**UNIVERSITY OF KWAZULU-NATAL**

# Analysis of Tax Avoidance Legislation in South Africa: Developments Over a Five Year Period

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- Above all, I give all the glory, honour and praise to the Almighty. Without his divine grace this work would not have been possible.

## Abstract

This study was undertaken to analyse the developments in the anti avoidance legislation over a five year period from 1 March 2006 to 28 February 2011. Emphasis were placed on describing the road from the old section 103 provisions leading to the new general anti avoidance rules (GAAR) as contained in sections 80A to 80L of the Income Tax Act 58 of 1962. The study began with a detailed analysis of the differences between tax evasion and tax avoidance based on definitions and interpretations by various courts. It then went further in chapter two to formulate an acceptable distinction between Tax evasion, Tax planning and impermissible tax avoidance as currently used by the South African Revenue Services (SARS).

It appeared from the study that firstly, courts have historically reviewed the circumstances surrounding an arrangement when determining whether tax evasion has occurred. The new GAAR requires the individual steps of an arrangement to be reviewed in isolation.

Secondly, the courts have historically held that the purpose test, when determining the taxpayer‘s purpose, was subjective. The wording of the new GAAR indicates that this test is now objective.

Thirdly, the courts have historically viewed the abnormality of an arrangement based of the surrounding circumstances. The wording of the new GAAR requires an objective view of the arrangement.

A comparison was made between countries that have adopted statutory GAAR with a view of understanding how they have applied these general anti avoidance provisions successfully to tax avoidance cases. This comparison revealed that there is an inconsistent application of these general anti avoidance provisions by different countries. Courts and administrators apply them differently, based on circumstances and the nature of avoidance.

Lastly, it has been acknowledged that most avoidance schemes are very complex and their perpetrators are always on the look for gaps in tax systems, hence any avoidance legislation to effectively curb tax evasion will need to be revised on a regular basis. Therefore, the

Commissioner would be expected to issue regular updates on anti avoidance provisions and latest developments in the form of interpretation and or practice notes.

## Table of Contents


| Description | Page |
|---|---|
| Title Page | i |
| Declaration | ii |
| Acknowledgements | iii |
| Abstract | iv |
| Table of Contents | v |
| **CHAPTER ONE** | |
| **Introduction** | 1 |
| 1.1 Background | 1 |
| 1.2 Purpose of the Study | 1 |
| 1.3 Objectives of the Study | 2 |
| 1.4 Definitions | 2 |
| 1.4.1 Tax avoidance | 2 |
| 1.5 Historical developments | 3 |
| 1.5.1 Road to the new GAAR | 4 |
| 1.5.1.1 Amendments of 1996 | 4 |
| 1.5.1.2 Amendments of 2006 | 5 |
| 1.6 Statement of problem | 5 |
| 1.7 Hypothesis | 6 |
| 1.8 Scope and limitation of the study | 7 |
| 1.9 Methodology | 7 |
| 1.10 Summary | 8 |
| **CHAPTER TWO** | |
| **Literature Review** | 9 |
| 2.1 Introduction | 9 |
| 2.2 Tax avoidance and tax evasion | 11 |
| 2.2.1 Tax evasion | 10 |
| 2.2.2 Impermissible tax avoidance | 11 |

2.2.3 Legitimate tax planning 12

2.3 Characteristics of tax avoidance 13

2.3.1 Goals of tax avoidance 13

2.3.1.1 Elimination of a tax liability 14

2.3.1.2 Deferral of a tax liability 14

2.3.1.3 Re-characterisation of a tax liability 15

2.3.1.4 Shifting of a tax liability 15

2.3.2 The techniques of tax avoidance 17

2.3.3 The key features of tax avoidance 18

2.4 Anti avoidance provision prior to 2006 amendments 19

2.4.1 Section 103(1) provisions 20

2.4.1.1 A transaction, operation or scheme (referred to as a 'transaction') entered into or carried out 20

2.4.1.2 A transaction entered into or carried out had the effect of avoiding or postponing liability for payment of any tax duty or levy imposed by the Act of reducing the amount of the liability 20

2.3.1.3 Depending on the type of transaction, the third requirement was either the bona fide business purpose test or the abnormality test and an abnormal right test 20

2.3.1.4 The transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit 21

2.4.2 Case law on section 103(1) 22

2.4.2.1 Cases where the Commissioner failed to enforce the provisions of section 103(1) 22

2.4.2.2 Cases where the Commissioner successfully enforced the provisions of section 103(1) 23

2.4.3 Section 103(4) 24

2.4.4 Section 103(7) 24

2.4.5 Section 103(6) 25

2.4.6 Section 103(3) 25

2.4.7 Section 103 and SARS Practice Note 20 26
2.4.8 Substance over form doctrine 26
2.4.8.1 South African cases on substance over form 28
2.5 General Anti Avoidance Provisions after 2006 amendments 32
2.5.1 Provisions of Part IIA of Chapter III 33
2.5.1.1 Section 80A: Impermissible tax avoidance arrangements 33
2.5.1.2 Section 80B: Tax consequences of impermissible tax avoidance 34
2.5.1.3 Section 80C: Lack of commercial substance 34
2.5.1.4 Section 80D: Round trip financing 36
2.5.1.5 Section 80E: Accommodating of tax indifferent parties 37
2.5.1.6 Section 80F: Treatment of connected person and accomodating or tax indifferent parties 38
2.5.1.7 Section 80G: Presumption of purpose 38
2.5.1.8 Section 80H: Application to step in or parts of arrangement 39
2.5.1.9 Section 80I: Use in the alternative 39
2.5.1.10 Section 80J: Notice 39
2.5.1.11 Section 80K: Interest 40
2.5.1.12 Section 80L: Definitions 40
2.6 Summary 41

**CHAPTER THREE**

**Developments in anti avoidance legislation over the past five years** 43
3.1 Introduction 43
3.2 Background 43
3.3 Road leading to new GAAR 44
3.4 New Part IIA of Chapter II of Income Tax Act 58 of 1962 47
3.4.1. Is the arrangement an impermissible tax avoidance arrangement? 47
3.4.2 What are the tax consequences of impermissible tax avoidance? 48
3.4.3 Does the arrangement lack commercial substance? 48
3.4.4 What is the round trip financing? 48

3.4.5 What are the accommodating and tax indifferent parties 48
3.4.6 The treatment of connected persons and accommodating parties 48
3.4.7 Presumption in respect of purpose 49
3.4.8 Application of GAAR to steps in or parts of arrangement 49
3.4.9 Application of GAAR as alternative basis for raising an assessment 49
3.4.10 Notice requirement 49
3.4.11 Interest provision 49
3.4.12 Section 80L: Definitions 50
3.5 Major changes in the new General Anti Avoidance Rules 50
3.5.1 Weaknesses identified in the section 103 Abnormality requirement 51
3.5.2. Changes necessitated by weaknesses in the abnormality requirements 51
3.5.2.1 Anticipated pre-tax insignificant in comparison to value of the anticipated tax benefit 52
3.5.2.2 Paying more or less than market value for assets or services 53
3.5.2.3 Inconsistent characterisation by the parties 53
3.5.2.4 Significant book or tax differences 53
3.5.2.5 Unnecessary step or complexity 53
3.5.2.6 High transaction costs 54
3.5.2.7 Fee variation clause or other provisions 54
3.5.2.8 Timing and duration of arrangement or failure to adhere normal business practices 54
3.5.3. The element of commercial substance: section 80A 55
3.5.3.1 Reduction of the Abnormality factors to five: Section 103(2) 55
3.5.3.2 Round trip financing provision: Section 80D 55
3.5.3.3 Tax indifferent Party redefined 56
3.5.4 Revision to the sole or main purpose requirement 57
3.5.4.1 Purpose requirement under section 103(1) 58
3.5.4.2 Purpose requirement under the new GAAR 58
3.5.5 Presumption of purpose of arrangement 60
3.5.6 Amendment to the Notice Requirement provision: Section 80J 60

3.5.7 Compulsory Interest: Section 80K 61
3.6 Other changes and additions in the new GAAR 61
3.6.1 Administration of the general anti avoidance rules 61
3.6.1.1 Remedy to steps in or in parts of an impermissible avoidance arrangement 62
3.6.1.2 Remedy in respect of accommodating tax indifferent or connected parties 62
3.6.1.3 Remedy to reallocate any amount of gross income: Section 80B(1)(d) 62
3.6.1.4 Remedy to the re-characterisation of any amount of gross income: Section 80B(1)(e) 63
3.6.1.5 General remedies 63
3.6.2 Use in the alternative 63
3.7 Summary 64

**CHAPTER FOUR**

**Problems and inconsistencies in the new anti avoidance legislation** 66
4.1 Introduction 66
4.2 Weaknesses in legislation 66
4.2.1 Section 80A: Impermissible arrangements 66
4.2.1.1 Determination of a tax benefit 66
4.2.1.2 Non business context 67
4.2.1.3 In any other context 68
4.2.1.4 Arm's length 69
4.2.1.5 Onus to prove existence and purpose 70
4.2.2 Section 80B: Tax consequences 71
4.2.2.1 Disregarding an arrangement 71
4.2.2.2 Deem appropriate 71
4.2.3 Section 80C: Effect of cancelling or nullifying 72
4.2.3.1 Cancelling or nullifying each other 72
4.2.4 Section 80E: Substantive active trading 73

4.2.4.1 Substantive active trading 73
4.2.4.2 At least 18 months 74
4.2.5 Section 80I 74
4.2.5.1 In the alternative or in addition to 74
4.2.6 Section 80L 75
4.2.6.1 Party to the arrangement 75
4.2.7 Section 80J: Notice period 76
4.2.7.1 Days to respond 76
4.2.7.2 Impossibility of performance by non taxpaying entities covered by section 80L 77
4.2.7.3 Consequences for non compliance 77
4.3 Summary 78

**CHAPTER FIVE**
**Other countries with general anti avoidance rules** 79
5.1 Introduction 79
5.2 Australia 80
5.3 Canada 81
5.4 New Zealand 81
5.5 Summary 82

**CHAPTER SIX**
**Conclusion and recommendations** 83

**BIBLIOGRAPHY** 86

**Appendix 1** Ethical clearance 91

# CHAPTER 1

## INTRODUCTION

### 1.1 Background

In the past two decades South Africa has experienced drastic changes in political activities, people's expectations, spending patterns, unemployment levels, economic growth, inequality levels and the quality of education. A recent study by Oguttu (2007) on curbing tax avoidance indicated that some of these changes have led to economic and political instabilities resulting in the government introducing new forms of taxes and in some instances improving and even increasing existing taxes in order to meet the rising demands and expectations of the people, and to continue providing essential social services.

With the introduction of new taxes, revision to the fringe benefit tax, and the continuous increase in tax rates and levies, some taxpayers even came to realise that often their after tax income does not increase in line with their expectations.

The period from March 2005 to February 2010 has been remarkable for these changes, thus posing challenges to the country's fiscal and taxation system. In order to lessen their tax exposure, some taxpayers have got involved in tax evasion schemes, with the aim of minimising their tax liability and increase their after tax income.

### 1.2 Purpose of the study

The purpose of this study is to highlight developments over a period of five years in tax avoidance legislation in South Africa, with the aim of drawing conclusions about the effectiveness of these provisions of the Income Tax Act in curbing tax avoidance. It is important that such an assessment is done to assess effectiveness because these schemes cost governments billions of rands every fiscal year and deny citizens of the country essential government social services which could be funded through efficient tax collections. The study highlights strengths and weaknesses in the legislation and recommends how those weaknesses can be rectified. The study also creates awareness to all taxpayers of impermissible tax avoidance schemes.

### 1.3 Objectives of the Study

The study is guided by the following specific research objectives:

- To identify gaps and weaknesses in tax legislation that has resulted in the system failing to curb anti avoidance schemes over the past five years.
- To discuss the effectiveness of the general anti avoidance rules in South Africa based on history and current cases of tax avoidance schemes.
- To describe impermissible tax avoidance schemes and the remedies available to the South African Revenue Services (SARS) should a taxpayer accommodate or be involved in these schemes.
- To highlight areas of improvement in anti avoidance tax legislation in order to assist SARS improve the income tax collection system.

### 1.4 Definitions

#### 1.4.1 Tax Avoidance

It is important to distinguish between avoidance and evasion in order to clearly define tax avoidance.

A simple definition of avoidance provided by Collins English Dictionary (2007) is that it is a reduction or minimization of tax liability by lawful methods. On the other hand evasion is a reduction or minimization of tax liability by illegal methods.

Simply put, avoidance is perfectly legal, whilst evasion is illegal and could result in severe penalties (fines and or imprisonment if SARS can get a conviction against the taxpayer).

This distinction can further be explained through sham transactions. According to Huxham & Haupt (2010:456) a sham transaction concept embodies two separate theories:

- A sham in fact: This is a fictional transaction that never actually occurred.
- A sham in substance: This is a transaction that actually occurred but lacked the substance it allegedly represented.

A sham in substance occurs when the taxpayer draws up papers to characterize a transaction contrary to the objective economic realities and which have no economic significance beyond

the expected tax benefit.  A transaction is considered a sham in substance if it effects no real change in each party's economic position.

Huxham (2010) further states that "Tax is always based on the substance of a transaction, rather than its form". This means that if the written agreement between two persons (the form) is different from their true intention (the substance), tax is based on their true intention, because that is the real agreement.

### 1.5 Historical development

The first general anti avoidance provision introduced in South Africa was in section 90 of the Income Tax Act of 1941. Since its inception, restrictive interpretation by the courts necessitated several amendments to its provisions until the introduction of section 103(1) of the Income Tax Act 58 of 1962. However, the succeeding provision, section 103(1), nevertheless did not deviate fundamentally from its predecessor. Since its first inception under section 90 until the last amendments to section 103(1) provisions it has involved a four point test:

- there must be an "arrangement";
- the arrangement must have a "tax effect";
- the arrangement must be "abnormal" or create non-arm's length rights and obligations; and
- tax avoidance must be the arrangement sole or main purpose. The purpose test was a subjective one.

In practice, the "abnormality" requirement had proven to be the "Achilles' Heel" of the old general anti avoidance rules (GAAR). According Liptak (2007), to remedy this problem, Parliament passed certain amendments to the legislation in 1995. Before these amendments could be tested, however, the Supreme Court of Appeal handed down a judgment on the other provisions of the GAAR that "effectively emasculated" the legislation. What was more concerning following the decision was whether a business purpose for an overall scheme could be used to insulate all of its steps from challenge.

The situation remained unchanged for the next ten years, that is no further amendments and only one court challenge that resulted in an unpublished opinion unfavourable to SARS.

### 1.5.1 Road to the new GAAR

#### 1.5.1.1 Amendments of 1996

Prior to 1996, there was less emphasis placed on tax compliance in South Africa. Since then, SARS has done a tremendous job to build a culture of compliance. Nonetheless tax evasion remained a serious, and in some ways, a problem that has been growing more and more difficult.

There were several reasons for this:

- South Africa's growing integration into the global economy following the fall of the Apartheid regime, the rapid changes in the financial markets, including the continuing evolution of ever more complex financial instruments, and equally rapid improvement in information technology.
- The weak GAAR and practitioner attitudes were equally to blame. It was not unusual to see tax opinions on abusive arrangements dismiss the GAAR in one or two paragraphs. This was the case, for example, in connection with the abusive film scheme that was included as Annexure A in the SARS Discussion Paper on Tax Avoidance (2005).
- Practitioner attitudes may have been an even more serious problem. The legal community remained wedded to the Duke of Westminster principle in its most unadulterated form:
  "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

- In addition, there was virtual no academic debate on the topic. By and large it was an unchallenged view. One side effect was that, in the minds of tax advisors, there was little if any room for the GAAR to operate. As one commentator to the SARS Discussion Paper (2005) noted following the enacted of the 1995 amendments, the GAAR could only be applied to the most blatantly abusive schemes.

#### 1.5.1.2 Amendment after 2006

According to SARS (2010) the amendment process was a lengthy process which lasted a full year from the introduction of a Discussion Paper in November 2005 to the enactment of the new GAAR in November 2006.

