bill, 1993.*

8 Section 23D(2).

The term "depreciable asset" is defined in section 1(1) as follows:

> " **'[D]epreciable asset'** means an asset as defined in paragraph 1 of the Eighth Schedule (other than any trading stock and any debt), in respect of which a deduction or allowance determined wholly or partly with reference to the cost or value of that asset is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss;"

Both section 23A and section 23D can apply to the same leased asset. Section 23A ring-fences specified capital allowances granted to a lessor for certain aircraft, ships, machinery, plant, implements, utensils and articles.[9]

Under section 23D the amount on which allowances and deductions can be claimed by the lessor is limited to the sum of –

- the cost of the asset to the most recent lessee or licensee, sublessee or sublicensee or connected person, that previously held the asset, less the sum of all deductions allowed to that person, or all deductions deemed to have been allowed to that person under sections 11(*e*)(ix),[10] 12B(4B),[11] 12C(4A),[12] 12D(3A),[13] 12DA(4),[14] 12F(3A),[15] 13(1A),[16] 13*bis*(3A),[17] 13*ter*(6A),[18] 13*quin*(3)[19] or 37B(4),[20]
- any recoupment included in the income of that person as a result of the disposal of the asset, and
- the applicable percentage of any capital gain that arises on the disposal.[21]

Example 1 – Sale and leaseback (section 23D)

Facts:

Company X sold a machine (a depreciable asset) costing R1,5 million to Company Y for R2 million. The machine qualified for a wear-and-tear or depreciation allowance of 20% a year under section 11(*e*). Before disposing of the machine to Company Y, Company X had claimed an allowance of R300 000 on the machine. Company Y then let the machine to Company Z, a subsidiary of Company X, for three years. Company Y was entitled to claim an allowance under section 11(*e*) of 20% a year on the machine.

9 For commentary on section 23A, see Interpretation Note 53 "Limitation of Allowances Granted to Lessors of Affected Assets".
10 The wear-and-tear or depreciation allowance.
11 Deduction in respect of certain machinery, plant, implements, utensils and articles used in farming or production of renewable energy.
12 Deduction in respect of assets used by manufacturers or hotel keepers and in respect of aircraft and ships, and in respect of assets used for storage and packaging of agricultural products.
13 Deduction in respect of certain pipelines, transmission lines and railway lines.
14 Deduction in respect of rolling stock.
15 Deduction in respect of airport and port assets.
16 Annual allowance on buildings and improvements.
17 Deduction in respect of buildings used by hotel keepers.
18 Deduction in respect of residential buildings.
19 Deduction in respect of commercial buildings.
20 Deduction in respect of environmental expenditure.
21 Section 23D(2A).

Result:

Cost on which Company Y can claim an allowance

Section 23D applies as Company Z is a connected party to Company X

		R
Cost to Company X		1 500 000
Less: Section 11(*e*) allowance claimed by Company X		(300 000)
		1 200 000
Section 11(*e*) allowance recouped by Company X		300 000
Capital gain made by Company X *(R2 million – R1,5 million)*	500 000	
Inclusion rate	80%	
Taxable capital gain R500 000 × 80%		400 000
Portion of cost subject to section 11(*e*)		1 900 000

Section 11 (*e*) allowance granted to Company Y for a year (R1 900 000 × 20%) 380 000

4.2 Sale and leaseback arrangements in which the lessee or lessor is exempt from tax (section 23G)

Despite the limitations of section 23D introduced in 1993, arrangements were still structured so that one entity could use the tax base of another to obtain a tax benefit. This result was achieved by introducing a lessee, sublessee or lessor whose receipts and accruals are exempt from tax. Section 23G was therefore introduced to address a sale and leaseback arrangement relating to an asset in which either the lessee or the lessor is a tax-exempt person. The effect of section 23G is that the deduction available to a lessee or sublessee relating to any lease payments due under an affected sale and leaseback arrangement will be limited to the interest element of such lease payments. Conversely, the lessor under such an arrangement will be taxed only on the interest element of the lease payments and the lessor will not be entitled to any depreciation allowances under the Act.[22]

Section 23G(1) defines a sale and leaseback arrangement. For purposes of the section, it is any arrangement in which –

- the seller disposes of any asset, directly or indirectly, to the purchaser; and
- the seller or any connected person[23] in relation to the seller leases, directly or indirectly, the asset from the purchaser.

