



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

An Interim Response

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You are invited to send your comments regarding this Interim Response
on or before 13 April 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:

An Interim Response

1. Introduction

The release of the Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act (Discussion Paper) on 3 November 2005 has sparked a high degree of interest and public comment.¹ The response, moreover, has generally been open and constructive, even when critical of the proposed changes, and has raised a number of important issues and concerns. At the outset, SARS would like to thank those who have already submitted comments for their contributions. This Interim Response takes account of comments received up to the extended deadline of 28 February 2006 and is intended to enhance further dialogue and the debate that will take place at the Portfolio Committee on Finance hearings on tax avoidance that are currently scheduled to begin on 16 March 2006.

In addition to general comments about the initiative, specific comments have focused upon –

- the distinctions drawn between evasion, impermissible avoidance and tax planning;
- the introduction of objective factors under the Abnormality Requirement, together with a new presumption of abnormality;
- the proposed changes to the Purpose Requirement;
- the application of section 103 to steps within a larger transaction;
- the use of the section “in the alternative”, together with related administrative concerns;

¹ The original deadline for comments was 31 January 2006. In response to a number of last minute requests for extensions, the deadline was extended to 28 February 2006. Formal comments have been received from Andrew Duncan & Associates (ADA), The Association of Chartered Certified Accountants (ACCA), The Banking Association South Africa (BASA), Bruno, Business Unity South Africa/South African Chamber of Business (BUSA/SACOB), The Cape Regional Chamber of Commerce (CRC), David Clegg (DC), Deloitte & Touche (DT), Deneys Reitz (DR), Ernst & Young (EY), Ian McClelland (IM), The Industrial Development Corporation of South Africa (IDC), The Institute of Administration and Commerce (IAC), Institute of Certified Public Accountants of South Africa (ICPASA), Incazi Ratings (Incazi), JP van Wyk (vWyk); KPMG, Mallinicks, Alastair Morphet (AM), Karl Müller (KM), PricewaterhouseCoopers (PwC), The South African Institute of Chartered Accountants (SAICA), Sonnenberg, Hoffmann, Galombik (SHG); and Telkom SA Ltd (Telkom). The Discussion Paper and proposed amendments have also generated significant comment in the public domain.

- the need to coordinate the introduction of a stronger GAAR with the phase-in of the new Advance Tax Ruling System (ATR System);
- the need for broader income tax reform;
- the use of additional specific anti-avoidance rules in lieu of a stronger section 103;
- a basic question as to whether change is really needed; and
- the proposed penalties for promoters and for the substantial understatement of income by taxpayers.

In the interests of continuing and promoting this dialogue, this document provides a summary of these comments and an initial response to them.²

2. General Comments

Many commentators recognise and support the need for a stronger General Anti-Avoidance Rule (GAAR).³ In this regard, they have acknowledged that an “appropriate general anti-avoidance regime is a prerequisite for [an] effective tax system”⁴ and have agreed that “[t]axpayers should support action that is taken to combat impermissible tax avoidance as this will serve to lessen the overall burden on all taxpayers”.⁵ Another commentator has firmly supported the view that “horizontal equity in the taxation system should be protected in order to advance economic prosperity to redress historical imbalances inherited from our painful past history”⁶. In addition, some have admitted that the current section 103 was “essentially

² Due to the volume and detail of the comments received, it is not possible to address all the points that have been raised. Instead, this Interim Response has tried to focus upon the major themes and recurring issues that seem to have emerged.

³ See, for example, Lester, M “Receiver tightening the screws on avoidance” *Sunday Times – Business Times* (6 November 2005) p. 18; Ntingi, A “Sars proposals among the best, says UK man” *Business Day* (23 November 2005) p. 6 (quoting David Hartnett, Director General, Her Majesty’s Revenue and Customs). Similar support, while subject to important caveats, has also been expressed in the formal comments by DT; DR, DC, AM, KM, and SAICA. In order to avoid any misunderstanding, it should be noted that references to general statements by commentators are not intended to imply support for any particular proposal(s) and should not be so construed. Indeed, it is a fair to say that a number of commentators that expressed support for the general concept of a stronger GAAR opposed specific aspects of the proposed amendments to section 103.

⁴ KPMG.

⁵ KM.

⁶ IDC.

emasculated” by the Conhage decision⁷ and that “for the past five or six years, the section has barely been a feature in tax planning and has ceased to be the deterrent it once was”.⁸ Others, while emphasising that the majority of taxpayers and practitioners have lost their appetite for aggressive and artificial schemes, have conceded that a stronger GAAR and the proposed penalties may be appropriate for the “cowboys” and “cowgirls” who still remain.⁹

Some commentators were disappointed that the Discussion Paper did not do more to acknowledge the improvements in compliance and changes in attitude that have occurred over the past few years. In a similar vein, others have criticised the Paper for being “a little one-sided”.¹⁰ These comments are noted. The Discussion Paper begins and ends with an unequivocal recognition of the fact that the vast majority of South Africans are honest, hard-working and willing to pay their fair share of tax. It also acknowledges the vital role that practitioners have played, and continue to play, in making the system work. Unfortunately, a Discussion Paper on impermissible tax avoidance will inevitably focus upon that problem. This focus, however, is in no way intended to detract from the invaluable contribution that taxpayers and practitioners have made in achieving a culture of compliance.

Others have gone further, however, and have objected to what they view as the Discussion Paper’s “scathing” tone in respect of “the efforts of some tax planners to avoid tax”.¹¹ There will be no apologies forthcoming here. Without question, many taxpayers have legitimately and honestly sought to reduce their liabilities within the bounds of the law. SARS has no quarrel with them. Indeed, the Discussion Paper explicitly recognises and reaffirms their right to do so. Unfortunately, SARS, like its counterparts throughout the world, has been forced to deal with aggressive schemers

⁷ CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391.

⁸ Mazansky, E “The discussion paper on tax avoidance” *Werksmans News* – Item [71419] (8 November 2005).

⁹ See, for example, Salgado, I “Proposal to penalise tax avoidance advice” *Business Report* (4 November 2005) p. 1 (quoting David Clegg, Tax Partner, Ernst & Young).

¹⁰ Salgado, I “Taxman gunning for convertible loan schemes” *Business Report* (18 November 2005) p.6 (quoting Ernie Lai King, Tax Director, Deneys Reitz).

¹¹ Richardson, P “Taxman to flex his considerable muscle” *Sunday Times – Business Times* (6 November 2005) p. 3 (quoting Ernie Lai King, Tax Director, Deneys Reitz).

who seek to game the tax system at the expense of other taxpayers, while often doing their best to hide or disguise their transactions.¹² Such behaviour is unacceptable under any tax system and SARS will not retreat in its campaign to deter and combat it.

Finally, commentators have commended SARS “on an extremely well researched and well written paper”¹³ and “for the frank and open manner in which the problems of tax avoidance are identified and analysed”.¹⁴ These comments are noted and appreciated. At the same time, commentators have criticised the proposed amendments for failing to achieve an appropriate balance between competing concerns that the Discussion Paper set as one of its goals.¹⁵ SARS takes note of these criticisms as well.

3. Tax Evasion, Impermissible Avoidance and Legitimate Tax Planning

Most commentators have accepted the basic categories of illegal tax evasion, impermissible tax avoidance and legitimate tax planning set forth in the Discussion Paper.¹⁶ Others, however, have taken issue with them. They have argued instead for a simple dichotomy between “unlawful” tax evasion and “lawful” tax avoidance – with nothing, apparently, in between. More bluntly, one commentator has dismissed the whole notion of “impermissible tax avoidance” and its consequences as, in essence, nothing more than “risible” “nonsense” advocated by a “string of ministers of finance and revenue commissioners over the years”.¹⁷ In a similar vein, SARS has been taken to task for allegedly “accus[ing] the hardworking taxpayer of something that they perceive to be impermissible when Parliament has never legislated against it”.¹⁸

¹² See, for example, Discussion paper at pp. 21-22; Speech by Hartnett, D, Director General, Her Majesty’s Revenue and Customs, UNISA Roundtable Discussion (22 November 2005).

¹³ DT.

¹⁴ BASA.

¹⁵ BASA; SAICA.

¹⁶ See, for example, Salgado, I “Taxman gunning for convertible loan schemes” op. cit. n 10, at p. 6 (quoting Ernie Lai King, Tax Director, Deneys Reitz).

¹⁷ Surtees, P “South Africa: Year in Review” *Tax Analysts Worldwide Tax Daily* (5 January 2006).

¹⁸ Richardson, P “Taxman to flex his considerable muscle” op. cit. n 11, at p. 3 (quoting Charles MacKenzie, Tax Partner, Ernst & Young).

SARS certainly recognises the difficulties with terminology in this area and the potential for miscommunication and misunderstanding. At a fundamental level, the term “tax avoidance” has become hopelessly ambiguous in today’s world; depending on the context, it may refer either to legitimate tax planning or to those transactions, operations or schemes that clearly run afoul of a specific or general anti-avoidance provision (or comparable judicial doctrines in countries such as the United States) – and sometimes even to both.¹⁹

In order to help resolve this ambiguity and to minimise misunderstandings, the Discussion Paper began by setting out detailed definitions of the terminology used. Alternatives were also considered, including terms like “unacceptable”, “aggressive” or “abusive” tax avoidance, as well as a distinction between “permissible” and “impermissible” tax avoidance.²⁰ In the end, the categories of “tax evasion”, “impermissible tax avoidance” and “tax planning” were chosen in part because they seemed to be as clear as possible, given the limitations of language, while remaining consistent with the terminology that has developed throughout the world over the past three decades.