There were major amendments to section 103(1) and they are discussed in details in Chapters two and three. It is worth noting the following major changes introduced to the new GAAR in 2006:

- A commercial substance test including statutory indicia such as round-trip financing and tax-indifferent parties. Most powerful tool may be the authority to treat connected persons and tax-indifferent parties as one and the same person,
- A “misuse or abuse test”, and
- Taxpayers are still free to structure their affairs in a tax-efficient way provided that those structures do not include one or more of the “tainted elements” identified by Parliament.

## 1.6 Statement of problem

Over two decades the world has experienced changes in economic activities, political and social practices of citizens. In South Africa these changes have led the government to introduce new forms of indirect and direct taxes, levies and duties, and in some instances improving the existing tax collection systems in order to meet rising demand and expectations, as well as costs associated with providing new and or improved infrastructure. With the introduction of new taxes and the continuous increase in tax rates and levies,

taxpayers have come to realise that often the increase in their after tax income is less than the original increase gross income as defined in section 1 of the Income Tax Act 58 of 1962.

This coupled with the recent economic downturn and the inflation effects over years have often resulted in earnings being largely minimal, and some taxpayers have found themselves having to pay higher taxes although their real purchasing power has not grown.

In order to lessen their tax exposure, taxpayers get involved in tax evasion. It is becoming a problem for most governments that because of these challenges mentioned above some taxpayers are no longer willing to pay correct amounts of tax due, but they want to pay as little tax as possible. To achieve this, they resort to tax evasion. This has been shown by an increased number of tax evaders over years. Because of the high levels of tax avoidance and tax evasion SARS continues to implement ways to reduce the tax gap. To achieve this objective, SARS has over the years made changes to the provisions of the Act dealing with tax avoidance especially section 103(1) in order to fight these tax avoidance schemes. However, these interventions by SARS have yielded little success. Hence, in 2006, section 103(1), the general anti-avoidance provision used at the time, was repealed and the general anti-avoidance rule (GAAR) was introduced. The GAAR is contained in Part IIA of Chapter III of the Income Tax Act and specifically applies to impermissible avoidance arrangements as defined in the Act.

## 1.7 Hypothesis

The study is about general anti avoidance legislation as was contained in section 103 prior to 2006 amendments and sections 80A to 80L after the amendments. These sections are referred to as anti avoidance provisions and are used by the Commissioner to curb illegal tax avoidance. In this study it is argued that there are three factors that encourage impermissible tax avoidance and those are:

- The existence of complex and aggressive tax avoidance schemes,
- The weaknesses and gaps in the current anti avoidance provisions, and
- Changes in economic activities, political and social practices of the citizens putting pressure to the income tax systems and as a consequence resulting to some taxpayers engaging in tax evasion in order to lessen their tax liability.

It is argued therefore that, the challenge facing all developing countries including South Africa is to ensure that legislation is way ahead the "Master Minds" of these abusive tax avoidance schemes. Because of these challenges it is necessary to analyse developments in tax legislation in line with existing schemes that tax payers employ in tax avoidance, and to evaluate the effectiveness of legislation or anti avoidance rules that South Africa has in place to fight such scheme or any other new schemes that may emerge in future.

## 1.8 Scope and limitation of the study

The current study looks at the general anti avoidance provisions only (section 103 and section 80A to 80L). It does not look at the specific anti avoidance provisions such as:

- the deeming provisions, which have their own internal anti-avoidance provisions. For example deemed income provisions as contained in section 7 of the Act.
- Section 8C(5) and (6) dealing with the position where a taxpayer tries to shift the gain or the exercise of a share option or on the vesting of a share, into another person's hands.
- Hybrid Equity Instruments as contained section 8E.
- Hybrid debt instruments as contained in section 8F.

## 1.9 Methodology

The study entails a review of South African and international text books, journal articles and case law on the topic studied as well as related issues. Previous studies have indicated that accurate and reliable information on issues of tax legislation is found in literature, legislation and case law especially reported cases. Therefore findings and recommendation of this study are based on the review of legislation, reported cases and recent impermissible tax avoidance scheme investigated.

### 1.10 Summary

This chapter highlighted what the study entails and the approaches used to achieve the set objectives. The study's objectives were also highlighted together with the scope and limitations of the study. The chapter ended with discussions on research methodology that was used as basis for both discussions on chosen legislation and conclusions drawn thereof.

# CHAPTER 2

## LITERATURE REVIEW

### 2.1 Introduction

The purpose of this chapter is to review the literature on tax avoidance legislation in South Africa and other countries with a view of analysing developments in general anti-avoidance provisions over the past five years. This incorporates the review of cases that have been used by courts as basis for judgment and for setting precedence on cases involving tax avoidance. The chapter begins with a critical analysis of important definitions surrounding tax avoidance legislation, and then focuses on the developments over the past five years starting from 2005 to 2011 tax years. A tax year in South begins on the first day of March and ends on the last day of February. Although reference is made to other forms of taxation, the focus of the chapter is on income tax avoidance legislation.

According to Arendse, et al, (2004), Income tax is the biggest source of government funds in most countries including South Africa. “It is defined a means whereby the State collects funds from persons to pay for its administration and for the benefits it provides its citizens and residents” (Huxham & Haupt, 2010p.2). In South Africa, Income Tax is levied on persons resident in South Africa and on certain non-residents who earn income from sources in South Africa (taxpayers) as defined in section 1 of the Income Tax Act no 58 of 1962. Therefore, to fulfil its mandate, the State has to efficiently and effectively collect income taxes from all taxpayers. However, in so doing the challenge faced by most governments of the world is the ever presence of tax avoidance schemes used by taxpayers to either legally or illegally reduce their tax liability or avoid paying taxation. These schemes cost governments billions of rands every year through lost income tax revenue. This concern was raised by Tomasek (2006), who stated that over the past five years, the government of South Africa had lost R10.7 billion through these impermissible and abusive tax avoidance schemes. The extent of how serious and concerning these tax avoidance schemes are to governments was further emphasised by Gordhan (2010), in his budget speech where he stated that “aggressive tax avoidance is a serious cancer eating into the fiscal base of many developing countries.” Firstly, some definitions need to be considered before a discussion on anti avoidance legislation.

## 2.2 Tax Avoidance versus Tax evasion

Literature and legislation provide a clear difference between tax avoidance and tax evasion. One is legally acceptable and the other is an offense.

Huxham (2010) provided a simple but clear distinction between the two concepts of avoidance and evasion through the following definitions:

- Avoidance – "is an attempt to minimise a tax liability using legal means, i.e. to regulate your affairs in such a way that you pay the minimum tax imposed by the Act rather than the maximum" Huxham (2010:456).
- Evasion – "is the use of illegal means to reduce a tax liability e.g. falsification of books, suppression of income, fraudulent non-disclosure of income, overstatement of deductions" Huxham (2010:456).

The above definitions suggest that tax evasion constitutes a criminal offence whilst tax avoidance is perfectly legal. The definitions further suggest that, the fiscus does require a statutory law to cope with tax evasion because the Income Tax Act 58 of 1962 provides for interest and penalties to be charged, however where tax has been evaded, section 75 of the Act provides for a fine or imprisonment of up to 24 months. Tax avoidance on the other hand does not fall foul of the Income Tax Act per se hence any form of protection which SARS may requires must be incorporated in the statute. The Act contains both specific anti-avoidance and general anti-avoidance provisions, and the difference between the two sections is that specific anti-avoidance provisions are incorporated into each section and are precise, whereas the general anti-avoidance provisions are separate and covered by originally section 103(1) prior to November 2006 and by section 80A to 80L after November 2006; these sections enable the Commissioner to address avoidance not covered by specific remedies.

The discussion of tax avoidance in literature often begins with an attempt to define and distinguish three broad concepts, namely:

- tax evasion;
- impermissible tax avoidance; and
- legitimate tax planning or tax mitigation.

This categorisation varies from jurisdiction to jurisdiction, and on occasion alternative distinctions have been attempted, such as the distinction drawn by Lord Hoffmann in *MacNivan v Westmoreland Investments Ltd (2001) BTC 44* between legal and commercial concepts. SARS now clearly differentiates between legitimate tax planning at one end of the scale and 'tax evasion' at the other, with 'impermissible tax avoidance'.

### 2.2.1 Tax Evasion

SARS has provided the following definition of tax evasion:
"it refers to illegal arrangements through or by means of which liability to tax is hidden or ignored, or deliberate steps undertaken by a taxpayer in order to reduce a tax liability by illegal or fraudulent means" SARS, Discussion Paper(2005).

Examples of tax evasion may include the falsifying of financial statements; not disclosing or misrepresenting relevant information in a tax return; or deliberate failure by a cash business to report the full amount of revenue received. Tax evasion constitutes fraud, which is a criminal offence.

### 2.2.2 Impermissible Tax Avoidance

Before the formal adoption by Parliament of GAAR in 2006 the term impermissible tax avoidance was broadly referred to as encompassing: "artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate or exploit perceived loopholes in the tax laws in order to achieve results that conflict with or defeat the intention of Parliament" SARS, Discussion Paper (2005). The term was also been loosely described as "an attempt to defer or eliminate a potential liability by manipulating or exploiting perceived inconsistencies' or discontinuities' in the tax system through various tax arbitrage techniques" SARS, Discussion Paper (2005).

Impermissible avoidance arrangements are now statutorily defined in section 80A as "being solely and mainly tax driven and being typically characterised by any one or more of the following, in a business context:

- a lack of commercial substance;

- abnormal features in terms of the manner entered into or carried out;
- non-arm's length rights or obligations; or
- the misuse or abuse of the provisions of the Income Tax Act".

### 2.2.3 Legitimate tax planning

Roberts (1999:4) defines tax planning as "organising the taxpayer's affairs (or restructuring of transactions) so that they give rise to the minimum tax liability within the law without resorting to impermissible tax avoidance arrangements"

The older United Kingdom (UK) case law is often referred to as authority for the notion that a South African taxpayer may arrange his tax matters in the most tax-efficient manner. Invariably the following dictum by Lord Tomlin in *Inland Revenue Commissioners v The Duke of Westminster (1936) A.C* is cited:

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.
South African courts have to a varying degree indicated acceptance of the taxpayer's right of choice in structuring his or her affairs. Certain tax cases indicate that the South African courts endeavour to decide tax matters in a manner that is equitable to both the taxpayer and the Commissioner".

South African courts for example have to a varying degree indicated acceptance of the taxpayer's right of choice in structuring his or her affairs. Certain tax cases indicate that the South African courts endeavour to decide tax matters in a manner that is equitable to both the taxpayer and the fiscus. In *CIR v King 1947 (2) SA 196 (A),14 SATC 184*, a taxpayer's freedom to structure his or her affairs in a tax efficient manner was confirmed by the following dictum by Watermeyer CJ:
"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 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 previous years merely because his purpose was to reduce the amount of his income and consequently of 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.

Also in this regard, in *CIR v Nemojim 1983(4) SA 935 (A),* it was observed obiter dictum that: "there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus".

In *Glen Anil Development Corporation Ltd v SIR 1975(4) SA 715 (A)*, which dealt with the application of section 103, it was warned that:

"this provision was clearly directed at tax avoidance schemes and that it should be construed in a manner that would advance the remedy provided by the section and suppresses the mischief against which the section is directed".

The opening remarks of Hefer JA in *CIR v Conhage (Pty) Ltd 61 SATC 391*, are of relevance in this regard: "Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner".

### 2.3 Characterising Tax Avoidance

Tax avoidance activities can be characterized in a number of ways. For example, Evans (2006) suggested that one way that could be used to characterize tax avoidance is considering avoidance in relation to: its goals, or by techniques used, or by reference to its key features. These characteristics are discussed in detail below.

#### 2.3.1 Goals of tax avoidance

Getting to the essence of tax avoidance perhaps requires an understanding of its goals or what the action sets to achieve. The ultimate aim of the avoidance is usually to reduce the tax

liability, but that also can take different forms. According to Evans (2006) it is possible to identify four possible goals that underpin tax avoidance activities namely:

- the elimination of a tax liability,
- the deferral of a tax liability,
- the re-characterisation of a tax liability, and
- the shifting a tax liability.

These goals are further discussed in detail below:

#### 2.3.1.1 Elimination of a tax liability

The permanent elimination of a tax liability is presumably the tax avoider's nirvana. In the Australian *FCT v Spotless Services Ltd (1996) 186 CLR 404*, the elimination of tax liability was sought by the taxpayer but on this occasion not attained.

#### 2.3.1.2 Deferral of a tax liability

Deferral involves the postponement of the payment of a tax liability, and relies on the concept of the time value of money for its effectiveness. The Australian case of *Commissioner of Taxation (Cth) v Citylink Melbourne Ltd (2006) 80 ALJR 1282; 62 ATR 648; [2006] HCA 35*, more than adequately illustrates how taxpayers postpone their tax liability.

In this case, Citylink, the State of Victoria and other parties executed a Concession Deed under which Victoria contributed the land for the project and passed legislation to enable Citylink to levy tolls. Clause 3.1 of the Concession Deed provided that during the concession period (1996 to 2034) Citylink would pay to Victoria an annual concession fee of $95.6 million. An additional concession fee was payable if toll revenues exceeded certain financial projections. Citylink claimed a deduction in each year of income for the concession fees. Clause 18.5 of the Master Security Deed provided that the obligation of Citylink to pay the concession fees "may...be satisfied" by it issuing State Concession Notes of the same face value. Citylink issued Concession Notes to Victoria for the concession fees payable in each year of income. Clause 1.9 of the Master Security Deed provided that for so long as any

"Project Debt" remained owing, the concession fee was "owing" but "not due for payment" unless and until there was a sufficient operating surplus "to meet that payment in full". According to the financial model used in the agreements, redemption of the Concession Notes was expected to commence in November 2013 and the Project Debt expected to be repaid by 2023. The appellant disallowed the deductions claimed by Citylink under the relevant provisions of the income tax legislation relating to general business or outgoings. S51(1) of the 1936 Income Tax Assessment Act 1936 (Cth) applied to the income years 1996 and 1997 while s8-1 of the Income Tax Assessment Act 1997 (Cth) applies to the 1998 income year. There are no relevant material differences between the two versions.

The trial judge (Merkel J) considered a number of issues including: whether the liability for the concession fee was incurred; whether the concession fee obligations were properly referable to the relevant income years: and whether the concession fees were losses or outgoings of capital, or capital in nature. Merkel found that although the concession fees had been incurred by Citylink in the relevant years of income, they were in the nature of a share of profits or payment of a dividend by it to Victoria as a joint venture in return for advantages ensuring to capital that Victoria contributed to the City Link Project. Therefore the concession fees were of a capital nature. Accordingly they were held not to be allowable deductions.

#### 2.3.1.3 Re-characterisation of a tax liability

This is simply the conversion of the character of an item or transaction, for example from a taxed or a highly taxed item like revenue to a tax exempt or less heavily taxed item like capital. The *IRC v McGuckian (1997) 1 WLR 991* case in the UK is a straightforward example of a re-characterisation activity. The case involved a transfer of shares to a non-resident trust, together with the subsequent sale of the rights to dividends from the shares for a lump sum which, it was unsuccessfully contended, was capital in nature.

#### 2.3.1.4 Shifting a tax liability

This can relate to income or profit shifting (as in shifting a liability from a highly taxed entity to a less heavily taxed or even exempt entity), as well as value shifting where value is shifted

between assets. The shifting of a tax liability is found in the Australian the *FC of T v Peabody (1994) 181 CLR 359; 94 ATC 4663* where the shares in the Pozzolanic group of companies were held by two controlling interests:

- TEP Holdings Pty Ltd (T Co) as trustee of the Peabody Family Trust: 62%; and
- Mr. Kleinschmidt (Mr. K) and his associates: 38%.

The beneficiaries of the trust were the taxpayer (Mrs. P) and her two children. The taxpayer and her husband (Mr. P) were the sole shareholders and directors of T Co.