An asset can be movable or immovable, corporeal or incorporeal.[24]

Arrangement

The word “arrangement” is not defined in the section. It is not a term of great technical complexity and its ordinary grammatical use may apply. *Lexico.com*[25] defines it as –

> “A plan or preparation for a future event. An agreement with someone to do something”.

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22 *Explanatory Memorandum on the Income Tax Bill, 1997.*

23 See the definition of “connected person” in section 1(1). For commentary on the definition, see Interpretation Note 67 “Connected Persons”.

24 Definition of “asset” in section 23G(1).

25 **www.lexico.com/definition/arrangement** [Accessed 18 February 2022].

Disposes

The context of the section clearly points to a transfer of ownership. Since agreement has to be reached between the parties on the disposal, the disposal is voluntary.

The transfer of ownership must be distinguished from the granting of a limited real right such as mortgage, pledge and servitude, which confer only limited and clearly defined powers on the holder of the real right.[26] By granting third parties these limited real rights, the owner's power to exercise his or her ownership is merely limited and does not amount to a disposal of an asset. Once these limited real rights are extinguished, the person's ownership automatically becomes unencumbered again.[27]

Directly or indirectly

The word "directly" bears its ordinary meaning, and is defined by *Lexico.com* as – [28]

> "With nothing or no one in between".

Similarly, "indirectly" is defined in *Lexico.com* as – [29]

> "In a way that is not directly caused by something; incidentally; obliquely".

An "indirect disposal" of an asset from one person to another requires the intention between the parties concerned to dispose of and acquire the asset. For example, a sale of an asset by person A to person B, followed by an unrelated sale of that asset from person B to person C, does not give rise to an indirect disposal of that asset from person A to person C.[30] However, if it can be shown that person A and person C had intentionally set up such disposal to take advantage of a tax benefit, the disposal would be an "indirect disposal".

Leases

Any sort of arrangement which can be legally categorised as a lease will be included. The Law of South Africa[31] states that a contract of lease is entered into when, within the limits laid down by law, parties agree that the one party, called the lessor, shall give the use and enjoyment of property to the other, called the lessee, in return for the payment of rent. An agreement that permits a party to consume or destroy the subject matter of the contract is not a lease even if the parties are referred to as lessor and lessee or one of them is said to be obliged to pay "rent". A lease contemplates the return of the property to the lessor at the end of the lease. A person who acquires an asset under an agreement contemplated in paragraph (*a*) of the definition of "instalment credit agreement" in section 1(1) of the Value-Added Tax Act is regarded as the owner of the asset for the purposes of claiming the various depreciation allowances under the Act. Such an asset is not acquired by the lessee under a lease agreement for the purposes of section 23G.

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26 CG van der Merwe Things / Ownership / Nature / Definition 27 (Second Edition) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 134.

27 CG van der Merwe Things / Ownership / Nature / Content 27 (Second Edition) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 135.

28 **www.lexico.com/definition/directly** [Accessed 18 February 2022].

29 **www.lexico.com/definition/indirectly** [Accessed 18 February 2022].

30 D Davis *et al Juta's Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – section 23G.

31 AJ Kerr Lease / Nature / Essentials of the Contract 14 (Second Edition) *LAWSA* [online] (My LexisNexis: 31 July 2007) in paragraph 1.

The effect of section 23G on a sale and leaseback transaction is that the transaction will in substance be treated on the same basis as a loan arrangement.

The underlying asset is ignored, no tax allowances are granted on the cost of the asset and the finance component of the arrangement is dealt with under section 24J. Section 24J was amended so that such sale and leaseback arrangements could be included in the definition of "instrument". This result was achieved by deeming the absolute value of the difference between the amounts receivable and payable by a person under such an arrangement to be "interest" for the purposes of that section.[32]

4.2.1 Receipts and accruals that do not constitute income [section 23G(2)]

Section 23G(2) seeks to provide for transactions in which a tax-exempt body[33] is used to obtain a tax benefit. It applies when all the potential receipts or accruals of a lessee or a lessor do not constitute income[34] of that person. It is irrelevant whether only a particular source of income of the lessee is exempt from tax. Thus, an institution or body enjoying only partial exemption (for example, a public benefit organisation), will not qualify as a lessee for purposes of section 23G(2). Similarly, a non-exempt company, all the receipts or accruals of which for a particular year of assessment happen to comprise exempt local dividends, will not qualify as a lessee under section 23G(2)because all its receipts and accruals of whatever nature are not exempt from normal tax. A typical example of a fully exempt body is a municipality.