More importantly, the terminology was chosen because it was in keeping with both the plain meaning of the language and the case law under section 103. “Impermissible” simply means “not permissible”.²¹ Indeed, Steyn CJ used precisely this language to describe the operation of section 103 in Smith’s case –

¹⁹ Thus, for example, Australia and New Zealand have typically used the term “tax avoidance” itself to refer broadly to any arrangements that run afoul of their GAARs. See Burman, LE and White, D “Taxing Capital Gains in New Zealand” (2003) *New Zealand Journal of Taxation Law & Policy* Vol. 9, No. 3, p. 355. Similarly in the United Kingdom, Lords Templeman, Wilberforce and Roskill have often used the term “tax avoidance” to describe impermissible or ineffective schemes in contradistinction to “permissible” or “effective” tax planning or tax mitigation. Lord Hoffmann, by contrast, seems to have occasionally used the term to encompass both “acceptable” and “unacceptable” forms of tax avoidance.

²⁰ For example, the term “abusive tax avoidance” is generally used in Canada, See Arnold, BJ “The Long, Slow, Steady Demise of the General Anti-Avoidance Rule” (2004) *Canadian Tax Journal* Vol. 52, No. 2, p. 488, while “potentially abusive tax shelter” is typically used in the United States. See Title 26, United States Code, Section 6112. In the United Kingdom, Lord Hoffman has introduced the terms “acceptable” and “unacceptable” tax avoidance. See MacNiven v Westmoreland [2001] STC 237 at p. 248.

²¹ *The New Shorter Oxford English Dictionary* (Vol. I) (Oxford, UK: 1993), at p. 1321. The word “permit” in turn is defined as follows: “allow the doing or occurrence of; give permission or opportunity for”. Ibid (Vol. II) p. 2167.

In so far as the exaction of tax in such circumstances may be said to be something in the nature of a penalty for entering into or carrying out such a transaction, operation or scheme, it would not be a penalty designed to exceed the amount by which the taxpayer would otherwise have enriched himself by outwitting the fiscus, and the means by which he would have done so may, because of its abnormal features, well be described as *not permissible* in the contest between the taxpayer and the tax-gatherer.²²

Particularly in light of the above, it is difficult to understand the contention that Parliament has never legislated against impermissible tax avoidance. From the enactment of section 90 in 1941 through the most recent amendments to section 103 in 1996, Parliament has repeatedly sought to draw the line between what is permissible and what is not in the area of tax avoidance.

In short, whether or not a simple dichotomy between “tax evasion” and “tax avoidance” has ever existed anywhere in the world, it certainly has not been the case for many, many years. Even in the United Kingdom, where the so-called “choice doctrine” originated, the House of Lords has declared that Lord Tomlin’s dictum in the Duke of Westminster decision²³ is no longer the last word on the subject, and that, in fact, it “tells us little or nothing as to what methods of ordering one’s affairs will be recognised as effective to lessen the tax that would otherwise attach to them if business transactions were conducted in a more straight-forward way”.²⁴ If the concept of impermissible or unacceptable tax avoidance applies even in the United Kingdom, a country that has yet to enact a GAAR, it does so all the more in South Africa, which has now had a GAAR for some 65 years.

At a fundamental level, these commentators simply seem to be in denial about the fact that the South African GAAR has been, and continues to be, an integral part of the Income Tax Act. Section 103, like its counterparts in other countries and the judicial

²² Smith v CIR 1964 (1) SA 324(A), 26 SATC 1, 14 (emphasis supplied). The limitations imposed by section 103 on what might otherwise be considered permissible tax avoidance were also recognised by Hefer, J in the Conhage case: “*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*”. CIR v Conhage (Pty) Ltd 1999 (4) SA 1149, 61 SATC 391, 393 (emphasis supplied).

²³ IRC v Duke of Westminster (1936) 19 TC 490, 512.

²⁴ IRC v Burmah Oil Co Ltd (1982) STC 30, 32 (Lord Diplock).

doctrines in the United States,²⁵ is specifically intended to draw a line between those ways of ordering one's affairs for tax purposes that are permissible – and therefore respected – and those that are not.²⁶ Under the circumstances, it is hard to see how a scheme that contravenes section 103 could be considered anything other than “impermissible tax avoidance”. Indeed, one is tempted to wonder if the attitudes expressed have been a contributing factor to the problem of impermissible tax avoidance.

Finally, it has also been claimed that the Discussion Paper creates the impression that taxpayers are not allowed to plan or structure their affairs within the parameters of the law. To the contrary, the Discussion Paper explicitly recognises a taxpayer's basic right to mitigate – and even eliminate – taxes that might otherwise be due through legitimate tax planning.²⁷ In addition, it acknowledges that this right may well be a healthy counterbalance to the power of the “Taxman” and recognises the deleterious impact an overbroad GAAR could have on legitimate or innovative business arrangements.²⁸ Again, the assertions in question seem to be based upon a refusal to accept the fact that some forms of tax avoidance have been, and continue to be,

²⁵ Thus, while Judge Learned Hand famously declared that “[e]very taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible”, Helvering v Gregory, 69 F.2d 809 (2nd Cir. 1934), he also emphasised that “we cannot suppose that it was part of the purpose of the Act to provide an escape from the liabilities it sought to impose”. Gilbert v CIR, 248 F.2d 299, at 411 (2nd Cir 1957).

²⁶ In this regard, the role of the GAAR is to complement, rather than to override, the specific provisions of the underlying tax law. As Brian Arnold has emphasised, this role is essential: “Better-designed and better drafted legislation is a desirable goal; but even if it is achievable to some degree, it cannot ever be an adequate response to the problem of tax avoidance”. Arnold, BJ “The Long, Slow Steady Demise of the General Anti-Avoidance Rule” (2004) *Canadian Tax Journal* Vol. 52, No. 2, 488, at p. 491. More important, contrary to the suggestions of some commentators, better tax legislation and a stronger, more effective GAAR does not present an “either/or” choice. Thus, while SARS and National Treasury have been moving forward with these efforts to improve section 103, they have also moved forward with new efforts to identify and resolve problems in the legislation, efforts that have already resulted in a number of improvements to the Act that have been widely welcomed by taxpayers and practitioners. Finally, it is also important to note that South Africa is by no means alone in struggling with these problems and issues. For example, in Australia, as one commentator has noted, in 1941, “the relevant federal legislation occupied 81 pages in the statute book. Now [as of 2004] it has exploded to 8,500 pages, or 13,500 pages if one includes fringe benefits, capital gains and superannuation provisions. It has been estimated that if tax legislation were to keep growing at the present rate, it would cover 830 billion pages by the end of the century and would take 3 million years to read.” Walker, G “The Tax Wilderness – How to Restore the Rule of Law” (2004) *CIS Policy Monograph 60*, at p. 2. By way of comparison, the South African Income Tax Act, including schedules, runs to some 470 pages.

²⁷ Discussion Paper at pp. 4-5.

²⁸ Discussion Paper at pp. 15 and 44-45.

impermissible under the South African GAAR, and that the GAAR has been, and continues to be, an integral part of the Income Tax Act.

4. The Abnormality Requirement

In general, under the current section 103, four basic requirements must be satisfied:

1. There must be a “transaction, operation or scheme” (the Arrangement Requirement);
2. The arrangement must result in the avoidance, reduction or postponement of a tax (the Tax Effect Requirement);
3. In the case of an arrangement in the context of business, the arrangement must have been entered into or carried out in a manner not normally employed for *bona fide* business purposes, other than obtaining a tax benefit (the Abnormality Requirement); and
4. The transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit (the Purpose Requirement).

In general, the proposed amendments would not affect the first two Requirements, but would make significant changes to both the Abnormality Requirement and the Purpose Requirement.

In particular, the Discussion Paper has proposed two basic changes to the Abnormality Requirement. The first would establish a new set of 11 non-exclusive objective factors to be used in the determination of abnormality. The second would introduce a new presumption of abnormality that would apply in certain circumstances.

4.1 Indicia of Abnormality

The comments in respect of the proposed “Abnormality” factors have generally been critical, though sometimes for contradictory reasons. Some commentators have cautiously welcomed the concept, if not the specific provisions. At least one commentator has acknowledged that “SARS has done its homework, as the list [of factors] is a comprehensive description of the kind of stratagems that characterize many avoidance schemes”.²⁹ Others have observed that many of the factors are

²⁹ Surtees, P “South Africa: Year in Review”, op. cit. n 17. BUSA/SACOB (“SARS has identified these factors as the common characteristics of ‘impermissible’ tax avoidance schemes that are indicative of abnormality”).

“nothing new” and, in fact, are already inherent in the current Abnormality Requirement.³⁰ Yet another group has strongly criticised the proposed changes, both for increasing the complexity of the law and for the vagueness and over-breadth of the factors themselves.³¹

Commentators are generally quite correct in noting that the factors are, to a large extent, inherent in the current Abnormality Requirement.³² In general, the proposed amendments to section 103, including the introduction of these factors, are intended to achieve four broad goals. These are to:

1. Improve the effectiveness of section 103 as a deterrent against impermissible tax avoidance and abusive avoidance schemes.
2. Consolidate the progress that has already been made in this area and to prevent any erosion of those hard-won gains.
3. Make it as clear as possible that section 103 applies to abusive avoidance schemes, while ensuring that the section will be broad and robust enough to counter other, perhaps less blatant, forms of impermissible tax avoidance that may arise.
4. Provide the Commissioner with the tools necessary to combat new forms of impermissible tax avoidance as they arise.

To the extent possible, however, the proposed amendments hope to achieve these goals through evolutionary, rather than revolutionary or radical, changes. The abnormality factors are one aspect of this strategy.

³⁰ Speech by Nalliah, N, Chairman, Tax Committee, South African Institute of Chartered Accountants, UNISA Roundtable Discussion (22 November 2005).

