



# Tax Avoidance and Section 103 of the Income Tax Act, 1962

## Revised Proposals

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Income Tax Act, 1962

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You are invited to send your comments regarding these revised proposals  
on or before 13 October 2006 to:

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Due to time constraints it will not be possible to respond individually to  
comments received.

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**Tax Avoidance and Section 103 of the Income Tax Act, 1962  
Revised Proposals**

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## **1. Introduction and Overview**

On 3 November 2005, the Minister of Finance launched a Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (the Act). This Paper also included a set of proposed amendments (original proposals) to the section 103, the current General Anti-Avoidance Rule (GAAR) in the Act.

The release of the Discussion Paper and original proposals sparked an open and healthy debate regarding the issue of impermissible tax avoidance and the role of the GAAR in our tax system. The process included an initial comment period that was extended until 28 February 2006, the issuance of an Interim Response by SARS and public hearings before the Portfolio Committee on Finance in March 2006 – as well as a number of seminars, articles and newspaper stories.

The revised proposals are based upon the public comments received and extensive discussions with international experts in this field. In some cases, the original proposals have been retained; in others, modified or withdrawn. Finally, several new provisions are being introduced.

The revised proposals have made a number of concessions in connection with valid criticisms that were received. Significantly, the revised proposals would reduce the original abnormality factors from eleven to five, refocus the remaining ones on arrangements lacking commercial substance, and provide additional guidance on their scope. They would leave the threshold test under the purpose requirement unchanged and introduce explicit procedural safeguards for taxpayers. In addition, they would eliminate the proposed presumption of abnormality. They would also retain a basic four-prong approach (as did the original proposals), notwithstanding recommendations from some commentators that the Abnormality Requirement be eliminated entirely.

An unavoidable side effect of some of these concessions has been an increase in the length and complexity of some provisions. In order to mitigate this side effect, the revised proposals have also adopted a multi-section approach using shorter sentences and simpler language to the extent possible.

At the same time, the revised proposals include new provisions that are intended to ensure that the new GAAR is broad enough to reach as many forms of impermissible tax avoidance as possible and strong enough to be an effective deterrent against them. Thus, by strengthening the original proposals where necessary and making concessions where appropriate, the revised proposals seek to achieve the proper balance between the need for a strong and effective deterrent and the need for certainty in connection with *bona fide* business arrangements.

The discussion below highlights key changes between the original proposals and the revised proposals and describes the key changes in greater detail.

## 2. Defined Terms and Structure

### 2.1. Defined terms

The revised proposals have introduced several new defined terms and have modified certain others –

**‘arrangement’** means “any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including any or all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property”.<sup>1</sup>

**‘avoidance arrangement’** means any arrangement that results in a tax benefit.

**‘party’** means any (a) person; (b) permanent establishment in the Republic of a person who is not a resident; (c) a permanent establishment outside the Republic of a person who is a resident; (d) partnership; (e) or joint venture, that participates in an arrangement.

**‘impermissible avoidance arrangement’** means any avoidance arrangement described in the new proposed section 80A – i.e., any avoidance arrangement in respect of which the Requirements of the GAAR, as revised, are satisfied.

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<sup>1</sup> These new definitions are found in proposed section 80L. As discussed more fully below, the revised proposals also modify the original definition of ‘tax indifferent party’ and introduce a new provision describing “round trip financing”.

## 2.2. Structure

A number of comments were received suggesting that the new GAAR be redrafted in a multiple section format using simpler language and shorter sentences in order to improve the clarity of the provisions. These suggestions have been accepted.

Under the revised proposals, a new Part IIA, *Impermissible tax avoidance*, would be inserted into Chapter III of the Act. The new GAAR would be comprised of twelve separate sections, 80A to 80L. The following is a brief summary of the new provisions –

- **Section 80A**                    **Impermissible avoidance arrangements.** This section provides the basic test for determining whether or not an avoidance arrangement is impermissible. In particular, the section would apply if there is (1) an arrangement, (2) a tax benefit attributable to that arrangement; (3) a “tax avoidance” purpose; and (4) any one or more “tainted elements”. The tainted elements would carry over the current “abnormality” and “non-arm’s length rights and obligations” provisions and would 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. The section would replace the provisions of section 103(1).
- **Section 80B**                    **Tax consequences of impermissible tax avoidance.** This section sets forth the remedies the Commissioner may apply in order to determine the tax consequences to any party of any impermissible avoidance arrangement. It would replace the remedy provisions currently found in section 103(1).
- **Section 80C**                    **Lack of commercial substance.** This is a new section. 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.