Mr. P sought to purchase the interest of Mr. K to enable a public float of 50% of the group. Mr. K agreed to sell his interest, but two problems were identified.
First, the sale price would have to be disclosed in the prospectus for the public float. This was problematic because the shares would probably be offered to the public at a higher price than that agreed between Mr. K and Mr. P.
Second, if T Co on-sold Mr. K's interest to the public within 12 months, as was intended, the transaction would be subject to considerable "capital gains tax" under s 26AAA.

These problems were avoided by the Peabodys using another company, Loftway Pty Ltd (L Co), to purchase Mr. K's shares and then transforming those shares into virtually worthless "Z-class" shares. This would have the effect of making those shares held by T Co in the Pozzolanic group represent 100% of the real value of the group. The purchase was financed by the group's banker, Westpac Banking Corporation, in a manner that affected a considerable reduction in financing costs. The subsequent public float of 50% of the shares in P Co was a great financial success.

The Commissioner included $888,005 in Mrs. P's income. This amount represented one third of the net capital gain Mrs. P would have realised if T Co had bought and then on-sold Mr. K's shares within 12 months.

Achievement of any or all of the above goals is only possible because of the potential for tax leverage or tax arbitrage that arises as a result of the so-called inconsistencies and discontinuities that exist within national tax jurisdictions and across international tax borders.

### 2.3.2 The techniques of tax avoidance

Recent cases such as the *WT Ramsay Ltd v Inland Revenue Commissioner (1982) AC 300,* and the *IRC v. Burmah Oil Co. Ltd [1982] S.T.C. 30, H.L.(Sc)*, have indicated that techniques used for tax avoidance schemes are rather complex and they share common features of the ingenuity of their design. It is however, not a difficult task to identify them. Lord Walker of Gestingthorpe, in his unpublished paper entitled Some Reflections on Tax Avoidance (2004), presented shortly after the decision in the Ramsay case was handed down by the House of Lords, identified seven types of tax avoidance, proceeding from the simplest case to the increasingly complex (and to most observers, increasingly objectionable). These were:

- "using a relief;
- finding a gap;
- exploiting (or abusing) a relief;
- anti-avoidance karate (by which he meant the capacity for taxpayers to turn to their own advantage statutory provisions designed to prevent tax avoidance);
- unnatural assets or transactions;
- pre-ordained transactions; and
- dodgy offshore schemes".

It may be argued (as Lord Walker readily concedes) that the first one is not tax avoidance at all, and that it falls squarely within the realms of tax planning or mitigation. However, in *CIR v Willoughby (1997) 4 All ER 65* for example, Professor Willoughby was not engaged in an elaborate or contrived scheme aimed at tax avoidance. As the judgment in his case clearly shows, he was involved in the utilisation of a tax regime enacted by Parliament which provided tax deferral for bona fide long term retirement saving. But before it is readily concluded that "using a relief" should not figure in any taxonomy of avoidance, it might be worth bearing in mind that the more recent House of Lords case *of Barclays Mercantile Business Finance Ltd v Mawson 2005) STC 1; (2004) UKHL 51*, which did involve an elaborate and contrived scheme, was in essence simply about a finance leasing company taking advantage of a relief in this case, capital allowances that Parliament had intended to be of benefit to such companies. The fact that the taxpayer in both Willoughby and Barclays

Mercantile was successful does not mean that simply "using a relief" can be readily discarded from Lord Walker's hierarchy of avoidance techniques. And by the same token (again conceded by Lord Walker), not all offshore schemes are by any stretch of the imagination worthy of the label of "dodgy".

### 2.3.3 The key features of tax avoidance

Many techniques share a series of common characteristics, most of which are very competently summarised in the paper on tax avoidance prepared in late 2005 by SARS (SARS, Discussion Paper…2005). In the view of that revenue authority, the "badges" or "hall marks" of avoidance typically include any or all of the following features:

- the lack of economic substance with the result that an apparently significant investment proves ultimately to be illusory, and, through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary;
- the use of tax-indifferent accommodating parties or special purpose entities, often referred to in the jargon as "washing machines";
- unnecessary steps and complexity, often inserted to prop up a claim of business purpose, or to disguise the true nature of a scheme or "as a device to cloak the tax shelter transaction from detection";
- inconsistent treatment for tax and financial accounting purposes;
- high transaction costs;
- fee variation clauses or contingent fee provisions;
- the use of new, complex financial instruments such as derivatives, hybrids and synthetic instruments which have made it possible for promoters to mimic almost perfectly the risks and returns attributable to more traditional financial instruments such as equity shares or "plain vanilla" debt without incurring, at least in theory, the tax consequences typically associated with them; and

- the use of tax havens, particularly in the context of captive insurance companies, captive finance subsidiaries and intangible property holding companies.

Of course this is not to suggest that the existence of these characteristics, either alone or in combination, must necessarily point to the existence of tax avoidance activity. That conclusion can only be drawn after a careful consideration of all of the facts. But it is to suggest that, prima facie, the existence of these features, alone or in combination, may indicate avoidance activity.

**2.4 Anti Avoidance provisions prior to 2006 Amendments**

Prior to 2006 the general anti avoidance provisions were set out in sections 103(1) of the Income Tax Act 58 of 1962, and acted as a safety net in respect of certain transactions which were not dealt with by the specific anti avoidance provisions Arendse, *et al* (2003:485).

There were however, other provisions that aimed at particular transactions only, such as section 103(2) and 103(5) that housed strategic weapons aimed at limited targets. This view was confirmed by Kruger and Scholtz (2003:230). Although these sections are highlighted here they are however, not dealt with in details.

Section 103 (2) dealt with schemes that absorbed the assessed loss of a company for the purpose of avoiding tax, while section 103 (5) was intended to combat schemes whereby taxpayers cede their rights to receive interest in exchange for dividends.

At first glance the provisions of section 103 appal in the breath of their scope. For example where SARS was satisfied that an avoidance scheme has been entered into, he was empowered in terms of the section to determine a taxpayer's liability for income tax as if the scheme has not been entered into, or in any other manner he may deem appropriate to prevent the avoidance of the tax. The provisions of section 103 are now discussed in detail below.

### 2.4.1 Section 103(1) provision

In terms of section 103(1) “the taxpayer had a cluster of separate defences, any one of which, if proved, will effectively counter any attempt by SARS to invoke the provisions of section 103(1)” Kruger & Scholtz (2003:232).

This was so because, before SARS could apply the provisions of section 103(1), the Act set four requirements that needed to be met. In *SIR v Geustyn and Joubert (1971 AD)*, the courts held that if the taxpayer can show that any one of the four requirements described does not apply, his liability for tax may not be determined under section 103(1).

In terms of section 103(1), SARS was required to be satisfied that:

#### 2.4.1.1 A transaction, operation or scheme (referred to as a ‘transaction’) has been entered into or carried out.

#### 2.4.1.2 The transaction entered into or carried out had the effect of avoiding or postponing liability for the payment of any tax duty or levy imposed by the Act of reducing the amount of the liability.

The taxes imposed under the Act were:

- Income Tax (Including capital gains tax),
- Secondary Tax on companies, and
- Donations Tax.

Therefore if the effect of a transaction was for instance, the avoidance of value added tax (VAT), section 103(1) could not be applied to counter the avoidance of VAT in respect to that transaction.

#### 2.4.1.3 Depending on the type of transaction, the third requirement was either the bona fide business purpose test or the abnormality test and an abnormal rights test.

Arendse (2003) described these tests as follows:

- The bona fide business purpose test

If a transaction in the context of business was entered into or carried out in a manner that would not normally be employed for bona fide business purposes, other than to save any tax administered by the Commissioner, the transaction may still be attacked in terms of section 103(1).

- The abnormality test

This test will be applied to any transaction other than those in the context of business. If the transaction was entered into or carried out by means or in a manner that would not normally be employed in the entering into or carrying out of a transaction of that nature, the abnormality requirement will be met.

- The abnormal right test

Any transactions, whether in the context of business or not, would be measured against this part of the third test. If a transaction created rights or obligations that would not normally be created between persons dealing at arm's length (*SAID v Botha, 62 SATC 264*).

The third requirement would be met irrespective of the outcome of the two tests above (bona fide business purpose and the abnormality tests).

#### 2.4.1.4 The transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

Section 103(7) defined a 'tax benefit' as including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed under the Act or any other law administered by the Commissioner. These laws included the Estate Duty Act 45 of 1955, the Value-Added Tax Act 89 of 1991, the Transfer Duty Act 40 of 1949, the Stamp Duties Act 77 of 1968 and the Marketable Securities Tax Act 32 of 1948.

The test was a subjective one, namely, why did the taxpayer enter into the scheme? Furthermore, section 103 (4) went on to provide that where it had been proved that a

transaction had the effects of avoiding tax, it would be presumed, until the taxpayer proves otherwise, that the avoidance of tax was one of the main purposes of the transaction. This authority was emphasised in *Ovenstone v SIR 1980 (2) SA 721 (A), 42 SATC 55* as well as *Hicklin v SIR 1980 (1) SA 481 (A), 41 SATC 179.*

If the sole or main purpose of a transaction was not the avoidance of the specified taxes, section 103 (1) may not be applied. Accordingly, a scheme designed solely or mainly to achieve business objectives other than the avoidance of these taxes would be safe from the application of the provision, even if incidental savings of the taxes were achieved.

Should SARS be satisfied that any one of the requirements set out above has not been met, section 103(1) may not be applied. Once satisfied on all four requirements, SARS may determine the liability for and the amount of any tax due, duty or levy imposed by the Act:

- As if the transaction had not been entered into or carried out, or
- In such a manner as in the circumstances of the case he deems appropriate for the prevention or diminution of the avoidance of any tax imposed by the Act.

**2.4.2 Case law on section 103(1)**

There is a limited number of recorded cases dealing with the application of section 103(1), and those recorded cases for example clearly show that each case must be dealt with on its own facts and according to its own peculiar circumstances. The more important cases which have dealt with section 103(1) are discussed below.

**2.4.2.1 Cases where the Commissioner failed to enforce the provisions of section 103(1)**

In *SIR v Geustyn and Joubert (1971A)*, it was found that it was not the sole or main purpose of the conversion of a partnership to a company to avoid tax. It was quite clear that such conversion may have taken place for reasons other than obtaining a tax benefit (for example to obtain limited liability), which generally renders section 103(1) ineffective. In this case the

Commissioner failed in his attempt to apply section 103(1) so as to treat the income of the company as if it were the income of the three former partners.

In *CIR v Louw (1983A)*, where the court viewed the incorporation of a partnership and the subsequent granting of loans as independent transactions and, while finding that the incorporation was safe from attack under section 103(1), held that the loans were vulnerable to the application of the provision. The incorporation of a partnership was found not to be abnormal, but 'the granting of loans to shareholders' instead of them receiving salaries as employees, was considered to be abnormal.

In *ITC 1636(1997)*, a case dealing with a sale and leaseback scheme, the provisions of section 103(1) could not be applied. In this case it was confirmed that all four requirements of section 103(1) should be present before the section could be applied to a particular transaction and that the onus rested on the Commissioner to prove that the requirements had been met. The sale and leaseback scheme was held to be genuine and effective and there was no abnormality present and the sole and main purpose was to raise finance for capital expansion.

#### 2.4.2.2 Cases where the Commissioner successfully enforced the provisions of section 103(1)

In *Meyerowitz v CIR (1963A),* the taxpayer in this case received in terms of a contract with a publisher, a share of profits from the sales of certain books of which he was the author. He then ceded his interest in the books for no consideration to a company formed by him and jointly owned by him and his wife. His further then formed a trust for the benefit of the taxpayer's minor children and the company ceded its interest in the books to the trust for an inadequate consideration. The taxpayer had indirectly diverted income from himself to his children by means of an artificial manoeuvre. The Appellate Division was satisfied that the avoidance of tax was the sole or one of the main purposes of the scheme and confirmed the Commissioner's right to tax the income in the taxpayer's hands.

In summary, section 103(1) as discussed above set out four conditions which had to be employed before the anti avoidance provisions could be invoked against the taxpayer. The

taxpayer on the other hand has defence from other provisions of section 103 which are discussed briefly below.

### 2.4.3 Section 103 (4)

The decision of SARS under section 103(1) as to whether the transaction was entered into for the sole or main purpose of avoiding or postponing the tax liability, or reducing the amount of any tax is subject to objections and appeals in terms of section 103(4).

The provisions of 103(4) were emphasised on *CIR v Conhage (Pty) Ltd 1999 SCA 61 SATC 391*. In this case the taxpayer required finance of approximately R135 million. After negotiations with the bank it was decided that the most effective way of raising finance required would by means of a sale and leaseback agreement. The Commissioner was under the impression that this arrangement was in effect a disguised loan agreement. In arriving at the decision the court dealt with the following issues:

- the question of onus and the function of the special court
- simulation of transactions
- section 11(a) in terms of the lease rentals
- application of section 103 of the Act.

It was therefore held that all the requirements for the application of section 103(1) must be fulfilled and should also apply at the same time. The special court also stated that “the primary onus of proving that all the requirements are present rests upon the Commissioner”. The Commissioner could not prove that the sole and main purpose was to avoid, postpone and reduce tax. Therefore section 103(4) was applied successfully in this case.

### 2.4.4 Section 103(7)

According to the fourth requirement of section 103(1) provisions, the Commissioner has to prove that the transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit. Section 103(7) provided a definition of a tax benefit. It is defined as

"including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income Tax Act or any other law administered by the Commissioner".

If the Commissioner cannot satisfy this definition of tax benefit, the provisions of section 103(1) cannot be invoked.

Tax benefit is also defined in section 73(2) of the Value Added Tax (VAT) Act as:

- "any reduction in the liability of any person to pay tax; or
- any increase in the entitlement of any vendor to a refund of tax; or
- any reduction in the consideration payable by any person in respect of any supply of goods or services; or
- any other avoidance or postponement of liability for the payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner".

### 2.4.5 Section 103(6)

Section 103(6) compels the Commissioner to use section 89 quat to levy interest on transactions, schemes or operations used to avoid tax.

Where all conditions of section 103(1) are met, the Commissioner can counteract the tax benefit by:

- nullifying a right to repayment,
- raising an assessment in terms of section 77 of the Income Tax Act, or
- Computing or re-computing profits or gains, or liability to tax, on such basis as the board may specify.

### 2.4.6 Section 103(3)

Section 103(3) extends the application of section 103(1) to transactions involving disposition of shares to the Republic companies held by any person ordinarily resident or carrying on a business in the Republic or any company registered or carrying on business in the Republic.

The purpose of this section is to put an end to the subterfuge which may be employed by a South African taxpayer to sell his shareholdings in the Republic companies to a company registered outside the Republic of which he is a beneficial shareholder with the result that instead of tax being paid on such dividends at substantial rates, the only tax attracted by such dividends is the non resident shareholder's tax.

Where the Commissioner is satisfied that the parties to such a transaction are independent persons dealing at arm's length with each other, section 103(3) will not apply.

### 2.4.7 Section 103 and the SARS Practice Note 20

Practice Note 20 which dealt with section 103(1) and 103(2), stated that the proviso of section 103(1) and (2) as well as section 103(5)(a), had given rise to the concern that SARS might have the right and perhaps even the obligation, when applying them, to reopen any assessment, no matter how long the period that might have expired since the date of the assessment. In SARS's view, in raising additional assessment under section 103, it is constrained by the restrictions to be found in section 79. In other words, the ordinary three year period of prescription, after which assessment become final, applies even to tax avoidance schemes susceptible to the application of section 103. But, by the same token, if the operation of this period is interrupted by the acts identified for this purposes by section 79 for example, if there has been inadequate disclosure, past assessments will remain open to attack under section 103.

### 2.4.8 Substance over form doctrine

According to Arendse *et al* (2003), traditionally it was considered that the courts could take into account only the actual transactions (the form) of a scheme and not the true essence (the substance) of the transactions. However, recent court cases such as *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR (1996 (3) SA 942 (A), 58 SATC 229),* have proved the contrary. In this case the question was whether the taxpayer had obtained a right, the value of which was taxable in terms of para (h) of the definition of gross income in s1 of the Income tax Act 62 of 1958. This paragraph stipulates that a landlord will acquire a taxable right where another person is obliged to make improvements to his property in terms of an agreement

which grants the right to the use or occupation of the property. The value of this right will be included in the landlord's gross income. The scheme was designed on the basis that the landlord owned property on which a valuable building was erected, without the accrual to the landlord of the right to have that building erected. A pension fund was added to the scheme as lessee and sub-lessor under two separate lease agreements. The sublease required the fund (which was exempted from normal tax), as sub-lessor to have the sub-lessee make improvements to the land. The parties tried to prepare the relevant agreements in such a way that the accrual of the taxable right to the landlord would be avoided.

