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A critical analysis of the development of tax avoidance in South Africa

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University of the Witwatersrand, Johannesburg

A Critical Analysis of the Development of Tax Avoidance in South Africa

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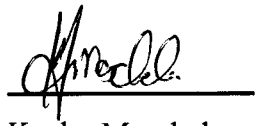
A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Johannesburg, 2011

1 DECLARATION

I 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 (Specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination at any other university.



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2 ABSTRACT

Tax avoidance is the legal utilisation of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. Tax evasion entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities in order to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, profits or gains than actually earned; or overstating the deductions). The revised general anti-avoidance measures were introduced in the Income Tax Act 58 of 1962 ('the Act') on 2 November 2006 in the form of section 80A to 80L, in order to replace the complicated and confusing as well as ineffective anti-avoidance measures contained in section 103(1).

Key words:

Tax avoidance; Tax evasion; Planning; Lack of commercial substance; Impermissible tax avoidance arrangements; Substance versus form; Misuse and abuse ; Reportable arrangements

3. INTRODUCTION

Tax avoidance refers to a situation in which a taxpayer, within the provisions of the tax statutes, arranges his affairs so that his tax obligation is minimised or completely avoided. The Organisation for Economic Cooperation and Development (OECD) (2004: International Tax Terms op.cit.n4.), similarly defines tax avoidance somewhat awkwardly, as an 'arrangement of a taxpayer's affairs that is intended to reduce his liability and that although the arrangement could be strictly legal, it is usually in contradiction with the intent of the law it purports to follow.' Tax avoidance is not tax evasion. Tax evasion is where a taxpayer unlawfully arranges his affairs in such a way that he escapes any tax liability which he ought to pay.[1] As such, tax evasion connotes criminal liability whereas tax avoidance does not.

Tax avoidance also reduces the state's revenue and brings the tax system into disrepute, so governments need to prevent tax avoidance or keep it within limits. It is generally accepted that the taxpayer is entitled to arrange his affairs so that his liability for income tax is minimised. But if the taxpayer arranges his affairs unlawfully so as to pay less tax, the taxpayer is taxed at the maximum rate permissible and a penalty imposed in terms of s 75 and additional tax in terms of s 76 of the Act.

Tax avoidance does not only result in obvious short-term revenue loss, but longer-term damage to the tax system and economy. These other effects include a corrosive effect upon taxpayer compliance, the uneconomic allocation of resources, upward pressure on marginal tax rates, an unfair redistribution of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.[2]

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[1] Tsatsawane, K. (*JBL Volume 9*), part 1at 9

[2] *Discussion Paper on Tax Avoidance* and *Section 103* of the Income Tax Act, 1962

4. TERMINOLOGY

4.1 General problem: Avoidance, Evasion and Planning

Debates on tax avoidance often begin with an attempt to define and distinguish three broad concepts: (1) 'impermissible' tax avoidance; (2) tax evasion and (3) legitimate tax planning or 'tax mitigation'. While there is a typical agreement over the meaning of 'tax evasion', the other concepts are more debatable.[3]

4.2 Terms Used

Both the taxpayers and the South African Revenue Service must fully understand the definitions of the above basic concepts if there is a doubt concerning any tax avoidance transaction or an agreement resulting in tax avoidance. These concepts also help to expose an agreement or a transaction involving tax avoidance. The categories do help to identify types of behaviour across a scale that ranges from a 'simple' tax planning at one end to criminal tax evasion at the other.[4]

The definitions below have been drawn from a number of sources, including publications by the Organisation for Economic Co-operation and Development (OECD), reports by revenue authorities and commissions in other countries, judicial decisions, and critical commentaries. It is hoped that they will help to minimise misunderstandings due to differences in semantics.

4.2.1 Tax Avoidance

Tax avoidance is defined as 'using perfectly' legal methods of arranging one's affairs so as to pay less tax.[5] At the other extreme, tax evasion is regarded as an evil because by escaping his fair share of the tax burden, the taxpayer forces the State to recover the lost revenue by increasing taxes on other taxpayers. Also such an agreement or arrangement

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[3] Lord Hoffman in *MacNiven v Westmoreland* [2001] STC 237 at 257
[4] Cooke, P. in *Haddle and Sydney Bridge Nominees Ltd v CIR* (1991) 13 NZTC 8, 116 (CA) at 8, 122
[5] *IRC v Duke of Westminster* (1936) AC 1 at 19

amounting to tax avoidance must be based on actual facts and circumstances and must be legally enforceable within the parameters of South African law generally.

Tax avoidance can be done by way of transfer pricing between connected parties in such a way that income is transferred to the lower tax-based jurisdiction, or alternatively to a taxpayer who is in an assessed loss position. This consensus on the legal nature of tax avoidance is contrasted by diverging views on the morality of such avoidance. (For example, it was held in *Duke of Westminster v IRC* 51 *TLR* 467, 19 *TC* 490, that a person was able to arrange his affairs so as to pay the least amount of tax without any moral sanction. By contrast, the general public frowns upon such schemes. Some people feel that the use of such schemes is in violation of equality in that higher-earning taxpayers are in a better position to capitalise on them). The moral acceptability of tax avoidance is usually defended by comparing tax avoidance with a respectable contest, stressing the adversarial relationship between a taxpayer, trying to protect his property, and the revenue authorities attempting to deplete the taxpayer's pocket by collecting as much tax as possible. Tax avoidance has long been accepted by the courts both in South Africa and in other countries. (See *Duke of Westminster v Tomlin and CIR v Meyerowitz*). Tax avoidance is a legitimate activity which the taxpayer is entitled to pursue, however unpopular the results of their activities may be to the fiscal authorities.

4.2.2 Tax Evasion

The OECD has defined 'tax evasion' as encompassing illegal arrangements through or by means of which liability to tax is hidden or ignored.[6] That is an arrangement by which 'the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities.'[7] In a tax context, it typically involves the use of illegal means to reduce a tax liability by falsification of books, suppression of income, and fraudulent non-disclosure of income and overstatement of deductions. Common examples of tax evasion include a deliberate failure by a 'cash' business to report the full amount of revenue received or the deliberate claiming of a deduction by a business for an expenditure it has neither incurred nor paid.

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[6] Ibid

[7] OECD, International Tax Terms for the Participants in the OECD Programme of Cooperation with Non - OECD Economies , 2000

Tax evasion is simply fraud against the *fiscus* for which a fine or period of imprisonment not exceeding five years is provided in s 104 of the Act. Taxpayers, who enter into aggressive schemes which verge on or constitute tax evasion, or which are based on sham transactions, should be dealt with harshly by the courts.

4.2.3 Tax Planning

Tax planning is concerned with the organisation of a taxpayer's affairs (or the structuring of transactions) so that transactions give rise to the minimum tax liability within the law without resorting to any 'impermissible tax avoidance'. As taxpayers have no liability for tax other than the obligation imposed upon them by statute, it is theoretically correct to say that a taxpayer may so arrange his tax affairs that he falls outside the ambit of the taxing act.

Taxpayers do not incur legal penalties and, strictly speaking, no moral censure, if having considered the lines drawn by the legislature for the imposition of taxes, they structure their affairs in such a way as to minimise tax liability, without resorting to tax evasion.[8] In short, the hallmark of tax mitigation is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.[9]

5 ANALYSIS OF THE DEVELOPMENT OF TAX AVOIDANCE IN SOUTH AFRICA

5.1 Introduction

The provision of s 103(1) of the Act used to contain the General Anti-Avoidance Rule (GAAR). Since the beginning of the 20th century, with the growth of modern welfare and the industrial state, and the increasingly burdensome imposition of income and other taxes, the practice of tax avoidance has grown amongst those aggrieved owing to the fact of paying an unequal share of the tax burden. They have had to contend with seeking out loopholes in the taxing statutes, such that would enable them to diminish their tax liability. The initial response of the authorities was to plug each hole as it

[8] *Levene v IRC* (1928) AC at 227
[9] *CIR v Willoughby* [1997] 4 A11 ER 65 at 73

appeared. This proved largely unsuccessful and the assistance of a more general anti-avoidance provision will come to the aid of the authorities.

In simple terms, s 103(1) empowered the South African Revenue Service to disregard avoidance schemes and to tax the taxpayer as though they had not been embarked upon, subject to all the criteria in s 103(1) being operative. The Income Tax Act contains both specific anti-avoidance and general anti-avoidance sections. The difference between the specific and the general anti-avoidance sections is that the specific anti-avoidance provisions are incorporated into each section and are precise, whereas the general anti-avoidance rules (s 80A to 80L) enable the Commissioner to address avoidance not covered by the specific remedies.[10]

Although s 103(1) was no doubt designed to enable the Commissioner to deal effectively with tax avoidance schemes, it was limited in the sense that all four requirements laid down in the section, had to be fulfilled before the Commissioner could invoke the section.[11] Broadly speaking, the section empowers the Commissioner to determine a taxpayer's liability for income tax and other taxes by disregarding any abnormal transaction which the latter has entered into for the purpose of avoiding or postponing a tax liability or reducing the amount thereof. A transaction is regarded as abnormal if it was entered into or carried out by a means or in a manner which would not normally be employed in the entering into or carrying out of a transaction in question, or has created rights or obligations which would not normally be created between persons dealing at arm's length. An abnormal transaction may be disregarded if it was entered into or carried out solely or mainly for the purpose of the avoidance or the postponement of liability for the payment of any tax or the reduction of the amount of such liability.[12]

In accordance with s 103(1), the taxpayer's liability for tax purposes must be determined either as if the transaction, operation or scheme had not been entered into or carried out or in such manner as in the circumstances of the case is deemed appropriate for preventing the tax avoidance or tax liability. It does not necessarily follow that,

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[10] Notes on South African Income Tax (2008) at 416
[11] *Commissioner for Inland Revenue v Conhage* (Pty) Ltd, 61 SATC at 391
[12] *CIR v IHB King & AH King* 1947 (2) SA 196 (A) at 2009

because a transaction, operation or scheme was entered into and had the effect of avoiding an anticipated liability for tax that it will be hit by s 103(1) of the Act. The provision of s 103(1) will be inapplicable if that transaction falls within the limits of normality or the means, manner, rights and obligations prescribed by s 103(1)(i) and (ii) which state the following:

> 'When a transaction, operation or scheme is an agreement, it is important to determine firstly whether it was one concluded at arm's length. That is the criterion postulated in para (ii). Dealing at arms' length is a useful and often easily determinable premise from which to start an enquiry. It connotes that each party is independent of the other and in so dealing will strive to get the utmost possible advantage out of the transaction for himself. Hence, in an at arms' length agreement, the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by Para (ii).' [See *Hicklin v Secretary For Inland Revenue* 1980 (1) SA, 481 (A)]

The means or manner employed in entering into an agreement or carrying it out are also more likely to be normal than abnormal in the sense envisaged by para (i). (See *Hicklin supra*)

The next observation is that, when considering the normality of the rights or obligations so created or of the means or manner so employed due regard has to be paid to the surrounding circumstances. The provision of s 103(1) itself postulates that. Thus what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. The last observation is that the problem of normality or abnormality of such matters is mainly a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence adduced thereto by either party.[13]

The provision of s 103(1) was introduced with the aim of combating tax avoidance which was long in existence both in South Africa and other countries, such as Canada; New Zealand; Australia etc. Both the taxpayer and the South African Revenue Service thought that it would be a simple tool to be implemented, but this proved to be incorrect. This section needed to be tested in the courts to see what the outcome would

[13] *Hicklin v Secretary for Inland Revenue* 1980 (1) SA 481 (A)

be, before it could be fully operational. There are certain requirements which have to be met before s 103(1) applies. In simple terms, s 103(1) requires the following:

(a) a transaction, operation or scheme
(b) which must have the effect of avoiding or postponing liability for the payment of tax or reducing the amount thereof, and
(c) which must have been entered into using abnormal means; and
(d) which must have been entered into or carried out solely or mainly for the purposes of obtaining a tax benefit

Though these requirements seem clear and simple, the amount of litigation (See for example *SIR v Hicklin and CIR v Meyerowitz*) suggests otherwise. Only when a taxpayer's transaction falls squarely within the ambit of the above provisions is the Commissioner entitled to apply the section.[14] Therefore, there are certain circumstances in which s 103(1) may not be applied, as for example when the parties are striving to obtain the maximum possible advantage for themselves (12 *supra*. In such a case the abnormality clause would not be operative and the relevant section under which the taxpayer sought to have the income taxed or the deduction allowed will be applicable). In *Hicklin v SIR*, the taxpayer (Mr Hicklin) and his two co-shareholders sold their dormant company to a dividend-stripping company. The purchase price of the company was equal to the net asset value of the company, less 10 percent of the distributable reserves. However, the agreement between the sellers and the dividend-stripper was an arm's length transaction in which each party was striving to obtain the maximum possible advantage.

The court held that the abnormality requirement was not satisfied as there was no reason to evade tax, other than tax advantages and the reason was to get rid of the dormant company which had become a burden [(2008), *Notes on South African Income Tax*, at 434)]. The attitude displayed towards tax avoidance by the courts in certain recent cases involving tax avoidance schemes, the application by the courts of the substance over form doctrine, and the introduction of the 'business purpose test' in s 103(1) the Act, have created additional uncertainty for taxpayers who wish to enter into tax avoidance

[14] Tsatsawane K JBL 9, part 1, at 9

schemes and for their advisers.[15] An article on tax avoidance by Professor Maeve Kolitz (1991) 13 *Tax Planning* 105; states that[16] -

> 'Successful tax avoidance has required the taxpayer to walk a fine line between staying outside the provisions of the Act and falling foul of the anti-avoidance provisions, which have been included in the Act to empower the Commissioner for the South African Revenue Service to take action against tax avoidance schemes. For example, the general anti-avoidance provisions of s 103(1) which can be used by the Commissioner to evaluate any tax avoidance scheme that meets the requirements of the section. It was for many years the generally accepted view that a taxpayer could enter into a tax avoidance scheme and, provided that there was nothing abnormal about the means or manner in which the scheme was entered into, and about the rights and obligations it created, then the scheme could not be successfully attacked by the Commissioner, under the provisions of s 103(1).'

The aggressive use of tax avoidance schemes which were often based on sophisticated financing structures became widespread in South Africa after 1985 and involved millions of rands. In some instances, the schemes went beyond constituting tax avoidance and probably amounted to tax evasion. Losses to the fiscus of the magnitude encountered inevitably provoked a strong reaction. (15 *supra*)

The provision of s 103(1), created uncertainty between the taxpayer and the South African Revenue Service. The decisions taken by the Courts were inconsistent in that in certain cases, the taxpayer was able to escape the provisions because; all four factors enunciated in s 103(1) were not present, but by the same token on other occasions the judgments did not strictly adhere to the provisions of s 103(1) and the court found in the favour of the Commissioner.

The Minister of Finance together with a team of experts decided to bring into play new anti-avoidance provisions which replaced s 103(1). Even though the new legislation is not specifically supported by case law, the new rules are more prescriptive in nature and are less dependent on the courts for the purpose of interpretation. There are however a number of similarities between the old and the new provisions and certain of the principles established in the cases will still be relevant. As s 80A to 80L are fairly strict, the courts are likely to interpret the provisions less harshly as far as taxpayers are

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[15] 12 supra

[16] See article on *Tax Avoidance* by Maeve Kolitz: (1999) 13 *Tax Planning* 105

concerned. Abnormality clauses must be cogent; there must be business reasons for entering into a transaction.

5.2 Comparisons and differences between s 103(1) and s 80A to 80L

The general anti-avoidance rule (GAAR) was previously governed by s 103(1) of the Income Tax Act. The South African Revenue Service found that the provisions in s 103(1) were an effective deterrent to certain avoidance arrangements.[17] These provisions are exceptionally complex. In tracing the history of s 103(1) and its evolution into its present form, and comparing it against the background of judicial interpretation, the following requirements are pivotal, namely:

(a) an abnormal arrangement; and
(b) a purpose which is solely or mainly tax avoidance

Both these requirements are contained in s 103(1) and s 80A to 80L of the Act. In order for a transaction to qualify in terms of these sections, the above-mentioned requirements have to be met. The provision of s 103(1) was based on judicial interpretations, while s 80A to 80L is based on clear definitions as per legislation.

The main differences between the new provisions (s 80A to 80L) and the old s 103 are as follows:

(a) connected persons are combined in determining whether a tax benefit has arisen
(b) the new provisions expand on what elements would taint an arrangement being;

- business and non-business abnormalities
- lack of commercial substance (including a general definition and list of indicators)
- arm's-length rights and obligations

(a) misuse and abuse of the law

[17] Justin Liebenberg; 'Tax Partner' (2007) 1 May (*Grant Thornton*)

(b) the new provisions provide remedies to the South African Revenue Service if an arrangement is found to be an impermissible avoidance arrangement

(c) the new provisions can apply to parts of a transaction

5.3 Conclusion

The provision of s 103(1) contained a number of loopholes which made it difficult to apply in practice. It created uncertainty for the South African Revenue Service and taxpayers alike. Although it has long been accepted both in South Africa and in other countries that a taxpayer is entitled to arrange his affairs, so as to ensure that his tax burden is less than it otherwise would be.

The South African Revenue Service and the taxpayer have to rely on the interpretation by the courts as to whether a transaction is abnormal and its purpose is to avoid tax. The new GAAR was introduced to avoid any uncertainties, loopholes or doubts that were contained in s 103(1). It was praised by other countries as a 'messiah' for the tax authorities in stopping tax avoidance schemes, such as Canada; New Zealand etc.

The new GAAR should serve the country well. It should reduce the loss of revenue to the *fiscus* and help to put our economy in good shape. It should assist in preventing the importation of schemes from other countries. If South Africa has succeeded in properly framing the wording of the new GAAR, the number of abusive schemes should be reduced.

6 SCOPE OF THE PROBLEM

6.1 The South African situation

Impermissible tax avoidance has been a growing problem both in South Africa and other countries for many years. The issue of corporate tax avoidance and evasion has assumed a prominent position within the South African political agenda in recent months. The South African Finance Minister, Trevor Manuel announced that tough new measures would be introduced as part of the Revenue Laws Amendment Bill to crack down on corporate tax avoidance. In South Africa, the problem is with the organisations that take advantage of our legislation, tax base and our legal system. Companies and

individuals avoid tax through various convertible loan structures and certain transactions are structured in a way that 'they show complete and reckless disregard for tax morality and South African tax law.'[18] Such schemes hamper efforts to alleviate poverty, and hinder the overall development of South Africa. In South Africa, both companies and individuals pay huge amounts to professionals that will structure their tax affairs deliberately to avoid the tax consequences that should flow from the associated transactions thereby robbing not only the fiscus of tax revenue, but making the rest of South Africans liable for the shortfall in subsequent revenues.

The impact of global forces on the problem in South Africa has been exacerbated by local factors as well. These include the major changes that have been made to the South African income tax system over the past few years, including the shift from source to residency based taxation, the concomitant enactment of new 'controlled foreign company' rules, the introduction of a new tax on capital gains and the adaption of new company restructuring rules. At its worst, the very complexity of some of these new provisions can interfere with legitimate business transactions; and in some cases actually create new opportunities for mischief. At the same time, advances in computer and telecommunication technology have radically transformed the way in which multinational firms, particularly multinational accounting firms can share and exchange information. As a result, new tax avoidance schemes that are developed in the United Kingdom or the United States can now migrate to South Africa almost immediately for practical purposes, rather than taking months if not years to do so, as they might have in the past. This effectively puts the South African Revenue Service on the front line with the most advanced tax administrators in the world in combating these schemes. If the South African tax system becomes more aligned with the systems in the OECD countries, the chances of avoiding tax will be minimal. Though huge costs will be incurred by the South African government, this will be a good strategy to combat tax avoidance.