- **Section 80D** **Round trip financing.** This provision sets forth a basic description of ‘round trip financing’.
- **Section 80E** **Accommodating and tax-indifferent parties.** This section provides a basic description of ‘accommodating and tax-indifferent parties’. It would replace the definition of ‘tax-indifferent party’ in section 103(7) of the original proposals.
- **Section 80F** **Treatment of connected persons and accommodating parties.** This section would give the Commissioner 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 proposed section 80C or determining whether or not a tax benefit exists.
- **Section 80G** **Presumption of purpose.** This section sets forth a revised 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. It would replace the presumption in respect of purpose currently found in section 103(4).
- **Section 80H** **Application to steps in or parts of an arrangement.** This section clarifies and confirms that the Commissioner may apply the GAAR to steps in or parts of an arrangement.
- **Section 80I** **Use in the alternative.** This section clarifies and confirms that the Commissioner may apply the GAAR as an alternative basis for raising an assessment.



- **Section 80J**            **Notice.** This section introduces a new notice requirement in connection with any potential application of the GAAR.
- **Section 80K**            **Interest.** This section carries over the provisions of current section 103(6).
- **Section 80L**            **Definitions.** This section sets forth the definitions of certain terms that are used throughout the GAAR.

### **3. Major Changes**

The revised proposals include six significant changes. The first would expand and reinforce the existing Abnormality Requirement through the introduction of a new “Commercial Substance Element” or test. The second would reduce the number of factors that had been proposed for use in determining abnormality from eleven to five and would recast those remaining five as indicators of a lack of commercial substance. The third would replace 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 provision. The fourth would introduce a second new element targeting avoidance arrangements that would frustrate the purpose of any provision of the Act. The fifth would introduce 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. Finally, the sixth would withdraw the presumption of abnormality included in the original proposals.

### **4. Tainted Elements**

As noted above, the revised proposals would retain a basic four-pronged approach. In particular, the proposed new GAAR would apply if there is (1) an arrangement, (2) a tax benefit attributable to that arrangement, (3) a “tax avoidance” purpose, and (4) any one or more “tainted elements”.

Under the current section 103, the fourth Requirement is satisfied if an arrangement is either abnormal or would create non-arm’s length rights and obligations. The revised proposals would retain both of these tests or “elements”. In addition, they would

supplement and complement these elements by introducing two new ones – a Commercial Substance Element and a Statutory Purpose Element. Each of these is discussed more fully below.

The revised proposals thus retain the benefit of precedent, while making it clear that the two new Elements represent an expansion of the scope of the current GAAR.

## **5. Commercial Substance Element**

The clear majority of commentators have agreed that tax driven arrangements with little or no commercial substance have no place in our tax system. Many commentators have also acknowledged the continuing weaknesses in the current Abnormality Requirement.

As the Discussion Paper observed, there are two fundamental weaknesses with that 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. The Commissioner 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, as several commentators noted, the lack of objective yardsticks continues to leave the Abnormality Requirement open to an “everyone’s doing it” defence.

In light of these comments, the revised proposals would strengthen and expand the current Abnormality Requirement by adding a new element or test explicitly targeting avoidance arrangements that lack commercial substance.<sup>2</sup> This new Commercial

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<sup>2</sup> Proposed section 80A(a)(ii).

Substance Element would apply whether or not an arrangement would be considered “abnormal” under current law.

As a guiding principle and general rule, a lack of commercial substance would encompass any avoidance arrangement that fails to have a substantial impact upon any 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 GAAR.<sup>3</sup>

The revised proposals would also identify five characteristics that are generally indicative of arrangements that lack commercial substance.<sup>4</sup> These characteristics encompass situations in which –

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

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

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<sup>3</sup> Proposed section 80C(1).

<sup>4</sup> Proposed section 80C(2).

In practice, promoters often seek to defeat the application of the GAAR in several ways. For example, they may try to use a *bona fide* business transaction as an excuse or camouflage for tax driven elements with little or no commercial substance. They may try to divide aspects of an impermissible avoidance arrangement among connected persons in order to give those individual aspects a semblance of commercial substance that they lack when they are viewed as a whole. Similarly, they may introduce accommodating or tax indifferent parties to achieve the same goal or to create an appearance of arm's length dealing.

The revised proposals would counteract these common devices in a number of ways. As a threshold matter, the Commercial Substance Element would apply to any avoidance arrangement that lacks commercial substance in whole or in part.<sup>5</sup> In addition, for purposes of applying the proposed Commercial Substance Element, the Commissioner would be given the authority to –

- treat parties that are connected persons in relation to each other as a single party; or
- disregard any accommodating or tax-indifferent party or combine that party with any other party to the arrangement.<sup>6</sup>

These provisions would apply regardless of the number of such parties that are interspersed or interposed in an avoidance arrangement. They would thus give the Commissioner the tools necessary to pierce the layers of “structural fog” in which certain promoters seek to cloak their schemes.

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<sup>5</sup> Proposed section 80A(a)(ii). As discussed below, this provision would be bolstered by proposed section 80H, which clarifies and confirms that the GAAR may be applied to steps in or parts of an arrangement, and proposed section 80G(2), which clarifies and confirms that the purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.

<sup>6</sup> Proposed section 80F.