The court acknowledged the principle that taxpayers could arrange their affairs in such a way as to fall outside of the ambit of a certain provision of the Act. However, it was for the court to decide whether they were successful. The court made its decision by considering the true intention of the parties, based on the substance of the transaction, and by interpreting the express, implied and tacit terms of the agreements. As it appeared that the parties were involved in a dishonest transaction, the court further investigated the agreements and surrounding circumstances. The court ignored the disguised transaction and considered the true intention of the parties, or of the agreement between them, was that a right to have improvements made to the land had accrued to the landlord and that it was liable to tax on the value of the improvements.

The substance over form doctrine originated in the context of commercial or corporate taxation. The substance over form doctrine in Australia is referred to in the Australian GAAR as the 'economic substance' doctrine.

In my opinion, the substance over form doctrine is a supplement to the business purpose doctrine since it has been said that both a business purpose and economic substance must be lacking before it will disregard a transaction. In other words, the presence of either a business purpose or a profit motive will suffice to represent a transaction. In *Rice's Toyota World v Commissioner, 752 F.2d 89, 91-92* for instance, the court stated that it will disregard a transaction if it finds that "the taxpayer was motivated by no business purpose other than obtaining a tax benefit and that the transaction has no economic substance because no reasonable possibility of a profit exist".

This meant that the presence of either the business purpose or profit motive will suffice to respect the transaction. The courts are consistent with this suggestion. Most of the courts

apply the substance over form doctrine after they have concluded that the transaction does not serve a non tax business purpose other than generating a profit.

In South Africa the substance over form doctrine has been widely used and the most significant cases and relevant decisions where authority was based on this doctrine of substance over form are discussed below.

#### 2.4.8.1 South African cases on Substance over form

**Customs and Excise v Randless, Brothers & Hudson Ltd 1941 AD 369**

The courts in this case had to decide whether change of procedures by the defendant entitled him to a customs duty rebate or not. The Commissioner in this case argued that the defendant remained the owner of the goods at all times and was thus liable to pay a full customs duty on the goods and not enjoy the rebate.

The Appellate Division found that the transaction between a defendant and the manufacturer did qualify for customs tax rebate.

Watermeyer JA referred to the case of *Zandberg v Van Zyl 1910 AD 302*, where Innes J; stated that:

"the words of the rule indicated its limitations. The courts must be satisfied that there is real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances, that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be".

He then said with regard to the case in question:

> "A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition of tax. A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction; dishonest in as much as

> the parties to it do not really intend it to have inter partes, the legal effect which in terms convey to the outside world".

He continued to say that:

> "Of course a transaction before the court can find that a transaction is the fraudulent legis in the above sense, it must be satisfied that there is some unexpected agreement or tacit understanding between the parties".

The court held that the ownership did pass between the manufacturer and the defendant. He said that the reason for the company to enter into an agreement was for a tax benefit in this case which a customs rebate is.

Contrary to this decision, in the *Furniss (Inspector of Taxes) v Dawson 1984 A.C. 474, the* approach followed to make a decision was different. In the Randles case above the Appellate Division pointed out that the court would not interfere if the arrangement between the defendant and the manufacturer were to avoid tax. In their decision the court indicated that the court would only attack the transaction if only the parties were tacitly entering into a totally different transaction in which in this case the parties entered into a genuine transaction which was also in compliance with the regulations. The Appellate Division said that the parties were entitled to a tax rebate.

On the other hand in the Furniss case, the court's approach towards making a decision was different. The House of Lords concluded that the transaction between the parties involved was also genuine and their aim was that the transaction be in accordance with the tenor of the agreement. The House of Lords did not approach the decision tacitly. The decision was made on the basis that the transaction had no commercial sense other than avoiding tax.

**CIR v Saner 1927 TPD 162; 2 SATC 199**

This case dealt with a taxpayer trying to avoid tax on the profits derived from the sale of shares that would have to be distributed by way of a dividend.

Because the transaction in the sale of shares was abnormal, and also the distribution of income was regarded as abnormal as well, the Commissioner assessed one of the directors amongst the four directors which happened to be Saner. Saner was assessed to be taxed upon

a quarter of the profits derived from the proceeds of the second sale which was the selling of the shares from or by a new company to the ultimate purchaser at a proper market value.

In delivering the judgement Tindall J, said:

> “the substance and not the form of a transaction must be looked at...In my opinion the facts stated by the special court in the present case shows that neither the intention to sell to Saner and his associates nor a genuine purchase price were present”.

He continued to say that:

> “as was pointed out by De Villiers JA in *McDams v Fiander’s Trustee and Bell 1919 Ad 207 at 224*, that there can be no contract of purchase and sale without the animus emendi on the part of the purchaser and the animus vended on the part of the seller, it must be a genuine animus of the one to sell and the other party to buy. It is not enough for the parties to think that they have the intention; ... must be proved as a fact apart from what they thought and the price must be real and also serious”.

The court held that various transactions should be regarded as a whole and therefore the transaction was in substance a realisation of the assets of the original company for the benefit of the shareholders.

The transaction in this case was a sale agreement of which the directors never intended. Their understanding of the transaction was different from the true meaning of the transaction itself.

**ERF 3183/1 Ladysmith (Pty) Ltd and Another v CIR *(*1996 (3) SA 942 (A), 58 SATC 229)**

The courts also looked at this case. This case dealt with a transaction where the parties wanted to use section 11(f) of the Income Tax Act.

Based on the fact of this case, the land owned by Ladysmith (“Lessor”) was let to the pension fund (“Lessee) that erected the buildings thereon, and sublet the land and building to another company in a group (Pioneer) that paid an upfront lease premium. This was done before section 11(f) was amended to require a deductible lease premium to be taxable in a lessor’s hands. The courts believed that:

- The sub- lessee (Pioneer) would qualify for section 11(f) lease premium allowance;
- The sub-lessor (Pension fund) would include in its gross income the value of the lease premium, but then because the pension fund enjoyed an absolute exemption from normal tax the amount of the lease premium was exempt from normal tax; and
- That no amount in respect of the lease premium or improvements would be included in the Ladysmith's gross income.

The Commissioner raised an argument based on the principles that were succinctly explained by Wessels ACJ in *Kilburn v Estate Kilburn 1931 AD 501 and 507* as follows:

> "the form of a transaction will not deceive Courts of law: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance".

The Commissioner argued that the documents did not reflect the real intention of the contracting parties because the entire purpose of the transaction was to evade tax. The agreements were concluded in a form that concealed the fact that the appellants did have the right to have the building erected. He argued that the entire purpose of the transaction was to evade tax.

The court in this case was faced with arguments from opposing parties that were based on two well known legal principles. The interaction between these two principles was referred to by Lord Russell of Killowen in the *IRC v Duke Westminister (1936) 19 TC 490* case when he said the following:

> "if all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non taxability in accordance with the legal rights, well and good ... if, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such doctrine".

The Appellate Division applied the substance over form approach in this case of *ERF 3183/1 Ladysmith (Pty) Ltd and Another v CIR (1996 (3) SA 942 (A), 58 SATC 229)*. The Appellate Division said that the first lease was a sham and ignored the role played by the pension fund in the transactions. It continued to say that Ladysmith was required to include in its income

the agreed upon value of the improvements that were made to the property by the sub-lessee (Pioneer). The Appellate Division further stated that this type of a scheme was abnormal and was not likely to happen again. The judgement in this case is very important in the sense that the Appellate Division indicated that where a transaction was perceived to be a 'sham' transaction it is simple to ignore one of the parties in a transaction.

The court held that the substance of the transaction was merely a lease between the lessor and the sub lessee and ignored the insertion of the pension fund. The lessor was taxed in terms of paragraph (h) of the definition of 'gross income' as contained in section 1 of the Income Tax Act on the value of the improvements. The court then found it unnecessary to examine the Commissioner's alternative grounds under section 103(1). The appeal was therefore dismissed with costs.

Having discussed the provisions of section 103(1) and related sections of the anti-avoidance legislation, the remainder of the chapter focuses on the amendments made by SARS in November 2006 to the provisions of section 103 (Huxham 2010:378). These amendments are discussed below.

### 2.5 General Anti Avoidance Provisions after 2006 Amendments

In November 2006, section 103(1), the general anti-avoidance provision was repealed and the General Anti-Avoidance rules were introduced. The amended General Anti-Avoidance provision is contained in sections 80A to 80L of the Income tax Act (Part IIA of Chapter III of the Income Tax Act No. 58 of 1962) These provisions are read together with the Reportable arrangements Sections 80M to 80T (Part IIB of the Income Tax Act No. 58 of 1962). Just like the old section 103, sections 80A to 80L provisions are meant to cover those types of taxes that are not covered by specific anti avoidance provisions. The content of these provisions as found in Part IIA of Chapter III of the Income Tax Act are listed below:

### 2.5.1 Provisions of PART IIA of Chapter III

#### 2.5.1.1 Section 80A: Impermissible tax avoidance arrangements

For the purposes of section 80A, an avoidance arrangement 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 bona fide 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 as discussed below;

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 bona fide purpose, other than obtaining a tax benefit; or

c) in any context:
   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 (including the provisions of this Part).

The important part of legislation is contained in the provisions of section 80 and the implication of this provision is that tax avoidance itself is not impermissible however, only certain arrangements are impermissible. As Lord Tomlin said in *IRC v Duke Westminister (1936) 19 TC 490* at page 520 that: "every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."

The legislation and case law have recognised this principle but have tried to distinguish normal tax avoidance (legitimate tax planning) from that type of avoidance which takes advantage of technical loopholes. In my opinion, the remedies referred to in section 80B below can only be applied to impermissible tax avoidance arrangements as defined above.

#### 2.5.1.2 Section 80B: Tax consequences of impermissible tax avoidance

For the purposes of section 80B,

1) "The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by:
   a) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
   b) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;
   c) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
   d) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
   e) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
   f) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit".

2) Subject to the time limits imposed by section 79, 79A(2)(a) and 81(2)(b), the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

#### 2.5.1.3 Section 80C: Lack of commercial substance

For the purposes of section 80C,

1) For purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part)

but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.

2) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but not limited to:
   a) the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
   b) the inclusion or presence of:
      i) round trip financing as described in section 80D below; or
      ii) an accommodating or tax indifferent party as described in section 80E below; or
      iii) elements that have the effect of offsetting or cancelling each other.

Section 80C deals with the meaning of the term 'lack of commercial substance' The section is therefore divided into two subsections (80C(1) and 80C(2)).

In the first subsection, it stated that arrangements lacks commercial substance if it results in a 'significant' tax benefit for a party, but does not have a 'significant' effect on the business risks or net cash flows of that party. However, the word 'significant is not defined in section 80L, the section that contains definitions. According to Huxham (2010), the word significant is from the point of view of a particular person. The question is whether the word should be interpreted subjectively or objectively. What is significant for one person might not be significant for another, depending on their circumstance. Therefore, 'significant' of a tax benefit would indicate that tax avoidance was a person's main purpose.

In the second subsection, it is stated that "for the purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to legal substance...". The term substance has been used in the context of tax avoidance, but only one case used term 'legal substance'. This was once in *ITC 1636 (60 SATC 267 – 1997).*

According to section 80C provisions, if there are no valid non-tax reasons for any of the arrangements, it would not lack commercial substance but only if subsection 80C(1) applies, is the arrangement deemed to lack commercial substance.

#### 2.5.1.4 Section 80D: Round trip financing

For the purposes of section 80D,

1) Round trip financing includes any avoidance arrangement in which:
    a) funds are transferred between or among the parties (round tripped amounts); and
    b) the transfer of the funds would:
        i) result, directly or indirectly, in a tax benefit but for the provisions of this Part; and
        ii) significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement.

2) This section applies to any round tripped amounts without regard to
    a) whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;
    b) the timing or sequence in which round tripped amounts are transferred or received; or
    c) the means by or manner in which round tripped amounts are transferred or received.

3) For the purposes of this section, the term 'funds' includes any cash, cash equivalents or any right or obligation to receive or pay the same.

According to Huxham (2010), because an arrangement involves 'round tripping' it does not necessarily render it a tax avoidance arrangement in terms of section 80L. The round-tripping has to be looked at in the context of the transaction of which it is a part.

### 2.5.1.5 Section 80E: Accommodating of tax-indifferent parties

For the purposes of section 80E,

1) A party to an avoidance arrangement is an accommodating or tax-indifferent party if:
   a) any amount derived by the party in connection with the avoidance arrangement is either:
      i) not subject to normal tax; or
      ii) significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and
   b) either:
      i) as a direct or indirect result of the participation of that party an amount that would have:
         aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party; or
         bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party; or
         cc) constituted revenue in the hands of another party would be treated as capital by that other party; or
         dd) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or
      ii) the participation of that party directly or indirectly involves a prepayment by any other party.

2) A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party.

3) The provisions of this section do not apply if either:

a) the amounts derived by the party in question are cumulatively subject to income tax by one or more spheres of government of countries other than the Republic which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or

b) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months: Provided these activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment as defined in section 9D(1) if it were located outside the Republic and the party in question were a controlled foreign company.

4) For the purposes of subsection (3)(a), the amount of tax imposed by another country must be determined after taking into account any applicable agreements for the prevention of double taxation and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

#### 2.5.1.6 Section 80F: Treatment of connected persons and accommodating or tax-indifferent parties

In terms of section 80F, for the purposes of applying section 80C or determining whether or not a tax benefit exists for purposes of this Part, the Commissioner may:

a) treat parties who are connected persons in relation to each other as one and the same person; or

b) disregard any accommodating or tax-indifferent party or treat any accommodating or tax-indifferent party and any other party as one and the same person.

#### 2.5.1.7 Section 80G: Presumption of purpose

For the purposes of section 80G,

1) An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

2) 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.

**2.5.1.8 Section 80H: Application to steps in or parts of an arrangement**

In terms of section 80H, the Commissioner may apply the provisions of this Part to steps in or parts of an arrangement.

**2.5.1.9 Section 80I: Use in the alternative**

In terms of section 80I, the Commissioner may apply the provisions of this Part in the alternative for or in addition to any other basis for raising an assessment.

This section provides that if the Commissioner uses the General Anti Avoidance rules in sections 80A to 80L, he is not tied down to these. He can use any other section of the Act to prevent the avoidance, whether he uses those sections as an alternative to or in addition to section 80A to 80L. If the matter ends up in Court, the Court can decide separately on each of the Commissioner's arguments (Huxham and Haupt 2010:467).

**2.5.1.10 Section 80J: Notice**

In terms of section 80J,

1) The Commissioner must, prior to determining any liability of a party for tax under section 80B, give the party notice that he or she believes that the provisions of this Part may apply in respect of an arrangement and must set out in the notice his or her reasons therefore.

2) A party who receives notice in terms of subsection (1) may, within 60 days after the date of that notice or such longer period as the Commissioner may allow, submit reasons to the Commissioner why the provisions of this Part should not be applied.

3) The Commissioner must within 180 days of receipt of the reasons or the expiry of the period contemplated in subsection (2):

a) request additional information in order to determine whether or not this Part applies in respect of an arrangement;

b) give notice to the party that the notice in terms of subsection (1) has been withdrawn; or

c) determine the liability of that party for tax in terms of this Part.

4) If at any stage after giving notice to the party in terms of subsection (1), additional information comes to the knowledge of the Commissioner, he or she may revise or modify his or her reasons for applying this Part or, if the notice has been withdrawn, give notice in terms of subsection (1).