³¹ Richardson, P “Taxman to flex his considerable muscle”, op. cit. n 11, at p. 3 (quoting Charles MacKenzie, Tax Partner, Ernst & Young).

³² See, for example, Smith v CIR 1964(1) SA 324(A), 26 SATC 1, 13-14. Indeed, in many ways, Steyn CJ anticipated the analysis of “tax arbitrage” set forth by the New Zealand Committee of Experts on Tax Compliance in 1999 by more than three decades when he made the following observation –

It is not a common practice for a taxpayer to divest himself completely and for all time by a transaction, operation or scheme displaying the abnormal characteristics mentioned in the section, of an income-producing assets or of the fruits of his labour, merely for the purpose of avoiding and postponing liability or reducing the amount thereof, without creating or retaining, as in the present case, the means of recovering the income, or a substantial portion thereof, in some form or another, not subject to tax or subject to a lesser tax, at some time in the future.

As noted above, commentators have also criticised the factors for being vague and overbroad.³³ Thus, for example, a number of commentators have noted that, taken literally, virtually all financing arrangements – even a simple loan – could be seen as involving a “circular flow of cash or assets between or among the parties to the arrangement”³⁴ since a *bona fide* lender obviously expects repayment.³⁵ Similarly, they have pointed out that the definition of “tax indifferent party” could be read to encompass virtually any non-resident, municipality, Public Benefit Organisation (PBO) or special purpose vehicle (SPV) – including an SPV established for use in an ordinary commercial transaction.³⁶ They have noted that a “vast number” of transactions could potentially run afoul of “income/expenditure offset” prong of the definition³⁷ simply because “income on one side” of a transaction will typically be “matched by some kind of expenditure on the other (e.g. wholesalers or retailers which purchase goods and on sell them, companies which take up interest-bearing debt to buy assets which are rented or sold on instalment sale in the ordinary course of their business, etc, etc)”³⁸.

Subject to the caveats expressed below, SARS is not unsympathetic to these concerns, particularly in light of the proposed presumption of abnormality. It remains the case, however, that circular flows of cash and tax-indifferent parties are well-recognised and well-understood components of many abusive avoidance schemes both within South Africa and throughout the world.³⁹ In addition, the examples given by

³³ AM; BASA; CRC; DC; DT; DR; EY; IDC; KPMG; Mallinicks; SAICA; SHG.

³⁴ Proposed section 103(2)(d).

³⁵ BASA; CRC; SAICA.

³⁶ DT; EY; Incazi; KPMG; Mallinicks; SAICA.

³⁷ Proposed section 103(2)(7)(b). The proposed paragraph provides that a “tax indifferent party” includes “any person that participates in an arrangement in such a way that any amount derived by that person in connection with the arrangement is substantially matched or offset by any expenditure or loss incurred in connection with the arrangement”.

³⁸ DT.

³⁹ For example, one of the first major “tax arbitrage” schemes in the United States using a combination of circular cash flows and tax indifferent parties arose in the early 1950s. See Knetsch v. United States (1960) 364 U.S. 361. More than 50 years later, as one authority has observed, the tax planning scheme at issue in Knetsch remains “the recognizable ancestor of myriad proposed and actual transactions today”. Shaviro, D “The Story of Knetsch v. United States and Judicial Doctrines Addressing Tax Avoidance,” in Caron, P *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (United States: Foundation Press, 2002).

commentators are often far less telling than they might appear at first glance. In most *bona fide* financing transactions, the proceeds from the loan are invested in the borrower's business – they are not simply re-routed to the lender through one or more tax-indifferent parties. While the fungibility of cash may be problematic in some instances, the loans in these *bona fide* arrangements are generally repaid from revenues earned in other transactions and not from a circular flow of the proceeds themselves.⁴⁰ Similarly, the commercial transactions used to illustrate the potential problems with the “income/expenditure offset” prong of the tax-indifferent party definition are a far cry from the “washing machine” arrangements that have been a prevalent feature of so many structured finance schemes.⁴¹

In one way, the deliberately “absurd” results posited by these examples help to demonstrate the fundamental viability of the proposed amendments. In each of these examples, the commercial normality of the transactions is generally self-evident. In addition, the commentators seem to ignore that all four requirements would still need to be satisfied under the new section 103. While the definition of “arrangement” may be broad and flexible enough to address the wide variety of impermissible tax avoidance schemes that are encountered in practice, it is doubtful that a court would stretch it to cover a genuine loan in which the proceeds are invested in a business that generates revenues from unrelated customers that are then used to replay the loan. Similarly, in each of the examples, the overriding non-tax business purpose is again apparent. Indeed, as one commentator has quite correctly observed, if SARS were “to attack in inappropriate circumstances”, the inevitable result would be “that the courts will again seek to narrow the section's ambit”.⁴²

⁴⁰ In a classic circular cash flow scheme, the proceeds from the borrowing are generally placed in a term deposit account with an affiliate of the lender (or in some cases, an unrelated accommodating party) as a result of one or more intermediate steps. The terms of this deposit account, in turn, mirror the terms of the “loan”, so that the lending group simply ends up “paying” interest to itself, with the revenue and expenditure in question at worst simply netting each other out. These circular arrangements are typically coupled with the formal purchase of legal title to an asset in order to generate an inflated capital allowance for the purported borrower in the scheme. The cross-border film scheme described in Annexure A of the Discussion Paper is one example of such a scheme.

⁴¹ Discussion Paper at pp. 20-21 and pp. 50-53.

⁴² SAICA.

Vagueness objections have also been raised in respect of the “pre-tax profit” and “anticipated tax benefit” factors.⁴³ In reading some of these comments, one is sometimes left with the impression that the commentators have not heard of income projections or financial modelling. In reality, virtually all abusive avoidance schemes are based upon detailed financial models that project, often in great detail, the tax benefits to be expected from the deal. In addition, these models typically provide the basis for calculating the fees due under various contingent fee, value billing and fee variation arrangements. The pre-arranged nature of these schemes often makes the determination of the expected pre-tax profit (if any) quite possible – in many cases, despite the best efforts of promoters to obscure the true numbers.⁴⁴ It is interesting to note, moreover, that other commentators have pointed out, in contrast to the above complaints, that taxpayers can typically rebut the current presumption of tax avoidance purpose by proving that “the major economic benefit gained is the benefit other than the tax benefit . . . [through] feasibility calculations over the term of the project”.⁴⁵ While additional guidance would always be helpful and certainly can be provided here, the concerns raised hardly amount to the insurmountable practical and constitutional problems suggested by one commentator.⁴⁶

A few commentators have raised issues in respect of some of the remaining factors. Notably, they have pointed to the potential overlap between the factors set forth in proposed section 103(2)(f) and (i)⁴⁷ and have recommended that these factors be consolidated or clarified.⁴⁸ These comments are generally accepted.

In sum, while SARS believes that the proposed factors will work in practice, it is mindful of the potential uncertainty that they might cause in connection with

⁴³ Proposed section 103(2)(j) and (k), respectively.

⁴⁴ See, for example, Long Term Capital Holdings v US, 300 F. Supp. 2d 122 (D. Conn. 2004); IRC v Scottish Provident Institution [2005] STC 52.

⁴⁵ vWyk.

⁴⁶ KPMG.

⁴⁷ Proposed section 103(2)(f) refers to “the inclusion of steps or transactions that offset or cancel each other, without a substantial effect upon the economic position of the parties”. Proposed section 103(2)(i) refers to “the lack of any change in the financial position of any person resulting from [the] arrangement”.

⁴⁸ SAICA.

legitimate business transactions, particularly in the initial period following their enactment. Nevertheless, SARS remains wary that the introduction of too many qualifications and limitations will only fuel the inevitable hunt by promoters and their allies for loopholes in the new legislation. With these competing concerns in mind, SARS welcomes specific suggestions in respect of how these factors could be refined and clarified without compromising their effectiveness. In addition, specific suggestions are also welcomed in connection with other proposals, such as safe harbour provisions,⁴⁹ that might be introduced to mitigate any potential uncertainty in connection with legitimate business transactions.

Some commentators have suggested that the factors might work better if they were moved to an Interpretation Note or General Binding Ruling.⁵⁰ Although these suggestions may have practical advantages, this approach has not been pursued due to concerns that it might be perceived as transferring too much taxing power from Parliament to SARS.⁵¹

Finally, the argument that the new factors will create undue complexity is more difficult to credit. First, the proposed changes will have little or no impact on the tax affairs of the vast majority of taxpayers. Second, as some of the same commentators have observed, the factors themselves are already largely inherent in the current Abnormality Requirement. Subject to refinement and clarification, making them explicit should increase certainty and clarity, not decrease them. Third, a stronger GAAR should also reduce the constant pressure for additional specific anti-avoidance rules in response to new schemes as they are discovered on audit. Indeed, the experience in the United Kingdom is instructive. In the absence of a GAAR, the

⁴⁹ Thus, for example, BUSA/SACOB has suggested “the publication, by the Minister of Finance, of a list of those arrangements that would fall outside the ‘abnormal’ category . . . similar to the reportable arrangements legislation”.

⁵⁰ DT; SAICA.

⁵¹ For expressions of concern by the judiciary on this score, see *CIR v King* 1947 (2) SA 196, 14 SATC 184, 192 (Watermeyer CJ) (“The tax is imposed by Parliament, not by the Commissioner”); ITC 963 (1961), 24 SATC 705, 709 (Galgut J) (“To interpret the section as contended for on behalf of the Commissioner would in the result mean that section 90 is to be regarded as overriding all the empowering provisions (as to the imposition of the tax) of the Act; it would mean that the tax would be imposed not by Parliament, but by the Commissioner at his discretion; it would mean giving the Commissioner power to deem a source of income”). As discussed more fully below, that is not to say that the issuance of an Interpretation Note contemporaneously with the enactment of the new provisions would not be extremely beneficial in providing additional guidance to taxpayers and practitioners.

