

The influence of the General Anti-Avoidance Rules on tax avoidance schemes and the significance thereof for tax payers and tax advisors in South Africa

Submitted in partial fulfillment of the requirements for the degree of Master of Laws-Business Law in the 'College of Law and Management Studies' and 'School of Law' at the University of KwaZulu-Natal

(Howard College Campus)

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List of Abbreviations

ITA - Income Tax Act

ITAA- Income Tax Assessment Act

TAAR- Targeted Anti- Avoidance Rule

GAAR- General Anti-Avoidance Rule

OECD- Organization for Economic Co-operation and Development

SARS- South African Revenue Service

Key words

- Anti-avoidance provisions
- Avoidance arrangement
- Commercial substance
- General anti-avoidance rule
- Impermissible tax avoidance
- Misuse or abuse
- Tax avoidance
- Tax evasion
- Tax benefit
- Tax planning

DECLARATION

I Sydney Pambili Sibisi declare that

- (a) The research reported in this dissertation, except where otherwise indicated, is my original research;
- (b) This dissertation has not been submitted for any degree or examination at any other university;
- (c) This dissertation does not contain other persons' writings unless specifically acknowledged as been sourced from other researchers. Where other written sources have been quoted, then;
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Signed:



Dated: 25th May 2016

ACKNOWLEDGEMENTS

As Isaac Newton stated, “if I have been able to see further it is by standing on the shoulders of giants”. In the course of this work, I have been helped by many people, directly and indirectly, through their gifts and talents, friendship and wisdom, for which I am deeply grateful.

This work would not have been possible if not for our almighty God’s grace and continuous protection, for which I will never stop praising and thanking him.

To my able and humble supervisor and co-supervisor Mr. Shaun Kruger and Mr. Simphiwe Phungula, for your thorough scrutiny of this work, without your set of learned eyes this work might have headed in the wrong direction. Thank you for making the burden of this work light. Also for your kind and warm reception and profound insight which was so invaluable. For this I wish you God’s blessing.

To my tax law lecturer Mr. Chris Schembri, I say thank you for your unwavering support and guidance throughout the duration of my coursework, I have no better way of appreciating your contribution and wise counsel, than to wish you God’s blessing.

To my wife Bonokuhle Sibisi thank you for your continuous support and sacrifice in ensuring that I complete this program.

And to my bigger family and friends I say thank you for your moral support and prayers through the sometimes turbulent academic life.

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Chapter 1

1 Introduction and Background

1.1 Background

It is believed that the problem pertaining to tax avoidance can be traced back as far as the existence of taxation.¹ Tax avoidance activities reduce and compromise the trustworthiness and equitableness of the tax system.² Governments in most if not all jurisdictions are confronted with a serious issue of combating or containing tax avoidance and because of this most of these jurisdictions have introduced a statutory mechanism known as the general anti-avoidance rule (GAAR) as a primary measure to target avoidance arrangements.³

Tax avoidance is on one hand broadly speaking concerned with the conduct that is *prima facie* lawful, but that results in tax benefits that are considered unacceptable. The term tax avoidance can be a very deceptive concept.⁴ This can partly be attributed to the fact that tax avoidance is on the face of it legal and yet somehow unacceptable in certain instances.⁵ Thus far, one clear distinction to be drawn is that the concept of tax avoidance is legal in nature.⁶

Tax avoidance was previously seen as the permissible way in which a taxpayer could take advantage of the law to lessen liability to taxation.⁷ However the position today is quite the opposite as most governments look upon many avoidance arrangements with a level of disregard which was once reserved for tax evasion.⁸

One clear challenge established thus far, is the distinction between tax avoidance considered acceptable on one hand and tax avoidance considered unacceptable on the other hand. Therefore precisely which activities are intolerable is a subject on which logical intellects can and do disagree.⁹ Tiley submits that, whether something is

¹ Krishna, V. *Tax avoidance: The General Anti-Avoidance Rule* (1990) 8, Carswel.

² Review of Business Taxation. *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) 7.

³ Atkinson, C. *General Anti-Avoidance Rules: Exploring the Balance between the Taxpayer's Need for Certainty and the Government's need to prevent Tax Avoidance* (2012) 14 (1) at p.1.

⁴ *Ibid*, p. 3.

⁵ Orow, N. *General Anti-Avoidance Rules: A Comparative International Analysis* (2000) 61, Jordans.

⁶ See note 3 above at p. 3.

⁷ *Ibid*, p.4

⁸ Bowler, T. *Countering Tax Avoidance Schemes in the UK: Which Way Forward?* (2009) 10, *Tax Law Review*.

⁹ See note 3 at p.5.

permissible or not, is a resolution and not a test' and hence it simply rehashes the problem.¹⁰ In *Hadlee and Sydney Bridge Nominees Ltd. v CIR*¹¹ President Cooke recognizes that while the contrast can be hard to attain on particular facts, it is both definitive and appropriate for some purposes.

In the case of *Ben Nevis Forestry Ventures v CIR*¹² the contrast was contemplated to be unhelpful and it was contested that the distinction can assist both in recognizing of actions that are acceptable and those that are unacceptable, and also to make clear factors that assist in establishing which side of the line certain actions fall.¹³

Taking into consideration that the main objective of a *GAAR* is to attack unacceptable and not tax planning or mitigation, it is within reason that it must include tests definitively or indirectly so as to establish whether an arrangement in question is acceptable or otherwise.¹⁴

Tax avoidance is best defined in the case of *CIR v Willoughby*, where it was expressed by Lord Noran that:

The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.¹⁵

In view of this, a taxpayer who takes advantage of the options granted to him/her by the statute in reducing his/her tax liability, such a taxpayer is well within the law if he suffers certain economic consequences as intended by Parliament for choosing such an option.

¹⁰ Tiley, J. Revenue Law 6th ed. (2008) 102, Hart Publishing

¹¹ (1991) 13 NZTC 8116, 8122.

¹² [2009] 2 NZLR 289, 328 [95].

¹³ *MacNiven v Westmoreland Investments* [2001] STC 237 [62] (Lord Hoffmann): Lord Walker, 'Ramsay 25 Years on: Some Reflections on Tax Avoidance' (2004) 120, Law Quarterly Review 412, 416.

¹⁴ See note 3 above at p.6.

¹⁵ [1997] 4 All ER 65, 73.

However where a taxpayer uses an option in a manner not intended by Parliament it is considered impermissible and unlawful.

Provisions of the general anti-avoidance rules will not apply to a taxpayer who genuinely utilizes the provisions of the tax statutes to reduce his tax liability as this will fall within the ambit of acceptable tax avoidance. For instance a taxpayer can take advantage of and claim all expenditure which is incurred in the course of his trade in terms of section 11 (a) and 23 (g) of the *Income Tax Act* 58 of 1962.

The *Income Tax Act*¹⁶ also contains other specific provisions designed to counter tax avoidance schemes whose sole or main purpose is to avoid taxes. Examples of some of these provisions are:

- The deeming provisions under section 7 (1) – (11)¹⁷ which provides for circumstances when income is deemed to have accrued or to have been received by a taxpayer;
- Dividends on certain shares deemed to be income in relation to recipients thereof under section 8E.¹⁸

Tax avoidance schemes which are not subject to specific anti-avoidance provisions are dealt with under the general anti-avoidance rules currently contained in section 80A to 80L of the Act¹⁹. The previous regime of anti-avoidance rules was provided for under the now repealed section 103 (1) & (3) of the same Act.²⁰

On the other hand the term evasion is used to denote a taxpayer who derives a benefit by reducing his tax liability or avoid paying taxes entirely using means which are illegal.

¹⁶No. 58 of 1962.

¹⁷*Ibid.*

¹⁸*Ibid.*

¹⁹*Ibid.*

²⁰*Ibid.*

Evasion involves not paying the correct amount of tax under the ordinary provisions of the law,²¹ and usually requires an element of guilt, for example the actual hiding income or information from tax authorities.²²

Historically, the distinction between tax avoidance and evasion provided both the starting point and the conclusion of the inquest – if an arrangement was considered to be the evasion of a liability to taxation, it was illegal and ineffective.²³ By contrast, those actions that avoided taxation were considered to be the legitimate use of the law to lessen one's liability to taxation.²⁴

1.2 Outline of Research problem

Tax avoidance which has a negative impact through the loss of revenue for governments has over a number of years risen significantly. This problem does not only affect South Africa but affects most world governments. The clear effects of tax avoidance include:²⁵

- Reduction of government revenue making it difficult for the executive to implement some of the social and economic needs;
- The integrity of the tax system is threatened;
- And the equity of tax system is undermined.

To combat tax avoidance most governments including South Africa have formulated statutory rules known as *GAAR*. It has been established that the legitimacy of the system of law relies largely on the permissibility of the processes and methods employed by individual laws.²⁶ It is in view of this that the validity of the *GAAR* is questionable in that the rule of law requires that a good law should be capable of being clear, certain and predictable, elements which the *GAAR* clearly lacks. It has been established that laws which fulfill the characteristics of clarity and certainty are known to provide its subjects with the ability to comply with the law, and the

²¹ United Kingdom, Royal Commission on the Taxation of Profits and Income , Cmd 9474 (1955)

²² OECD, International Tax Terms for the Participants in the OECD Programme of Cooperation with Non- OECD Economies (OECD, 2007).

²³ See note 3 above at p.4.

²⁴ Ibid.

²⁵ See note 3 at p. 5.

²⁶ Thomas Aquinas, *Summa Theoregiae* (1274), I-II, 18, iv.

maximum freedom to act within the boundaries set by the legislature.²⁷ In 1776 Adam Smith highlighted that the four canons of taxation are, equality, certainty, convenience and economy and in relation to certainty, he noted that:

The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax gatherer... The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality... is not near so great an evil a very small degree of uncertainty,²⁸

In a concurring view, the OECD committee on Fiscal Affairs stated that taxpayers have a right to a high degree of certainty as to the taxation consequences of their tax affairs.²⁹ Still on the issue of certainty, the study group appointed by the United Kingdom government on the possibility of introducing a *GAAR* also highlighted taxpayer certainty as a major issue to be considered in drafting an appropriate *GAAR* for the UK.³⁰

Notwithstanding the uncertainty surrounding the *GAAR*, the courts have also not been of much help in formulating decisive tests to determine when an arrangement or transaction is an acceptable or unacceptable avoidance behavior.

1.3 Rationale for the study

The rationale of this study is to examine the perspective and reaction of the judiciary to tax avoidance in South Africa in comparison to the selected jurisdictions.

The other objectives to be considered by the study are:

- To evaluate the responsibility or role of the courts towards tax avoidance;
- To examine whether the presence of the *GAAR* has provided certainty in tax avoidance cases;

²⁷ Raz, J. The Rule of Law and its Virtue (1977) 33, Law Quarterly Review 195, 204.

²⁸ Smith, A. An Inquiry into the Nature and Causes of the Wealth of Nations (1776) (1990), Encyclopaedia Britannica, 405-6, cited in British Columbia Railway v The Queen (1979) 79 DTC 5020, 5025

²⁹ OECD, Taxpayer's Rights and Obligations: A Survey of the Legal Situation in the OECD Countries (1990), OECD, [2.21].

³⁰ Aaronson, G QC. *GAAR Study* (2011), UK Treasury [3.13].

- To establish the judiciary's viewpoint to date on tax avoidance; and
- To establish whether case law has advanced so as to conclusively anticipate arrangements or transactions which are acceptable or unacceptable tax avoidance behavior?

1.4 Research Questions

The study will seek to establish answers to the following specific research questions:

- Is the *GAAR* effective enough to combat tax avoidance?
- Is the judiciary accomplished enough to deal with the issue of tax avoidance?
- Is the attitude of the judiciary more favorable to taxpayers or the *fiscus* on tax avoidance?
- Has case law advanced enough so as to specify exactly which arrangements or transactions constitute acceptable and unacceptable tax avoidance behavior ?
- Has the *GAAR* clearly defined what acceptable and unacceptable tax avoidance behavior is?

1.5. Literature review

Literature to be reviewed in this study will include various works of eminent writers and case law on the subject. Tax avoidance is a problem which affects most if not all jurisdictions including South Africa.

South Africa and Australia among them, have formulated a statutory mechanism known as *GAAR* to counter arrangements considered to be unacceptable avoidance behavior. On the other hand countries such United Kingdom do not have this broad spectrum statutory mechanism but depend on various statutory provisions contained in various statutes known as *TAAR*'s and the common law doctrines formulated by the courts.

This study recognizes the fact that most governments' source of income including South Africa is derived from taxes.³¹ According to the Review of Business Taxation, tax avoidance activities minimize government income and erode the integrity and equity of the tax system.³²

³¹ Arendse, J.A., et al. *Silke on South African Income Tax* (2003).

³² See note 2 above.

Huxham and Haupt³³ state that the state through revenue authorities collects the funds from the taxpayers which it administers for the benefit of its subjects. However it is of importance to note that this process of correcting taxes by the revenue authorities is met by serious challenges through taxpayers who devise sophisticated schemes to avoid the payment of taxes.

The gravity of tax avoidance was highlighted by the Minister of Finance Pravin Gordhan in the 2010 budget speech, who stated that vigorous tax avoidance is a grievous cancer consuming into the fiscal base of many developing countries.³⁴

Atkinson submits that the problem of combating tax avoidance is encountered by many world governments and because of this;- many jurisdictions have introduced a statutory *GAAR* as a primary mechanism to target unacceptable avoidance behavior.³⁵

Judith Freedman has however noted that despite the presence of the *GAAR* in Canada and the absence of it in the United Kingdom, the courts have in both countries arrived at almost similar conclusions on the application of the general principles of tax avoidance.³⁶ Therefore at face value a conclusion to be drawn is that the presence or absence of the *GAAR* will give rise to the same effect.

It has also been observed that , notwithstanding the existence of the *GAAR* in countries such as Canada, the Supreme Court is seemingly more conventional in its viewpoint than the more recent tax avoidance decisions of the House of Lords in the United Kingdom where there is no *GAAR*³⁷.