This section states that SARS has to afford the taxpayer an opportunity to explain why anti avoidance provisions should not be applied to a particular transaction. This means that an assessment cannot be raised automatically. The section gives the taxpayer 60 (sixty) business days to give reasons, and SARS 180 (one hundred and eighty) business days to ask for additional information or raise an assessment or advise the taxpayer that the anti-avoidance provision will not be applied.

**2.5.1.11 Section 80K: Interest**

In terms of section 80K, where the Commissioner has applied this Part in determining a party's liability for tax, the Commissioner may not exercise his or her discretion in terms of section 89quat (3) or (3A) to direct that interest is not payable in respect of that portion of any tax which is attributable to the application of this Part.

**2.5.1.12 Section 80L: Definitions**

"For the purposes of this Part:

‘**arrangement’** means 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;

**‘avoidance arrangement’** means any arrangement that, but for this Part, results in a tax benefit;

**‘impermissible avoidance arrangement’** means any avoidance arrangement described in section 80A;

**‘party’** means any:

a) person;

b) permanent establishment in the Republic of a person who is not a resident;

c) permanent establishment outside the Republic of a person who is a resident;

d) partnership; or

e) joint venture,

who participates or takes part in an arrangement;

**‘tax’** includes any tax, levy or duty imposed by this Act or any other Act administered by the Commissioner”.

**2.6 Summary**

This chapter interrogated literature on Anti Avoidance provisions in South Africa as contained in section 103(1) of the South African Income Tax Act which was repealed in 2006 and was replaced by sections 80A to 80L of the Act (Part IIA of Chapter III of the Income Tax Act No. 58 of 1962).

Firstly, the chapter provided important definitions and distinguished between tax avoidance and tax evasion. This was done with the help of SARS discussion papers and various literatures.

Secondly, this chapter provides an in depth analysis of the provisions of section 103 prior to the 2006 amendments as well as the provisions of after 2006 amendments as contained in sections 80A to 80L of the Income Tax Act.

Thirdly, the chapter provides a brief discussion on other provisions of the Act that are used to cover those types of taxes that are not covered by specific anti avoidance provisions.

Lastly, the chapter looked at case law with the view of finding out how the courts have applied the provisions of the Anti Avoidance legislation. The researcher looked at cases where the Commissioner has successfully enforced the provisions of the Anti avoidance legislation, as well as cases where the Commissioner has failed to successfully enforce the provisions of the general anti avoidance legislation.

The next chapter provides an in depth analysis of developments in anti avoidance legislation over the past five years with a view of highlighting changes and what necessitated those changes. It further looks at other provisions that SARS has put in place in an attempt to curb tax evasion scheme and tax havens.

**CHAPTER 3**

# DEVELOPMENTS IN ANTI AVOIDANCE LEGISLATION OVER THE PAST FIVE YEARS

## 3.1 Introduction

In this chapter developments in the anti avoidance legislation over the past five years are discussed, and the important changes together with reasons for those changes to legislation are highlighted.

The Anti Avoidance provisions in South Africa go back a long way in terms of amendments and developments. The first general anti-avoidance provision introduced in South Africa was in section 90 of the Income Tax Act of 1941. Restrictive interpretation by the courts necessitated several amendments to those provisions. This section was replaced by section 103(1) in the Income Tax Act No 62 of 1958. But this succeeding provision as contained in section 103(1) nevertheless did not deviate fundamentally from section 90 provisions. Hence, the 1986 Margo Commission and the 1995 Katz Commission noted that section 103 had certain shortcomings which led to significant amendments of section 103(1) provision. These changes took place in 2006 and this chapter focuses mainly on those changes and the resultant provisions as contained in sections 80A to 80L. Before these new provisions of section 80A to 80L are discussed in detail it is important to reflect on section 103(1) requirements for the successful application of its provisions.

## 3.2 Background

Firstly, as discussed in chapter 2, in order to apply section 103(1) provisions the Commissioner was required to be satisfied that the following four requirements existed and each one of them was present:

- A transaction, operation or scheme must have been entered into or carried out,
- The transaction carried out must have had the effect of avoiding or postponing a tax liability,
- Depending on the type of a transaction the third requirement would either :

- The bona fide business purpose test or
- The abnormality test, and
- The Abnormal right test, and

- A transaction must have been entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

In the case of a transaction in the context of business, as long as it is entered into or carried out in a manner normally employed for bona fide business purpose other than the obtaining of a tax benefit and it has not created abnormal rights or obligations, a taxpayer may carry out any transaction for the avowed purpose of avoiding or reducing the amount of tax he has to pay. The same principle applies in the context of any other transaction, that is, a non-business transaction. As long as he complies with the requirement of normality laid down in section 103(1), a taxpayer may carry out any transaction for the purpose of avoiding or reducing the amount of tax liability.

### 3.3.2 Road leading to new GAAR

The findings of the Margo Commission (1986) and the Katz Commission (1995) paved way for the new GAAR of 2006. According to the Katz Commission report (1995:133), section 103(1) had proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated forms of impermissible tax avoidance implemented, and it had not kept up with international developments. In responding to these findings, the Minister of Finance launched the Discussion Document on 3 November 2005 for public comment and an Interim Response was released in March 2006. Subsequent to hearings before the Portfolio Committee on Finance, SARS issued a final document referred to as the Revised Proposals. These proposals were incorporated into the Revenue Laws Amendment Bill, which was enacted on 29 September 2006, and apply to arrangements (including any step or part) entered into on or after 2 November 2006.

In November 2006 the Minister of Finance signed a new section, 80A to 80L and repealed the old section 103. In my opinion the reasons for these major changes were to tighten the provisions of the then general anti-avoidance rule as was contained in section 103 in a South

African context. It was clear and had been proven by the Katz Commission that section 103 was inconsistent and sometimes ineffective deterrent to the increasingly complex and sophisticated tax products that were being marketed by South African financial institutions. In particular, transactions incorporating the use of circular flows of funds, special purpose vehicles and other accommodating parties and the use of derivatives had been identified as being the source of anti avoidance transactions.

Hence a distinction had to be made between impermissible tax avoidance and legitimate tax planning. According to SARS (2010) guidelines, legitimate tax planning entails a transaction where a taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and generally suffers the economic consequences that the legislature intended to be suffered by those taking advantage of the option. An example of this type of transaction would be whether or not a new business would be operated through the means of a company or a sole proprietorship. On the other hand the concept of impermissible tax avoidance has been described as including the manipulation of the law and the focus on form and legal effect rather than substance. These kinds of transactions generally have little or no actual economic impact upon the taxpayer. The so called badges of anti-avoidance schemes have been said to be:

- the lack of economic substance;
- the use of tax indifferent accommodating parties or special purpose vehicles;
- unnecessary steps and complexity;
- inconsistent treatment for tax and financial accounting purpose;
- high transaction costs;
- fee variation clauses or contingent fee provisions;
- tax haven arrangements;
- the use of derivatives.

The old section 103(1) on the other hand contained only four provisions as described in chapter 2, namely:

- a transaction, operation or scheme;

- a tax effect;
- abnormality;
- a sole or main purpose to obtain a tax benefit.

Although these four requirements of the old section 103(1) were retained, and a number of amendments has been made and are incorporated to the new section 80A to 80L provisions, especially in view of the Enron and Parmalat events that took place internationally. These amendments entail the following:

- a non-exclusive set of factors were introduced in determining the abnormality for schemes. In addition, the burden of proof is now on a taxpayer to disprove abnormality where certain of these factors are present;
- general anti avoidance provisions to be applied to steps within a larger scheme and not only to the overall transaction;
- general anti avoidance provisions to be applied in the alternative. In other words, SARS can rely on specific provisions of the Act and, in the alternative, argue that GAAR is applicable;
- new penalties have been introduced for scheme promoters and for taxpayers that substantially underreport their income; and
- the purpose of the taxpayer is to be determined objectively by reference to the relevant facts and circumstances and no longer subjectively.

With reference to the relevant indicia of abnormality, some of them may have far reaching consequences. For instance, some of them are:

- the time at which the arrangement or any step or part thereof was entered into and the length of period during which the arrangement or step was carried out;
- the form and economic substance of the arrangement;
- a circular flow of assets;
- the participation of a tax indifferent party or a special purpose vehicle;

- inconsistent treatment of any items or amounts for tax purposes by the parties to the arrangement (such as the payment of a deductible interest expense and the receipt of an exempt dividend);
- the lack of any change in the financial position of any person resulting from the arrangement; and
- the absence of a reasonable expectation of a pre-tax profit.

According to Broomberg (2007), it is to be welcomed that the abnormality requirement will be retained. However, it seems that, in most cases, even a financial lease will potentially be seen to be abnormal and it will be up to a taxpayer to discharge the burden of proof that the transaction is not abnormal given the circumstances in question. In my opinion, the problem is that, once SARS has proved that there is an abnormality, the onus is on a taxpayer to prove what the sole or main purpose of the transaction was. The amended legislation provisions simply means that this requirement is now tested objectively, which may be relatively difficult as a main purpose would more often than not be present, even though it may not be the predominant purpose in the circumstances.

### 3.4 New Part II A insertion into Chapter III of the Income Tax Act 58 of 1962

The revision to section 103 resulted to a new Part IIA, Impermissible tax avoidance, which has been inserted into Chapter III of the Act. The new anti avoidance rules after a revision comprised of twelve separate sections, 80A to 80L. The discussion in this section involves a summary of each revised section of the new GAAR with the aim of highlighting major changes brought about the new provisions as contained in sections 80A to 80L.

The next section provides a summary of what each provision of the new GAAR is trying to address and where it originates from. The question of whether the objectives of each provision have been met is discussed in the next chapter.

#### 3.4.1 Is the arrangement an Impermissible avoidance arrangement?

Section 80A, provides the basic test for determining whether or not an avoidance arrangement is impermissible. In particular, the section applies if there is an arrangement; a

tax benefit attributable to that arrangement; a "tax avoidance" purpose; and any one or more "tainted elements".

The tainted elements carry over the section 103 'abnormality' and 'non arm's length rights and obligations' provisions and further introduce two new elements that would target avoidance arrangements that lack commercial substance or would frustrate the purpose of any provision(s) of the Act. This section replaces the provisions of section 103(1).

### 3.4.2 What are the tax consequences of impermissible tax avoidance?

Section 80B set forth the remedies SARS may apply in order to determine the tax consequences to any party of any impermissible avoidance arrangement. This section replaces the remedy provision which was found in section 103(1).

### 3.4.3 Does the arrangement lack commercial substance?

Section 80C is a new section altogether. It sets forth a basic description of avoidance arrangements that lack commercial substance, as well as a non-exclusive list of characteristics that are indicative of such avoidance arrangements.

### 3.4.4 What is round trip financing?

Section 80D is also a new section which sets forth a basic description of 'round trip financing'.

### 3.4.5 What are the accommodating and tax-indifferent parties?

Section 80E, provides a basic description of 'accommodating and tax-indifferent parties'. This section replaces the definition of 'tax-indifferent party' in section 103(7).

### 3.4.6 The treatment of connected persons and accommodating parties

Section 80F, gives SARS the authority to treat parties that are either connected persons in relation to each other or accommodating or tax-indifferent parties in certain ways for

purposes of applying section 80C provisions or determining whether or not a tax benefit existed.

### 3.4.7 Presumption in respect of purpose

Section 80G, set forth a presumption that would arise in respect of the purpose of an avoidance arrangement and clarifies and confirms that the purpose of a step in or part of an avoidance arrangement may differ from a purpose attributable to the avoidance arrangement as a whole. This section replaces the presumption in respect of purpose found in section 103(4).

### 3.4.8 Application of GAAR to steps in or parts of an arrangement

Section 80H clarifies and confirms that SARS may apply the GAAR to steps in or parts of an arrangement.

### 3.4.9 Application of GAAR as alternative basis for raising an assessment

Section 80I, clarifies and confirms that SARS may apply the GAAR as an alternative basis for raising an assessment.

### 3.4.10 Notice requirement

Section 80J is a new section that introduces a new notice requirement in connection with any potential application of the GAAR. The section provides that SARS must give notice, with reasons, of an intention to invoke the GAAR.

### 3.4.11 Interest provision

Section 80K carries over the provisions of section 103(6). The section provides that interest may not be waived in terms of section 89*quat* of the Income Tax Act if the GAAR has been invoked successfully.

### 3.4.12 Section 80L: Definitions

Section 80L, defines the concepts of arrangement, avoidance arrangement, impermissible avoidance arrangement, party, tax, and tax benefit as it relates to the interpretation of the provisions of the GAAR.

Having tabled above what each provision of section 80A to 80L entails and its origin, the next discussion focuses on the differences between the old section103 and the new GAAR. The discussion highlights both major and minor changes brought about by the new provisions of sections 80A to 80L.

## 3.5 Major changes in the new General Anti Avoidance Rules (GAAR)

The amendments to section 103 included six significant changes.

- The first change was the expansion and reinforcement of the Abnormality Requirement through the introduction of a "Commercial Substance Element" or test.
- The second was the reduction in the number of factors that had been proposed for use in determining abnormality from eleven to five, and the recasting of these remaining five as indicators of a lack of commercial substance.
- The third was the replacing of the factor relating to "circular flows of cash and assets" with one targeting "round trip financing", together with a detailed description of the scope of the new provisions.
- The fourth was the introduction of a second new element targeting avoidance arrangements that would frustrate the purpose of any provision of the Act.
- The fifth was the introduction of a new notice requirement that would apply whenever the Commissioner believes that the provisions of the new GAAR may be applicable in determining the tax liability of a taxpayer.
- The final change was the withdrawal of the presumption of abnormality included in the old section 103(1) provisions.

All these major changes and other minor additions to section 103 are now discussed in the following section.

### 3.5.1 Weaknesses identified in the section 103 abnormality requirement

This study has identified two fundamental weaknesses in the abnormality requirement.

First, the tax world is not neatly divided into two types of arrangements, one for bona fide business transactions and the other for impermissible avoidance arrangements. To the contrary, promoters typically "hijack" elements that were developed for non-tax reasons.

Second, this dynamic often gives impermissible avoidance arrangements an undeserved patina of normality.

These weaknesses contribute directly to the practical problems that have been encountered under section 103. SARS is often forced to proceed on a case-by-case basis despite the common features of many impermissible avoidance arrangements. In addition, expert testimony is often required to pierce the semblance of normality that is created by the use of "normal" elements.

Finally, the lack of objective yardsticks continues to leave the abnormality requirement open to an "everyone's doing it" defence.

### 3.5.2 Changes necessitated by weaknesses of section 103 abnormality requirement

As a result of the above weaknesses in section 103 abnormality requirement, the new anti avoidance legislation has strengthened and expanded the abnormality requirement by adding a new element or test explicitly targeting avoidance arrangements that lack commercial substance (section 80A (a)(ii)).

This commercial substance element applies whether or not an arrangement would be considered abnormal under section 103 provisions. As a guiding principle and general rule, a lack of commercial substance would encompass any avoidance arrangement that fails to have a substantial impact upon any party's business or commercial risks; or net cash flows; or beneficial ownership of any asset involved in the avoidance arrangement, apart from any effect attributable to the tax benefit that would be obtained but for the provisions of the new general anti avoidance rules (section 80C(2)).

The general anti avoidance provisions (section 80C(2)) also identify five characteristics that are generally indicative of arrangements that lack commercial substance. These characteristics encompass situations in which:

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

The above list as contained in section 80C(2) is non-exclusive and is just intended to provide additional guidance in identifying avoidance arrangements that lack commercial substance. There are other indicative tests that are likely to be considered, although not statutorily contained in this section, and they include those contained in guidelines developed by SARS as described below. (SARS, 2010)

#### 3.5.2.1. Anticipated pre-tax profit insignificant in comparison to value of the anticipated tax benefit

An additional indicator of a lack of commercial substance in particular, and of impermissible tax avoidance in general, is where the reasonably expected pre-tax profit that would be derived by a party is less than the value of the expected tax benefit that would otherwise be obtained by that party but for the provisions of the GAAR. This indicator is typically present in arrangements designed to generate deductions or losses for tax purposes (without a corresponding or comparable impact upon a party‘s economic or financial position). Pre-tax profit is determined, taking into account the following:

- A party may use any reasonable method to determine its pre-tax profit; the method must be consistent with General Accepted Accounting Principles (GAAP).
- SARS will not treat any item more favourably for purposes of making a determination in terms of this test than the taxpayer used in its financial statements.