United Kingdom has had to resort to over 400 pages of new specific anti-avoidance legislation in the past few years. Fourth, as David Hartnett has emphasised, a major driving force behind the need for more complex tax legislation in recent years has been precisely the relentless development of ever more sophisticated and aggressive schemes by promoters and advisers throughout the world.⁵² A stronger GAAR goes directly to the heart of this problem. Fifth, as discussed more fully below, the new ATR System will actually give South African taxpayers the opportunity for greater certainty and less “tax risk” in their affairs than ever before.

4.2 Presumption of Abnormality

While a few commentators have expressed some very qualified sympathy for the proposed presumption of abnormality,⁵³ most have been opposed to it, particularly in its current form.⁵⁴ Many have strongly objected to the fact that the presumption would be triggered whenever any one of eight separate factors is present.⁵⁵ Given the perceived over-breadth of proposed factors in the current draft, these commentators fear that taxpayers will be “immediately presumed guilty of a contravention even for transactions which would normally not be considered to be ‘abnormal’”.⁵⁶ Other commentators have echoed this “presumption of guilt” language,⁵⁷ with some even

⁵² Speech by Hartnett, D, Director General, HMRC, op. cit. n 12. By contrast, the widely welcomed recent changes to various specific anti-avoidance provisions, such as the refinements to the definitions of foreign and domestic financial instrument holding companies and the reduced reporting requirements for shareholders of controlled foreign corporations, were only made possible in large measure by virtue of the improved compliance culture among South African taxpayers and practitioners. As discussed more fully below, to the extent that a stronger section 103 furthers this process, it will help both to facilitate similar changes and to mitigate the need for new specific anti-avoidance rules. Annexure A provides an example of the types of arrangements SARS actually encounters in practice.

⁵³ DC (“It is my view that the presumption of abnormality, particularly in relation to the business purpose test, is the most valuable (from SARS’ perspective) of the proposed amendments, since it clearly creates a difficulty for the taxpayers who cannot demonstrate the reality of his competing business purpose in the application of that test”); BUSA/SACOB (“The triggering of the 103 presumption indicator should create a presumption of abnormality, but this presumption should be rebuttable by the taxpayer showing that there has not been a misuse or abuse of the Act”).

⁵⁴ BASA; CRC; DT; SAICA.

⁵⁵ DT; SAICA.

⁵⁶ SAICA; see also CRC (“We are concerned that the onus will unfairly fall upon the taxpayer in every instance, particularly in a situation where it appears that an unbiased consideration of the situation at hand would lead to a conclusion that the arrangement is commercially normal, albeit that it offers a tax benefit to the taxpayer”).

⁵⁷ IAC; ICPASA.

questioning the constitutionality of the proposal.⁵⁸ In more temperate language, another group has simply asked for greater clarity in respect of how the presumption would operate in practice,⁵⁹ noting that “shifting of the onus from SARS to the taxpayer is a significant change from the previous section 103 . . . [and] must be moderated by an obligation on the part of SARS to exercise its judgment in the face of mitigating circumstances presented by the taxpayer”.⁶⁰

The Abnormality Requirement has repeatedly been recognised as the “Achilles Heel” of section 103. As the Discussion Paper has emphasised, the current Abnormality Requirement has suffered from two closely related weaknesses. The first is that “the tax world is not neatly divided into two types of arrangements, one for *bona fide* business transactions and the other for impermissible tax avoidance schemes. To the contrary, scheme promoters routinely ‘hijack’ techniques that were originally developed for *bona fide* business purposes”.⁶¹ The second is that this hijacking of techniques makes it “relatively easy for promoters to ‘manufacture’ plausible sounding ‘business purposes’”⁶² or, perhaps more precisely in the language of the Abnormality Requirement, to give their schemes an undeserved semblance of normality. Experience both here and abroad has shown, moreover, that promoters and taxpayers are not above wrapping their schemes in layers of “structural fog” in order both to avoid detection and to disguise the nature of their arrangements, a stark reality that only compounds the problems under the current provisions.⁶³

As the commentators have made clear, however, the ‘hijacking’ of legitimate business techniques “cut both ways” by raising a troubling possibility that “good” transactions

⁵⁸ AM; DT; IAC; Incazi; KPMG.

⁵⁹ DC.

⁶⁰ DR. Some of these administrative concerns are discussed more fully in section 7 below.

⁶¹ Discussion Paper at p. 42.

⁶² Ibid. at p. 43.

⁶³ Speech by Hartnett, D, Director General, HMRC, op. cit. n 12; Discussion Paper at p. 22, note 67 and the authorities cited therein.

may be swept up along with the “bad”.⁶⁴ It is for this reason, in particular, that the proposed amendments only create a presumption of abnormality rather than “deeming” an arrangement to be so. Nonetheless, SARS appreciates the concerns that have been raised.

Abusive avoidance schemes often involve two or more of the eight factors that would trigger the proposed presumption, for example, a circular flow of cash through a tax indifferent party or a limited expectation of pre-tax profit coupled with a substantial tax benefit. In this regard, commentators have urged that the presumption only be triggered if more than one factor is found to be present.⁶⁵

As to the constitutional questions that have been raised in respect of the presumption, it is important to note at the outset that it does not presume a taxpayer to be “guilty” of anything. It is an evidentiary matter in a civil proceeding and would simply shift the burdens of production and persuasion to the taxpayer under certain circumstances in connection with one of the four Requirements under the proposed section 103.

As several commentators have themselves conceded, the factors at issue capture the basic elements of abusive avoidance schemes – precisely the area where the problems are most pronounced. In these situations, it is the taxpayer that has chosen the form of its transaction and that the greatest access to information about it. More importantly, impermissible tax avoidance is a matter of grave concern that harms society in manifold ways.⁶⁶ Under these circumstances, the shifting of the burden of proof is clearly warranted. Indeed, precisely the same sort of presumption has existed under the Purpose Requirement since the introduction of the original South African GAAR in 1941.⁶⁷

⁶⁴ For example, circular flows of cash and special purpose vehicles are sometimes necessary elements of legitimate business deals, particularly in the BEE context, and are often driven by other provisions of South African law such as section 38 of the Companies Act.

⁶⁵ Deloitte and Telkom, for example, have suggested a minimum of three. Particularly in light of the fact that all four Requirements would still need to be satisfied in any event under the new 103, there is concern that requiring three or more factors to be present would deprive the proposed presumption of too much of its benefit as a potential deterrent. Additional comments on this issue are welcomed.

⁶⁶ Discussion Paper at pp. 9-15.

⁶⁷ It is worth noting that section 82 similarly places the burden of proof on the person claiming that any amount is (a) exempt from tax or not liable to any tax chargeable under the Act; (b) subject to

In terms of international practice, it is interesting to note that Canadian taxpayers bear the burden of proof under their GAAR on both the issue of whether or not a tax benefit results from a transaction and the issue of whether or not the transaction had a non-tax business purpose. Australian taxpayers, moreover, bear the burden of proof under their GAAR, while American taxpayers do so under the various judicial anti-avoidance doctrines in the United States.⁶⁸

5. Changes to the Purpose Requirement

The Discussion Paper has proposed two changes to the current Purpose Requirement in Section 103. The first would shift the focus from an inquiry into the subjective intent of the taxpayer to an objective determination of the purpose of the arrangement in light of the facts and circumstances. The second would lower the bar under this requirement from a “sole or main purpose” standard to a “sole or one of the main purposes” standard. Both proposals have proven to be controversial.

5.1 Objective Determination

While some commentators have welcomed the objective purpose test,⁶⁹ most have questioned or criticised it. Thus, several commentators have noted that the proposals would, to a large extent, do no more than reinforce the approach the courts have generally taken under current law.⁷⁰ Others have asked for guidelines that would indicate how the new standard would be applied. By contrast, a number of commentators have argued that a taxpayer’s subjective intent must be taken into account under this requirement,⁷¹ while others have noted that the requirement will inevitably have a subjective component, no matter how much the courts may discount

any deduction, abatement or set-off in terms of the Act; and (c) to be disregarded or excluded in terms of the Eighth Schedule.

⁶⁸ Curiously, one commentator has noted, in respect of the presumption of abnormality “**that no such presumption is provided for in the foreign jurisdictional GAARs referred to in the Discussion Paper**” (emphasis in original). The reason for this, of course, may lie in the fact that, as pointed out in the Discussion Paper, none of the other GAARs in question has an Abnormality Requirement.

⁶⁹ SAICA.

⁷⁰ DC (“the requirement does no more than set out the process that a court should in any event follow under the terms of the existing section”); PwC (“in most reported cases, courts have considered all the circumstances very carefully and, should these indicate the tax avoidance motive, the taxpayer’s arguments to the contrary have been overlooked”).

⁷¹ BASA; Incazi.

a taxpayer's self-serving testimony.⁷² Finally, several commentators, echoing the reasoning of the court in Gallagher,⁷³ have expressed concern that adopting a "pure" objective approach would eliminate any real distinction between the "Purpose" and "Effect" Requirements.⁷⁴

The proposed changes to the Purpose Requirement have been motivated by two major concerns. First, the change to an objective standard is necessary to resolve a basic anomaly under the current provisions identified by RC Williams:

"In essence . . . a taxpayer could with impunity enter into a transaction with the (subjective) sole purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner or in the rights and obligations which it 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".⁷⁵

Unless this anomaly is resolved, the application of the section 103 will depend, not upon the arrangement itself, but upon the taxpayer's purported subjective intention when entering into it or carrying it out, thus opening the door for virtually identical transactions to receive radically disparate treatment. Second, SARS remains concerned about the ease – and in some cases, cynicism – with which practitioners and taxpayers, both here and abroad, have manufactured plausible sounding business purposes for their schemes.⁷⁶ A test based upon subjective intent runs the risk of encouraging and perhaps rewarding precisely this type of behaviour.

