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SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

WEAKNESSES IN THE LEGISLATION FOR TAX AVOIDANCE AND TAX EVASION IN SOUTH AFRICA AND SUGGESTED IMPROVEMENTS

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A dissertation submitted to the Faculty of Commerce, Law, and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Masters of Commerce (specializing in Taxation)

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ABSTRACT

'Tax avoidance and tax evasion threaten government revenues' (OECD n.d.). As the globalization of domestic and international trade continually increases, tax evasion remains a hurdle for governments around the globe (OECD 2017a:9). Governments rely on tax collections primarily to finance economic expenditure; however, governments face a huge loss of revenue through tax evasion at different levels (OECD 2014:91). It is submitted that stringent tax collections are imperative for South Africa as a developing country. An examination of the difference between tax avoidance and tax evasion will be performed given that the difference is often perceived to be faint (Davidov 2016:1). The main aim of the study is to examine the weaknesses in the legislation for tax avoidance and tax evasion in SA and suggest improvements. An analysis of the role of the government, the Organisation for Economic Co-operation and Development (OECD), and other countries towards adopting a holistic approach to designing policies to prevent tax avoidance and tax evasion will be performed. Tax avoidance, harmful practices and aggressive tax planning must be tackled (African Tax Administration, African Union and OECD 2021:18).

Key words: OECD, government, policies, legislation, tax avoidance, tax evasion, trade, impermissible tax avoidance

DECLARATION

I, Katelynne Ann Naidoo, declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specializing in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

_____

Katelynne Ann Naidoo
30 November 2021

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ABBREVIATIONS AND ACRONYMS

ACT	Income Tax Act 58 of 1962
EOI	Exchange of Information
EOIR	Exchange of Information on Request
GAAR	General Anti-Avoidance Rule
ITAA	Income Tax Administration Act
GDP	Gross Domestic Product
OECD	Organisation for Economic Co-operation and Development
SA	South Africa
SARS	South African Revenue Service
TAA	Tax Administration Act
The US	The United States
The UK	The United Kingdom

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CHAPTER 1: INTRODUCTION

1.1 Background

Benjamin Franklin once said:

> 'Our new Constitution is now established, everything seems to promise it will be durable; but, in this world, nothing is certain except death and taxes.' (Hanson 2010:23)

Taxes are inevitable and said to be of paramount importance in the growth, sustainability and development of the economy and the primary source of revenue for government. Taxes are fundamental for the growth of developing countries (OECD 2014:92).

It has been argued that tax resistance takes two major forms: tax avoidance and tax evasion (Oberholzer and Stack 2014:1). Tax avoidance is the legitimate minimising of taxes by seeking loopholes in the tax provisions to intentionally reduce tax liabilities (Oberholzer and Stack 2014:2). Tax evasion is a subset of fraud and refers to illegally understating tax liability or failing to pay tax, by intentionally and deliberately misrepresenting taxable income through means of deceit, concealment, or other affirmative acts to dodge or defeat taxes. Tax fraud is a general term and refers to taxpayers intentionally and willfully defrauding the government by not paying taxes that are lawfully due (OECD 2017b:6).

According to the South African Revenue Service (SARS), there are various effects of aggressive tax avoidance. They include short-term revenue loss and longer-term damage to the tax system and the economy. These may include an erosion in the tax base, uneconomic allocation of resources, an increase in marginal tax rates, and a weakening ability of Parliament and National Treasury to set and implement economic policy (SARS 2005:1).

Taxpayers' actions to avoid and evade tax are due to the perception that tax collections are not used in an appropriate manner to develop and sustain economies but rather to finance personal needs of politicians and other powerful people thus providing no utility to taxpayer citizens. Tax evasion also increases with the perception that public goods are underprovided, fraud is committed, funds are mismanaged, and policies are designed to benefit a specific group of people only (Viljoen 2016:34). Developing countries tend to suffer more from tax evasion, which needs to be tackled as tax collections are key to financing development (African Tax Administration, African Union and OECD 2021:18).

SA is faced with the issue of illicit activities that are a real threat to the country and its impact is enormous. These illicit activities range from underground economy, which operates outside of the legislation to organized crime. A large portion of SA's GPD is forgone annually due to the illicit economy (SARS 2021c). The tax-to-GPD ratio for the 2019/20 financial year was 26.3% (SARS 2019/20:89). According to the SARS, the major components of illicit activities have been:

> 'in the form of smuggling of tobacco products, counterfeit textiles, drug manufacturing and smuggling, illicit mining of gold and diamonds, ivory smuggling and the poaching of endangered species like abalone and rhino.' (SARS 2021c)

Illicit financial flows, particularly tax evasion, deprive countries of the resources required for development. The immediate effect of tax evasion is the decrease of domestic resources, which could be used develop socio-economic infrastructures. The Tax Transparency in Africa Report states that:

> 'in the absence of capital flight, income per capita would be 1.5% higher and the poverty rate nearly 2 percentage points lower in Africa.' (African Tax Administration, African Union and OECD 2021:18)

It is estimated that Africa loses between USD50–80 billion every year due to tax evasion (African Tax Administration, African Union and OECD 2021:17). The OECD put together guidelines and recommendations in response to tax evasion and fighting tax crime globally, including the Tax Transparency in Africa Report and Fighting Tax Crime: The 10 global principles.

According to the Tax Justice Network, SA is not included in the world's top 10 biggest enablers of global corporate tax abuse (Mansour 2021:para 4). It is submitted that the question remains whether South African authorities are doing enough to combat tax avoidance and tax evasion.

1.2 The Research Problem

1.2.1 The statement of the problem

Accordingly, the purpose of this report is to assess what are the weaknesses in the legislation for tax avoidance and tax evasion in SA and to suggest improvements. An analysis of the role of the government, the OECD, and other countries—such as the United States (the US), the United Kingdom (the UK), and Australia as it is suggested that these countries have taken a cautious approach to tax anti-avoidance—towards adopting a holistic approach to designing policies to prevent impermissible tax avoidance and tax evasion will be conducted.

A study of the tax transparency in Africa report, OECD guidelines, and other reports will be performed to determine the research problem, what weaknesses exist in the legislation for tax avoidance and tax evasion in SA, and to suggest improvements that can be implemented by SARS to combat the problem of tax avoidance and tax evasion in South Africa.

Sub-problem 1

The first sub-problem is, what South Africa's legislation is on tax avoidance and tax evasion. An examination into what is tax avoidance and tax evasion and the fine line determinants differentiating the two terms will be performed. The General anti-avoidance rules (GAAR), in terms of the ss 80A to 80L, will be performed using purposive reading of legislation relating to permissible tax avoidance and impermissible tax avoidance. Typical examples of tax avoidance and evasion used to defraud South Africa's tax system will be considered.

Sub-problem 2

The second sub-problem is, what are the consequences (to the fiscus and taxpayers) and penalties imposed by SARS in terms of the s 235 of the Tax Administration Act?

Sub-problem 3

The third sub-problem is to identify what are the weaknesses in the legislation for tax avoidance and tax evasion in South Africa? The Tax Transparency in Africa report, OECD guidelines and other reports will be examined to determine what are the weaknesses.

Sub-problem 4

The fourth sub-problem is to investigate what improvements can be feasibly implemented by SARS to combat the problem of tax avoidance and tax evasion in South Africa? The Tax Transparency in Africa report, OECD guidelines and other reports will be examined to assess if any improvements are needed. GAAR in terms of ss 80A to 80L of the Income Tax Act will be studied to conclude on the effectiveness and if the GAAR addresses the weaknesses that are exploited by taxpayers (Benn 2013:9). A comparison of The United States of America, The United Kingdom and Australia anti-avoidance rules will be examined to assess if any improvements can be suggested for South Africa.

1.3 Research Methodology

The research method adopted is qualitative and interpretive in nature, based on a detailed interpretation and analysis of amongst other things, case law. An extensive literature review and analysis will be undertaken, to identify the weaknesses in the legislation for tax avoidance and tax evasion in South Africa and suggest improvements that can be implemented to South Africa's tax collection system, that includes the following sources –

- Articles
- Books
- Cases
- Internet
- Journals
- Legislation
- OECD reports
- Research report/Theses

1.4 Chapter Outline

Chapter 2 will examine what South Africa's legislation is on tax avoidance and tax evasion. It will further investigate the difference between tax avoidance and tax evasion and fine line determinants of the two terms. This chapter will also analyse the concepts of permissible tax avoidance and impermissible tax avoidance in terms of ss 80A to 80L and provide examples of tax avoidance. Examples of tax avoidance and tax evasion in SA will thereafter be explored.

Chapter 3 will examine the consequences (to the fiscus and taxpayers) and penalties imposed by SARS in terms of s 235 of the Tax Administration Act. The consequences of tax avoidance and tax evasion for taxpayers and the fiscus will be considered. SARS (2021) states:

> 'How SARS can be defrauded, misinformed, misled, deceived, contrived, with the intention to evade tax or obtain an undue refund are too numerous to mention, and it is not possible to offer even the briefest of discussions on every possible such action that may be directed against SARS.'

'Tax evasion is a global concern that reduces government revenue' (Vanderberg and Myrold 2015). It could possibly be argued that the main consequence of tax avoidance and tax evasion schemes is that governments collect less tax revenue than expected, leading to a shortfall in tax revenue. This is

a global issue but often particularly a problem for developing countries with poor tax infrastructure (African Tax Administration, African Union and OECD 2021:18).

The consequences to taxpayers are usually penalties and criminal charges. The Tax Administration Act contains s 234 and s 235, which levy penalties for non-compliance with the tax acts and for tax evasions that occur. Section 234 deals with criminal offences relating to non-compliance with tax acts while s 235 deals with tax evasion and obtaining undue refunds by fraud or theft (Storm and Coetzee 2017:162). Investigation and prosecution of tax crimes and corruption will be examined by considering the legal systems and general law enforcements available (OECD and The World Bank 2018:21).

Chapter 4 will highlight the weaknesses and unintended loopholes that taxpayers exploit to avoid and evade tax. Tax administrative weaknesses in tax collections are a contributing factor (National Treasury 2019:35). Tax evaders remain keen to exploit any new loopholes and weaknesses in the legal and regulatory framework across the world (OECD 2019:35).

Chapter 5 will investigate South Africa's legislation and suggest improvements that can be adopted and implemented to combat tax avoidance and tax evasion. An analysis will be undertaken to compare other countries' legislation, including the OECD reports, guidelines, and initiatives to suggest improvements for South Africa. The chapter will focus primarily on where the major deficiencies lie and how best to rectify them (OECD and The World Bank 2018:16).

Chapter 6 will provide a summary and draw conclusions of the research conducted.

The chapters in this research report makes numerous references to the Dr Benjamin Kujinga who has performed extensive research and published several reports relating to tax avoidance legislation.

CHAPTER 2: WHAT SOUTH AFRICA'S LEGISLATION IS ON TAX AVOIDANCE AND TAX EVASION?

The overall aim of the discussion in this chapter is to examine South Africa's legislation on tax avoidance and tax evasion. The GAAR in the Income Tax Act is of most importance when studying tax avoidance and tax evasion. A further study will be conducted relating to permissible and impermissible tax avoidance. The common law doctrine of substance over form will also be analysed as it is applied and relied on in the context of impermissible tax avoidance.