[17] *Discussion Paper on Tax Avoidance* and *Section 103* of the Income Tax Act, 1962 (Act No 58 of 1962), 2005

6.2 Causes

The forces driving these trends differ from one country to another. Major factors include globalisation, increasing deregulation, particularly in the financial markets[19], and rapid advances in computer and telecommunications technology. Crime, unemployment and other factors reduce investors' confidence in business and they are unprepared to pay their fair tax share to the South African Revenue Service. Companies are then motivated to seek out professionals to structure their tax affairs in such a way that they avoid tax for their businesses to increase their profit margins. Changing attitudes and market forces also play a major role. Thus, for example, 'the United States Department of Treasury has noted that some commentators explain the growth in corporate shelters as a reflection of more accepting attitudes of tax advisors and corporate executives toward aggressive tax planning.'[20] At the same time, lucrative markets for tax avoidance schemes and 'tax optimisation' plans have led to an increase in the resources and talent being devoted to those areas by professional firms in many countries.[21]

6.3 The Harm Caused by Impermissible Tax Avoidance

The harm caused by impermissible tax avoidance is different and persistent. They include short-term revenue loss, growing disrespect for the tax system and the law, increasingly complex tax legislation, the uneconomic allocation of resources, unfair shifting of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.[22] Short-term revenue loss is clearly the most immediate and obvious problem, but by no means the only problem.

6.3.1 Short-term revenue loss

The most immediate harm caused by impermissible tax avoidance is short-term revenue loss. Accurate estimates of the size of the problem are difficult to make, whether in South Africa or elsewhere. This has become a huge problem that South Africa is facing and it is also a challenge. Short-term revenue loss makes it difficult for the government to engage in proper planning. In part, these difficulties are due to disagreements about what constitutes impermissible tax avoidance; in part due to the fact that many schemes

[19] The Problem of Corporate Tax Shelters, op. cit. at 16
[20] The problem of Corporate Tax Shelters, op cit. n 19, at 19
[21] A taxing battle *The Economist* (29 Jan. 2004)
[22] Ralph Final Report, op. cit. n 5, at s. 6.2 *(c)*; Brooks, M and Head, J, op.cit. n 7, at 53

are deliberately designed to avoid detection. There is no question however, that the amounts at stake are substantial.[23]

6.3.2 Cost to the Economy

At a deeper level, impermissible tax avoidance creates significant deadweight losses for the economy by distorting trade and investment flows.[24] In particular, avoidance schemes often involve a re- or misallocation of resources from productive investments to activities that are, at best marginally profitable on a pre-tax basis.[25] These distortions reduce economic efficiency and impede growth.[26]

As the OECD has flatly stated: 'Tax avoidance and tax evasion are economically costly.'[27] These costs arise in a number of ways. At a basic level, to the extent that impermissible tax avoidance inevitably results in new amendments, more complex legislation and increasingly comprehensive and detailed reporting requirements, administrative costs and compliance burdens swell for both taxpayers and the government.[28] Additional costs are reflected in the resources that are diverted from productive investment to the development, marketing, implementation and subsequent defence of impermissible tax avoidance schemes. These so-called 'avoidance costs' can be substantial. Professional fees can often amount to a significant percentage of the promised tax benefits, especially in situations involving contingent fees or 'value billing' arrangements.

6.3.3 Disrespect for the Tax System and the Law

While short-term revenue loss may be the most immediate problem, it is by no means the most serious. Impermissible tax avoidance also encourages 'disrespect for the tax system – both by the people who participate in the tax shelter market and by others who

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[23]First Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (18 November 1994) at para. 5.1.6; Report of the Margo Commission, para. 27.4

[24]P Groenewegen, *Distributional and Allocation Effects of Tax Avoidance,* in D Collins ed., *Tax Avoidance and the Economy*, (Sydney, Australian Tax Research Foundation, 1984) at 23

[25] Ibid.

[26] Bankman, J, op. cit. n 35, at 18

[27] OECD, Forces Shaping Tax Policy, at 165

[28] OECD, Harmful Tax Competition . . . . op. cit. n 17, at 30

perceive unfairness.'[29] Even the New York State Bar Association – hardly a 'pro – tax' organisation – has decried this corrosive effect: -

'The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm and to follow the lead of other taxpayers who have engaged in tax advantaged transactions.'[30]

6.3.4 Unfair Shifting of the Tax Burden

Impermissible tax avoidance has a tremendous impact upon the equity and fairness of the tax system.[31] At its most basic level, it creates a 'form of subsidy for those paying their fair share of tax according to the intention of the law to those shirking their similar obligations.'[32] Taxpayers engaging in such impermissible tax avoidance have thus been seen as a particular aspect of the free rider problem.[33] At a more systematic level, impermissible tax avoidance, particularly in the context of globalisation and harmful tax competition, may severely constrain the ability of governments to tax income from capital and other relatively mobile sources.[34] These forces, in turn have tended to result in a shift of the tax burden to less mobile factors such as labour and consumption.[35] At the same time, by eroding the tax base, impermissible tax avoidance exerts an artificial upward pressure on marginal rates.

6.3.5 Increasing Complexity

Often harm manifests itself in increasingly complex tax laws. This problem has two aspects: one, a proliferation of specific anti-avoidance measures that are enacted in response to particular schemes that are discovered on audit; the other, a tendency to try and pre-empt possible avoidance through increasingly complex and detailed legislation in the first instance. While this complexity may sometimes be self- defeating, it invariably increases the compliance burden upon all taxpayers.

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[29]The problem of Corporate Tax Shelters op. cit. n 19, at 12
[30]Statement of Harold R. Handler, on behalf of the Tax Section, New York State Bar Association, Before the Committee on Finance (27 April 1999) at 2, 'quoted in The Problem of Corporate Tax Shelters', op.cit. n 19, at 3
[31]OECD, International Tax Terms . . . op .cit. n 4
[32]Ralph Final Report, op. cit. n5, at s.6.2 *(c)*
[33]Waincymer, J *The Australian Tax Avoidance Experience and Responses : A critical Review In Tax Avoidance* and *the Rule of Law*, op. cit. n 17 at 256
[34]OECD, Harmful Tax Competition. op. cit. n 17, at 23
[35]Avi-Yonah, RS *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State* (2000), 113*Harvard L Review* 1575, at 1578

6.3.6 Conclusion

Institutions involved in designing such aggressive tax schemes intending to abuse or misuse the law and deprive the fiscus of its fair share of revenue, must desist from such schemes. The consequences of failure in this regard will be seriously heavy penalties and closure of businesses could result depending on the court's decisions if the transactions are found to have illegal means to avoid tax. Therefore, South Africa must tighten its' legislation and the law must be tougher than before. Some of the decisions made in previous judgements should be re-visited when a transaction involving tax avoidance is found, for example, the South African Revenue Service and the courts should not only rely on imposing heavier penalties, but rather come up with stronger remedies.

7 LACK OF COMMERCIAL SUBSTANCE APPROACH

7.1 Introduction

The original abnormality factors generated a significant amount of comments in the past. In the case of companies, PAYE may be claimed for somebody who is a relative or extended family member who is not registered on the payroll of the company. This is purely a transaction with an element of tax avoidance in it. The current abnormality requirements have two fundamental weaknesses. Firstly, the tax world is not neatly divided into two types of arrangements, one for *bona fide* business transactions and the other for impermissible avoidance arrangements. To the contrary, promoters typically 'hijack' elements that were developed for non-tax reasons. Secondly, this dynamic often gives impermissible avoidance arrangements an underserved semblance of normality.
These weaknesses contribute directly to the practical problems that have been encountered under s 103(1). The Commissioner is often forced to procede on a case-by-case basis despite the common features of many impermissible avoidance arrangements. In addition, expert testimony is often required to pierce the semblance of normality that is created by the use of 'normal' elements. Finally, as several commentators have noted, the lack of an objective yardstick continues to leave the abnormality requirement open to an 'everyone's doing it' defence. In the light of these comments, the revised proposal

would strengthen and expand the current abnormality requirement by adding a new element or test explicitly targeting arrangements that lack commercial substance.[36]

Taking the above into account, the Act does not define what is normal or abnormal for the purpose of establishing whether the manner or means in which a transaction, operation or scheme has been entered into or carried out is normal, or whether the rights and obligations created are those which would normally be created between persons dealing at arm's length. The courts have therefore, in many cases involving tax avoidance been called upon to consider the question of normality and abnormality. The findings in these cases are important in giving guidance to those taxpayers and their advisors who are contemplating entering into tax avoidance schemes. This can also apply to taxpayers and advisors who wish to structure the schemes, so that there are no elements of abnormality which could result in the schemes failing with regard to the tax avoidance purpose.

Many of the tax avoidance cases which have been heard by the courts since 1990 have resulted from the attempts by the Commissioner to attack the widespread increase in tax avoidance schemes after 1985. (See 15 *supra*). The latter cases in which decisions have been made on the question of abnormality, and which have been reported, are all cases which were heard in the *Special Court for Hearing Income Tax Appeals*. The findings in these later cases do not, therefore, create precedent as do the findings in cases heard at the *High Court and Supreme Court of Appeal* level. It is interesting that amendments have however, been introduced into the Act and are apparently in response to some of the decisions in these cases heard in the *Special Court*. (See 15 *supra*).

This new commercial substance element would apply whether or not an arrangement would be considered 'abnormal' under current law. As a guiding principle and general rule, a lack of commercial substance would encompass any avoidance arrangement that fails to have a substantial impact upon any parties –

- business or commercial risks, or
- net cash flows, or

[36] Proposed section 80A*(a)*(ii)

- beneficial ownership of any asset involved in the avoidance arrangement, apart from any effect attributable to the tax benefit that would be obtained, but for the provisions of the new GAAR.[37]

The revised proposals would also identify five characteristics that are generally indicative of arrangements that lack commercial substance.[38] These characteristics encompass situations in which –

- The legal or economic effect resulting from the avoidance arrangement as a whole is inconsistent with, or differs substantially from the legal form of its' individual steps;
- The avoidance arrangement includes or involves –
  - Round- trip financing;
  - An accommodating or tax indifferent party;
  - Elements that have the effect of offsetting or cancelling each other without a substantial change in the economic position of any one or more of the parties; or
- There is an inconsistent characterisation of the avoidance arrangement for tax purposes by the parties.

The list is non-exclusive and is intended to provide additional guidance in identifying avoidance arrangements that lack commercial substance.

7.2 Examples of abusive avoidance schemes

7.2.1 No mechanical definition or bright-line test

Following a tremendous amount of study and critical analysis devoted to this topic internationally, there has been a growing realisation that a single mechanical definition of abusive avoidance schemes is simply not possible. Such schemes appear to create improper tax planning as the revenue authorities would be unable to set proper targets, and unable to estimate their spending.

