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A Critical Analysis of the Reportable Arrangements Provisions of the Income Tax Act, focusing on section 80M(1)(*d*)

by

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DECLARATION

I, Lee-Ann Steenkamp, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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ABSTRACT

The Organisation for Economic Cooperation and Development (OECD) warns that tax avoidance and tax evasion threaten government revenues throughout the world. In light of the OECD's call for greater transparency and exchange of information for tax purposes, the South African Revenue Service (SARS) required a more aggressive reporting system. Consequently, the new reportable arrangements provisions were introduced in sections 80M to 80T of the Income Tax Act No. 58 of 1962, as amended, (the Act) and replaced the former section 76A on 1 April 2008.

This study focuses on one such reportable arrangement provision, namely section 80M(1)(*d*). If the following requirements of section 80M(1)(*d*) are met, an arrangement is reportable:

1. An "arrangement" (as defined) is entered into,
2. A "tax benefit" (as defined) is or will be derived or is assumed to be derived,
3. By any "participant" (as defined) by virtue of that arrangement and
4. The arrangement does not result in a reasonable expectation of a "pre-tax profit" (as defined) for any participant.

Although a "pre-tax profit" is defined, the concept of a "reasonable expectation of a pre-tax profit" is, regrettably, not defined in the Act, it has not been considered by our courts (in the context of reportable arrangements) and SARS has not issued any guidance or an Interpretation Note as to the application of section 80M(1)(*d*). The objective of this study is therefore to conduct a critical analysis of the language of section 80M(1)(*d*) in order to determine its nature and scope.

Due to this lack of local case law and implementation guidelines, the legislation and court cases of other countries must therefore be considered. In light of the Constitutional principles of interpretation, South African courts are allowed to consider comparative, foreign law. Canada's Income Tax Act contains a "reasonable expectation of profit" (REOP) test which has been developed over 70 years of research and court cases and which is similar to the "reasonable expectation of a pre-tax profit" requirement of section

80M(1)(*d*). Consequently, the Canadian REOP test is examined so as to identify objective guidelines for the application of section 80M(1)(*d*).

The analysis of the wording in section 80M(1)(*d*), together with the objective guidelines identified in the Canadian REOP test, are incorporated in the development of a workable model that could be utilized by South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement. The accuracy, completeness and usability of the proposed model are tested in a survey conducted among the tax partners at a sample of leading audit and legal firms.

The results from the survey indicate that the overwhelming majority of respondents considered the proposed model to be more accurate, user-friendly and helpful than the model provided by SARS. Also, the vast majority of respondents found the Canadian objective guidelines helpful in determining whether the "reasonable expectation of a pre-tax profit" requirement in section 80M(1)(*d*) is met.

A section 80M(1)(*d*) reportable arrangement must be disclosed in terms of section 80O. Any participant to such an arrangement who fails to comply with the disclosure obligation shall be liable to a penalty of R1 million in terms of section 80S. It is therefore of the utmost importance that taxpayers fully understand the precise meaning of the requirements of section 80M(1)(*d*). It is hoped that the results from this study will assist in affording taxpayers greater clarity on the identification and application of the reportable arrangements provisions. The workable model proposed in this study could be of value to taxpayers when considering the tax implications of the reportable arrangements provisions.

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ABBREVIATIONS AND GLOSSARY

Act	The Income Tax Act No. 58 of 1962 (as amended)
APB	Accounting Practices Board
BASA	Banking Association of South Africa
CA	Chartered Accountant
CICA	Canadian Institute of Chartered Accountants
Commissioner	Commissioner of SARS
CPD	Continuing Professional Development
CRA	Canada Revenue Agency
DTLAB	Draft Taxation Laws Amendment Bill
GAAP	Generally Accepted Accounting Practice
GAAR	General Anti-Avoidance Rule
HMRC	Her Majesty's Revenue and Customs
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IRBA	Independent Regulatory Board for Auditors
IRS	Internal Revenue Service
ITA	Canadian Income Tax Act
IWTA	Canadian Income War Tax Act
JSE	Johannesburg Stock Exchange
LII	Legal Information Institute
LSSA	Law Society of South Africa
OECD	Organisation for Economic Cooperation and Development
REOP	Reasonable Expectation of Profit
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service
STC	Secondary Tax on Companies
TAB	Tax Administration Bill
UK	United Kingdom
USA	United States of America

CHAPTER 1

Introduction

"A reporting system was necessary to uncover innovative corporate tax products that effectively cost the tax system hundreds of millions of Rand annually."

~ SARS (2003)

CHAPTER 1
Introduction

1.1 Background

1.1.1 Tax Evasion

An important distinction must be drawn between tax evasion and tax avoidance. Tax avoidance is characterised by open and full disclosure, where a taxpayer has arranged his affairs in a perfectly legal manner whereby he has either reduced his income or he has no income on which tax is payable. Tax evasion, on the other hand, is characterised by fraud and deceit. It refers to all those activities deliberately undertaken by a taxpayer to free himself from the tax that the law charges upon his income. Examples include the falsification of returns and the conclusion of sham transactions (De Koker 2010:par19.1).

The Organisation for Economic Cooperation and Development (OECD) warns that tax avoidance and tax evasion threaten government revenues throughout the world (OECD 2011:3). In many developed countries the sums run into billions of Euros and developing countries lose vital revenue through tax evasion. This translates into fewer resources for infrastructure and affects the standard of living for many in both developed and developing economies.

The OECD has initiated a global forum on the transparency and exchange of information for tax purposes.[1] The forum correctly observes that although globalisation generates opportunities to increase global wealth, it also results in increased risks. The increases in cross-border flows that come with a global financial system require more effective tax cooperation. The OECD (2011:3) notes that:

> *"Better transparency and information exchange for tax purposes are key to ensuring that taxpayers have no place to hide their income and assets and that they pay the right amount of tax in the right place."*

[1] The aim of the Global Forum is to ensure that all jurisdictions fully implement the international standards on transparency and exchange of information (OECD 2011:2).

The South African Revenue Service (SARS) concurs with the OECD and acknowledges that the inevitable delays between the conclusion of the transactions, the submission of the related annual returns, and the return's assessment and audit mean that years may pass before the transactions are detected, analysed and challenged (SARS 2008). According to SARS (2008), one measure to improve response times, and which is increasingly being adopted worldwide, involves the advance reporting of transactions meeting criteria that indicate that they may give rise to concern.

The Explanatory Memorandum on the Revenue Laws Amendment Bill of 2003 explains that a reporting system was necessary to uncover innovative corporate tax products that effectively cost the tax system hundreds of millions of Rand annually (SARS 2003). This reporting system (in the form of the first reportable arrangements provisions) was designed to counter tax evasion and to serve as an aggressive anti-avoidance tool. The special reporting rules were introduced to the Income Tax Act No. 58 of 1962, as amended, (the Act) by section 76A and came into effect on 1 March 2005.

Section 76A was repealed on 1 April 2008 and replaced with a new Part IIB, inserted into the Act by section 6(1) of the Revenue Laws Second Amendment Act No. 21 of 2006. Part IIB contains sections 80M to 80T and will apply to any arrangement entered into with effect from 1 April 2008. Sections 80M to 80T are hereafter collectively referred to as the "reportable arrangements provisions".

According to a media release issued by SARS, the main purpose of the new reportable arrangements provisions is to counter tax abuse more speedily (SARS 2008). SARS also stated that the number of transactions previously reported (under the former section 76A) was disappointing.[2] In addition, some taxpayers raised technical points to avoid reporting or restructured their transactions to avoid the triggers for reporting. As such, when SARS adopted the new General Anti-Avoidance Rule (GAAR)[3] in 2006, it granted them the opportunity to also revise the reportable arrangements legislation (SARS 2006a).

[2] According to the media release, fewer than 150 transactions, most of them involving well known hybrid instruments, were reported in the 25 months the legislation was in force.

[3] The new GAAR was introduced in the form of sections 80A to 80L of the Act on 2 November 2006.

1.1.2 Reportable Arrangements

A reportable arrangement is defined in section 80T of the Act as any arrangement contemplated in section 80M. Such an arrangement must be reported to the Commissioner of SARS (the Commissioner) within 60 days in terms of the disclosure obligation of section 80O.

Sections 80M(1) and (2) identify arrangements which are considered to be reportable to the Commissioner and section 80N(1) contains a list of arrangements that are specifically excluded from the reportable arrangements provisions. Reportable arrangements can be classified into two categories. One category is contained in section 80M(2) and refers to hybrid equity instruments, hybrid debt instruments and any arrangement identified by the Minister by notice in the *Government Gazette* as an arrangement which is likely to result in any undue tax benefit.

The other category is contained in section 80M(1) and relates to arrangements that result in a tax benefit (as stated in the introductory requirement of section 80M(1)) and meet the requirements of one of five scenarios found in sections 80M(1)(*a*) to (*e*).

One such scenario is the reasonable expectation of a pre-tax profit requirement as contained in section 80M(1)(*d*), which is the focal point of this study. The Act defines an arrangement as a section 80M(1)(*d*) reportable arrangement if:

> *"any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement and the arrangement does not result in a reasonable expectation of a pre-tax profit for any participant."*

Therefore, if the following requirements are met, the arrangement is reportable in terms of section 80M(1)(*d*):

1. An "arrangement" (as defined) is entered into,
2. A "tax benefit" (as defined) is or will be derived or is assumed to be derived,
3. By any "participant" (as defined) by virtue of that arrangement and
4. The arrangement does not result in a reasonable expectation of a "pre-tax profit" (as defined) for any participant.

1.2 Problem Statement

The "reasonable expectation of a pre-tax profit" is a concept as a whole that was introduced to the Act for the first time on 1 April 2008. Some of the elements of the requirements of a section 80M(1)(*d*) reportable arrangement (as listed in paragraph 1.1.2 above) are defined in section 80T of the Act. Although a "pre-tax profit" is defined, the concept of a "reasonable expectation of a pre-tax profit" is, however, not defined anywhere in the Act.

This concept as a whole, in the context of reportable arrangements, has not appeared in South African law and has never been considered by our courts. Furthermore, SARS has not issued any guidance or an Interpretation Note as to the application of section 80M(1)(*d*). The only guide currently issued by SARS is outdated as it still refers to the scrapped section 76A. On 31 March 2010, SARS issued an updated Draft Guide to Reportable Arrangements for public comment (SARS 2010). Since then, more than a year has passed and the Draft Guide has not been revised nor issued in its final format. It will be seen in Chapter 3 and Chapter 5 that the Draft Guide contains numerous anomalies and that the model developed by SARS for the application of the reportable arrangements provisions is flawed.

As a result of the aforementioned, it is submitted that any interpretation regarding the meaning of the "reasonable expectation of a pre-tax profit" concept will be subjective, meaning that the view of any person interpreting this concept will be his own subjective view. It will be shown in Chapter 3 that this subjective interpretation could lead to considerable uncertainty in practice regarding the correct identification and application of a section 80M(1)(*d*) reportable arrangement (see, for example, SAICA 2004a, 2007a, 2007b, 2008 and 2010a).

As such, determining when arrangements should be reported to SARS remains both problematic and onerous. South African taxpayers therefore still require easily understandable, objective standards against which to apply the "reasonable expectation of a pre-tax profit" requirement.

Due to this lack of local case law and implementation guidelines, the legislation and court cases of other countries must therefore be considered. In the original *Reportable Arrangements Guide*, SARS (2005) refers to the international tax position regarding tax disclosure requirements. One of the countries that is specifically mentioned in this guide is Canada, as it has well developed reportable transaction legislation in the form of tax shelter rules. Moreover, following an extensive Internet and *LexisNexis Butterworths Intranet* search of comparative tax law, Canada appears to be the only country with tax legislation containing a similar requirement to South Africa's "reasonable expectation of a pre-tax profit".

Section 248(1) of the Canadian Income Tax Act (ITA) prohibits the deduction of personal and living expenses and refers to a "reasonable expectation of profit" (REOP) test in determining whether or not an expense is for business or private purposes. This test is long-established, resting on 70 years of research and court cases which helped Canadian taxpayers to formulate objective standards against which to apply their REOP test.

It will be seen from the rules of interpretation discussed in Chapter 3, that, because the wording of the Canadian REOP test is similar to the wording contained in section 80M(1)(*d*) of the Act, South African courts may consider applying the Canadian REOP test to a section 80M(1)(*d*) reportable arrangement.

1.3. Research Objective

The objective of this study is to conduct a critical analysis of the language of section 80M(1)(*d*).

Examining the meaning of the wording contained in section 80M(1)(*d*) will assist in determining the nature and scope of section 80M(1)(*d*). This, together with the objective guidelines identified in the Canadian REOP test, will assist the development of a workable model that could be utilized by South African taxpayers in the identification and application of section 80M(1)(*d*) to an arrangement. The accuracy, completeness and usability of the proposed model will be tested in a survey conducted among tax partners at a sample of leading audit and legal firms.

1.4. Importance and Value of the Research

A section 80M(1)(*d*) reportable arrangement must be disclosed in terms of section 80O. Any participant to a section 80M(1)(*d*) reportable arrangement who fails to comply with the disclosure obligation shall be liable to a penalty of R1 million in terms of section 80S. It is therefore of the utmost importance that taxpayers and tax planners fully understand the precise meaning of the requirements of a section 80M(1)(*d*) reportable arrangement.

A critical analysis of the wording of section 80M(1)(*d*) will establish the definition of the theoretical constructs to be used in the research. The outcome of the detailed literature review will serve as a theoretical underpinning for the development of a workable model to assist South African taxpayers in the identification and application of section 80M(1)(*d*) to an arrangement.

This workable model will serve as an aid to prevent taxpayers from spending valuable time and money on obtaining expensive tax advice to determine whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(*d*) is met. Moreover, by applying the proposed model, taxpayers could be prevented from incurring unnecessary costs in order to comply with the disclosure obligation when in fact they were under no obligation to report such an arrangement.

The research findings resulting from the literature study, as well as the empirical study, will give more certainty to South African taxpayers by providing them with a clearer picture as to the correct identification and application of a section 80M(1)(*d*) reportable arrangement.

The proposed research has already resulted in an article which was published in *Meditari Accountancy Research*, Volume 18(2) of 2010.[4] The article, titled *Applying the Canadian "reasonable expectation of profit" test to a section 80M(1)(d) reportable arrangement*, submitted that the Canadian REOP test may be applied to a section 80M(1)(*d*) reportable

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arrangement and may be of value in formulating objective standards against which to apply the section 80M(1)(*d*) reportable arrangement.[5]

1.5. Research Design, Method and Scope

This study is qualitative by nature and specifically adopts an interpretive approach, which seeks to develop understanding through detailed description and to develop theory or build models which can be tested empirically in later research (Cooper & Schindler 2011:162).

Although the research is mainly qualitative in its approach, it also has a positivist underpinning, as it is based on the broad premise that an ideal norm or standard exists against which to identify and apply the requirements of a section 80M(1)(*d*) reportable arrangement (Stiglingh 2008:19). The study does not merely seek to understand, but to develop a model based on an ideal standard.

The main outcome of the research is the development of a workable, usable model that could be used by South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement.

Both a literature study and an empirical study will be performed. As the analysis of section 80M(1)(*d*) of the Act can be done with reference to already published data, the literature study will consist of a literature review of both foreign and local statutory laws, court decisions and published articles and textbooks. The outcome of the literature review will serve as a theoretical underpinning for the development of the proposed workable model.

[5] This article, however, only focused on some aspects of one of the chapters in this dissertation. Chapter 4 of this study examines the suitability of the Canadian REOP test in order to identify objective factors which may be applied in South Africa. The chapter is an in-depth study on the origin and development of the Canadian test and the problems that have been encountered by Canadian taxpayers over the years. The chapter also seeks to address some of these problems to enhance the applicability of the test in a South African environment. Lastly, the study compiles a comprehensive list of objective factors that may be used by South African taxpayers.

The completeness, accuracy and relevance of the model as well as the objective factors identified in the literature study to address the "reasonable expectation of a pre-tax profit" requirement, will be tested by a self-administered questionnaire to be completed by tax partners at a sample of leading audit and legal firms. The results of both the literature and empirical studies will be used to ensure that the proposed model is indeed logical, workable and usable.

The study will focus on a section 80M(1)(*d*) reportable arrangement. The other four scenarios in section 80M(1)(*a*), (*b*), (*c*) and (*e*) fall outside the scope of this study. The specific arrangements contained in section 80M(2) will also not be addressed in this study.

Section 80N(1) of the Act contains four categories of arrangements that are specifically excluded from the reportable arrangements provisions. The Minister has also excluded by way of notice in the *Government Gazette* (No. 30941 of 1 April 2008, Volume 514) any arrangement where the tax benefit from the arrangement:

- does not exceed R1 million; or
- is not the main or one of the main benefits of the arrangement.

The excluded transactions fall outside the scope of this study, but the requirements of section 80N will be addressed briefly in order to facilitate understanding when section 80M(1)(*d*) does not apply to an arrangement.

1.6. Structure of the Dissertation

The main outcome of the present research takes the form of a dissertation. A discussion of the structure of the dissertation is provided below.

1.6.1 Chapter 2: History and Development of Section 80M(1)(*d*) of the Act

It is the purpose of this chapter to analyse the development of section 80M(1)(*d*) from its initial inception as section 76A on 1 March 2005 to its current format as part of the reportable arrangements provisions of sections 80M to 80T.

Due to the fact that courts often refer to the legislative history of a provision, it may be useful to compare the wording of the previous legislation to that of the current section 80M(1)(*d*) as an aid in interpreting the wording of section 80M(1)(*d*).

1.6.2 Chapter 3: Examining the Language of Section 80M(1)(*d*) of the Act

The purpose of this chapter is to examine the definitions and interpretations attached to the words contained in section 80M(1)(*d*) in order to determine their meaning. This will firstly be done by observing their ordinary, grammatical meaning and thereafter by looking at the meaning the courts have ascribed to them. The interpretation rules regarding foreign law will also be discussed. This will assist in analysing the Canadian REOP test.

Examining the meaning of the words in section 80M(1)(*d*) will aid in determining the nature and scope of section 80M(1)(*d*) and will also assist in applying the objective factors used in the Canadian REOP test.

1.6.3 Chapter 4: Examining the Reasonable Expectation of Profit (REOP) Test in Canada

It is the purpose of this chapter to compile a comprehensive list of objective factors used by Canadian tax practitioners in applying the REOP test. This will assist in addressing the subjective nature of the wording of section 80M(1)(*d*).

Chapter 4 explores the legislative history and development of the REOP test and discusses a number of practical problems that were encountered by Canadian taxpayers. The objective factors identified in this chapter will be incorporated in the development of the workable model proposed in this study.

1.6.4 Chapter 5: Developing a Workable Model for the Identification and Application of a Section 80M(1)(*d*) Reportable Arrangement

The purpose of this chapter is to develop a workable model to serve as a quick-reference,

usable guide for South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement.

Chapter 5 first analyses the model developed by SARS and thereafter discusses the seven questions posed in the workable model developed in this study. The chapter also examines the effect of section 80M(1)(*d*) on an arrangement, *viz.* the disclosure obligation in terms of section 80O as well as the penalty that could be levied in terms of section 80S.

1.6.5 Chapter 6: The Empirical Study

Chapter 6 tests the completeness, accuracy and relevance of the proposed model as well as the objective factors identified in the literature study to address the "reasonable expectation of a pre-tax profit" requirement. This will be done by means of a self-administered questionnaire to be completed by the tax partners at selected audit and legal firms.

This chapter describes the data collection method and process, the design of the data collection instrument (the self-administered questionnaire) and provides a statistical summary of the responses.

1.6.6 Chapter 7: Conclusion

Chapter 7 provides a summary of the main research findings of each chapter in the dissertation. Suggestions for areas of future research are provided and the chapter ends with a few concluding remarks.