2.1 Tax avoidance and tax evasion legislation in South Africa

South Africa's primary legislation that deals with tax avoidance and tax evasion is the Income Tax Act that was first introduced in 1914. Since then, the Act has been amended over time with the latest version being the Income Tax Act 58 of 1962 and contained anti-avoidance rules in s 103(1) and ss 80A to 80L (Viljoen 2016:39). The Value Added Tax Act of 1991 provides for anti-avoidance provisions in s 73, similar to that of ss 80A to 80L of the Income Tax Act.

The Tax Administration Act (TAA) was implemented by proclamation with effect from 1 October 2012 to supplement the Income Tax Act by assisting with specific anti-avoidance and anti-evasion rules (Viljoen 2016:39). The TAA provides for, amongst others, the effective and efficient collection of tax, criminal offences and sanctions, the carrying out of an audit or investigation by the SARS and the powers for the SARS to carry out searches.

The South African Revenue Service Act 34 was enacted in 1997 to make provision for the effective and efficient administration of the revenue collecting system of South Africa. SARS is established as an organ of the State within public administration and is an institution outside public service. The Minister of Finance appoints a Commissioner for the SARS. The Commissioner is the chief executive officer and the accounting officer responsible for the performance of the SARS by its functions.

2.2 Tax avoidance, tax evasion, and tax planning

2.2.1 Tax avoidance

It could be argued that the ultimate goal for every taxpayer is to minimize one's tax liability. This is generally achieved with one of three behaviours: tax avoidance, tax evasion, or tax planning. Tax avoidance can be described as a perfectly legal manner used to reduce tax liability by doing everything possible within the provisions of the Act by a taxpayer. A taxpayer may therefore arrange their tax affairs in a perfectly and lawful manner with the result of paying lower tax or no tax at all. Tax avoidance is the legitimate and legal process of protecting a taxpayer's property from unnecessary erosion through tax (Stiglingh *et al.* 2021). In the case of *Challenge Corporation Ltd v CIR*, Lord Templeman stated:

> 'Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.'

In the case of *Gregory v Helvering,* Learned Hand, an American judge, once said:

> 'Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.'

Tax avoidance through tax havens has been increasingly popular in recent times. This is when offshore countries offer lucrative investment opportunities, resulting in low tax liability or no tax liability. The use of tax havens is legally permissible for tax planning; however, there is no doubt that taxpayers use tax havens illegally to evade tax (Deloitte n.d). To combat this struggle and curb the misuse, there are double tax agreements with certain countries in place together with other provisions in the Act.

Although it is legally permissible for a taxpayer to arrange their tax affairs in a manner that will result in a lower tax liability, the Act contains specific proactive provisions aimed at abusive avoidance schemes. Table 1 shows some of the specific anti-avoidance provisions included in the Act (Stiglingh *et al.* 2021):

Table 1: Anti-avoidance provisions in the Income Tax Act

Sections of the Income Tax Act	**Topic**	**Anti-avoidance provisions**
Sections 7(2) to (10)	Donations	These sections were introduced to prevent tax avoidance by means of donations, settlements, or dispositions by a taxpayer to another person. Certain income is deemed to be taxable in the hands of the donating taxpayer and not in the hands of the receiving party.
Section 8C	Share incentive schemes	This section acts as an anti-avoidance mechanism for employees who attempt to reduce their normal tax liability by structuring payments through share and other incentive schemes. The gains earned on the shares are classified as income rather than capital.
Section 8E	Dividends	Dividends received or accrued from certain shares and equity instruments, which constitutes a hybrid equity instrument, are deemed to be income and are taxed accordingly.
Section 8F	Interest paid on hybrid debt instruments	This provision regulates and deems interest on hybrid debt instruments to be a dividend in specie and denies the interest deduction to the borrower.
Section 9	Foreign-sourced income	This section deems income to be from a source within the Republic if the services were rendered in the Republic or by persons who are ordinarily resident in the Republic.
Section 9D	Controlled foreign companies	This provision is to avoid South African residents shifting or deferring tax liabilities by investing in foreign jurisdictions. If more than 10% ownership is held by South Africans, the proportionate ownership percentage of net income of the foreign entity must be included in the calculation of tax liability.
Section 22(8)	Donation or private consumption of trading stock	Where trading stock is donated, consumed or disposed of other than in the normal course of business, the amount is a deemed inclusion in the taxpayer's income.
Section 23B	Deductions and allowance	This section limits the amount for a deduction under the general deductions (s 11(*a*)) where a specific provision grants a deduction and imposes a limitation on the amount of a deduction.
Sections 23F	Unsold trading stock	This section provides that unsold trading stock for the tax period is disallowed as a deduction.

Section 24J	Interest	Interest is deemed to occur on a yield to maturity basis in scheme to avoid tax.
Sections 31	Transfer pricing	This section prevents transactions that result in a lower tax liability whereby parties enter transaction on terms that are not at arm's length. These favourable transaction terms are disregarded and are deemed to be at market-related price and are taxed accordingly.
Sections 54 to 64	Donations tax	Donations tax is levied at a flat rate on the value of the property disposed of by a donation.
Section 103(2)	Assessed losses in companies	This section disallows set offs between certain assessed losses against profits where the transaction has been entered into for the purpose of avoiding tax liability.
Section 103(5)	Cession of a right to income	Where a transaction includes the exchange of income for an amount of dividends and results in a reduced tax liability, the Commissioner shall disregard the transactions and determine the tax liability accordingly.

2.2.2 Tax evasion

There seems to be a misperception as to the difference between tax avoidance and tax evasion, so the public tends to use the terms interchangeably. It is often argued that there is a fine line determinant between the two terms. Denis Haley, however, once said, 'The difference between tax avoidance and tax evasion is the thickness of a prison wall' (Kumarasingam 2010). In the case of *R v Mears,* it was noted that:

> '…the difference between the two is simple and clear. Tax avoidance involves using or attempting to use lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful.'

Tax evasion can be described as an illegal manner used to reduce tax liability, therefore paying less taxes than legally obligated to. Tax evasion typically includes understating income, failing to report income, and overstating deductible expenditure to reduce taxes illegally (Kumarasingam 2010). It could be stated that tax evasion leads to corporations gaining in a competitive market and individuals gaining by not meeting their legal obligations. This risk of tax evasion falls on the taxpayer with the hope of not getting caught. This can be in the form of fraud, whereby the taxpayer deliberately falsifies their tax return, or it could be an honest error referred to as a 'bona fide inadvertent error' in the Tax Administration Act.

During the 2019/20 financial year, a total of 500 criminal investigations cases, for customs and tax prosecutions, were provided to the National Prosecuting Authority (NPA) by the SARS. Of the 500 investigations, 132 cases were finalised in court with a conviction rate of 98.5% (SARS 2019/20:35). SARS does not define tax evasion; however, the act of evading to pay tax is referred to as tax crime. SARS (2021b) provides the following as key examples of tax crime:

- 'People don't declare income to evade paying tax on that income.
- People lie about their expenses to reduce the tax they pay or to obtain an undue refund. For example, they may lie about their business mileage, business expenses or even medical contributions.
- People just don't submit a tax return to SARS or fail to truthfully respond to our questions.
- Employers sometimes deduct tax from employees and never pay it over to SARS.
- Vendors, whether registered for VAT or not, sometimes charge VAT and never pay it over to SARS.
- Entities submit fraudulent invoices in an attempt to pay less tax or obtain undue (fraudulent) refunds (Income Tax and VAT).
- Individuals do not register for tax purposes to evade paying their dues.
- People do not submit returns as and when required to evade paying taxes due to SARS.
- Employers withhold employees tax (PAYE) and do not pay it over to the SARS.'

One of the most famous tax evasion cases in history is that of Al Capone, a gangster who commented 'They can't collect legal taxes from illegal money,' and did not file federal income tax throughout his lifetime. He was associated with several illegal acts, including tax evasion, murder, drugs, and prostitution. Capone was reportedly generating revenue up to $100 million per annum. In 1931, Al Capone was found guilty of tax evasion and sentenced to 11 years in prison. He was further fined $50,000, ordered to pay taxes of $215,000, and charged for the costs of the courts (Erb 2020).

2.2.3 Tax planning

Tax planning is the process of arranging a taxpayer's financial and economic situation to reduce their tax liability. Good tax planning includes legally applying the available provisions to reduce, mitigate, or avoid tax liability. The provisions include deductions, credits, rebates, allowances, and structures with special exemptions (Franklin Templeton n.d.).

There are various methods of tax planning, which may be classified as follows:

- Short term tax planning: this is generally a 12 month or immediate plan to reduce tax liability in a legal manner.
- Long term planning: this refers to a few years or future tax benefits without necessarily immediate benefits.

- Permissive tax planning: this means making plans that are permissible under the provisions of the Act.
- Purposive tax planning: this involves the use of tax structured instruments with a specific purpose to ensure maximum tax benefits can be achieved. (Franklin Templeton n.d.)

Tax avoidance is legally permissible and acceptable if arranged in a lawful manner; however, deceitful tax planning, results in tax evasion. For this reason, s 103(1) of the Act was amended to include ss 80A to 80L with the aim of curbing impermissible tax avoidance. In the case of *IRC v Duke of Westminster*, Lord Tomlin acknowledged that taxpayers have a right to plan their financial affairs, within the law, to avoid tax and stated that:

> '[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.'

2.3 Permissible and impermissible tax avoidance

2.3.1 Permissible tax avoidance

Permissible tax avoidance can be defined as the legitimate application of the provisions of the Act to reduce the tax liability in a lawful manner (Bodlo 2015:7). According to Kujinga (2013:16), tax planning, as explained above, can be said to be synonymous with permissible tax avoidance. One of the ways this is achieved is where a taxpayer studies and comprehends the tax legislation and makes minor adjustments to their financial affairs to avoid tax (Kujinga 2013:16).

The nature of the agreement giving rise to the revenue may have a decisive impact on the taxability of that revenue (Kujinga 2013:16).

This principle is noted in the case of *Vacu-Lug (Pvt) v COT*. This case dealt with the sale of a right of a patent for lugging tyres, and the contract was drawn up in the form of a lease. The purchaser was entitled to deduct the use of rights payments against income; consequently, the seller was required to include receipts from the use of rights in taxable income. The seller could have avoided tax if this were an outright sale of the rights as the capital amount received would not have been subject to tax.

2.3.2 Impermissible tax avoidance

Bodlo (2015:7) describes impermissible tax avoidance as artificial or deceitful arrangements that are usually designed to manipulate or exploit loopholes within the provisions of the Act to achieve tax reduction or avoidance. Kujinga (2013:29) describes impermissible tax avoidance as a form of tax avoidance that is a target of anti-avoidance rules, and further states it must be struck down in the courts if successfully challenged and should not result in tax avoidance.

In the case of *Craven (Inspector of Taxes) v White*, Lord Templeman described impermissible tax avoidance as:

> 'My Lords, an artificial tax avoidance scheme is carried out by an individual taxpayer to avoid (or reduce or postpone) payment of the tax exigible in respect of a taxable transaction by means of one or more tax avoidance transactions which serve no business purpose apart from the avoidance of the tax on the taxable transaction…an artificial tax avoidance scheme does not alter the incidence of tax.'

The harms caused by impermissible tax avoidance are said to be pervasive and substantial. The most immediate harm is short-term revenue loss. Accurate estimates of the impact and size of the problem are difficult to measure mainly due to the fact that many schemes are deliberately designed to avoid detection. Impermissible tax avoidance encourages disrespect for the tax system, which may lead to a perception that the system is unfair and may further lead to discouraging compliance by honest taxpayers. This has an impact on the equity and fairness of the tax system by eroding the tax base and exerting pressure on marginal tax rates (SARS 2006:9−10).