⁷² DC; DR; KPMG; PwC.

⁷³ SIR v Gallagher, 40 SATC 39.

⁷⁴ SAICA.

⁷⁵ Williams, RC "The 1996 Amendments to the General Anti-Avoidance Section of the Income Tax Act" *SALJ* Vol. 114, Part IV, p. 675.

⁷⁶ A recent American case, Long Term Capital Holdings v US, 300 F. Supp. 122 (D. Conn. 2004), has again demonstrated the extent to which even prominent taxpayers and promoters will go to disguise a scheme or to devise a plausible sounding business purpose for what was, in reality, nothing but an impermissible tax avoidance scheme. Similarly, in his speech at the UNISA Roundtable Discussion, David Hartnett offered his own examples, including one involving a law firm that deliberately sought to hide the true nature of a scheme in layers of "structural fog". Speech by Hartnett, D, op. cit. n 12. The most telling indictment of this behaviour, however, remains the internal correspondence of the US affiliate of KPMG that was discovered by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the US Senate. Discussion Paper, p. 22, note 66 and the authorities cited therein.

In short, as in the case of the Australian GAAR, the proposal would require the “purpose” of a transaction to be determined from the standpoint of a “reasonable person” in light of the relevant facts and circumstances, without regard to the taxpayer’s purported motive or subjective intent.⁷⁷ Indeed, this result is simply consistent with the plain language of the statute – it is the purpose of the arrangement, not the subjective motive or intent of the taxpayer, which is at issue.

5.2 “One of the Main Purposes”

Many commentators have also expressed serious misgivings about the proposal to replace the current “sole or main purpose” test with a “sole or *one of* the main purposes” test.⁷⁸ Commentators have warned that the new standard might “adversely affect genuine business transactions” by making “it easier for the receiver to attack even the most insignificant legitimate tax planning”.⁷⁹ An example given to illustrate this danger involves an individual who shifts his or her investments from securities yielding taxable interest income to equities yielding tax exempt dividends in order to maximise the potential after-tax return.

It bears repeating that the new section 103, like the current one, would require all four Requirements to be satisfied. Thus, the fact that tax might be (and often will be) a consideration in business or investment decisions would not be enough, standing alone, to trigger the section. The other three Requirements, including Abnormality,

⁷⁷ The Australian Tax Office has recently explained the application of Section 177D of Part IVA as follows –

The consideration of purpose or dominant purpose under paragraph 177D(b) requires an objective conclusion to be drawn. The conclusion required by section 177D is not about a person’s actual, i.e., subjective, dominant purpose or motive. Section 177D requires an objective conclusion as to purpose to be reached having regard to objective facts. The actual subjective purpose of any relevant person is not a matter to which regard may be had in drawing the conclusion under section 177D. In other words, a conclusion about a relevant person’s purpose for section 177D is the conclusion of a reasonable person based on all the facts and evidence that are relevant to considering the eight factors for the scheme (see paragraphs 79 and 87 to 112).

ATO “Application of General Anti-Avoidance Rule” Practice Statement – Law Administration, PS LA 2005/24, Para. 85 (13 December 2005).

⁷⁸ BASA; KPMG

⁷⁹ Ensor, L and Tempkins, S “Manuel, SARS unveil plan to combat tax avoidance” *Business Day* (4 November 2005) p. 2 (quoting Des Kruger, Tax Director, Mallinicks Attorneys).

would also have to be present. The “interest vs. dividend” example itself illustrates the point. There is nothing “abnormal” about a simple decision to invest in shares rather than bonds.⁸⁰ In this instance, to borrow Lord Templeman’s language, the taxpayer actually incurs the expenditure that entitles him or her to the reduction in liability.⁸¹ A problem would arise, however, if taxpayers seek to recast their interest income as dividends through certain swap schemes or other contrived arrangements, without changing their economic position or the substance of their investments.⁸²

SARS recognises the need to minimise the negative impact a stronger section 103 might have on legitimate tax planning.⁸³ At the same time, as commentators and the Discussion Paper have both emphasised, the GAAR involves a delicate balancing act between that concern and the problems discussed above. Any changes to the proposed amendment must avoid sacrificing either of these concerns.

4.3 Grammar

On a somewhat lighter note, quite a few commentators have attacked the grammar of the new proposal, pointing out that it is technically impossible to have more than one “main” purpose under the common meaning of that term. The particular wording was chosen in large part due to its familiarity, as the language in question had appeared in the Purpose Requirement during the two decades from 1959 to 1979.⁸⁴ In its defence,

⁸⁰ It is interesting to note that this is exactly the same conclusion that the Special Court reached in ITC 963 (1964), 24 SATC 705 in respect of a transaction in which a taxpayer transferred his investment in shares in a building society yielding taxable interest to shares in a foreign branch of that building society yielding tax-exempt interest. Thus, as Galgut J observed at p. 709: “A taxpayer who changes his investments so as to have an investment, the income from which is not taxable, for example, from shares in a building society to ‘Union Loan Certificates’, is not indulging in an abnormal transaction or scheme”. The case, which related to the taxpayer’s 1959 and 1960 years of assessment, was decided in part, moreover, under the “sole or one of the main purposes” test.

⁸¹ CIR v Challenge Corporation Ltd (1987) AC 155.

⁸² See, for example, CIR v Cactus Investments (Pty) Ltd (1998) 61 SATC 43.

⁸³ As discussed more fully elsewhere, this need is one of the reasons that the proposals seek to introduce, for the first time, a set of explicit, objective factors for use in determining abnormality. Similarly, it is behind the proposal to expand the scope of the ATR System in order to give taxpayers greater certainty as to whether or not a contemplated transaction may be susceptible to challenge under the new provisions. Finally, it has prompted SARS to actively review the feasibility of a system, like the ones in Australia and Canada, in which the authority to invoke the GAAR is centralised at the Head Office level in order to ensure its proper and consistent application.

⁸⁴ The Explanatory Memorandum accompanying the 1978 amendments to the Purpose Requirement indicate that they were a response to the decision in the Appellate Division case of SIR v Gallagher 1978 (2) 463 (AD), 40 SATC 39. The amendment made it clear that taxpayers could no

it is not unusual for a transaction to have several purposes, some of them significant, others relatively minor. Under the circumstances, it is common to speak of the “main” or “major” reasons for the transaction. In this context, “main” refers to the set of significant purposes rather than to any individual purpose. Thus, if a transaction were to have three main purposes (for example, raising capital, improving the borrower’s balance sheet, and avoiding tax), the avoidance of tax would be one of those main purposes.⁸⁵ An alternative wording might be “the sole purpose or one of the major purposes”. Other proposals are again most welcome.

In sum, from SARS’ perspective, the new Purpose Requirement must be able to address three serious concerns. First, it must be able to deal effectively with the problem of carefully “manufactured” business purposes. Second, it must be able to resolve the anomaly identified by RC Williams. Third, it must ensure that substantially similar arrangements receive the same tax treatment, regardless of the taxpayer’s purported motive or subjective intent.

SARS again appreciates the concerns that have been raised. One option may be to include an explicit proviso to the effect that the Requirement would not be satisfied where tax avoidance is only an incidental, subsidiary or secondary purpose. As a point of comparison, the New Zealand GAAR applies to “an arrangement . . . that directly or indirectly . . . has tax avoidance as 1 of its purposes or effects... if the purpose or effect is not merely incidental”.⁸⁶ Other specific proposals are welcomed.

longer defeat that application of section by contending that their purpose was to avoid a tax other than the income tax. No explanation was given, however, for the accompanying change from “sole or one of the main purposes” to the current “sole or main purpose”.

⁸⁵ This interpretation is also consistent with the interpretation the courts gave to the relevant language during the period from 1959 to 1979. See, for example, Hicklin v SIR (1) SA 481(A), 41 SATC 179, 193 (Trollip JA) (“while [tax] avoidance was not their sole purpose . . . it was one of their main purposes”); Ovenstone v SIR 1980 (2) SA 721(A), 42 SATC 55, 69 (Trollip JA) (“Whereas appellant’s sole purpose in originally formulating the scheme was the saving of estate duty, that and the additional purpose of now avoiding the anticipated, new liability for income tax on the dividends in question probably became his two main purposes when he hurriedly carried out the scheme in 1969”); CIR v Louw 1983 (3) SA 551(A), 45 SATC 113, 140 (Corbett JA quoting the findings of the Special Court) (“although tax was a factor it was not a major factor in influencing [the taxpayer] to incorporate the practice. It was not one of the main purposes of incorporation”). Courts in the United States adopted the same approach in respect of statutes that refer to “a principal purpose”. See Johnson, CH “Corporate Tax Shelters, 1997 and 1998” 80 *Tax Notes* 1603 (28 September 1998) (“If there are three principal purposes, then the smallest principle purpose must have a weight of one-third or less”).

⁸⁶ Section OB1 of the New Zealand Income Tax Act of 2004. See Discussion Paper p. 72.

6. Steps in a Larger Transaction

The proposed amendments would also make it clear that section 103 may be applied either to an entire arrangement or to steps within it. This proposal has received widespread support among commentators and has generally been identified as an essential element in restoring the effectiveness of section 103 following the Conhage decision.⁸⁷

A few commentators have expressed some concerns about how this clarifying amendment might be applied in practice and have noted that additional guidance on that score would be helpful.⁸⁸ In general, it is anticipated that this provision would be used to nullify the incremental benefits that were sought. For example, if a circular flow of cash and a tax indifferent party were used to create inflated deductions for the borrower without an offset receipt or accrual of gross income by the lender, the new section 103 might be used to strip the transaction of the incremental benefit to the borrower and to ensure that the lender properly included the interest from the underlying loan in its gross income.