Section 23G(2) refers to a lessee or a sub-lessee in relation to a sale and leaseback arrangement. If a head lease and a number of sub-leases are entered into, section 23G would apply even if the ultimate user of the asset were not exempt as long as the head lessee's income were exempt. Under these circumstances the lessor would still be impacted.

4.2.2 Impact of section 23G(2) on lessee and lessor

Under section 23G(2) the lessor will–

- have to account for the amount received or accrued to the extent that it constitutes interest for the purposes of section 24J; and
- not be entitled to any allowances under sections 11(*e*)[35] (*f*)[36] or (*g*A), (*g*C),[37] 12B, 12C, 12DA,[38] 13[39] or 13*quin*.[40]

For the purposes of section 23G, "interest" is defined with reference to the definition of that term in section 24J, namely, the absolute value of the difference between all amounts receivable and payable by a person throughout the full term of the arrangement. This determination applies irrespective of whether the amount is calculated with reference to a fixed or variable rate of interest or is payable or

32 Explanatory Memorandum on the Income Tax Bill, 1997.
33 Explanatory Memorandum on the Income Tax Bill, 1997.
34 "Income" is defined in section 1 as the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II.
35 The wear-and-tear or depreciation allowance.
36 The allowance for lease premiums.
37 The allowance for patents and similar rights.
38 Depreciation allowances for machinery and similar assets.
39 The allowance for industrial buildings.
40 The allowance for commercial buildings.

receivable as a lump sum or in unequal instalments during the term of the financial arrangement.[41]

The interest is calculated for the period of the lease and spread over its term. When an asset is leased for only part of the financial year, the interest amount will be apportioned on a day-to-day basis over the period.

Example 2 – Tax-exempt lessee or sublessee

Facts:

All the receipts or accruals of Company X are exempt from normal tax under section 10. Company X sold an asset to Company Y for R100 000 on the first day of the year of assessment. On the same day Company Y let the asset to Company X for five years at an annual rental of R30 000.

Result:

Company X, the lessee in this arrangement, is exempt from tax. Company Y will not be allowed to claim any capital allowances on the asset. Company Y's income from this arrangement is limited to an amount which constitutes interest under section 24J.

	R
Amount receivable under the lease R30 000 × 5	150 000
Less: Amount paid for the asset	(100 000)
Interest	50 000

The interest of R50 000 accrues to Company Y on a day-to-day accrual basis over the period of the lease under section 24J. Instead of recognising the annual lease rentals of R30 000 as income, Company Y must include total interest of R50 000 over five years in its income on the yield to maturity basis.

4.2.3 Lessor's receipts and accruals arising under the agreement are not income [section 23G(3)]

If the receipts and accruals of a lessor arising from a sale and leaseback arrangement do not constitute income, a lessee or sublessee may not deduct the full lease rentals for tax purposes. Instead, the deduction is limited to an amount which constitutes interest under section 24J.

As already noted, section 23G(2) requires that all the receipts or accruals of the lessee of whatever nature be exempt from tax. By contrast, section 23G(3) requires that only the lessor's receipts and accruals arising from the sale and leaseback arrangement be exempt from tax. It is likely that in most situations a lessor that is exempt from tax on the income from a sale and leaseback arrangement would be a fully exempt person such as a municipality. However, there could be situations in which a partially taxable entity could be exempt from tax on such receipts or accruals. For example, a public benefit organisation, which is subject to partial taxation under section 10(1)(*c*N), may potentially be taxable on some of its receipts or accruals but its income from a sale and leaseback arrangement may be exempt from tax in a particular year of assessment if its receipts or accruals for that year are below the threshold exemption (greater of 5% of all receipts and accruals and R200 000).

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41 Paragraph (*c*) of the definition of "interest" in section 24J(1).