- For purposes of this indicator, pre-tax profit refers to profit before normal tax.
- The projected pre-tax profit and the projected tax benefit over the period of the avoidance arrangement are discounted to a present value as at the end of the first year of assessment in which the avoidance arrangement is entered into or carried out.
- The same discount rate must be used for determining the present value of the pre-tax profit and the tax benefit.
- SARS will have regard to the financial model, if any, which reflects the implementation of the arrangement concerned.

#### 3.5.2.2 Paying more or less than market value for assets or services

Where a party pays substantially more or less than market value for assets acquired or services rendered, this is indicative of a lack of commercial substance. An arrangement involving a sale of shares in a company, where there is clearly no relation between the price paid for the shares and the market value of such company is also clearly indicative of a lack of commercial substance and may be challenged in terms of the GAAR.

#### 3.5.2.3 Inconsistent characterisation by the parties

Where parties to an avoidance arrangement are inconsistent in how they characterise the arrangement for tax purposes, this is indicative of a lack of commercial substance.

#### 3.5.2.4 Significant book or tax differences

Where an arrangement results in significant deferred tax liabilities or permanent differences for financial reporting purposes, this may be indicative of a lack of commercial substance.

#### 3.5.2.5 Unnecessary steps or complexity

The level of complexity of an arrangement and the insertion of unnecessary steps (other than to derive tax benefits) may be indicative of a lack of commercial substance.

#### 3.5.2.6 High transaction costs

Avoidance arrangements are frequently characterised by high transaction costs, often as a direct result of the unnecessary steps and complexity inherent in such schemes. These costs may be reflected as administrative fees for accounting, legal and financial services rendered in implementing the arrangement in question. An arrangement which results in high transactional costs may be indicative of a lack of commercial substance.

#### 3.5.2.7 Fee variation clause or other provisions

The presence of a fee variation clause or of provisions whereby tax risk is shifted to a particular party to the arrangement may be indicative of a lack of commercial substance. Payment for services rendered in connection with an arrangement may involve a fee arrangement based on factors other than normal hourly billing rates. This may be either a value billing arrangement or a flat fee. A promoter may charge a non-refundable upfront fee when presenting the proposed arrangement to a prospective participant. Any one or more of these fee arrangements may be indicative of a lack of commercial substance.

#### 3.5.2.8 Timing and duration of arrangement or failure to adhere to normal business practices

The timing and duration of an arrangement or the timing and duration of any step therein may be indicative of a lack of commercial substance. Where a four-day arrangement is entered into two days before the financial year-end of a participant and this aspect results in a tax benefit, albeit a timing benefit that would not otherwise have materialised, this may be indicative of a lack of commercial substance. Where an arrangement is entered into in a manner than is inconsistent with how the participant has generally concluded previous arrangements, this may be indicative of a lack of commercial substance.

This new element of commercial substance is discussed in detail in the following section. The discussion begins with the indicators of commercial substance to a transaction.

### 3.5.3 The element of commercial substance: Section 80A

The section 103 abnormality factors did capture the features of most impermissible avoidance schemes. However, some of them were vague, overbroad and even overlapped to an extent that they created confusion and uncertainty.

The new abnormality factors are intended to address these concerns in the following ways:

#### 3.5.3.1 Reduction of the abnormality factors to five: Section 103(2)

Because several factors seemed to overlap and that this had a potential of giving rise to uncertainty and confusion, and also because the number of factors itself was a source of additional complexity, in response to these concerns, the factors were reduced to only five:

#### 3.5.3.2 Round Trip financing provision: Section 80D

One of the original abnormality factors related to circular flows of cash or assets.

This factor was overbroad and read literally, could be applied to any financing arrangement

In order to provide additional clarity, the new provision as contained in section 80D replaced the original "circular flow of cash or assets" factor with one targeting "round trip financing". In addition, this new provision also provides a description of the scope of the new factor.

This description encompasses any avoidance arrangement in which funds are transferred between or among the parties ("round tripped amounts") and those round tripped amounts would result directly or indirectly in a tax benefit (but for the provisions of the GAAR), and significantly reduce, offset or eliminate any credit or economic risk incurred by any party in connection with the avoidance arrangement.

The provisions are not subject to any "tracing" requirement and apply regardless of the timing or sequence in which the funds are transferred or received or the means by or manner in which the round tripped amounts are transferred.

The term "funds" is defined in section 80D to include any cash, cash equivalents or any right or obligation to receive or pay the same. By way of comparison, the concept is analogous to the concept of "round robin financing" in Australian GAAR and "circular cash flows" in the United States Income Tax Act.

#### 3.5.3.3 Tax Indifferent Party redefined

The section 103(7) definition of "tax indifferent party" when read literally could have encompassed almost any foreign entity or special purpose vehicle.

The new section 80E definition has limited the scope of the term in several significant ways.

Firstly, the definition only apply to a party if that party's involvement would have a significant impact upon the tax liability of one or more other parties to the arrangement. Accommodating and tax indifferent parties are typically used in impermissible avoidance arrangements, inter alia, to shift items of gross income from one party to another, to convert the character of amounts from revenue to capital, non deductible to deductible, or taxable to exempt, or to absorb a prepayment or accelerated payment of expenditure. The section 80E definition incorporates the functional analysis and limits the scope of the term to parties that are used to achieve any one or more of these ends. This definition limits the scope of the term in two other ways:

Firstly, it does not apply to a party if the amounts received by that party are subject to tax in another country, provided that the tax in question is equal to at least two thirds of the normal tax which would have been payable if those amounts had been subject to tax under the Act. For the purposes of this provision, the amount of tax imposed by the foreign country must be determined after taking into account any assessed loss, credit, rebate, or other right of recovery to which that party or any connected person in relation to that party may be entitled.

Secondly, the definition does not apply to a party if that party continues to engage in substantive active trading activities in connection with the avoidance arrangement. These activities must be conducted for a period of at least 18 months and must be attributable to a business establishment, as defined in section 9D(1), whether or not the party is a foreign controlled company.

By contrast, accommodating parties with a transitory or conduit function typically with the aim of defeating the application of a specific anti avoidance rule, such as section 9D or section 31 would continue to fall within the scope of the provision.

Furthermore, two final changes contained in section 80E refined and expanded the definition. The first change extended the definition to include any party that is not subject to normal tax in connection with any amount derived by it in connection with the avoidance arrangement. The second change was the defined term itself to specifically include accommodating parties.

### 3.5.4 Revision to the sole or main purpose requirement

The purpose of an arrangement is fundamental to determine whether such arrangement constitutes an impermissible avoidance arrangement. Section 80A provides that the avoidance arrangement is an impermissible avoidance arrangement if, amongst other things, its sole or main purpose was to obtain a tax benefit. Section 80G provides a rebuttable presumption that the avoidance arrangement has been entered into or carried out for the sole or main purpose of obtaining a tax benefit. Thus, the mere presence of a tax benefit gives rise to the presumption that the avoidance arrangement was designed and entered into solely or mainly to obtain a tax benefit. The purpose requirement under GAAR deviates from the purpose requirement under section 103(1), and particularly in the following respects:

Firstly, section 80A refers to the purpose of the avoidance arrangement itself, as opposed to the purpose of the parties in entering into or carrying on the avoidance arrangement. This difference moves towards a more objective requirement for the purpose.

Secondly, under section 80G(1) an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining the tax benefit proves that, reasonably considered in the light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. This is comparable to the previous wording which provided that it shall be presumed until the contrary is proved that the sole or main benefit is to derive a tax benefit. The inclusion of the words “reasonably considered” in light of the relevant facts and circumstances directs that the taxpayer‘s ipse dixit should be tested against the surrounding

facts and circumstances. The onus of proof in relation to the purpose of the arrangement, however, does not differ significantly from the previous provision.

Thirdly, the purpose of a step in or part of an arrangement may be different from a purpose attributable to the arrangement as a whole. The GAAR clarifies that the tax benefits derived from a single step or part may therefore be adjusted under section 80B.

#### 3.5.4.1 Purpose requirement under section 103(1)

The purpose of a transaction, operation or scheme under section 103(1) was determined by applying a subjective test. This was confirmed in *SIR v Gallagher 1978(2) SA 463(A), at 471* where it was held, per Corbett JA, that: If the subjective approach be adopted (as it must) then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of respondent, the progenitor of the scheme, as to why it was carried out.

Furthermore, the purpose requirement under section 103(1) required that the sole or main purpose of the arrangement as a whole must be to derive a tax benefit.

#### 3.5.4.2 Purpose requirement under the new GAAR

The changes to the purpose requirement have been motivated, firstly, by the need for a more objective standard to resolve a basic anomaly that existed under section 103(1), as identified by Williams (1996): "In essence...a taxpayer could with impunity enter into a transaction with the (subjectively) sole or main purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner or in the rights and obligations which is created. Conversely, a taxpayer could with impunity enter into a transaction which was objectively abnormal' provided that he did not, subjectively, have the sole or main purpose of tax avoidance."

Compared to section 103, section 80A created a more objective standard, and provides a uniform basis for the tax treatment of identical transactions, by removing reliance purely on the subjective intention of a participant to an arrangement. Secondly, the creation of a more objective standard addresses the problem that existed under section 103(1) that plausible sounding business purposes were artificially manufactured to fit in with the subjective requirements of that section. By virtue of changes made to the wording of the purpose

requirement in the GAAR, the purpose test under the GAAR is therefore a more objective test. Although the onus of proof has not changed substantially, the sole or main purpose of the arrangement itself is the relevant purpose and no longer the subjective purpose of the taxpayer.

In my opinion SARS has used the USA's business purpose test, which is an objective test, for a useful guidance in the interpretation in this regard. It should be considered, however, that the commercial substance test contained in the USA's business purpose test is relevant only in the context of arrangements entered into or carried out in the context of business.

The change in wording in the onus of proof provision furthermore clearly indicates that when determining the sole or main purpose of the avoidance arrangement, regard must be had to the relevant facts and circumstances of the arrangement and not to the subjective purpose or intention of a participating taxpayer, either at the time the arrangement is entered into or subsequently. The purpose of a party may be taken into account as one of the relevant facts, but this will not be the determining factor in making such objective determination. The test aims at being a more balanced test than the test applied under section 103(1).

It should be considered that, although an avoidance arrangement is impermissible if its sole or main purpose was to obtain a tax benefit, this is not the only requirement. In addition to this, SARS must prove the presence of any one or more of the tainted elements.
The meaning of the phrase "solely or mainly", as contained in the now repealed section 103(1), has not been defined in the Income Tax Act, but has been reviewed judicially. The case law continues to find application to the phrase sole or main purpose contained in the preamble to section 80A. The word "mainly" has been construed as :

- in *SBI v Lourens Erasmus (Edms) Bpk 1966 (4) SA 434 (A), 28 SATC 233*, a purely quantitative measure of more than 50%;
- in *CIR v King 1947 (2) SA 196 (A), 14 SATC 184* , as conveying the idea of dominant; or
- more than anything else, for the most.

When determining the purpose of an arrangement, the time of implementation thereof is crucial and not the time of conceptualisation and this was evident in *Ovenstone v CIR 1980 (2) SA 721 (A), 42 SATC 55.*

### 3.5.5 Presumption of purpose of arrangement

According to section 80G(1) "the onus is on the taxpayer to prove that the sole or main purpose of the avoidance arrangement was not to obtain a tax benefit". Since the Commissioner must firstly notify the taxpayer of his or her intention to apply the GAAR provisions, a taxpayer will at this early stage already be afforded the opportunity to provide the Commissioner with what the taxpayer considers to be relevant facts and circumstances which should be taken into account. Although the Commissioner is obliged to take these into account in making the assessment based on the GAAR provisions, the taxpayer nevertheless retains the ultimate onus of proving such facts and circumstances indicating the reasons why these facts and circumstances should be taken into account.

### 3.5.6 Amendment to the Notice Requirement provision: Section 80J

In conjunction with section 103 provisions clarifying that the Commissioner may use the GAAR as an alternative basis for raising any assessment, references to "Commissioner's satisfaction" in the old section 103(1) was deleted in the new section 80J. Instead, section 80J has introduced a new provision that would require the Commissioner to issue a written notice to any taxpayer prior to invoking the provisions of the new GAAR. This notice has to set forth the reasons why the Commissioner believes the GAAR may be applicable.

Furthermore, the new provision also give taxpayers the opportunity to submit reasons to the Commissioner, within 30 days, as to why they believe the general anti avoidance rules should not be applied. If a taxpayer fails to respond to the notice or the Commissioner is not satisfied with the response, the Commissioner then may either determine the liability of the taxpayer under the GAAR based upon the information available or request additional information in order to determine whether or not the GAAR should be applied. If additional information does come to the Commissioner's knowledge after the notice has been issued, the Commissioner may revise or modify his or her reasons for applying the GAAR. Section J requires that this notice be issued as soon as reasonably possible during the audit process. In

addition, the issuance is subject to internal review and approval in order to ensure that the new GAAR is only raised in appropriate situations.

### 3.5.7 Compulsory Interest: Section 80K

Although there is no major change to interest provision of section 103, Section 80K essentially retains the compulsory interest provision previously contained in section 103. This section provides that where the Commissioner has applied the GAAR in determining a party's liability for tax, the Commissioner may not exercise his or her discretion in terms of section 89quat(3) or (3A) to direct that interest is not payable in respect of any tax which is attributable to the application of the GAAR

## 3.6 Other changes and additions in the new GAAR

It is worth noting the following changes to certain and additions to the provisions of the new GAAR:

### 3.6.1 Administration of the general anti avoidance rules

In terms of the old section 103(1), the Commissioner was given a broad-based remedy to determine the tax liability of a party to a transaction, operation or scheme, either on the basis that:

- it had not been entered into or carried out, or
- in such other manner as in the circumstances of the case he deemed appropriate for the prevention or diminution of the tax benefit that would otherwise have been obtained.

The new anti avoidance provisions retains this broad-based remedy, but in addition, introduces a number of new, specific remedies. The GAAR remedies are principally aimed at eliminating any tax benefit that would directly or indirectly have been derived from or attributable to the tainted element(s) in an impermissible avoidance arrangement. In applying section 80B(1), the Commissioner will:

- generally seek to identify the tainted features(s);

- the tax benefits which are used which would not otherwise have been available to the taxpayer (that is, but for, for example, the abnormality, round-tripping, or misuse or abuse); and
- the specific remedy to be used to eliminate the tax benefit that would not otherwise have been obtained by the party in question.

The Commissioner is given the absolute discretion to decide which of the remedies will be applied but the exercise of his or her discretion is subject to objection and appeal.

#### 3.6.1.1 Remedy to steps in or parts of an impermissible avoidance arrangement

Sections 80H and 80G(2) address the Commissioner‘s authority to apply the GAAR to steps in or parts of an arrangement. These provisions must be read with the definition of an arrangement as contained in section 80L, which explicitly provides that the term includes, and applies to, all the steps in or parts of an arrangement, as well as to the entire arrangement itself, and with section 80B(1)(a) which authorises the Commissioner to disregard, combine or re-characterise steps in or parts of an impermissible avoidance arrangement in determining the tax consequences of that arrangement for any party.

#### 3.6.1.2 Remedy in respect of accommodating, tax-indifferent or connected parties

Section 80F ensures that an accommodating, tax-indifferent or connected party cannot defeat the application of the GAAR by, for example, by shifting an existing income stream or an existing income producing activity to another party. The Commissioner may, for purposes of applying section 80C or determining whether a tax benefit exists:

- treat parties who are connected persons in relation to each other as one and the same person; or
- disregard any accommodating or tax-indifferent party or treat any accommodating or tax-indifferent party and any other party as one and the same person.

#### 3.6.1.3 Remedy to reallocate any amount of gross income: Section 80B(1)(d)

The Commissioner may reallocate to any party any gross income, receipt or accrual of a capital nature or expenditure, or rebate derived by another party to an impermissible avoidance arrangement among the parties.