7. Use in the Alternative and Other Administrative Issues

The final proposed amendment is intended to permit the Commissioner to apply section 103 as an alternative basis for raising an assessment.⁸⁹ In connection with this amendment, the reference to the ‘Commissioner’s satisfaction’ would also be deleted from subsection one.

Several commentators have objected to these proposed changes and have raised several other administrative issues. In general, they have expressed a concern that “the abolition of the Commissioner’s satisfaction as a test to invoking the section” would permit SARS to “use this provision whenever they desire”.⁹⁰ In a similar vein, others have cautioned that “it must be ensured in its application that [section 103] is

⁸⁷ CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391.

⁸⁸ DC; EY.

⁸⁹ Proposed section 103(6).

⁹⁰ AM.

not automatically relied upon by SARS as a ‘catch-all’ section of last resort without due and proper consideration”.⁹¹

The proposed amendments are concerned with issues of administrative and judicial economy. While many commentators have recognised that the commercial world has grown increasingly complex and that the tax system needs to keep pace, some still insist upon an over simple “black and white” approach when it comes to the application of the GAAR. As the Discussion Paper notes, in practice, arrangements often raise multiple issues. For example, a particular film scheme may present issues under both the section 24F and section 103, with the taxpayer contending that it has achieved technical compliance with the literal language of the specific provision. There is little disagreement that the Commissioner should normally raise the issues under the specific provisions of the Act first, both in order to resolve the issues under those provisions and, as the commentators themselves have argued, to ensure that section 103 does not become a catch-all provision. In doing so, the Commissioner should not have to put aside the section 103 claims until the issues in respect of section 24F have been fully and finally resolved. In such circumstances, permitting both issues to be brought in a single proceeding is simply a matter of administrative and judicial economy, fully consistent with international practice on this score. The only alternative, moreover, would be to extend the prescription period in respect of section 103 until the initial dispute under the specific provision is resolved. This alternative, however, would require multiple dispute resolution proceedings and would clearly increase the burden and uncertainty for taxpayers.

It should be noted that in many cases section 103 will not be an issue at all. Similarly, there may be cases in which technical compliance with a specific provision has clearly been achieved, but the elements of section 103 are present. In the first situation, the Commissioner would proceed solely under the specific provision, while in the second he would proceed solely under section 103. Again, it would only be in those situations in which there is both a *bona fide* dispute under a specific provision and the

⁹¹ SAICA.

elements under section 103 are also present, that the Commissioner would apply section 103 as an alternative basis for assessment.⁹²

Commentators have also raised a related concern that this amendment, together with the introduction of the abnormality factors, could result in a mechanical and overly aggressive application of the new section 103 by SARS.⁹³ In connection with this concern, some commentators have suggested that an Interpretation Note be issued simultaneously with the enactment of the new section 103 both to help ensure its proper and consistent application by SARS and to provide additional guidance to taxpayers and practitioners in respect of the new provisions.⁹⁴ They have also urged that that final authority for invoking section 103 be vested in a new centralised committee. Similarly, a number of commentators have expressed regret that SARS did not develop a greater body of case law under the current section 103 and have recommend that the Commissioner move more quickly in the future to identify impermissible avoidance schemes as they are discovered and to take appropriate cases to court.⁹⁵

In general, SARS acknowledges these concerns. SARS accepts the recommendations to issue an Interpretation Note contemporaneously with the enactment of the new section and is exploring the feasibility of a centralised body to review and approve the application of the GAAR, as well as alternative approaches to maintaining

⁹² Comments on this issue have revealed a fundamental hostility toward both the concept of impermissible tax avoidance and section 103 among a segment of the taxpayer and practitioner community. Thus, one commentator has argued that the Commissioner should not be permitted to invoke section 103 if there is a dispute in respect of a specific section of the Act. The same commentator then argues that “[i]f the taxpayer is able to show that the specific provision has been complied with any action from the tax collector under section 103 should fail”. Taken to its logical conclusion, this position would result in a Catch-22 situation in which section 103 could never be invoked.

Similarly, some commentators have seized upon the phrase “so contrived and artificial” that was used in this context, Discussion Paper at p. 57, to argue that the Commissioner would have no need for section 103 in these circumstances and could simply proceed under the “substance over form” doctrine. SAICA. In this context, “so” simply means “to that extent” rather than “very”. *The New Shorter Oxford English Dictionary* (Vol. 2) (Oxford, UK: 1993), at p. 2927. More important, like the British judicial doctrine of fiscal nullity, the GAAR is specifically intended, *inter alia*, to address precisely those schemes that would not normally be susceptible to challenge under a traditional “substance over form” analysis – because the legal agreements are technically valid – but which are nonetheless sufficiently non-commercial or “abnormal” that they are denied any tax effect under the law.

⁹³ DT; IDC; SAICA.

⁹⁴ DT; IDC; SAICA.

⁹⁵ DC; DT; IDC.

consistency in the application of a GAAR. SARS also intends to move more quickly to identify new schemes as they are discovered and to take appropriate test cases to court under the new legislation as quickly as possible. Finally, SARS welcomes suggestions in respect of how the ‘Commissioner’s satisfaction’ language might be retained without undermining the Commissioner’s authority to apply the new section 103 in the alternative.

8. Coordination with the Advance Tax Ruling System

Section 76G(2)(a) of the Act gives the Commissioner the discretion to decline an application for a binding ruling if the application involves the application or interpretation of any specific or general anti-avoidance provision, including section 103.⁹⁶ In connection with the implementation of the new section 103, the Discussion Paper stated that “it is anticipated that the ATR System would be modified as it is phased in so as to permit taxpayers to obtain greater guidance and certainty in respect of the application of the new provisions”.⁹⁷ Not surprisingly, there was strong support for this proposal.⁹⁸

One option may be to limit the exercise of this discretion to situations in which the ruling application either specifically calls for the application of interpretation of the provisions of section 103 itself or involves a proposed arrangement that would raise serious concerns under that section. Another possibility would be to include a commitment by the Commissioner in a positive ruling that section 103 would not be invoked on audit in connection with the underlying arrangement, provided that there has been full disclosure and compliance with the terms and conditions set forth in the ruling. This commitment would be similar to the “pre-transaction clearances” that United Kingdom Inland Revenue had considered in conjunction with its 1998

⁹⁶ Similar limitations in respect of anti-avoidance provisions are a basic feature of the ruling systems in most of the major jurisdictions that were reviewed in connection with the development of the ATR System, including Australia, Canada, Germany, the Netherlands and the United States.

⁹⁷ Discussion Paper at p. 58.

⁹⁸ Some commentators have called for the effective of the new section 103 to be delayed until the new ATR System is “on-line”. BASA; DR; IDC; SAICA. While it is hoped that the ATR System will be ready to entertain applications for binding private rulings before the end of this year, the timing will depend upon a number of factors and the actual implementation date cannot be guaranteed.

proposals for a GAAR.⁹⁹ Any changes here would need to balance the need for greater certainty in respect of legitimate business arrangements against the danger of the ruling system being misused to plot out new roadmaps for impermissible tax avoidance.¹⁰⁰

9. The Need for Broader Tax Reform

Many commentators have emphasised the need for broader tax reform in conjunction with the introduction of the new GAAR.¹⁰¹ In this regard, they have also noted a discrepancy between the proposed amendments, which move section 103 toward an “economic substance” approach, and many provisions of the Act itself, which remain based largely, if not exclusively, on legal form.¹⁰² Unless this incongruity is addressed, they argue, the introduction of the new section 103 may create an unacceptable and unworkable “heads they win, tails we lose” system for taxpayers. They have also pointed out that these anomalies and problems often provide an impetus for taxpayers to engage in various schemes – permissible or otherwise.

In general, commentators have focused upon three basic areas for reform. The first concerns the lack of “group taxation”.¹⁰³ The second concerns that the fact that taxpayers “are given very limited and in some cases no tax allowances for commercial property”.¹⁰⁴ The third concerns the non-deductibility of interest expense incurred in connection with share acquisitions of businesses.¹⁰⁵ Viewed from a taxpayer’s

⁹⁹ See United Kingdom *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document* (Crown Copyright: 1998) section 5.2.

¹⁰⁰ Some commentators have suggested that section 76G should be amended to remove the Commissioner’s discretion in this area entirely. This recommendation is not accepted because it would not achieve the appropriate balance between these competing concerns. In addition, section 76S, which gives the Commissioner the authority to issue a binding general ruling establishing procedures guidelines for the implementation and operation of the System, provides sufficient authority for these issues to be addressed under existing legislation.

¹⁰¹ BUSA/SACOB; DT; SAICA.

¹⁰² Speech by Nalliah, N, Chairman, Tax Committee, South African Institute of Chartered Accountants, *op. cit.* n 30.

¹⁰³ SAICA.

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

perspective, a scheme may appear more as a much needed “self-help remedy” rather than an attempt to shirk a fair share of the tax burden.¹⁰⁶

Commentators have also emphasised that taxpayers and practitioners have been subject to many fundamental changes to the tax system over the past five years. As the Discussion Paper itself notes, these changes include the shift from source to residence based taxation, the concomitant enactment of new “controlled foreign company” rules, the introduction of a new tax on capital gains, and the adoption of new rules governing the tax consequences of various corporate restructurings.¹⁰⁷ Unfortunately, the practical difficulties faced by taxpayers and practitioners in trying to understand and comply with these new provisions have often been compounded by the repeated amendments, sometimes with retrospective effect to assist taxpayers. In this environment, some commentators fear that a new, stronger GAAR may only worsen an already difficult situation.