[37] Proposed section 80C(1)
[38] Proposed section 80C(2)

7.2.2 Common Characteristics

However, there has been a growing recognition that many of the most abusive avoidance schemes share common attributes – what have sometimes been called the hallmarks or badges of avoidance. These characteristics include:

- the lack of economic substance (usually resulting from pre-arranged circular or self-cancelling arrangements);
- the use of tax-indifferent accommodating parties or special purpose entities;
- unnecessary steps and complexity;
- inconsistent treatment for tax and financial accounting purposes;
- high transaction costs; and
- fee variation clauses or contingent fee provisions.[39]

Other characteristics could include significant marketing activities by promoters, which have been a serious issue, for example, both in Australia and the United States, and the involvement of taxpayers in activities outside their normal areas of expertise. Films and plantation schemes are typical examples of the latter, in South Africa. Schemes possessing most, if not all, of these characteristics are referred to generally as *'abusive avoidance schemes'*.

7.2.3 Lack of economic substance

One of the most important characteristics of abusive avoidance schemes is the lack of economic substance. In many abusive avoidance schemes, the taxpayer purports to make a substantial investment. This investment however, is largely an illusion. Through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary.

In any investment, risk and return are related – the greater the risk, the greater the return. As a consequence, in so far as most abusive avoidance schemes typically involve little or no economic risk, they typically offer little or no opportunity for pre-tax gain.[40] Rather, the 'return' to the 'investor' takes the form of the significant tax benefits promised by the arrangement. In this manner, 'a negligible pre-tax profit is transformed

[39] See ITC 1496 (1990) 53 SATC 229

[40] Indeed, in many cases, the purported pre-tax profit is actually less than the transaction fees and costs. In other examples, the transactions actually produce pre-tax losses.

into a significant after-tax return'[41]. Indeed, the mismatch between a limited (or non-existent) potential for pre-tax profit and the promise of very significant tax benefits is often a good indicator of an abusive avoidance scheme.

7.2.4 High transaction costs

Given particularly, the complexity of many abusive avoidance schemes and the development and marketing costs often incurred by promoters, it is not surprising that fees tend to be extremely high. In a recent film scheme, for example, the fee paid to the promoter actually exceeded the amount that went to the film producer. In other financing transactions, fees can easily run into millions.

7.2.5 Unnecessary steps and complexity

Abusive avoidance schemes are often not accompanied by genuine commercial activity. There are several reasons for this. These schemes often require the completion of certain formalistic steps to claim the desired tax result. In so-called 'bare dominium' schemes, for example, promissory notes evidencing future rental obligations are typically discounted through a tax indifferent party in order to enable the financing party to avoid tax on the full amounts received (while the borrower in the transaction continues to claim deductions for the full amount of the 'rent'). Similarly, a complex structure may be used to disguise the true nature of a scheme or 'as a device to cloak the tax shelter transaction from detection.'[42]

7.2.6 Conclusion

The legislation should be expanded and reinforce the existing abnormality requirement through the introduction of a new commercial substance element or test. Heavy penalties and other factors that will combat tax avoidance should be implemented to reduce or eradicate these schemes. Furthermore the taxpayer had to bear in mind the onus of proof under s 103(1). The taxpayer must at all time act against s 82 of the Act, when entering into a tax avoidance arrangement which means proof must always be provided when needed. Once this is shown, South African Revenue Service bears the onus of showing that all four requirements have been met, should South African

[41]The Problem of Corporate Tax Shelters, op. cit. n 19, at 15
[42]The Problem of Corporate Tax Shelters op. cit. n 19, at16

Revenue Service wish to invoke the provisions of s 103(1) of the Act. With the advent of the new s 80A to 80L, the question of onus has been charged.

If a transaction or an arrangement is found containing an element of tax-avoidance, the new provisions of s 80A*(c)*(ii) of the Act should be applied as this section is capable of reinforcing the modern approach to the interpretation of tax statutes.[43] This implies that it will strengthen or support the modern approach. This begs the following question: Will s 80A*(c)*(ii) strengthens (increase) or merely support (maintain) the modern approach? In common law tradition, there are two broad approaches to the interpretation of statutes (which includes tax statutes), namely the traditional and the modern approach. In order to evaluate the ability of s 80A*(c)*(ii) to reinforce the modern approach, it will be necessary to construe the meaning of the phrase 'a misuse or abuse of the provisions.'[44] For it to reinforce the modern approach, it is submitted the meaning of the phrase must prescribe such an approach. It will also be necessary to evaluate the scope of s 80A*(c)*(ii) in order to ascertain whether it is wide enough to reinforce the modern approach.

7.3 Proposed Changes

7.3.1 An objective purpose requirement

The proposed amendments would change the purpose requirement to an objective test in accordance with the practice in other countries. In particular, the proposed amendment would require the determination to be made 'objectively by reference to the relevant facts and circumstances.'[45] The amendment is intended to preclude the anomalous results identified by RC Williams that could potentially arise under the current provisions.[46] It is anticipated that it will be very difficult for a taxpayer to rebut the presumption of a 'tax avoidance' purpose in any case in which a tax effect has been established and the taxpayer has been unable to rebut a presumption of 'abnormality' arising under the proposed amendment to the abnormality requirement.

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[43] *Meditari Accountancy Research* Vol. 17 No. 2 2009 : 167-185
[44] Ibid.
[45] SARS: *Discussion Paper on Tax Avoidance* and *Section 103* of the Income Tax Act, 1962 (Act No 58 of 1962), November 2005, at 44
[46] William, RC, op. cit. n 148, at 675

7.3.2 Application in the Alternative

In many cases, there is often a threshold dispute in respect of the applicability of a specific provision. For example, given the complexity of many derivatives, an audit may well involve a very technical dispute as to whether or not a particular arrangement constitutes an instrument for the purpose of s 24J of the Act. At the same time, the arrangement may be so artificial and contrived that the application of s 103(1) may also be appropriate (in the event that the arrangement does avoid s 24J on technical grounds). Permitting the Commissioner to raise GAAR (s 80A to 80L) as an alternative basis for an assessment, after giving proper notice to the taxpayer, simply makes sense from the standpoint of administrative and judicial economy and would bring South Africa into in line with Australia, Canada and New Zealand.

7.3.3 Penalties

Experience from other jurisdictions, including Australia, Canada, the United Kingdom and the Unites States, has shown that a significant portion of the tax avoidance problem is attributable to the aggressive marketing of abusive avoidance schemes by various promoters. At present, however, the Act does not contain any penalties specifically applicable to them. Given the lucrative fees involved and the extent to which promoters can protect themselves through devices like fee variation clauses, such penalties are an essential element of any effort to deter impermissible tax avoidance. In addition, separate amendments would also be proposed to introduce a new penalty that would be imposed in the event of a substantial understatement of income by a taxpayer.

7.3.4 Implementation and Related Issues

As noted above, it is anticipated that the Advance Tax Ruling System would be modified as it is phased in so as to permit taxpayers to obtain greater guidance and certainty in respect of the application of the new provisions. It is also anticipated that the Commissioner will develop and implement procedures to ensure their consistent and appropriate application. Changes to the 'reportable arrangement' rules would also be made in order to capture transactions embodying the factors giving rise to a presumption of abnormality. Finally, as noted above, these provisions may provide the

necessary and essential foundation for possible tax reform and simplification in the future.

7.3.5 Conclusion

The above proposed changes will be of good use to the Commissioner of the South African Revenue Service and if the proposed changes can be applied correctly and without bias, cases with a tax avoidance element will be presented less often both in the courts and to the South African Revenue Service. However, the honest, hard-working taxpayers of South Africa deserve better. The South African government and the group of experts must sit down and try to come up with a strategy to reward those taxpayers and this could be a step forward for the government to try to combat tax avoidance and even if not completely successful, a meaningful progress can be made out of this by encouraging others to come forward and do the right thing.

8. SUBSTANCE VERSUS FORM APPROACH

8.1 Introduction

Tax is always based on the substance of a transaction, rather than its form. This means that if the written agreement between two persons (the form) is different from their true intention (the substance); tax is based on their true intention, because that is the real agreement. In the case of *Zandberg v Van Zyl*[47] the court said:

> 'Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what it should have. Not infrequently however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose) the parties to a contract endeavour to conceal its real character. They call it by a name, or give it(s) shape, intended not to express but to disguise its true nature. And when the court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies *plus valet quo agitur quam quod simulate concipitur.* (What it says is that truth and not simulation will win the day – this is an unalterable rule and throughout life one experiences this axiom in action: whether in law, religion, politics or economics). But the words of the rule indicate its limitations.

[47] 1910 AD 309

> The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstance that the same object might have been attained in another way will not necessarily make the arrangement other than what it purports to be.'

It may be that where the substance of a transaction is different from its form, this amounts at least to tax avoidance. In either case South African Revenue Service will not have to apply anti-avoidance rules, it will merely tax the true transaction.

> 'In another case, that of *Erf 3183/1 Ladysmith (Pty) Ltd v CIR* (1996 (3) SA 942 (A), 58 SATC 229): Company 1 owned vacant land. Its holding company wanted to build a furniture factory on the land. If the land was leased to another company within the group with the requirement that it build the factory on the land, the lessee would have written the cost of the building off, over the period of lease, as a leasehold improvement. The lessor would have been taxed on the value of the improvements in terms of paragraph *(h)* of the gross income definition. They therefore devised the following plan –
>
> The lessor let the land to a pension fund which was a tax–exempt entity. The pension fund was not obliged to build the factory on the land. The pension fund sub-let the land to the lessee and there was an obligation placed on the lessee to pay a lease premium to the pension fund, which would enable the pension fund to build the factory. The lessee (at that time) could not write off the cost of the leasehold improvements under section 11*(g)* of the Income Tax Act, as the pension fund was not taxed. However, section 11*(f)* allowed a deduction of a lease premium even if the sub-lessor was not taxed. The section has since been amended'. [Taken from the facts in the case of *Erf 3183/1 Ladysmith (Pty) Ltd v CIR* (1996 (3) SA 942 *(a)*, 58 SATC 229].