Another harm is that impermissible tax avoidance is economically costly. This is due to the administration and compliance costs needed to implement measures to prevent and detect tax avoidance and tax evasion. Further losses to the economy stem from distorted trades and investment flows, which reduce economic efficiency and impede economic growth. Impermissible tax avoidance directly undermines the tax system goals, which leads to weakening the ability of Parliament and National Treasury to set and implement economic policy successfully. In attempting to curb impermissible tax avoidance, specific anti-avoidance measures become increasingly complex, which may sometimes be self-defeating. (SARS 2006:11−15.)

Section 103 prior to November 2006

One of the problems with tax avoidance is that sometimes a taxpayer enters a transaction using the provisions of the Act and may have believed it to be in good faith to reduce or avoid their tax liability. This is sometimes later found to be a disguised transaction whereby the Commissioner has the power

to regard the taxpayer as having made an incorrect or deceitful statement in a return in terms of the Tax Administration Act (Stiglingh *et al.* 2021).

The old GAAR was previously contained s 103(1) of the Act however, SARS notes this provision contained inherent weaknesses, inconsistencies, and is, at times, ineffectively deterrent to the increasingly and sophisticated tax products that have entered the market by banks, structured finance firms, multinational accounting firms, and law firms. These products typically include round trip financing, offsetting cashflows, special purpose entities, and complex financial instruments (SARS 2005:1). The Explanatory Memorandum on the Revenue Laws Amendment Bill (National Treasury 2006:62) provides the following reasons for a change of s 103(1):

> 'The GAAR has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated forms of impermissible tax avoidance that certain advisor and financial institutions are putting forward and some taxpayers are implementing. In addition, it has become clear that the GAAR has not kept up with international developments. Finally, uncertainty has arisen with respect to the application of the GAAR in the alternative due to conflicting Court decisions in this regard.'

In 1986, the Margo Commission highlighted that s 103(1) suffered major deficiencies, which Parliament did not address (SARS 2005:45). The Margo Commission stated:

> 'The test of abnormality presents difficulties. If a particular form of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its utilization becomes normal. The concept of abnormality must therefore be qualified to this extent.'

In 1995, the Katz Commission reiterated the concerns of the Margo Commission regarding the abnormality requirement:

> 'The test of abnormality presents difficulties for revenue in that if a particular form of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its utilisation becomes normal.' (SARS 2005:45)

The Katz Commission also identified that ambiguity existed as to whether the normality test required an objective test, and further suggested that the normality test be replaced with a business purpose test. Subsequent to the Katz Commission, Parliament amended the abnormality requirement in s 103 (1) of the Act (SARS 2005:45).

Section 80A to 80L post-November 2006

Owing to the weaknesses in the previous s 103(1) of the Act, new provisions on impermissible avoidance arrangements were incorporated within the Act, ss 80A to 80L, and enacted on or after 2 November 2006 (Stiglingh *et al.* 2021). The GAAR refers to any general or specific anti-avoidance

provision of the tax laws, including s 80L and s 103 of the Act, inclusive of any judicial anti-avoidance doctrine, principle, or mechanism (SARS 2013:2). In the case *CIR v BNZ Investments*, the role of a GAAR was summarised as follows:

> '[A GAAR] is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislation through [the GAAR] has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn. Line drawing and the setting of limits recognize the reality that's commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than an existence of a tax benefit on one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice…The function of [the GAAR] is to protect the liability for the income tax established under the other provisions of the legislation.'

This summary demonstrates that a GAAR should only be aimed at artificial transactions that fall within impermissible tax avoidance. This is an important requirement of a GAAR because it allows permissible tax avoidance while simultaneously restricting impermissible tax avoidance (Kujinga 2013:50). The Discussion Paper on Tax Avoidance states that it is equally important to note that a GAAR is not a charging provision or a revenue raising measure. It is intended to protect the established tax base of the country and not to expand it (SARS 2006:6).

Four requirements must be met before the provision of ss 80A to 80L of the Act can be applied:

> 1. 'There must be an arrangement.
> 2. The arrangement results in a tax benefit and therefore constitutes an avoidance arrangement (s 80L, definitions of 'tax', 'tax benefit' and 'avoidance arrangement').
> 3. The sole or main purpose of the avoidance arrangement was to obtain a tax benefit (introduction to ss 80A and 80G).
> 4. If the avoidance arrangement is in the context of business, one of four requirements must be met, namely;
> - means or manner not normally employed (s 80A(*a*)(i))
> - rights or obligations not normally created (s 80A(*c*)(i))
> - lack of commercial substance (s 80A(*a*)(ii))
> - misuse or abuse of provisions of the Act (s 80A(*c*)(ii)).
>
> If the avoidance arrangement is in a context other than business (therefore in a personal or private context), one of three requirements must be met, namely;
> - means or manner not normally employed (s 80A(*b*))
> - rights or obligations not normally created (s 80A(*c*)(i))
> - misuse or abuse of provisions of the Act (s 80A(*c*)(ii))' (Stiglingh et al. 2021).

The first three points are the basic element whereas point 4 includes the tainted elements. In an application of the GAAR to an arrangement, the tainted elements are usually decisive as the basic

elements do not draw the line between permissible and impermissible tax avoidance (Kujinga 2013:106). These four elements will now be explained further.

Requirement 1: Definition of arrangement

According to s 80L of the Act, arrangement includes:

- 'any transaction
- any operation
- any scheme
- any agreement
- any understanding (whether enforceable or not) including all steps therein or parts thereof and
- any of the foregoing involving the alienation of property.'

The terms 'transaction', 'operation', and 'scheme' remain from the previous GAAR in s 103 of the Act. In the case *Meyerowitz v CIR,* it was held that the term scheme is a broad one and could be interpreted to have a wide meaning. The terms 'agreement' and 'understanding' were then inserted into s 80A, the meaning and scope of which is yet to be determined by the courts. The words 'enforceable or not' refers to any arrangement made verbally or written for which an understanding is created.

Kujinga (2013:106) notes that steps in a broader arrangement are also considered arrangements, this means that a GAAR can apply to a single step in a transaction. The advantage of this principle is that it prevents taxpayers from abusing the commercial nature by adding additional steps to the transaction. However, by isolating a single step of the transaction and concluding that the sole purpose is tax avoidance, the taxpayer may be disadvantaged as this prevents the taxpayer from arguing that a step of the composite transaction has commercial purpose.

Requirement 2: Tax, tax benefit, and avoidance arrangement

Kujinga (2013:109) states that for an arrangement to constitute an avoidance arrangement, a tax benefit must be obtained.

Section 80L defines the term 'tax benefit' to include the reduction, postponement or avoidance of tax. Postponement includes the deferral of tax, which the Commissioner has the power to nullify the deferral through the invocation (Stiglingh *et al.* 2021).

The term ‘tax’ includes all taxes, duties, or levies executed by any other law administered by the Commissioner (Stiglingh *et al.* 2021). For the purposes of applying the GAAR, the taxes covered by the Income Tax Act are the only inclusions.

The Act does not prescribe a test to determine the existence of a tax benefit, but it is suggested the alternative arrangement test of action be looked at to determine if the avenue pursued might reasonably be entered into for the existence of a tax benefit. However, the presence of a tax benefit should not be difficult to prove since its presence in the avoidance of tax is one of the main indicators of an enquiry into the application of GAAR (Kujinga 2013:109).

The burden of proving a tax benefit was obtained lies with the Commissioner. For the Commissioner to conclude that a tax benefit arose, a sufficiently clear alternative must be presented to produce the commercial and tax consequences concerned.

Requirements 3: Sole or main purpose

Section 80A emphasises that an avoidance arrangement constitutes an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit. The main purpose to obtain a tax benefit is rebuttably presumed. Section 80G(1) states that:

> ‘an avoidance arrangement is presumed to have been entered into or carried out with the sole or main purpose of obtaining a tax benefit unless and until the party obtaining tax benefit proves that, reasonably considered in light of the relevant facts and circumstance obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.’

The word purpose is then further analysed as to whether it is subjective or objective. In *Secretary for Inland Revenue v Gallagher*, the distinction between objective and subjective were explained:

> ‘by an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a subjective test which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme.’

Therefore, the wording of s 80A indicates that the purpose is an objective test, and the subjective purpose of those carrying out the arrangement is thus irrelevant.

Requirement 4: Further requirements for ‘in the context of a business’ and ‘in a context other than business’

One of the following requirements (tainted elements) must be met to meet requirement 4.

Means or manner normally employed

The first tainted element requires the transaction to be made in bona fide or good faith other than the sole purpose of obtaining a tax benefit. The means or manner in which the arrangement is carried out must be compared to those similar transactions. The transaction should normally be in a business context. This provision was retained from s 103 (Kujinga 2013:111). The principle of substance over form further determines the bona fide purpose later in this paper.

Kujinga (2013:112) further states that the term 'normal', which is used to determine what is bona fide, can lead to inconsistencies in judicial decisions that can result in limiting the effectiveness of the GAAR. It is also stated that the legislation fails to provide guidance on the term 'abnormal'.

1. Rights or obligations not normally created

This requirement is the third tainted element and looks at terms created between persons dealing at arm's length; this is a factual inquiry. If the rights and obligations arise due to unusual transactions, it is said to meet this requirement. (Stiglingh *et al.* 2021.)

This provision is related to the one that outlaws transactions that are said to be abnormal. However, it is intended to apply to family transactions where the sole purpose is to obtain a tax benefit (Kujinga 2013:116).

The case of *ABC (Pty) Ltd v Commissioner for the South African Revenue Service* is between and South African company and a connected Swiss entity. The issue was relating to transfer pricing and whether transactions were at arm's length. The case highlights that determining whether a transaction is at arm's length or not, is the first step in determining whether an adjustment will be made by SARS. The judge concluded by stating that the establishment whether a consideration is or is not at arm's length precedes the question of adjustment, regardless of what method is employed. The question of adjustment does not even arise prior to determining the arm's length nature of a transaction. The inquiry into the arm's length nature of a transaction is an overriding principle in transfer pricing matters.

2. Misuse or abuse of the provisions of the Act

This requirement is the fourth tainted element and confirms that, to constitute permissible tax avoidance, the contextual and purposive approach must be followed in the interpretation of the

legislation. If only the textual or literal meaning of the legislation is complied with, it will result in misuse or abuse of the law and constitute impermissible tax avoidance (Kujinga 2013:116). The concept of misuse or abuse denies a tax benefit that confirms to the law but are not part of the purpose of the Act (Kujinga 2013:116). The concept of abuse is a new to the GAAR as it was absent from s 90 and s 103(1) of the Act.

In the Canadian court case, *Canada Trustco Mortgage Co v Canada*, the court stated a two-stage process regarding this provision:

- interpret the provisions, relied on by the taxpayer, giving rise to the tax benefit to determine the provisions' object, spirit and purpose, and
- determine whether the transaction frustrates or defeats the object, spirit or purpose of the provisions.

The taxpayer must therefore not seek loopholes in provisions aimed to specifically target an anti-avoidance tax arrangement.

3. A 'lack of commercial substance' (only applies in the context of business)

This requirement is the second tainted element and can be explained as a taxpayer obtaining a significant tax benefit; however, the impact on business risk and net cash flows is not considered significant. The benefit must presumably be significant in the context of the taxpayer's financial affairs in general. The terms 'significant' and 'net cash flows' are not defined by the Act but the Draft Comprehensive Guide to the GAAR, which states that these terms will be given their 'ordinary meaning' and applied accordingly in interpretations (Stiglingh et al. 2021).