Chris Evans has submitted that many cases recently decided in the United Kingdom have provided disappointing outcomes to revenue authorities and further asserts that there has been remarkable headway in the principles that lead the courts to make the decisions concerning tax avoidance and that there is certainty in the approaches that the courts are likely to take in statutory interpretation of the anti-avoidance legislation.³⁸

³³ Huxham, K. & Haupt, P. Notes on South African Income Tax (2010) p.2

³⁴ www.treasury.gov.za/documents/2010/speech/speech2010.

³⁵ See note 3 above at p.1

³⁶ Converging tracks? *Recent Developments in Canadian and UK Approaches to Tax Avoidance*.

³⁷ Ibid

³⁸ Evans, C. *Barriers to Avoidance: Recent legislative and judicial developments in Common law jurisdictions* (2006).

Sonnenbergs observed that much as the taxpayer is to take advantage of the tax statute so as to minimize his tax liability at what point does the activity ceases being legitimate tax planning and become tax avoidance which the law should prohibit?³⁹

In addressing the difficulties confronted with the concept of tax avoidance, Pagone points out that, this is inherent in the fact that it refers to activity that is perfectly legal yet somehow unacceptable.⁴⁰

Much as it is recognized that the primary role of the judiciary is to interpret law, it is also commonplace as Ian Saunders affirms that the responsibility of the court is twofold: the first been to formulate their own doctrines and secondly to interpret the statutes. He further points out that the judicial approach to counter tax avoidance must act as a guide the revenue authorities.⁴¹

1.6 Research Methodology

This research study will be conducted by way of a desktop study with a main focus on literature review. Prominence will be given to the relevant legislation, applicable case law, policy documents and works of eminent writers of text books, journal articles, newspaper articles and magazines. A short focused comparative study will also be undertaken to determine how other jurisdictions have dealt with the tax avoidance.

The main focus of this research is to evaluate the statutory mechanism to counter avoidance specifically the *GAAR* and case law in South Africa in comparison to that of Australia and the United Kingdom to be specific.

The primary source of reference is relevant tax laws followed by judicial precedents and works of eminent writers. Preference for materials gathered for this research shall take the form of repute granted to the author, publishers of such study and authenticity of the journal or magazine in which such an article is published.

³⁹ Sonnenbergs, EN. Anti-avoidance 1733 Acceptable tax planning (2009) 118.

⁴⁰ Pagone, C. T. Tax Avoidance in Australia (2010), Australia, Federation Press, ch. 1.

⁴¹ Recent Trends in the United Anti-Avoidance Law (1993).

Chapter 2

1 General overview of tax avoidance

The main focus of this chapter is to discuss the general principles underlying tax avoidance focusing tax planning or mitigation, impermissible avoidance and the evasion of tax. The issue regarding tax avoidance can be quite intricate particularly when drawing a distinction between acceptable and unacceptable avoidance behavior⁴². Therefore it is of absolute importance to examine the principles of tax avoidance in totality so as to appreciate the difficulties encountered by the law makers and the judiciary when formulating laws and undertaking adjudication respectively.

The concept of tax avoidance is best discussed by looking at other concepts which are closely connected to it. The starting point should therefore to distinguish tax avoidance with the three broad related concepts which SARS has also identified. These are, legitimate tax planning or tax mitigation, impermissible tax avoidance and tax evasion.⁴³ While tax avoidance can be easily distinguished from tax evasion, the distinction between tax planning and tax avoidance has been a difficult one.

According to SARS Discussion Paper on tax avoidance, tax avoidance is best approached by looking at the following extract from Practice Note No. 6:

A taxpayer who has carried out a legitimate tax avoidance scheme, i.e. who has arranged his affairs so as to minimize his tax liability, in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner, will have met his duties and obligations under the Act if he fully and honestly completes his income tax return and fully and honestly answers any queries raised by the Commissioner.⁴⁴

⁴²Bendel, E. Tax avoidance- is the party over? Without Prejudice, at p.21

⁴³ Discussion Paper on Tax Avoidance and section 103 of the Income Tax Act 1962 Act No. 58 of 1962. SARS, (2005)

⁴⁴ Issued by the Commissioner for Inland Revenue on 1 April 1987 in connection with s105A of the Act

It would perhaps be more helpful to taxpayers and their advisors if a legislative GAAR can point out beforehand those elements that connote that an arrangement is an avoidance arrangement.⁴⁵

2.1 Tax Avoidance

Tax avoidance is on the face of it legal and lawful. This can involve the use of legitimate means to structure one's tax affairs to obtain a tax benefit. This can be achieved by utilizing loopholes in tax laws and exploiting them within legal parameters⁴⁶. Although tax avoidance may be against the purpose or true intention of the law, no legal measures can be taken to prevent it, unless the legislature amends the law to restrict the practice in question.⁴⁷

Courts hold the view that no legal understanding rests upon a taxpayer to pay higher taxes than he is legally bound to under the taxing Act and that a taxpayer is not prevented from entering into a genuine or bona fide transaction which, when carried out, has the effect of avoiding or reducing liability to tax⁴⁸. In *Levene v IRC*, Viscount Sumner held that his Majesty's subjects are free to reduce their tax liability by structuring their tax arrangements so as to fall outside the ambit of the taxing Act.⁴⁹

The view above was endorsed in *Duke of Westminster*, where Lord Tomlin held that:

[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then however inappropriate to the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax⁵⁰.

The *Duke of Westminster* principle has been the underlying principle in tax avoidance related cases. However with the passing of time, we have seen the courts slowly shifting from this approach and adopting a relatively harsher approach and currently many governments look upon

⁴⁵ See note 3 at p. 53.

⁴⁶ Merowitz in 29.1; Huxham & Haupt at 350-351. On the meaning of tax avoidance see also Olivier, L *Tax Avoidance Options Available to the Commissioner for Inland Revenue* (1997) 4 South African Law Journal at 1-3. A Rapakko Base Company Taxation (1989) at 39 that it is the courts that are ultimately faced with difficult task of having to draw a line in certain practical cases between tax avoidance and evasion.

⁴⁷ Oguttu, AW. *Curbing Offshores Tax Avoidance: The Case of South African Companies and Trusts* (2007). P.2.

⁴⁸ Ibid p.2.

⁴⁹ [1928] AC 21.

⁵⁰ [1936] A.C. 1 HL.

many avoidance arrangements with almost the same level of contempt once reserved for tax evasion.⁵¹

In *Hicklin v SIR*⁵² and *CIR v Sunnyside Centre (Pty) Ltd*, it was observed that companies are often used in a number of ways to avoid taxes and when a scheme works no tears are shed for the Commissioner simply because a taxpayer can structure his tax affairs so as to reduce his tax liability and when he arranges his tax affairs so as to attract more than the minimum then he has to bear the repercussions.⁵³

Therefore given a set of facts, if a taxpayer's activities fall within the provisions of the tax statute, he is liable for tax; and if they do not, he is not liable⁵⁴.

In *Smith v CIR*⁵⁵, it was held that the ordinary meaning of avoiding liability for a tax on income was 'to get out of the way of, escape or prevent an anticipated liability'.

In *Hicklin v SIR*⁵⁶, the Appellate Division recognized that such liability may vary from an impending certain expectation to some unclear distant possibility.

Some judicial decisions have used the term 'tax avoidance' in a derogatory sense.⁵⁷ For instance in *CIR v Challenge Corp Ltd*⁵⁸, Lord Templeman outlined that tax avoidance connotes more than merely getting out of the way of an anticipated liability and noted further that:

Income tax is avoided and a tax advantage is derived for an arrangement when the taxpayer reduces his liability to tax without involving him [sic] in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a deduction in his liability as if he had... In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of delivering and implementing the arrangement)...

⁵¹ See e.g. [We] are strongly determined to attack those who try and avoid tax. Our approach in this area is clear-to deter tax avoidance in any form: HMRC. Disclosure of Tax Avoidance Schemes, Consultative document (2009) 4, <http://customs.hmrc.gov.uk>.

⁵² 1980 (1) SA 481 (A) at 483F.

⁵³ 1997 (1) SA 68 (A) at 77F.

⁵⁴ Stinglingh, M... et al. *Silke on South African Income Tax* (2014) at §19.1.

⁵⁵ 1964 (1) SA 324 (A); 26 SATC 1.

⁵⁶ 1980 (1) SA 481 (A); 41 SATC 179.

⁵⁷ See note 41 above at §19.1.

⁵⁸ [1987] AC 155.

Determined generally, avoidance includes all actions that may have the consequences of reducing, removing or postponing tax liability in a manner which does not collide with the law.⁵⁹

While the courts welcomes the view that a taxpayer can structure his/her tax affairs so as to achieve the minimum tax liability possible, if a taxpayer does so in a manner which defeats the purpose and true intention of the law makers, he is liable to pay tax no matter what the ensuing austerity.⁶⁰

2.2 Tax Planning

The term tax planning or mitigation is when the taxpayer utilizes options presented to him by the statute and as such the taxpayer must genuinely suffer the economic consequences as intended by the legislature.⁶¹ Every day, taxpayers structure their transactions to make use of the deductions, exemptions and allowances contained in the tax statutes so as to minimize the tax liabilities imposed by the detailed, complicated and lengthy sets of taxing provisions⁶².

Tax avoidance can be split into acceptable avoidance such as tax planning or mitigation and unacceptable avoidance behavior. The latter is punishable by law while the former is seen as a bonafide structuring of one's tax affairs within the ambit of the law.

The concept of tax planning is therefore only interested in the structure of the taxpayer's transactions with the effect of reducing tax liability within the framework of the law without recourse to impermissible tax avoidance.⁶³

Sonnenbergs submits that courts and law makers have long found it difficult to discover abusive transactions so that taxpayers cannot benefit from the related tax savings⁶⁴.

⁵⁹ Freedman, J. Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle (2004), Tax Review.

⁶⁰ CIR v Delfos [1933] AD 242 at 253.

⁶¹ CIR v Willoughby [1995] STC 995.

⁶² See note 25 above.

⁶³ SARS Discussion Paper on Tax Avoidance and section 103 of Income Tax Act 58 of 1962.

⁶⁴ See note 38.

In the United States authority of *Gregory v Helvering*⁶⁵, It was stated that the legal right of a taxpayer to decrease the amount of what otherwise would be its taxes, or to altogether avoid them by means which the law permits, cannot be doubted.

Similarly in the United Kingdom, in *IRC v Duke of Westminster*, the House of Lords affirmed that a taxpayer is entitled to structure his tax affairs by taking advantage of the various options offered by the legislation so as to achieve the minimum liability possible and no matter how unhappy the Commissioners of Inland Revenue or other taxpayers may be of his ingenuity, he cannot be coerced to pay more.⁶⁶

In support of the view above, Watermayer CJ unequivocally asserted the taxpayer's freedom to structure his tax affairs so as to reduce his tax liability by emphasizing that:

In a wide sense also the amount of a man's income tax can be reduced from what it was in previous years if he earns less income than in the previous years, but here again it is absurd to suppose that the legislature intended to impose a penalty upon a man who enters into a transaction which reduces the amount of his income from what it was in the previous years merely because his purpose was to reduce the amount of his income and consequently his tax. These two types of cases may be uncommon but there are many other ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or freeing himself from taxation of some part of his future income.⁶⁷

From the above it is clear that the taxpayer may structure his tax affairs to reduce his tax liability in a manner which does not conflict with the law. It should however be noted that, even when tax avoidance seems genuine and lawful, the conduct maybe regarded immoral or otherwise considered unacceptable behavior.

2.3 Tax evasion

Tax evasion is considered a criminal offence which attracts grievous penalties, including the possibility of and imprisonment. Tax evasion includes the use of fraud and trickery to minimize tax liability through the process of non-disclosure of income and sometimes exaggerated

⁶⁵ 293 U.S 465 [1935].

⁶⁶ [1936] A.C. 1 HL.

⁶⁷ CIR v King (1947) 2 SA 196 (A).

deductions.⁶⁸ Tax evasion has also been termed as ‘illegal arrangements through or by means of which liability to tax is hidden or ignored’⁶⁹

Some examples of tax evasion include:

- Falsification of returns, books and accounts;
- Conclusion of sham transactions;
- Deliberate non- disclosure of income or deliberate overstatement of deductible expenditure.

The distinction between tax avoidance and tax evasion is best illustrated in *R v Mears*, where Gleeson CJ states that:

... the difference between the two is simple and clear. Tax avoidance involves using or attempting to use lawful means to escape reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful.⁷⁰

Tax evasion is said to have occurred when the Commissioner is not informed of all relevant facts concerning an assessment and if found to be dishonesty may lead to criminal prosecution while innocent evasion may lead to reassessment.⁷¹

Tax evasion just like tax avoidance affects many jurisdictions. In South Africa, the *Income Tax Act*⁷² imposes sanctions on taxpayers found guilty of evading tax and this may include imprisonment.

2.4 Impermissible tax avoidance

An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and in the context of business- *it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business*

⁶⁸ Hauxham, K & Haupt, P. Notes on South African Income Tax (2007). Cape Town, Hedron at 350.

⁶⁹ OECD, International Tax Terms for the Participants in the OECD Programme of Co-operation with Non- OECD Economies.

⁷⁰(1997) 37 ATR 321.

⁷¹ CIR v Challenge Corporation Ltd (1987) AC 155.

⁷² Act 58 of 1962.

*purposes, other than a tax benefit; or it lacks commercial substance, in whole or in part.*⁷³ *In a context other than business, (an arrangement entered into by a taxpayer must make economical sense), an impermissible avoidance arrangement must have been entered into or carried out by means or in a manner, which would not normally be employed for bona fide purposes, other than obtaining a tax benefit*⁷⁴.

The SARS Discussion Paper on ‘impermissible tax avoidance’ points out tax avoidance practices which are not legally acceptable.⁷⁵ The report’s main focus is the form of ‘tax avoidance’ which is essentially a misuse or abuse of the law that is driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by Parliament. Lord Templeman in *CIR v Challenge Corporation* stated that:

Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction, The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had⁷⁶.