As the Commissioner could not tax the pension fund, the agreements were looked at and someone asked the question – if the pension fund could require the lessee to pay a lease premium, then wasn't there really an agreement between the lessor and the pension fund that the factory had to be built? The court held that there was a real likelihood that there was an unexpressed agreement that the lessor would be able to require the pension fund to build the factory. It said that the written agreement probably did not reflect the parties' full intentions. Therefore, the lease between the lessor and the pension fund, in substance required the pension fund to build the factory. In the circumstances the Revenue Service was entitled to apply paragraph *(h)* of the gross income definition to tax the lessor on the value of the factory as a leasehold improvement.

One could say that this was a tax avoidance scheme, but it was not necessary to apply any anti-avoidance rule to tax it. The scheme did not go as far as being tax evasion, because the lease agreement was not fraudulent. The court merely said that it was probable that there were extra requirements which were not specifically referred to in the lease agreement, and that all the requirements had to be looked at together to work out the parties' overall intentions.

Another case involving a transaction entered into or carried out solely or mainly for the purpose of avoiding, postponing or reducing the liability for any tax, duty or levy under the Act or under any other law administered by South African Revenue Service (which s 103(1) defined as being a 'tax benefit' was the *Commissioner for Inland Revenue v Conhage (Pty) Ltd*[48] , this case stipulates the transaction that was entered into in order to avoid tax in the form of sale and leaseback agreements.

> 'A taxpayer entering into two sets of agreements with a bank and in form each set comprised a sale and leaseback of some of its manufacturing plant and equipment. The true nature and substance of such agreements was whether such agreements were simulated transactions – the Commissioner for Inland Revenue contended that, despite the form of the agreements, the taxpayer did not sell and lease back its equipment, but in substance borrowed the purchase price from the bank. The question was whether the Commissioner for Inland Revenue had correctly invoked s 103(1) of the Act? It was held that the evidence that parties had every intention of entering into agreements of sale and leaseback and of putting the agreements into effect had not been contradicted. The special court had not erred in finding that there was not sufficient reason to doubt the authenticity of the agreements at issue. Furthermore, it was held that it was by no means unusual to find provisions in a sale and leaseback which did not typically appear in a contract of purchase and sale or in a contract of lease. Although a sale and leaseback comprises an agreement of sale as well as an agreement of lease, it must be treated as one composite transaction'.

8.2 Examples of abusive avoidance schemes and proposed changes

The same principles to be applied under this topic were discussed above when dealing with the lack of commercial substance approach.

[48] 61 SATC 391

9. SECTION 80A TO 80L OF THE INCOME TAX ACT, REVISED GAAR

9.1 General

As mentioned, the General Anti-Avoidance Rule (GAAR) was embodied in s 103(1) of the Act. Essentially, for the GAAR to apply, four requirements had to be satisfied (See discussion on page 13 *supra*).

With regard to the 'abnormality' requirement, it was interpreted by the courts on a number of occasions, and it could be quite difficult for the South African Revenue Service to prove that an abnormality existed (the burden of proof in this case being on the South African Revenue Service). But what really weakened the s 103(1) irretrievably and raised question marks concerning the *Ladysmith (Pty) Ltd v CIR* 1996 (3) SA 942 *(a)*, 58 SATC 229 was the *Conhage case*,[49] which essentially denied the application of the s 103(1) to any inserted step or part of a composite transaction, even though the inserted step or part was solely tax-motivated, as long as the entire transaction was commercially motivated, i.e. not motivated by tax reasons.

As the result of the above, GAAR proposed six changes, where it is believed that this will strengthen and tighten any loophole that may be in existence:

- Firstly, rather than testing whether the purpose of the scheme was solely or mainly to obtain a tax benefit by looking at the taxpayer's subjective intent, it was proposed that the purpose of the scheme be tested objectively by reference to the relevant facts and circumstances.
- Secondly, because of the difficulties caused by the abnormality requirement, it was proposed that the legislation include a non-exclusive list of factors which would be used in determining abnormality. The proposal also stated that, if any of those factors were present, there was a rebuttable presumption of abnormality. The list of 'indicia or indicators' included the presence of a circular flow of cash or assets, the participation of a tax-indifferent party, the presence of offsetting or self-cancelling steps, and the absence of a reasonable expectation of a pre-tax profit.

[49] *CIR v Conhage (Pty) Limited* [1994] 4 SA 1149 (SCA); 61 SATC 391

- Thirdly, to counter the effect of the *Conhage* decision, it was proposed that the new legislation apply to the scheme as a whole as well as to any step therein or part thereof.
- Fourthly, contrary to the opinion in relation to the existing GAAR, the new GAAR could be applied in the alternative to other legislation.
- Fifthly, in contrast to the existing GAAR, which could be applied where the sole or main purpose of the scheme was to obtain a tax benefit, the new GAAR would apply where the sole or one of the main purposes was to obtain a tax benefit (the grammatical difficulties arising from this formulation gave rise to much discussion).
- Finally, and most controversially, it was proposed that penalties be imposed on both the promoters of a scheme and the taxpayers who participate in it.

Under the GAAR, there were also some responses from the South African Revenue Service and the Treasury, some of the more pertinent responses, particularly in relation to the controversial areas, are summarised below:

- Much criticism was levelled against the indicia of abnormality, one of the criticisms being that a circular flow of cash or assets was very common, without in any way being sinister (for example, the mere fact that a loan is advanced and then repaid involves a circular flow of funds). Also criticised was the wide definition of 'tax indifferent party', which could include an innocent special purpose vehicle in a transaction or even, literally interpreted, a new company formed to buy a business. The South African Revenue Service indicated that it was not unsympathetic to these concerns and, indeed, while the principles found their way into the legislation, their scope was narrowed down somewhat.
- Concern was expressed that there would be a lack of guidance as to how South African Revenue Service intended to interpret the legislation and also that different branch offices of the South African Revenue Service might interpret and apply GAAR differently. Consideration was also given to centralising the decision to apply GAAR by a committee at the head office of the South African Revenue Service in order to ensure its consistent application. (There is, however, nothing in the legislation requiring this.)

- Generally, vociferous opposition was expressed against the presumption of abnormality and, while the presumption was defended, the South African Revenue Service stated that it appreciated the concerns that had been raised. At the end of the day, the presumption of abnormality did not find its way into the legislation.
- Another area of concern was that the 'purpose' requirement (i.e. that the sole or main purpose of the scheme [to obtain a tax benefit] was to be determined objectively) in effect nullified the subjective element and, in any event, was contrary to what the courts had previously stated on the matter[50] because it had the result that there was no difference between the purpose of the scheme and its effect (the latter being one of the other four requirements). Once again, this was defended quite vociferously, but at the end of the day, the test was left as a subjective purpose test.[51]

Moreover, the South African Revenue Service dismissed criticism of the attempt to change the test from the 'sole or one of the main purposes'. The South African Revenue Service also dismissed, as being on 'a somewhat lighter note', the criticisms levelled against the grammatical difficulties in interpreting the test. Despite this, the legislation continues to retain the expression 'sole or main purpose'.

The General Anti-Avoidance Rule (GAAR) was introduced mainly to target the 'most serious elements' of schemes devised purely for the avoidance of taxation. This rule will be supported by an enhanced system of required reporting known as 'reportable arrangements' to give the government an early detection system. In real terms, these schemes cost the fiscus billions in tax revenue and that money can be much better spent for society's benefit elsewhere. The new rules will also primarily target businesses and high net-worth individuals who can afford tax consultants. No doubt there will be a great deal written about these provisions in the months and years to come, as taxpayers and their advisors grapple with the problem of its interpretation, in the absence of specific case law on the new GAAR.

[50] *SIR v Gallagher*, 1978 (2) SA 463 A; 40 SATC 39
[51] Sec 103

The GAAR, by its nature, operates in tension with this notion. It imposes limits upon the extent to which an 'ordering of affairs' is to be respected for tax purposes. This rule comes as a relief to the poor, because they cannot afford to pay for tax avoidance advice, and as a result end up paying the major portion of the tax burden. Hopefully, the results will bring an eventual reduction in tax rates for all South Africans. The new General Anti-Avoidance Rule will serve as an income producing tool in both South Africa and other countries, it will boost the economy, help to reduce government borrowings, improve the unemployment rate and shrink criminal offences. Everyone will be paying his/her fair share of taxes and contributing towards the national fiscus. Short-term revenue loss, which is the most important harm caused by tax avoidance schemes, having been obviated.

9.2 The Introduction of the GAAR

9.2.1 The role of the GAAR

It is equally important to emphasise what a GAAR is not. It is not a provision to facilitate criminal charges. In addition, a GAAR is not, and should not become a substitute for well drafted and well designed legislation. The GAAR nevertheless reflects a fundamental recognition that even the best drafted, best designed tax legislation cannot anticipate every possible nuance and circumstance that may arise, let alone every scheme that may later be devised in response to it.[52] It will enable both the South African Revenue Service and the courts to interpret the provisions less harshly as far as taxpayers are concerned. This was described as the most powerful tool/legislation developed to get rid of uncertainties, where doubts that emerged when a decision has to be made on a case involving avoidance. The GAAR was developed to give the courts and the South African Revenue Service a clear understanding of any transaction incorporating an element of avoidance within that transaction and also to come up with a precise decision that would satisfy both parties. The GAAR would target the 'most serious elements' of schemes devised purely for the avoidance of taxation, and would be supported by an enhanced system of required reporting known as 'reportable arrangements' to give the government an early detection system. If South Africa can get the wording right in this new GAAR, then these schemes will come to an end.

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[52]Cooper, GS. *Conflicts, Challenge and Choices* – The Rule of Law and Anti-Avoidance Rules in Tax Avoidance and the Rule of Law, op. cit. n 7 at 13

9.2.2 Application of the GAAR

The application of the General Anti-Avoidance Rule (s 80A to 80L) to impermissible tax avoidance 'schemes' may help to stem the tide of short – term revenue loss. The GAAR itself is a revenue raising measure. It is intended to protect the tax base established by Parliament, not to expand it.[53] This protection may in turn provide the necessary and essential foundation for any future tax reform and simplification, particularly in the area of business tax. The provisions of the new GAAR present a challenge to both taxpayers and their advisers as they attempt to determine exactly how the new legislation should be interpreted and how it will apply. Parliament was well aware of the fact that there was a tax gap in previous years based on the old s 103(1).
The GAAR no doubt came as a welcome relief to our legislators as there should now be more revenue to be collected and distributed and the taxpayers will not find any space to try and arrange their tax affairs in a manner that will avoid tax. 'As the GAAR was developed mainly to protect the liability for the income tax established under the other provisions of the legislation,[54] and as the new s 80A to 80L are fairly strict, the courts are likely to interpret the provisions less harshly as far as the taxpayers are concerned'.