#### 3.6.1.4 Remedy to the re-characterisation of any amount of gross income: Section 80B(1)(e)

The Commissioner may re-characterise any item of gross income, receipt or accrual of a capital nature or expenditure at issue in connection with the impermissible avoidance arrangement. Thus, for example, in a bare dominium scheme, the Commissioner may re-characterise the rental payments made by a lessee as a loan repayment and accordingly only apply a deduction for the interest portion thereof.

#### 3.6.1.5 General remedies

In addition to the abovementioned specific remedies, section 80B(f) authorises the Commissioner to treat an impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit. This remedy is available to the Commissioner as an alternative to any of the abovementioned remedies and it remains in his or her absolute discretion, subject to objection and appeal, to apply this remedy.

### 3.6.2 Use in the alternative

Before the introduction of the GAAR the case law was inconclusive as to whether the general anti-avoidance provisions may be applied in the alternative to any other ground of assessment. Section 80I clarifies and confirms that the Commissioner may apply the GAAR in the alternative to or in addition to any other basis of assessment. In this regard, any number of alternative grounds may be relied on, including, but not limited to, various alternative grounds under the GAAR.

### 3.7 Summary

This chapter provided a detailed analysis of developments in the anti avoidance legislation over between 2005 and 2010. It further highlighted the important changes made during this period together with possible reasons for those changes in legislation.

In essence the chapter provided an in depth analysis of a road map from the old section 103(1) provisions to the new general anti avoidance provisions as contained in section 80A to 80L now included to Part IIA of Chapter III of the Income Tax Act 58 of 1962.

It has been argued that these revised anti avoidance sections 80A to 80L introduced provisions making the new general anti avoidance rule broad enough to reach as many forms of impermissible tax avoidance as possible and strong enough to be an effective deterrent. One notable change among others was that it introduced a "commercial substance test" that clarifies what is needed for a transaction to be considered valid, and further reduced the number of factors that could signal a lack of commercial substance from eleven to five.

It was also noted that another essential element retained in the new GAAR was that SARS can simultaneously contest that "a transaction fails to meet the requirements of a specific provision of the law" and that the general anti-avoidance rule applies. Hence it was concluded that the general anti avoidance rules exists to plug the gaps left by specific rules.

Furthermore, the chapter provided a discussion on additional specific remedies available to the Commissioner over and above the broad based remedy given by the old section 103(1). The new anti avoidance provisions retains the section 103(1) broad based remedy, but in addition, introduced a number of new, specific remedies. The GAAR remedies are principally aimed at eliminating any tax benefit that would directly or indirectly have been derived from or attributable to the tainted element(s) in an impermissible avoidance arrangement. It was further noted that The Commissioner has been given the absolute discretion to decide which of the remedies will be applied but the exercise of his or her discretion is subject to objection and appeal. The additional remedies discussed were:

- Remedy to steps in or parts of an impermissible avoidance arrangements;
- Remedy in respect of accommodating, tax-indifferent or connected parties;
- Remedy to reallocate any amount of gross income; and

- Remedy to the re-characterisation of any amount of gross income.

Lastly, the discussion specifically on legislative changes in section 90 of the Income Tax Act of 1941 and its replacement by the now repealed Section 103(1) of the Income Tax Act 58 of 1962 indicated that South Africa has gone a long way to effectively fight impermissible tax avoidance schemes. The complexity of these schemes has made the formulation of adequate anti avoidance provisions a major challenge for most governments of the world. Hence the overhauling of section 103(1) could signal a break- through for SARS in fighting aggressive tax avoidance schemes and the dismantling of tax havens. In the next chapter each section of the new anti avoidance provisions are interrogated to ascertain whether they do meet this objective of curbing aggressive tax avoidance. Gaps and or loopholes in the new GAAR that may result to inconsistent application of the new legislation and its failure to curb impermissible arrangements are identified.

# CHAPTER 4

## PROBLEMS AND INCONSISTENCIES IN THE NEW ANTI AVOIDANCE LEGISLATION

### 4.1 Introduction

This chapter provides an analysis of the changes identified in the preceding chapter and highlights weaknesses identified by the researcher in the new provisions as contained in sections 80A to 80L. The aim of the chapter is to present findings on provisions studied in this study and to indicate areas where SARS need to focus on when applying provisions of these sections.

### 4.2 Weaknesses in legislation

Where the wording or the content of the provision is not clear or is ambiguous it is recommended that the Commissioner provide guidance in the form of Practice Notes or consider those close to when the legislation is amended in future. The problems were identified in the following section 80A, 80B, 80C, 80E, 80I, 80J, and 80L. These are discussed below.

#### 4.2.1 Section 80A: Impermissible arrangements

The following areas of the section I have highlighted as needing attention of SARS:

##### 4.2.1.1 Determination of a tax benefit

There is no formal test to determine the existence of a tax benefit. A possible approach that could be used would be for the Commissioner to identify income that might have otherwise accrued to the tax planner.

However, in *CIR v Louw 1983 (3) SA 551 (A); 45 SATC 113*, there was no income accruing to the tax planner. The directors of the company caused the entity to make loans to them as

opposed to issuing dividends. The court accepted that taxable salaries would have been paid had the loans not been paid. The Commissioner then raised an additional assessment based on the tax payable in respect of those salaries.

It is therefore submitted that the approach above was not correct as it involved the creation of notional income on which tax might have been paid. In *ITC 1625 (1996) 59 SATC 383(T),* the judgment held that a possible test would be to determine if the taxpayer would have incurred taxation but for the transaction.

An implication of this case is that the Commissioner would need to determine or predict an alternative transaction that the taxpayer would have entered into. The prediction of what the taxpayer could have done is very subjective in nature.

The Commissioner may predict a certain alternative arrangement while the taxpayer may introduce evidence indicating that he would have adopted another course of action.

Alternatively, a situation could exist where the taxpayer would not have entered into any transaction other that the one he has implemented. In *ITC 1625 (1996) 59 SATC 383(T),* Wunch J addressed a similar issue holding that, in the case of a new income earning structure, it would be impossible for the Commissioner to prove that tax avoidance has taken place. As there is no existing income stream it would be difficult for the Commissioner to prove there is an anticipated liability for tax and he will thus not be able to invoke the new GAAR.

#### 4.2.1.2 Non business context

Section 80A*(b)* states that an avoidance arrangement is an impermissible avoidance arrangement if in a context other than business, it was entered into or carried out by a means or in a manner which would not be normally employed for a bona fide purpose other than obtaining a tax benefit. The above provision indicates that if an arrangement has a bona fide purpose other than to obtain a tax benefit in any non-business arrangement, it will not fall foul of this section of the new GAAR. The term bona fide was discussed in a previous section relating to the business context approach. In the same section it was also established that there is no formal definition of business. It is therefore possible that the Commissioner may

take a bona fide business arrangement and assess it using the section 80A*(b)* as opposed to section 80A*(a)* and vice versa due to this term not being adequately defined.

#### 4.2.1.3 In any other context

Section 80A*(c)* states that in any context an avoidance arrangement is an impermissible avoidance arrangement if:

(i) it has created rights or obligations that would not normally be created between persons dealing at arm's length, and

(ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

Section 80A(*c)(i)* existed in the now repealed section 103(1). The first point that needs consideration is that this section applies to any context. This would indicate that this provision has a very wide application. It was submitted by Cilliers (2005) that this section can be described as the heart of section 80A as a result of it applying in any context. An interesting point to note is that the term 'nature of the transaction, operation or scheme' has been removed.

The term 'any' indicates that the term liability has a very wide meaning. This raises several potential issues.

This would indicate that a tax benefit in respect of an avoidance of tax could relate to a current liability, an accrued liability or a past liability. This would create uncertainty for a taxpayer as it is possible that the Commissioner may attack a past liability in the current year of assessment.

Another implication of the definition of tax benefit is that the avoidance, postponement or reduction of any of the non Income Tax Act laws administered by the Commissioner would enable the GAAR to be effected by the Commissioner.

Previously in South Africa, the Commissioner only invoked the previous section 103(1) if the avoidance of a non income tax related tax or duty (for example, estate duty and VAT) had an impact on the taxpayer‘s liability in terms of the Income Tax Act as well. This principle was confirmed in *SIR v Gallagher 1978(2) SA 463*. In addition, some of these other Acts administered by the Commissioner also have their own respective anti avoidance provisions. An example of these Acts and their respective anti avoidance provisions are as follows:

Section 73 of the Value-Added Tax Act allows the Commissioner to determine the VAT liability of a taxpayer if a scheme has been entered into which has the effect of granting a tax benefit to any person and was entered into solely or mainly for the purpose of obtaining a tax benefit. Section 28 of the Estate Duty Act imposes fines and penalties upon any party making fraudulent or false statements in respect of any estate duty matter.

This would create uncertainty for the taxpayer dealing with the above two provisions as it indicates that an anti avoidance rule imported from another Act will be used to raise an additional assessment for them. Alternatively this could also have the effect of the Commissioner being able to utilise the new GAAR in the alternative for a non income tax related issue.

It is submitted that an avoidance arrangement will now exist under section 80A if for example only VAT is avoided and not income tax in terms of the Act. He mentions the example of a vendor purchasing a truck instead of a motor car solely to obtain a VAT input credit. Section 80B(2) states that the Commissioner can only issue amended assessments under the Income Tax Act. Therefore, if a taxpayer enters into an avoidance arrangement which could also have an impact on Value Added Tax, he will not be able to raise an assessment for VAT using the new GAAR.

#### 4.2.1.4 Arm's length

The absence of any requirement to consider the circumstances of the arrangement effectively neutralizes the argument used under the equivalent test in section 103(1), that one has to consider the fact that the parties in certain arrangements are manifestly not at arm‘s length.

The court found in *SIR v Geustyn Forsyth & Joubert (1971A),* that the subjective circumstances surrounding the taxpayer‘s operations needed to be considered when considering normality. An implication of this case is that the normality requirement could be relaxed under certain circumstances (business and family relationships) if they are not dealing at an arm‘s length. It is therefore submitted that the removal of the terms ‘nature of the transaction operation’ or ‘scheme’ would have the effect of the normality requirement being more strictly applied and commercial and family relationships will be ignored. This would have a significant impact on transactions between family members and holding and subsidiary companies.

Secondly, the fiscus has gone to great lengths to define certain sections of the GAAR, but the term ‘arm length transaction’ has not been defined in the new GAAR. Reference must therefore be made to case law to ascertain the meaning of this term.

#### 4.2.1.5 Onus to prove existence and purpose

Section 82 of the Income Tax Act, enforces the requirement that in the event of any dispute between a taxpayer and the Commissioner, the onus is on the taxpayer to prove that he is not liable for any tax. The previous section 103(4) of the Income Tax Act stated:

"Any decision of the Commissioner under sections103(1)…shall be subject to objection and appeal and whenever in proceedings relating thereto it is proved that the transaction, operation or scheme…would result in the avoidance or the postponement of a liability for payment of any tax, duty or levy imposed by this act… it shall be presumed, until the contrary is proved…in the case of any such transaction, operation or scheme, that it was entered into or carried out solely or mainly for the purpose of the avoidance or postponement of such liability...".

The effect of the words above resulted in the South African courts deeming that section 82 did not apply to section 103(1). The Commissioner had to have sufficient evidence that an avoidance transaction had taken place before the onus shifted onto the taxpayer to prove that his sole or main purpose was not to obtain tax benefit.

There is currently no equivalent wording in the new GAAR requiring the Commissioner to prove that there was a tax benefit in relation to the taxpayer. It is believed that the onus of proof that a tax benefit exists is that of the Commissioner and it is important for him to be

able to prove, on a balance of probabilities, that a tax benefit has been received by the taxpayer before invoking the principles of the new GAAR.

#### 4.2.2 Section 80B: Tax consequences

The following areas of the section I have highlighted as needing the attention of SARS:

##### 4.2.2.1 Disregarding an arrangement

Section 80B includes a detailed description of all the tax consequences of an impermissible avoidance arrangement. The remedies available to the Commissioner include, disregarding an arrangement, re-characterising the entire arrangement or components of an arrangement etc.

The determining of a tax liability by disregarding a transaction has been called the power to annihilate the transaction for tax purposes.

The weakness of such a power is that the ignoring of a transaction or the annihilation of them so to speak does not itself create a liability for tax. By disregarding steps or parts of an arrangement, the Commissioner is in effect restoring the taxpayer to the situation he was in prior to entering into the avoidance arrangement. While this may be a fairly simple method of correcting a situation it would have a nil effect on the Fiscus, i.e. no revenue will be earned from this process. In the normal course of business, the benefit of a transaction must exceed its cost. The Commissioner may thus incur a large amount of costs to receive a minimal benefit.

##### 4.2.2.2 Deem appropriate

Section 80B(f) states that the Commissioner may remedy an arrangement by treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such a manner as in the circumstances of the case, the Commissioner deems appropriate. This section has two effects.

The first component of section 80B(f) allows the Commissioner to treat an avoidance arrangement as if it had not been entered into or carried out. This has the effect of disregarding an arrangement. The exact same concept is repeated under section 80B(1)(a*)* to

80B(1)(e*)*. This creates confusion for taxpayers as the same issues are being duplicated in the same section by another provision.

The second effect of this section is that it gives the Commissioner a right to remedy a situation using any method he deems appropriate. The term 'he can deem appropriate' is not defined in the Act and creates uncertainty. This could result in the taxpayer receiving an assessment for a significantly higher amount of tax than he should based on the Commissioner's hypothetical view of events. This would result in unnecessary lengthy legal proceedings and by implication excessive legal costs being incurred by both parties to initiate or defend proceedings.
It is submitted that the Commissioner should make it clear as to what additional remedies he could utilise to create certainty for taxpayers by issuing an Interpretation Note.

S80B(2) requires the Commissioner to make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment to all parties to an avoidance arrangement. This could create potential problems for a Commissioner.

#### 4.2.3 Section 80C Effect of Cancelling or Nullifying

The following areas of the section I have highlighted as needing the attention of SARS:

##### 4.2.3.1 Cancelling or nullifying each other

Elements that offset or cancel each other:
Section 80C (b)(iii*)* indicates that if an arrangement has elements that have the effect of cancelling or nullifying each other, this could indicate a lack of commercial substance in an arrangement.
This section did not previously exist under the now repealed section 103(1) and no further guidance on how to interpret this section has been provided by either the Fiscus or the Commissioner.

The purpose of this provision has been summed up as follows:

The self neutralising mechanism draws upon precedent in the United Kingdom and other jurisdictions that gave rise to the so-called fiscal nullity doctrine. It is targeted primarily at complex schemes, typically involving complex financial derivatives, which seek to exploit perceived loopholes in the law through transactions in which one leg generates a significant tax benefit while another effectively neutralises the first leg for non-tax purposes.

The terms cancelling or nullifying have the exact same effect of neutralizing a tax benefit. It is therefore submitted that only one of these terms should have been used and should be addressed by way of a legislative amendment to the Income Tax Act. For an arrangement where there are minimal steps, the Commissioner may be able to identify instances of cancellation or nullification and possibly invoke the new GAAR easily. However for complex schemes where part of the scheme creates a tax benefit this year but the relevant cancelling provision is only enacted many years later, it may be very difficult for the Commissioner to identify and apply the new GAAR. Alternatively a situation could exist where, from a legal perspective, two provisions appear to cancel each other out but from an economic perspective they do not.

It is submitted that for the purposes of this section one should consider and compare the economic substance of the various terms of an arrangement with each other to ascertain if they cancel or offset each other; and one should also consider and compare the legal substance of the various terms of an arrangement with each other to ascertain if they cancel or nullify each other.

### 4.2.4 Section 80E: Substantive active trading

The following areas of the section I have highlighted as needing the attention of SARS:

#### 4.2.4.1 Substantive active trading

The term 'substantive' in section 80E (3) (b) has not been defined. The term can ordinarily denote material or substantial in relation to the other party. The term 'material' or 'substantial' can denote different things to different people and are open to interpretation.

The Commissioner may be able to deduce that the other party has engaged in substantial activities using certain parameters, whereas the taxpayer and the courts may utilise different approaches yielding another result.