1.7 Conclusion

This chapter has provided an introductory discussion of the scope of the present research. The structure of the dissertation in achieving the stated objective was also considered. The next chapter examines the history and development of section 80M(1)(*d*) as a starting point for the critical analysis of a section 80M(1)(*d*) reportable arrangement.

CHAPTER 2

History and Development of Section 80M(1)(*d*) of the Act

"… it is admissible for a court in construing a statute to have regard … to the history of the law and from the circumstances applicable to its subject matter."

Dadoo Ltd v. Krugersdorp Municipal Council (1920)

CHAPTER 2

History and Development of section 80M(1)(*d*) of the Act

2.1 Introduction

Those who don't know history are destined to repeat it.[6] It is a well-known maxim that past behaviour is the best indicator of future actions. In order to better understand the impact of a new statute, it is useful to analyse its history and development. This way one can better understand the "bigger picture" when the statute is viewed within its proper context.

It is the purpose of this chapter to analyse the development of section 80M(1)(*d*) from its initial inception as section 76A on 1 March 2005 to its current format as part of the reportable arrangements provisions in sections 80M to 80T. The tax disclosure rules of the United Kingdom (UK), the United States of America (USA) and Canada, as well as the reasons provided by SARS for replacing section 76A, will also be addressed.

2.2 Background

When it comes to interpreting statutory provisions, courts often refer to the legislative history of that statutory provision. Solomon JA stresses the importance of the legislative history in *Dadoo Ltd v. Krugersdorp Municipal Council (1920)* [at paragraph 554]:

> *"It is true that owing to the elasticity which is inherent in language it is admissible for a court in construing a statute to have regard not only to the language of the Legislature, but also to its object and policy as gathered from a comparison of its several parts, as well as from the history of the law and from the circumstances applicable to its subject matter."*

De Koker (2010:par25.9) states that in order to ascertain the meaning of a provision, a court may have regard to its history and the form in which it appeared in earlier Acts. Examples of cases in which the court found recourse to the history of a provision, include the following: *CIR v. Simpson (1949),*[7] *New Union Goldfields Ltd v. CIR (1950),*[8] *Buglers*

[6] A quote by Edmund Burke, British Statesman and philosopher of the 1800s.

[7] In which Watermeyer CJ went fully into the history of section 7(2) (then section 9(2)) of the Act in order to determine whether the word "income" was to be given its defined meaning or its natural meaning of

Post (Pty) Ltd v. SIR (1974),[9] *CIR v. Golden Dumps (Pty) Ltd (1993),*[10] and *COT v. F Kristiansten (Pvt) Ltd (1995).*[11]

Meyerowitz (2008:par3.37) explains that when the legislature inserts an amendment into an existing act and, in so doing, clearly indicates the meaning of the context in which the amendment must be read, that meaning is the meaning of the context. The position is therefore the same as if the enactment had originally been passed in the form in which it now stands. He furthers notes that previous legislation cannot be invoked as an aid in construction unless the relevant provisions are ambiguous.

The previous legislation may therefore be useful as an aid in interpreting the wording of the current provision. As such, the next paragraph will examine the precursor to section 80M, *viz.* section 76A, as well as the surrounding circumstances, or reasons, for the introduction of section 80M(1)(*d*), as rationalized by SARS.

2.3 Section 76A of the Act

Chapter 1 delineated the distinction between tax evasion and tax avoidance. It was noted that SARS required a more robust reporting system to counter tax evasion and to serve as an aggressive anti-avoidance tool. This reporting system (in the form of the first reportable arrangements provisions) was introduced to the Act by section 76A which came into effect on 1 March 2005.

profits or gains. He said [at paragraph 282], that the answer "was to be found in the history of the provision".

[8] In which the court tried to find the meaning of the words "distributed by way of dividend". The court examined the history of the taxation of the undistributed profits of companies in order to discover its nature and purpose.

[9] In which the court considered the scope of the words "in respect of" by examining the legislation preceding the then paragraph 12(1)(*d*) of the First Schedule to the Act.

[10] In which Nicholas AJA examined the use of the word "actually" in "actually incurred" in successive Income Tax Acts.

[11] In which the court examined earlier income tax legislation in Zimbabwe since 1922 and found that the Commissioner was exempt from paying interest on overdue refunds of taxes paid.

In terms of section 76A of the Act, every company or trust which derives or will derive a tax benefit in terms of a "reportable arrangement" must report the arrangement to the Commissioner, at such place as the Commissioner may determine, within 60 days after the date that any amount is first received or accrues to any person or is paid or actually incurred by any person in terms of that arrangement. A "reportable arrangement" means:

- any arrangement in terms of which
  - the calculation of interest as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the tax treatment of that arrangement;
  - provision is made for the variation of that interest or those finance costs, fees or any other charges should the actual tax treatment differ from the anticipated tax treatment (otherwise than by reason of any change in the provisions of the Act) or should the anticipated tax treatment be challenged by the Commissioner; and
  - the potential amount of the variation contemplated exceeds R5 million;
- arrangements identified by the Minister by notice in the Gazette which are likely to lead to an undue tax benefit.[12]

Failure to report, in the case of wilful or reckless failure, results in a penalty not exceeding the tax benefits. Other failures to report result in the stricter application of the general anti-avoidance section 103 of the Act.

Section 76A was an anti-avoidance section introduced to impose reporting rules for transactions that contained indicators of potential tax avoidance (Zulman, Stretch & Silke 2008:parR17). In its *Reportable Arrangements Guide*, SARS (2005) sets out the reasons as to why section 76A was introduced in the Act. They are as follows:

1. The Commissioner will be able to evaluate the reportable arrangements from an anti-avoidance point of view at an early stage of the implementation thereof;

[12] A tax benefit, as defined in former section 76A(1)(*b*), means any reduction in or postponement of the liability of a person for any tax, duty, levy, charge or other amount in terms of any Act administered by the Commissioner based on the anticipated tax treatment of the arrangement.

2. SARS is enabled to be proactive in respect of tax avoidance; and

3. Although various provisions in the Act enabled the Commissioner to request further information or detailed returns with respect to any matter from taxpayers,[13] these existing procedures had certain limitations. These limitations were that:

   (a) The provisions were not sufficiently proactive due to the fact that the information was only obtained once the taxpayer had filed its return; and
   (b) The provisions did not properly describe what was meant with "structured finance" transactions.

Section 76A was designed to address these deficiencies and to act as an early warning system to the Commissioner as to the type of tax structuring taking place in the market. Due to the fact that SARS refers to the international tax position in the *Reportable Arrangements Guide* (SARS 2005), it might be useful to refer to the tax disclosure rules of these overseas countries. This will perhaps assist in placing the South African reportable arrangements provisions in a global context and might aid in the interpretation of the meaning of the words contained in section 80M(1)(*d*). Accordingly, a brief summary of the disclosure rules of the UK, USA and Canada is provided in Annexure B.

2.4 The New Section 80M(1)(*d*) of the Act

As was stated in Chapter 1, section 76A was repealed on 1 April 2008 and replaced with a new Part IIB, inserted into the Act by section 6(1) of the Revenue Laws Second Amendment Act No. 21 of 2006. Part IIB contains sections 80M to 80T and will apply to any arrangement entered into with effect from 1 April 2008.

In order to better understand the evolution from section 76A to the new section 80M(1)(*d*), section 80M(1) must be regarded as a whole. Please refer to Annexure A for the wording of the whole of section 80M(1). Due to the fact that the courts may have regard to a statute's history and the form in which it appeared in earlier Acts in order to determine the

[13] These information gathering powers were contained *inter alia* in the then sections 66, 69, 74A, 74B and 74C of the Act (subsequent to the 2004 amendments).

meaning of the statute, the next paragraph will compare the wording of the former section 76A with the wording of the current section 80M(1)(*d*).

2.5 Comparison of Section 76A and Section 80M(1)(*d*)

Table 2.1 (on the following page) provides a comparison of the wording contained in sections 76A and 80M(1)(*d*). Wording that is similar is indicated in bold text.

The only similarity with the previous section 76A definition of a reportable arrangement (in section 76A(1)(*a*)) is found in section 80M(1)(*a*), whereby the calculation of interest is dependent on the tax treatment of the arrangement. In terms of section 76A, the arrangement was reportable if the variation of that interest exceeded R5 million. In terms of section 80N, the arrangement already becomes reportable if the tax benefit exceeds R1 million (or is not the main or one of the main benefits of the arrangement). By decreasing the amount by which an arrangement becomes reportable, the scope and application of the reportable arrangements rules have considerably widened.

The definition of a "tax benefit" also remained mostly similar. In section 76A(1)(*b*) a "tax benefit" was defined as a reduction in or postponement of a liability for tax, whereas in section 80T it is defined so as also to include the avoidance of any liability for tax. The requirement of the "anticipated" tax treatment fell away.

By extending the list of specifically reportable arrangements from one type of transaction in section 76A to five types of transactions in section 80M(1), the Commissioner has now greatly expanded the application of the reportable arrangements provisions. The idea, presumably, is to widen the net that the Commissioner has cast into the area of tax avoidance.

Table 2.1: A comparison of section 76A and section 80M(1)(*d*)		
Term	**Section 76A(1)**	**Section 80M(1)**
Reportable arrangement	Section 76A(1)(*a*): Any arrangement in terms of which: (i) **the calculation of interest as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the tax treatment of that arrangement**; (ii) provision is made for the variation of that interest or those finance costs, fees or any other charges should the actual tax treatment differ from the anticipated tax treatment (**otherwise than by reason of any change in the provisions of the Act**) or should the anticipated tax treatment be challenged by the Commissioner; and (iii) the potential amount of the variation contemplated exceeds R5 million.	An arrangement is a reportable arrangement if it is listed in subsection (2) or if any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement and the arrangement: Section 80M(1)(*a*): contains provisions in terms of which **the calculation of interest as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the assumptions relating to the tax treatment of that arrangement** (**otherwise than by reason of any change in the provisions of this Act** or any other law administered by the Commissioner). Amounts excluded in section 80N (by way of notice in the *Gazette, nr 30941 of 1 April 2008*): The tax benefit does not exceed R1 million or is not the main or one of the main benefits of the arrangement.
Tax benefit	Section 76A(1)(*b*): Any **reduction in or postponement of the liability of a person for any tax**, **duty, levy**, charge or other amount in terms of **any Act administered by the Commissioner** based on the anticipated tax treatment of the arrangement.	Section 80T: Includes any avoidance, **postponement or reduction of any liability for tax**. **"Tax"** includes any **tax, levy, duty** or other liability imposed by **this Act or any other Act administered by the Commissioner**.
Reasonable expectation of a pre-tax profit	None	Subsection (*d*): Does not result in a reasonable expectation of a pre-tax profit for any participant.

The reasonable expectation of a pre-tax profit requirement, as contained in section 80M(1)(*d*), certainly did not evolve from the former section 76A. The "reasonable expectation of a pre-tax profit" is a concept as a whole that was introduced into the Act for the first time on 1 April 2008.

It is interesting to note that SARS is also silent on comments made specifically relating to the "reasonable expectation of a pre-tax profit" requirement. In a Response Document released by SARS on 31 October 2006, all the written commentary (other than as noted below) made by the various industry role-players were responded to by the Portfolio Committee on Finance and SARS (either by noting, accepting or rejecting the comments). However, on page 16 of the Response Document, the Banking Association of South Africa (BASA) made a comment to which SARS did not respond. Instead, and somewhat ominously, SARS left an open space and continued on page 17 with the next comment and response. The comment made by BASA reads as follows (SARS 2006b:17):

> *"Transactions are reportable where there is no reasonable expectation of pre-tax profit.* ***This measure turns on its head a substantial body of tax law****, which holds that tax expenditures do not have to be laid out in the expectation of profit. Indeed, the number of transactions that have no such immediate intent is vast. This provision condemns all of these transactions with all of the* ***onerous requirements*** *that this entails."* [own emphasis].

It will become clear in Chapter 3 that BASA did, indeed, make a valid comment. Even though most of the wording in section 80M(1)(*d*) is defined in the Act, it will be seen in Chapter 3 that there could be much uncertainty in practice as to the application of section 80M(1)(*d*) to an arrangement. This lack of response by SARS (and the lack of objective guidelines or an Interpretation Note), further necessitates the examination of the meaning of the words in section 80M(1)(*d*).

2.6 Conclusion

The previous disclosure requirements of section 76A were introduced in 2005 to provide SARS with a more pro-active tool against tax avoidance. However, the number of transactions that were actually reported thereafter was disappointing. As a result, SARS introduced the new reportable arrangements provisions of sections 80M to 80T on 1 April 2008.

It was determined, by a comparison of the wording contained in sections 76A and 80M(1)(*d*) that the "reasonable expectation of a pre-tax profit" requirement did not evolve from previous legislation. Devenish (1992:133) states that before a prior Act (*i.e.* section 76A) can serve as a guide in the interpretation of a later Act (*i.e.* section 80M(1)(*d*)), the two Acts must be "kindred legislation". This requires that they must deal with identical subject matter, not merely give effect to a single policy.

Therefore, because section 76A and section 80M(1)(*d*) do not contain similar wording, the repealed section 76A cannot be used to assist in the interpretation of section 80M(1)(*d*). This, together with the lack of objective guidelines from SARS, further strengthens the submission that will be made in Chapter 3, namely that the Canadian REOP test may be applied to a section 80M(1)(*d*) reportable arrangement.

Having explored the development of section 80M(1)(*d*), it is now necessary to determine the meaning of the words contained therein. Chapter 3 will therefore analyse the language of section 80M(1)(*d*), as this will assist in determining the nature and scope of section 80M(1)(*d*) as well as in applying the Canadian REOP test.

CHAPTER 3

Examining the Language of Section 80M(1)(*d*) of the Act

"The process of interpretation therefore starts with the ordinary grammatical meaning of words, but should never end with it."

~ Devenish (1992:289)

CHAPTER 3

Examining the Language of Section 80M(1)(*d*) of the Act

3.1 Introduction

The meaning of words is of extreme importance in statutory construction, as is evidenced by Smalberger JA in *Public Carriers Association and Others v. Toll Road Concessionaries (Pty) Ltd and Others (1990)* [at paragraph 942I]:

> *"The primary rule in the construction of statutory provisions is to ascertain the intention of the Legislature. It is now well-established that one seeks to achieve this, in the first instance, by* ***giving the words*** *of the enactment under consideration* ***their ordinary grammatical meaning****, unless to do so would lead to an absurdity so glaring that the Legislature could not have contemplated it."* [Own emphasis].

Devenish (1992:289) warns, though, that it must never be assumed that even if the ordinary meaning of words used in a statute is clear and unambiguous, such ordinary meaning is the legal meaning. He states that the words must be read in light of their immediate linguistic context as well as their wider legal and jurisprudential context. Devenish thus summarises the approach that will be followed in this chapter:

> *"The process of interpretation therefore starts with the ordinary grammatical meaning of words, but should never end with it."*

Kellaway (1995:92) states that meaning must be given to every word where the context lends itself to it. The cardinal rule that effect must be given, where possible, to every word, unless necessity or absolute intractability of language dictates otherwise, emanates from the English case of *The Queen v. Bishop of Oxford (1897).* In *CIR v. Golden Dumps (Pty) Ltd (1993)* the court noted that although surplusage and tautology is not wholly unknown in a statute, a statute is never supposed to use words without meaning. Kellaway (1995:92) comments that the reason for this is that it must be supposed that the law-giver will choose its words carefully in order to express its intention correctly and will therefore not use words that are superfluous, meaningless or otherwise redundant.

It is the purpose of this chapter to examine the definitions and interpretations attached to the words of section 80M(1)(*d*) in order to determine their meaning. Each term contained in the general requirement of section 80M(1), subsection (*d*), as well as the exclusions provisions of section 80N - whether defined in section 80T or not - will be examined in turn. This will firstly be done by observing their ordinary, grammatical meaning and thereafter by looking at the meaning the courts have ascribed to them. The impact of the relevant proposals of the Tax Administration Bill and the Draft Taxation Laws Amendment Bill will also be considered.

Examining the meaning of the words in section 80M(1)(*d*) will aid in determining the possible nature and scope of section 80M(1)(*d*) (refer to Chapter 5) and will also assist in applying the objective factors contained in the Canadian REOP test (refer to Chapter 4).

3.2 Background

As section 80M(1)(*d*) is a subsection of section 80M(1), the general requirement of section 80M(1) must first be met. Section 80M(1) states that an arrangement is a reportable arrangement if:

> *"any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement".*

If the introductory requirement of section 80M(1) is met, the requirement of subsection (*d*) must then be considered:

> *"does not result in a reasonable expectation of a pre-tax profit for any participant."*

Therefore, if the following requirements are met, the arrangement is reportable in terms of section 80M(1)(*d*):

1. An "arrangement" (as defined) is entered into,
2. A "tax benefit" (as defined) is or will be derived or is assumed to be derived,
3. By any "participant" (as defined) by virtue of that arrangement and
4. The arrangement does not result in a reasonable expectation of a "pre-tax profit" (as defined) for any participant.

As mentioned earlier in Chapter 1, the "reasonable expectation of a pre-tax profit" is a concept as a whole that was introduced into the Act for the first time on 1 April 2008. Some of the elements of the requirements of a section 80M(1)(*d*) reportable arrangement (as listed above) are defined in section 80T of the Act. Although a "pre-tax profit" is defined, the concept of a "reasonable expectation of a pre-tax profit" is, however, not defined anywhere in the Act.

It was pointed out in Chapter 1 that this concept as a whole has not appeared in South African law and, in the context of reportable arrangements, has never been considered by our courts. Furthermore, SARS has not issued any guidance or an Interpretation Note as to the application of section 80M(1)(*d*). The only guide currently issued by SARS is outdated, as it still refers to the scrapped section 76A.

On 31 March 2010, SARS issued an updated Draft Guide to Reportable Arrangements for public comment (SARS 2010). The Draft Guide, which seeks to address the new reportable arrangements provisions, has not been issued in its final format and no response document to public commentary has been released by SARS yet.[14] Therefore, more than a year after the release of the Draft Guide, there is still no finalised, updated guide available to address the new reportable arrangements provisions.

As a result of the aforementioned, it is submitted that any interpretation regarding the meaning of the "reasonable expectation of a pre-tax profit" concept will be subjective, meaning that the view of any person interpreting this concept will be his own subjective view. This subjective interpretation could lead to considerable uncertainty in practice (as will become evident in the rest of this chapter), regarding the correct identification and application of a section 80M(1)(*d*) reportable arrangement.

De Koker (2010:par25:16) states that the interpretation by SARS of any provisions of the Act will not influence the courts to place a construction upon that provision that the language of the section will not allow. The court noted, however, in *ITC 1572 (56 SATC 175)* [at page 186] that:

[14] In e-mail and telephone correspondence with SARS' Legal & Policy Division, SARS could not confirm if and when the new guide would be released, nor if and when they would publish any response document.

> *"Departmental practice is not necessarily, of course, an indication of what the law means. However, it seems to me that the departmental practice is a very sensible approach to what should be done in this type of case. Plainly the procedure and the practice laid down by the Commissioner in that regard, is, if nothing else, commercial wisdom and good sense."*

In light of the above, even though SARS has not released an Interpretation Note or even a finalised, updated guide that refers to the amended reportable arrangements provisions, the Draft Guide might give an indication of the meaning of the words contained in section 80M(1)(*d*).[15] As such, this chapter will include SARS' interpretation of the relevant terminology, including the practice prescribed by the Draft Guide.