According to Kujinga (2013:109), by interpreting the wording of s 80C(1)(1), it can be stated that 'significant' means that when the tax benefit obtained is extensive compared to the impact the arrangement has on the taxpayer's financial and business affairs; it is clear that the taxpayer has entered into the arrangement for the purpose of avoiding tax.

According to s 80C(2), typical indicators of a lack of commercial substance include:

Round-trip financing

Kujinga (2013:113) notes that the presence of round-trip financing indicates an arrangement may lack commercial substance. This includes an avoidance arrangement whereby funds are transferred between parties, results in a tax benefit and significantly reduces, offsets, or eliminates any business

risk related to the avoidance arrangement. This is achieved through skilful deception whereby parties transfer funds through complex structures for the sole purpose of avoiding tax (Stiglingh *et al.* 2021). This can be seen in *WT Ramsay v Inland Revenue Commissioners*, where round-trip financing is described as follows:

> 'Although sums of money, sometimes considerable, are supposed to be involved in individual transactions, the taxpayer does not have to put his hands in his pocket…The money is provided by means of a loan from a finance house which is firmly secured by a charge on any asset the taxpayer may appear to have, and which is automatically repaid at the end of the operation.'

Legal substance

Kujinga (2013:306) describes legal substance as 'the real effect of a transaction as a whole'. Therefore, the series of individual transactions must be viewed as single indivisible whole. An avoidance arrangement lacks legal substance if the transactions as a whole differ significantly from the legal form of its individual steps. The legal substance is the true legal rights and obligation of a transaction (Stiglingh *et al.* 2021).

An accommodating or tax-indifferent party

This requirement is met when a party receives an amount that has no influence on their normal tax liability or the receipts are significantly offset by expenses and that amount would have had an influence on the tax liability of another party if received by this other party or involves a prepayment by the other party (Stiglingh *et al.* 2021).

Section 80E(2) states that a connected person to the other party in an avoidance arrangement may qualify as an accommodating or tax-indifferent party. Section 80E(3) provides for the exclusion for accommodating or tax-indifferent parties, such as a party whose income is taxable in another jurisdiction. A further exclusion is parties who actively trade and continue to engage directly in substantial and active trading activities in relation to the avoidance arrangement for a period exceeding 18 months (Kujinga 2013:115).

Based on the above requirements, the Commissioner has the power to conclude on the substance of the transaction and to take certain actions deemed appropriate. The general remedy available is for the Commissioner to disregard the transaction entered. On conclusion that the arrangement is an

impermissible avoidance arrangement, the Commissioner may determine the appropriate taxes to be levied under the Income Tax Act.

Tax avoidance and the Value-Added Tax Act

Section 73 of the Value-Added Tax Act (VAT Act) encompasses similar anti-avoidance provisions of ss 80A to 80L of the Act as described above with regards to schemes for obtaining undue tax benefits. In the case of *Mpande Foodline CC v CSARS and Others*, the court stated that four requirements need to be met before s 73 can be invoked:

- 'whether a scheme has been entered into or carried out;
- which has the effect of granting a tax benefit to any person;
- by means or in a manner not normally employed for *bona fide* business purposes, other than obtaining of a tax benefit, or it has created rights or obligations that would not normally be created between persons dealing at arm's length; and
- it was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.'

Whenever the Commissioner is satisfied that these requirements have been met, he has the power to disregard the scheme entered into and may determine the VAT liability accordingly. Section 73(3) of the VAT Act further states that the decision taken by SARS is subject to objection and appeal. There is a rebuttable presumption that the sole or main purpose of entering into the transaction was to obtain a tax benefit.

2.4 Substance over form principle

The legal form of the transaction generally refers to a written agreement and focuses on the effect of an individual transaction in a series. The legal substance of the transaction generally refers to the taxpayer's true intention or real effect of the transaction as a whole (Kujinga 2013:306). In the case *WT Ramsay Ltd v Inland Revenue Commissioners,* it was noted that:

> 'Substance over form is a common law doctrine that allows the courts to ignore the form of a disguised transaction to examine the true intentions of a transaction and attach adequate legal implications to it.'

In the past, the mere form of the transaction was assessed and taxed accordingly. This has created loopholes for taxpayers to arrange their affairs in a manner to reduce or avoid taxes. The courts have however noted this reoccurrence and have based their findings on the actual intention of taxpayers, thereby ignoring the form of the transaction. Even though tax avoidance is legal, it is often argued by the Commissioner to be impermissible due to the substance over form test (Stiglingh *et al.* 2021).

It could be stated that SARS generally relies on the substance over form principle, backed by the cases such as *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*, if a taxpayer's true intentions are not reflected in the contract of the transactions and it is evident the substance of the transaction is to avoid tax liability. Further, this is usually applied when the benefit is to the receiver and not to the benefit of the taxpayer. Taxpayers often seek loopholes to reduce tax liability through dishonest contracts by transferring the benefit to a non-taxable party.

In the case of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*, the question was whether the appellant was liable for tax on the rights obtained due to improvements made on his land. The appellant entered into a lease agreement with a non-taxable entity to lease out the land. The lease provided that any improvements to be made by the lessor were optional. The entity then subleased the land to the appellant with the obligation that the entity erected a factory on the land. On the expiry of the lease, the land would revert to the appellant who was not required to compensate the lessee in relation to any improvement made.

The taxpayer argued that he had not placed an obligation to effect improvements on the land, but he had concluded numerous contracts that ensured that another party imposed such obligation. The court found that the true intention of the taxpayer was that a right to have improvements made to the land had accrued to the lessor and that he was liable to tax on the value of the improvements.

In the case of *CSARS v NWK*, it was noted that the SCA held that 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 simulation 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.

The principle of substance over form has its limitations and cannot simply be used to ignore agreements where the parties in fact and in law intend to give effect to an agreement as seen in the *ITC 1618* case.

In the case *ITC 1618*, a taxpayer entered a contract with a labour broker to provide his services to a major project at Port Elizabeth harbour. The taxpayer intended to do this through a close corporation

but before he could set it up, the project was awarded to him and he proceeded to render the services in his personal capacity via a labour broker. He then set up a close corporation and was later paid via the close corporation. SARS regarded the income derived as accruing to the taxpayer and not to the close corporation. The court ruled in favour of the taxpayer as the true intention, to provide a measure of security for his personal assets should the business fail, by conducting the business through a close corporation, was reasonable.

The principle of substance over form therefore confirms the practice that a taxpayer's true intention behind a transaction is of utmost importance, irrespective of what is recorded in the resulting contracts. However, the principle only applies where the parties to the transaction do not really intend it to have, inter parties, the legal effect which its terms convey to the outside world. When assessing the tax liability of a taxpayer, consideration should be given to the true intentions of the party as a whole and not merely the written agreements (Stiglingh *et al*. 2021).

2.5 Other countries' anti-avoidance rules

This section contains a comparative analysis of SA's GAAR as contained in the Income Tax Act to the anti-avoidance provisions of foreign jurisdictions (the UK, the USA, and Australia). It is worth noting that the statutory enacted GAARs in SA and Australia have similar features, particularly the requirements that must be met for an arrangement to be considered an avoidance arrangement (Kujinga 2013:60). However, the UK and the US' anti-avoidance rules are based on a different approach when compared to the South African GAAR.

Australia

Prior to 1981, Australia's GAAR was contained in s 260 of the Income Tax Assessment Act (ITAA). The GAAR was said to be problematic in the sense that it was broad and created uncertainty. In 1981, s 260 was replaced with s 177, which makes up part IVA of the ITAA and remains as the current GAAR of Australia (Kujinga 2013:146).

Part IVA targets transactions with a dominant purpose to avoid tax and not all tax avoidance transactions. The Australian GAAR has three basic elements:

1. a scheme,
2. a tax benefit, and
3. a tax purpose objectively determined.

Section 177D(2) of the ITAA lists eight factors that may be used when objectively assessing the purpose of a scheme:

> (a) 'the manner in which the scheme was entered into or carried out;
> (b) the form and substance of the scheme;
> (c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
> (d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
> (e) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
> (f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
> (g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
> (h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in paragraph (f).'

Only one of these eight elements needs to be present to conclude that the sole or main purpose of the transaction was to obtain a tax benefit. Once all three requirements have been met, the Commissioner has the power to conclude the transaction is an impermissible tax arrangement and cancel the tax benefit arising (Kujinga 2013:148).

Part IVA allows taxpayers the right to avoid tax legally as long as it is clear that the dominant purpose is not to avoid tax. The introduction of Part IVA has narrowed down the uncertainties that were contained in s 260 and has been invoked successfully in various cases.

However, it has created controversy and uncertainty regarding the extent to which commercial schemes may obtain a tax benefit without concluding the dominant purpose was to avoid tax (Kujinga 2013:171). The case of *Federal Commissioner of Taxation v. Peabody* states that the Commissioner may advance alternative schemes including a narrower scheme within a wider scheme in support of Part IVA. It further states:

> 'But the Commissioner is entitled to put his case in alternative ways. If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirement of Pt IVA, then in our view there is no reason why the Commissioner should not be permitted to do so, provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allow such a course.'

The United Kingdom

The UK and SA both have anti-avoidance methods with the ultimate goal of curbing tax avoidance however, the South African GAAR may be improved by applying the fundamental principles and

approach from the UK GAAR. Previously, the UK rejected GAARs due to the uncertainty they create regarding the operation of law. Prior to 2013, the UK did not have a GAAR and relied on judiciary to come up with anti-avoidance doctrines instead of GAARs. In 2010, the UK government mandated consultations on introducing a GAAR in the UK. An advisory committee put together a report in 2011 after investigating whether a GAAR was needed (Kujinga 2013:274).

The report recommended that a targeted GAAR be introduced instead of a broad GAAR. A targeted GAAR focuses on impermissible tax avoidance whereas a broad GAAR contains uncertainty and creates confusion as to what is permissible and impermissible. It was concluded that a broad GAAR restricts taxpayers from carrying out permissible tax avoidance and sensible tax planning. The report noted that the previous UK anti-avoidance rules, which included the purposive construction of statue, specific anti-abuse rules and the disclosure requirements, were effective in reducing impermissible tax avoidance. However, it was problematic when dealing with complex and potential anti-avoidance schemes (Kujinga 2013:275).

In 2013, the UK GAAR was introduced into the UK Finance Act. The UK GAAR is principle based and focuses on what makes permissible tax avoidance permissible rather than a narrow definition of what a tax arrangement is. One of the principles introduced was the reduction of uncertainty and recommendation that when impermissible is unclear in cases it must be decided in the favour of the taxpayer. Kujinga (2013:286) notes that the UK GAAR seeks to curb impermissible tax avoidance by:

1. ‘deterring taxpayers from entering into abusive transactions or deterring promoters from promoting abusive transactions; and
2. Countering abusive transaction where the taxpayer or promoter is not deterred.’

The approach taken in drafting the UK GAAR is significantly different to the approach taken in drafting the South African GAAR. Kujinga (2013:290) highlights the following points from the UK GAAR approach:

- The GAAR is target based and not broad.
- The GAAR aimed at reducing uncertainty and does not rely on uncertainty to act as a deterrent.
- The purposive interpretation is not relied on to conclude on impermissible tax avoidance.
- The characteristics of permissible tax avoidance are relied on to conclude whether the tax benefit obtained was a reasonable course of action.