It is submitted that clarity on what constitutes substantive active trading needs to be clarified by the Commissioner by issuing an Interpretation Note. The next requirement is that the other party was engaging with the taxpayer for a period of at least eighteen months. The Act is silent as to what would satisfy this requirement. From a common sense perspective the Commissioner would require the taxpayer to provide documentary proof that they together with the other party engaged in business activities for eighteen months. An example of such proof will be the avoidance arrangement in question, invoices, copies of minutes of all meetings held and delivery notes between all the relevant parties. Note the above list is not all inclusive. However it is submitted that the Commissioner must clarify exactly what forms of evidence would be satisfactory to him to avoid uncertainty by issuing an Interpretation Note

#### 4.2.4.2 At least 18months

The next problem with this requirement is why would a company that has been in existence for less than eighteen months, but meets all the other criteria not benefit from this exemption.

### 4.2.5 Section 80I

The following areas of the section I have highlighted as needing the attention of SARS:

#### 4.2.5.1 In the alternative or in addition to

Section 80I, empowers the Commissioner to use the GAAR in the alternative for or in addition to any other basis for raising an assessment. There was no similar provision in the previous section 103(1). The reason for this inclusion is to reduce the uncertainty of conflicting court decisions.

Two problem areas in the application of this provision were identified:

The first obvious problem is that the GAAR can be applied in addition to a specific anti avoidance provision. This could have unintended consequences if the results of the GAAR and the specific anti avoidance provisions yield different results. If they yield different results, the Commissioner will encounter problems in issuing a new assessment. This is due

to the fact that he may only issue one final assessment after all objections and appeals are resolved.

For example, the Commissioner applies section 8E and deems certain dividends to be interest. The Commissioner then raises the GAAR in addition to this provision. The Commissioner using the GAAR intends to re-characterise this transaction as if it did not occur using section 80B. As can be seen, the Commissioner is attempting to increase the tax liability using section 8E and then at the same time nullifying the whole transaction with the GAAR. Alternatively, if a court rules that a specific provision yielding a particular result is valid and accepts that the GAAR (which yields a different result) may also be applied, this would send conflicting signals as to the strength of the tax system as a whole in South Africa.

Another obvious implication is that this section empowers the Commissioner to raise the GAAR in the alternative to a specific provision. Broomberg (2007) indicates that it has been a long standing principle of SARS not to attack a transaction with section 103(1) if the matter was specifically dealt with in the Act. From a common sense perspective it appears illogical that the Fiscus enacts and then raises a specific anti avoidance provision against an arrangement, then at the same time is able to raise a general avoidance provision against the same arrangement as well.

#### 4.2.6 Section 80L

The following areas of the section I have highlighted as needing the attention of SARS:

##### 4.2.6.1 Party to the arrangement

The term ‘party’ is defined in section 80L and includes a person; permanent establishment in the Republic of a person who is not a resident; permanent establishment outside the Republic of a person who is a resident; partnership; and joint venture.

I argue that partnerships, joint ventures and permanent establishments are not separate taxpaying legal entities in South Africa. Therefore a strict interpretation of the Act is that the Commissioner would not able to make any reasonable adjustments to their tax returns. It is

therefore logical to assume that the Commissioner would need to identify all the separate taxpaying entities in the arrangement and assess them individually.

If a taxpayer is disallowed a deduction because it is of a capital nature, the compensating adjustment would ordinarily be to deny the other taxpayer the right to include this amount in his gross income even though this may be of a revenue nature for this party. Another situation could exist where a taxpayer receives a tax benefit related to the Income Tax Act and at the same time receives a VAT benefit in the form of an input deduction. If the Commissioner were to disregard this transaction or re-characterise it, the possibility that VAT could no longer be claimed exists. A common sense approach would be for the Commissioner to deny the VAT input claim. However section 80B limits the Commissioner to only disregarding, re-characterising etc. an arrangement under the Income Tax Act and he can thus not exercise any powers over the VAT Act. Another problem with the Commissioner‘s unlimited power he deems fit is that it could give him the right to lift the corporate veil of a statutory entity.

Section 80B (2) is subject to sections 79, 79A(2)*(a)* and 81(2)*(b)*. Section 79 has a prescription period of three years from the date of any assessment.

The following scenario could exist: The Commissioner intends on invoking the new GAAR a month before the three year period is completed. By the time the taxpayer and Commissioner respond to the respective notices, the prescription period is over. Alternatively the prescription period may be applicable while the taxpayer and the Commissioner are in court. The Commissioner may be able to issue an amendment to the current taxpayer‘s assessment but may be unable to issue a compensating adjustment to the other parties to the arrangement. This could create a scenario where income is deemed to be received in one person‘s hand, but no deduction is allowed for the other taxpayer. This would create an inequitable tax system in South Africa.

#### 4.2.7 Section 80J: Notice period

The following areas of the section I have highlighted as needing the attention of SARS:

##### 4.2.7.1 Days to respond

Section 80J provides that the Commissioner must lodge in writing with the taxpayer his intention of invoking the GAAR. The taxpayer is then given 60 days to respond as to why the

GAAR should not be implemented. The Commissioner then has 180 days to respond to any reasons provided by the taxpayer.

In my opinion the provision is unclear as to whether the term day is the same as term day denoted in Part III of the Income Tax Act. This confusion may result in a taxpayer submitting his reasons too late, as to why the Commissioner should effect the GAAR and thus causing hardship to the taxpayer. The Commissioner should thus issue an Interpretation Note to clarify these issues.

Secondly the provision makes reference to the Commissioner notifying a party and then allowing the party 60 days for responding.

#### 4.2.7.2 Impossibility of performance by non taxpaying entities covered by section 80L

Section 80L indicates that the term party includes a joint venture and a partnership. These parties, as mentioned in previous sections, are not separate taxpaying entities and the Act is therefore unclear as to how these parties will be given notice or opportunities to respond, giving rise to uncertainty on the part of taxpayers. It is therefore submitted that the Commissioner should address this matter by way of an Interpretation Note.

#### 4.2.7.3 Consequences for non compliance

The Act is also unclear as to what would happen should a taxpayer and the Commissioner fail to respond within the 60 day and 180 day period respectively.

A common sense response would be that the Commissioner would by default invoke the GAAR if the taxpayer fails to respond on time. However what would then happen if the Commissioner were to fail to respond within the 180 day period? Would he then not be able to invoke the GAAR? These questions have been left unanswered by the new GAAR. It is therefore submitted that the Commissioner should issue an Interpretation Note indicating the repercussions for both himself and the taxpayer should they fail to respond within the relevant period.

### 4.3 Summary

The chapter presented a summary of the researcher's findings from the analysis of the new general anti avoidance rules as contained in section 80A to 80L of the Income Tax Act 58 of 1962. It appeared from the discussion that there are provisions of this legislation that require further interpretation and if not addressed would result to inconsistent application of the new anti avoidance rules. Where the wording of these provisions is ambiguous or not clear it is recommended that the Commissioner provide guidance in the form of interpretation notes. The next question that further research on this field should address is whether these inconsistencies and problems identified in this piece of legislation are only common in South Africa or they are present in other countries as well. As a point of departure the researcher identifies other countries with statutory general anti avoidance rules and briefly highlights how they have applied them successfully. Hence the next chapter provides a brief discussion on countries that have successfully adopted statutory general anti avoidance rules (GAAR).

**CHAPTER 5**

# OTHER COUNTRIES WITH GENERAL ANTI AVOIDANCE RULES

## 5.1 Introduction

The chapter provides an overview of tax avoidance in other countries and whether the GAAR exist

Firstly, countries like the United Kingdom (UK) and the United States of America (US), do not have statutory GAAR but have vigorous judicial anti-avoidance doctrines while other countries with similar legal traditions namely Australia, Canada, New Zealand and South Africa have enacted statutory GAARs.

In essence, both the UK and the US do not have a general anti avoidance rules, and they have adopted disclosure requirements in respect of 'potentially abusive tax avoidance schemes'.

The UK, for instance, has developed specific sets of broad anti-avoidance rules addressing, inter alia, financial avoidance and double tax avoidance.

Meyerowitz (2006:64), notes that "the UK courts would look at the total steps of the arrangement as well as the ultimate result thereof. Should any artificial steps be present with no consequential commercial purpose, and the taxpayer only benefited as a result from the tax saving, the taxpayer is to be denied the tax saving. The courts have taken this approach by considering the purpose of the legislation and not merely the literal language of the relevant provisions".

The American courts on the other hand have developed 'robust judicial doctrines', closely related to one another, and designed to counter tax avoidance schemes, not only through the application of such doctrines, but by applying legal analysis with common sense in interpreting facts and rules.

The countries that have adopted statutory general anti avoidance rules (GAAR's) together with South Africa are Australia, Canada and New Zealand and these are described briefly below.

### 5.2. Australia

GAAR provisions are present in the Australian income tax law.

Broomberg (2007) notes that these are widely considered less than satisfactory. He advises that both the courts and the tax administrators inconsistently apply the general anti-avoidance provisions in countries like Australia and that they are replete with unanswered question.

To apply the Australian GAAR successfully, three basic requirements must be met.

Firstly, there must be a scheme.

Secondly, the taxpayer must derive a tax benefit from such scheme.

Thirdly, having regard to the following eight matters set out in section 177D of the Australian Income Tax Act, the scheme, or any part of such scheme, must have been entered into for the sole or dominant purpose of obtaining a tax benefit. The eight matters are:

- "The manner in which the scheme was entered into or carried out;
- The form and substance of the scheme;
- The time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- The result achieved by the scheme under the income tax law if part IVA did not apply;
- Any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result from the scheme;
- Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, that has resulted, will result, or may reasonably be expected to result, from the scheme;
- Any other consequences for the relevant taxpayer, or for any person referred to above having been entered into or carried out; and

- The nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to above".

It follows that the "purpose" question set out above does not concern the taxpayer's actual purpose, but requires an objective conclusion to be reached about the purpose of a relevant person, and is determined after considering the eight specified matters.

### 5.3. Canada

GAAR provisions are also present in Canadian Tax law. Similar to Australian GAAR, Broomberg (2007) noted that the Canadian statutory general anti avoidance rules are widely considered less than satisfactory and that both the courts and the tax administrators inconsistently apply these general anti-avoidance provisions.

Similar to the Australian general anti avoidance provisions, the application of the Canadian GAAR also involves three steps:

The first step is to determine whether there is a "tax benefit" arising from the "transaction".

Secondly, it must be determined whether the transaction is an avoidance transaction under section 245(3) Canadian Income Tax Act in the sense of not being arranged primarily for bona fide purposes other than to obtain the tax benefit.

Thirdly, it must be determined whether the avoidance transaction is abusive under section 245(4).

All three requirements must be fulfilled before the GAAR is applicable to deny the relevant tax benefit.

### 5.4. New Zealand

Section 99 of the New Zealand Tax Act of 1976 contains the general anti avoidance provision, which provides the following:

Every arrangement made or entered into...shall be absolutely void as against the Commissioner for the income tax purposes if and to the extent that, directly or indirectly, its purpose or effect is tax avoidance.

According to the above provision tax avoidance need not be the sole or principal purpose, as long as it is not merely an incidental purpose or effect. Once tax avoidance is proved, section 99 provides that the Commissioner shall adjust tax, as he considers appropriate, to counteract the tax advantage.

### 5.5 Summary

In this chapter the researcher reviewed Income Tax legislation for five countries to ascertain if they do have statutory general anti avoidance provisions. The countries selected for this purpose were Australia, Canada, New Zealand, the United States of America and the United Kingdom. The study revealed that countries like the United Kingdom and the United States did not have statutory GAAR but have vigorous judicial anti-avoidance doctrines while the other three countries (Australia, Canada and New Zealand) have enacted statutory GAARs.

The application of GAAR differs from country to country depending on their legislation. It was observed that both the courts and tax administrators have inconsistently applied the general anti-avoidance provisions and that they are 'replete with unanswered questions'.

# CHAPTER 6

## CONCLUSION AND RECOMMENDATIONS

The objective of this study was to analyse the provisions of the new GAAR as set out in sections 80A to 80L of Part IIA of Chapter III of the Income Tax Act no 62 of 1958.

Historically, the fundamental principle established by the courts was that a taxpayer is entitled to arrange his affairs so as to pay the least amount of tax. South Africa has implemented a new GAAR. The reason for the implementation of the new GAAR was that the now repealed section 103(1) was ineffective and inappropriate at curbing aggressive anti avoidance schemes. As discussed in Chapter 3, many of the provisions within the new statute originate from the old section 103(1), however several concepts have been brought in which have their origins in other parts of the world. The effect of having these new concepts is to defeat several of the old principles established by the South African courts.

Firstly, in this regard the courts have historically determined whether tax avoidance has taken place based on a review of the total circumstances surrounding an arrangement. The new GAAR requires that the Commissioner reviews individual steps of an arrangement in isolation to ascertain whether tax avoidance has taken place.

Secondly, courts have historically held that the purpose test, when determining whether the sole or main purpose of the taxpayer was to obtain a tax benefit, was subjective in nature. The wording of the new GAAR indicates that this test is now objective in nature. This would have the effect of almost all arrangements resulting in a tax benefit being scrutinized for tax avoidance by the Commissioner.

Thirdly, the courts have historically viewed the abnormality of an arrangement in the light of the surrounding circumstances, for example family relationships and commercial practices. The wording of the new GAAR now requires an objective application of the arrangement without taking into account the surrounding circumstances. This would have the effect of preventing transactions between family members or holding and subsidiary companies as they face the possibility of being attacked by the Commissioner using the new GAAR.

The wording of the new GAAR also poses potential problems for the Commissioner when administering the new GAAR. In this regard, section 80A is effective for arrangements entered into on or after 2nd November 2006. It was decided that the old GAAR should be used for all steps or parts entered into before the effective date, and the new GAAR should be utilised to assess steps entered into after the effective date.

The fiscus has implemented a very detailed definition of an arrangement. It has historically been established that the terms transaction, operation or scheme are of very wide import and conceive almost every form of arrangement. It was therefore submitted that certain of the inclusions to this definition were not required and should be resolved by way of an amendment to the Income Tax Act. Furthermore, the new GAAR does not prescribe how to determine the existence of a tax benefit. In certain instances, the Commissioner may consider predicting an alternative arrangement and comparing it to the one conducted using the taxpayer‘s past history of transactions. However, in the instance where the taxpayer would not have entered into any arrangement other than the one enacted, there is no solution currently available. It was submitted that the Commissioner may not be able to implement the new GAAR in this regard.

The new GAAR does not define the term business for the purposes of section 80A*(a)(i)*. A review of various cases did not provide any conclusive definition for this term. This could result in the Commissioner incorrectly applying section 80A*(a)(i)* to an arrangement as opposed to section 80A*(b),* or vice versa. Section 80A*(c)(ii)* is written in positive language and as such maybe open to a wide application. The conclusion reached was that if a statute is interpreted purposively and contextually, there is no need for the insertion of this provision.

Section 80I allows the Commissioner to raise the GAAR instead of or in addition to any specific provision. This would have unintended consequences if the application of a specific provision and the GAAR have opposite results. It was submitted that it was illogical for the Commissioner using this provision to contend that an avoidance arrangement is not allowed, yet at the same time be able to contend that an arrangement is allowed but he intends to implement the new GAAR.

Section 80B allows the Commissioner to remedy an avoidance arrangement using any method he deems appropriate. This could result in the Commissioner levying higher taxes on a taxpayer than are warranted, resulting in lengthy and costly legal battles. It was submitted that the Commissioner should issue an Interpretation Note detailing all the methods he deems fit in this regard.

Section 80I, is unclear whether the definition of the term day is the same as that mentioned in part III of the Income Tax Act. It was submitted that the Commissioner should issue an Interpretation Note in this regard to avoid any uncertainty or misunderstandings.

South Africa is a developing economy, and requires large amounts of foreign and local investment to grow the economy. The new rigid and onerous provisions of the new GAAR may result in many arrangements aiming at boosting the economy being investigated by SARS for tax avoidance. This may be counterproductive to the development of South Africa.

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