It is pertinent at this stage to briefly refer to the proposed Tax Administration Bill (TAB) which was introduced in Parliament on 23 June 2011. According to the Draft Explanatory Memorandum on the Draft Tax Administration Bill (SARS 2009:1), the drafting of the TAB was announced in the 2005 Budget Review as a project to incorporate into one piece of legislation certain generic administrative provisions, which are currently duplicated in the different tax Acts. The Minister of Finance (SARS 2011:1) stated that:

> *"The Bill seeks to facilitate tax compliance, provides consistency in the application of tax law and to further improve the levels of tax compliance in South Africa."*

In terms of the proposed TAB, the reportable arrangements provisions will be removed from the Act and will henceforth be included as sections 34 to 39 in Part B of Chapter 4 "Returns and Records" of the TAB. The penalty provision of section 80S of the Act will be included as section 212 in Part B "Fixed Amount Penalties" of Chapter 15 "Administrative Non-compliance Penalties" of the TAB. Except for the penalty provision and the definition of "arrangement", the remainder of the reportable arrangements provisions are transferred *verbatim* from the Act to the TAB. If the TAB is to be enacted in its current format, section 80M(1)(*d*) will henceforth be known as section 35(1)(*d*).

[15] Unfortunately, due to the lack of any response document and SARS' inability to disclose any particulars about comments received (and the parties who commented) on the Draft Guide, only the comments made by SAICA were obtained. An extensive Internet search was conducted, but SAICA was the only role-player to publish submissions to SARS on its website. At this stage, no other commentary appears to be publicly available.

The only change in the wording of the reportable arrangements provisions is that of the penalty provision and the definition of an "arrangement". The penalty provision of both section 80S of the Act and the proposed section 212 of the TAB will be discussed in Chapter 5. The proposed definition of "arrangement" will be discussed in paragraph 3.4 of this chapter.

Due to the fact that the reportable arrangements provisions are unchanged in the proposed TAB, and also because the TAB is not yet enacted, only sections 80M to 80T are referred to throughout this study. Accordingly, the survey which was conducted among tax partners at a sample of leading audit and legal firms (see Chapter 6) also referred to sections 80M to 80T.

3.3 Rules of Interpretation

Clegg and Stretch (2010:par2.1) remark that income tax is essentially the creature of statute, and the principles of construction which apply to statutes generally apply equally to the interpretation of taxation statutes. They further observe that the interpretation of statutes is often a difficult task, and that the rules of construction, which vacillate from a literal application to one based on the aims and context of the legislation, are not applied consistently. It is considered to be beyond the scope of this study to discuss the rules of interpretation or the intricacies and difficulties in interpreting fiscal legislation.

There are two broad approaches to the interpretation of statutes in common law tradition, namely the traditional and the modern approach. Du Plessis (2002:93-98) explains that each of these approaches consists of two general theories to interpretation. In the case of the traditional approach, there are the literalism and intentionalism theories and in the case of the modern approach, the purposivism and contextualism theories.

Irrespective of which approach or theory is applied, De Ville (2000:par8.3) states that the role of the courts is to ensure that statutes comply with the requirements of the Constitution. As such, the next paragraph will examine the interpretation of fiscal legislation in light of the values of the Constitution.

3.3.1 Applying Constitutional Principles to the Interpretation of Fiscal Legislation

The principles for the interpretation of statutes are to be derived from the Constitution. The Constitution of the Republic of South Africa Act No. 108 of 1996, as amended (the Constitution) was promulgated in 1993 and enacted in 1996. Section 1 of the Constitution indicates that the Constitution is superior to all other legislation, as the Bill of Rights applies to all law, and binds the legislature, the executive, the judiciary and all organs of state. Section 3 determines that when applying a provision of the Bill of Rights to a natural or juristic person, a court, in order to give effect to a right in the Bill:

> *"(a) …must apply, or if necessary develop, the common law to the extent that legislation does not give effect to that right; and*
> *(b) may develop rules of the common law to limit the right, provided that the limitation is in accordance with section 36(1)."*

As regards constitutional and statutory interpretation, sections 39(1) and (2) state the following:

> *"(1) When interpreting the Bill of Rights, a court, tribunal or forum –*
> *(a) must promote the values that underlie an open and democratic society based on human dignity, equality and freedom;*
> *(b) must consider international law; and*
> *(c) may consider foreign law.*
>
> *(2) When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights."*

Section 39(1) of the Constitution gives specific instructions on how to interpret the Bill of Rights. Section 39(2) deals with the interpretation of any other legislation. These sections command a similar interpretative approach to both the Constitution and statutes. Statutory interpretation is therefore to be seen not as a search for the intention of the legislature but an enforcement of constitutional values (De Ville 2000:par8.3).

Thus, the primary aim of statutory interpretation should be to ensure that the statute is in accordance with the aims and values of the Constitution. Both the interpretation of the Bill

of Rights specifically and other sections of the Constitution in general (including fiscal legislation by implication) must promote the values that underlie an open and democratic society based on human dignity, equality and freedom.

Goldswain (2008:115) indicates that sections 39(1) and 39(2) oblige the judiciary, when interpreting statutes to, *inter alia*, promote the protection of the liberty of persons, their property and the enforcement of the principles of human dignity, equality and fairness. He notes that these qualities are central to the purposive theory to the interpretation of statutes.

Goldswain (2008:119) concludes that if the judiciary interprets a provision without attempting to establish the intention or purpose of the legislature, such an omission would constitute grounds for a constitutional challenge to the decision. Goldswain thus indicates that the Constitution requires a modern approach to the interpretation of statutes.

De Ville adopts a similar view (2000:par8.4.1). He indicates that the Constitution requires statutes to be interpreted by following a broad contextual approach. The context in which the statute is interpreted should include the constitutional values, the statute's background and purpose (viewed in the light of the aims of the Constitution), other statutes as well as the social, political and economic context and (where relevant) comparative and foreign law.

The next paragraph will therefore address interpretation in the context of comparative and foreign law.

3.3.2 Foreign Law

It is important to note that the Bill of Rights (in section 39(2)) requires the courts to consider international law and allows them to consider foreign law. While there is no one, specific body of international law, the term is understood to mean the collection of treaties, customs, and multilateral agreements governing the interaction of nations and multinational businesses or non-governmental organisations (Legal Information Institute

2011).[16] Foreign law consists of the rules governing the domestic laws of individual foreign countries (Duke Law 2011). Du Plessis (2010:151) distinguishes between international and foreign law as follows:

> *"Foreign law, in the domestic context, can never have more than persuasive force while some international law may well be as binding or prescriptive as domestic laws."*

When referring to the income tax decisions of foreign courts, De Koker (2010:par25.4) cautions that one should always bear in mind that they may be based upon a differently worded statute from the statute under consideration. However, they may be most valuable and may very well influence South African courts, particularly when they deal with a point of law that also occurs in the South African Act.

Clegg and Stretch (2010:par2.4.2) also emphasise that even though the judgments of the courts of other countries are not binding on South African courts, they are of significance because they do have persuasive value. Such judgments are often quoted in the courts of the Republic and are sometimes even applied. These cases include, amongst others, *CIR v. Paul (1956), ITC 827 (21 SATC 194), ITC 836 (21 SATC 330)* and *Joffe & Co v. CIR (1946).*

Section 248(1) of the Canadian Income Tax Act prohibits the deduction of personal and living expenses and refers to a "reasonable expectation of profit" test in determining whether or not an expense is for business or private purposes. This long-established test has helped Canadian taxpayers to formulate objective standards to serve as a guide for the application of the Canadian REOP test.

Both the South African Act and the Canadian Income Tax Act contain a similar REOP requirement. The principle that foreign cases were relevant when they were dealing with language similar to that in the South African Act was established by Watermeyer CJ in *Joffe & Co v CIR (1946).*

[16] According to the Legal Information Institute (2011), public international law concerns itself only with questions of rights between several nations or nations and the citizens of other nations. In contrast, private international law deals with controversies between private persons (natural or juridical), arising out of situations having significant relationship to more than one nation.

Also, by applying the *in pari materia*[17] principle when a statute (such as section 80M(1)(*d*) of the Act) is ambiguous, its meaning may be determined in light of other statutes on the same subject matter (such as section 248(1) of the Canadian Income Tax Act).

Therefore, the Canadian court cases (and the Canadian REOP test) are relevant when interpreting a section 80M(1)(*d*) reportable arrangement, since the Canadian REOP test deals with language similar to that in the South African Act. As such, the Canadian REOP test, which will be discussed in detail in Chapter 4, can be of immense value in assisting South African taxpayers to formulate objective standards against which to apply the section 80M(1)(*d*) reasonable expectation of a pre-tax profit requirement.

Having briefly addressed the rules of interpretation, it is now necessary to analyse the wording of section 80M(1)(*d*), by first examining the meaning of the term "arrangement".

3.4 Arrangement

Before the reportable arrangements provisions can apply, an arrangement must first be entered into. An arrangement, according to section 80T, means any transaction, operation or scheme.

"Transaction", "operation" and "scheme" are not defined in the Act. One therefore has to look at the meaning the courts have ascribed to them as well as their ordinary, grammatical meaning. Also, the precise identification of the transaction, operation or scheme is of vital importance to the taxpayer to avoid any misunderstanding in determining whether or not the "arrangement" is reportable. The ordinary meaning of the words "arrangement", "transaction", "operation" and "scheme" can be found in any reputable dictionary and are as follows:

> **Arrangement** ·noun → a plan for a future event;[18] an agreement.[19]

[17] Meaning: "upon the same matter or subject". According to Devenish (1992:134), if two statutes are *in pari materia*, any judicial decisions as to the construction of one is a sound rule of construction for the other. Or, stated differently, if two statutes are *in pari materia*, it is assumed that uniformity of language and meaning was intended.

[18] Oxford Dictionaries Online (2010).

Transaction ·noun → instance of buying or selling; the action of conducting business. [18]

Operation ·noun → the action or process of operating or being active;[18] an action or series of actions which have a particular effect.[19]

Scheme ·noun → a systematic plan or arrangement for achieving a particular object or effect;[18] a secret plan intended to cause harm or damage.[19]

An arrangement therefore encompasses a wide range of steps or actions in order for a future event to take place. De Koker (2010:par19.4) states that an arrangement requires a conscious involvement of two or more participants who arrive at an understanding. It presupposes a meeting of the minds or an expectation by each party that the other will act in a particular way. Support for this can be found in *Newton v. COT (1958)* where Lord Denning expressed the view [at paragraph 760] that:

> *"[T]he word 'arrangement' is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons…"*

Thus, an arrangement includes different kinds of concerted action by which persons may arrange their affairs to produce a particular effect. The terms "transaction, operation or scheme" were considered in *Meyerowitz v. CIR (1963)* which was decided under section 90 of the Income Tax Act No. 31 of 1941. The Appellate Division of the Supreme Court agreed with the following finding of Watermeyer J in the court *a quo* [at paragraph 300]:

> *"The word 'scheme' is a wide term and I think that there can be little doubt that it is sufficiently wide to cover a series of transactions".*

In the *Meyerowitz* case, the appellant submitted that the transactions he entered into were not a preconceived plan and that the continuity of operations and connection between the different steps were lacking in such a degree as not to constitute a scheme.

However, the Appellate Division held that from beginning to end, the transactions constituted a scheme even though they were not all contemplated at the outset. The important test that the Appellate Division applied, is as follows: if the different steps, upon

[19] Chambers Online Dictionary (2010).

examination in retrospect, appear to be so connected with one another that they could ultimately lead to the avoidance of taxation, the transactions are a scheme. As stated in the *Meyerowitz* case [at paragraph 299]:

> *"Merely because the final step to secure this objective is left unresolved at the outset, and decided on later, does not seem to me to rob the scheme of the necessary unity to justify its being called an 'arrangement'."*

Clegg and Stretch (2010:par26.3.2) maintain that the fact that the intention to avoid the payment of tax appears only from later steps is of no consequence. This argument is supported by *CIR v. Louw (1983),* where the court found that if there was sufficient unity between the ultimate step and what has gone before, having regard to the ultimate objective, then together they might be regarded as being part and parcel of a single scheme. Moreover, in the *Meyerowitz* case, an act which did not form part of the scheme when it was entered into could become part and parcel of the scheme if it was later pressed into the service of the scheme.

Also noteworthy, is the fact that in *Ovenstone v. CIR (1980)* it was held [at paragraph 68] that, in respect of an arrangement, "entered into" does not mean "formulated":

> *"Because of its context it has, I think, a connotation of implementation that is similar to 'carried out'. Probably both expressions were used because it was considered that 'carried out' is more appropriate to connote the implementation of a 'scheme', while 'entered into' is more apposite to connote the implementation (i.e. the taxpayer's actually engaging in) of a 'transaction' or 'operation'."*

Therefore, "carried out" is considered by the courts to be similar to "formulated" and is to be used in the context of a "scheme". The phrase "entered into", is considered more appropriate in the context of "transactions" and "operations", as the taxpayer engages in the implementation thereof.

As previously stated in Chapter 1, SARS introduced the reportable arrangements provisions after the new GAAR provisions were brought into effect. SARS wanted to link the reportable arrangements legislation to the factors that are indicative of a lack of commercial substance for GAAR purposes (SARS 2006b). As such, it might be useful to

refer to the GAAR provisions if they contain definitions similar to those of the reportable arrangements provisions. One of these similarities is found in the definition of an "arrangement". Section 80L of the GAAR provisions defines an arrangement so as to mean:

> *"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."*

Table 3.1 provides a comparison of the definition of an "arrangement" as contained in sections 80T and 80L. Similarities are indicated in bold text.

Table 3.1: Comparison of the definition of "arrangement"

Section 80T	Section 80L
Any transaction, operation or scheme.	**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.

Clearly, the section 80L GAAR definition has a wider scope than the section 80T reportable arrangements definition. The section 80L definition also refers to an "understanding" (whether enforceable or not). The ordinary meaning of the word "understanding" is as follows:

> **understanding** ·noun → an informal or unspoken agreement or arrangement;[18] a condition agreed upon.[19]

De Koker (2010:par19.4) suggests that regardless of whether an agreement is reduced to writing and explicitly records all the terms and conditions, or whether it merely constitutes a verbal broad understanding of proposed future conduct which will more than likely take place, it will constitute an arrangement. In *BNZ Investments Ltd v. CIR (2000)* the word "understanding" suggested [at paragraph 732]:

> *"**something like a dealing between two or more persons**, so that a taxpayer who deliberately refuses to see the obvious, but proceeds with a transaction in which the obvious occurs downstream,*

readily enough could be held to be part of at least an understanding to that effect. A taxpayer who actually knows all the details, and proceeds nevertheless, is of course, at equal or greater risk." [Own emphasis].

Clegg and Stretch (2010:par26.3.2) illustrate this principle with an example:

- Trust A does not anticipate making profits out of its businesses;
- Trust B is a tax exempt trust;
- Trust A has a broad understanding with the trustees of Trust B that any profits will more likely than not be distributed to Trust B;
- Thus, although Trust B cannot enforce this understanding, the authors submit that it could constitute part of an avoidance arrangement between the parties.

It is suggested (De Koker 2010: par19.4) that the descending order of the terms transaction, operation, scheme, agreement or understanding may suggest descending degrees of enforceability. While an agreement is ordinarily (but not necessarily) legally enforceable, an understanding may not be.

The section 80L definition of "arrangement" furthermore includes "all steps therein or parts thereof". The section 80T definition contains no such phrase. The terms "steps" and "parts" are not defined. De Koker (2010:par19.4) suggests that each connotes a distinct transactional element of the whole. Thus, the "steps" or "parts" constitute arrangements in themselves and the Commissioner has the power to apply the GAAR to each such step or part.

Due to SARS' stated objective of minimising tax avoidance and countering tax abuse more quickly, it is submitted that SARS should amend the section 80T definition of an "arrangement" to align it with the section 80L GAAR definition. This should assist in widening the potential scope of the reportable arrangements provisions, thereby combating tax avoidance more effectively.

At first glance it is gratifying to observe that the Draft Taxation Laws Amendment Bill (the DTLAB) of 2011 proposes a revised section 80T definition for "arrangement" (in the reportable arrangements provisions) which echoes the submission made above. The

DTLAB defines an "arrangement" so as to mean 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. If enacted, the new definition will come into operation on 1 April 2012.

The proposed amendment widens the scope of an "arrangement" considerably. However, more careful consideration reveals that the TAB contains a different definition of an "arrangement" which supersedes the definition in the Act (and thus also the amendment in the DTLAB).[20] The proposed section 34 of the TAB (which is part of the reportable arrangements provisions) defines an "arrangement" so as to mean a transaction, operation, scheme, agreement or understanding (whether enforceable or not). Although it is more broadly defined than the current section 80T, it will not have the same reach as the proposed definition in the DTLAB.

Much of the uncertainty surrounding the interpretation and application of the reportable arrangements provisions is due to the very broad definition of a tax benefit. The next paragraph will address this problematic term.

3.5 Tax Benefit

A tax benefit is defined in section 80T so as to include any avoidance, postponement or reduction of any liability for tax. The tax referred to here, is also defined in section 80T. This definition includes any tax, levy, duty or other liability imposed by this Act or any other Act administered by the Commissioner.[21] The definition of a tax benefit clearly

[20] Section 4(3) of the TAB states that in the event of any inconsistency between the TAB and another tax Act, the other Act prevails. A "tax Act" is defined in section 1 of the TAB so as to mean the TAB or an Act, or portion of an Act, referred to in section 4 of the SARS Act, excluding the Customs and Excise Act. Section 1 of the TAB defines the "SARS Act" as meaning the South African Revenue Service Act No. 34 of 1997. The Act is included in the list of Acts in section 4 (read with Schedule 1) of the SARS Act. The Act (and by implication section 80T) will therefore prevail over the TAB (and therefore section 34) in the event of any inconsistency. However, the reportable arrangements provisions will be removed from the Act once the TAB is enacted; consequently, there will no longer be any inconsistency. The provisions of the TAB will therefore prevail.

[21] The other taxes, in addition to normal tax, administered by the Commissioner are:

encompasses a wide range of taxes and benefits. It is precisely this broad definition that results in many of the anomalies surrounding reportable arrangements. SAICA (2007b) states that the scope of this legislation is too wide and that it affects an "absurd amount of routine transactions".

As previously stated, the GAAR provisions might prove helpful in interpreting the reportable arrangements provisions. Section 80L also contains a definition for "tax benefit", the wording of which is exactly the same as that of section 80T, namely

> *"any avoidance, postponement or reduction of any liability for tax."*

Section 80L also defines "tax" so as to include

> *"any tax, levy or duty imposed by this Act or any other Act administered by the Commissioner."*

Table 3.2 provides a comparison of the definition of a "tax benefit" as contained in sections 80T and 80L. The wording is exactly the same.

Table 3.2: Comparison of the definition of "tax benefit"

Section 80T	Section 80L
Any avoidance, postponement or reduction of any liability for tax.	Any avoidance, postponement or reduction of any liability for tax.

- Donations' tax in terms of the Act;
- Secondary Tax on Companies (STC), which will be replaced by Dividends Tax on 1 April 2012, in terms of the Act (as announced by Finance Minister Gordhan (Treasury 2011:30) when he delivered the National Budget Speech on 23 February 2011);
- Turnover tax in terms of the Act;
- Securities Transfer Tax, in terms of the Securities Transfer Tax Act No. 25 of 2007;
- Customs and excise duties in terms of the Customs and Excise Act No. 91 of 1964;
- Estate duty in terms of the Estate Duty Act No. 45 of 1955;
- Skills development levies in terms of the Skills Development Levies Act No. 9 of 1999;
- Transfer duty in terms of the Transfer Duty Act No. 40 of 1949;
- Value-added tax in terms of the Value-Added Tax Act No. 89 of 1991; and
- Unemployment insurance contributions in terms of the Unemployment Insurance Contributions Act No. 4 of 2002.

Table 3.3 provides a comparison of the definition of "tax" as contained in sections 80T and 80L. The wording is materially the same, except in section 80T where "or other liability" is also included (see underlined text in Table 3.3).