## *Examples*<sup>7</sup>

The first example in this series is not itself an impermissible avoidance arrangement, but is being used to illustrate the underlying mischief in question. Unless otherwise indicated, all parties are South African tax residents.

*Example 1.* Company X owns certain assets that have appreciated in value. It borrows funds from Bank A, pledging the appreciated assets as security, and invests the funds in preference shares issued by the Bank. The interest expense incurred in connection with the borrowed funds is not deductible under section 11(a) because it is not used in the production of income. (The dividends received are exempt in terms of section 10(1)(k).)

*Example 2.* Company X is a holding company. It owns a subsidiary, Company Y, that owns assets that have substantially appreciated and significant taxable income. Company X forms a new subsidiary, Company Z. Company Z then borrows from Bank A ostensibly in order to purchase the assets of Company Y in a section 45 intra-group transaction. Company Y then invests the proceeds of the sale in preference shares issued by a Bank A subsidiary that has a large assessed loss for tax but not financial accounting purposes. The terms of the loan and the preference shares are substantially similar.

In this example, the arrangement would result in a tax benefit in the form of an interest expense deduction, despite the fact that the proceeds are invested in preference shares yielding exempt dividends. Company Y is a tax-indifferent party because the amounts it derives from the avoidance arrangement are not subject to tax and it results in the conversion of a non-deductible expense into one that would be deductible but for the provisions of the new GAAR. In addition, the circular flow of funds from Bank A through Companies Y and Z and back to the Bank A subsidiary constitutes round trip financing, while the substantially similar terms of the loan and preference shares constitute an offsetting element within the arrangement.

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<sup>7</sup> The examples in this document are intended solely to illustrate the application of the revised proposals. They do not, and are not intended to, express or reflect any opinion in respect of the treatment of the schemes described under the primary provisions of the Act or the current section 103.

Furthermore, for purposes of applying section 80C, the Commissioner may deem Companies Y and Z, who are connected persons in relation to each other, to be a single party.<sup>8</sup> That being the case, the avoidance arrangement would not have a substantial effect upon their business or commercial risks, net cash flow or beneficial ownership of the assets involved in the avoidance arrangement. Accordingly, the avoidance arrangement lacks commercial substance on multiple grounds and constitutes an impermissible avoidance arrangement within the meaning of section 80A.

*Example 3.* The facts are the same as in *Example 2* except that Company Y invests the proceeds of the sale in preference shares issued by a long term insurance company rather than in preference shares issued by the Bank A subsidiary. The long term insurance company and Bank A have a side agreement regarding the investment of the funds received. For purposes of section 80C, the Commissioner may disregard any accommodating party or combine that party with any other party to the avoidance arrangement. In this instance, the long term insurance company would either be disregarded or combined with Bank A and the result would be the same as in *Example 2*.

*Example 4.* The basic facts are again the same as in *Example 2*. In this instance, however, Company X's new subsidiary, Company Z, issues 25% of its equity shares to a third party in exchange for cash. The issue price is set at an amount equal to 25% of the market value of Company Y's assets. Company Z then borrows an amount from Bank A equal to 75% of the market value of Company Y's assets. Company Z uses the funds it has raised to purchase Company Y's assets in a section 45 transaction and Company Y in turn invests the proceeds in preference shares issued by the Bank A subsidiary.

The Commercial Substance Element applies whenever an avoidance arrangement lacks commercial substance in whole or in part. Except to the extent of the 25% stake acquired by the third party, the avoidance arrangement in question is the same as the one described in *Example 2* and the same analysis applies. Accordingly, this

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<sup>8</sup> The Commissioner may also do the same in respect of Bank A and its subsidiary in establishing the presence of round trip financing.

avoidance arrangement also lacks commercial substance and constitutes an impermissible avoidance arrangement within the meaning of section 80A.

## **6. Commercial Substance Indicators**

### **6.1. General**

The original abnormality factors generated a significant amount of comment. Some commentators acknowledged that these factors did indeed capture the features of most impermissible avoidance schemes. Others criticised various factors for being vague or overbroad. They also noted that the potential overlap of several factors could create confusion and uncertainty. The revised proposals are intended to address these concerns in several ways.