Example 3 – Tax-exempt lessor

Facts:

Company Y, a subsidiary of Company X, sold an asset to Company Z, a tax-exempt institution, for R80 000 on the first day of the year of assessment. On the same day, Company Z leased the asset to Company X for five years at R18 000 a year, and Company X in turn sublet it to Company Y for five years at R19 200 a year.

Result:

Company X

The rental received from Company Y of R19 200 a year is taxed in full, since both Company X and Company Y are subject to tax.

The total rental of R90 000 (R18 000 × 5) paid by Company X to tax-exempt Company Z is limited to an amount equal to the interest determined under section 24J of R16 000. The amount of R16 000 must be spread over the five years in accordance with the yield to maturity method.

Company Y

Company Y, the sub lessee, is a party to the sale and leaseback arrangement.

	R
Rentals payable under the lease agreement R19 200 × 5	96 000
Less: Amount received on sale of asset by Company Y	(80 000)
Deductible rentals to be spread in the same manner as interest	16 000

The internal rate of return is 6,40% (rounded) and the interest equivalent of R16 000 must be spread over years 1 to 5 as follows: R5 122, R4 221, R3 261, R2 241 and R1 155.

Treatment of lease premiums by the lessee

Section 23G(3) provides that the section is subject to section 11(*f*)[42], which provides an allowance for lease premiums. Section 11(*f*) denies the lessee the right to claim an allowance in respect of a lease premium or similar consideration if the lessor is a tax-exempt body. Since section 11(*f*) takes precedence in denying a deduction for a lease premium paid to a tax-exempt body, no portion of such a premium will qualify as a deduction under section 11(*a*) on the same basis as the interest calculation applicable to normal lease rentals.[43]

42 See Interpretation Note 109 “Lease Premiums”.

43 Section 23B(3).

Example 4 – Tax-exempt lessor and section 11(*f*) applicable to lessee

Facts:

Company X sold a machine to Company Y, a tax-exempt institution, for R100 000 on the first day of the year of assessment. On the same day, Company Y let the machine to Company X for R25 000 a year subject to the payment of an up-front lease premium of R20 000.

Result:

The rentals payable by Company X of R125 000 (R25 000 × 5) to tax-exempt Company Y are subject to section 23G and limited to the equivalent interest of R25 000 payable over the period of five years under section 24J:

	R
Rentals payable under the lease agreement R25 000 × 5	125 000
Less: Amount received on sale of asset by Company X	(100 000)
Deductible rentals to be spread in the same manner as interest	25 000

The up-front lease premium of R20 000 is an amount that was payable for the use of the machine and is distinct from and in addition to the annual rental of R25 000. It therefore constitutes a premium payable for the right of use of the machine under section 11(*f*). Since section 11(*f*) takes precedence over section 23G(3), Company X will not be allowed to claim the premium over the period of the lease by virtue of paragraph (*dd*) of the proviso to section 11(*f*). The latter proviso makes section 11(*f*) inapplicable when the premium or like consideration does not constitute income of the person to whom it is paid, subject to an exception for qualifying communication cables not relevant to the present example.

4.2.4 Taxpayer is both lessor and lessee [section 23G(4)]

Section 23G(4) provides that section 23G(2)(*a*) does not apply to any person who is both a lessor and a lessee in relation to the same sale and leaseback arrangement during any year of assessment. Section 23G(2) applies when the lessee or sublessee is a tax-exempt person. Section 23G(2)(*a*) then limits the receipts or accruals of the lessor to an equivalent amount of interest determined under section 24J.

However, since section 23G(4) "turns off" section 23G(2)(*a*), the limitation of receipts and accruals of the lessor to an equivalent amount of interest does not apply if the lessor is also a lessee in relation to the same sale and leaseback arrangement. The lessor, being a party to the sale and leaseback transaction, is also subject to section 23G(2)(*b*), and will not be permitted to deduct any allowances under sections 11(*e*), (*f*) or (*g*A), (*g*C), 12B, 12C, 12DA, 13 or 13*quin.*[44] The effect of section 23G(4) is that the lease receipts will be taxed in full and not limited to the interest element only but that no deduction for depreciation allowances will be allowed against such income.