9.2.3 The lack of commercial substance

The GAAR defines 'lack of commercial substance' as meaning that the avoidance arrangement would result in a significant tax benefit for a party, but the arrangement does not have a significant effect upon either the business risks or net cash flows of that party (other than the effect attributable to the tax benefit). These are very broad, and even vague, concepts. The legislation does, however give a list of indications of where a lack of commercial substance would exist, (but the legislation is at pains to point out that the list is not exhaustive). The first is where the legal substance of the avoidance arrangement as a whole is inconsistent with, or differs significantly from the legal form of its separate steps. The entire area of legal substance versus legal form is a complex area of the law and one that has been referred to and dealt with on a number of occasions by the South African courts.[55] What is new here is that the legislation

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[53] Joffe H *Never mind the technicalities of tax, let's hear the philosophy*, Business Day (12 April 2005), at 8
[54] *CIR v BNZ Investments* [2002] 1 NZLR 450
[55] Mazansky, Ernest, *The Duke of Westminster Still Lives in South Africa* (But Is Very Careful

attempts to import into South African law the effect of certain decisions in the United Kingdom[56] on the basis that, while the legal substance of each separate step conforms with the legal form, the legal substance of the avoidance arrangement as a whole does not. Once again, it will be up to the courts to determine the scope and meaning of this provision (and similarly, it is likely to be some years before this happens).

Another indication is the inclusion or presence of:

- Round- trip financing;
- an accommodating or tax–indifferent party; or
- elements that have the effect of off-setting or cancelling each other.

The offsetting or self-cancelling aspects are also concepts imported into South African law from decisions of the UK and US courts. These aspects, unlike the other two, are not dealt with further in the legislation.

9.2.4 The effect of avoiding tax versus a tax benefit

The effect of avoiding tax can increase the country's debt and force it to borrow funds from other countries, the interest that would be paid and the effect on the inflation rate would be high and that would tend to move the economy towards a recession scenario. Short-term revenue loss would also be the most immediate and obvious problem. The un-employment rate would go up leading to increased crime and the closure of companies which would impact negatively on the country's economy. Other countries interest in investing in South Africa would be reduced, because it would be perceived to lack control over its tax morality and tax laws. The effect of avoiding tax would also hinder the overall development of South Africa and hamper its efforts to alleviate poverty. In terms of tax benefit, the following points stand out in the revised GAAR:

- an impermissible avoidance arrangement means any avoidance arrangement described in s 80A;
- an avoidance arrangement means any arrangement that, but for the provisions of this part results in a tax benefit;

When He Crosses the Road), 59 Bulletin for International Fiscal Documentation 3 (2005), at 116

[56] WT Ramsey Ltd v IRC, [1981] ALL ER 865; and Furniss v Dawson, [1984] AC 474

- a tax benefit includes any avoidance, postponement, or reduction of any liability for tax;

- tax includes any tax, levy, or duty imposed by the Act or any other Act administered by the Commissioner

In South Africa, if we are all honest with our tax affairs, the tax paid to South African Revenue Service will also benefit us as a nation, because the more that people pay their fair share of taxes to South African Revenue Service, the more this will result in eventual reduction in tax rates, State coffers would fill up, leading to reduced government borrowing. This would come as a relief to honest taxpayers, as most of them want to lift the country's economy, for the creation of jobs and other projects that are still in the pipe-line for the government to pursue.

9.2.5 The purpose requirements

Another area of concern was that the 'purpose' requirement (i.e. that the sole or main purpose of the scheme [to obtain a tax benefit] was determined objectively) in effect nullified the subjective element and, in any event was contrary to what the courts had previously stated on the matter,[57] because it had the result that there was no difference between the purpose of the scheme and its effect (the latter being one of the other four requirements). Once again, this was defended quite vociferously, the end result being that the test was left as a subjective test.[58] In most other countries, such as UK; Canada etc, the courts and their authorities, have come to the opposite conclusion in interpreting legislation which referred to 'the purpose of an arrangement.' The principle that has been established is that, it is difficult to prove the intention of the taxpayer.

The legislation must be very clear on this one as most taxpayers will enter into a transaction in both ways. It can be entered into or carried out for the sole or main purpose of obtaining a tax benefit or unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. In terms of s 80A – 'an arrangement is an impermissible avoidance arrangement in that

[57] *SIR v Gallagher*, 1978 (2) SA 463 A; 40 SATC 39.
[58] Sec 103

its sole or main purpose was to obtain a tax benefit'. Have the ground rules changed? The question is then; must the courts now apply an objective test? Rather, the courts have ruled that the onus lies with the Commissioner to prove that the presence of all the requirements for the application of s 103(1), subject to the proviso that once the tax avoidance effect of the transaction had been proven by the Commissioner, the onus then shifts to the taxpayer to prove that the taxpayer's main purpose was not to avoid tax.[59]

The Commissioner can also rely on s 80H which empowers him to apply the provisions of the GAAR to steps in or part of an arrangement, and also s 80G(2) provides that the purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole. Most probably the legislature was out to destroy the principle that had been established by the courts in cases like *Conhage*, to the effect that where a transaction, operation, or scheme was entered into for an overriding non-tax reason, the Commissioner could not apply s 103(1) to any steps in or parts of that transaction, operation, or scheme which were tax driven.

9.2.6 The tainted element

The tainted element is one of the tools that both the taxpayers and their advisors used to design such avoidance arrangements. The provision of s 80C of the Income Tax Act (the Act) was no doubt intended to form the heart of the new general anti-avoidance rule. It is however poorly and ambiguously drafted, and requires urgent 'by-pass surgery' in order to bring about further clarity.

9.2.7 The legal substance of the avoidance agreement

The first characteristic is that the legal substance or effects of the avoidance arrangement as a whole is inconsistent with, or differs significantly from the legal form of its individual steps. It is necessary to obtain clarity about the nature of this test. For a start, it must not be confused with the familiar substance-versus-form issue as considered, for example in *Relier (Pty) Ltd v CIR.*[60] The well-known substance–over-form exercise explained in the *Relier* case must indeed always be applied in tax cases

[59] *CIR v Conhage* (Pty) Ltd 1999 (4) SA 1149 (SCA)
[60] [1997] (SCA), 60 SATC 1

involving potential tax avoidance arrangements. But that exercise must be carried out and completed before even beginning to consider whether the provisions of the general anti-avoidance rule apply to the arrangement in question. The substance–over-form rule may well require the stripping away of the form of a sham transaction and the exposing of its true substance. The point is however that the provisions of the general anti-avoidance rule are to be applied only to its true rights and obligations that have been identified after all substance–versus-form issues have been resolved.

The test as postulated in s 80C(2)*(a)* must accordingly refer to a different comparison. It seems to require that a comparison be made between the following:

- on the other hand, the 'legal substance or effect' of the whole scheme, and
- on the other hand, the 'legal form' of the individual steps.

This is confusing, because the word '*legal*' is used in relation to either the substance or effect of the avoidance arrangement as a whole, and in relation to the form of its individual steps. However, in common and also in judicial parlance the word '*legal*' is usually used to draw a contrast between the legal effect of an arrangement and its' economic or commercial effect.

By way of example, in *Barclays Mercantile Business Finance Ltd v HM Inspector of Taxes*,[61] the court interpreted a provision in the United Kingdom legislation that referred to the cost to the taxpayer of an asset, by applying the legal meaning of the word 'cost' and not it's economic meaning. In the result, the court allowed the taxpayer to deduct the cost price of machinery expressed to be payable by the taxpayer in terms of a written contract forming part of a sale and lease-back scheme. Even though there was no economic cost to the taxpayer once the economic effect of the whole scheme was taken into account. In short, the test set out in s 80C(2)*(a)* would have made obvious sense if it had referred to the situation in which 'the (economic effect) of an avoidance arrangement as a whole is inconsistent with, or differs significantly from the legal (effect) of its individual steps'.

[61] [2005] STC 1

The wording would also have accorded with the object of the exercise, namely to determine whether the arrangement as a whole had commercial substance. But it does not read that way, so the question must still be asked: what is meant by the term 'the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from the legal form of its individual steps'? Some might argue that the test is meaningless because the 'legal substance or effect' of the avoidance arrangement as a whole can never amount to anything more or less than the totality of the 'legal nature' of its individual steps.

9.2.8 Lack of commercial substance – round- trip financing

Round-trip financing includes any avoidance arrangement in which the following occurs:

- funds are transferred between or among the parties; and
- the transfer results directly or indirectly in a tax benefit, and it significantly reduces, offsets or eliminates any business risk incurred by any party to the avoidance arrangement.

Anticipating a factual attack on these tests, the legislation states that no regard may be had to -

(a) whether or not the round tripped amounts can be traced to funds transferred to or received by any other party
(b) the timing or sequence in which the amounts are transferred or received or
(c) the means by or manner in which the amounts are transferred or received

9.2.9 Lack of commercial substance – the presence of an accommodating or tax indifferent party

The third 'indicator' of an arrangement lacking commercial substance is the presence of an 'accommodating or tax-indifferent party'. The provision of s 80E(2) provides that '[a] party to an avoidance arrangement is an accommodating or tax-indifferent party if-

(a) any party amount derived by the party in connection with the avoidance arrangement is either –

- not subject to normal tax; or
- significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any other assessed loss of that party; and

(b) either:

- as a direct or indirect result of the participation of that party an amount that would have –

(aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature or another party would be included in the gross income or receipts or accruals of a capital nature of that party; or

(bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party; or

(cc) constituted revenue in the hands of another party would be treated as capital by that other party; or

(dd) gives rise to taxable income to another party that would either not be included in gross income or be exempt from normal tax; or

(ee) the participation of that party directly or indirectly involves a prepayment by any other party.[62]

[62] SARS, *Draft Guide to Reportable Arrangements*

At least in this instance one can discern the possibility, but not the certainty of a relevant connection, albeit tenuous between the status of the taxpayer and the fact that there is an accommodating party involved in an arrangement to which the taxpayer is also a party. Yet, on closer examination, it becomes apparent that it would be impermissible to draw any inference against the taxpayer from the mere fact that they are an accommodating party figure in the arrangement, the reason is that the fact that an arrangement includes an accommodating party tells one nothing about the quantum of any economic benefit derived by the taxpayer.