Table 3.3: Comparison of the definition of "tax"	
Section 80T	**Section 80L**
Any tax, levy, duty or other liability imposed by this Act or any other Act administered by the Commissioner.	Any tax, levy or duty imposed by this Act or any other Act administered by the Commissioner.

SARS has not provided any reason for this difference. The section 80T reference to "other liability" possibly widens the application of the reportable arrangements provisions. In the Draft Guide, SARS (2010:10-11) considers the following to form part of the definition of a "tax benefit":

- any deductions, allowances, exemptions and tax credits (including foreign tax credits) that are, or will be, or which are anticipated to be claimed by a participant; and
- any deferral of the receipt or accrual of income claimed or included.

SARS (2010:12) also prescribes that a tax benefit is calculated by considering the tax benefit derived over the period of the arrangement. As a result, annual recurring tax benefits will be taken into account. Projected tax flows over the period of the arrangement are taken into account on a nominal basis, *i.e.* they are not discounted (except in the case of section 80M(1)(*e*)).

As the definition of "tax benefit" refers to the avoidance, postponement or reduction of any liability for tax, the meaning of these words must also be taken into consideration. The following paragraphs will provide an in-depth analysis of these terms.

3.5.1 Liability for Tax

The section 80T definition of a tax benefit includes the avoidance, postponement or reduction of any "liability for tax". The term "liability for tax" occurs in the section 80T definition of a tax benefit, but the term itself is not defined. This phrase also appears as the third scenario of reportable arrangements, which is contained in section 80M(1)(*c*). The

section 80M(1)(*c*) reportable arrangement is defined as an arrangement that results in a tax benefit and which:

> *"is or will be disclosed by any participant as giving rise to a financial liability for purposes of Generally Accepted Accounting Practice but not for purposes of this Act."*

Even though section 80M(1)(*c*) falls outside the scope of this study, the fact that it refers to "financial liability for purposes of Generally Accepted Accounting Practice" (GAAP) might shed light on the "liability for tax" requirement.

GAAP has specific International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) in place for the measurement and recognition of financial liabilities. The Act, however, only deals with the calculation and payment of tax, and not the recognition of liabilities. Thus, the exact meaning of a "liability for tax" will be addressed in the following paragraphs by comparing the accounting definition for "liability" with the statutory interpretation followed by the courts.

(a) Accounting Definition

According to a SAICA Circular (SAICA 2004b), South Africa has been harmonising its Statements of GAAP with international standards. In 2004, the harmonisation was completed and the Accounting Practices Board (APB) has since agreed to issue IFRS as Statements of GAAP without amendment. The effective dates of the improved statements are for financial periods commencing on or after 1 January 2005 with earlier application encouraged.

The International Accounting Standards Board (IASB) *Framework* sets out the concepts that underlie the preparation and presentation of financial statements for external users. The *Framework* defines the elements that are directly related to the measurement of financial position in the balance sheet (*i.e.* assets, liabilities and equity) as well as those elements directly related to the measurement of performance in the income statement (*i.e.* income and expenses).

A "liability" is defined in the *Framework* (IASB 2010b), at paragraph 49(b), as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The *Framework* notes, at paragraph 60, that an essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. The *Framework* further states that obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. An example is the amount payable for goods and services received. It is furthermore noted that obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

Noteworthy is the fact that the *Framework* clearly distinguishes (at paragraph 61) between a present obligation and a future commitment. An example provided is a decision by the management of an entity to acquire assets in the future. This decision does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset.

In the case of an irrevocable agreement, the *Framework* explains that the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

The *Framework* states (at paragraph 62) that the settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement may occur in a number of ways,[22] for example, by:

- Payment of cash;
- Transfer of other assets;
- Provisions of services;
- Replacement of that obligation with another obligation; or
- Conversion of the obligation to equity.

[22] The *Framework* notes (at paragraph 62) that an obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

The *Framework* maintains (at paragraph 64) that some liabilities can be measured only by using a substantial degree of estimation. It is noted that some entities describe these liabilities as provisions, but in other countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates.

However, the definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions to be made under existing warranties and provisions to cover pension obligations.

The recognition, measurement and disclosure rules of an accounting "liability" are addressed in *IAS 37, Provisions, Contingent Liabilities and Contingent Assets* (IASB, 2010c). Paragraph 10 reiterates the *Framework* definition of a "liability" by stating that it is a present obligation as a result of past events whereby the settlement thereof is expected to result in an outflow of resources embodying economic benefits.

IAS 37 states, at paragraph 10, that an obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Furthermore, a "legal obligation" is defined as an obligation that derives from:

- A contract (through its explicit or implicit terms);
- Legislation; or
- Other operation of law.

Also, a "constructive obligation" is defined as an obligation that derives from an entity's actions where:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

For the purposes of section 80M(1)(*c*), the accounting definition of "financial liability" specifically is relevant and is stated here for the sake of completeness and ease of reference.[23] However, for the purposes of section 80M(1)(*d*), only the accounting definition of "liability" is deemed appropriate.

An accounting "financial liability" is defined in paragraph 11 of *IAS 32, Financial Instruments: Presentation* (IASB 2010d), as any liability that is:

> *"(a) a contractual obligation:*
> *(i) to deliver cash or another financial asset to another entity; or*
> *(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*
>
> *(b) a contract that will or may be settled in the entity's own equity instruments and is:*
> *(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or*
> *(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments."*

Furthermore, as will be seen from the discussion in the next paragraph, the contrast between an "existing" and "anticipated" liability is of great importance. Or, to use the wording in *IAS 37*, the contrast between a "present obligation" and a "future commitment" is of great importance. For this reason, the IAS definition of "contingent liability" is also discussed in this paragraph.

[23] The Draft Guide (SARS 2010:20) states that where one party does not know that another party intends to disclose the arrangement as a financial liability for accounting purposes, the first party may not realise that the arrangement is required to be disclosed. In this case, SARS acknowledges that this is a factor that will be taken into account in potentially reducing the R1 million penalty.

A "contingent" liability is defined in *IAS 37*, paragraph 10, as a

> *"(a) possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*
> *(b) a present obligation that arises from past events but is not recognised because:*
> *(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or*
> *(ii) the amount of the obligation cannot be measured with sufficient reliability."*

The recognition criteria of *IAS 37* determine that an entity may not recognise a contingent liability (paragraph 27).

A "contingent liability" does not meet the recognition criteria of *IAS 37*, paragraph 27, and as such, an entity may not recognise a contingent liability in its financial statements. The contingent liability must be disclosed (in terms of paragraph 86), unless the possibility of an outflow of resources embodying economic benefits is remote.

It is submitted that the requirement of an entity having a "present obligation" is the distinguishing factor between an "existing" liability and an "anticipated" liability. *IAS 37* notes, at paragraph 15, that it rarely unclear whether there is a present obligation. In these rare cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

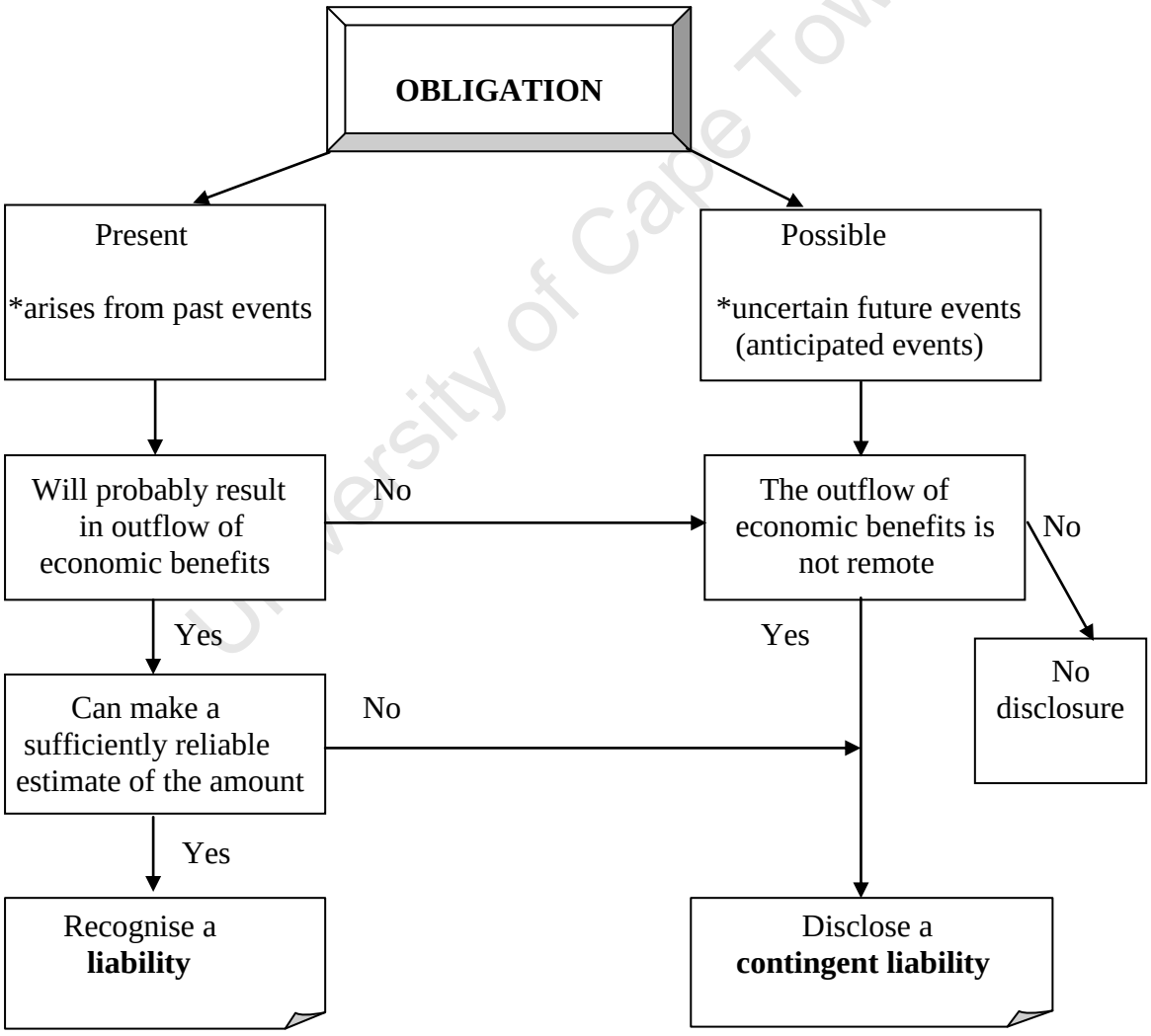
The entity must therefore, at the end of the reporting period, take into account all available evidence, including the opinion of experts. Additional evidence provided by events after the reporting period must also be considered. If, on the basis of such evidence, it is more likely than not that a present obligation exists, the entity recognises a liability. Otherwise the entity discloses a contingent liability (unless the possibility of an outflow of economic benefits is remote).

To summarise: the following elements must be present in order for an entity to recognise a liability in its financial statements:

- A present obligation (or, in other words, an existing obligation);
- Arising from past events;
- The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits; and
- The amount must be reliably estimated.

Figure 3.1 (below) provides a summary of the interaction between the accounting requirements of a "liability" and a "contingent liability".

Figure 3.1 Accounting criteria for a "liability" and a "contingent liability".



The ordinary definition of the word "liability" is as follows:

> **Liability** ·noun → a thing for which someone is liable;[18] a debt or obligation.[19]

The ordinary definition concurs with the accounting definition of the word, *i.e.* there has to be a debt or obligation. This, it is submitted, implies an existing liability, and not an anticipated (or contingent) liability. This approach, however, seems to contradict the interpretation adopted by the courts.

(b) Interpretation by the Courts

In order to avoid, postpone or reduce the "liability for tax", the liability first has to exist. The question whether a "liability for tax" exists and has been avoided by the taxpayer has been considered by the courts on numerous occasions. In all the court cases referred to in this paragraph, the courts attempted to ascertain whether a liability for tax existed and, if so, whether it was avoided. This paragraph overlaps, to a certain extent, with the discussion of an "avoidance" of a liability for tax in paragraph 3.5.2.

In *CIR v. King (1947)* Watermeyer J pointed out [at paragraph 161] that:

> *"There are many…ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or of freeing himself from taxation on some part of his future income…yet it cannot be imagined that Parliament intended…to do such an absurd thing as to levy a tax upon persons who carry out such operations as if they had not carried them out."*

Also, in *Smith v. CIR (1964)* the Supreme Court held [at paragraph 133] that the ordinary, natural meaning of avoiding a liability for tax is to:

> *"get out of the way of, escape or prevent an* ***anticipated*** *liability".* [Own emphasis].

The court in *Smith* found that the arrangement concerned avoided Mr Smith's anticipated liability for tax and that there was no need for the income still to be economically Mr

Smith's, for the GAAR to operate. *Smith's* case thus indicates that it is not a requirement that it be shown that the taxpayer is avoiding the tax on what is in reality his income.

De Koker (2010:par19.5) maintains that the liability for tax that was sought to be avoided, postponed or reduced for the proper application of the GAAR is not an accrued or existing liability, since such a liability cannot be avoided, but was an anticipated liability. This has been interpreted, in the case of *Hicklin v. SIR (1980)*, as meaning a liability for tax that the taxpayer anticipates will or may fall on him in the future.

Determining the existence of a tax benefit therefore typically requires one to identify income which might otherwise have accrued to the taxpayer. It is this problem that has faced the courts in most of the reported cases. However, in the case of *CIR v. Louw (1983)* there was no such income, as the directors of a private company which had previously acquired their partnership business, caused the company to make loans to them in lieu of increased salaries. In this case, the court adopted the broad approach to the circumstances in which a liability for tax can be said to have been avoided, holding [at paragraph 142] that:

> *"In order to determine whether the advancing of the loans enabled respondents to get out of the way of, escape or prevent an anticipated liability for tax one must, I think, ask oneself the question whether, but for the loans, equivalent or even lesser amounts would probably have been received by respondent in a taxable form, i.e. as salary or dividend."*

The court thus accepted that salaries would have been paid had the loans not been made. Clegg and Stretch (2010:par26.3.3) consider this approach to be incorrect, as it involves the creation of notional income on which tax might have been paid. The argument being that the company and the taxpayer were parties to the arrangement and a clear choice existed whether to distribute the surplus after tax income of the company by way of dividend (which would have been taxable) or to accumulate it or to make it available by way of loan, or to pay it out by way of salary, each with its differing tax effects. The authors submitted that to hold otherwise would lead to the absurd results alluded to in *CIR v. King (1947)*.

Clegg and Stretch (2010:par26.4.6) consider the United Kingdom approach to be correct. There, the relevant transaction is ascertained and it is that transaction which the Commissioner is entitled to subject to tax (as the relevant transaction must produce the same end result in the form of legal rights and obligations). In *Hicklin v. SIR (1980)* it was held [at paragraph 179] that a liability for tax:

> *"May vary from an imminent certain prospect to some vague, remote possibility…In Newton's case…Lord Denning spoke of 'a liability which is about to fall on you', which suggests one of some imminence. However, it is unnecessary and hence unadvisable to decide here whether a vertical line should be drawn somewhere along that wide range of meanings in order to delimit the connotation of 'an anticipated liability'."*

It is therefore submitted that the accounting and ordinary, grammatical meaning of a "liability for tax" differs from the meaning attached to it by the courts, *i.e.* that an "anticipated" liability is, in terms of accounting principles, not a liability, but a contingent liability to be disclosed, instead of recognised, in the financial statements.

Notwithstanding the above submission, the remainder of this chapter will examine the meaning of a "liability for tax" in light of its construction as applied by the courts. The next paragraph will briefly consider the proposed tax treatment of contingent liabilities as envisaged in the recently decided *Ackermans* case.

(c) The Ackermans case and contingent liabilities

The ability to claim a deduction of contingent liabilities in the context of the disposal of a business or assets has recently been considered in the case of *Ackermans Limited v. CSARS* (2011). The Supreme Court of Appeal ruled that, where the seller sold its business as a going concern on terms whereby the purchaser took over those contingent liabilities in return for a reduced purchase price, the liabilities in question had not been "actually incurred" and were therefore not deductible by the seller in terms of section 11(*a*) of the Act.

Thereafter, SARS issued binding Class Ruling 029 (on 10 May 2011) in respect of the deductibility of contingent liabilities when buying the assets and liabilities of another

company in the same group of companies. National Treasury has subsequently released the DTLAB which proposes the new sections 11F and 24CA.

The proposed new section 11F (which is to become effective on 1 April 2012) will permit a deduction for the seller in precisely the circumstances of the *Ackermans* decision. As PWC (2011:7) succinctly remarks:

> *"Perhaps only a tax lawyer can understand SARS' stance in fighting, tooth and nail, the taxpayer's claim for a deduction, whilst simultaneously drafting amending legislation that would permit such a deduction."*

In terms of the proposed new section 24CA (which is to become effective on 1 January 2012), the value of contingent liabilities assumed by the purchaser will be added to the consideration paid by him for the purchase of the business. This will be added to cost price or base cost (depending on whether the consideration is allocated to trading stock or capital assets), but the purchaser will simultaneously claim an upfront allowance of the same amount. This allowance will be added back as income in the following year and rolled forward in subsequent years, until the real liability becomes expenditure actually incurred. If the contingent liability never occurs, then the purchaser will have had an amount included in income.

The next paragraph will address the first problem related to a "liability for tax", namely the avoidance of such a liability.

3.5.2 Avoidance of a Liability for Tax

The section 80T definition of a tax benefit includes the avoidance, postponement or reduction of any liability for tax. Tax avoidance is the topic of much conducted research any many court cases. It is not the purpose of this study to elaborate on the GAAR requirements of sections 80A to 80L (which deal with tax avoidance) but it is, however, necessary to briefly address the avoidance of tax to better understand the definition of a tax benefit.

The avoidance of tax has two implications: it firstly triggers the GAAR provisions in sections 80A to 80L, and secondly, it could trigger the reportable arrangements provisions of sections 80M to 80T. Unfortunately, from the taxpayer's perspective, an arrangement entered into to achieve a tax benefit will not necessarily succeed simply because it negotiates the hurdles imposed by these various provisions. De Koker (2010:par19.4) notes that the substance-over-form doctrine must be applied in cases involving potential arrangements. Furthermore, Clegg and Stretch (2010:par2.7.1) suggest that a clear distinction needs to be drawn between economic substance and legal substance.

The economic substance is the commercial reality of a transaction[24] or the accounting treatment of a transaction,[25] to determine, for example, whether a particular expense is of a revenue or capital nature. The legal substance refers to actual facts, which must include the legal reality of the agreements entered into.[26] The legal substance of an agreement is of relevance when its form does not give clear guidance as to the relationship between the parties, which will usually occur when the agreement is poorly or confusingly drafted (Clegg & Stretch 2010:par26.7.3).

However, the legal form may be overruled by the "sham transaction" test, which is applied where the parties have purposefully disguised the true nature of the transaction between them through the adoption of a form which is intended to be different to its nominal form (Clegg & Stretch 2010:par26.7.5).

Based on the substance-over-form doctrine (which emanated in tax law from *IRC v. Duke of Westminster (1936)),*[27] the court must regard the legal substance of the matter. Stark J, in *Jaques v. FCT (1924),* added the qualification that while the taxpayer had such an inalienable right, his success or otherwise depended on the particular legislation. Lord Wilberforce affirmed (*WT Ramsay Ltd v. IRC 1981)* that the proper approach was to examine both the substance and the form and whether it fitted within the language and policy of the Act.