Since a person cannot let an asset to himself, it must follow that section 23G(4) envisages, say, a tripartite arrangement which involves a sublessee letting the asset to the tax-exempt person. The sublessee would be a lessor in relation to the tax-exempt person and a sublessee in relation to the lessee.

[44] The application of section 23G(2)(*b*) is not excluded by section 23G(4).

Section 23G(4) applies only for that period of the year during which the person concerned is both lessor and lessee, and not for the entire year.[45]

Example 5 – Person both a lessor and lessee in relation to the same sale and leaseback arrangement

Facts:

Municipality sold a machine to Company X for R100 000 on the first day of the year of assessment of Company X. Company X in turn immediately let the machine to its wholly owned subsidiary Company Y at R25 000 a year over five years, and Company Y in turn sublet the machine to Municipality at R30 000 a year over five years. The machine would normally qualify for a wear-and -tear or depreciation allowance under section 11(*e*) at 20% a year on the straight-line basis.

Result:

Section 23G(4) applies to Company Y because it is both a lessor (in relation to the Municipality) and a lessee (in relation to Company X) under the sale and leaseback arrangement.

Consequently, Company Y must include the full lease rentals of R30 000 a year in its income because section 23G(4) suspends the application of section 23G(2)(*a*). In other words, Company Y is not permitted to reduce its rental income to an equivalent amount of interest under section 24J.

Company Y may deduct the rentals of R25 000 a year it paid to Company X under section 11(*a*), since Company X is a fully taxable entity and section 23G(3) does not apply to this leg of the arrangement.

Company X

Municipality is a sublessee in relation to the sale and leaseback arrangement and its receipts or accruals are exempt from tax.

Company X is a lessor in relation to Company Y and a party to the sale and leaseback transaction because it is indirectly leasing the machine to the municipality through Company Y. Under section 23G(2)(*a*), any amount which is received by or accrues to Company X ("any lessor") in relation to the sale and leaseback arrangement, is limited to an amount which constitutes interest as contemplated in section 24J.

	R
Amount receivable under the lease (R25 000 × 5)	125 000
Less: Amount paid for the asset	(100 000)
Interest	25 000

Instead of recognising the annual lease rentals of R25 000 as income, Company X must include total interest of R25 000 over five years in its income on the yield to maturity basis under section 24J.

Company X will not be allowed to claim any capital allowances on the asset under section 23G(2)(*b*).

45 D Davis *et al Juta's Tax Library* [online] (Jutastat e-publications: 30 November 2017) in Commentary on Income Tax – section 23G.

In summary: Over the five-year lease term, Company Y will have taxable income of R25 000 [(R30 000 − R25 000) × 5]. Company X will have taxable income of R25 000 (rental reduced to R25 000 less zero wear-and-tear or depreciation allowances). The total taxable income of Company X and Company Y is thus R50 000, which is equal to the difference between the rentals paid by Municipality of R150 000 (R30 000 × 5) and the cost of the machine of R100 000.

4.3 Simulated transactions

Often loan agreements are concealed as sale and leaseback transactions or the transactions are structured to prevent the application of sections 23D and 23G. It is therefore necessary to establish the true nature of the relevant transactions.

Since the judgement in *C: SARS v NWK Ltd*[46] many commentators have criticised the judgement as it was interpreted as changing the fundamental and longstanding principles applicable to simulated transactions.

The Supreme Court of Appeal in *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC*[47] confirmed that the foundation of our law in regard to simulated transactions was set out in the following statement in *Zandberg v Van Zyl*:[48]

> "Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a 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 so 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, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down."

Wallis JA confirmed the principle that the law permits people to arrange their contractual or business affairs so as to obtain a benefit for themselves that a different arrangement would not permit or so as to avoid a prohibition that the law imposes. That principle was laid down in *Dadoo Ltd and others v Krugersdorp Municipal Council* in which it was held that –[49]

> "parties may genuinely arrange their transactions so as to remain outside [a statute's] provisions. Such a procedure is, in the nature of things, perfectly legitimate".

46 2011 (2) SA 67 (SCA), 73 SATC 55.

47 2014 (4) SA 319 (SCA). See also *C: SARS v Bosch & another* 2015 (2) SA 174 (SCA), 77 SATC 61 and *Sasol Oil v C: SARS* [2019] 1 All SA 106 (SCA), 81 SATC 117.