An accommodating or tax-indifferent party (accommodating party) to an avoidance arrangement is one who participates where the following alternative circumstances exist:

- the amount received by the accommodating party is not subject to normal tax in South Africa or is significantly offset by any expenditure or loss; or
- because of the party's participation

(a) something that would have been taxable in someone else's hands becomes capital in the accommodating party's hands
(b) something that would have been non-deductible in someone else's hands becomes deductible in the accommodating party's hands
(c) something that would have been taxable in someone else's hands is exempt in the accommodating party's; or
(d) the accommodating party's participation directly or indirectly involves a prepayment by someone else.

There are two exclusions to prevent ordinary business transactions from being caught within the net. The first is, if the potential accommodating party is taxable in another country in an amount equal to at least two thirds of the tax that would have been payable in South Africa. The second is, if the potential accommodating party continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months and the activities are attributable to a proper place of business (equivalent to a foreign business establishment as defined in s 9D of the Act, which is the *Controlled Foreign Companies* (CFC) legislation, if it were located outside South Africa).

9.2.10 Lack of commercial substance – the arrangements include elements that have the effect of offsetting or cancelling each other

The offsetting or self-cancelling aspects are also concepts imported into South African law from decisions of the UK and US courts.[63] In terms of s 80C(2)*(b)*(iii), an arrangement which includes 'elements that have the effect of offsetting or cancelling each other', indicates a lack of commercial substance. The self-neutralising mechanism described here will be readily recognised as a feature of the type of tax avoidance scheme considered by the court[64] . In fact, if one runs one finger down the list of characteristics which are in s 80C to indicate a lack of commercial substance, it is apparent that they are all features of a specific type of tax avoidance scheme, namely, the type of scheme in which a party without any economic interest is interposed in an arrangement so as to procure a tax benefit for the 'real' parties.

Perhaps some of the problems besetting the new general anti-avoidance rule might have been avoided if this type of scheme had been countered by way of a specific-anti-tax avoidance provision in the Act, rather by way of inclusion in the general anti-avoidance rule. To sum up the appraisal of s 80C and its appendages, it would seem that the drafters have linked together in s 80C(1) and s 80C(2) two types of tests for a commercial substance that are incompatible. In the aggregate s 80C is fraught with confusion.

There is probably only one way to handle a situation such as this, at least until these issues have been resolved. The logical and jurisprudential anomalies should be ignored and the arrangement under consideration should be evaluated as if s 80C(1) and s 80C (2) postulated separate and distinct tests. If the arrangement fails either,

- the s 80C(1) test, or
- any one of the guidelines, or whatever they are as described in s 80C (2), it should be assumed that the arrangement is at risk of a successful attack by the commissioner.

[63] *WT Ramsey Ltd v IRC*, supra note 13, and *Knetsch v United States*, 364 U.S. 361 (1960)
[64] *Furniss (Inspector of Taxes) v Dawson* (1984) 1 AII ER 530 (HL)

9.2.11 Reportable Arrangements

An 'arrangement' is widely defined in s 80T to include any transaction, operation or scheme; interrelated transactions might be considered as forming part of a larger scheme and falling within this definition. The onus is on the participant to an arrangement to determine whether it needs to be disclosed to South African Revenue Service and to prove on the balance of probabilities that the transaction operation or scheme does not constitute an 'arrangement' as defined. Whether a transaction, which forms part of a larger scheme, is disclosed to South African Revenue Service and the remainder of the scheme will also need to be disclosed.[65]

Conversely, where the wider scheme is disclosed to South African Revenue Service, the component parts do not have to be so disclosed. When in doubt, the participant should disclose the transaction or part of a scheme to avoid a potential exposure to the R1 million non-disclosure penalty.

When dealing with these kinds of arrangement, one must also bear in mind the purpose of the legislature in respect to 'reportable arrangements'. One of the purposes is to provide an early warning system of potential tax-aggressive products being implemented in South Africa. These would enable South African Revenue Service to respond to any kind of identified abuse. Responses to such products may vary and could include legislative proposals as well as challenging the transaction in terms of the current law.

In essence, s 76A provided that every company or trust which derived any tax benefit in terms of a 'reportable arrangement' had to disclose that arrangement to the Commissioner within sixty (60) days after the date that any amount was first received by, or accrued to, any person or was paid or actually incurred by any person in terms of that arrangement. The period could also be extended by no more than 60 days if the Commissioner was satisfied that reasonable grounds existed for the delay in reporting such an arrangement.[66]

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[65]SARS, 31 March 2010 : *Draft Guide to Reportable Arrangements*
[66]Sec 76A of the Income Tax Act

There are also broad overviews on the 'reportable arrangement' provisions available as guides on when and how an arrangement should be reported. The provisions mostly rely on objectively determined characteristics to establish whether an arrangement is a 'reportable arrangement', as defined. These characteristics together with the 'tax benefit' requirement are applied to filter out arrangements to be disclosed to South African Revenue Service. The purpose of the disclosure requirement is to notify South African Revenue Service of a transaction or transactions that have the main objective, or one of the main objectives, to obtain a tax benefit. However, merely because a transaction is reportable does not mean that it is automatically deemed an impermissible avoidance arrangement for the purposes of GAAR nor does it have any effect on the substantive consideration of normal tax liability by South African Revenue Service.

The legislation aims to assist participants and promoters in determining whether an arrangement should be disclosed to South African Revenue Service for the purposes of the 'reportable arrangement' provisions and hence ensures greater certainty. In terms of the provisions, a distinction is made between two types of reportable arrangements, namely, -

- those that require that a tax benefit be derived [s 80M(1)]; and
- those that are presumed to give effect to a tax benefit and which are listed in s 80M(2).

The test whether a tax benefit is derived, or will be derived, or is assumed to be derived as contemplated in s 80M(1), is a balanced test based on an objective calculation. Unique circumstances relating to the participants to the arrangement may in some instances be taken into account. Certain arrangements are specifically excluded from the definition of 'reportable arrangement' (see s 80N). The exclusion list was expanded in *Government Notice No.*384 of 1 April 2008. In terms of the notice, an arrangement is specifically excluded if the tax benefit that is, or will be derived, or is assumed to be derived does not exceed R1 million or if such tax benefit is not the main or one of the main benefits obtained. An objective test is applied in determining whether a tax benefit

constitutes one of the main benefits and the subjective purpose test of the taxpayer is not taken into account.[67]

In order to determine whether an arrangement is a 'reportable arrangement', the following tests need to be applied –

An arrangement is reportable if it falls under one of the following two categories, which are set out in s 80M:

- Firstly, 'specific arrangements', which are those arrangements deemed reportable by the legislature, as set out in ss 80M(2)
- Secondly, 'generic arrangements', meaning arrangements that result in a tax benefit and meet any of the other requirements in ss 80M(1)

The specific 'reportable arrangements' [s 80M(2)], test whether the arrangement falls under any of the following categories:

- hybrid equity instruments;
- hybrid debt instruments;
- arrangements identified by notice in the *Government Gazette* which are likely to result in an undue tax benefit
- 'Generic' reportable arrangements [s 80M(1)], which dwell much on the arrangement which does not fall under any of the abovementioned categories, but gives rise to a tax benefit, namely, any avoidance, postponement or reduction of any tax liability, which is calculated as follows:
- objectively compare the situation where no arrangement is entered into with the situation existing following the implementation of the arrangement (tax benefits determined over the anticipated life-span of the arrangement); or
- compare total tax benefits (over the anticipated life-span of the arrangement and discounted at a reasonable discount rate) derived from the arrangement with the tax benefit that would have been derived from a reasonable comparable transaction of the same or similar nature.

[67] Sec 80M(1) and Sec 80M(2) of the Income Tax Act

The assumed tax treatment of an arrangement is, generally speaking apparent from the agreements as well as from the financial model (if any) which accompanies the arrangement. The financial model itself usually offers the most accurate reflection of what the tax benefits are assumed to be, or what they will be if not challenged by South African Revenue Service. There is normally consent among the parties as to what these assumed tax benefits are, as they sign off on the agreements which underpin the model. There does not seem to be much room for debate as to what is meant by the tax benefits 'assumed by a participant', where a variation from the assumed tax benefits in any event has the potential of triggering an adjustment in the pricing of the arrangement in question.

The term 'tax benefit' is broadly defined to include any avoidance, postponement or reduction of any liability for tax. Even if the arrangement only defers a tax liability, this is sufficient for s 80M to 80T to apply. For the purposes of the 'reportable arrangement' provisions, the 'tax benefit' must be at least R1 million, while further filters are applied which may result in the arrangement not being required to be disclosed in terms of the provisions. This definition does not introduce any new concepts and substantially agrees with the interpretation given by the Supreme Court of Appeal[68] , 'has the effect of avoiding or postponing liability for the payment of any tax, or reducing the amount thereof', as set out in the predecessor to the GAAR (s 103).

In *Hicklin*, *supra*, at 193, it was held that 'liability' in s 103(1), does not refer to an accrued or existing one, for such liability cannot be avoided by any transaction, (see *CIR v King* 1947 (2) SA 196 (AD). The Supreme Court of Appeal held in *Smith v CIR*[69] that the liability in question is an anticipated liability. It was further held that the ordinary, natural meaning of the term 'tax benefit' must prevail; to avoid, escape or prevent an anticipated liability.

There are certain methods used to calculate a tax benefit, namely, the comparative method and the control transaction method. These methods are listed below:

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[68] *CIR v Louw* 45 SATC 113 and *Hicklin v SIR* 41 SATC 179
[69] 1964 (1) SA 324 (A)

(a) The Comparative method

The South African Revenue Service favours the comparative method for determining a tax benefit. This test compares the situation where the parties did not enter into an arrangement, that is, they did nothing with the position following the implementation of an arrangement and discounted the tax benefit over the period of the transaction to the date of the first cash flow of the arrangement, unless the participant is able to prove a more reasonable alternative method.