The Discussion Paper itself recognises the link between the need for tax reform and a stronger GAAR.¹⁰⁸ Unfortunately, it is often easier to identify “anomalies and problems” than to solve them. For example, the recent introduction of consolidated filing in Australia has brought with it some 800 pages of new regulations. Similarly, many countries that permit a deduction for interest expense incurred in share acquisitions have also enacted rules in respect of thin capitalisation, “earnings stripping”, and the basic distinction between “debt” and “equity” in order to prevent an undue erosion of the tax base in connection with such transactions. These difficulties are not an excuse for inaction, but they do demand a deliberate and careful approach. As the Discussion Paper emphasised, moreover, a stronger and more effective GAAR remains the “necessary and essential foundation for possible tax reform and simplification in the future”.¹⁰⁹

¹⁰⁶ While SARS appreciates the nature of these concerns, it is important to note that many schemes encountered in practice go far between just “righting the balance”. In respect of the capital allowance issue, for example, many schemes seek to achieve the equivalent of extremely accelerated depreciation, significantly inflated deductions, and the avoidance of any recoupment.

¹⁰⁷ Discussion Paper at p. 8.

¹⁰⁸ Ibid. at pp. 14 and 58.

¹⁰⁹ Ibid.

10. Use of Specific Anti-Avoidance Rules

Commentators have also suggested that SARS and National Treasury reopen the issue of whether or not additional specific anti-avoidance rules might be preferable to a stronger GAAR.¹¹⁰ The Katz Commission debated this issue at great length a decade ago and rejected an approach that would have relied exclusively on specific anti-avoidance rules.

If anything, the experience of the last decade, both here and abroad, has amply demonstrated the need for a strong and effective GAAR. The challenges posed by globalisation, deregulation, advances in technology, and increasingly sophisticated and aggressive schemes have made it virtually impossible for legislators and tax administrators to keep pace with new schemes as they arise, let alone to anticipate them when legislation is being drafted. Without an effective GAAR, SARS and National Treasury would be left on an endless treadmill, always one or two steps behind the developments in the marketplace.

At the same time, the proliferation of new specific anti-avoidance rules would add enormously to the complexity to the Income Tax Act. This has certainly been the case in both the United Kingdom and the United States. To be sure, some of this complexity is simply an unavoidable response to an increasingly complex and constantly evolving global economy. An effective GAAR, however, can help to mitigate these trends by taking some of the pressure off the system. This goal could be furthered even more by explicitly confirming that section 103, like its Canadian counterpart, applies to arrangements that seek to circumvent existing specific anti-avoidance rules.¹¹¹

Finally, specific anti-avoidance rules bring with them their own set of drawbacks and problems. At a basic level, these rules tend to be quite complex in their own right and can often interfere with legitimate transactions while nonetheless failing to adequately address the mischief at which they are aimed.¹¹² Aspects of the original Financial

¹¹⁰ SAICA.

¹¹¹ Canada Trustco Mortgage Co. v Canada, 2005 SCC 54 at para. 45.

¹¹² See Weisbach, D “Ten Truths About Tax Shelters” (2002) vol. 55, no. 2 *Tax Law Review* p. 215—53 (“constant legal change[s] to eliminate the shelter *de jure* . . . make the law less stable and

Instrument Holding Company provisions, prior to their recent amendment, may be an example of this problem. In addition, experience in the United States and elsewhere has shown that specific anti-avoidance rules often create, albeit unintentionally, new opportunities for tax arbitrage and abuse.¹¹³ Finally, because such legislation would almost inevitably be enacted after the fact, such an approach would potentially reward more aggressive taxpayers at the expense of others that had paid their fair share of tax. Such a result is simply unacceptable.

11. No Need for Change

At perhaps the opposite end of the spectrum, some commentators have contended that there is no need to “revamp” section 103 at all and that the Discussion Paper has “signally failed” to “sustain its charge that section 103 has ‘proven’ to be inconsistent and sometimes ineffective”.¹¹⁴ Others have volunteered that they “are not as negative as regards the deterrent value of the present GAAR formulation and as a general proposition see no need for its reformulation”.¹¹⁵

There is a vast difference between an effective deterrent and an effective remedy. As the Discussion Paper repeatedly stated, the problem is that section 103 has proven to be an inconsistent, and at times, ineffective, *deterrent* to impermissible tax avoidance in general, and to various abusive avoidance schemes in particular. The Discussion Paper goes to great length to identify various schemes that have been, and in many cases continue to be, entered into and carried out by taxpayers under the current

more complex. This means more work for tax lawyers. They can command high fees for interpreting the latest changes and even higher fees for structuring new shelters that avoid the changed rules”).

¹¹³ Schizer, DM “Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning” (2000) 73 *S Cal Law Review* 1339, p. 1349.

¹¹⁴ PricewaterhouseCoopers “Proposed amendments to section 103 of the Income Tax Act” *Synopsis* (November/December 2005) at p. 6.

¹¹⁵ Mallinicks. The same commentators later note that it “is not uncommon to find that various professionals consulted do not all agree with each other as to the outcome of all or some of the aspects incorporated in a scheme. The facts that various professionals do not agree as regards to the outcome on the same set of facts can be seen from the fact that the invariably learned advisors land up arguing the same set of facts before the courts from different perspectives”. *Ibid.* The fact that there is serious disagreement among “invariably learned advisors” in respect of the viability of schemes and that these schemes are nonetheless sold, implemented and defended on what appears to be a fairly routine basis would seem to be fairly strong evidence of that fact the current section 103 has proven to be “an inconsistent, and at times ineffective, deterrent” to impermissible tax avoidance. Discussion Paper at p. 1.

statute, including compulsory convertible loans, various “inflated cost” and “double dip” sale and leaseback arrangements, bare dominium schemes, and various film schemes. As SARS has indicated, moreover, the compulsory convertible loan schemes alone have cost the fiscus nearly R6 billion in recent years.¹¹⁶ Taken together with the concession by some commentators that section 103 has ceased to be the deterrent it once was, one would think that this is evidence enough of the current section’s shortcomings as a consistent and effective deterrent to such behaviour.¹¹⁷

Other commentators have argued that the current section 103 be further tested in the courts before any changes are made.¹¹⁸ Litigation, by its very nature, is an expensive, arduous, and lengthy process. It is for this very reason that the Commissioner has introduced Alternative Dispute Resolution, a development that has been welcomed by taxpayers and practitioners. More importantly, cases often turn very closely on their particular facts, with small differences leading to conflicting results. Thus, in addition to the lengthy delays that would ensue while individual cases are pursued to their ultimate conclusion, the results could well be prove inconclusive, as has been the case in Canada.¹¹⁹ In the interim, the *status quo* is likely to continue – once again at the expense of taxpayers that pay their fair share, while the Commissioner remains condemned to the same “Sisyphean task” he currently faces.¹²⁰

¹¹⁶ Tomasek, F “Dodging payments starts race to bottom” *Business Report* (9 November 2005) p. 2.

¹¹⁷ It should be noted that additional examples of such schemes were included in earlier drafts of the Discussion Paper. Due to the already considerable length of the document, these examples were deleted in the final version. It should also be noted that many of the same commentators who contend that section 103 is an effective remedy in its current form at the same time vigorously dispute its application to some of the exact same schemes in practice.

¹¹⁸ Mallinicks.

¹¹⁹ See, for example, Bernstein, J; Worndl, B, Leung, K “Canadian Supreme Court’s Pronouncement on GAAR: A Return to Uncertainty” *Tax Analysts Document Service* (2005) Doc 2005-21313. One commentator has even expressed the view that the recent cases have actually restored the *status quo ante* the enactment of section 245 in 1987, “which is ironic given that the GAAR was enacted because of perceived shortcomings” of the judicial anti-avoidance principles that had been laid down by the Supreme Court of Canada in *Stubart Investments Ltd v The Queen* [1984] CTC 294, 84 DTC 6305 (SCC). Sandler, D “The Supreme Court of Canada and the General Anti-Avoidance Rule: Tax Avoidance after *Canada Trustco* and *Matthew*” (18 November 2005) (draft cited with author’s permission).

¹²⁰ Discussion Paper at p. 53.

These commentators have also questioned why the “abnormality” factors “would make section 103 any more effective”.¹²¹ As a threshold matter, it is one thing to say that “there is nothing to stop a court from taking into account of any of the items on the proposed list in determining whether there is abnormality in a transaction”.¹²² It is quite another to require these factors to be taken into account and to create a presumption of abnormality when certain of those factors are present. It is hard to believe that a taxpayer presented with a scheme displaying the factors in question – including, for example, the use of circular cash flows and tax indifferent parties to generate a substantial tax benefit with little or no pre-tax profit potential or net economic effect – would be likely to pursue the arrangement, particularly if that arrangement is subject both to the reporting requirements under section 76A and new penalties in respect of the understatement of income.

Some commentators have attempted to minimise the impact of the problem of impermissible tax avoidance by noting that its building blocks often underpin “the ability of the banking sector to provide cost effective finance” or that “[l]egitimate tax savings are not hidden under mattresses – they are reinvested by businesses and put to work in profitable ways or returned to providers of capital who are an essential component necessary for the growth of our developing economy”.¹²³ Again, SARS fully recognises that legitimate tax planning is an essential feature of modern business life. What these commentators seem to downplay, however, are the significant dead weight losses to the economy that are created by impermissible tax avoidance in general and abusive avoidance schemes in particular. As the Discussion Paper noted, “pre-tax financing costs actually increase as a result of these schemes – an increase that is only masked by the artificial tax ‘savings’ that are generated”.¹²⁴ In addition to the time and resources consumed in devising and implementing such schemes, they typically distort investment decisions and often result in a transfer of capital from

¹²¹ PricewaterhouseCoopers “Proposed amendments to section 103 of the Income Tax Act” op. cit. n 114, at p. 7.