[24] *CIR v. General Motors SA (Pty) Ltd (1982).*

[25] *ITC 1636 (60 SATC 267).*

[26] *CIR v. George Forest Timber Company Limited (1924).*

[27] This doctrine was accepted into our law in *CIR v. Estate Kohler (1953).*

In the South African context, Wunsh J held that the test to be applied in determining whether a transaction had the effect of avoiding tax was to ask whether the taxpayer would have suffered tax but for the transaction. He also pointed out in *ITC 1625 (59 SATC 383)* [at paragraph 383] that:

> *"if the transaction in issue…had not been entered into, the taxpayer would not have acquired the property, it would not have earned the income and it would not have incurred the interest expenditure."*

Thus, in the case of a wholly new income earning structure, the court found that, strictly speaking, it would be impossible for the Revenue to show that tax had been avoided since, without the existing income stream, it would be impossible to show that there was any anticipated liability.

In light of the above, Clegg and Stretch (2010:par26.3.3) state that before an avoidance of tax is deemed to have occurred for the purposes of GAAR, the following conditions must first be met:

- The accrual of a stream of income must be anticipated with some degree of likelihood in the sense that a contracted basis must exist for income to accrue to the taxpayer (whether in the near or distant future);
- The income will be subject to tax in the hands of the taxpayer if it is received by or accrues to him; and
- After the entering into of the arrangement, the tax on the income in the hands of the taxpayer or a third party is less than it would have been without the arrangement.

It is clear, then, that in applying the law, the substance of the transaction, rather than its form, determines the tax consequences. Concerning a reportable arrangement, the courts will have to focus on the legal rights and obligations of the parties and not on the labels attached to the arrangement. The fact that the reportable arrangements legislation refers to the avoidance of tax opens the door wide for litigation and aggressive tax planning. The next paragraph will address the second problem related to a "liability for tax", namely the reduction of such a liability.

3.5.3 Reduction of a Liability for Tax

The section 80T definition of a tax benefit includes the avoidance, postponement or reduction of any liability for tax. The ordinary meaning of the word "reduce" is as follows:

> **Reduce** ·verb → make or become smaller or less in amount, degree or size.[18]

The word "reduction" poses an interesting problem. It implies that there was an existing tax liability to reduce and thus it can only be measured against a certain comparative liability. It goes without saying that the arrangements concerned will be the only ones entered into and as such it may be problematic to identify what comparative arrangement with a lesser liability is to be selected for this purpose (Clegg & Stretch 2010:par26.3.3).

Assume that there are three possible methodologies available for achieving the same commercial end result, each of which has a different potential tax liability. Assume further that the middle methodology is chosen. How does one then determine whether there is a reduction (or conversely, an increase) in a tax liability? Which methodology should be regarded as the benchmark?

Bearing in mind the R1 million penalty (in terms of section 80S) that the Commissioner may impose on failure to disclose a reportable arrangement, it is advisable to err on the side of caution. Clegg and Stretch (2010:par26.3.3) maintain that the tax liability must be compared with any reasonably common commercial alternative for achieving the same end results.

An issue related to this matter of identifying the alternative arrangement, is that of quantifying the tax liability where the alternative arrangement is entirely hypothetical. Assume that a taxpayer shows that, except for the arrangement he had actually entered into, he would not have entered into any other arrangement. The question now arises as to whether it can be said that a tax benefit has arisen at all?

The Australian answer to this question can be found in the case of *FCT v. Spotless Services Ltd (1996)* where the Australian High Court rejected an argument that the anti-avoidance provision could not apply because it was not possible to identify an alternative course of action the taxpayer might have taken but for the tax avoidance arrangement.

SARS (2010:11) acknowledges that although it may be argued that the participant could have implemented the arrangement in a different manner, or could have entered into a different type of transaction, had the one in question not been entered into, and use the hypothetical differences in the tax result of these arrangements, it is not always practical to use the hypothetical differences in the tax result as it involves too many potential variables to properly facilitate objective comparison. SARS is, however, prepared to consider properly motivated exceptions to the rule for the sake of fairness.

The next paragraph will address the third problem related to a "liability for tax", namely "any" such liability.

3.5.4 Any

The section 80T definition of a tax benefit includes the avoidance, postponement or reduction of any liability for tax. The ordinary meaning of the word "any" includes:

> **Any** ·adjective → every, no matter which; indefinitely large.[19]

It is submitted that the insertion of the word "any" has the effect of potentially including an indefinitely large number of routine transactions. In *Hayne and Co v. Kaffrarian Steam Mill Co Ltd (1919)* [at paragraph 371] and in *CIR v. Ocean Manufacturing Ltd (1990)* [at paragraph 618H], it has been held that in its natural and ordinary sense (unless restricted by the context) "any" is an indefinite term which includes all of the things to which it relates.

De Koker (2010:par25.7I) concurs that the word "any" is a word of wide and unqualified generality. It may be restricted by the subject matter or the context, but *prima facie* it is unlimited. He further states that unless the context requires differently, it should be given a wide meaning.

The following examples are just two of the numerous ordinary, routine, operating transactions that could become reportable if the rest of the section 80M requirements are met.

(a) Expenditure incurred

The general deduction formula of section 11(*a*), read with section 23(*g*), of the Act allows the deduction, by any person from carrying on any trade, of expenditure actually incurred in the production of income, unless it is of a capital nature. Normal, routine trade expenditure incurred by a company is usually deductible in terms of section 11(*a*). Examples include the purchase of stationery or the payment of salaries. Usually, these expenses are actually incurred in the course of carrying on a trade, are in the production of income and are not of a capital nature.

Because the expenditure is deductible under section 11(*a*), the taxpayer's taxable income is reduced. This, in turn, reduces the liability for tax for the year of assessment. Thus, a tax benefit is obtained and this routine transaction could become reportable (assuming that the rest of the requirements of section 80M(1) are complied with).

(b) Acquisition of an asset

The acquisition of an asset by a taxpayer for use in his trade, usually qualifies for a wear-and-tear allowance. These allowances reduce the taxpayer's taxable income, and as such, also reduce the tax liability for the year of assessment. Thus, a tax benefit is obtained and this routine transaction could become reportable (assuming that the rest of the requirements of section 80M(1) are met).

Even though the excluded transactions fall outside the scope of this study, the requirements of section 80N will be addressed briefly in order to facilitate understanding when section 80M(1)(*d*) does not apply to an arrangement. In terms of section 80N(1), an arrangement is an excluded arrangement if it is:

" a) a loan, advance or debt in terms of which—

i) the borrower receives or will receive an amount of cash and agrees to repay at least the same amount of cash to the lender at a determinable future date; or

ii) the borrower receives or will receive a fungible asset and agrees to return an asset of the same kind and of the same or equivalent quantity and quality to the lender at a determinable future date;

b) a lease;

c) a transaction undertaken through an exchange regulated in terms of the Securities Services Act, 2004 (Act No. 36 of 2004); or

d) a transaction in participatory interests in a scheme regulated in terms of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002)."

In terms of subsection (2), the subsection (1) exclusions will only apply to an arrangement that:

"a) is undertaken on a stand-alone basis and is not directly or indirectly connected to, or directly or indirectly dependent upon, any other arrangement (whether entered into between the same or different parties); or

b) would have qualified as having been undertaken on a stand-alone basis as required by paragraph (a), were it not for a connected arrangement that is entered into for the sole purpose of providing security and where no tax benefit is obtained or enhanced by virtue of that security arrangement."

There are further requirements, contained in subsection (3), which determine that subsection (1) does not apply to any arrangement that is entered into

- with the main purpose of obtaining or enhancing a tax benefit; or
- in a specific manner or form that enhances or will enhance a tax benefit.

Fortunately, in terms of subsection (4), the Minister may determine an arrangement to be an excluded arrangement by notice in the *Gazette*, if he or she is satisfied that the arrangement is not likely to lead to an undue tax benefit. The Minister has excluded by way of notice in the *Government Gazette* (nr 30941 of 1 April 2008, Volume 514) any arrangement where the tax benefit from the arrangement:

- does not exceed R1 million; or
- is not the main or one of the main benefits of the arrangement.

SAICA (2007a) notes that they consider the scope of section 80M to be too wide and that it affects an absurd amount of routine transactions. Even though the Minister has excluded arrangements where the tax benefit does not exceed R1 million, some taxpayers could easily exceed this cut-off amount with just a few routine transactions. To this end, SAICA (2007a) has proposed the inclusion of numerous specific transactions in the section 80N(1) list of exclusions as they are unlikely to lead to an undue tax benefit. Table 3.4 (below) is largely based on SAICA's recommendations to SARS and proposes an extended list of excluded transactions.

Table 3.4 Proposed extended list of excluded transactions

Transaction	Description of transaction	Reason for exclusion
1. Acquisition of any asset, trading stock, consumables and services on credit.	▪ Expense is deductible in terms of the general deduction formula or another specific allowance.	• These items generally comprise trade debts and form the basis of the majority of transactions between suppliers and customers. • This does not give rise to an undue tax benefit.
2. Acquisition of fixed property, including fixed property acquired with the purpose of earning rental income.	▪ The property can be financed by a mortgage bond or other form of financing.	• These items usually comprise long-term finance of an asset acquired. • This does not give rise to an undue tax benefit.
3. Acquisition of household items and motor vehicles, motor cycles and other personal assets.	-	• This does not give rise to an undue tax benefit
4. Various credit facilities	▪ Bank overdrafts ▪ Credit cards ▪ Discounting of trade debtors or other receivables ▪ Acquisition of trade debtors or other receivables	• These do not give rise to an undue tax benefit

SARS (2010:11) concedes that the strict interpretation of "tax benefit" will result in many everyday transactions falling within the ambit of a "tax benefit", leading to uncertainty for taxpayers applying legitimate tax planning. It is, however, not the intention that routine

transactions, for example, the purchase of stationery or the payment of salaries, which are incurred in the ordinary course of business, should be disclosed to SARS. The "main or one of the main benefits" test is aimed at eliminating the need to disclose such routine transactions to SARS, whereas the R1 million threshold test introduces a *de minimis* rule.

However, as will be discussed in paragraph 3.9.4, the "main benefit" requirement is subjective and difficult to comply with. It is therefore submitted that the section 80N(1) list of plain-vanilla, excluded transactions should be extended to also include other routine, operating transactions such as the acquisition of any asset, trading stock, consumables and services on credit.

Some of the other problematic terms in section 80N will be addressed in paragraph 3.9. The next paragraph will examine the meaning of the word "assumed" which is contained in the introductory requirement of section 80M(1).

3.6 Assumed

Section 80M(1) states that an arrangement is a reportable arrangement if any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement. The ordinary meaning of the word "assume" is as follows:

> **Assume** ·verb → accept as true without proof or take responsibility or control.[18]

Based on the ordinary meaning of the word, it is clear that someone must take responsibility for establishing whether or not a tax benefit has arisen. It is unclear, though, upon whom this responsibility to establish the tax benefit will rest. Will SARS assume that a tax benefit was obtained by the participant, or must the taxpayer make that assumption?

Firstly, the definition of a participant must be considered (this definition will be addressed in detail in paragraph 3.8). A participant in relation to a reportable arrangement is defined in section 80T as:

"(a) any promoter; or

(b) any company or trust which directly or indirectly derives or assumes that it derives a tax benefit or financial benefit by virtue of a reportable arrangement."

Secondly, the definition of a "financial benefit" is also contained in section 80T and means any reduction in the cost of finance, including interest, finance charges, costs, fees, and discounts in the redemption amount. From the above definitions, it would seem that the participant has to make the assumption that a tax benefit was obtained, as the definition of a participant includes the phrase "any company or trust which directly or indirectly assumes that *it* derives". In this case, "it" refers to the company or trust.

However, based on the arguments set out below, it is submitted that this is not the case - the Commissioner will have to assume that a tax benefit was derived.

As previously stated in paragraph 3.5.2 regarding the avoidance of tax, it could be useful to refer to tax avoidance court cases and research that deal with the assumption of whether or not a tax benefit has arisen. Applying the GAAR principles and court cases might assist in ascertaining on whom the burden of proof lies.

Clegg and Stretch (2010:par26.3.3) state that is incumbent upon the Commissioner to show, on a balance of probabilities, that a tax benefit has arisen as a consequence of an arrangement as defined, before the specific terms of section 80A (one of the GAAR provisions) can even be considered. Cilliers (2008:104) places the burden of proof on the Commissioner, stating that:

> *"A tax-avoider's goal is always primarily to secure an advantage for himself, even if his action should happen to be accompanied by an attitude of insouciance or one-upmanship towards the fiscus. At any rate, it is submitted, the onus in this regard must rest on the fiscus. To place the onus on the taxpayer in this context would be absurd."*

De Koker (2010:par19.5) submits that in order for the Commissioner to show that a tax benefit has indeed arisen, it is firstly necessary for him to establish and show what arrangement would otherwise have been entered into to produce the commercial result and the resulting tax consequences. Clegg and Stretch (2010:par26.3.3) concur that it is not

enough for the Commissioner simply to aver that a tax benefit has arisen – he must be sufficiently clear in his mind as to the nature of the alternative arrangement, to quantify the benefit.

Meyerowitz, Emslie and Davis (2007:160) are also of the opinion that the burden of proof must be placed on the Commissioner and state that:

> *"With respect it is also our view that although section 82 of our Act casts the onus upon the taxpayer to prove the assessment to be wrong he will have discharged this onus if the Court accepts that the requirements of section 80A (other than the misuse or abuse provisions) are not met, and it is then for the fiscus to convince the court that the taxpayer has misused or abused the relevant provisions."*

In respect of the GAAR provisions, section 80G contains a presumption test. Once it has been established that an avoidance arrangement exists, section 80G(1) creates a presumption that it was entered into or carried out for the sole or main purpose of obtaining the tax benefit identified. The party obtaining that tax benefit may rebut that presumption by proving that obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

In *SIR v. Gallagher (1978)*, the court found that the section 80G presumption placed a heavy burden of proof on the taxpayer, since the mere assertion by him that his purpose was not the avoidance of tax does not carry a great amount of weight. The taxpayer has to be able to point to some compelling reasons for entering into the arrangement but the court must also be satisfied that the tax benefit was not the sole or main purpose. Clegg and Stretch (2010:par26.3.4) submit that the courts must take an objective view of the facts and circumstances (which includes the *ipse dixit* of the taxpayer) to determine the actual purpose of the transaction.

It is unnecessary for a taxpayer to prove any point beyond a reasonable doubt or even for him to be faced with too high a standard of proof. Furthermore, the onus is discharged if the court has no reason to disbelieve the taxpayer and his evidence is not contradicted by objective facts. On the other hand, mere statements not corroborated by evidence are hardly sufficient to discharge the onus (De Koker 2010:par19.6).

Consequently, an important point to bear in mind is the onus of proof as determined by section 82 of the Act. According to section 82, the burden of proof as to exemptions, deductions, abatements, disregarding or exclusions shall be upon the taxpayer. This suggests that the onus to disprove a tax benefit is likely to be placed on the taxpayer. This opinion is strengthened by the fact that the reportable arrangements provisions contain no special presumption to indicate otherwise.

In light of the above discussion, it would seem that the Commissioner must assume that a tax benefit was obtained by the participant before invoking the reportable arrangements provisions. The onus to disprove this assumption will probably rest on the taxpayer. The above argument is substantiated by the following statement made by SARS (2010:7):

> *"The onus is on the participant to an arrangement to determine whether it needs to be disclosed to SARS."*

SAICA (2007b) contends that the words "assumed to be derived" is meant to cover situations where it is uncertain whether any tax benefit would flow. In such a case, SAICA suggests that the words "assumed to be derived" be replaced by "may be derived". Furthermore, it is SAICA's view that it is a factual enquiry whether a tax benefit is or will be derived. This study concurs with SAICA's submission.

However, the Draft Guide states that the assumed tax treatment of an arrangement is apparent from the agreements as well as from the financial model (if any) which accompanies the arrangement (SARS 2010:9). It further states that there is normally consent among the parties as to what these assumed tax benefits are, as they sign off on the agreements which underpin the model.

According to SARS, there is little room for debate as to what is meant by "assumed" (SARS 2010:9). However, SAICA notes that not all parties to these transactions are given insight to the financial models contained in these arrangements (SAICA 2010a). It is therefore possible that a participant, for example a company, may not be aware of the assumed tax treatment of the arrangement other than to the extent that it directly has an impact on the tax liability of that company or trust.

Furthermore, the Draft Guide requires a participant to calculate the tax benefit of the arrangement by taking into account the assumed tax effect in the hands of each participant and comparing this with the position had the arrangement not been entered into (SARS 2010:11). Again, SAICA (2010a) notes that not all parties might be privy to the financial models which underpin these arrangements and, as such, may not be aware of the assumed tax effect in the hands of each participant other than to the extent that it directly has an impact on the tax liability of that company (or trust). That participant will thus be unable to determine the assumed tax effect in the hands of each participant and will be unable to make the required comparison.

Law firm Cliffe Dekker Hofmeyr (2010:4) concurs and deems this problem to be an obvious one. They note that in a complex transaction, for example, many of the participants may not necessarily be aware who the other parties are, and may not know which parties may, or may not have a reasonable expectation of a pre-tax profit.

SARS (2010:11) cautions that in order to prevent exposure to a R1 million penalty, all participants to such arrangements should consider not only their own, but other parties' tax benefits.

However, it is submitted that SAICA's view is correct and that SARS should specifically address circumstances where not all the parties are given insight to the financial models contained in the arrangements. This will assist in ensuring that participants will not be expected to make assumptions relating to arrangements to which they are not fully privy.

The next paragraph will examine the meaning of the term "by virtue of", due to the fact that a tax benefit is derived by virtue of the arrangement.

3.7 By Virtue Of

Section 80M(1) states that an arrangement is a reportable arrangement if any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement. The ordinary meaning of the term "by virtue of" is as follows:

By virtue of →because of it; on account of it.[19]

Thus, it is on account of the arrangement entered into, that a tax or financial benefit is derived (or assumed to be). In other words, the benefit is caused by the arrangement. In *Miller v. CIR (1928)* the phrase "by virtue of" were held to be equivalent to "for".

This concept of a causal link has been dealt with in, amongst others, section 11(*a*) of the Act. In order for an expense to be deductible, it must be, *inter alia*, incurred in the production of income.

In the case of *Port Elizabeth Tramway Co Ltd v. CIR (1936)* the taxpayer concerned was a transport company. One of its drivers had suffered injuries during an accident while driving one of the company's cars. The company was compelled to pay damages to the dependants of the deceased driver and the court held that the compensation was incurred in the production of income (and was therefore deductible). Watermeyer AJP explained how closely the expenditure had to be linked to the business operation in order to be deductible, stating that [at page 17]:

> *"…whether such expenditure are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so* ***closely connected*** *with it that they may be regarded as part of the cost of performing it."* [Own emphasis].

Thus, the expenditure must be closely connected with the activity in order to be deductible. Or, to state it differently, the expense must be a necessary concomitant of the business activity.

The concept of causation is also an essential element of delictual liability in South African law. Midgley and Van der Walt (2005:par129) state that causation in the law of delict (in other words in the legal sense) comprises two fundamental aspects or elements: factual causation and legal causation.[28]

[28] The question of legal causation is not a logical concept, but a moral reaction, involving a value judgment and applying common sense. It is aimed at assessing whether the result can fairly be said to be imputable to the defendant (Midgley & Van der Walt 2005:par132).

The enquiry as to factual causation is generally conducted by applying the so-called "but-for" test, which implies that an act is a necessary condition if, but for the particular act, the consequence would not have occurred. Furthermore, if knowledge and experience indicate a factual nexus between an act and a particular consequence, the act is considered to be a cause-in-fact of the consequence (Midgley & Van der Walt 2005:par129).

Thus, causation, from a delictual point of view, aims to establish a causal link between a person's actions and the consequences arising from those actions. The same argument holds true for certain provisions in the Act. There has to be a causal link, for example, between an expense incurred and the income produced by that expense, before a taxpayer may claim a section 11(*a*) deduction.