- The wider arrangement is analysed and the sub-arrangements cannot be isolated when considering the composite arrangement.
- The GAAR aims to provide a balance between curbing impermissible tax avoidance and protecting taxpayers' rights by allowing permissible tax avoidance.

It is argued that the South African GAAR may be improved by applying the fundamental principles and approach from the UK GAAR.

The United States

The US legislation does not have an enacted GAAR but relies on judicially created doctrines that function similar to GAARs that are aimed at curbing impermissible tax avoidance. These doctrines include 'the business purpose doctrine, the economic substance doctrine, the sham transaction doctrine and the step doctrine' (Kujinga 2013:208). The fundamentals of these doctrines are based on the purposive interpretation of tax legislation. This study will focus on the economic substance doctrine as it is of most relevance when studying the anti-avoidance measures for the US (Kujinga 2013:209).

The primary consideration of the judicial doctrines in the US is the substance over form principle. In the case of *Gregory v Helvering*, the taxpayer had transferred business assets to benefit from a minimal rate of taxation and the reorganisation provisions. The court acknowledged the taxpayer's compliance with the literal terms of the legislation but also applied to judicial doctrine to ascertain whether the transaction had substance. The court then created the business purpose test and denied the tax benefit based on the substance over form doctrine as the transaction was said to have no business purpose. This case laid the foundation for the application of the judicial doctrines in the US and was successfully developed and applied in many cases thereafter.

In the 1920s, in the case of *United States v Phellis*, the US Supreme court noted:

> 'We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases, we have under varying conditions followed the rule.'

It is clear from earlier cases that the courts in the US were prepared to give effect to the true substance of the transaction and not its form. The US courts further stated that to determine the economic substance, two questions must be answered. The first question is an objective test: it is whether the transaction provides for any economic change in the taxpayer's position aside from the economic impact of the tax benefit. The second question is a subjective test: it inquires what the purpose of the

transaction was and was it entered into for business purposes aside from solely obtaining a tax benefit (Kujinga 2013:213).

The objective test involves consideration into the expected profits, the risk of loss, and if any profits or losses were realised. The subjective test involves an inquiry into the taxpayer's motives for entering into the transaction. The latter investigates factors such as the possibility of profits, other reasons aside from tax benefit, considerations of other business matters, committed capital, the involvement of other entities, and the weighting of the tax benefit received compared to the capital invested. Both tests must be satisfied before the economic substance doctrine can be applied to disregard a transaction (Kujinga 2013:213−214.)

The economic substance doctrine is included in s 7701(*o*) of the Internal Revenue Code in the US, which reads as:

> 'Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transactions shall be treated as having economic substance only if-
> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.'

A key principle of the economic substance doctrine is the purposive interpretation of statutes, where the formal terms of the Code must be read with purpose and interpreted accordingly. This is because taxpayers have historically taken advantage of the provisions of tax legislation. It is stated that the literalism interpretation exposes tax legislation to abuse by taxpayers to only comply with formal requirements of the legislation. However, the US experience is indicative that taxpayers still apply the literal approach and the purposive approach does not deter taxpayers from merely complying with the formal requirements of the Code (Kujinga 2013:231−237).

The judicial doctrines have been criticised for the lack of certainty by failing to clearly distinguish between permissible and impermissible tax avoidance. The US judicial doctrines have many similarities to the South African GAAR. They both serve as GAARs, have similar business purpose requirements, the commercial substance indicator is known as the economic substance in the US rules, the purposive interpretation is applied by both. and the lack of uncertainty has a similar effect on both (Kujinga 2013:242).

It is noted that even though the judicial doctrines have been successfully invoked in many cases, some cases raised concerns about the efficacy of the doctrines. This is primarily due to the uncertainty around the application of the doctrines to cases that have both tax benefits and economic substance. The efficacy is also limited by the uncertainty of what constitutes permissible and impermissible tax avoidance. It could be argued that the US doctrines contain very similar weaknesses to the South African GAAR; therefore, the US doctrines are not fully effective in curbing impermissible tax avoidance (Kujinga 2013:245).

The table below summaries the indicators of impermissible tax avoidance of the countries studied in this research (Kujinga 2013:292):

Table 2: Comparison of impermissible tax avoidance indicators

Indicators/Requirements	**SA**	**Australia**	**The UK**	**The US**
Abnormality for a bona fide business purpose	✓			
Lack of commercial or economic substance	✓			✓
Abnormal rights and obligations created	✓			
Absence of business purpose	✓			✓
Misuse or abuse of the law	✓	✓	✓	✓
Sole or dominant tax purpose, objectively determine		✓		
Self-canceling composite transactions	✓			
Assess whether the transaction can reasonably be said to be a reasonable course of action			✓	

CHAPTER 3: WHAT ARE THE CONSEQUENCES OF TAX AVOIDANCE AND TAX EVASION?

The purpose of the chapter is to present the consequences of tax avoidance and tax evasion for taxpayers and the fiscus. SARS estimates a calculated collection ratio of 85.7% or R1.2 trillion of tax revenue for the 2020/21 financial year. Therefore, in view of the estimated collection, SARS faces significant drawbacks in collections on account of tax evasion and tax avoidance (SARS 2021d). This leads to the question: What are the consequences of evasion and avoidance of paying taxes on the country's GDP and on the individual?

3.1 Effects on the GDP of South Africa

In a developing country such as the Republic of South Africa, revenue from tax accounts for an estimated R1.4 trillion or 26.3% of the Gross Domestic Product (GDP) (National Treasury 2020:19). The revenue tax landscape within the South African context is driven mainly by Personal Income Tax, Corporate Income Tax, Value-Added Tax, and Taxes on International Trade and Transactions (National Treasury 2020:3).

It may be noted that non-payment of taxes owing to evasion and/or avoidance can have a multifaceted effect on the GDP, which can lead to a reduction in available funds that the government may utilise for re-investing in the country, a delay in the government projects due to restriction in the amount of spending, and may cause a significant increase in inflation due to excess money flooding the banking system.

3.2 Tax avoidance consequences

It can be argued that profit shifting from a source in one country to a destination tax haven illustrates the crossing of the Rubicon for the taxpayer between tax evasion, in this case, diverting funds from a source country where the taxpayer should have declared the income to tax avoidance, illustrated by shifting the income to a tax haven where the ultimate benefit is paying significantly less tax.

One can then ask the question 'Where does tax avoidance end, and where does tax evasion begin?' as the difference between the two theories can be vague at times but the consequences can differ severely. Although legal, tax avoidance entails the structuring of one's tax affairs in such a way, that

it reduces the burden of tax on the person liable for tax. In comparison of the two theories, one being legal and the other illegal, both theories result in income tax revenue losses for the country (Kumarasingam 2010). SA has participated in the OECD'S Base Erosion and Profit Shifting initiative to address these tax avoidance and evasion issues on a global scale as this is a worldwide problem (OECD 2021:1).

It could be argued that there are several reasons why tax paying citizens make the decision to avoid or even evade tax; avoiding tax stems mainly from organising your one's affairs in such a way as to pay less tax than one is obligated to pay. Evasion of tax holds a much deeper psychological, economic, and sometimes even criminal reasoning as taxpayers may see the system as unjust or even have no trust in the sovereign government and its administration.

A good tax system encourages its citizens to pay tax by showing the benefits in the form of efficient revenue collection by the receiver of revenue, consistent maintenance of the country's infrastructure, just social benefit policies to its citizens, and fair application of the tax administration framework.

It could further be noted that the citizens of a country are likely to evade tax if they feel the system is unjust, or there are unfair distributions of power amongst the government that has the power to implement the local tax laws, high marginal tax rates that are more oppressive to the lower income tax bracket individuals, and a lack of integrity by the ruling party or the government in charge and in some cases the criminal element that may be fueled by greed. A combination of these different but not limited factors significantly lowers the morale for paying tax and results in the country's citizens looking for a way to keep money in their own pockets as opposed to paying it over to the government.

The OECD (2019) published an article on Tax Moral and Integrity in Developing Countries in which they noted the following based on research conducted by the organisation:

> 'Integrity is essential for the tax system, underpinning trust between taxpayers and governments and is a vital component of tax morale. OECD work on tax morale confirms that taxpayers' willingness to pay taxes is linked to their trust in institutions, perceptions of corruption, as well as satisfaction with public service.'

The research implies that taxpayers have a willingness to pay tax, but they need to also see the benefits that come with parting with their hard-earned income (OECD 2019: Par 2). A taxpayer who is caught understating or evading tax can be liable for a penalty of between 10% and 200% of the amount

understated in accordance with s 234 relating to non-compliance with the TAA and s 235 relating to evasion of tax in accordance with the Tax Administration Act (BDO 2018).

According to an article published by BDO (2018) on SARS' clarity on understatement penalties and consequences for taxpayers, the following are aspects in which SARS identifies understatement of taxable income:

> 'Six predetermined behaviours can trigger the imposition of the understatement penalty. These include a substantial understatement (this not behavioural but rather factual, which read with the other behaviours, contribute to determining the appropriate penalty to be imposed); reasonable care not taken in completing a return; no reasonable grounds for the tax position taken; an impermissible avoidance arrangement; gross negligence; and intentional tax evasion.'

The above predetermined behaviours that trigger the imposition of the understatement penalty as constructed or applied by SARS indicate the thin line between tax avoidance and tax evasion; they clearly show that it is up to the taxpayer to prove that their reluctancy or failure to paying the prescribed tax does not stem from the predetermined behaviours as this could result in stringent penalties being applied to the offender (BDO 2018).

It can be argued that irrespective of how one looks at whether they are avoiding or evading tax, both scenarios create a large financial hole within the country's fiscal pool that has a devastating knock-on effect that stretches from the wealthiest members of society to the less economically fortunate.

One could argue that the wealthier members are able to utilise legal tax loopholes to reduce their tax obligation. However, this class of society may not necessarily be affected financially but rather from a social perspective as less funds are available to the government to boost the economy by creating jobs, resulting in higher unemployment and therefore an increase in social unrest in the form of crime. Secondly, less revenue collected by the receiver of revenue results in the government having to borrow funds from organisations such as the International Monetary Fund (IMF) to plug the holes created by the avoidance and evasion of tax.

It is further noted that the borrowing of funds from the IMF results in SA having an ever-growing debt that the country is obliged to repay. This has a direct impact on the citizens of the country as the government requires more revenue from its citizens in the form of increasing taxes. Thirdly, the financial maintenance of the country would see a deterioration in its social services and infrastructure as the budget for such services and maintenance would be decreased and/or shifted to other areas of

the yearly budget for the ministry of finance to balance more important areas of the country's financial and economic requirements with available financial resources.

The less economically fortunate members of society are normally not able to utilise legal tax loopholes as these require professional expertise, which requires money. Thus, one could say over and above the socio-economic impact that the less fortunate suffer from avoidance and evasion of tax, they also suffer financially as an increase in taxes on food and transport, living expense, etcetera directly impacts their ability to save money and be less reliant on government grants. It is critical for the citizens of a country to pay their tax to stimulate the economy and maintain an efficient and accountable tax administrative government (Ponaka 2021).

Therefore, it is evident in the argument that the hole created by evasion and avoidance of tax not only affects the poor but also the wealthy members of society in one way or another. Setting up a fair and efficient tax system is not an easy task as there are several factors that need to be considered, especially in a developing country such as South Africa. Although the country has come a long way in having an established but growing economy with a considerably stable tax system, there are still a number of improvements that could be implemented to minimise the ability for its citizens to successfully evade tax and also to squeeze the corridors used to avoid paying tax.