### **6.2. Reduction of the Factors from Eleven to Five**

The original proposals identified eleven objective factors to be taken into account in determining abnormality. As noted above, many commentators pointed out that several factors seemed to overlap and that this could give rise to uncertainty and confusion in practice. They also noted that the number of factors itself was a source of additional complexity in the proposals. In response to these concerns, the revised proposals would reduce the number of factors to five.<sup>9</sup>

As was the case with the original proposals, the enumerated factors would not be exclusive. Other factors that would tend to indicate a lack of commercial substance would include, for example, the absence of a reasonable expectation of pre-tax profit

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<sup>9</sup> In certain instances, the original factors have been combined – for example, the factors relating to offsetting and self-cancelling steps or transactions (originally proposed section 103(2)(f)) and the lack of any change in financial position (originally proposed section 103(2)(i)). In other instances, the proposed factors appeared to have been either sufficiently well established under existing case law – for example, the factors relating to the timing and duration of an arrangement (originally proposed section 103(2)(b)) or the absence of a reasonable expectation of pre-tax profit (originally proposed section 103(2)(k)) – or potentially redundant – for example, the factor relating to the tax result that would have applied but for the application of the GAAR (originally proposed section 103(2)(c)). As discussed more fully below, the remaining factors, as revised, seek to retain the critical elements of the original proposals in a more focused way, thereby mitigating the potential problems that were identified without compromising or sacrificing their intended scope and effectiveness.

or an expected pre-tax profit that is insignificant in comparison to the amount of the expected tax benefit.

### **6.3. Round Trip Financing**

One of the original abnormality factors related to “circular flows of cash or assets”. A number of commentators complained that the proposed factor was overbroad and that, read literally, it might be applied to any financing arrangement (since creditors inevitably expect to be repaid).

As the Interim Response noted it remains the case that circular flows of cash are well-recognised and well-understood components of many impermissible avoidance arrangements – a fact that has since been acknowledged on more than one occasion. In addition, the examples given by commentators are often far less telling than they appear. In typical *bona fide* financing transactions, the proceeds from a loan are invested in the borrower’s business and repaid from revenues earned in the regular course of business – they are not simply re-routed to the lender through one or more accommodating or tax-indifferent parties.

Nevertheless, in order to provide additional clarity, the revised proposals would replace the original “circular flow of cash or assets” factor with one targeting “round trip financing”.<sup>10</sup> In addition, the revised proposals also provide a description of the scope of the new factor.<sup>11</sup>

In general, the description would encompass any avoidance arrangement in which funds are transferred between or among the parties (“round tripped amounts”) and those round tripped amounts would both (1) result, directly or indirectly, in a tax benefit (but for the provisions of the GAAR), and (2) significantly reduce, offset or eliminate any credit or economic risk incurred by any party in connection with the avoidance arrangement.<sup>12</sup> The provisions are not subject to any “tracing” requirement

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<sup>10</sup> Proposed section 80C(2)(b)(i).

<sup>11</sup> Proposed section 80D.

<sup>12</sup> Proposed section 80D(1).



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.<sup>13</sup> The term “funds” is defined to include any cash, cash equivalents or any right or obligation to receive or pay the same.<sup>14</sup> By way of comparison, the concept is analogous to the concept of “round robin financing” in Australia and “circular cash flows” in the United States.

### *Examples*

For examples of arrangements involving round trip financing, please see the compulsory convertible loan arrangement described on page 50 of the Discussion Paper and the film scheme described in Annexure A to the Paper.

#### **6.4. Revised Definition of Tax Indifferent Party**

A number of commentators criticised the definition of “tax indifferent party” in the original proposals.<sup>15</sup> These commentators noted that this definition, read literally, could have encompassed almost any foreign entity or special purpose vehicle.

The revised definition would limit the scope of the term in several significant ways. First, it would 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.<sup>16</sup> 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 revised definition incorporates this

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<sup>13</sup> Proposed section 80D(2).

<sup>14</sup> Proposed section 80D(3).

<sup>15</sup> Originally proposed section 103(7).

<sup>16</sup> Proposed section 80E(2).

functional analysis and limits the scope of the term to parties that are used to achieve any one or more of these ends.

The revised definition would also limit the scope of the term in two other ways. First, it would 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.<sup>17</sup> For 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.<sup>18</sup>

Second, the revised definition would not apply to a party if that party continues to engage in substantive active trading activities in connection with the avoidance arrangement.<sup>19</sup> These activities must be conducted for a period of at least 18 months<sup>20</sup> and must be attributable to a business establishment, as defined in section 9D(1), whether or not the party is a foreign controlled company.<sup>21</sup> 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.

Two final changes would refine and expand the original definition. The first would extend 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

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<sup>17</sup> Proposed section 80E(3)(a).

<sup>18</sup> Proposed section 80E(4).

<sup>19</sup> Proposed section 80E(3)(b).

<sup>20</sup> *Ibid.*

<sup>21</sup> *Ibid.*

arrangement.<sup>22</sup> The second would change the defined term itself to specifically include accommodating parties.<sup>23</sup>

### *Examples*

Examples of accommodating or tax-indifferent parties would include FinCo in the compulsory convertible loan scheme described on page 50 of the Discussion Paper and LeaseCo and FinCo in the finance lease scheme described on pages 51-52 of the Paper.

*Example 1.* Company X is a South African company. It decides to acquire the business operations of Company Y. In order to do so, Company X forms a new wholly-owned subsidiary, Company Z, in order to carry out the transaction. Company Z receives a portion of the purchase price from Company X in the form of share capital and borrows the balance of the funds needed from Bank. Company Z will continue to operate the acquired business for a period of at least 18 months. Company Z would, *inter alia*, qualify for the safe harbour in proposed section 80E(3)(b) and would not be considered an accommodating or tax-indifferent party.