Impermissible tax avoidance is seen as an arrangement which is far-fetched or artificial with remote or no actual economic effect on a taxpayer, which is usually formulated to manipulate tax statutes so as obtain an outcome which is in conflict with the true intention of the law makers.⁷⁷

Such an arrangement defeat the purpose of section 80A (c) of the *Income Tax Act*⁷⁸ which requires that a legitimate arrangement must create rights and obligations that would not normally be created between persons dealing at arm’s length (an arm’s length transaction is when parties involved in a transaction act independently and have no relationship to each other), where an arrangement in question does not conform with this provision, it may give rise direct or otherwise in the misuse and abuse of the provisions⁷⁹. This condition or test has proved to be a

⁷³ *Income Tax Act* 58 of 1962 s. 7(3)-(6) and 239.

⁷⁴ *Ibid* s. 80A (b).

⁷⁵ Discussion Paper on Tax Avoidance and section 103 of the Income Tax Act 1962 Act No. 58 of 1962. SARS, (2005).

⁷⁶ (1987) AC 155.

⁷⁷ *Ibid* at p. 4.

⁷⁸ *Act 58 of 1962*

⁷⁹ Section 80A *Ibid*.

very powerful tool for the Commissioner to cramp down on unacceptable avoidance behavior also known as impermissible tax avoidance.

Mitchell observed that in drafting section 80A; it would seem that the legal draftsman hoped for a provision that could certainly be used by the Commissioner to prevent tax-saving arrangements from being successful⁸⁰. This provision has proved to be a very powerful tool in the hands of the Commissioner, to deal with the tax avoidance schemes⁸¹.

Interim responses suggests that most commentators have accepted the basic categories of tax evasion, impermissible tax avoidance and legitimate tax planning as highlighted in the SARS Discussion Paper.⁸² While others, have, however taken issue with them⁸³. They have argued instead for a simple distinction between “unlawful” tax evasion and “lawful” tax avoidance with nothing, seemingly in between⁸⁴. To be more specific, one observer called the whole notion of “impermissible tax avoidance” and its consequences as, in essence, nothing more than “risible” “nonsense” advocated by a “string of Ministers of Finance and Revenue Commissioners over the years”⁸⁵.

Similarly other commentators have hit hard on SARS for allegedly accusing the hard working taxpayers of something which only they see as ‘impermissible’ even when the law makers’ have not outlawed it.⁸⁶

Even in the United Kingdom, where the “choice doctrine” originated⁸⁷, the House of Lords have made it clear that Lord Tomlin’s dictum in the *Duke of Westminster decision*⁸⁸ is no longer the last word on the subject, and that, in fact, it “tells us little or nothing as to what methods of

⁸⁰ Mitchel, L. No entry Route to Ladysmith Closed (2007) 21 Tax Planning 123 -125.

⁸¹ Ibid.

⁸² Salgado, I. Taxman gunning for convertible loan schemes, 18 November 2005, Business Report, p.6 (quoting Ernie Las King, Tax Director, Denes Reitz).

⁸³ See note 9 at p. 4.

⁸⁴ Ibid p.4.

⁸⁵ Surtess, P. South Africa: Year in Review , 5 January 2006, Tax Analysts World Wide Tax Daily

⁸⁶ Richardson, P. Taxman to flex his considerable muscle, 6 November 2005, Sunday Times- Business Times, p.3 (quoting Charles Mackenzie, Tax Partner, Ernest &young).

⁸⁷ (1936) AC 1 HL.

⁸⁸ Ibid.

ordering one's affairs will be recognized as effective to lessen the tax that would otherwise attach to them if business transactions were conducted in a more straight forward way"⁸⁹.

The rule of law requires that a good law must be clear, certain and predictable, a notion which most legal philosophers subscribe to. It has been established that a law must be relatively certain in order to conform to the principles of the rule of law.⁹⁰ This concept has proved to be difficult and complicated; Hayek outlines the essence of the rule of law as follows:

[G]overnment in all its actions is bound by rules fixed and announced beforehand-rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge.⁹¹

The two major elements underlying the rule of law is first and foremost the emphasis which is placed on rules which have been fixed and that these rules must be announced in advance so that subjects must be governed by known rules and not by whim of discretion.⁹² Secondly, the importance of the rule of law is that the law must be capable of guiding the behavior of its subjects.⁹³

It is further acknowledged that the rule of law requires that subjects must be governed by law and not by administrative measures.⁹⁴ It is therefore in line with these requirements that all legal rules must generally meet a certain standard including inter alia, that they be prospective and not retrospective, possible to comply with, published and fairly stable through time.⁹⁵ For a *GAAR* to meet these criterions, it would require a clear and coherent mechanism under which mitigation could be consistently distinguished from avoidance.⁹⁶ Certainly a broad based administrative discretion does not meet the requirement of certainty and thus does not conform to the rule of law.⁹⁷ Taxpayers should not have to rely on the administrative discretion of revenue officials as

⁸⁹ IRC v *Burmah Oil Co. Ltd* (1982) STC 30, 32 (Lord Diplock).

⁹⁰ Hayek, F.A. *The Constitution of Liberty* (1960) 143

⁹¹ Hayek, F. A. *The Road to Serfdom* (1994) 54, G Routledge & Sons.

⁹² Dice, A.V. *Introduction to the Study of the Law of the Constitution* (first published 1885, 10th ed 1985) 188, Macmillan.

⁹³ Raz, J. *The Authority of Law* (1979) 214, Clarendon Press.

⁹⁴ See note 3 above at p.12.

⁹⁵ Fuller, L. *The Morality of Law* (2nd ed 1969) 33-94, Yale University Press

⁹⁶ See note 3 above at p. 12.

⁹⁷ *Ibid.*

to whether they will suffer the full severity of a too widely drawn provision which is not clear, certain and predictable.⁹⁸

2.5 Conclusion

It is generally an acceptable concept that a taxpayer has a legal right to arrange or structure his tax affairs to achieve the minimum tax liability possible. This study has so far established that tax avoidance is at face value legal. Tax avoidance is further divided into acceptable avoidance also known as tax planning or mitigation and unacceptable avoidance behavior which is sometimes referred to as 'impermissible tax avoidance'.

Unacceptable avoidance behavior generally alludes to a practice that lessens, eradicates or defers a tax liability employing specific provisions of the tax statute in a way not intended by the legislature.

To combat unacceptable avoidance behavior most jurisdictions including South Africa have adopted a statutory mechanism known as the *GAAR*. It has also been established that tax statutes do not provide a clear distinction between tax avoidance which is acceptable and tax avoidance which is unacceptable leading to uncertainty among taxpayers and tax advisors alike.

On the other hand, tax evasion is illegal as it involves deceit and fraud and is punishable by law which may sometimes include imprisonment.

It is trite that legal rules which are clear, predictable and certain increase compliance as taxpayers will be fully aware of the consequences before making a decision of entering into an arrangement or transaction.

Notwithstanding that the judiciary have not come up with a conclusive concept to distinguish acceptable from unacceptable avoidance behavior, they have gone a step further to fill in the lacuna left by our tax statutes by formulating doctrines to help arrive at their decisions involving tax avoidance.

⁹⁸ Venables, R. QC. Tax Avoidance: A Practitioner's Viewpoint in Adrian Shipwright (ed) Tax Avoidance and the Law: Sham, Fraud or Mitigation (1997) 64, Key Haven Publications.

Chapter 3

3 South African General Anti-Avoidance Rules (*GAAR's*)

An aptly drafted *GAAR* is one which would include clear and unwavering standards known to taxpayers in advance, but would not eliminate the need for administrative discretion.⁹⁹ A *GAAR* should provide taxpayers, the revenue authority and the courts with a comprehensible and systematic framework able to be applied consistently to ascertain whether an arrangement is of a type caught by the *GAAR*.¹⁰⁰

The attributes deep rooted in all *GAARs* are that a *GAAR* will be applied where a taxpayer undertakes an arrangement that results in a tax benefit, where the taxpayer or arrangement is conceived to have a dominant purpose.¹⁰¹ In the sub-sections to follow, the writer will discuss the South African statutory *GAAR* and the relevant case law so as to ascertain how the courts have dealt with the issue of tax avoidance.

3.1 Brief background to the South African *GAAR*

The concept of *GAAR* in South Africa dates back as far as 1941, making it one of the first countries to introduce this statutory mechanism which was incorporated under section 90.¹⁰² The main object of this was to combat the increasing number of tax avoidance cases at the time. With the passage of time, section 90 proved to be ineffective and it was repealed and replaced with section 103¹⁰³. However with the lapse of time again, the hope which was bestowed on section 103 diminished as it was perceived to be too weak to counter sophisticated schemes formulated by taxpayers. Accordingly SARS and its stakeholders resolved section 103 was too ineffective to withstand tax avoidance.

⁹⁹ See note 3 above at p. 15.

¹⁰⁰ *Ibid.*

¹⁰¹ *Ibid.*

¹⁰² *ITA* (1941).

¹⁰³ *ITA* (1962)

However such a conclusion by SARS and its stakeholders was seen as a tactic to vilify the responsibilities of the court to safeguard taxpayers and the *fiscus* and therefore the court could not be held accountable for the insufficiency of the GAAR¹⁰⁴.

Section 103 was however repealed and replaced with the new GAAR contained in sections 80A to 80L¹⁰⁵. The new GAAR applies to any arrangement entered into on or after the 2nd of November 2006. The GAAR in its current form was enacted so as to stop taxpayers from deriving a tax benefit from what would otherwise be an impermissible avoidance arrangement.

The key provision in the current GAAR is section 80A of the *Income Tax Act*.¹⁰⁶ This provision provides us with the definition of the term “impermissible avoidance arrangement”. It is however important to note that the subsequent provisions of the GAAR merely ride on and expand section 80A of the Act. The provisions also provide the Commissioner with procedural and administrative guidance.

Section 80A of the Act provides as follows:

“An avoidance arrange is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and-

(a) In the context of business-

- (i) It was entered into or carried out by means or in a manner which would not normally be employed for bonafide business purposes, other than obtaining a tax benefit; or*
- (ii) It lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;*

(b) In a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bonafide purpose, other than obtaining a tax benefit; or

(c) In any context-

¹⁰⁴ Taxpayer, vol. 54 (4) April 2005 at p. 61-62.

¹⁰⁵ Part IIA of ITA (1962).

¹⁰⁶ No. 58 of 1962.

- (i) *It has created rights or obligations that would not normally be created between persons dealing at arm's length ; or*
- (ii) *It would result directly or indirectly in the misuse or abuse of the provisions of this Act.*

Despite the existence of differences in the predated and the current GAAR, certain terms such as purpose and abnormality are present in both, these tests are cardinal in that, for a transaction, operation or scheme to be attacked by the GAAR, both the purpose and the abnormality requirement must be satisfied.

The writer will discuss the current South African statutory GAAR and where necessary the repealed section 103 and examine the requirements which have to be met for an arrangement, transaction or scheme to be adjudged an 'impermissible avoidance arrangement'.

3.2 Statutory GAAR

The GAAR currently in force replaced section 103 and is incorporated in section 80A to L under *Part IIA* of the *Income Tax Act*.¹⁰⁷

For a GAAR to be applied on an arrangement which is considered an impermissible avoidance arrangement, essential elements which must be met are that, there must be a transaction, operation, or scheme. In the present GAAR, it is required that an 'arrangement' i.e. agreement or understanding, whether enforceable or not, including all steps in it or part of it and that the sole or main purpose is to gain a tax benefit.

In conformity with section 80A of the *Income Tax Act*¹⁰⁸, *an arrangement is an 'impermissible avoidance arrangement' if its sole or main purpose was to obtain a tax benefit and-*

- *It is entered into in a manner which would not normally be employed for bona fide business purposes other than obtaining a tax benefit;*
- *It lacks commercial substance, in whole or in part;*

¹⁰⁷ No. 58 of 1962

¹⁰⁸ Ibid.

- *It has created rights or obligations that would not normally be created between persons dealing at arm's length; or*
- *It would result directly or indirectly in the misuse or abuse of the provisions.*

3.2.1 Impermissible avoidance arrangement

An arrangement is deemed an impermissible avoidance arrangement firstly if its sole or main purpose was to obtain or derive a tax benefit.¹⁰⁹

The second aspect is that, for avoidance behavior to be considered unacceptable there has to be an 'arrangement' present.

An arrangement is spelled out as 'any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property'.¹¹⁰

The arrangement denotation also includes the words 'enforceable or not', which simply signify that whether a 'transaction, operation or scheme' is not legally enforceable, the GAAR will still be employed.

In examining the terms 'transaction, operation or scheme', it was said that the word 'scheme' is a wide term and that there can be insignificant apprehension that it is amply broad to include a series of transactions.¹¹¹

The above interpretation was validated by the court in the case of *CIR v Louw*¹¹², where it was held that, the term scheme is wide enough to cover circumstances in which later steps in a course of action were left undetermined from inception.

The term 'all steps therein or parts thereof' are included in the definition of an 'arrangement' meaning that all parts or to some degree part of an arrangement may amount to an 'arrangement'.

¹⁰⁹ Section 80 A of Act 58 of 1962.

¹¹⁰ Ibid Section 80 L.

¹¹¹ *Meyerowitz v Commissioner for Inland Revenue* (1963) 25 SATC 287 (A).

¹¹² 1980 (2) SA 721 (A)

The *Income Tax Act*¹¹³ does not provide a definition of ‘all steps or parts’, however Clegg and Stretch¹¹⁴ suggests that each relates to a recognizable transactional element of the whole.

The Commissioner has the power to invoke the *GAAR* and apply it to steps or parts of an arrangement.¹¹⁵

In light of the above it is of great importance to note that the Commissioner has to formally inform the taxpayer exactly which parts of the arrangement he is attacking, this has been seen as advantageous to a taxpayer.¹¹⁶

This brings us to another important element to be examined in the following sub-section which requires that an ‘arrangement in question must have an effect of procuring a tax benefit.

3.2.2 The sole or main purpose was to obtain a tax benefit

In terms of the *GAAR*, tax avoidance is only contemplated unacceptable if the sole or main purpose of entering into an arrangement was to obtain a tax benefit.¹¹⁷ The words to be scrutinized are ‘solely’ and ‘mainly’ as they are not defined by the Act.