48 1910 AD 302 at 309.

49 1920 AD 530 at 548.

These two principles are but two sides of the same coin, as is apparent from the fact that in both *Zandberg v Van Zyl* and *Dadoo Ltd and others v Krugersdorp Municipal Council* the court relied on the principle that the real intention carries more weight than a fraudulent pretence. Whether a particular transaction is a simulated transaction is, therefore, a question of its genuineness. If it is genuine, the court will give effect to it, and, if not, the court will give effect to the underlying transaction that it conceals. And whether it is genuine will depend on a consideration of all the facts and circumstances surrounding the transaction.

These principles were considered and applied in *Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd*.[50] Having cited both *Zandberg v Van Zyl* and *Dadoo Ltd and others v Krugersdorp Municipal Council*, the court held as follows:[51]

> "I wish to draw particular attention to the words 'a real intention, definitely ascertainable, which differs from the simulated intention', because they indicate clearly what the learned Judge meant by a 'disguised' transaction. 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 Courts according to its tenor, and then the only question is whether, so 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: dishonest, in as much as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or not subject to the tax. 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 so, 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."

Wallis JA held that nothing said subsequently in any of the judgments of the Supreme Court of Appeal dealing with simulated transactions alters those original principles in any way or purports to do so. However, in a number of them dealing with income tax, the courts have been called upon to apply these principles in a different context. The earlier cases dealt with cases of agreements being dressed up in a particular form where the underlying intention of the parties was inconsistent with that form. In the income tax cases a different problem arises.

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50 1942 AD 369.

51 At 395-396.

In the income tax cases, the parties seek to take advantage of the complexities of income tax legislation in order to obtain a reduction in their overall liability for income tax. There are various mechanisms for doing this, but they all involve taking straightforward commercial transactions and adding complex additional elements designed solely for the purpose of claiming increased or additional deductions from taxable income, or allowances provided for in the legislation. The feature of those that have been treated as simulated transactions by the courts is that the additional elements add nothing of value to the underlying transaction and are very often self-cancelling. Thus in *Erf 1383/1 Ladysmith (Pty) Ltd & another v CIR* Hefer JA said that "there is a distinct air of unreality about the agreements".[52] In *Relier (Pty) Ltd v CIR* Harms JA referred to the "unusual and unreal aspects" of the transactions.[53] The analysis by Lewis JA of the transactions in NWK clearly demonstrated that a range of unrealistic and self-cancelling features had been added to a straightforward loan. They served no commercial purpose, were based on no realistic valuation of the different elements of the transaction and were included solely to disguise the nature of the loan and inflate the deductions that NWK could make against its taxable income. In those circumstances, the courts stripped away the unrealistic elements in order to disclose the true underlying transaction.

The problem dealt with in NWK was the contention that, irrespective of the unreality of most of the elements of the arrangement under scrutiny, provided the parties intended to take all the steps provided for in the contractual documents, in other words to jump through the contractual hoops as a matter of form, the court could not find that the transaction was simulated. That is what Lewis JA was dealing with, in paragraph 55 of her judgment, when she said:

> "In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. 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."

It appears that in some circles this, and particularly the statement that "[i]f 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", has been understood to condemn as simulated transactions any and all contractual arrangements that enable the parties to avoid tax or the operation of some law seen as adverse to their interests. But that fails to read this sentence in the context of both the particular paragraph in the judgment and the entire discussion of simulated transactions that precedes it. If it meant that whole categories of transactions were to be condemned without more, merely because they were motivated by a desire to avoid tax or the operation of some law, that would be contrary to what was held in *Zandberg v Van Zyl* as follows:

> "The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down."

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[52] 1996 (3) SA 942 (A), 58 SATC 229 at 241.
[53] [1998] 1 All SA 183 (SCA), 60 SATC 1 at 7.

The notion that NWK transformed our law in relation to simulated transactions, or requires more of a court faced with a contention that a transaction is simulated than a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect. The position remains 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.

The facts of each case will be considered having regard to all the agreements entered into between parties to determine whether a *bona fide* sale and leaseback arrangement has been entered into or whether it should be considered as a simulated transaction.