Ultimately, the consequences of avoidance and evasion of tax have a far more devastating effect on the country: not only does it affect the individual taxpayer's pocket but also the ability for the country to continue providing services to its citizens. A developing economy such as SA heavily relies on revenue generated from tax as cash flow is fundamental in its quest to develop into an emerging market and have the financial ability to compete on a global platform. Therefore, improvements to the current tax system in SA are critical in minimising tax collection leaks due to evasion or avoidance of tax (Ponaka 2021).

One way SA can improve revenue collection is by curbing exemptions where most tax avoidance loopholes are exploited as identified by a study performed by the International Monetary Fund in an article about 'Raising Revenue'. A second benefit of curbing exemptions is that it reduces the complexity of the country's tax system where exemptions may overlap one another and reduces the taxpayers' ability to exploit these avenues (IMF 2018).

One needs to be careful not to implement a tax system that is so stringent that it appears to be oppressive to the citizens as this would counter the attempts of minimising tax evasion and avoidance. Tax systems are not perfect, but one needs to ensure that they are efficient and effective. Although curbing exemptions is a way to improve revenue collection, there should be sufficient exemptions within the system to promote income disclosure by taxpayers; in that way, disclosure of income to the receiver of revenue is seen as a duty rather that an obligation.

Citizens have an expectation that government will use their tax money for the benefit of the country; the evidence is seen in the quality of infrastructure, the roads, railway line, the service in the public hospitals, the quality of education in public schools, public housing. One could give an endless list of how and where the non-payment of tax, due to avoidance or evasion, affects the country's economy. The consequences of tax evasion and avoidance do not discriminate based on economic class, race, or even level of education; less revenue received by the receiver of revenue will affect everyone within that country in some way or another (Ponaka 2021).

3.3 Tax evasion consequences

In an article titled 'West Africa leaks: Investigating missing tax money', Sandner details how the investigations made by the international journalists' network, the International Consortium of Investigative Journalists (ICIJ), evaluated secret documents and concluded that "West African countries lose millions in unpaid taxes due to money being diverted elsewhere". The evidence uncovered was a result of 14 journalists from the West African region evaluating a vast number of secret documents that indicated several high-profile individuals from companies to politicians and private individuals who conducted business in the region and had subsequently taken their money abroad to other countries. The movement of funds out of the West African region resulted in the countries within that region losing out on millions of dollars in unpaid taxes (Sandner 2018).

Many companies and individuals utilise countries in the Caribbean region, such as the US., Virgin Islands and the Bahamas, as these countries offer significant tax benefits in return for investment in the countries' economies. Companies that qualify under the Economic Development Commission's (EDC) tax programme qualify for benefits such as a 90% reduction in corporate income tax, a 90% reduction in personal income tax, and a 100% exemption on excise tax and property taxes (United States Virgin Islands Economic Development Authority 2020/2021).

It could be argued, as a seasoned business or business individual, the tax benefits that one could exploit begin to manifest into clear advantages as opposed to keeping hard-earned revenue in a region, such as West Africa where lies a general notion of weak or corrupt governments, and a severe misappropriation of state assets.

The investigation into missing tax money conducted by the ICIJ is a mirror image investigation into the Panama Papers conducted by the same network of journalists that shook society's fundamental belief in the financial system upon release of the evidence uncovered on April 3, 2016, by the German newspaper Süddeutsche Zeitung (SZ).

According Kenton's 'The Panama Papers' (2021):

> 'The document exposed the network of more than 214,000 tax havens involving people and entities from 200 different nations. A yearlong team effort by SZ and the International Consortium of Investigative Journalists (ICIJ) went into deciphering the encrypted files before the revelations were made public.'

The Panama Papers refers to a data leak to the German newspaper of 11.5 million highly confidential documents that include offshore companies and tax havens spanning from the 1970s to 2015. The documents implicated a Panamanian law firm, known as Mossack Fonseca, that assisted its clients who included heads of states and government officials, celebrities, and high net-worth individuals to hide their taxable income and even launder potentially illegal funds (Kenton 2021).

A key note that arose from the Panama Papers was that most of the documents did not detail any illegal activities. However, according to the article, several of the shell companies that had been set up by the law firm had been used for fraud, tax evasion, or avoiding international sanctions (Kenton 2021).

This leads back to the question 'What are the consequences of evasion and avoidance of paying taxes on the country's GDP and on the individual?' It should be noted that the act of removal of funds out of a country for reasons of hiding assets in a bank account or in a vehicle that can hold funds, that would be out of reach from the Income Receiver of Revenue in that specific region, could be regarded as tax evasion, which generally carries significant punishment by law, whether serving a sentence of imprisonment, paying a fine, or even both.

Avoiding the duty of paying tax, whether legally or illegally, has a devastating effect on the country's GDP. A research brief conducted by Southern Africa—Towards Inclusive Economic Development (SA-TIED) on 'The impact of tax havens on South Africa' investigated companies that were foreign owned and operated in South Africa with a parent registered in a tax haven and would tend to report significantly less profits, as much as 80% less, as compared to companies without a parent in a tax haven. Although the research report was highly suggestive, it was not conclusive of profit shifting (SA-TIED Research Brief 2019/8:1).

Although the research report was inconclusive, it had significant data-based findings that can be applied to the South African landscape. The report noted the following:

> 'In South Africa, 19% of tax revenues come from corporate income taxes. Addressing the underreporting of corporate income by large multinationals with offshore affiliations could increase these tax receipts by 4% of their total, a benefit to the South African fiscus of approximately R7 billion a year.'

Based on the findings of the report, SA loses an estimated R7 billion per year in unreported profits, which could be a direct injection into the country's fiscus. The report further indicated that:

> 'Nearly all profit shifting is done by the largest firms. The top 10% of multinational firms with affiliates in lower tax-rate jurisdictions are responsible for 98% of profit shifting. The biggest multinationals shift 78% of their profits, on average, to offshore tax havens.' (SA-TIED Research Brief 2019/8:1)

One can argue that tax evasion and tax avoidance are two sides of the same coin that are only governed by the legal aspects of the Tax Act that governs that region; the consequences thereof, have a far-reaching effect on the economy and its citizens and government should place revenue collection at the forefront of any fiscal policy implementation strategy as reliance on the cash-flows thereof will determine the improvement of the lives of its citizens and will also place the country at the forefront of participation in the global emerging markets.

CHAPTER 4: WHAT ARE THE WEAKNESSES IN THE LEGISLATION FOR TAX AVOIDANCE AND TAX EVASION IN SOUTH AFRICA?

The purpose of this chapter is to present the weaknesses identified in the tax legislation relating to tax avoidance and tax evasion.

4.1 Weaknesses of the South African GAAR

The GAAR attempts to draw a line between permissible and impermissible tax avoidance. However, the wording contains several uncertainties and intricacies in its application and interpretation (Stiglingh *et al*. 2021). Some of the provisions of the GAAR are said to be problematic, and it could be stated that this is due to the weaknesses in the drafting of the legislation. The following provisions could be stated as problematic and will be addressed further:

1. the definition of impermissible tax avoidance,
2. sections 80A to 80L scope,
3. the term 'significant',
4. the commercial substance provision,
5. the misuse or abuse provision, and
6. the abnormality provision and abnormality for bona fide purpose provision.

The definition of impermissible tax avoidance has not been defined with precision. The GAARs in South Africa, Australia, and Canada identify impermissible tax avoidance differently, which supports the view that there is no universally acknowledged definition of impermissible tax avoidance. This inherent weakness cannot merely be corrected by a precise definition but needs to be clearly expressed in legislation (Kujinga 2014:439). Cooper (1997:26) notes:

> 'What can and ought to be focus of anti-avoidance rules? And more importantly…can text be drafted which can still be called a rule, but for which there is no clear target, and, what is worse, not even agreement on what the target should be? How can the drafter prepare a weapon against something that in the opinion of some cannot be adequately defined and certainly cannot be defined ex ante?'

Kujinga (2013:53) further states that it is clear in determining the efficacy of the SA GAAR that inherent uncertainty will generally be present due to fact that impermissible tax avoidance proved to be incapable of precise definition. This uncertainty is compounded by the general weaknesses of tax legislation regarding tax avoidance. It is impossible to predict the infinite options taxpayers may

create to obtain tax benefits; however, a GAAR has to be effective in protecting the integrity of the tax base (Kujinga 2013:53).

There needs to be more certainty in GAARs for it to be relevant and effective. The view that the distinguishing line between permissible and impermissible tax avoidance has proved to be basically impossible to draw; therefore, the focus should be elsewhere rather than on drawing this line, deleting GAARs, or introducing new GAARs (Cooper 1997:19). Cooper (1997:19) further notes:

> 'Since a GAAR is enacted as one strategic element in solving tax avoidance, how important is that problem? Is it sufficiently important to justify that other fallout from the means employed to solve the problem? If governments choose to enact GAARs in the face of vocal opposition, what alternatives are open to government to achieve the goals sought but using less contentious tolls?'

Sections 80A to 80L are only applicable to impermissible arrangements that relate to income tax. The GAAR is therefore limited only to the Income Tax Act and does not cover arrangements falling outside this scope (Viljoen 2016:41). It could be argued that impermissible arrangements occur throughout the tax spectrum and should not be limited to the Income Tax Act.

The term 'significant' is not defined in the legislation. Kujinga (2013:110) states that the word significant in s 80C(1)(1) is unnecessary and the GAAR can do without it. The enquiry should rather be based on whether the tax benefit, when compared to non-tax impact of the transaction on the business or financial affairs, gives rise to an inference that the transaction was entered into for the tax benefit.

Mzila (2020:37) states that s 80H provides that an arrangement loses its commercial substance when a part is considered in isolation without considering the wider text. In addition, Kujinga (2013:301) further states that the commercial substance provision in s 80A(*a*)(*ii*) is problematic due to the fact that the guidelines for this provision provided in the legislation do not adequately explain its scope. It is further stated that s 80C(1) also contains provisions for which no clear definitions are provided, such as concept of commercial substance, legal form and legal substance, and self-cancelling.

The tainted elements and the sole purpose requirement are two separate tests that must both be met prior to applying GAAR. This provides taxpayers with a loophole to escape the application of the GAAR. Further guidance is required on the impact of special relationships between parties to an affected transaction (Mzila 2020:38).

Theoretically the misuse or abuse provision in s 80A(*c*)(*ii*) is a good approach as it targets transactions that are inconsistent with the purpose of the law. However, Kujinga (2013:299) states that in practice this provision has proved to be problematic due to the following factors:

- The court is usually influenced by the purposive statutory interpretation being subject to value judgements of what the legislative purpose is.
- The purposive statutory interpretation may create uncertainty on the interpretation of the meaning of the words misuse or abuse, which may result in authorities challenging permissible transactions.
- Studies have shown that courts have applied this provision inconsistently by applying unconventional methods of interpretation. This can be seen in the case of *McNiven v Westmoreland,* where it was stated that some provisions require legal interpretation while others require a commercial interpretation. This creates further uncertainty and diminishes the effectiveness of this purposive statutory interpretation as a measure against impermissible tax avoidance.