In *SBI v Lourens Erasmus (Edms) Bpk*, it was held that ‘solely’ refers to the only purpose of the taxpayer, whereas ‘mainly’ will refer to a quantitative measure of more than 50%.¹¹⁸

To elaborate on the term ‘solely’, it must be clear that the only reason that the taxpayer entered into an ‘arrangement’ in question was to derive a tax benefit. Similarly where the ‘sole’ purpose was not to obtain a tax benefit, it must at least be proved that the purpose was ‘mainly’ to obtain a tax benefit which translates to a calculable measure of slightly more than 50%.

¹¹³ No. 58 of 1962.

¹¹⁴ Clegg, D., Stretch, R. *Income Tax South Africa* (2013). P26.

¹¹⁵ Section 80 H of Act 58 of 1962.

¹¹⁶ Broomborg, EB. *Then and Now-II* (2007) 21. *Tax Planning Corporate and Personal*

¹¹⁷ Section 80 A of Act 58 of 1962.

¹¹⁸ 1996 (4) SA 344 (A).

3.2.3 Tax Benefit

For an ‘arrangement’ to be considered an ‘avoidance arrangement’, there must be a tax benefit involved and it must also be evident that the taxpayer’s sole or main purpose of entering such an arrangement must be to obtain a tax benefit.¹¹⁹

The definition of tax benefit is provided for in section 1 of the Act and describes it as follows:

*It includes any avoidance, postponement or reduction of any liability for tax.*¹²⁰

To determine whether a tax benefit has been secured by a taxpayer, the court in *ITC 1625*, held that a feasible test to determine the existence of a tax benefit was whether the taxpayer would have suffered tax but for the transaction. The Commissioner would then need to determine or predict another transaction or scheme that the taxpayer would have entered into.¹²¹

In in as much as there is no clear test provided by the legislation to determine what amounts to tax benefit, the courts have adopted the ‘but for’ test as evidenced in the decision above.

3.2.4 Tainted elements

The abnormality element is the last requirement which must be satisfied in order to determine an avoidance arrangement as an impermissible avoidance arrangement. An arrangement in question must contain an abnormality element; this is a trace of something bad, offensive or harmful which SARS called tainted elements.¹²²

In compliance with the Act, the abnormality element can be in the context of business¹²³, non-business context¹²⁴ and in any other context.¹²⁵

¹¹⁹ Section 80 A of Act 58 of 1962.

¹²⁰ Act 58 of 1962.

¹²¹ 1996 59 SATC 383.

¹²² SARS. Draft Comprehensive Guide to the General Anti-Avoidance Rule

¹²³ Section 80A (a) of the Income Tax Act No. 58 of 1962

¹²⁴ Section 80A (b)

¹²⁵ Section 80A (c).

3.2.4.1 in the Context of Business

An abnormality element in the context of business is apportioned into two further criterions namely, the business purpose test and the lack of commercial substance test which the writer will expand on below.

(i) Business purpose test

This test provides that a taxpayer entering into an arrangement must in a business context, not engage in any means which would not normally be employed for legitimate or *bona fide* business purposes other than securing a tax benefit.

The Act does not furnish us with the definition of the term ‘bonafide business purpose’. However Clegg¹²⁶ recommends that the term means that the transaction must be non-fictitious and not mythological, but it is also submitted that the term bears the judicial interpretation of ‘good faith’.¹²⁷

The term bonafide business purpose has been a subject of contention among scholars with some alleging it only creates lack of certainty. Silke in exploring the term bonafide noted that the term relates to the business purpose so that, even if the arrangement is entered into or carried out in a bonafide manner the method employed may nevertheless be found to be abnormal in a business context.¹²⁸

It is thus not conclusive in the sense that an arrangement may be entered into or carried out in a bonafide manner and still found to be abnormal in a business context.

(ii) The lack of commercial substance test

The commercial substance test which is an extension of the business purpose test is split into a general test and a list of indicators that indicates a lack of commercial substance.

The Act in light of the general test establishes the definition of the lack of commercial substance on which the Commissioner places reliance to determine whether an ‘arrangement’ in dispute

¹²⁶ Clegg, D. *Business Purpose Test* (2002). Tax Planning Corporate and Personal, vol.16.

¹²⁷ Jarvis, J. Things are Seldom What They Scheme (1996)4. Juta’s Business Law.

¹²⁸ De Koker, A.P., Williams, R.C. Silke on South African Tax (2013). Chapter 19.

lacks commercial substance.¹²⁹ In line with the definition of an ‘arrangement’ such an ‘arrangement’ must give rise to a tax benefit as well as a notable effect on the business risks or net cash flows.

One of the issues which the current GAAR addresses is the disguised schemes created by taxpayers so as to maximize their tax benefit. It is of great importance to note that a mere tax benefit will not on its own be enough, it must be established that a significant tax benefit was obtained.

According to SARS¹³⁰ commercial substance will be lacking where there is:

- (i) A disproportionate relationship between the actual economic expenditure or loss incurred by a party and the value of the tax benefit that would have been obtained by that party but for the provisions of the GAAR; or*
- (ii) A loss claimed for tax a purpose that significantly exceeds any measurable reduction in that party's net worth.*

(iii) Commercial substance indicators

To appreciate that an ‘arrangement’ lacks commercial substance with regard to section 80C (1) of the Act, the Commissioner will place reliance on section 80C (2) of the Act which lists the indicators to determine whether an ‘arrangement’ in question lacks commercial substance.¹³¹ In terms of the Act, the indicators include but are not limited to the following:¹³²

- The legal substance or effect differs from the legal form of the steps (substance v form);
- The inclusion or presence of round trip financing;
- Accommodating or tax indifferent parties;
- Elements that offset or cancel each other.

¹²⁹ Section 80 C of Act 58 of 1962.

¹³⁰ South African Revenue Service. Draft Comprehensive Guide to General Anti-Avoidance Rule (2010). P.26.

¹³¹ Act 58 of 1962.

¹³² Ibid.

No guideline or indicator tabulated in section 80C (2) of the Act is predominant than the other and once the Commissioner verifies that one of the indicators is present he may subject to section 80C (1) hold such an ‘arrangement’ to be an impermissible avoidance arrangement.

3.2.4.2 in a non business context

The *Income Tax Act No. 58 of 1962* provides in section 80A (b) that an avoidance arrangement is an impermissible avoidance arrangement if in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bonafide purpose, other than obtaining a tax benefit

The aforementioned provision highlights that where an arrangement in a non business context has a bonafide purpose other than obtaining a tax benefit, the Commissioner can still invoke the GAAR to attack the ‘arrangement’.

Clegg recommends that the test to be used in the non business context would be an objective test in that it has to be determined if the arrangement under examination was entered into or carried out by a means or in a manner which would not normally be employed for a bonafide purpose.¹³³

The Commissioner may therefore at his preference attack a legitimate business arrangement using section 80A (b) of the Act instead of section 80A (a).

3.2.4.3 in any other context

The third requirement of the tainted elements is in any other context is also known as the non-length rights and obligations element. This element was also present in the previous GAAR.

An avoidance arrangement is an impermissible avoidance arrangement if¹³⁴:

- (i) *It has created rights or obligations that would not normally be created between persons dealing at arm’s length.*¹³⁵
- (ii) *It would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).*¹³⁶

¹³³ See note 89 above at 26.3.5.

¹³⁴ Section 80A (c) of the *Income Tax Act No. 58 of 1962*.

¹³⁵ Ibid section 80A (c) (i).

In terms of its application section 80A (c) is wide in nature as it applies to any context. Cilliers submitted that this section can be described as the heart of section 80A in that it applies in any context.¹³⁷

The Act does not define the term ‘arm’s length transaction’ and in view of this reference to case law shall be made.

In *CIR v Hicklin*¹³⁸, the court held that the term ‘arm’s length transaction’ indicates a deal between two parties who are independent of each other in a willing buyer and seller environment.

The ‘arms length’ test in so far as rights and obligations is concerned can be elucidated as meaning what unrelated persons to the transaction would have done in a given a situation. Hence such parties to a transaction who are independent of each other will be perceived to have acted at ‘arms length’ in line with the principle of demand and supply.

The second provision under examination is section 80A (c) (ii) , the purpose of this section is to ascertain whether an ‘arrangement’ in question leads to a misuse or abuse of the provisions of the *Income Tax Act No. 58 of 1962*.

The ‘misuse or abuse’ provision is new to the South African *GAAR* and the rationale behind this insertion was to strengthen the modern approach to the translation of tax statutes “in order to find meaning that harmonizes the wording, object, spirit and purpose of the provisions of the *Income Tax Act*”.¹³⁹

There are no guidelines on the concept of misuse or abuse in the Act nor has it been judicially contemplated. It is in view of this that Garg submits that it has to be seen in the context of existing South African legal principles and guidance found in foreign jurisdictions.¹⁴⁰

¹³⁶ Ibid section 80A (c) (ii).

¹³⁷ Cilliers, C. Thou shalt not peep at thy neighbour’s wife: Section 80A (c) (ii) of the Income Tax Act and the abuse of rights (2008). South Africa. The Taxpayer. May: 85-92.

¹³⁸ 1980 (1) SA 481 (A), 41 SATC 179.

¹³⁹ SARS. Tax Avoidance and Section 103 of the Income Tax Act (1962): Revised Proposals. Quoted from Canada Trustco Mortgage Company v Canada 2005 SCC 54.

¹⁴⁰ Garg, R. Removing the fences: *Looking through GAAR* (2012) at 47.

The ‘misuse or abuse’ provision’s origin can be traced back to the *Canadian Federal Income Tax Act* under section 245(4)¹⁴¹ which provides that:

For greater certainty, subsection 245(2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provision of this Act or an abuse having regard to the provisions of this Act.

The main reason of this provision is to limit the *GAAR* found in the Canadian section 245(2) which gives power to the Commissioner to countermand univocal provisions which creates unpredictability and causes prohibitory judicial interpretation.¹⁴² In view of this the Canadian *GAAR* may therefore not be applied where a transaction does not result in the misuse or abuse of the provision of the Act.¹⁴³

Seen as most of the provisions contained in the *GAAR* lack clarity, certainty and predictability, the writer will in the following sub-section examine case law to determine how the courts have applied their minds in reaching at the decisions in tax avoidance related cases.

3.3 Judicial Approach

This section will conceptualize how the courts in South Africa have addressed or applied the provisions of the now repealed section 103 and the *GAAR* currently in force by examining selected case law. This section will also attempt to examine how the courts decisions have influenced taxpayers and their tax advisors.

Bearing in mind that for an ‘arrangement’ to be declared impermissible, there must be an existence of a transaction, operation or scheme, it should further be recognized that South Africa is a common law state and the courts in order to battle tax avoidance schemes which are contemplated intolerable, have embraced a common law ideology that the courts will not be deceived by sham transactions, substance and not the form of a transaction prevails. In *Kilburn v Estate Kilburn*, it was expressed in the most enduring terms that a court will not be misled by the

¹⁴¹SARS.Explanatory Memorandum at 63.

¹⁴²Broomberg, E.B. Then and now (2008) at 31.

¹⁴³ Van Schalkwyk, L.,. Geldenhuys, B. Meditari Accountancy Research (2009) at 167-183.

form of a transaction as it set aside the veil in which the transaction is enveloped and examine its true nature and substance.¹⁴⁴

3.4 Case Law

South Africa has over a period of time developed a wealthy tradition of case law to deal with unacceptable tax avoidance. Some of the cases which the writer will examine relate to the *GAAR* which has since been repealed. Below are a few examples to illustrate how the courts have applied their minds in arriving at certain decisions concerning tax avoidance.

3.4.1 *CIR v Bobat, Moosa and Moolla*¹⁴⁵

In the unreported case of *Bobat, Moosa & Moolla* a trust was formed by the taxpayers' father Mr. E.M. Moosa who was a director in various family companies. The first and third taxpayers are sisters with taxpayer number two. Two family companies namely Trueart Furniture Sales (Pty) Ltd. And KIM Investments (Pty) Ltd. were under the control of the trust. In 1990 a complex scheme was hatched and the two companies under the control of the trust were afterwards deregistered and certain payments made to the beneficiaries. Taxpayer one and three did not declare this income in their returns and taxpayer number two said his receipt was of a capital nature and hence the three taxpayers were not taxed. The taxpayers in this case were acting under the advice of the accountant who actually attested to that effect as a witness that the main purpose of the scheme was to circumvent estate duty at the instance of the beneficiaries upon their deaths.

In view of the above, the Commissioner invoked section 103(1) and applied it to the alleged scheme. On appeal, it was contended by the appellants that section 103(1) did not apply to the alleged scheme.

For section 103 (1)¹⁴⁶ to be invoked, the following four elements listed below must be present:

- (a) A transaction, operation or scheme;

¹⁴⁴ 1931 AD 501 at 507.

¹⁴⁵ In the High Court of South Africa, Natal Provincial Division case no: Ar232/02.

¹⁴⁶ Income Tax Act No. 58 of 1962.

- (b) With the consequence of gaining a tax benefit;
 - (c) Whose sole or main purpose is to obtain a tax benefit; and
 - (d) The transaction in question must have been entered into in a manner which is not normal.
- (a) In arriving at its decision, the court had to first establish whether a transaction, operation or scheme was carried out.**

Placing reliance on *Meyerowitz v CIR*¹⁴⁷ a case which dealt with whether various transaction in terms of section 90¹⁴⁸ amounted to “schemes”, Bayer J stated that:

... Even if it were otherwise, I think that there is sufficient unity about the whole matter to justify its being called an arrangement for this purpose, because the ultimate object is to secure for somebody money free from what would otherwise be the burden or the full burden of surtax. Merely because the final step to secure this objective is left unresolved at the outset, and decided on later, does not seem to me to rob the scheme of the necessary unity to justify its being called an “arrangement.”