5. Conclusion

Section 23D limits the allowances that a lessor may claim under a sale and leaseback arrangement should the asset be held within a two-year period before the commencement of the arrangement by that lessee or licensee or by any sublessee or sublicensee in relation to that asset.

Before the introduction of section 23G, parties to a sale and leaseback arrangement made use of the tax benefit that arose should one party be tax exempt. Since the lessor buying an asset from a tax-exempt lessee was entitled to allowances on the asset purchased, the lessor could effectively provide financing at a lower rate to the lessee. As these arrangements are effectively financing arrangements, section 23G serves to treat them as loan arrangements and no tax allowances are granted on the asset and the finance component is covered under section 24J. Section 23G(2) applies when income of whatever nature received by or accrued to the lessee is exempt from tax, while section 23G(3) applies when the income received or accrued to the lessor arising from the sale and leaseback arrangement is exempt from tax.

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Annexure – The law

Section 23D

23D. Limitation of allowances granted in respect of certain assets.—(1) . . . . . .

(2) Where any depreciable asset which is let or licensed by a taxpayer to a lessee or licensee was held within a period of two years preceding the commencement of the lease or licence—

(*a*) by the lessee or licensee, or by any sublessee or sublicensee in relation to the asset; or

(*b*) by a person who was at any time during that period a connected person in relation to the lessee, licensee, sublessee or sublicensee,

the cost or value of the depreciable asset for the purpose of this section and any deduction or allowance claimed by the taxpayer in respect of the asset shall not exceed the amount determined in accordance with subsection (2A).

(2A) The amount to be determined for purposes of subsection (2) is the sum of—

(*a*) the cost of the asset to the most recent lessee, licensee, sublessee, sublicensee or connected person contemplated in subsection (2) that previously held that asset, less the sum of—

(i) all deductions which have been allowed to the lessee, licensee, sublessee, sublicensee or connected person in respect of the asset; and

(ii) all deductions that are deemed to have been allowed to the lessee, licensee, sublessee, sublicensee or connected person in respect of the asset in terms of section 11(*e*)(ix), 12B(4B), 12C(4A), 12D(3A), 12DA(4), 12F(3A), 13(1A), 13*bis*(3A), 13*ter*(6A), 13*quin*(3) or 37B(4);

(*b*) any amount contemplated in paragraph (*n*) of the definition of "gross income" in section 1 that is required to be included in the income of the lessee, licensee, sublessee, sublicensee or connected person that arises as a result of the disposal of the asset; and

(*c*) the applicable percentage in paragraph 10 of the Eighth Schedule, of the capital gain of the lessee, licensee, sublessee, sublicensee or connected person that arises as a result of the disposal.

(3) . . . . . .

Section 23G

23G. Sale and leaseback arrangements.—(1) For the purposes of this section—

"asset" means any asset, whether movable or immovable, or corporeal or incorporeal;

"sale and leaseback arrangement" means any arrangement whereby—

(*a*) any person disposes of any asset (whether directly or indirectly) to any other person; and

(*b*) such person or any connected person in relation to such person leases (whether directly or indirectly) such asset from such other person.

(2) Where the receipts or accruals of any person, who is a lessee or sublessee in relation to a sale and leaseback arrangement, do not for the purposes of this Act constitute income of such person—

(*a*) any amount which is received by or accrues to any lessor in relation to such sale and leaseback arrangement, shall be limited to an amount which constitutes interest as contemplated in section 24J; and

(*b*) such lessor shall, notwithstanding the provisions of this Act, not be entitled to any deduction in terms of section 11 (*e*), (*f*) or (*g*A), (*g*C), 12B, 12C, 12DA, 13 or 13*quin* in respect of an asset which is the subject matter of such sale and leaseback arrangement.

(3) Where the receipts or accruals of any person, who is a lessor in relation to a sale and leaseback arrangement, arising from such arrangement do not for the purposes of this Act constitute income of such person, any deduction to which a lessee or sublessee in relation to such sale and leaseback arrangement is entitled under the provisions of this Act shall, subject to the provisions of section 11 (*f*), be limited to an amount which constitutes interest as contemplated in section 24J.

(4) The provisions of subsection (2) (*a*) shall not apply to any person who is both a lessor and a lessee in relation to the same sale and leaseback arrangement during any year of assessment.