¹²² Ibid.

¹²³ BASA and Gad, R “Tax Avoidance – another view, same conclusion” *Without Prejudice* (December 2005) p. 13, respectively.

¹²⁴ Discussion Paper at p. 12.

South Africa to other countries, often tax haven jurisdictions. These effects are clearly detrimental to the South African economy.¹²⁵

Finally, other commentators have sought to discount the need for change by pointing to the “extremely effective campaign in improving tax compliance and in curbing a perceived unacceptable level of (legitimate) tax avoidance”, which “has manifested in record tax collections and in an apparent decrease in the proliferation of so called tax ‘products’ (or at least those which have been targeted by the Revenue)”.¹²⁶ In addition to serving as a better deterrent, the new section 103 is intended to help secure the significant progress that has been made in these areas and to ensure that these hard-worn gains are not eroded by a new generation of more sophisticated schemes. In this changing environment, SARS also has a fundamental responsibility to the taxpayers and practitioners who have helped to make these gains possible to provide a level playing field in which everyone is shouldering their fair share of the tax burden. The proposed amendments to section 103 are intended to give SARS the tools it needs to meet these challenges.

12. Proposed Penalties

The Discussion Paper has proposed the enactment of penalties against promoters of abusive avoidance schemes and against taxpayers that substantially understate their income. In this respect, South Africa would be following the lead of other countries including Australia, New Zealand and the United States.¹²⁷ As the

¹²⁵ Discussion Paper pp. 11-13; Speech by David Hartnett, Director General, HMRC, op. cit. n 12.

¹²⁶ Gad, R “Tax Avoidance – another view, same conclusion” op. cit. n 123, at p. 13. The quotation is telling in its own way since it seems to imply that the current enforcement efforts have not been an effective deterrent outside of the specific schemes that have been identified and challenged by SARS. Needless to say, SARS does not agree with the description of such schemes as “legitimate” tax avoidance.

Another commentator has pointed to “a significant shift in the attitudes of our clients away from aggressive tax structures” and to the fact that “a number of financial institutions have recently closed down their tax structuring divisions”. SHG. SARS agrees that these developments should be commended as steps in the right direction. A number of factors, however, are at play here, including drop in tax and interest rates (which has reduced the “up-side” potential of many schemes) and the renewed emphasis on corporate governance in the United States and Europe in the wake of the recent spate of corporate scandals (which has increased the “down-side” risk). Changes in these factors could very quickly reverse some of these trends toward better compliance absent continued vigilance by SARS.

¹²⁷ In this respect, contrary to the views expressed by some commentators, the proposed penalties would hardly be “unique”.

Discussion Paper notes, promoter penalties represent a response to the growing recognition that a significant portion of the problem is driven by the “supply side” of the equation rather than taxpayer demand.

Most, but not all, commentators have objected to the proposed promoter penalties. Some, however, have expressed support for “the idea of promoter penalties and believe it is justifiable to make these significant”.¹²⁸ At the same time, these commentators have emphasised that these penalties must be properly targeted at true scheme promoters and not tax advisers who are simply “acting in their professional capacities by giving advice on tax for which they are paid a fee having regard solely to their time and skill as opposed to the success or otherwise of the scheme upon which they opine”.¹²⁹ SARS acknowledges these comments and concerns and will take them under consideration in preparing the draft legislation in respect of these promoter penalties.

The proposed penalty for substantially understating income has also been controversial. Many commentators have objected to this proposal on the grounds that it would effectively criminalise taxpayers even though, by definition, they have not engaged in illegal tax evasion. As a threshold matter, the term “penalty” when used in a statute does not always import a punishment for a criminal offence.¹³⁰ More important, this sanction would reflect just how seriously Parliament views the problems of impermissible tax avoidance and abusive avoidance schemes and the high priority it has given to deterring such behaviour. This approach would thus be in line with the recommendation of one commentator that the degree of penalty depend upon the offence committed by the taxpayer.¹³¹

¹²⁸ DT. SAICA has also acknowledged that “there may be some grounds for the imposition of penalties on promoters of tax impermissible and evasion schemes”, while emphasising that “caution needs to be exercised in determining who will be classified as promoters for this purpose”.

¹²⁹ SAICA. DT has also suggested that the penalties be limited to “parties which earn fees out of the transaction on a basis other than time charged”.

¹³⁰ R v Laughton 1930 NPD 53 (per Matthews, J). To the extent that the “criminal” connotations of the word “penalty” are the problem, the proposals could be recast in the form of “additions to tax” under section 76 of the Act.

¹³¹ SAICA.

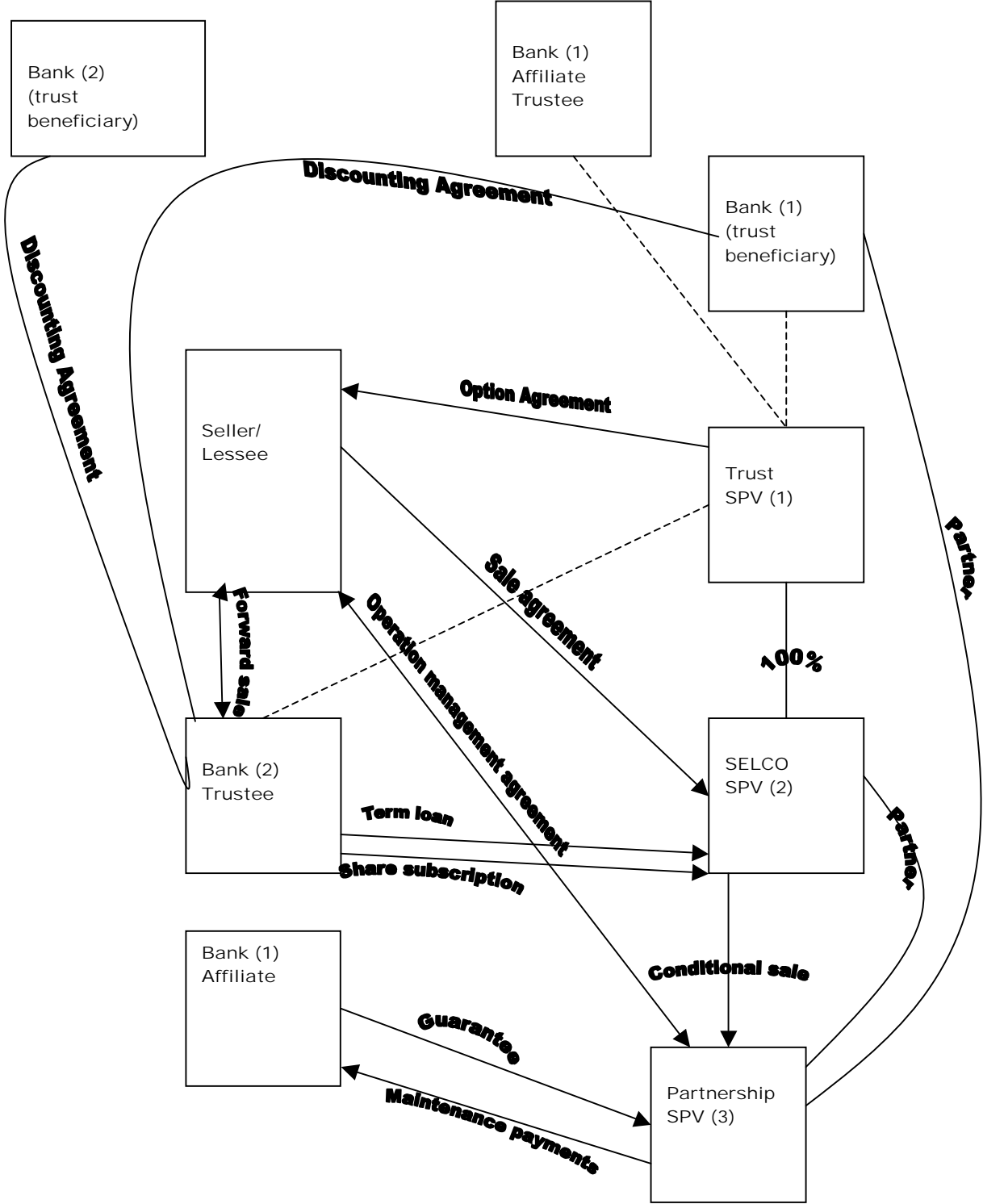
13. Conclusion

The Discussion Paper was intended to provide both a starting point and a basis for an open and constructive discussion of the sensitive and often highly charged subject of tax avoidance. So far, it appears to be achieving those goals. SARS would like to thank, once again, those taxpayers and practitioners who have already spoken out or provided comments directly to SARS and would like to encourage others to do so as well. As stated in the Discussion Paper, the goal is to create a more effective deterrent to impermissible tax avoidance and to do so as fairly and efficiently as possible. It is this goal, rather than the contents of any specific proposal, that remains paramount.

DISCLAIMER

This Interim Response is solely intended to serve the purpose of enhancing the dialogue around the Discussion Paper and should therefore not be used as a legal reference.

This annexure provides an example of a moderately complex arrangement SARS encountered in practice. Once the layers of “structural fog” are stripped away, the arrangement reveals itself to be nothing more than a sale and leaseback transaction that seeks to inflate and transfer capital allowances from one taxpayer to another while enabling the transferee to avoid any recoupment when the transaction ultimately unwinds.





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