In view of *Bobat, Moosa, Moolla*, the taxpayers appointed their wives as beneficiaries of the trust which was formed by the taxpayer’s father. Secondly two of the various companies owned by the family were under the control of the trust and lastly, the two companies are deregistered and certain payments are made to their beneficiaries. The planning and amount of work which went into this can only be construed as an ‘arrangement’ or ‘scheme’ as there was a motive for all this planning and work. The writer is therefore satisfied that that the first element of ‘arrangement’ or ‘scheme’ has been met.

- (b) The second question to be established is whether such transaction, operation or scheme had the repercussion of obtaining a tax benefit.**

The meaning of ‘avoiding tax’ was explored in *CIR v King*, where Watermeyer CJ stated that:

the legislature intended the words “avoiding tax” to cover the case whereby a man orders his affairs that he escapes from liability from taxation which he ought to pay upon the income

¹⁴⁷ Meyerowitz v CIR 25 SATC 287.

¹⁴⁸ Income Tax Act 31 of 1941.

which is really his and reducing the amount of tax from what it ought to be in the next tax year under consideration¹⁴⁹.

However a contradictory view was expressed in the case of *Smith v CIR*¹⁵⁰, where Steyn J held that- the ordinary meaning of avoiding liability for tax on income should be applied meaning “to get out of the way of, escape or prevent anticipated liability”.

Applying Steyn J’s translation of avoiding liability in the *Smith’s case*, it can be explained that taxpayers *Bobat, Moosa and Moolla* conceived a scheme whose sole or main purpose was to get out of the way of, escape or prevent anticipated liability.

This conforms to the second element which stipulates that the transaction, operation or scheme must be carried out to derive a tax benefit.

(c) The third element to be appraised is that the sole or main purpose of entering into the transaction, operation or scheme was to obtain a tax benefit.

In establishing the sole or main purpose of entering into the transaction, operation or scheme, the onus rests on the taxpayer to adduce evidence as to why the ‘arrangement’ or ‘scheme’ was carried out. This premise is backed by Kroon J in *Income Tax Case 1636* where it was expressed that:

The test to be applied is a subjective one, i.e. what was the subjective intention of the taxpayer in entering into or carrying out the transaction? Because a subjective approach is to be applied in the determination of the purpose of the transaction, the evidence of the taxpayer, the progenitor of the transaction, as to why it was entered into or carried out, is of prime importance. The *ipse dixit* of the taxpayer is, however, not decisive and it must be measured against the credibility of the witness who give the evidence, the other evidence adduced and the probabilities¹⁵¹.

The Act does not define nor does it give us guidance on what the term main purpose mean. To determine or ascertain what the term main purpose mean the writer shall make reference to case law.

¹⁴⁹ CIR v King 1947 (A).

¹⁵⁰ Smith v CIR 26 SATC 1.

¹⁵¹ 60 SATC 267.

In the case of *SBI v Lourens Erasmus (Edms) Bpk*¹⁵², it was held that ‘main purpose’ means the most unquestionable, authentic or dominant purpose. This test is subjective meaning that a taxpayer may be influenced by personal taste or opinion therefore a taxpayer may enter into an ‘arrangement’ for two different reasons, for instance one may be induced by a tax consideration while the other may have a different purpose.

Quantitatively the term ‘sole’ would mean 100% in other words it has to be the only reason for engaging in a particular ‘arrangement’ while ‘mainly’ simply has to be above 50% meaning that of the two or more reasons advanced, one has to have a dominant effect.

In the case under consideration, the evidence presented by the accountant showed that the transaction, operation or scheme had been entered into to avoid liability for estate duty payable by the estate upon the demise of the beneficiaries. Secondly, it was necessitated by the need to clean up the group especially because of the impediment emanating from crossholdings between the companies.

Thus it was held that the purpose of the scheme had nothing to do with avoiding liability for income tax.¹⁵³

It was further observed that, if there are two or more purposes and one is chosen over the other, it cannot be said that the main purpose was to avoid tax.¹⁵⁴

To this effect the taxpayers discharged the onus of proving that the sole or main purpose was not carried out for the benefit of obtaining a tax benefit hence the third element was not satisfied and consequently appeal was upheld.

3.4.2 Commissioner for Inland Revenue v Conhage (Pty) Ltd¹⁵⁵

The issue in contention in *Conhage* was the abnormality of the transaction in which SARS challenged the substance over form in light of the rental deductions through a sale and lease back agreement.

¹⁵²1956 (4) SA 344 (A).

¹⁵³67 SATC 47.

¹⁵⁴ITC 1307 (1980).

¹⁵⁵*CIR v Conhage (Pty) (formerly Tycon (Pty) Ltd* 1999 (4) SA 1149 (SCA) 61 SATC 391.

In this case the respondent concluded an agreement with regard to its manufacturing plant and equipment through a sale and leaseback agreement with Firstcorp Merchant Bank Ltd 'Firstcorp'. The respondent included in its returns, rental expenditure for deduction in the production of income under section 11 (a) of the *Income Tax Act*.¹⁵⁶ However SARS disallowed the deductions alleging that, the agreements were not what they appeared to be and went on and went on to invoke section 103 of the Act.

The taxpayer was discontented with the Commissioner's decision appealed to the Special Court and appeal was granted.

The issue in this appeal was to determine the legitimate nature of the sale and leaseback agreements and ascertain whether commissioner correctly applied section 103 of the Act.

(a) The first point of the study is therefore to explore and determine whether an undertaking is a transaction, operation or scheme.

The taxpayer (Tycon) needed a capital injection so that it could diversify its operations and Firstcorp was willing provide such a loan. The parties settled for a sale and leaseback agreement fully aware of the tax benefits to be gained from this undertaking. Prior to the conclusion of these agreements, the parties' orchestrated substantial deliberations with their experts, this gave rise to the agreements under examination.

Following the lengthy process the parties underwent, the sale and leaseback agreements was finalized by the taxpayer (Tycon) and the financier Firstcorp Merchant Bank. In accordance with section 103, the undertaking constituted a transaction, operation or scheme.

(b) The second element to be satisfied is whether such a transaction, operation or scheme gave rise to a tax benefit.

As seen above, the Commissioner alleged that the parties designed the agreement in such a manner so as to obtain a tax benefit as envisaged by section 103. However the taxpayer noted that the financing could either be arranged as a loan or a sale and leaseback and the taxpayer

¹⁵⁶ No. 58 of 1962.

choose the latter fully acknowledging that although the transaction was entered into so as to reduce its tax liability, it argued that it was not the main purpose of the transaction.

The second element of a transaction, operation or scheme giving rise to a tax benefit has also been satisfied.

(c) The third element to be determined is that the taxpayer entered into a transaction, operation or scheme for the sole or main purpose of gaining a tax benefit.

The general rule is that once it has been determined that a taxpayer entered into a transaction, operation or scheme for the purpose of obtaining a tax benefit, the burden of proving that such a transaction, operation or scheme was not entered into for the sole or main purpose of obtaining a tax benefit is on the Taxpayer.

The taxpayer (Tycon) in giving evidence contended that the main purpose of entering into a sale and leaseback agreement was to procure capital and not to obtain a tax benefit. It further contended that if the tax benefit derived from the agreements can be considered as a purpose of the transaction, then it was not the main purpose of the transaction.

In arriving at the decision, the Judge held that the taxpayer could not have carried out an undertaking if it did not require capital, thus the third element was not satisfied.

(d) Upon determining that the dominant purpose was to obtain a tax benefit or otherwise, the last inquiry as anticipated by section 103¹⁵⁷ is to establish if the transaction was entered into in a manner which is abnormal.

Section 103¹⁵⁸ warrants the Commissioner to establish the taxpayer's liability for tax by dismissing any abnormal transaction which a taxpayer may have carried out to gain a tax benefit. It is notable that the consequence of such transactions is fundamentally a question of fact. Unlike the third element where we noted that onus lies with the taxpayer to prove that the tax benefit was not the dominant purpose of entering into a transaction in question, the onus of proving the existence of an abnormal element in a transaction rests on the Commissioner.

¹⁵⁷ Income Tax Act No. 58 of 1962.

¹⁵⁸ Ibid.

In *Conhage*, the Commissioner contended that while the taxpayer did not act dishonestly by concealing the transactions, the undertaking fell short of the necessary elements of a sale. It was further contended that the parties had no true intention of entering into the agreements of sale and leaseback as they masked the real nature of the transactions.

In passing judgment, the court established that the onus of proving the originality of the agreements was on the taxpayer which it rightly discharged. It was also held that the Commissioner had failed to prove the abnormality of the sale and leaseback agreements and that the taxpayer proved the lack of the purpose requirement.

Relying on the authority of *SIR v Geusteyn, Forsyth and Joubert*¹⁵⁹, the Judge outlined three points to contemplate when establishing what amounts to ‘normality’ or ‘abnormality’ of the transaction.

The first one was that, given that the Commissioner may invoke section 103(1) upon the satisfaction of all the requirements, the court may on appeal reconsider the whole case.

Secondly, when deciding on the consequence, motive and normality of a transaction these are questions of fact and the onus rests with the Commissioner.

And the last point to be determined is the real purpose of the taxpayer.

On conclusion, Hefer J stated that, the agreements of sale and leaseback had a dual purpose of securing the taxpayer (Tycon) with capital and the benefit of tax advantage. It was further noted that even if the transaction was purely for a tax benefit, the taxpayer would not have entered into the transaction if it did not require a loan; therefore, the main purpose was because it needed capital.

3.4.3 Commissioner for South African Revenue Authority Service v NWK Ltd.¹⁶⁰

The court in establishing that a transaction, operation or scheme is an ‘impermissible avoidance arrangement’ has due to the lacuna not addressed by the GAAR moved a step further and adopted

¹⁵⁹ 33 SATC 113.

¹⁶⁰ C: SARS v NWK Ltd 2011 (2) SA 67 (SCA).

common law doctrines to assist in determining the true substance and commercial purpose surrounding a transaction in question.

The doctrine of substance over form was applied in *C: SARS v NWK*.¹⁶¹ The brief facts of this case are that the financial institution approached the respondent with an offer amounting to six agreements. The respondent borrowed R96 million instead of the R50 million which it initially wanted. The respondent secured this deal by entering into a contract on the set terms. In accordance with the six agreements, the financier was in a position to apply for a set off so that the commitment to repay the loan borrowed by the respondent (taxpayer) would be expunged when time for repayments came.

The loan was structured in such a way that, the respondent was to make repayments in the form of delivering maize to the financial institution. This formal proposal was confidential and property of the financial institution to which the respondent (taxpayer) was to sign a confidentiality undertaking to protect the financial institution's trade secrets and highly confidential and sensitive information. This proposal which was subsequently approved also indicated that the respondent (taxpayer) would be able to deduct the interest incurred on the capital sum in the year of assessment under section 11(a).

After allowing the deductions; the Commissioner reversed his decision and imposed additional tax of about 200 per cent plus interest. The taxpayer objected to this assessment but it was disallowed.

The taxpayer took the matter on appeal to the Tax Court. On appeal, the Tax Court found in favour of the taxpayer alleging that, the parties only intended to give effect to the terms of the contract.

The court further held that, section 103 could not be applied on the basis that it cannot be used as an alternative to declare a transaction simulated.

On appeal to the Supreme Court of Appeal the Commissioner placing reliance on section 103 alleged that, the series of transactions gave rise to a transaction, operation or scheme.

¹⁶¹ Ibid.

Three essential elements to be met as contemplated by section 103(1)¹⁶², were met. The dispute was whether this transaction, operation or scheme, was entered into in a manner which is abnormal.

The court stated that, the mere fact that the taxpayer produced the agreements does not mean that the taxpayer discharged the onus that loan was not manufactured.

In examining the nature of the transaction, operation or scheme in *Erf 3183/1 Ladysmith (Pty) Ltd. v CIR*¹⁶³, Hefer JA stated that:

... This is plainly not so. That the parties did not indeed deliberately cast their arrangement in the form mentioned, must of course be accepted, that, after all, is what they had been advised to do. The real question is; however, whether they actually intended that each agreement would between the parties have effect according to its tenor. If not, effect must be given to what the transaction really is.

The Judge also reflected on the perspective of Harms JA as highlighted in the case of *Relier (Pty) Ltd. v CIR*¹⁶⁴, where it was noted that if agreements under consideration were taken at the apparent worth then the court have to rule in favour of the taxpayer, however if it is found that the agreement in question had ‘unfamiliar’ and ‘fictitious’ characteristics to it then questions of the real intention of the taxpayer have to be raised.

The court in this case had to remove the wrapping from the transaction to examine the substance and the true nature of the transaction. Lewis JA came to the conclusion and held that:

... There is something with dressing up or disguising a transaction to make it appear to be something that it is not, especially if that has the purpose of tax evasion or the avoidance of a peremptory rule of law.¹⁶⁵

It was thus held that the transaction was manufactured in that the transactions *inter partes* had no commercial substance and hence did not make business sense.

The *NWK* decision is a departure from the *Conhage* case in that the court has embraced the doctrine of substance over form. It was attested by the Supreme Court of Appeal that there is

¹⁶² Income Tax Act No. 58 of 1962.

¹⁶³ 1996 (3) SA 942 (A) at 953A-F.

¹⁶⁴ 60 SATC 1 (SCA) at 7.

¹⁶⁵ 2011 (2) SA 67 (SCA).

nothing erroneous in principle to enter into arrangements which are tax effective; it is however wrong to conceal a transaction to make it appear something it is not.¹⁶⁶ Therefore the commercial sense aspect must be reviewed in establishing the true substance and purpose of a transaction.

The *NWK* judgment received mixed reaction. Some practitioners and scholars¹⁶⁷ believed that, the existence of a statutory *GAAR* creates a challenging obstacle to the creation of judge-made anti-avoidance rules¹⁶⁸.

It is also discerned that, even if the court used the term ‘tax evasion’ it actually intended to refer to tax avoidance¹⁶⁹.

Broomberg also asserted that, if this is correct, then the court did not respect the rule of law because no tax should be payable if a transaction gives rise to genuine rights and obligations that, even after the application of the statutory *GAAR* do not attract tax under the *Income Tax Act*¹⁷⁰.

3.5 The effect hereof on Tax Payers and Tax Advisors

Having examined the predated *GAAR* in section 103, *Part IIA* of the *GAAR* which is currently in force and some selected case law, it has been established that there has been a notable development in the study and theory of law in the area of tax avoidance.