(b) The Control transaction method

The control transaction method compares the tax benefit obtained by the arrangement in question with the benefit that would have been obtained by a comparable transaction not considered to have been entered into to achieve a tax benefit. If the participants, or South African Revenue Service, wish to rely on the control transaction method to prove that a tax benefit had not, or had been attained, they must justify why the proposed method would be more appropriate than the comparative method.

No substantive tax consequences attach to the calculation of the tax benefit for the purposes of applying the 'reportable arrangement' provisions, other than to establish whether the R1 million penalty should be imposed for non-disclosure. The test is not applied for the same purpose as the test contained in the GAAR. Participants aggrieved by the R1 million penalty have recourse to several remedies. If a participant does not derive, nor anticipates deriving a tax benefit from the arrangement, but another participant to the same arrangement derives a tax benefit, then both participants will have a potential disclosure obligation. To prevent exposure to a R1 million penalty, all participants to such an arrangement should consider not only their own, but the other parties' tax benefits also. If a tax benefit exists, see whether the arrangement meets any of the following requirements:

(a) the arrangement provides for interest, finance, costs, fees or other charges that are partly or wholly dependent on the assumptions relating to the tax treatment of that arrangement

(b) It contains any of the characteristics which are substantially similar to the indicators of a lack of commercial substance under GAAR, including the presence of -

- round- trip financing;
- an accommodating or tax indifferent party; and
- elements which offset or cancel each other:

(c) It is or will be disclosed by any participant as a financial liability for the purposes of General Accounting Accepted Practice (GAAP), but not for income tax purposes;

(d) it does not result in a reasonable expectation of a pre-tax profit for any participant; or

(e) It results in a reasonable expectation of a pre-tax profit for any participant that is less than the value of those tax benefits to that participant on a present value basis.

The question would then be what would happen if the reportable arrangement is excluded in terms of s 80N, or the tax benefit is less than R1 million, or is the tax benefit the main or one of the main benefits of the arrangement or is it a stand–alone arrangement that is unlikely to be tax driven? Then the answer would be that it must not be reported, but if the total tax benefit is more than R1 million, the arrangement must be reported. Stand-alone arrangements that are unlikely to be tax driven, such as ordinary loans, leases, collective investment schemes and share transactions are excluded in terms of s 80N, and do not have to be reported.

The taxpayers and their consultant should always bear in mind that whatever they do, South African Revenue Service would always have a way of dealing with those situations. The South African Revenue Service' enforcement powers have been widened with an expansion of the provisions relating to 'reportable arrangements'. In general, the promoter of certain transactions has a responsibility to report these arrangements to South African Revenue Service. This gives South African Revenue Service advanced warning of transactions that are taking place which may warrant further investigation. The following arrangements may have to be reported:

- a transaction where the calculation of interest and similar charges is dependent on tax assumptions
- a transaction that has characteristics similar to the indications which lack commercial substance provided by GAAR
- a transaction which is disclosed by a participant as a financial liability for GAAR, but not for tax
- a transaction that will result in a reasonable expectation of pre-tax profit for any participant being greater than the present value of the tax benefit
- a transaction qualifying as a hybrid instrument as defined in s 8E if the period for determining this was 10 years, instead of the normal 3 years
- an arrangement that may qualify as a hybrid instrument as defined in s 8F if the period was 10 years, instead of the normal 3 years
- a transaction specifically identified by the Commissioner as being reportable

There are certain arrangements which are specifically excluded from being reported, these are:

(a) no frill loans, advances or debts
(b) where a borrower receives or will receive an asset and agrees to return the same in quality and quantity
(c) a lease
(d) transactions in terms of the Security Services Act No. 36 of 2004
(e) transactions in relation to participatory interest in a collective investment scheme in securities

The arrangement has to be reported within sixty (60) days after any amount is received or accrued to a participant in the arrangement. If the promoter or, in the absence of a promoter, any participants, do not report such an arrangement to South African Revenue Service, a fine of R1 million could be levied against the responsible person.

9.2.12 Remedies of the South African Revenue Service

In order to apply the GAAR, the South African Revenue Service is given very wide powers to determine the tax consequences of an impermissible avoidance arrangement. The following options are available to the South African Revenue Service:

- any steps in or parts of the arrangement can be disregarded, combined or recharacterised;
- any accommodating party can be disregarded, or that party and any other party can be treated as one and the same person;
- connected persons can be deemed to be one and the same person;
- any gross income, receipt or accrual of a capital nature, expenditure or rebate may be reallocated among the parties;
- very worryingly, any gross income, capital receipt or expenditure may be recharacterised (for example, an exempt dividend received may be recharacterised as taxable interest); and
- as in the past, the arrangement can be treated as if it had been entered into or carried out, in such a manner as in the circumstances of the case, that South African Revenue Service deems appropriate.

A small consolation is that, subject to prescription, the South African Revenue Service is obliged to make compensating adjustments to ensure consistent treatment of all the parties to the impermissible arrangement. Thus, for example, if the South African Revenue Service recharacterises a dividend received as interest, the South African Revenue Service must recharacterise the dividend paid as interest paid (though whether or not the recharacterised interest is deductible will have to be tested against the other requirements of the law).
The South African Revenue Service's decision to invoke these remedies is subject to objection and appeal.

A simple example demonstrating these powers is a subsidiary that borrowed money from its parent company to fund the subsidiary with working capital. The subsidiary then borrows money from a South African bank at a market related interest rate and repays the parent company. The parent company then invests the proceeds in redeemable preference shares issued by the same bank. One remedy (and there may be

others) which the South African Revenue Service may have is to treat the parent company and subsidiary as one and the same person. In this case, the South African Revenue Service could contend that the borrowed money was used to fund an investment in preference shares which yield tax-exempt dividends and, therefore, the interest ought to be disallowed as a deduction.
In addition, solely for the purpose of determining whether a tax benefit indeed exists, the South African Revenue Service is empowered to treat connected persons as one and the same person and to disregard any accommodating party, or treat that party and another party as one and the same person.

10 CONCLUSION

As can be seen from the above, the new GAAR is wide-ranging and replete with unfamiliar and new concepts, which will take years if not decades to be properly defined by the courts.

While the South African Revenue Service has been aware of the need not to introduce uncertainty into doing ordinary, everyday business it has taken steps to eliminate elements of uncertainty. Large areas of uncertainty nevertheless remain as is evident from the above.

One must not assume, however that by definition, the GAAR will apply every time there is an element of tax planning or tax structuring. The overall guideline must be that, as long as the tax structuring or tax planning is done within the confines of a proper commercial transaction or main purpose, then the requirement to obtain a tax benefit will not be satisfied. But, clearly, future transactions will have to be carefully scrutinised and tested against the new legislation. The new GAAR is with us and is now part of tax planning. And the more one analyses it in the light of practical situations, the more one realises its power and breadth. The introduction of the GAAR was justified by the South African Revenue Service and Treasury as being an important part of tax reform in South Africa. But it is recognised that broader tax reform is needed, and this was clearly stated in the original discussion paper and in the March 2006 interim response. The authorities acknowledge that many of the schemes which become

vulnerable to the GAAR were undertaken because the Act did not keep pace with modern developments in the economy. The following three major difficulties were highlighted:

- The first concerned the lack of group relief, as a result of which losses in one subsidiary could not be offset against taxable income in another.
- The second was that, while most fixed assets, including industrial buildings could be depreciated for tax purposes, commercial buildings could not.
- Thirdly, South Africa suffers from the rather anomalous position that interest on a debt to finance the acquisition of a new business is allowed for tax purposes, but it is not allowed if, instead of buying the business, the taxpayer purchases shares in an existing company.

Some schemes were undertaken to overcome these difficulties, including shifting profits within a group, concluding various complex transactions whose result is that much of the cost of a building is 'rolled up' into a rental charge or included into various arrangements to push debt down into an operating company.

In the March 2006 interim response, the South African Revenue Service made the point that viewed from the taxpayer's perspective, a scheme may appear more as a much needed 'self-help remedy' than as an attempt to shirk a fair share of the tax burden. On the other hand, the South African Revenue Service did comment, correctly it is submitted, that many schemes go far beyond just 'righting the balance'.

It remains to be seen whether any of these areas of reform will be introduced and if so, how soon? On 21 February 2007, the *Minister of Finance* presented his Budget Speech to Parliament. One of the announcements was that new commercial buildings, and upgrades to existing buildings, would be able to be depreciated at the rate of 5 per cent per year, i.e. over a 20 year period. This would seem to address, to some extent, the second area of reform referred to above, but, regrettably, nothing was mentioned about the first and third areas which are by far the more important.

11 RECOMMENDATIONS

The provision of s 103(1) has been subjected to substantial judicial enquiry. This has led to a wealth of judicial precedence being set. Nevertheless, the legislation is brief and a s 103(1) enquiry is still subject to the uncertainties, which may arise in court proceedings.

By contrast, s 80A to 8L is much more detailed in legislative content. Caution must be noted, in that although there are a plethora of definitions in s 80A to 80L supra, they have not as yet been subjected to judicial scrutiny. The contentions of the Memorandum that the s 80A to 80L provisions would provide more clarity, may be somewhat naive. Until such time as these provisions have been subjected to close scrutiny by the courts. It seems that judicial uncertainty has merely replaced legislative uncertainty.

It does however; seem that s 80A to 80L represents a substantial improvement on the old s 103(1) provision. For example, the old Achilles heel attaching to the abnormality provisions appears to have gone and the new s 80A to 80L provides considerably more clarity in this regard. That in itself goes a long way to ensuring that the South African tax avoidance landscape has become more clearly defined.

In summation, it is recommended that the existing s 80A to 80L legislation be further refined and drafted in a more sophisticated manner in order to overcome abnormalities that have already been referred to in this work. If this is successfully done, the South African Revenue Service can rightfully take its place amongst first World Countries (i.e. US, Canada, Germany, and Australia) in becoming a top class revenue collector.

With respect to 'reportable arrangements', an arrangement which is supposed to be reported and if it is not, then the aspect of imposing a penalty of R1 million, should be revisited. A material fine of say R5 million hypothetically should be imposed, if a participant is found not to report such an arrangement.

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