It is therefore submitted that the meaning of the term "by virtue of" implies that a causal link must be established. In the context of reportable arrangements, the causal link between the arrangement entered into and the tax or financial benefit that was obtained, must be established. Or, to state it differently, the arrangement and the benefit must be closely connected.

It light of the above submission, the "but-for" criterion of factual causation could be helpful in indicating a causal link. In other words, the tax benefit would not have been derived, but for the arrangement entered into. Only by first proving this causal nexus, can a benefit be derived "by virtue of" an arrangement.

The next paragraph will address the meaning of the terms "participant" and "promoter", as the disclosure obligation rests on these persons.

3.8 Participant

As was previously stated, a participant in relation to a reportable arrangement is defined in section 80T so as to mean:

> *"(a) any promoter; or*
> *(b) any company or trust which directly or indirectly derives or assumes that it derives a tax benefit or financial benefit by virtue of a reportable arrangement."*

3.8.1 Promoter

The section 80T definition of a promoter in relation to a reportable arrangement means

> *"any person who is principally responsible for organising, designing, selling, financing or managing that reportable arrangement. "*

The ordinary meaning of the word "promoter" is as follows:

> **Promoter** ·noun → a supporter of a cause or aim;[18] the organiser.[19]

The definition of a promoter did not appear in the previous section 76A. Due to the fact that SARS (2005) referred to the international position of countries such as the USA and the UK when it introduced the reportable arrangements provisions (refer to Chapter 2), one could infer that the concept of a promoter originated from the legislation of these countries. SAICA (2008) is of the opinion that SARS has introduced legislation that is unsuitable for the South African market.[29]

The UK definition of a promoter is contained in section 307 of the United Kingdom Finance Act that deals with notifiable arrangements (the UK equivalent of South Africa's reportable arrangements). Section 307 defines a promoter as follows:

[29] SAICA's reasons being:

(a) The market for these types of products (or arrangements) is vast in the UK and the USA, whereas in South Africa, the market is extremely small or limited. As a result, targeting these types of activities becomes difficult.

(b) It was the practice of professional advisors based in the UK and the USA to deliberately develop extensive tax practices which had as their main objective the development, marketing and implementation of so-called "tax products". This marketing included call centres devoted to "cold calling" potential clients or targets. This practice is in contrast with the practices of the majority of professional advisors based in South Africa.

"(a) in relation to a notifiable proposal, if, in the course of a relevant business-

(i) he is to any extent responsible for the design of the proposed arrangements, or

(ii) he makes the notifiable proposal available for implementation by other persons, and

(b) in relation to notifiable arrangements, if he is by virtue of paragraph (a)(ii) a promoter in relation to a notifiable proposal which is implemented by those arrangements or if, in the course of a relevant business, he is to any extent responsible for –

(i) the design of the arrangements, or

(ii) the organisation or management of the arrangements."

The "relevant business" mentioned above refers to any trade, profession or business which involves the provision of tax services or is carried out by a bank or a securities house.[30] Essentially, the definition excludes persons in respect of whom certain tests, *viz.* the "benign tax advice", "non-tax advisor" or "ignorance test", apply (SAICA 2008).

The UK and South African definitions of a promoter differ slightly. Unlike the current South African definition, professional tax advisors are excluded from the UK definition under certain circumstances. In addition, the South African definition is significantly broader than the UK definition by virtue of the insertion of the word "or" in the South African definition.

SAICA (2008) suggests that the South African definition be amended as follows in order to bring it in line with the UK definition:

"A promoter in relation to a reportable arrangement means any person who is principally responsible for

(a) designing and selling or

(b) designing or selling and organising or managing

that reportable arrangement."

Furthermore, SAICA (2008) does not believe that the person responsible for managing the transaction should be included in the definition of promoter. Banks often appoint an outside party, unrelated to the transaction, to act as "facility agent" or "inter-creditor agent". If that person played no part in setting up the transaction and is merely there to

[30] A "relevant business" is defined in section 307(2) of the UK Finance Act.

ensure that the interests of the parties are adequately catered for, there is no reason to include them in the definition of promoter. It is submitted that SAICA's recommendation is correct and that, as an alternative to the above proposed definition, the word "managing" should be deleted from the current section 80T definition of a promoter.

SARS concedes that, by definition, "promoter" is a very wide term (SARS 2010:26). The Draft Guide recommends that if any doubt exists as to whether a particular participant is the promoter, a letter should be obtained from the disclosing promoter as contemplated in section 80O(3).

SAICA (2010a) is of the opinion that the Draft Guide is incomplete without a detailed discussion of the various parties who are required to disclose reportable arrangements. It is therefore proposed by SAICA, and, again, this study concurs, that SARS should also specifically address the following circumstances where:

- the promoter is not based in South Africa;
- the promoter is a member of a profession, such as an accountant or lawyer; and
- there is no promoter, for example in-house arrangements.

It is important, however, to take cognisance of the client/attorney privilege if the promoter is a lawyer. Her Majesty's Revenue and Customs (HMRC) office provides guidelines in such cases (HMRC 2011:par3.8), as schemes promoted by lawyers fall within the scope of the disclosure rules in the same way as for other promoters. The HMRC states that where an advisor who would ordinarily be a promoter is prevented by reason of legal professional privilege from providing any of the information needed to make a full disclosure, that advisor has no obligation to make a disclosure.

Furthermore, unless there is another promoter who has an obligation to disclose the scheme, it must be disclosed by any person in the UK who enters into any transaction forming part of it. It is noted that the client of the lawyer has the option of waiving any right to legal privilege.[31] If legal privilege is waived the lawyer is required to disclose.

[31] The HMRC (2011:par3.8) notes the following important points in relation to waiver of legal privilege:

In South Africa, taxpayers may lawfully refuse to supply information to the Commissioner which is subject to legal professional privilege. Law firm Edward Nathan Sonnenbergs (2011:11) explains that in principle, legal professional privilege applies where a person seeks legal advice from an attorney or advocate on a professional basis (the so-called "advice privilege") or where advice is sought in anticipation of litigation from an attorney or advocate acting in a professional capacity (the so-called "litigation privilege").

Noteworthy is the fact that legal privilege is only extended to qualified attorneys or advocates of the High Court. However, it does not follow that simply by virtue of the person being an advocate or an attorney, legal privilege will be afforded to everything said by or to the advocate or attorney; he or she must have acted as an advisor in a professional capacity (Perry 2008). Therefore, before legal professional privilege can be claimed, any communication between a client and attorney or advocate must have been made to a legal advisor acting in a professional capacity, in confidence, for the purpose of pending litigation or for the purpose of obtaining professional advice (Croome 2007:52).

It should be pointed out that under existing statutory provisions, tax advice supplied by an accountant to a client is not subject to legal professional privilege (Edward Nathan Sonnenbergs 2011:14). It should be cautioned that where an accountant provides tax advice (including advice on the structuring of arrangements that might fall within the ambit of the reportable arrangements provisions), such advice is not protected by legal professional privilege.[32]

It is therefore submitted that SARS should take the client/attorney privilege into consideration so as to adequately address the scenario where the promoter is also a lawyer.

- any waiver must be made within sufficient time to enable the lawyer to disclose within five days of the scheme being made available; otherwise the client must make the disclosure within five or 30 days, as applicable, of the first transaction; and
- any waiver can be limited by the client so as to apply only to the extent necessary to enable the lawyer to comply with the disclosure obligation and to have no relevance for any other purpose.

[32] Edward Nathan Sonnenbergs (2011:14) contends that, if called on by SARS, such advice would (on the face of it) be required to be supplied to SARS. This could place attorneys and advocates in a preferential position in advising clients on tax matters. It should be noted that the TAB currently does not contain a provision extending legal professional privilege to accountants who act as tax advisors.

It is furthermore proposed that legal professional privilege should also be extended to accountants who act as tax advisors. The next paragraph will address the term "directly or indirectly" which is also contained in the section 80T definition of a "participant".

3.8.2 Directly or Indirectly

Part (*b*) of the section 80T definition of a participant (in relation to a reportable arrangement) refers to any company or trust which directly or indirectly derives or assumes that it derives a tax benefit or financial benefit by virtue of that arrangement. The ordinary meaning of the words "directly" and "indirectly" are as follows:

> **Directly** ·adverb → in a direct manner;[18] exactly.[19]
>
> **Indirectly** ·adverb → not direct;[18] not going straight to the point; not straightforward or honest; devious.[19]

In the case of *SIR v. Consolidated Citrus Estates Ltd (1967)* Galgut JA explained [at paragraph 148] that:

> *"Directly appears to have been deliberately added in order to serve some purpose that the Legislature had in mind. The purpose, I think, was to postulate that the connection between the taxpayer's incurring the expenditure and the object for which it was incurred…should be direct, i.e.* ***straight and close****, not* ***devious and remote****."* [Own emphasis].

Thus, the word "directly" implies an exact, straight and close manner. The word "indirectly" implies something devious and remote, or not straightforward. As the words "directly" and "indirectly" are antonyms, by using them simultaneously, the scope of section 80M(1) has been widened. An arrangement can therefore directly or indirectly cause a benefit to be derived.

The next paragraph will examine the meaning of the words contained in section 80N(3), which was alluded to earlier in this chapter.

3.9 Section 80N(3) Terminology

Of specific interest is the wording of section 80N(3), namely that the excluded list of section 80N(1) does not apply to any arrangement that is entered into with the main purpose of obtaining or enhancing a tax benefit. The meaning of the terms "main purpose", "enhance", "undue" and "main benefit" will be analysed.

3.9.1 Main purpose

The ordinary meaning of the word "purpose" is as follows:

> **Purpose** ·noun → the reason for which something is done or for which something exists;[18] the object or aim in doing something[19].
> ·verb → have as one's objective[18]; to intend to do something[19].

Tax avoidance is based on the purpose of the arrangement or the person undertaking the arrangement as the essential distinction between permissible tax planning and impermissible tax avoidance. The word "purpose" appears in the opening words of section 80A of the GAAR provisions:

> *"An avoidance arrangement is an impermissible avoidance arrangement if **its** sole or main purpose was to obtain a tax benefit…"* [own emphasis].

Note the clear reference to the purpose of the arrangement itself (by using the determiner "its") and not to the purpose of the taxpayer. Based on Lord Denning's judgment in *Newton v. COT (1958)*, purpose in this sense means not intention, but the effect which it sought to achieve, *i.e.* the end accomplished or achieved. It is thus not a subjective test, but an objective one.

De Koker (2010:par19.6) contends that the words "purpose" and "effect" have usually been construed in case law as a composite term. If an arrangement has a particular purpose, then that will be its intended effect (*i.e.* the intention of the taxpayer is irrelevant). If an arrangement has a particular effect, then that will be its purpose. Oral evidence to show that it has a different purpose or different effect to that which is shown by the

arrangement itself, is irrelevant to the determination of the question whether the arrangement has (or purports to have) the purpose or effect of in any way altering the incidence of income tax.

However, in the reportable arrangements provision of section 80N(3) the wording is slightly different. Section 80N(3)(*a*) states that subsection (1) does not apply to any arrangement that is entered into **with** the main purpose of obtaining or enhancing a tax benefit.

Section 80N(3) thus refers to the situation where the arrangement was entered into with the main purpose of obtaining or enhancing a tax benefit. It refers, therefore, to the intention of the taxpayer (in this case the participant to the arrangement) and not to the effect which it sought to achieve. It is therefore submitted that the proper test to apply in this case, is a subjective test, and not an objective test.

In the case of *SIR v. Geusteyn, Forsyth and Joubert (1971)*, a subjective test was applied. In the case of *SIR v. Gallagher (1978)*, the subjective test took as its criterion the purpose that those carrying out the scheme intended to achieve by it. Thus, the question to be asked is: what was in the mind of the taxpayer who entered into the transaction?

It was determined in *CIR v. Conhage (1999)* that where a taxpayer is presented with a choice between two single transactions as alternative methods of achieving the same commercial end result, but which have quite different tax consequences – for example the choice between lease finance and suspensive sale finance of a moveable asset – it is considered that, irrespective of which transaction type is selected, the main purpose of that transaction cannot be the obtaining of a tax benefit.

This judicial approach emanated from the so-called principle of choice expounded in *IRC v. Duke of Westminster (1936)* where Lord Tomlin expressed that taxpayers are entitled to order their affairs so the tax attaching is less than it otherwise would be.[33]

[33] The choice principle proceeds on the footing that the taxpayer is entitled to create a situation by entering into a transaction which would attract tax consequences for which the Act makes a specific provision. The validity of the transaction is not affected merely because the tax consequences which it attracts are

In the South African context, the choice principle was affirmed by the *Conhage* case. The court confirmed that where two alternative methods of achieving largely the same commercial results are available to a taxpayer, his purpose in choosing the alternative which carries the more advantageous tax consequences amounts to a subsidiary or incidental purpose, and not the main or sole purpose of the transaction. The main purpose remains that of achieving the commercial result.

In *ITC 1636 (60 SATC 267)* Kroon J cited various cases to ascertain the meaning of "solely or mainly" in the context of section 103(1). The first case that he referred to, was *ITC 983 (25 SATC 55)*, where the court dealt with section 90(1)(*b*) of the Income Tax Act No. 31 of 1941. This provision contained words similar to those in section 103(1), *viz.* "solely or mainly for the purpose". The court stated the following [at page 58]:

> *"... for the section to operate the avoidance of tax must at least have been the principal purpose of the taxpayer. In the present case the court is satisfied that although the avoidance or reduction of tax was one of the purposes, it was not the main purpose. The main purpose was to obtain a production unit which could go into immediate operation, as indeed the Appellant company did."*

Thereafter, Kroon J referred to *ITC 1307 (42 SATC 147)* which dealt with a previous version of section 103(1) which contained the words "the sole or one of the main purposes". The court investigated the meaning of the word "main" and found it to mean [at page 153]:

> *"... principal, major and most important, and the ascertainment of a main purpose involves a weighing against each other of the various purposes of a scheme. In a case such as the present, where at most two purposes have been suggested (a saving on income tax and a saving on estate duty), if one purpose preponderates over the other it cannot be said that the other is a main purpose."*

Kroon J concluded that the mere fact that one purpose is regarded as not being of the same importance as another purpose, it does not preclude the former purpose from being one of the main purposes. He stated [at page 334], that:

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advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage.

> *"It is not necessary, for more than one purpose to qualify for the epithet of 'main', that each of the purposes be of equal importance. Provided that a particular purpose, viewed by itself, is of sufficient importance to attract the description of 'main' in the sense of being a major inducing consideration, it matters not that another purpose featured more prominently. … In short, to qualify as the main purpose, the* ***purpose in question must preponderate over any other purpose*** *(or, possibly, at least be as important as any other purpose)."* [own emphasis].

Clegg and Stretch (2010:par26.3.4) note that an issue which has never been considered by the courts is exactly how a main purpose is to be determined. The commercial consequences of a transaction may have both quantitative (*i.e.* numerical) and qualitative (*i.e*. business efficiency) components, whereas the tax benefit to be weighed in the balance is purely quantitative. The question then arises as to how one must give weight to qualitative consequences?

As indicated earlier by the *Conhage* case, single step arrangements with real substantive commercial advantages for the taxpayer will always have as its main purpose a non-tax benefit. In the case of multi-step transactions, however, there may be elements present where the commercial advantages are less clearly dominant, notwithstanding that they contribute to the overall commercial result.

Clegg and Stretch (2010:par26.3.4) suggest that in such situations, the question should be whether that particular step is commercially necessary in achieving the final commercial result or whether it could be dispensed with without affecting the commercial end. The authors submitted that if that step can be dispensed with, the main reason for its incorporation would be the tax benefit.

A final question to be addressed is determining the time the arrangement was entered into. Should the main purpose be determined at the time when the arrangement was implemented or when it was first conceived? In *Ovenstone v. CIR (1980)* Trollip JA delivered the judgment [at page 68] that:

> *"even if the purpose or effect of [a] scheme when it is formulated is not to avoid liability for tax, it may have that effect or that may become one of the taxpayer's main purposes when he subsequently carries it out…"*

Thus, the purpose of a scheme when it is first formulated may not be to avoid tax but this may become the purpose at the time of implementation. The next paragraph will discuss the meaning of the word "enhance".

3.9.2 Enhance

Section 80N(3) refers to the enhancing of a tax benefit. The ordinary meaning of the word "enhance" is as follows:

> **Enhance** ·verb → increase the quality, value or extent of.[18]

In order to enhance a tax benefit, it presupposes the existence of a tax benefit. This, in itself, is problematic, as was discussed in earlier paragraphs. One must therefore consider two things when interpreting the meaning of the word "enhance". Firstly, the existence of a tax benefit must be established and secondly, the value of that tax benefit has to increase after the arrangement was entered into. SARS identifies two methods for determining a tax benefit (SARS 2010:10):

(a) Comparative method

This is the method favoured by SARS. This test compares the situation where the parties did not enter into an arrangement (*i.e.* they did nothing) with the position following the implementation of an arrangement. The tax benefit is discounted over the period of the transaction to the date of the first cash flow of the arrangement, unless the participant is able to prove a more reasonable alternative method.

(b) Control transaction method

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

It is submitted that the above methods could also be used to determine whether or not a tax benefit was enhanced. For example, by applying the "comparative method" to an existing tax benefit, the participant could compare the position before and after the arrangement was entered into. The value of the tax benefit is therefore compared before and after the implementation of the arrangement in order to determine whether it was enhanced.

The next paragraph will consider the meaning of the word "undue".

3.9.3 Undue

Section 80N(4) of the Act states that the Minister may determine an arrangement to be an excluded arrangement by notice in the *Gazette*, if he or she is satisfied that the arrangement is not likely to lead to an undue tax benefit. The ordinary meaning of the word "undue" is as follows:

Undue ·adjective → excessive or disproportionate;[18] unjustifiable; improper.[19]

The dictionary definition seems to imply that an undue tax benefit, obtained by the participant to the arrangement, is excessive or unjustifiable. How, exactly, should the excessive portion be determined and by whom?

SAICA (2004a) states that the term "undue" attempts to second-guess the intention of the legislature. This statement is explained by the fact that in a South African tax context, the concepts of tax evasion and tax avoidance already exist. "Undue" introduces a new concept which implies that even where there is no question of tax evasion or tax avoidance, and where there is undisputed compliance with tax law, it must now be decided whether or not a legitimate tax effect of the legislation is "undue".

SAICA (2004a) suggests that the terms "undue tax benefit" be replaced with the term "reporting requirement". This study concurs, as the term "reporting requirement" should achieve the intention of including and excluding specially Gazetted arrangements without making use of problematic terminology.

However, the yardstick that SARS will employ to determine the excessive amount, is not yet evident. It is unclear whether the R1 million exclusion in section 80N(4) is meant to be the yardstick. The next paragraph will address the term "main benefit".

3.9.4 Main benefit

The term "one of the main benefits" found in section 80N(4) is, in SAICA's phrasing, "difficult to comprehend" (SAICA 2010a). The plural use of the word "benefit" is problematic as the term "main" implies that there can be only one (singular) main benefit.

Furthermore, the Draft Guide states that an objective test is applied in determining whether a tax benefit constitutes one of the main benefits and the subjective purpose of the taxpayer is not taken into account (SARS 2010:5). The Draft Guide does not explain why SARS has adopted this approach in determining what a "main benefit" is. SAICA submits that while a "tax benefit" can be objectively quantified (as set out in paragraph 6.3 of the Draft Guide), it is not possible to objectively determine whether that tax benefit is the "main" benefit in a commercial arrangement (SAICA 2010a).

SAICA (2010a) correctly argues that there may be many benefits to an arrangement; for example a restructuring of corporate groups may lead to commercial benefits (such as corporate synergy and enhanced efficiency) as well as tax benefits. But it is unclear as to how SARS will objectively determine which of these benefits is more significant and is thus the "main" benefit. This argument is further strengthened by the section 80T definition of a "tax benefit", *i.e.* the "avoidance", "postponement" and "reduction of tax", as these are all purposive acts by a taxpayer.