## **7. Statutory Purpose Element**

During the comment period, it became increasingly clear that both section 103 and the original proposals deviated from international best practice insofar as they did not have a test or requirement based upon the purpose of the underlying tax laws. In order to redress this shortcoming, the revised proposals would introduce a new Statutory Purpose Element aimed at schemes that would frustrate the purpose of any provision of the Act, including the provisions of the new Part IIA itself.<sup>24</sup>

Financial and commercial markets are becoming increasingly complex and the rate of change shows no signs of abating. Throughout the world, tax laws have been forced

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<sup>22</sup> Proposed section 80E(1)(a).

<sup>23</sup> Proposed section 80E(1).

<sup>24</sup> Proposed section 80A(c)(ii).

to follow suit and have increased in both length and complexity in order to cope with this rapidly changing environment. At times, the traditional “literal” approach to the interpretation of tax statutes has exacerbated this problem.<sup>25</sup> As a result, there has been a broad movement towards the so-called “modern” approach to interpretation which requires a “contextual and purposive approach . . . in order to find the meaning that harmonizes the wording, object, spirit and purpose of the provisions of the [tax laws]”.<sup>26</sup> The proposed Element is intended to reinforce this emerging trend in South Africa.

To be sure, most impermissible avoidance arrangements either have abnormal features or lack commercial substance (or both). In certain instances, however, these characteristics may be less obvious or more attenuated. The proposed Element would thus serve to complement Abnormality and Commercial Substance Elements by discouraging impermissible avoidance arrangements that rely upon excessively literal or technical readings of the tax laws to defeat their purpose.

The proposed Statutory Purpose Element would also apply to the provisions of the new GAAR itself. The revised proposals would provide significant guidance in respect of the intended scope of many provisions in the new GAAR. It is inevitable that some will seek to parse these revised proposals in an effort to find unintended gaps or “loopholes”. In these circumstances, the proposed Requirement would serve to ensure that this additional guidance is not misused in ways that would frustrate the purpose the new GAAR itself in defeating impermissible tax avoidance and suppressing the mischief against which it is directed.

### *Examples*

*Example 1.* Parties A and B intend to enter into a repurchase agreement in respect of certain securities. In order to avoid the provisions of section 24J, they substitute married put and call options for the portion of the agreement requiring the repurchase

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<sup>25</sup> In particular, the temptation is often to draft a provision in an excessively detailed and comprehensive manner in order to avoid the possibility of any gaps or unintended loopholes.

<sup>26</sup> Canada Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 44.

of the securities at the conclusion of the arrangement. The strike price both for the put and the call is identical. The parties take the position that their arrangement falls outside the statutory definition of a repurchase agreement since the married put and call, taken literally, give them the right, but not the obligation, to repurchase the securities.

Consistent with the economic substance of repurchase agreements and the approach of other countries, section 24J treats such agreements as a form of secured loan. In addition, section 24J is intended to ensure the proper accrual of income earned in connection with any instrument. Since the strike price for the put and call in this example is the same, the arrangement ensures that one of the options will be executed and that the underlying securities will be reacquired by the original owner despite the absence of a technical legal obligation to do so. Under the circumstances, if the parties' position were to be accepted, the avoidance arrangement would frustrate the purpose of section 24J by permitting interest attributable to an instrument to be taxed on other than the yield to maturity basis. The married put and call arrangement would also run afoul of the Abnormality Element.

*Example 2.* Company A is a South African company. Company B is a foreign company, resident in Country X, and is not subject to tax in South Africa. Company B owns shares in another foreign company, Company C, that is resident in Country Y. Country Y imposes a 15% withholding tax on dividends paid to foreign shareholders of resident companies.

The market value of the Company C shares is R1000 million. On 1 October 2006, Company C declares a dividend of R100 million, payable to shareholders of record on 15 October 2006. The dividend is to be paid on 16 October 2006.

Promoter P approaches Company A with a pre-conceived plan. Company A would enter into a repurchase arrangement with Company B in respect of the Company C equity shares. Pursuant to this repurchase agreement, Company A would acquire 10% of the Company C shares for R100 million on 14 October 2006. It would resell them to Party B on 18 October 2006 for R100.1 million (R100 000 being equivalent to the interest foregone on R100 million for four days). Company A would also agree

to pay Company B a manufactured dividend on 15 October 2006 of R9.1 million. Company A also pays Promoter P a fee of R200 000.

If this scheme is accepted at face value Company A would only report taxable income from the foreign dividend of R900 000 (R10 million of gross dividend less the manufactured dividend of R9.1 million). It would also claim a foreign tax rebate of R1.5 million, equal to the full amount of the withholding tax imposed by Country Y. As a result of this approach, Company A would incur South African income tax of only R261 000 (R900 000 x 29%), but would claim a foreign tax rebate of R1.5 million, thereby avoiding R1.239 million of South African income tax on other foreign income.