The leading judgement of the approach of interpretation of documents were noted in the case of *Natal Joint Municipal Pension Fund v Endumeni Municipality*. The judge said that the general rule is that the words used in a statute are to be given their ordinary grammatical meaning unless they lead to absurdity. He referred to authorities that stress the importance of context in the process of interpretation and concluded that:

> 'A court must interpret the words in issue according to their ordinary meaning in the context of the Regulations as a whole, as well as background material, which reveals the purpose of the Regulation, in order to arrive at the true intention of the draftsman of the Rules.'

The abnormality provision in s 80A(*c*)(*i*) of the Act does not provide guidance as to what constitutes abnormal rights and obligations between persons dealing at arm's length. This weakness was carried from s 103(1) to the current GAAR. Therefore, the reliance is placed on the courts to interpretate and explain the meaning of abnormal for a bona fide business purpose, which may lead to further weaknesses and inconsistencies (Kujinga 2013:298).

Adam Smith states the following regarding certainty:

> 'The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax gatherer, who can either aggravate the tax upon any obnoxious contributor,

> or extort, by terror of such aggravation, some present or prerequisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe. From the experiment of all nations, is not near so great as a very small degree of uncertainty.' (Kujinga 2013:54)

This study has indicated the weaknesses of SA's GAAR, particularly the uncertainty due to the fact that there is no precise definition of impermissible tax avoidance. This uncertainty results in the GAAR being ineffective in adequately informing taxpayers of the extent to which they can exercise their right to avoid tax (Kujinga 2013:294).

As absolute certainty may be impossible, it is imperative for a GAAR to create reasonable certainty for a taxpayer to apply the provisions regarding impermissible tax avoidance transactions (Kujinga 2013:55). The GAAR provisions include many terms for which no definition is provided for in the Act, which could lead to further weaknesses and uncertainty (Mzila 2020:38).

4.2 Weaknesses of the Tax Administration Act

On 1 October 2012, the Tax Administration Act introduced severe penalties for taxpayers who submit understated tax returns. In response to public concerns, the Minister of Finance announced there would be an amendment to include relief for bona fide errors. The Tax Administration Laws Amendment Bill 2013 introduced the term 'bona fide inadvertent error', and this relief was backdated to the Tax Administration Act enactment date (SAICA 2017). This term is, however, not defined in the Tax Administration Act or any legislation. In 2016, judgement was delivered in the *Income Tax Case (ITC) 1890,* and the court held that a 'bona fide inadvertent error' is defined as:

> 'an innocent misstatement by a taxpayer on his or her return, resulting in an understatement, while acting in good faith and without the intention to deceive'.

In 2018, SARS issued guidance to the terms and concluded:

> 'the only errors that may fall within the bona fide inadvertent class are typographical mistakes - but only properly involuntary ones.'

The absence of the definition of 'bona fide inadvertent error' in legislation has resulted in SARS officials disregarding its existence. However, the proof of burden regarding the understatement penalties is on SARS (SAICA 2017). According to Williams (2018), this action could easily result in perceived coercive power by the SARS. It is stated that due to the lack of guidance provided,

taxpayers may rely on the outcome of the *Income Tax Case (ITC) 1890* as a means to avoid tax and may lead to a decrease in tax compliance.

4.3 Weaknesses of the governance at the SARS

SARS is the tax collecting authority and is responsible for administering SA's tax system and customs service. It is imperative for stringent governance policies to effectively discharge its duties as SARS collects more than 90% of all government revenue (SARS 2019/20:2). According to SARS' annual report (2019/20:116), the internal audit department reported findings on certain governance issues.

These included:

- information technology resource constraints, which are key to the effective management and collection of taxes, and
- inadequate controls to mitigate the risk of implementing workforce plans; it could be argued that the lack of key human resources to administer the collection of taxes imposes a huge risk to the fiscus.

According to Williams (2018), the loss of skilled staff poses the risk of lack of capacity to effectively apply the tax legislation and conduct tax audits and investigations. William (2018) further states:

> 'From the point of view of the fiscus, unlawful behaviour, or simply incorrect tax positions adopted, would easily be overlooked by a "reduced capacity" SARS. If a person who deliberately evades taxes is audited and SARS does not find anything, this is sure to result in massive increases in tax evasion. It is therefore critical that, if and when SARS audits, they have the skills necessary to identify and address the real risk areas. Also, if SARS does not make the correct legal argument when attempting to assess a taxpayer, SARS may easily lose the tax dispute, even if the tax position of the taxpayer is actually arguably incorrect.'

SARS (2019/20:74) reported 276 investigations for incidents of internal corruption and fraud by SARS employees and third parties. SARS has an Anti-Corruption Unit (ACU) in place to combat internal fraud and corruption; however, there remain loopholes for which further controls are required.

SARS tends to focus on 'soft targets'. This term refers to taxpayers who have already voluntarily registered for taxes and are submitting their tax returns. Minimum work is done to target businesses that avoid registration for taxes or are registered but evading taxes. SARS has also been focusing on

tax practitioners' 'timing differences' instead of matters that would have a permanent effect (Williams 2018).

William (2018) states that a further contributor to the loss of tax collections is that the tax base is not reflective of the true market base. SARS has the power to perform unannounced inspections and, where there is a reasonable belief that a trade is carried out, confirm the tax registration and compliance status. However, SARS has failed to do so to a material extent.

SARS responses to tax disputes that are considered potentially tax aggressive structures and require change in legislation often take serval years to be introduced. The delay in acting causes a loss to the fiscus. While legislation is pending amendments, taxpayers may choose to introduce these tax structures to obtain tax benefits. Similarly, there is a perception there is a lack of equal enforcement regarding court wins by SARS. The outcome of a case is not applied consistently to similar cases, resulting in inequality among taxpayers. This results in less tax collections for the fiscus (William 2018).

According to Williams (2018), there have been numerous allegations in the public space questioning the credibility of SARS. These include political determinants of tax compliance and lack of trust in SARS. The misuse of funds by government and parastatals remains a staggering issue. All these factors negatively affect the public's perception of SARS and the paying of taxes, which consequently contribute to the decrease in tax compliance.

4.4 Transparency in tax administration

Illicit financial flows are a major contributing factor to the low tax revenue in developing countries. This is mainly due to the insufficient capacity of tax administration to enforce tax legislation and curb illicit financial flows. International tax evasion and aggressive tax avoidance are major components of illicit financial flows and therefore the fundamental target for tackling illicit financial flows. The majority of illicit flows are from African countries to financial institutions outside of Africa. This shifts the potential tax revenue out of the country, which results in the low percent of tax revenue to GDP. In response to tackling the problem of illicit financial flows, intergovernmental cooperation is imperative to enhance transparency and promote exchange of information (EOI) (Monkam *et al.* 2018:3-4).

According to the Cooperation with Africa report (Monkam *et al.* 2018:6), the following are some of the challenges that revenue administrators experience regarding exchange of information:

> - 'Treaty networks and exchange of information networks are limited for many African jurisdictions which result in low numbers of Exchange of Information on Request (EOIR);
> - Personnel trained in EOIR in revenue administrations are reallocated to different business divisions – resulting in a loss of skills to other departments;
> - Marketing EOIR as not only as a tool for increased compliance but also as a money generation tool for revenue administrations remains difficult given co-operation with Africa the challenge to isolate the effects of EOIR on additional revenues from other contributing factors;
> - Some jurisdictions require several months to reply to requests from developing countries;
> - Convincing revenue administrations that EOIR is not only limited to transfer pricing division but it is a support function for the entire revenue administration; and
> - Lack of willingness from policy makers to introduce EOIR in a jurisdiction as the scarce resources are mainly focused on BEPS and Transfer Pricing while EOI is largely ignored. In some revenue administrations, staff in the EOI unit has been reallocated to different units. In other jurisdictions, there is no will to implement an EOI unit.'

There are also challenges that exist for Africa to benefit from the automatic exchange of information. These include:

- political leaders not prioritising investments needed to facilitate the automatic exchange of information,
- data security and information technology requirements can be very expensive,
- capacity constraints for tax administration for the reciprocal exchange of information between financial institutions and tax administrators,
- lack of technical expertise to assist in implementing automatic exchange of information, and
- the information exchanged is not always effectively and efficiently utilised, resulting in wasted costs and time (Monkam *et al.* 2018:7).

Despite numerous amendments and enactments of legislation over the years, there remain weaknesses in the legislation regarding tax avoidance and tax evasion. It is submitted that it is impossible to provide for all the different arrangements or agreements a taxpayer may engage in to explore the loopholes available due to weaknesses in legislation. However, it is imperative for legislation to provide reasonable guidance with regard to tax avoidance and tax evasion.

CHAPTER 5: WHAT IMPROVEMENTS CAN BE IMPLEMENTED TO REMEDY TAX AVOIDANCE AND TAX EVASION PROBLEMS IN SOUTH AFRICA?

The purpose of this chapter is to suggest potential improvements that may be implemented in the tax avoidance and tax evasion tax legislation to address the weaknesses as noted in the previous chapter. In response to tackling tax avoidance and tax evasion, the OECD (2019:5) stated:

> 'Only through co-ordinated global action, and swift reaction to newly emerging risks, governments around the world can win the battle against tax evasion and avoidance and secure the integrity of their tax system.'

5.1 Improvements to the South African GAAR

The weaknesses noted in chapter 4 need to be addressed to improve the effectiveness of the GAAR. It could be argued that the majority of the weaknesses can be addressed if the legislation provides clarity and further guidelines for the problematic provisions. Of noticeable importance, the uncertainty inherent in the GAAR provisions need to be addressed.

5.1.1 Amending the current GAAR

The term 'arrangement' includes a single step in a series of transactions. This provision empowers the Commissioner to apply the GAAR to steps of a composite agreement. Kujinga (2013:303) states that similar provisions have caused controversy in other countries. It is suggested that this amendment should follow the guidance of the courts that state steps of a transaction should not be interpreted in isolation but rather as a composite when attempting to invoke the GAAR provisions. Alternatively, an amendment to provide clear guidance should be included as to when a step should and should not be isolated.

Section 80A(*a*)(*i*) defines impermissible transactions as transactions that are 'entered into or carried out by means or in a manner would not normally be employed for bona fide business purposes, other than obtaining a tax benefit'. This is similar to that of s 103(1) and was carried over to the current GAAR. This provision remains uncertain as to what the terms normal and abnormal for bona fide business purpose mean. It is suggested that the guidance provided in the US GAAR regarding the manner that is not normally employed for bona fide business purposes should be applied to the SA GAAR and amended accordingly to limit the uncertainty of this provision. The main indicators suggested for the provision is that a bona fide purpose should include the possibility of profits, have

a business objective, and the investment of capital and the tax benefits should not overshadow the investment made (Kujinga 2013:304).

The terms ‘abnormal rights’ or ‘obligations’ are also not clearly defined in the Act, which creates uncertainty in interpreting the provision. Kujinga (2013:305) suggests that the indicators provided in the UK GAAR should be incorporated into the SA GAAR to reduce the uncertainty of this provision. The indicators of abnormal transactions include transactions that contain characteristics or involve a party that would not be included in a transaction without the sole or main purpose of avoiding tax, transactions where assets are located they would have not been place, individuals are placed in positions where they would have not been place aside for the purpose of tax avoidance, and where the payments significantly differ from the market value of the transaction or the business objectives make no commercial sense.