However, the Draft Guide does seem to address this predicament (SARS 2010:26) by stating that benefits, including commercial benefits (to the extent that these are quantifiable) are to be taken into account in determining whether the tax benefit is the main or one of the main benefits of the arrangement. SARS points out that a quantitative analysis is to be carried out, and that the participant will need to demonstrate on a balance of probabilities that the tax benefit does not constitute the main or one of the main benefits if such participant wishes to rely on the exclusion in section 80N.

The rest of the chapter is devoted to examining the meaning of the section 80M(1)(*d*) requirement of "reasonable expectation of a pre-tax profit". The next paragraph will address the term "reasonable".

3.10 Reasonable

Section 80M(1)(*d*) of the Act refers to the reasonable expectation of a pre-tax profit for any participant. The term "reasonable" is the first part of the section 80M(1)(*d*) reasonable expectation of a pre-tax profit requirement to be examined. The ordinary meaning of the word "reasonable" is as follows:

> **Reasonable** ·adjective → not extravagant or excessive; moderate;[18] sensible; rational; showing reason or good judgement; fair or just.[19]

The ordinary meaning of the word "reasonable" is described as moderate, fair or rational. The term "reasonable" is nowhere defined in the Act. South Africa's common law, however, does contain guidance on the definition of a "reasonable person", as this term is a legal fiction representing an objective standard against which any individual's conduct can be measured.

It is submitted that by applying these common law principles, one could infer that a "reasonable expectation" is similar to a "reasonable person's expectation". This paragraph will therefore briefly explore the characteristics of a reasonable person.

The criterion of the reasonable person is the embodiment of a standard that is always objective and which varies only in regard to the exigencies arising in any particular circumstance *(Jones NO v. Santam Bpk 1965).* This standard of the *diligens paterfamilias*[34] is a standard which is one and the same for everybody under the same circumstances. Or, to state it differently, the reasonable person is the legal personification

[34] Meaning "careful father" (or "careful head of the family"); used to describe the way the law expects people to behave towards one another.

of the ideal standard to which everyone is required to conform (Midgley & Van der Walt, 2005:par121).

A reasonable person could be characterised as one who:

- takes reasonable chances (*Herschel v. Mrupe (1954));*
- is not a chronic pessimist who fears the worst (*Coetzee and Sons v. Smit and Another (1955));*
- has the knowledge required for his work *(Fred Saber (Pty) Ltd v. Franks 1949)*; and
- knows and complies with the law *(McMurray v. HL & H (Pty) Ltd 2000)*.

A reasonable person is not considered to have special skills and a lack of skill or knowledge does not *per se* constitute negligence (Midgley & Van der Walt 2005:par121). But a reasonable person must have the necessary skills and knowledge usually associated with the proper discharge of his duties, as is illustrated by the commentary in the Supreme Court case of *Durr v. Absa Bank Ltd and Another (1997)* [at paragraph 11]*:*

> *"It is not negligent not to be a lawyer. But those who undertake to advise clients on matters including an important legal component do so at their peril if they have not informed themselves sufficiently on the law."*

It is therefore submitted that if a reasonable person expects to generate a profit from a transaction, he has a reasonable expectation of a profit. Thus, if a promoter entered into an arrangement and expected to generate a profit from that arrangement, he or she can only be considered to have a "reasonable expectation of a profit" if that promoter is deemed to be a reasonable person. Cleary, this is a subjective test and a more objective approach than the "reasonable person" test is required.

The next paragraph will explore the meaning of the term "expectation".

3.11 Expectation

The term "expectation" is the second part of the section 80M(1)(*d*) reasonable expectation of a pre-tax profit requirement to be examined. The ordinary meaning of the word "expectation" is as follows:

Expectation ·noun → a strong belief that something will happen or be the case.[18]

The word "expectation" is derived from the term "expect", which has an ordinary meaning defined as follows:

Expect ·verb → to require something as rightfully due or appropriate in the circumstances;[18] to think of something as likely to happen.[19]

The ordinary meaning of the word "expectation" is described as a strong belief that something is likely to happen and which is appropriate in the circumstances. This is in contrast with the term "assumption", which has the following ordinary meaning:

Assumption ·noun → a thing that is accepted as true or as certain to happen;[18] something that is accepted as true without proof.[19]

An assumption is therefore a certainty that something will happen (as was alluded to in the paragraph 3.6 discussion of "assume" earlier in this chapter), whereas an expectation is a belief that something is likely to happen. Consequently, expecting a pre-tax profit is not akin to being certain of generating a profit.

It will be seen in Chapter 4 that, as regards the Canadian REOP test, the existence of a reasonable expectation is not to be determined by the presence of subjective hopes or aspirations (no matter how genuine or deep-felt they may be), nor of an expectation that the taxpayer in good faith entertains the effect that a profit will eventually be realised. The expectation must be proven by objective factors. It is submitted that the same holds true for the South African "reasonable expectation of a pre-tax profit" requirement.

The term "expectation" is nowhere defined in the Act. Although not directly related to the objectives of this study, it might be appropriate to draw attention to the doctrine of legitimate expectation in administrative law. Quinot (2004:543) states that South African administrative law has protected individuals' legitimate expectations at least since the landmark case of *Administrator, Transvaal v. Traub (1989)*. It specifically requires an

administrator to adhere to the *audi alteram partem*[35] principle where the individual concerned has a legitimate expectation of a favourable decision or of a hearing before a decision is taken.

The principle at the root of the doctrine is the so-called Rule of Law, which requires regularity, predictability and certainty regarding the government's dealing with the public (Watkin 2009:18). An expectation could be based on an express promise, or representation or by established past action or settled conduct.[36]

Interestingly, this doctrine takes into account past action, whereas the reasonable expectation of a pre-tax profit requirement seems to require a consideration of future actions or events. At any rate, there is clearly a need for objective guidelines in determining the existence of a "reasonable expectation". To conclude the discussion of the section 80M(1)(*d*) requirement, the next paragraph will explore the meaning of the term "profit".

3.12 Profit

The term "profit" is the third part of the section 80M(1)(*d*) reasonable expectation of a pre-tax profit requirement to be examined. The ordinary meaning of the word "profit" is as follows:

> **Profit** ·noun → the net gain made in a commercial transaction or series of transactions;[18] an excess of income over expenses.[19]

The ordinary meaning of the word "profit" is deceptively plain. As will be seen from the following definition in the Act, profit is somewhat more difficult to determine. The term "pre-tax profit" is defined in section 80T so as to mean:

[35] This literally means to "hear the other side". It is most often used to refer to the principle that no person should be judged without a fair hearing in which each party is given the opportunity to respond to the evidence against them.

[36] This study will not contribute to the debate about the perceived need for substantive protection of legitimate expectations.

> *"the profit of a participant resulting from that arrangement before deducting any normal tax, which profit must be determined in accordance with Generally Accepted Accounting Practice after taking into account all costs and expenditure incurred by that participant in connection with the arrangement and after deducting any foreign taxes paid or payable by that participant."*

The reference to GAAP necessitates a closer look at the accounting definition of a profit. Thus, in order to determine the meaning of profit, the IAS definition applies. An accounting "profit or loss" is defined in paragraph 7 of *IAS 1, Presentation of Financial Statements* (IASB 2010a), as the total of income less expenses, excluding the components of other comprehensive income.

"Income" is defined in the *Framework* (IASB 2010b), paragraph 74, so as to encompass both revenue and gains. Revenue, which is also defined in paragraph 74, arises in the course of the ordinary activities of an entity and is referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent.

"Gains", as defined in paragraph 75, represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. The *Framework* includes examples such as gains arising from the disposal of non-current assets and also includes unrealised gains (resulting, for example, from increases in the carrying amount of long-term assets).

The accounting definition of "income" therefore differs from the tax treatment of income. "Income" is defined in section 1 of the Act so as to mean the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part 1 of Chapter II.

Gross income is also defined in section 1 of the Act as the total amount, in cash or otherwise, received by or accrued to or in favour of the taxpayer during the year of assessment, but excludes receipts or accruals of a capital nature. As a result, with the exception of amounts subject to capital gains tax in terms of the Eighth Schedule of the Act, it is only receipts or accruals of a non-capital nature that are included in taxable income. Amounts that are subject to capital gains tax, will also be included in taxable

income, but at an inclusion rate of 25% in the case of natural persons (or special trusts) and 50% in the case of legal entities. In the accounting definition, the full amount of the gain, *i.e.* the amount which is capital of nature, is included in "income".

It is not the purpose of this chapter to expound on the many court cases that distinguish between "income" and "capital" amounts. In *CIR v. Visser (1937)*, Maritz J summarised the distinction as follows [at paragraph 276]:

> *"If we take the economic meaning of "capital" and "income", the one excludes the other. "Income" is what "capital" produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in the hands of another."*

"Expenses" is defined in the *Framework* (IASB 2010b), paragraph 78, so as to encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity (for example, cost of sales, wages and depreciation).

"Losses", as defined in paragraph 79, represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. The *Framework* includes examples such as losses resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets.

"Other comprehensive income", in turn, is also defined in *IAS 1*, paragraph 7, and comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS provisions.[37]

[37] The components of other comprehensive income include: changes in revaluation surplus, actuarial gains and losses on defined benefit plans, gains and losses arising from translating the financial statements of a foreign operation, gains and losses from investments in equity instruments measured at fair value through other comprehensive income and the effective portion of gains and losses on hedging instruments in a cash flow hedge.

Thus, when determining the meaning of the term "pre-tax profit", effect must be given to the accounting treatment thereof. Briefly, a pre-tax profit is the total of income less expenses and excludes comprehensive income. Also, an accounting "income" takes the full amount of a capital gain into account, whereas a tax "income" excludes amounts of a capital nature.

In terms of section 80T, the pre-tax profit must be determined *before* deducting normal tax, but *after* taking into account costs and expenditure incurred in connection with the arrangement *and after* deducting foreign tax paid or payable. One could question whether it is not redundant for the definition to state that the costs of the arrangement must be deducted from the pre-tax profit, as presumably, these costs would already have been deducted as part of accounting expenses. Also questionable is the deduction of foreign taxes, as the section 80T definition is in respect of a *pre-tax* profit.

The next paragraph will address the meaning of the term "resulting from" as the section 80T definition of a "pre-tax profit" refers to the profit resulting from that arrangement.

3.13 Resulting From

Section 80T of the Act defines a pre-tax profit and refers to the profit of a participant resulting from that arrangement. The ordinary meaning of the word "result" is as follows:

> **Result** ·verb → to arise as a consequence, effect, or conclusion from some action;[18]
> ·noun → to end in a specified way.[19]

Thus, the word "result" refers to the end or outcome of an arrangement. It also refers to the effect of the arrangement, as evidenced by Lord Denning's statement in *Newton v. COT (1958)* [at paragraph 763] that the word "effect" means the end accomplished or achieved. Moreover, as was also stated in the *Newton* case, the effect of an arrangement must be determined objectively, irrespective of the motive of the parties.

It is thus necessary for an objective standard to determine whether or not a pre-tax profit has resulted from that arrangement. It is submitted, therefore, that in order to determine

whether section 80M(1)(*d*) is applicable, the result of an arrangement has to be a reasonable expectation of a pre-tax profit, which result must be objectively measured.

The next, and final paragraph, will briefly incorporate the few criteria for a "reasonable expectation" that have been identified by South African courts.

3.14 South African Criteria for a "Reasonable Expectation"

The term "reasonable expectation" (which is only one element of the "reasonable expectation of a pre-tax profit" concept) has been considered by our Courts a few times when determining whether or not an expense incurred in connection with immovable property let at a loss, is an allowable deduction in terms of section 11(*a*). The principle that expenses incurred in connection with rental losses do not qualify as a deduction unless there is a reasonable expectation of realising a rental profit is found in, amongst others, *ITC 561 (13 SATC 313), ITC 1292 (41 SATC 163)* and *ITC 1367 (45 SATC 39)*.

These court cases, however, only refer to the specific instances of rental losses and do not provide objective guidelines applicable to any other arrangement. Furthermore, the above-mentioned cases appeared before the Income Tax Court, which is not a court of law. It has no inherent jurisdiction (as is possessed by the Highest Court of Appeal) and is not bound by its own decisions (Clegg & Stretch 2010:par2.4.1). A decision of the Special Court is only binding on the parties to the specific case (Stiglingh, Koekemoer, van Schalkwyk, Wilcocks, de Swardt & Jordaan 2011:8). The term "reasonable expectation" is thus only addressed specifically in the context of rental losses and the judgments from these court cases are also not binding.

However, for the sake of completeness, the factors identified in the above court cases will be included in the model which will be discussed in Chapter 5. The model (as well as the table of objective factors identified in the Canadian REOP test in Chapter 4) will be submitted as part of the questionnaire for the survey which will be discussed in Chapter 6.

In *ITC 561 (13 SATC 313)* the court considered whether there was hope of profit being realised on the income from rent after taking into account the expenditure on the

repayment of the loan taken out to finance the purchase and other expenses. The court found [at page 131] that the prospects of earning a profit at the time of the purchase were non-existent but were not *per se* decisive. The taxpayer was expected to have made some inquiries as to the viability of the proposition.

In *ITC 1292 (41 SATC 163)* the court held that the intention to make a profit from farming activities must be a genuine intention. The court noted that because intention is always subjective it is difficult to determine if it is genuine or not; it could only be determined with regard to the objective facts. Furthermore, the person's *ipse dixit* cannot be decisive; if his activities are in no way reconcilable with his *ipse dixit* then his *ipse dixit* cannot be accepted. If, however, his *ipse dixit* is supported by objective facts, his intention is regarded as genuine.

The court laid down the following test [at page 165-166]:

> *"If the possibility to earn a profit is excluded by the evidence, as is the position in the present case, then such expenses are not deductible. The test is the* ***real hope*** *to make a profit. Such hope must* ***not be based on fanciful expectations but on reasonable possibility****."* [Own emphasis].

In *ITC 1367 (45 SATC 39)* the court concluded [at paragraph 47] that the fact that profits may be earned at some future date cannot influence the decision in relation to a particular year where no profits were made unless that possibility has been established to be a reasonable possibility. The court held that, although the taxpayer did not have a reasonable prospect of making a profit in each year, he did have a reasonable prospect of making a profit in the future.

In *CSARS v. Smith (2002)*, a case similar to the Canadian "hobby farm" cases (which are discussed in Chapter 5) appeared before the Supreme Court of Appeal. The issue was whether farming operations could be carried on as contemplated in section 26(1) of the Act in the absence of a reasonable prospect that profit will be derived from such operations. Hefer AJA held [at page 14-15]:

> *"Neither the words of our statute nor the context of section 26 provide a discernible reason for introducing a reasonable prospect of profit as a requirement independent of the taxpayer's genuine*

> *intention to make a profit. As far as the contention that such an objective element is necessary to facilitate the Commissioner's evaluation is concerned, it is commonplace in our law to refer to objective criteria in order to determine a subjective intention ... That is, however, no reason to elevate the objective facts above the subjective element...".*

Notably, the Court did not regard the objective criteria as elevated above the taxpayer's subjective intention.

These "rental loss" criteria unfortunately do not add any usable objective factors to assist in determining whether or not there is a "reasonable expectation of a pre-tax profit" in the context of any other arrangement. As such, the objective guidelines identified by Canadian courts and tax practitioners in the application of the Canadian REOP test are discussed in Chapter 4. It will be seen that, based on the REOP test, a reasonable expectation must be proven by objective factors, and not the taxpayer's subjective expectations.

3.15 Conclusion

Despite the fact that many of the terms in section 80M(1)(*d*) are defined in section 80T, some of these definitions are difficult to apply in practice. Other terms have not been defined at all. This chapter examined the meaning of the words in section 80M(1)(*d*) in order to determine the nature and scope of section 80M(1)(*d*) and to assist in applying the objective factors contained in the Canadian REOP test.

It was determined that the primary aim of statutory interpretation should be to ensure that the statute is in accordance with the aim and values of the Constitution. The Bill of Rights encourages the courts to consider international law and allows them to consider foreign law. Thus, the rules of interpretation determine that a statute may be viewed in the context of comparative and foreign law. Granted, foreign case law (and thus the Canadian REOP test) is not binding on our courts. But, provided the REOP test does not violate the principles and the jurisprudence of our common law, it may be of considerable assistance and of persuasive value in shedding light on how other legal systems (most notably Canada's) deal with the subjective interpretation of a "reasonable expectation of a pre-tax profit" concept.

Numerous submissions were made in an effort to clarify the meaning of section 80M(1)(*d*); many of which are included in the survey conducted among tax partners at a sample of audit and legal firms (see Chapter 6). The complete list of submissions and recommendations is contained in Annexure C.

Having examined the language of section 80M(1)(*d*), it is evident that the "reasonable expectation of a pre-tax profit" requirement is subjective and that a more objective approach is required. Chapter 4 will identify some objective guidelines by examining the Canadian REOP test.

CHAPTER 4

Examining the Reasonable Expectation of Profit (REOP) Test in Canada

"The reasonable expectation of profit
is an objective determination to be made from all the facts."

~ Moldowan v. The Queen (1977)

CHAPTER 4

Examining the REOP test in Canada

4.1 Introduction

The meaning of the words contained in section 80M(1)(*d*) was examined in Chapter 3 and was found to be subjective. This subjective interpretation could lead to much uncertainty in practice and the need for objective guidelines is clearly evident.

Chapter 2 noted that in the *Reportable Arrangements Guide* (SARS 2005), the international tax position is referred to regarding tax disclosure requirements. One of the countries that is specifically mentioned in this guide is Canada, as it has well developed reportable transaction legislation in the form of tax shelter rules.

As was stated in Chapter 1, Canada appears to be the only country that contains a similar requirement to South Africa's "reasonable expectation of a pre-tax profit" requirement as contained in section 80M(1)(*d*). Section 248(1) of the Canadian ITA prohibits the deduction of personal and living expenses and refers to a REOP test in determining whether or not an expense is for business or private purposes.[38] The test has been developed over 70 years of research and court cases and has led to the emergence of objective standards used by Canadian tax practitioners.

As was discussed under the rules of interpretation in Chapter 3, both the South African Act and the Canadian ITA contain a similar "reasonable expectation of profit" requirement. As such, the Canadian court cases (and the Canadian REOP test) are relevant when interpreting a section 80M(1)(*d*) reportable arrangement. Accordingly, it is submitted that

[38] In that sense, the purpose of the REOP test is perhaps more similar to the general deduction formula of section 11(*a*), read with section 23(*g*), of the Act, although the wording echoes that of section 80M(1)(*d*). The REOP test has a much wider application compared with section 80M(1)(*d*), as the latter only forms part of the reportable arrangements provisions, wheras the REOP test could apply in any scenario. One could therefore argue that, although there are contextual differences, the wider scope of the REOP test automatically encompasses arrangements falling within the narrower scope of the reportable arrangements provisions. As such, the REOP test may be of use in establishing whether the "reasonable expectation of a pre-tax profit" requirement is met.

South African courts may consider applying the Canadian REOP test to a section 80M(1)(*d*) reportable arrangement.

It is therefore the purpose of this chapter to compile a comprehensive list of objective factors to address the subjective nature of section 80M(1)(*d*). This will be done by analysing the Canadian REOP test. The legislative history of the REOP test and Canada's source of income rules will be examined. This chapter will also address various practical problems of the REOP test encountered by Canadian taxpayers.

4.2 Background

The Canadian income tax system is largely based on the "source of income" rule – a fundamental assumption that only gains and losses that flow from a source of income are to be taken into account to determine a taxpayer's income and resulting tax.