It has been observed that when section 103 was in force, Judges used a literal approach of interpreting provisions of the tax statutes an attitude which was seen to favour taxpayers (as noticed in *Conhage*) than the *fiscus*. However with the enactment of *Part IIA*, Judges have developed a tougher attitude known as a purposive approach of interpreting tax statutes. This approach favors the *fiscus* contrary to the literal approach which favored taxpayers as witnessed in cases before the *NWK Ltd*.

¹⁶⁶ C:SARS v NWK Ltd. 2011 (2) SA 67 (SCA).

¹⁶⁷ Davies, D. Income Tax- Deductibility of Interest- Test for Simulated Transactions- Former Section 103(1) of the Income Tax Act (Note on NWK) (2010). 59 The Taxpayer 11/12 at 203-221; and Emslie, T. Simulated Transactions- A New Approach? (2011). 60 The Taxpayer 1 at 2-7.

¹⁶⁸ Broomberg, E. NWK and Founders Hill (2012). 60 The Taxpayer 10/11 at 200.

¹⁶⁹ Judge Wagley’s concurring opinion in the unreported case of Bosch v Commissioner for South African Revenue Service at para 5 and 9.

¹⁷⁰ See not 87 above at 199 and 202.

The inquiry has also shown that both the *GAAR* and case law has not provided us with a clear test to indicate what constitutes acceptable or unacceptable tax avoidance. The lack of clarity, certainty and predictability in as far as acceptable and unacceptable avoidance behavior is concerned has posed serious challenges for taxpayers and their advisors.

With the ever increasing complex and sophisticated schemes formulated by taxpayers and their advisors, it has become increasingly difficult for law makers to foretell schemes which would amount to unacceptable tax behavior. It is therefore imperative that more research on tax avoidance and the *GAAR* is required so as to come up with a conclusive *GAAR* which will help pre-empt tax avoidance.

While it is generally acceptable that a taxpayer should be ‘entitled to use his craftiness and expertise without limit in order to secure a lower tax charge’, and that it is the responsibility of the law makers to ‘introduce specific rules to block such attempts’ this is seen to lead to a ‘sort of fiscal chess game, but with an ever increasing number of moves and pieces’.¹⁷¹

The uncertainty surrounding tax avoidance and the *GAAR* can partly be attributed to a poor design of a *GAAR* which has negative effect in that it has a conceptual advantage of drawing a line in the sand to guide taxpayers between what is acceptable or impermissible tax behavior.¹⁷²

However it must be noted that according to the *contra fiscum* rule, were the *GAAR* is found to be enigmatic both in design or administration leading to uncertainty for taxpayers, then such ambiguity should be ruled in favour of a taxpayer.¹⁷³

Considering that the burden of proof is mostly on the taxpayer to defend against a *GAAR* attack, the inference to be drawn on having a *GAAR* may be seen as commanding a significant and arguably oppressive compliance burden on taxpayers.¹⁷⁴

It is however common place that, the application of the *GAAR* is often a relevant factor in the administration of other provisions of a tax code affecting advisors.¹⁷⁵ For instance under *Part*

¹⁷¹ *Ibid.*

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

¹⁷⁴ *Ibid.*

¹⁷⁵ *Ibid*, p.8.

IVA of the Australian *Income Assessment Tax Act* No.27 of 1936 is a relevant factor in the application of the Promoter Penalties rules which make tax avoidance an offence.¹⁷⁶

The deep-rooted judicial approach which allowed taxpayers to structure their tax affairs so as to reduce their tax liability seems to have been annihilated by the decision of the *C: SARS v NWK*¹⁷⁷, therefore thwarting the taxpayer's hope of utilizing the loopholes of the tax statutes as permitted by law to reduce their tax liability.

¹⁷⁶ *Ibid*, p.8

¹⁷⁷ *C: SARS v NWK Ltd* 2011 (2) SA 67 (SCA).

Chapter 4

4 Comparative Jurisdictions

Having established that tax avoidance affects many if not all jurisdictions other than South Africa, Australia and the United Kingdom will be examined to ascertain how these comparative jurisdictions have approached the challenges surrounding tax avoidance.

Most common law jurisdictions such as Australia have enacted a *GAAR* to capture unacceptable tax avoidance behavior. It has also been established that most jurisdictions originally drew the principles of tax avoidance from the *Duke of Westminster* case, where it was pointed out by the House of Lords, that every man is entitled to order their affairs so as to minimize the amount of tax payable¹⁷⁸.

This has made the tax systems of most of these world governments endemic in the United Kingdom tax system simply because these jurisdictions share a common heritage with the UK tax Jurisprudence.

4.1 Australia

Just like South Africa, Australia has in order to address the challenges posed by tax avoidance devised a statutory mechanism which is contained in the Australian *Income Assessment Tax Act*¹⁷⁹ known as the *GAAR*.

4.1.1 Background

The Australian anti-avoidance rules were initially contained in section 260 of the Australian *Income Tax Act* and just like the South African section 103;- it proved ineffective to address tax avoidance related challenges.

Section 260 was expressed in extremely broad language, such that it had practically inexhaustible application, operating to invalidate any transaction that produced a tax benefit¹⁸⁰. Given that the legislature could not have purposefully intended to cancel all arrangements with

¹⁷⁸ (1936) A.C 1 HL.

¹⁷⁹ No. 27 of 1936.

¹⁸⁰ See note 3 above at p. 32.

this effect, the courts desired to place reasonable limits on the operation of section 260¹⁸¹. To achieve this outcome, the courts interpreted the section using the choice principle.

The purpose of the choice principle as established by the court was that section 260¹⁸² intended to safeguard the general provisions of the Act from vexation and not to oppose taxpayers any right of elect between alternatives which the Act itself affords them.¹⁸³

In view of the above section 260 proved to be ineffective to fight sophisticated tax avoidance schemes promoted by tax advisors¹⁸⁴ resulting in it been repealed and replaced with *Part IVA of the Income Tax Assessment Act*, which subsequently came into effect on the 27th May 1981.

The introduction of *Part IVA of the ITAA of 1936* was welcomed by the Treasurer, were it was stated that, it was introduced to:

... Strike down blatant, artificial or contrived arrangements but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs¹⁸⁵.

It was also stated that *Part IVA of the ITAA* would not affect normal commercial transactions by which taxpayers genuinely take advantage of the occasion available for the arrangement of their affairs.¹⁸⁶

The *Income Tax Assessment Act of 1936* provides essential criterion to be met before the *GAAR* can be invoked on an arrangement.

4.1.2 Features of the Australian GAAR

The essential features for the application of the *GAAR* are that:

- there must be a scheme;¹⁸⁷

¹⁸¹ Ibid p.

¹⁸² Income Tax Assessment Act of 1936.

¹⁸³ Keighery (Pty) Ltd v Federal Commissioner of Taxation (1957) 100 CLR 66, 92.

¹⁸⁴ Grbich, Y. Problems of tax avoidance in Australia. In Head, JG (ed). Tax Issues of the 1980s (2983). Australian Tax Research Foundation at p 413.

¹⁸⁵ Cassidy, J. The Holy Grail: The search for the optimal GAAR, quoting second reading speech, Hansard, House of Representatives, 27th May 1981, 2683-4 at 744.

¹⁸⁶ Ibid.

¹⁸⁷ Section 177A of the *Income Tax Assessment Act of 1936*.

- which must give rise to a tax benefit;¹⁸⁸ and that
- Such a scheme must have been entered into for the sole or dominant purpose of obtaining a tax benefit.

4.1.3 There must be a scheme

*The Australian Income Tax Act defines a ‘scheme’ as:*¹⁸⁹

- *Any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;*
- *Any scheme, plan, proposal, action, course of action or course of conduct.*

Australia uses the term ‘scheme’, while in South Africa the term ‘arrangement’ is used to bring out the elements that must be met for an arrangement to be categorized an impermissible avoidance arrangement.

The inclusion of an ‘arrangement’ or ‘part’ of ‘arrangement’ in section 80L¹⁹⁰ and the express statement in section 80H¹⁹¹ that the Commissioner can apply the legislation to any ‘any steps in or parts of an arrangement’ removes the need to consider the difficulty question under *Part IVA* whether the arrangement is a scheme or a mere sub-scheme.¹⁹²

It is further observed that the definite recollection in sub-section 80G (2)¹⁹³ that it is sufficient under the South African GAAR if one part of an arrangement has the necessary predominant basis of obtaining the tax benefit, rather than demanding that the scheme in its entirety be distinguished, meaning that the subject of recognizing the true scheme is mainly worthless.¹⁹⁴

¹⁸⁸ Ibid section 177C.

¹⁸⁹ Section 177A (1).

¹⁹⁰ Income Tax Act No. 58 of 1962.

¹⁹¹ Ibid.

¹⁹² Cassidy, J. The Holy Grail: The Search for Optimal GAAR (2009) 126. *South African Law Journal*, p.752.

¹⁹³ Income Tax Act No. 58 of 1962.

¹⁹⁴ Cassidy, J. The Holy Grail: The search for the optimal GAAR (2009). *South African Law Journal*, vol. 126 at 752.

It is not necessary for an ‘arrangement’ in its entirety to be justified by a non-tax purpose, as long as each step/part of the arrangement in seclusion is founded on a genuine non-tax purpose¹⁹⁵.

Both the Australian and South African tax statute defines ‘scheme’ and ‘arrangement’ in a dissimilar manner. For instance *Subsection 177A (3)*¹⁹⁶ provides that a ‘scheme’ includes unilateral scheme, plan, proposal, action, course of action or course of conduct, while the latter provides that an ‘arrangement’ includes any operation, transaction, scheme...

In *FCT v Peabody*¹⁹⁷, the term ‘scheme’ was interpreted by demanding that the attributes that comprises the professed scheme must be capable of standing on their own without being dispossessed of all actual interpretation. The consequence of this precondition is that the weaker the authentic arrangement appears to be; the less likely it will be capable of standing on its own in line with the set test by the High Court¹⁹⁸.

To determine what a ‘scheme’ is as per the provisions of *Part IVA* the court will look at the circumstances surrounding each case on a case by case basis.

In *Spotless Services Ltd v FCT*, in dealing with the definition of a scheme it was stated that a ‘scheme’:

... requires that the parties to the scheme, insofar as they are known, must be identified and in terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal insofar as they are relevant, be identified. In addition, the courts held that ‘all the relevant facts had to be included in the relevant formulation before the factual scenario could be said to be capable of standing on its own and own and thus constituting a scheme’¹⁹⁹.

Part II A of the ITA No. 58 Of 1962 only applies to part or parts of an ‘arrangement’ and the Australian ‘capable of standing alone’ principle is therefore not applicable under section 80L of the Act.

In examining the ‘capable of standing alone’ principle Callinan J noted that the Commissioner:

¹⁹⁵ Ibid.

¹⁹⁶ Income Tax Assessment Act of 1936.

¹⁹⁷ (1994) 94 ATC 4663 at 4670.

¹⁹⁸ (1992) 92 ATC 4585; (1993) 93 ATC 4104; (1994) 94 ATC 4663.

¹⁹⁹ (1995) 95ATC4775 at 4805.

... cannot seize upon and isolate on event, or a series of events, which standing alone may appear to have a complexion which it or they cannot truly bear when other relevant connected events are taken, as they should be into account²⁰⁰.

The exposition of the ‘capable of standing alone’ test would appear immaterial to section 80L as section 80G, 80H and 80L clearly provides that connected attributes do not have to be contained in the specialty arrangement.²⁰¹

Section 80C (2) of the Act²⁰² provides that, an avoidance arrangement lacks or is deemed to lack commercial substance, if 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 step.

Section 80L of the Act²⁰³ provides for an arrangement to include ‘all steps there in or parts thereof,

And section 80G (2) of the Act²⁰⁴ 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’. To this end, no matter how legitimate the overall arrangement is, *Part IIA* will not be prevented from being applied if part of an arrangement was entered into for the sole or main purpose of obtaining a tax benefit²⁰⁵. This serves as an advantage to taxpayers because only part of an ‘arrangement’ which falls short will be under attack and before the Commissioner attacks such an ‘arrangement’; he is obliged to disclose exactly which part of the arrangement he is attacking.

However section 177D of Part IVA cannot be applied to part of an ‘arrangement’ which is alleged to be not genuine if the overall ‘arrangement’ seems legitimate. This provision is applied to a ‘scheme’ in its entirety and the determining factor is the dominant purpose underlying such an arrangement.

²⁰⁰ FCT v Peabody 4670.

²⁰¹ Cassidy, J. The Holy Grail: The search for optimal GAAR (2009). South African Law Journal, vol. 126

²⁰² ITA No. 58 of 1962.

²⁰³ Ibid.

²⁰⁴ Ibid.

²⁰⁵ SARS. Explanatory Memorandum.

In *Peabody v FCT*, it was stated that:

Where, as a matter of fact, a scheme consists of a course of action comprising several steps the Commissioner may [not] isolate out of that course of action one step and classify that as a scheme... [In] a case where a series steps constitutes, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself²⁰⁶.

Notwithstanding that the decision of the High Court was unanimous; the court was divided on the continued application of *Part IVA*, while the majority of the court accepted and applied the decision in the *Peabody case*. , the Judgment of Gummow and Hayne JJ outright rejected its principles and this is seen as an outright shift away from the existing law, the decisions of Gleeson CJ, McHugh and Callinan JJ also represent a shift in the approach, this has been the perception of the courts²⁰⁷.

4.1.4 A scheme must have the effect of a tax benefit

On establishing that a transaction entered into by a taxpayer is a ‘scheme’ the next essential factor to be identified is that such a ‘scheme’ gave rise to a tax benefit. The definition of ‘tax benefit’ under section 177C²⁰⁸ is extensive and includes among others, an amount not included in an assessable income, a deduction, incurrance of a capital loss and the allowance of a foreign tax credit.