In this arrangement, Company A actually suffers a negative cash flow and loss of R700 000 before South African tax. (The profit on sale of shares of R100 000, plus R10 million dividend, less R1.5 million foreign withholding tax, less the manufactured dividend of R9.1 million, less the R200 000 fee paid to Promoter P). After taking the South African income tax avoided into account this changes to a profit of R539 000.

The purpose of the foreign tax rebate under section 6quat is to provide relief from the double taxation of the same income. In this scheme, Company A, Company B and Promoter P have attempted to manipulate the literal provisions of section 6quat to produce a result that would frustrate the purpose of those provisions. The arrangement in question would also run afoul of both the Abnormality Element and the Commercial Substance Element.

## **8. Notice Requirement**

In conjunction with the current and revised proposals clarifying that the Commissioner may use the GAAR as an alternative basis for raising any assessment, references to “Commissioner’s satisfaction” in the current section 103(1) would be deleted. A number of commentators expressed concern that the deletion of this

language, together with the originally proposed presumption of abnormality, would result in the new GAAR being applied “automatically”.<sup>27</sup>

In order to address these concerns, the revised proposals would introduce 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.<sup>28</sup> This notice must set forth the reasons why the Commissioner believes the GAAR may be applicable.<sup>29</sup> The provision would also give taxpayers the opportunity to submit reasons to the Commissioner, within 30 days, as to why they believe the GAAR should not be applied.<sup>30</sup>

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.<sup>31</sup> 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.<sup>32</sup>

It is intended that this notice be issued as soon as reasonably possible during the audit process. In addition, the issuance would be subject to internal review and approval in order to ensure that the new GAAR is only raised in appropriate situations.<sup>33</sup>

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<sup>27</sup> For a discussion of these issues, see pages 22 to 25 of the Interim Response. In general, the “Commissioner’s satisfaction” has been used as the basis for arguments against the application of section 103 in the alternative.

<sup>28</sup> Proposed section 80J.

<sup>29</sup> Proposed section 80J(1).

<sup>30</sup> Proposed section 80J(2).

<sup>31</sup> Proposed section 80J(3).

<sup>32</sup> Proposed section 80J(4).

<sup>33</sup> As indicated in the Interim Response, the Commissioner is exploring the feasibility of a centralised body to review and approve the application of the GAAR. If such an approach is adopted, that body would be responsible for both approving the issuance of the notice and any application of the new GAAR in raising an assessment.

## **9. Elimination of the Presumption of Abnormality**

The original proposals would have introduced a presumption of abnormality that would have been triggered if any one or more of eight objective factors were present. These factors captured the basic elements of most impermissible avoidance arrangements, or as the Australians have put it, the “badges of avoidance”. Contrary to some of the comments received, the proposal would neither have presumed taxpayers to be guilty nor deemed arrangements to be abnormal.

Given the proposed introduction of a new and more objective Commercial Substance Element and the other revised proposals to strengthen the GAAR, a decision has been taken to withdraw the proposed presumption in the new GAAR. Nevertheless, the underlying rationale for shifting the onus to taxpayers in connection with factual matters remains valid, particularly in connection with judicial proceedings in which a taxpayer is challenging the correctness of an assessment by the Commissioner. Taxpayers are the ones who have chosen their transactions (and the form in which they are cast) and have the most knowledge of and the greatest access to the facts. Under the circumstances, the onus should properly be placed on them, consistent with the general rule in other civil litigation. Accordingly, this issue will be revisited at a later date in connection with possible amendments to section 82 of the Act.

## **10. Summary of the Remaining Revised Proposals**

### **10.1. Purpose requirement**

The original proposals would have reduced the threshold under the Purpose Requirement to a “one of the main” purposes test.<sup>34</sup> In addition, they would have required the purpose of an arrangement to be “determined objectively by reference to the relevant facts and circumstances”.<sup>35</sup>

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<sup>34</sup> Originally proposed section 103(1)(a).

<sup>35</sup> Originally proposed section 103(3).



The revised proposals would leave the current “sole or main” purpose test unchanged.<sup>36</sup> They would also modify the original proposal requiring the purpose of an arrangement to be determined “objectively”.

Some commentators expressed concern that the proposed “objective” purpose requirement might preclude the court from considering a taxpayer’s *ipse dixit*. It was never the intent of the original proposals to prevent a taxpayer’s explanation of the reasons for an arrangement from being taken into account. Rather, it was intended to ensure that a taxpayer’s statements of intent be rigorously tested against the relevant facts and circumstances. The revised proposals are intended to better reflect that intent and reinforce existing precedent in this regard.