The definition of ‘commercial substance’ provided in s 80C(1) states that the characteristics are not exhaustive. This provides the Commissioner with the opportunity to apply this provision inconsistently. This may create uncertainty for taxpayer, which could be reduced if further guidance is provided. The indicators provided in the US GAAR could assist in improving the SA GAAR. These indicators of commercial substance include a reasonable expectation of profits, a risk of loss should be present, a profit or loss aside from the actual profit due to the tax benefits that include commercial substance, and an inclusion of a provision which states that the economic impact of a transaction must be real and not artificial (Kujinga 2013:306).

The provision of ‘legal substance versus legal form’ requires an explanation in the GAAR. This provision can be improved by an amending the legislation to include an explanation of these terms. Kujinga (2013:306) states that legal substance is the ‘real effect of a transaction as a whole’; therefore, the single steps in a composite transaction must be ignored. The legal form is the opposite: ‘it focuses on individual steps in a series without reference to the other transactions it is intended to work with’.

5.1.2 Future GAARs

It is likely that there will be future amendments or a whole new GAAR to curb the weaknesses in the current GAAR. It is suggested that when this happens, the future GAAR should not drafted with the same approach as the current GAAR to address the major uncertainties that exist. The South African GAAR can be compared to the GAAR principles and approach to those of the UK and may be amended accordingly.

Kujinga (2013:308) states that the UK approach to GAAR can be said to be 'unique and substantially different' to the South African GAAR, and characteristics from it can be applied to improve the current weaknesses. The following are some of the characteristics of the UK GAAR approach:

- Consultations with independent experts to assess whether a GAAR is needed. The result was that a targeted, not a broad, GAAR was needed for the UK.
- The GAAR is governed by principles such as the reduction of uncertainties and respecting the taxpayers' right to avoid tax while curbing the acts of impermissible tax avoidance.
- The approach focuses on what is permissible tax avoidance and uses this as a basis for building on provisions for impermissible tax avoidance.
- The approach further includes a double reasonable approach that is used to distinguish whether a transaction is permissible or not. A transaction is said to be permissible if:

    a. 'it can reasonably be concluded that it is a reasonable course of action; and
    b. It cannot be said with certainty that it is an unreasonable course of action, which means that the case will be decided in the taxpayer's favour.' (Kujinga 103:308)

It is stated that SA can improve its GAAR by applying the approach taken by the UK to reduce uncertainties and improve the effectiveness of the GAAR. This will provide taxpayers with a more guided interpretation and understanding of what constitutes permissible and impermissible tax avoidance.

Kujinga (2013:59) argues that legal measures alone are not totally effective to curb impermissible tax avoidance; therefore, non-legal measures are as important because impermissible tax avoidance is a system problem. As a result, the tax system requires a holistic approach to combating impermissible tax avoidance beyond just legal provisions. McBarnet (1988:114) notes that:

> 'enforcers cannot enforce laws unless they are violated. What regulation studies have underplayed is the extent to which the regulated do not violate but merely avoid the law. Responses to law are not just a matter of breaking it (crime) and obeying it (compliance) it is also possible to use legal technique to achieve non-compliance with the intent of the law without technical violating its content. The law is not broken but it is, nonetheless, entirely ineffective in achieving its aims. Despite the legislature, despite the enforcers, law becomes merely symbolic.'

5.2 Improvements to the Tax Administration Act

The controversy around the term 'bona fide inadvertent error' is said to result in coercive power by SARS. According to Williams (2018), the issue of coercive power needs to be clarified. The following steps are suggested by Williams (2018) to improve on this weakness:

- National Treasury and SARS should consider a collaborate effort to analyse the submissions made by the tax industry in relation to the TAA. These are submitted as Annexure C of the tax returns. Where similar issues or concerns arise, attention must be given to finding an overarching solution to address these concerns.
- An interpretation note or other guidance on the meaning of 'bona fide inadvertent error' should be provided.
- National Treasury and SARS should consult with tax specialists and experts on the issues of perceived inequity in the TAA and other Acts. Inequity is also said to arise in relation to the long periods SARS has to issue additional assessments but provides taxpayers with a very short periods to respond to requests. An example provided by Williams (2018) is:

  > 'The VAT law used to allow for waiver of interest in cases where there was no loss to the fiscus. SARS and National Treasury saw fit to purposefully remove this discretion, in order to levy interest on taxpayers even when SARS suffered no loss.'

It is submitted that a thorough review of the TAA should be performed in relation to all issues and concerns raised by taxpayers and tax practitioners. Where there is uncertainty, consultations with tax specialists and experts should be consider and draft interpretation notes should be issued for public comment. This will hopefully reduce the said inequality and ambiguities inherent in the TAA.

Where taxpayers disregard the provisions of the TAA, the SARS should consider adopting the 'crime against the state' in the TAA similar to the approach of Australia and the US (Storm and Coetzee 2017:165).

5.3 Improvements to the governance at the SARS

Section 5 of the SARS Act provides SARS with the powers to do all that is necessary or expedient to perform its functions properly. Proper governance relating to the procedures and controls within SARS is key to execute its mandated functions. The findings around the governance issues noted in the chapter above may be addressed by SARS reconsidering and revising the strategies of the Information Technology and Human Resource departments. It is suggested that SARS consider

engaging with an external service provider to conduct a full analysis of the governance at SARS and act on the recommendations provided.

The issue of chasing after soft targets may be addressed by SARS rebuilding its specialist tax teams and investigative units. The investigation, audit, and assessment of complex transactions could take several years to finalise. Furthermore, the performance measures for SARS officials should be carefully designed to avoid measures focusing on easy targets such as the number of audits completed or the amount of tax collected.

It could possibly be argued that the methodology used to select taxpayers for investigation should be revised to include more unannounced inspections to increase and protect tax base. SARS should also consider using performance measures to monitor the turnaround time to resolve disputes and reward and punish performance accordingly.

Furthermore, SARS should consider striking a balance in the measurement criteria of SARS officials to include complex transactions and problematic areas as well, such as tax avoidance, transfer planning, profits from permanent establishments, and other base erosion aspects. Complex areas should also be allocated to skilled staff who are better equipped to tackle those areas (William 2018). Furthermore, SARS should consider implementing a more serious attitude towards prosecuting tax evaders. This may be done by appointing more specialists in the investigating department, with a continuous development programme.

5.4 Transparency and Exchange of Information in tax administration

The Tax Transparency in Africa report is published annually and provides the key outcomes of the Africa initiative towards the challenges of illicit financial flows. The goal of tax transparency and EOI is to assist tax authorities with the administration and enforcement with their tax laws when dealing with foreign jurisdictions. By committing to tax transparency and EOI to combat cross border tax evasion, SA may improve tax compliance and increase revenue collection (African Tax Administration, African Union and OECD 2021:32).

The following are two pillars of the Africa initiative:

1. 'Raising political awareness and commitment in Africa and
2. Developing capacities in African countries in tax transparency and exchange of information.' (African Tax Administration, African Union and OECD 2021:11)

It could be argued that SA needs to take a more active approach in raising political awareness and commitment to curb the illicit financial flows while continuously developing capacities to enhance tax transparency and exchange of information.

Many of the challenges mentioned in the previous chapter, with regards to the automatic exchange of information, stem from the lack of consultation with African countries. Improvement to facilitate the exchange of information and tax transparency may include the following:

- ongoing engagements between countries regarding system changes required, also considering the capacities and concerns;
- improvements and adoption of business models that are used by other countries to reduce costs of effectively implement the exchange of information;
- data collection can be used to increase the transparency of the benefits of the exchange of information. This can attract other institutions to successfully implement and commit to the exchange of information; and
- the African Union should find creative initiatives to enhance and strengthen political willingness to be actively involved and committed to improving tax transparency and the exchange of information (Monkam *et al.* 2018:9).

CHAPTER 6: CONCLUSION

The objective of this research report was to analyse SA's legislation on tax avoidance and tax evasion and to investigate the weaknesses in and improvements to SA's legislation in relation to tax avoidance and tax evasion. It is stated that tax avoidance and tax evasion is a serious concern worldwide as it erodes the tax base, undermines the tax system, and impedes economic development.

This study also highlighted the changes and developments over time of the anti-avoidance rules for SA, the UK, the US, and Australia. Tax legislation worldwide has been amended numerous times to counter tax avoidance and tax evasion. South Africa's anti-avoidance legislation intended to curb the loopholes and uncertainties that existed under previous anti-avoidance provisions in s 103(1) by introducing ss 80A to 80L in 2006. It was found that the new provisions do not fully address the loopholes and uncertainties but further provide a new set of weaknesses that need to be addressed. It could be argued that the current enacted GAAR increased the complexity of the anti-avoidance legislation. This may further motivate and introduce opportunities for taxpayers to exploit loopholes in the provision.

The UK did not initially have a GAAR; instead, they made use of targeted anti-avoidance rules. The UK later enacted a GAAR that can be said to be unique and substantially different to the other GAARs. The UK's approach seeks to strike a balance between allowing taxpayers to avoid tax legally while curbing impermissible tax avoidance.

The US uses judicial doctrines as anti-avoidance provisions and does not have a GAAR. The economic substance doctrine is based on the purposive interpretation approach and the business purpose indicator. The US provisions are said to very similar to SA's GAAR and contain similar inherent weaknesses.

The Australian anti-avoidance rules, which were initially in s 260, were said to be broad and ineffective mainly due to the excess use of the literal interpretation rather than a purposive test. Part IVA of the ITAA later replaced s 260 with the intention to narrow the GAARs focus. It can be stated that the Australian GAAR suffers similar shortfalls as the South African GAAR.

Tax crime remains a key challenge to sustainable economic, political, and social development, particularly in developing economies. It is established that tax evasion reduces efficiency and

increases inequality; therefore, co-operation between tax authorities and anti-corruption authorities is critical in the fight against tax crime. While SA has measures in place to facilitate this co-operation, there are still weaknesses that exist, that require further improvements (OECD 2018:97). It is stated that transparency and exchange of information is critical in the fight against tax evasion and illicit financial flows in SA.

There remain concerns regarding the governance and actions of SARS. Despite continuous improvements and procedures being implemented over the years, there remain weaknesses, as discussed in this report, that need to be addressed. It could be argued that a formal inquiry into the governance at SARS may assist in improving the governance issues. Furthermore, the TAA has been criticised due to the lack of guidance when interpreting the term 'bona fide inadvertent error'. It is suggested that SARS should consult with tax experts on the perceived inequity of the Tax Administration Act and other tax legislation.

It should be noted that taxpayers will always seek new and innovative loopholes to avoid tax, so the effectiveness of the anti-avoidance provisions remain a concern despite the amendments to the legislation. It could be stated that no jurisdiction has perfect anti-avoidance legislation or flawless tax administration rules.

It should also be noted that one could list many ways in how a country may improve tax collection. However, when one door closes, there is always a possibility of another door opening; therefore, the best way in which a country can improve revenue collection is to gain the trust of its citizens in the tax administration process. The government should be dedicated to eradicating fraud and corruption; it should be evident in how the government deals with taxpayers who evade payment by instilling harsher punishments and having a highly competent tax system that roots out tax evaders.

This study analysed the weaknesses in South Africa's legislation on tax avoidance and tax evasion and suggested improvements. It was identified that various weaknesses exist in the current legislation. The recommendations made in this study to address the identified weaknesses include legislative amendments, guidance on interpretations, and enhanced governance at SARS. The weaknesses that exist in South Africa's legislation may render the anti-avoidance provisions an ineffective deterrent to impermissible tax avoidance arrangements. It is impossible for any tax system to exist without tax avoidance; however, the right balance should be struck between protecting taxpayers' rights and raising sufficient revenue needed for government within the law.

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