Much as the definition seems to be exhaustive in nature, other tax benefits such as rebates and credit were not covered and such were not a concern of *Part IVA*. To secure rules on establishing whether a tax benefit has arisen or not, section 177C (4)²⁰⁹ was amended. This was done so as to tighten the rules which determine when a tax benefit had been obtained.

Section 177C²¹⁰ is specific as to when, a taxpayer is deemed to have obtained a tax benefit. The South African definition of a tax benefit is inclusionary and comprehensive in comparison to the Australian one.²¹¹

²⁰⁶ (1993) 93 ATC 4104, 4111.

²⁰⁷ *Macquarie Finance Ltd v FCT* (2004) 2004 ATC 4708, 4710.

²⁰⁸ Income Tax Assessment Act 1936.

²⁰⁹ Income Tax Assessment Act of 1936.

²¹⁰ *Ibid*.

In the case of *Peabody v FCT*, both the Federal Court and the High Court held that:

Section 177C (1) (a) desires a logical prospect, not a minimal likelihood, that the taxpayer would have gained a tax benefit but for the scheme²¹². It is further notable that, this test prescribes a forecast of occurrences that may have transpired if the scheme had not been entered into and the projection must be adequately dependable for it to be contemplated as reasonable.²¹³

Under *Part IIA of the Act*, there is no requirement for causal connection, all is needed is establish that there is a tax benefit. Upon establishing that a tax benefit has been obtained, there is a shift as to whether the sole or main purpose of the ‘arrangement’ was to obtain a ‘tax benefit’.

Section 80E (1) (b) (i) of the South African Income Tax Act and *section 177C (1)*²¹⁴ both contain the phrase ‘would have’.

Part IVA is much more specific and detailed compared to *Part IIA* and it is perceived that the more specific and detailed the system’s rules become, the more ways people find to outwit those rules²¹⁵

4.1.5 Dominant Purpose

The third element to be determined is that a ‘scheme’ was entered into for a ‘sole’ or ‘dominant’ purpose of obtaining a tax benefit.

The term ‘purpose’ is described in section 177A (5) as:

A reference in this part of to a scheme or part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part

²¹¹ Cassidy, J. The Holy Grail: The Search for Optimal GAAR (2009). South African Law Journal, vol. 126 p.752

²¹² (1993) 93 ATC 4104, (1994) 94 ATC 4663.

²¹³ Ibid at 4111-4112.

²¹⁴ Income Tax Assessment Act of 1936.

²¹⁵ Freedman, J. Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle (2004). 4 Brit Tax Review at 346.

*of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose*²¹⁶.

The general effect of section 177A (5) is that the ‘sole or dominant purpose’ of entering into the scheme must have been to obtain a tax benefit²¹⁷. It would appear that the pertinent justification need not be that of the person to derive the tax benefit²¹⁸ and that it is not inevitable that the benefit obtained is the benefit desired to be obtained²¹⁹.

The third requirement is solely based on the eight elements as contemplated by section 177D of *Part IVA*. These factors or tests may be summarized as follows:²²⁰

(1) the manner in which the scheme was implemented; (2) its form and substance; (3) the timing of the scheme (4) the result which would be achieved by the scheme but for *Part IVA*; (5) any change in the taxpayer’s financial position as a result of the scheme; (6) any change in any other person’s financial position; (7) any other consequences for the relevant taxpayer or any other person connected with the scheme; (8) the nature of the connection between or among parties to the scheme.

Section 177D draws its principles from Lord Denning’s Predication Test as set out in *Newton v FCT*²²¹ where it was noted that:

In order to bring the arrangement within the section you must be able to predicate by looking at the overt acts by which it was implemented that it was implemented in that particular way so as to avoid tax.

If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessary being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares cum dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div. 7 tax, see *W.P. Keigherry Pty Ltd v*

²¹⁶ Income Tax Assessment Act 1936.

²¹⁷ Martin, F., Rodman, S. *Part IVA and Peabody*. Queensland University of Technology Law Journal, p 164.

²¹⁸ *Ibid*.

²¹⁹ *Ibid*.

²²⁰ Australian Tax Office Comments on the Operation of *Part IVA* (2005) at p.4.

²²¹ (1958) 98 CLR1.

Commissioner of Taxation (1958) 32 ALJR at 118. Nor can anyone, on seeing a declaration of trust made by a father in favour of his wife and daughter, predicate that it was done to avoid tax, see *Deputy Federal Commissioner of Taxation v Purcell (1921) 29 CLR 464*. But when one looks at the way the transaction were effected in *Jacques v Federal Commissioner of Taxation (1932) 48 CLR 548*- the way the cheques were exchanged for like amounts and so forth there can be no doubt at all that the purpose and effect of that way of doing things was to avoid tax²²².

The prediction test was applied in *FCT v Consolidated Press Holdings*²²³ where it was established that the appropriate dominant purpose may be so recognizable on the evidence taken as a whole.

In a more recent case *FC T v Hart*, a taxpayer borrowed money under a split loan facility, and put part of it to a private or domestic use and applied the balance to purchase an asset to be used for the purpose of gaining or producing assessable income. The loan agreement contained a condition that the borrower must ‘direct the application of the whole of the payments required under the loan agreement to the satisfaction of that part of the loan used for private or domestic purposes’. Interest on the balance of the loan was allowed to accrue and be capitalized and compounded.²²⁴

The court held that the significance of the scheme was the borrowing of money for use in financing and refinancing the two properties on the terms of the ‘Wealth Optimiser’ loan facility, and that the dominant purpose was to secure the acquisition or retention of the properties rather than the tax benefit.²²⁵

It was however observed that the court’s decision in the above case amplified the application of *Part IVA* past the requirements of the Act and by so doing; the High Court has set the magnitude for avoidance arrangements too low.²²⁶

²²² (1958) 98 CLR1.

²²³ 2001 ATC 4343.

²²⁴ (2004) ATC 4599.

²²⁵ Ascenzo, MD. *Part IVA: Post Hart* (2004) 7(2) Journal of Australian Taxation.

²²⁶ Zeman, L. *Federal Commissioner of Taxation v Hart: Did The High Court Set The Threshold Too Low?* (2007) 17 Issue 1, Art. 3. Revenue Law Journal.

A recognized tax benefit should not lead necessarily to satisfaction of the dominant purpose test and two concepts unfold from the *Hart case* to underpin this argument.²²⁷ The first point is that, when applying the section 177D (b) factors the High Court focused too much on the manner, form and substance criteria.²²⁸

Secondly, that they ignored the ‘commerciality’ of the arrangement when coming to a conclusion about dominant purpose.²²⁹

In reaching the decision, Hill and Hely JJ discerned and applied the perspective taken by the Full bench in *Eastern Nitrogen Ltd v FC of T*²³⁰ and in *FCT v Metal Manufacturers Ltd*²³¹, where the assumption by business enterprises of lease finance transactions instead of money lending transactions in the literal sense was found to fall outside of the operation of *Part IVA*, and although one of the purposes of the taxpayer in each case was to obtain a tax benefit, the prevalent or most influential purpose of each taxpayer was to obtain a large financial facility on the best terms reasonably available²³².

The equivalent of section 177D of *Part IVA* in South Africa is section 80A which provides that:

an impermissible avoidance arrangement exists where; the sole or main purpose of the avoidance arrangement was to obtain a tax benefit”²³³.

As envisaged by section 80G²³⁴, a taxpayer obtaining a tax benefit must establish that, to a moderate or acceptable degree in light of the relevant facts and circumstances, the sole or main purpose of obtaining a tax benefit is not the main purpose of the avoidance arrangement.

Under the repealed section 103, the onus was on the Commissioner to establish that all elements are present and once it was satisfied that the sole or main purpose was to obtain a tax benefit, and then the burden of proof shifted to the taxpayer²³⁵.

²²⁷ Ibid at 7.

²²⁸ Ibid.

²²⁹ Ibid.

²³⁰ 2001 ATC 4164; (2001) 108 FCR 27.

²³¹ 2001 ATO 4152; (2001) 108 FCR 150.

²³² 2002 ATC 4608, 4627.

²³³ Income Tax Act (1962).

²³⁴ Ibid.

The above was criticized in that case law suggests that the taxpayer's *ipse dixit* may be inadequate to discharge the onus of proof²³⁶. With regard to *Part IIA*, the purpose test is when the arrangement was implemented, whereas under *Part IVA*, the time for testing the dominant purpose is generally the time at which the scheme was entered into or carried out, and by reference to the law as it then stood²³⁷.

In view of the decisions reached in *Hart and Spotlight Stores*, section 177D requires that, a person must have entered into the scheme with the sole or dominant purpose of obtaining a tax benefit for the taxpayer. The question posed under this provision is aimed at establishing the dominant purpose of the relevant person(s), not the dominant purpose of the scheme itself²³⁸. It is important to note that the person with the purpose need not be the taxpayer, in *Vincent v FCT*²³⁹ and *FCT v Sleight*²⁴⁰, it was held that it is enough that the promoter of the scheme has a dominant purpose.

Therefore if a taxpayer utilizes the services of a professional tax advisor, it matters not that the taxpayer did not have a purpose in relation to the scheme or part of the scheme, hence this will not prevent the operation of section 177D.²⁴¹

Arrangements that lack commercial substance are listed in section 177D²⁴² and in the case of South Africa they are listed under section 80C (2)²⁴³

In the South African scenario, the factors that are indicative of a tax avoidance scheme are not supplementary to, but rather inter-connected with the question of whether the 'sole or dominant

²³⁵ CIR v Conhage (1999) 4 SATC 1149 (SCA), 61 SATC 391.

²³⁶ Brinker, E. The purpose requirement of the general anti-avoidance provision in South African fiscal law (2001). TSAR, 158 at 160.

²³⁷ FC of T v Spotlight Stores Pty Ltd (2005) ATC 4001 at 4015; FC of T v Sleight (2004) ATC 4477 at 4511-12.

²³⁸ Hart v FCT (2004) ATC 4599 at 4613; FCT v Spotlight Stores Pty Ltd (2005) ATC 4001 at 4015.

²³⁹ (2002) ATC 4490 at 4518-19.

²⁴⁰ (2004) ATC 4477.

²⁴¹ FCT v Consolidated Press Holdings Ltd (2001) ATC 4343 at 4360.

²⁴² Part IVA of ITAA OF 1936.

²⁴³ Income Tax Act No. 58 of 1962.

purpose was to enable the taxpayer to obtain a tax benefit²⁴⁴. Section 177D requires that an unbiased inference has to be drawn and not the taxpayer's genuine purpose.

4.2 United Kingdom

The United Kingdom does not have a statutory mechanism known as the general anti-avoidance rules to help them combat tax avoidance. More recently the government asked Graham Aaronson QC to steer a study that would appraise whether there should be a general anti-avoidance rule for the UK²⁴⁵.

The United Kingdom mostly relies on statutory provisions known as the Targeted Anti-Avoidance Rules (*TAARS*) and judicial doctrines which have been developed over a period of time to combat tax avoidance.

4.2.1 Statutory approach

As established above, the United Kingdom does not have a *GAAR* in place to curb tax avoidance. The UK mainly relies on specific anti-avoidance rules as contained in various other statutes known as the Targeted Anti-Avoidance Rules to counter tax avoidance.

In contrast to the *GAAR*, the *TAARS* are not contained in one single document but exist in various other statutes. It has been observed that *TAARS* have in effect embraced an equidistant road between the administering of the *GAAR* and the detailed technical provisions aimed at rebuffing every element of unacceptable tax avoidance²⁴⁶.

In the Budget of 2008 it was announced that the HMRC was considering whether there might be a possibility for greater a greater alignment of provisions that include the concept of 'unallowable purposes'²⁴⁷.

²⁴⁴ See note 117 above vol. 126 issue 4 at 773.

²⁴⁵ http://webarchive.nationalarchives.gov.uk/http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.pdf.

²⁴⁶ Freedman et al. *Alternatives to tax risks and tax avoidance: an analysis of a face to face corporate survey* (2008). Oxford University Centre for Business Taxation, WP 8/14 at 24.

²⁴⁷ HMRC. 'Simplifying Anti-Avoidance Legislation: A Progress Report on the Anti-Avoidance Simplification Review (12 March 2008), paragraph 3.8 (<http://www.hmrc.gov.uk/budget2008/aa-simplification.pdf>).

The main feature for most *TAARs* is the taxpayer's motive of entering into a transaction. Therefore, if a *TAAR* carries an 'unallowable purpose' test, there are difficulty questions of construction to be contemplated by the taxpayer, such as working out which part or parts of commercial arrangements the *TAAR* applies to²⁴⁸. The test requires that the element of 'tax advantage' or 'tax benefit' be satisfied, and that the taxpayer is left to come to a conclusion as to what their transaction should be compared with in order to establish whether such advantage or benefit has been obtained²⁴⁹. It has also been stated that the effectiveness of *TAARs* and the clarity of the system are not improved by putting provisions into secondary rather than primary legislation²⁵⁰.

The *TAARs* are generally complex and raise a lot of uncertainties in the fight against tax avoidance. It is against this that the UK government appointed a committee in 2010 to conduct a study so as to establish whether the introduction of the general anti-avoidance rules will help solve this problem.

4.2.2 GAAR v TAAR

One notable feature as established above is that the *GAAR* is contained in one single document whereas the *TAARs* are contained in different statutes. The *GAARs* are all-embracing in nature aiming to encapsulate a wider domain of tax avoidance activities, whereas the *TAARs* are focus driven in nature and thus have a restricted application.²⁵¹

Despite the differences highlighted above, the *TAARs* and *GAARs* both have the same effect of combating tax avoidance.

A well drafted *GAAR* which brings out what Parliament had intended is more likely to go a long way to aid the judiciary by giving effect to the legislature's intention.²⁵²

²⁴⁸ Bowler, T. Countering Tax Avoidance in the UK: Which Way Forward? (2009), Tax Law Review Committee, p. 26.

²⁴⁹ Ibid.

²⁵⁰ Ibid, p. 28.

²⁵¹ Cashmere, M. *The Interrelation of scheme and purpose* (2003). E-Journal of Tax Research, p. 1-44.

²⁵² Freedman, J. *Interpreting tax statutes: tax avoidance and the intention of parliament* (2007), Law Quarterly Review at 20.