### **10.2. Application to Steps In or Parts Of an Arrangement**

Consistent with the original proposals, the revised proposals would clarify and confirm that the GAAR may be applied to step in or parts of an arrangement.<sup>37</sup> In order to ensure the effectiveness of this amendment, the revised proposals also clarify and confirm that the purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.<sup>38</sup>

### **10.3. Use in the Alternative**

Consistent with the original proposals, the revised proposals would clarify and confirm that the Commissioner may apply the provisions of the GAAR as an alternative for or in addition to any other basis for raising an assessment.

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<sup>36</sup> Proposed section 80A.

<sup>37</sup> Proposed section 80H. Proposed section 80L would also define the term ‘arrangement’ to include any or all steps in or parts of “any transaction, operation, scheme, agreement or understanding (whether enforceable or not)”.

<sup>38</sup> Proposed section 80G(2).

#### **10.4. Tax Consequences of Impermissible Tax Avoidance**

The current remedy provisions, while very broad, focus exclusively on the neutralisation of any undue tax benefits that have been obtained. This emphasis on nullifying arrangements has opened the door for taxpayers to argue that current section 103 cannot be applied to them because they would not have had a tax liability but for the very arrangement under review. On the other hand, the breadth of the current remedy provision has occasionally resulted in excessive or inappropriate adjustments. The new proposal is intended to mitigate these problems.

In particular, the revised proposals would introduce new remedy provisions. These provisions would set forth specific actions that the Commissioner may take in order to determine the tax consequences for any party to an impermissible avoidance arrangement. The revised proposals would retain the current remedy provisions as a final general remedy in the event that the specific remedies are not sufficient to counteract the effects of a particular impermissible avoidance arrangement.

The specific remedies would permit the Commissioner to do any one or more of the following in applying the GAAR to any party –

- disregard, combine or recharacterise any step in or part of an impermissible avoidance arrangement;
- disregard any accommodating or tax-indifferent party or combine that party with any other party;
- deem persons who are connected persons in relation to each other to be a single person for purposes of determining the tax treatment of any amount;
- reallocate any gross income, receipt or accrual of a capital nature, expenditure, or rebate amongst the parties; or
- recharacterise any gross income, receipt or accrual of a capital nature, or expenditure.

In general, these specific remedy provisions are intended to permit the Commissioner to determine the tax consequences for the parties by eliminating those elements of the impermissible avoidance arrangement that otherwise would have resulted in a tax benefit. In addition, parties would no longer be able to defeat the application of the

GAAR by arguing that they would not have had any income but for the impermissible avoidance arrangement itself.

The revised proposals would also give the Commissioner the discretion to make appropriate compensating adjustments that are necessary to ensure the consistent treatment of all parties to an impermissible avoidance arrangement.

### *Examples*

*Example 1.* The facts are the same as in *Example 3* in section 5 above. Pursuant to proposed section 80B(1)(c), the Commissioner may treat parties that are connected persons in relation to each other as if they were a single taxpayer for purposes of determining the tax treatment of any amount. In addition, pursuant to proposed section 80B(a), the intragroup transaction would also be disregarded. Accordingly, in applying the provisions of the proposed section 80B, the deduction for the interest expense incurred by Company would be disallowed since it was incurred in order to invest in preference shares yielding exempt dividends.

*Example 2.* The facts are the same as in *Example 4* in section 5 above. In this instance, 25% of the borrowed funds were used to finance the acquisition of a 25% stake in the pre-transaction business operations of Company X. This portion of the avoidance arrangement therefore would not have been lacking in commercial substance. Accordingly, in applying the provisions of proposed section 80B in order to determine the tax consequences to Company Z, only 75% of the deduction for interest expense incurred by Company Z would be disallowed.

*Example 3.* The facts are the same as those in the compulsory convertible loan scheme described on page 50 of the Discussion Paper. In this instance, pursuant to proposed section 80B(1)(a), the steps in or parts of this impermissible avoidance arrangement that were used to accomplish the round trip financing would be disregarded. In addition, pursuant to proposed section 80B(1), FinCo, the accommodating or tax-indifferent party, would also be disregarded. Accordingly, in applying the provisions of proposed section 80B in order to determine the tax consequences for Borrower, any interest expense directly or indirectly attributable to

the round tripped amounts would be disallowed. Pursuant to proposed section 80B(2), the Commissioner would make appropriate compensation adjustments that are necessary to ensure the consistent treatment of Bank.

*Example 4.* The facts are the same as those in the finance lease scheme described on pages 52 and 53 of the Discussion Paper. In this instance, the impermissible avoidance arrangement involves both the inconsistent characterisation of the arrangement by Borrower and Bank and the participation of two accommodating or tax-indifferent parties, LeaseCo and FinCo. As a result of the impermissible avoidance arrangement, Borrower would have received a tax benefit in the form of fully deductible rental payments instead of partially deductible payments of principal and interest. Accordingly, in applying the provisions of section 80B(1)(a) and (b), the Commissioner would disregard the participation of LeaseCo and FinCo and would recharacterise the remaining steps in or parts of the impermissible avoidance arrangement as a direct loan between Bank and Borrower. No compensating adjustments would be made to any other party.