4.2.3 Judicial approach

The courts in the United Kingdom have for long used the literal interpretation of statutes which is a more conventional approach to fighting tax avoidance. This approach requires that if a taxpayer's affairs fall outside the provisions of the relevant act, then he is not liable for tax.

The courts approach is best demonstrated in the case of *Partington v Attorney General*²⁵³ where it was stated that:

If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

The literal interpretation of statutes approach was mainly influenced because the courts did not want to tolerate the purposive interpretation of statutes particularly where tax anti-avoidance provisions are concerned.

The insistence on the literal interpretation approach and the reluctance regarding the use of common law doctrines to bypass a literal interpretation was emphasized in *IRC v Duke of Westminster*²⁵⁴ and this principle formed the basis of the court's approach to tax avoidance cases for a very long time.

In the above case the House of Lords completely declined the economic substance doctrine, creating the impression that the statute can only apply if the taxpayer acts exactly as described in the text. It also denied the application of the business purpose test, hence permitting taxpayers to arrange their businesses with the proclaimed purpose of only reducing tax liability²⁵⁵.

²⁵³ (1869) LR 4 HL 100.

²⁵⁴ (1936) A.C.1 H.L.

²⁵⁵ <http://saf.uwaterloo.ca/mtax/documents/MTAXResearchPaperbyAlexanderChan.pdf>.

The court's literal interpretation attitude was partly attributed to the fact that it did not see as a law makes and was strongly of the view that the court's main responsibility is to bridge the lacuna of tax inconsistencies of the British tax system.²⁵⁶

With the progression of time the courts developed a change of attitude which saw a shift from the literal interpretation of statutes to a more purposive interpretation approach which resulted in Lord Wilberforce's decision in *Ramsay*²⁵⁷ which became known as the *Ramsay principle*. The court established that:

the courts are not confined to literal interpretation of tax statutes, and that they should consider for tax reasons the context, the scheme and purpose of an act, the court also established the nature of a transaction for tax purpose can be determined by a combination of more than one transaction²⁵⁸

Ramsay seems to be the trailblazer for the foundation in the United Kingdom of a judicially developed new approach to combat tax avoidance schemes. The courts have now adopted the view that while the techniques of tax avoidance are progressing and technically improving, the courts are not compelled to stand still²⁵⁹.

In *Floor v Davis*²⁶⁰, also highlights a new approach the court, based on a purposive approach in that they must adopt a step by step approach in determining the tax consequences of the transaction and that the court must evaluate the transaction in its totality where a transaction was part of an entire composite whole.

The *Ramsay* Principle was applied in *Furness v Dawson*²⁶¹, where Lord Brightman noted that:

The effect of his [Oliver L.J's] judgment was to change Lord Diplock's formulation from a pre-ordained series of transactions... into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax" to "a pre-ordained series of transactions... into which there are inserted steps that have no enduring legal

²⁵⁶ Tiley, J. In Comparative Income Taxation, edited by Ault, HJ. Kluwer Law International (1997).

²⁵⁷ WT Ramsay v IRC [1982] AC 300.

²⁵⁸ Ibid.

²⁵⁹ Mossner, J.M. Tax Avoidance Concepts and European Tax Education, pp. 23-25.

²⁶⁰ Floor v Davis (1978), Ch. 295.

²⁶¹ Furness v Dawson (1984) 1 All E.R. 530 H.L.

consequences.” That would confine the Ramsay principle to so called self-cancelling transactions.²⁶²

To this day the purposive interpretation approach has buried the literal interpretation approach and is still followed in the UK to attack tax avoidance schemes not addressed by fiscal legislation.

In support of the purposive interpretation attitude it was noted that under this approach the court will verify whether the legal form of a transaction is equivalent to its economic substance.²⁶³

In *Barclays Mercantile Business Finance Limited v Mawson (Inspector of Tax)*,²⁶⁴ affirmed this new approach, and stated that the ethos of this approach was to bestow on the statutory provision a purposive construction or the ‘modern principle in construction’ in order to establish the essence of the transaction to which it was preconceived to apply and then to resolve whether the real transaction responded to the statutory interpretation.²⁶⁵ It was further elaborated that this did not mean that the court have to place their reason into the straitjacket of first translating the statute in the hypothetical and then glancing at the facts.²⁶⁶ It was stated that it may be more appropriate to examine the facts and establish that they please the characteristics of the statute. However, one’s perspective of the matter is to establish whether the applicable provisions of the statute upon its literal construction apply to the facts having been discovered.²⁶⁷

The shift of the court’s attitude has to an extent reduced the restriction which was previously placed on the interpretation of tax statutes and this has been seen as more effective way of fighting tax avoidance considering that the UK does not have a *GAAR*.

4.2.4 General anti-abuse rule

After the decision in *Ramsay* the courts enjoyed a wide discretion in curbing tax avoidance through the common law doctrines under the purposive approach to fiscal legislation.

²⁶² Ibid.

²⁶³ Prebble, Z., Prebble, J. Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law, April 2008, Bulletin for International Taxation.

²⁶⁴ (2004) UKHL 51 at 32.

²⁶⁵ Ibid.

²⁶⁶ Ibid.

²⁶⁷ Ibid.

Bearing in mind that the new legislated *GAAR* may usurp what the courts in the UK consider unacceptable avoidance behavior, the danger that subsists is that the courts through common law doctrines have equipped themselves with capacity outstretching even past legislation²⁶⁸, a danger which has been recognized in South Africa subsequent to the *NWK* decision.²⁶⁹

It is perhaps against this atmosphere that the study group gathered in 2010 to guide the UK Government on the prudence of launching a legislated *GAAR* in the UK *fiscal* statutes, opposed to introducing against such an all-embracing rule being legislated.²⁷⁰

The study group advised against the introduction of an all-embracing spectrum rule being legislated and proposed the following as a substitute:

I have concluded that introducing a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system. This would carry a real risk of undermining the ability of business and individuals to carry out sensible and responsible tax planning. Such tax planning is an entirely appropriate response to the complexities of a tax system such as the UK's...

However, introducing a moderate rule which does not apply to responsible tax planning, and is instead targeted at abusive arrangements, would be beneficial for the UK tax system.²⁷¹

The rule so suggested is the 'general anti-abuse rule' contrary to a broad spectrum 'general anti-avoidance rule'. Following the proposed general anti-abuse rule Lethaby indicated that this rule may go past catching the so-called 'Category 1' arrangements (i.e. arrangements with the sole purpose of reducing a tax liability) and also capture 'Category 2 & 3' arrangements (respectively arrangements with the main purpose to obtain a tax benefit, but which also has a commercial purpose and arrangements with a predominant commercial purpose but which also encompass an element designed to counterbalance certain tax effects).²⁷²

Nonetheless, in the absence of the broad spectrum general anti-avoidance rule and or the general anti-abuse rule, the counter avoidance technique currently accessible at the hands of Her

²⁶⁸ Marais, A.J. *Simulation Discussed: Tax avoidance in the common law* (2012), p33-34.

²⁶⁹ Broomberg, E.B. *The Founders Hill and NWK cases under the spotlight* (2011). Comment on C: *SARS v NWK Ltd* (27/10) ZASCA 168. Cape Town, South African Fiscal Association at 16.

²⁷⁰ See note 265 above.

²⁷¹ The *GAAR Study Group* led by Aaronson, G.QC. *GAAR Study- A Study to consider whether a general anti-avoidance rule should be introduced into the UK tax system*. 11 November 2011 at 1.5 to 1.7.

²⁷² Lethaby, H. *Aaronson's GAAR* (2012) 1, *British Tax Review*.

Majesty's Revenue and Customs (HMRC) are:²⁷³ a purposive interpretation of tax statutes; specific anti-avoidance rules targeted at recognized areas of exposure in fiscal legislation; and the Disclosure of Tax Avoidance Schemes (DOTAS).

²⁷³ See note 265 at p. 35.

Chapter 5

5. Conclusion and Recommendations

5.1 Conclusion

This study has examined the statutory legislation ON and the judicial approach to tax avoidance in South Africa in comparison to the Australian and the United Kingdom tax system. This has been achieved by scrutinizing the general anti-avoidance rules (*GAARS*) and case law on tax avoidance. The study's main focus was to determine the position and point of view of the judiciary in the evolution of case law on tax avoidance and also to determine whether the presence of the *GAAR* has provided the much needed clarity, certainty and predictability in as far as the determination of acceptable and unacceptable tax avoidance behavior is concerned.

It has been established that complicated tax avoidance scheme are on the increase, and notwithstanding a notable progress in the legal philosophy on tax avoidance, it has also become increasingly difficult for law makers to predict schemes which amounts to unacceptable tax avoidance.

In relation to section 260 of the *Income Tax Assessment Act of 1936*, Judge Murphy noted that the accumulation of creative intellect to circumvent revenue laws has repeatedly demonstrated boundless and accordingly it is neither attainable nor safe to say beforehand what must be found...²⁷⁴

Prior to the enactment of the current *GAAR* under Part II of the *Income Tax Act*, the courts had adopted a literal approach of interpreting tax statutes which favored taxpayers as seen in most cases which where decided under section 103²⁷⁵. The courts where seen to be more favorable to taxpayers than the *fiscus* and this was consequentially seen as been sympathetic to tax avoidance. Therefore following the decision handed down in *Conhage* section 103 was declared ineffective and was replaced with the current *GAAR* under section 80A -L²⁷⁶.

²⁷⁴ *FCC v Hancock* (1961) 8 A.L.T.R. 326,333.

²⁷⁵ *Income Tax Act No. 58 of 1962*.

²⁷⁶ *Ibid*.

Henceforth the attitude of the judiciary has shifted from a literal to a purposive interpretation of tax statutes, where the courts have become feisty through the adoption of common law doctrines in the fight against tax avoidance as displayed in *Ramsay* in the UK,²⁷⁷ and the South African Supreme Court of Appeal judgment in the *Commissioner for the South African Revenue Service v NWK Limited*²⁷⁸ practically eradicating the long –established judicial principle that a taxpayer can structure their tax affairs in a legal manner so as to reduce their tax liability.²⁷⁹

Considering the challenges of establishing with a degree of certainty as to when an ‘arrangement’ or ‘transaction’ will be considered acceptable or unacceptable tax avoidance behavior is a serious matter of concern. It has been demonstrated that the validity of the set of principles of law hinges mainly on the legitimacy of the series of actions and the *modus operandi* engaged by individual laws.²⁸⁰

For the *GAAR* to be legitimate, it must satisfy the requirement of certainty as demanded by the rule of law. It has been established that certainty of laws presents legal subjects with the capacity to fulfill the law and the utmost liberty to act within the borderline set by the law makers.²⁸¹

Emphasizing on certainty, the OECD Committee on Fiscal Affairs expressed the opinion that taxpayers have an entitlement to a high degree of certainty as to the taxation repercussions of their activities.²⁸²

The Aaronson report underlined taxpayer certainty as a significant theme to be contemplated in drafting a suitable *GAAR* for the UK.²⁸³

It is submitted that in the absence of certainty, taxation is unpredictable. For certainty of taxation empowers taxpayers to decide the tax consequences of their actions before committing to those activities.²⁸⁴

²⁷⁷ *WT Ramsay Ltd v Inland Revenue Commissioner* [1982] AC 300.

²⁷⁸ (27/10) [2010] ZASCA 168.

²⁷⁹ *IRC v Duke of Westminster* (1936) AC 1HL.

²⁸⁰ Aquinas, T. *Summa Theologiae* (1274), I-II, 18, IV.

²⁸¹ Raz, J. *The Rule of Law and its Virtue* (1977) 33, *Law Quarterly Review* 195-204.

²⁸² OECD. *Taxpayer's Rights and Obligations: A Survey of the Legal Situation in the OECD Countries* (1990) 2.21.

²⁸³ Aaronson, G QC. *GAAR Study* (2011), UK Treasury, Aaronson's Report.

²⁸⁴ Carter Commission in Canada. *Report of the Royal Commission on Taxation* (1966), Queens Press.

5.2 Recommendations

Having examined the challenges faced on the issue of tax avoidance in as far as determining ‘arrangements’ or ‘transactions’ which fall within acceptable or unacceptable tax avoidance behavior. It is suggested that more research should be conducted in the area of tax avoidance.

It is apparent that *NWK* has attracted a lot of pronouncements and criticisms. Emslie indicated that while we are under the impression that the effect of the *NWK* was flawless, due to the effect of confusion, we respectfully query whether there was any true sham at all...²⁸⁵

NWK decision will moving forward undoubtedly determine how taxpayers and the revenue authority examine arrangements entered into for their own commercial reasons.²⁸⁶

Taking into account that the tax terrain has changed it is recommended that the judiciary should recognize the uncertainty concerning sham transactions and address the issue by determining the right position in as far as sham transactions are concerned.

The statutory *GAAR* should bring out beforehand all characteristics that stipulate that an arrangement is an avoidance arrangement, and that the contrast between avoidance and mitigation should not be brought out by way of makeshift judgments on a case-by-case basis, but by mention of comprehensible and logical general principles which can be applied time and again by taxpayers, revenue authorities and the courts.²⁸⁷

Having established that a law with a high degree of certainty is a law that guides conduct, it is put forward that tax laws should be adequately coherent to allow subjects to manage their affairs in advance.²⁸⁸

Finally, it is also recommended that a *GAAR* should only apply where the arrangement entered into with respect to specific objective elements contained within the statute, is deemed to

²⁸⁵ Emslie, T SC. Simulated Transactions- *NWK* revisited, 60 (2), *The Taxpayer*

²⁸⁶ See note 265 at p.57.

²⁸⁷ See note 3 at p. 53.

²⁸⁸ Freedman, J., Vella, J. HMRC’s Management of the U.K. Tax System: The Boundaries of Legitimate Discretion’ in Chris Evans, Judith Freedman and Rick Krever (eds) *The Delicate Balance: Tax Discretion and the Rule of Law* (2011) 11.

misapply or abuse the provision depended upon as this perspective is favored over leaving the courts to determine the criteria.²⁸⁹

²⁸⁹ See not 3 at p. 54.

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