## **10.5. Interest**

Consistent with the original proposals, the revised proposals would carry over the provisions of current section 103(6).<sup>39</sup>

### **DISCLAIMER**

This background note is solely intended to serve the purpose of providing a basis and framework for discussion and should therefore not be used as a legal reference.

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<sup>39</sup> Proposed section 80K.

**Part IIA**  
**Impermissible tax avoidance**

**Impermissible avoidance arrangements**

**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;
- (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 frustrate the purpose of any provision of this Act (including the provisions of this Part).

**Tax consequences of impermissible tax avoidance**

**80B.** (1) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement to any party by—

- (a) disregarding, combining, or recharacterising any steps in or parts of the impermissible avoidance arrangement;
- (b) disregarding any accommodating or tax-indifferent party or combining that party with any other party;
- (c) deeming persons who are connected persons in relation to each other to be a single 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;

## **Annexure A**

- (e) recharacterising any gross income, receipt or accrual of a capital nature or expenditure;
- (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) The Commissioner may make appropriate compensating adjustments that are necessary to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

### **Lack of commercial substance**

**80C.** (1) For purposes of this Part, an avoidance arrangement lacks commercial substance if it fails to have a substantial effect upon a party's—

- (a) business or commercial risks;
- (b) net cash flows; or
- (c) 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 this Part.

(2) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to—

- (a) a legal or economic effect resulting from the avoidance arrangement as a whole that is inconsistent with, or differs significantly from, the legal form of its individual steps;
- (b) the inclusion or presence of—
  - (i) round trip financing as described in section 80D; or
  - (ii) an accommodating or tax indifferent party as described in section 80E; or
  - (iii) elements that have the effect of offsetting or cancelling each other without a substantial change in the economic position of any one or more of the parties; or
- (c) an inconsistent characterisation of the avoidance arrangement for tax purposes by the parties.

**Round trip financing**

- 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 round tripped amounts—
    - (i) would result, directly or indirectly, in a tax benefit but for the provisions of this Part; and
    - (ii) significantly reduce, offset or eliminate any credit or economic 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 purposes of this section, the term ‘funds’ includes any cash, cash equivalents or any right or obligation to receive or pay the same.

**Accommodating or tax-indifferent parties**

- 80E.** (1) A party to an avoidance arrangement is an accommodating or tax-indifferent if—
- (a) any amount derived by it in connection with the avoidance arrangement is either—
    - (i) not subject to normal tax; or
    - (ii) substantially offset either by any expenditure or loss incurred by it in connection with that avoidance arrangement or any assessed loss of that party; and
  - (b) the participation of that party would directly or indirectly involve or result in any of the following—

## **Annexure A**

- (i) an amount which would have constituted gross income of that party (including the recoupment of any amount) being shifted to another party;
  - (ii) the character of any amount being converted from—
    - (A) revenue to capital;
    - (B) one that would not have been deductible to one that would be deductible; or
    - (C) one that would have given rise to taxable income to one that would either not be included in gross income or would be exempt from normal tax; or
  - (iii) a prepayment of any expenditure by another party to that 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 subject to tax in another country 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 business establishment, as defined in section 9D(1), whether or not the party is a controlled foreign company.
- (4) For purposes of subsection (3)(a), the amount of tax imposed by another 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.

### **Treatment of connected persons and accommodating or tax indifferent parties**

**80F.** For 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 a single party; or



- (b) disregard any accommodating or tax-indifferent party or combine that party with any other party to the arrangement.

**Presumption of purpose**

**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 that party 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.

**Application to steps in or parts of an arrangement**

**80H.** The Commissioner may apply the provisions of this Part to steps in or parts of an arrangement.

**Use in the alternative**

**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.

**Notice**

**80J.** (1) The Commissioner must, prior to determining any liability of a taxpayer for tax under section 80B, give the taxpayer notice that he or she believes that the provisions of this Part may apply in respect of an arrangement, setting out the reasons therefor.

(2) A taxpayer who receives notice in terms of subsection (1) may, within 30 days after the receipt thereof, submit reasons to the Commissioner why the provisions of this Part should not be applied.

## **Annexure A**

(3) If a taxpayer fails to submit reasons under subsection (2), or the Commissioner is not satisfied with the reasons so submitted, the Commissioner may—

- (a) request additional information in order to determine whether or not this Part applies in respect of an arrangement; or
- (b) determine the liability of that taxpayer for tax in terms of this Part.

(4) If at any stage after issuing notice to the taxpayer 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.

## **Interest**

**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 89~~quat~~(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.

## **Definitions**

**80L.** (1) For 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 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 law administered by the Commissioner;

‘tax benefit’ includes any avoidance, postponement or reduction of any liability for tax.



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