The *Interpretation Bulletin IT-334R2, Miscellaneous Receipts*, issued by the Canada Revenue Agency (CRA) states that in order for any activity or pursuit to be regarded as a source of income, there must be a REOP. Where such an expectation does not exist, neither amounts received nor expenses incurred are included in the income tax calculation (CRA 1992). A judicial doctrine is thus relied upon to identify a source of income by testing for a REOP.

Williamson and Chapman (2010:175) state that the REOP test was often used by the Canadian tax authorities to determine whether a business venture had a serious profit-making objective or whether it was an enterprise that, for one or more reasons, had less focus on profit-making and a greater focus on another objective.

The legislative history and development of the REOP test will be examined in the next paragraph in light of the fact that courts often refer to the legislative history of a statutory provision.

4.3 The Legislative History and Development of the REOP Test

The REOP test was developed as part of the "personal and living" expenses provisions of the Canadian tax laws. The first reference to personal and living expenses is found in Canada's first income tax legislation - the Income War Tax Act (IWTA). Paragraph 6(*f*) was introduced to the IWTA in 1927, thereby disallowing the deduction of personal or living expenses. The rationale for this prohibition is explained in the case of *Maurice Samson v. Minister of National Revenue (1943:64):*

> *"It is obvious that* ***the determination of what the taxable income of a taxpayer shall be cannot depend upon or be left to the taxpayer's own choice****."* [Own emphasis].

Two court cases were instrumental in the development of the REOP test. The first of these was the *Commissioner of Internal Revenue v. Field (1933:877-878)* where the US Circuit Court of Appeals determined that:

> *"if the right to deduct losses under the statute required that profit appear to the court to be possible, that requirement would be quite general and would be applicable to any enterprise, whether it was farming, manufacturing, or promotion of any character. We may not, in this way, foredoom any business venture."*

The same case made another important point [at paragraph 878]:

> "*...we think the respondent embarked in these enterprises with the expectation of making profits; at least he did so, with an* ***earnest and honest intention****."* [Own emphasis].

A few years later, the case of *Hatch v. MNR (1938:98)* found that a venture operated in good faith for profit constituted a business. It is clear from the above two cases that the courts considered the genuineness of the taxpayer's intention to generate a profit and not whether they had, realistically speaking, a reasonable expectation to do so (Steenkamp 2010:75).

The IWTA was amended in 1939 to add the requirement that the taxpayer had to have a good-faith intention to earn profits as well as a reasonable expectation of doing so. This amendment came in the form of the inclusion of the definition of "personal and living

expenses". Subparagraph 2(*r*)(i) was added which defined "personal and living expenses" so as to include:

> *"the expenses of properties maintained by any person for the use or benefit of any taxpayer or any person connected with him by blood relationship, marriage or adoption, and not maintained in connection with a business carried on bona fide for a profit and not maintained with a* ***reasonable expectation of profit****."* [Own emphasis].

Thus, the concept of a REOP test was first introduced to Canadian tax law in 1939 during the second reading of the IWTA Amendment Bill in the House of Commons (Canada House of Commons 1939). The Minister of National Revenue explained the introduction of the test as follows:

> *"The effect of this section is to make it impossible for taxpayers to deduct as a business expense…the expenses of properties…not maintained in connection with a business carried on bona fide for profit,* ***and not maintained with a reasonable expectation of profit****."* [Own emphasis].

The examples above include gentleman farming operations and private stables that are not carried on *bona fide* for profit and are not maintained with any reasonable expectation of profit. These operations are of such a nature that they sometimes incur heavy losses. But, as was noted in Steenkamp (2010:75), since there is no REOP, these losses are not deductible as they are considered to be personal expenses (*i.e.* not from a source of income).

In 1948 the IWTA was replaced by the ITA and the definition of "personal and living expenses" was reworded. This definition is now contained in section 248(1) of the ITA and reads:

> *"the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or adoption, and not maintained in connection with a business* ***carried on for profit or with a reasonable expectation of profit."*** [Own emphasis].

The new definition effected two distinct changes, namely the deletion of the words "*bona fide*" and the requirement to test for a REOP (the conjunction "and" changed to "or").

Prior to this change, the taxpayer had to demonstrate that he was conducting a business with a *bona fide* profit motive and that he had a reasonable expectation to generate a profit from that business.

Steenkamp (2010:76) states that the case of *McLaughlin Executor v. MNR (1952)* contained two compelling arguments as to why the change in wording was confusing. Firstly, the new either/or test makes the wording of "reasonable expectation" questionable, as presumably, the required profit motive would always be present where there was a REOP. Secondly, the deletion of *bona fide* was probably intended to make the test stricter so that an actual profit was required. However, the deletion rendered the first profit criterion redundant, since these situations are presumably covered by the second REOP criterion.

Fien (1995:1292) suggests that a REOP is an inherent ingredient of a business. He logically questions why the need exists to include the words "for profit" or "with a reasonable expectation of profit" in the definition of personal or living expenses.

As the REOP test must be applied in order to determine a "source of income", the next paragraph will address the evolvement of Canada's source rules.

4.4 The Evolvement of Canada's "Source of Income" Rules

The "source" concept was initially derived from the English taxation statutes (Arnold, Edgar & Li 1993:49). Section 3 of the IWTA defined "income" so as to include:

> *"the annual net profit from a trade or commercial or financial or other business… and also the annual profit or gain from any other source."*

Section 3(*a*) of the ITA defines the calculation of income for the year as an attempt to:

> *"determine the total of all amounts, each of which is the taxpayer's income for the year (other than a taxable capital gain from the disposition of a property) from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business and property".*

The ITA contains no other definition of "source" and thus common law principles are applied to define a source. In *Nathan v. Federal Commissioner of Taxation (1918:189)*, the word "source" was not viewed as a legal concept, but something which a practical man would regard as a real source of income. The Canadian courts have also referred to a source as an originating cause of receipts (*The Queen v. Kuhl et al 1974:6032)*. Traditionally, the courts have referred to a source as that which "bears the fruit of the tree" *(Front & Simcoe Ltd v. MNR 1960:1087).*

According to Hansen (1978:142), income, as stated in conformity with the source concept, is characterised by the following attributes:

- recurring on a periodic basis,
- proceeding from a productive source, and
- representing the creation of new wealth.

Fien (1995:1296) states that the concept of a business, as determined from early case law, was consistent with this notion of source and that it involves two components, namely

(a) the pursuit of profit (or, in other words, intention) and
(b) habitual activity (or, in other words, behaviour).

As the ITA refers to "business" in the income definition, it is necessary to ascertain what the meaning of "business" is. A "business" is defined in section 248(1) of the ITA, so as to include a profession, calling, trade, manufacture or undertaking of any kind whatsoever and an adventure or concern in the nature of trade. A business does not, however, include an office or employment.

Steenkamp (2010:77) regards the time the business was started as an important point to consider, as a taxpayer must carry on a business in the fiscal period during which the expense was incurred. To this end, the CRA issued the *Interpretation Bulletin IT-364, Commencement of Business Operations*, providing guidelines as to when a business is considered to have started (CRA 1977). Briefly, the guidelines are as follows:

- A business commences whenever some significant activity is undertaken that is a regular part of the income-earning process in that type of business or is an essential preliminary to normal operations;
- There must be a fairly specific concept of the type of activity to be carried on; and
- A sufficient organisational structure must be assembled to undertake at least the essential preliminaries.[39]

Until the 1970s, the existence of a source did not appear to be dependent on a REOP (Fien 1995:1296). The income tax cases that dealt with losses from farming activities (commonly referred to as the "hobby farm" cases) only started referring to the source issue in the early seventies.

One earlier case, *J.S. Stewart v. MNR (1964:5338),* which concerned the raising of dogs for use in a display advertising business, did suggest the REOP as a condition for the existence of a business. The court stated that the business had to be carried out in good faith with a reasonable expectation of generating a profit. Later, in *O. Dorfman v. MNR (1972:154),* the following judgment was made which confirmed this earlier decision:

> *"the words 'source of income' are used in the sense of a business, employment, or property from which a net profit might reasonably be expected to come".*

Duff (2004:399) explains that until the 1970s, Canadian courts affirmed a narrow approach to the application of tax legislation, according to which these statutes were interpreted in a strict and literal manner. Tax consequences were based on the legal character of transactions and arrangements irrespective of their commercial or economic substance and the absence of any non-tax purpose for their existence.

These judicially-established norms of literalism and formalism were highly conducive to tax avoidance (Sherbaniuk 1968:430) and account for much of the length and complexity of Canadian tax legislation. The legislation has been drafted and amended in order to

[39] This requirement is applicable whether the projected business is intended to be a continuing one or is to be a single transaction in the form of an adventure in the nature of trade.

anticipate and respond to restrictive interpretations by the courts and taxpayer efforts to avoid tax burdens that might otherwise apply (Bowman 1995:1183).

Steenkamp (2010:77) observes that in the 1970s, two Federal Court decisions came to different conclusions regarding the significance of the REOP concept. In *James v. MNR (1973:5341-5342),* the court determined that a REOP is:

> *"**one of the indicia** to be employed in determining whether or not a taxpayer in a given taxation year is in the business of farming. But the converse is not true, i.e., the fact that a taxpayer in a given taxation year of for years before and after, had or appeared to have **no reasonable expectation of profit is not proof in itself** that he was not in the business of farming if other indicia establish or prove that such a taxpayer was in fact in the business of farming".* [Own emphasis].

However, in *D.A. Holley v. MNR (1973),* the court stated [at paragraph 542]:

> *"An undertaking must be carried on for profit or with a reasonable expectation of profit for it to come within the generally held concept of the commercial. Profit or the **reasonable expectation of it is inseparable from the basics of business**."* [Own emphasis].

Thus, in the *James* court case, REOP was only one of the indicia to be employed in determining whether or not a taxpayer in a given taxation year was in the business of farming. Whereas, in the *D.A. Holley* court case, the court found that profit, or the reasonable expectation of it, was inseparable from the basics of business. In this instance, the court clearly did not accept that the REOP was only one of the indicia to be considered in each case (Steenkamp 2010:77). Fien (1995:299) suggests that the above cases might well have been the springboard to the CRA's adoption of a broadly-based REOP test.

These differing court decisions were followed by years of court cases where the emphasis of the REOP test continued to shift. Then, in 1977, the landmark Supreme Court case of *Moldowan v. The Queen (1977)* affirmed the status of the REOP test.

In this case, the taxpayer had a horse-racing activity (which was considered to be a business) as well as a farm that suffered losses. The court had to decide whether the taxpayer's farming was his chief source of income, in order for him to be permitted to fully deduct his losses. The Supreme Court stated [at paragraph 5215] that:

> *"Although originally disputed, it is now accepted that in* ***order to have a "source of income" the taxpayer must have a profit or a reasonable expectation of profit****. Source of income, thus, is an equivalent term to business."* [Own emphasis].

Dickson J concluded that a taxpayer's chief source of income is decidedly not a pure quantum measurement, but depends upon objectively determinable economic criteria such as the taxpayer's reasonable expectation of income from his various revenue sources and his ordinary mode and habit of work. The Tax Court of Canada (*Knight v. MNR 1993:1259*) confirmed the *Moldowan* findings, stating:

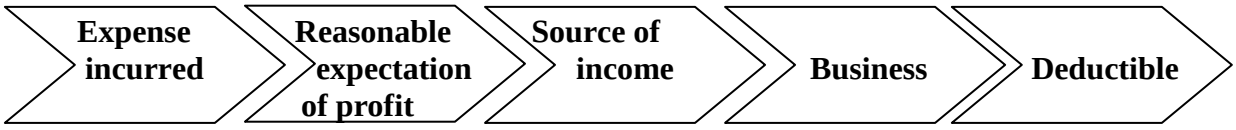
> "*To have a source of income, a taxpayer must have a profit or a reasonable expectation of profit.* ***Source of income, therefore, is an equivalent term to business****. If a taxpayer does not have a profit or a reasonable expectation of profit, then he does not have a source of income. And if he does not have a source of income, he does not have a business."* [Own emphasis].

Thus, it was affirmed that a "source of income" was an equivalent term to business. The carrying on of a business therefore presupposed a REOP. Steenkamp (2010:78) notes that the deductibility of a private or living expense remained unchanged when the IWTA was replaced by the ITA in 1948. The prohibition of a private or living expense is now contained in section 18(1)(*h*) of the ITA and reads as follows:

> *"In computing the income of a taxpayer from a business or property no deduction shall be made in respect of personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer's business."*

To summarise: in order for an incurred expense to be deductible, it must be a business expense (and not a private or living expense). In addition, for an activity to qualify as a business, there must be a source of income. In order to prove a source of income, the taxpayer must have a reasonable expectation of generating a profit from that activity. The deductibility of an expense is illustrated by Figure 4.1 (Steenkamp 2010:78):

Figure 4.1: The deductibility of an expense – the *Moldowan* approach



However, the REOP test is regarded by many Canadian taxpayers as an unjust test as it was the CRA's favoured weapon in rejecting money-losing ventures as legitimate tax deductions (Reasonable expectation of profit 2002). Fien (1995:1288) is of the opinion that there is little historical justification for the test as it can produce inconsistent and unjust results. The next paragraph will explore an alternative to the REOP test.

4.5 An Alternative Test

In the years after *Moldowan*, the CRA relied on the REOP test to disallow the deduction of losses on numerous occasions – mostly in cases involving a personal element in which the activity engaged in by the taxpayer could be characterised as a hobby or other personal endeavour, but also in other cases involving ostensibly commercial activities.

Due to the confusion and litigation caused by the REOP test, the need for an alternative test was soon realised (Steenkamp 2010:82). It seemed, in 2002, that the Supreme Court of Canada had "finally driven a stake through the heart of the REOP test" (*Tax & Trusts E-Newsletter* 2002:19).

In two landmark cases, *Stewart v. Canada (2002)* and *Walls v. Canada (2002)*, a simple two-stage approach was established to determine whether a taxpayer had a source of income:

1. Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
2. If it is not a personal endeavour, is the source of the income a business or property?

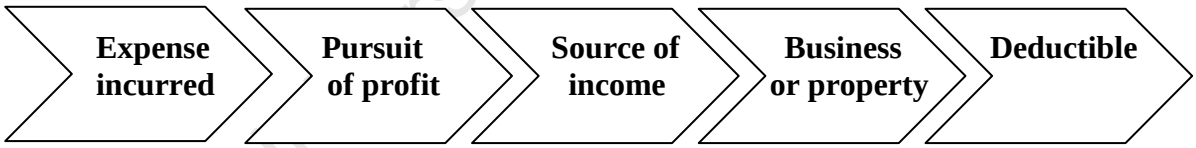
The facts of the *Stewart* case are, briefly, as follows: the taxpayer had purchased four condominium units as rental properties. All the units were highly leveraged. The developer's projections contemplated negative cash flows and tax deductions for ten years, with the prospect of a capital gain at the end. The taxpayer's interest expenses exceeded his rental income and the losses claimed consisted primarily of interest expenses.

The CRA disallowed these losses on the basis that the taxpayer had no REOP, and therefore no source of income. However, the Supreme Court of Canada allowed the deduction, based on the two-step approach cited above. It was found that the taxpayer had borrowed money to engage in a *bona fide* investment from which he had a reasonable expectation of income. The court considered the anticipated gain in assessing the commerciality of the venture. Consequently, the interest expense was deductible.

The court emphasised that the pursuit of profit analysis is only required where a personal or hobby element exists. Should this analysis be required, the REOP is one factor for consideration. However, REOP is not the only factor and it is by no means conclusive (*Tax & Trusts E-Newsletter* 2002:19).

To summarise: based on the *Stewart* approach, in order for an incurred expense to be deductible, it must be a business or property expense (and not a private or living expense). For an activity to qualify as a business, there must be a source of income. In order to prove a source of income, the taxpayer must prove that he had undertaken an activity in pursuit of profit. The deductibility of an expense is illustrated by Figure 4.2 (Steenkamp 2010:83):

Figure 4.2: The deductibility of an expense – the *Stewart* approach



As the Federal Court of Appeal suggested in the *Tonn et al v. The Queen (1996)* case, the REOP test does not contradict the common law definition of a business, but merely adds to the requirement of a subjective profit-making purpose an objective REOP requirement in order to assess this subjective purpose when other, more direct forms of evidence are lacking.

However, Steenkamp (2010:83) remarks that the pursuit-of-profit test in *Stewart* did not replace the REOP test and was certainly never included in Canadian legislation. As such, the REOP test has remained and still requires clarification.

Fien (1995:1310) submits that the appropriate test for the existence of a "source" ought not to be whether there is a REOP, but whether the taxpayer can establish that:

1. His predominant intention is to make a commercial profit in the activity, and
2. The activity is carried out in accordance with objective standards of business-like behaviour.

Fien's test recognises the importance of a taxpayer's intention, but also requires that the intention is substantiated by the taxpayer's conduct. In order to constitute a business, there must be a requisite amount of effort and commitment to further the activity's profit-making prospects (Fien 1995:1310).

A further benefit of this test is that it does not expose the CRA to any material risk. Fien (1995:1311) argues that the requirement of predominant intention to profit favours the CRA where there is an ambiguous motive, as the requirement of a commercial profit excludes expenditures incurred merely to effect a tax reduction.

The evidentiary burden on the taxpayer under this proposed test was confirmed by *Lorentz v. MNR (1985:132),* where it was stated that:

> *"[The taxpayer] must place evidence before the Court from which it can be objectively concluded that his conduct was that which could be expected of a reasonably prudent person becoming involved in a commercial undertaking designed to extract profit".*

Steenkamp (2010:83) is of the opinion that it is unfortunate that this test was never submitted to, or adopted by the courts, as it would have shifted the focus to the taxpayer's conduct and away from his business judgment. Certainly, it would have been far less subjective than the so-called "objective" REOP test.

Annexure D contains a summary of a number of important REOP principles that have evolved from post-*Moldowan* case law. Despite these established principles, there are numerous practical problems surrounding the application of these principles. The next paragraph will explore some of the flaws inherent to the REOP test.

4.6 Practical Problems in Applying the REOP Test

Steenkamp (2010:78) states that the REOP test was typically used by the CRA in hindsight to deny losses and expenses incurred in a large number of unprofitable, but *bona fide* commercial ventures. As the test is highly uncertain in its application to any given situation, it caused a high volume of tax litigation (*Tax & Trusts E-Newsletter* 2002:19).

In the *Moldowan* case, the Supreme Court stated [at paragraph 5215] that the REOP was an objective determination to be made from all the facts. Additionally, the Tax Court of Canada stated in *Kerr & Forbes v. MNR (1984:1095)* that:

> *"The existence of a reasonable expectation of profit is not to be determined by the presence of subjective hopes or aspirations, no matter how genuine or deep-felt they may be. The issue is to be decided by* ***objective testing****."* [Own emphasis].

Moreover, the Federal Court of Canada (*W. Chequer v. The Queen 1988:259)* confirmed the objective test by stating that:

> *"There exists a burden of proof on every taxpayer who claims a deduction of net losses resulting from a business adventure, to establish that there was, at the time he engaged in and carried on with the business, a reasonable expectation of profit. The* ***reasonableness of the expectation must be viewed objectively*** *and cannot merely consist of an expectation that the taxpayer in good faith entertains the effect that a profit will eventually be realised."* [Own emphasis].

It is clear, then, that the courts intended (at least since the *Moldowan* case) for the REOP test to be an objective one (Steenkamp 2010:78). In 1995, the CRA issued the *Interpretation Bulletin IT-504R2, Visual Artists and Writers,* to provide the criteria that the CRA considers relevant in determining whether artists and writers have a REOP (CRA 1995). It states that any undertaking or activity of a taxpayer that results in profits or has a reasonable prospect of profits would be viewed as the carrying on of a business.

In the bulletin, the CRA emphasises that the REOP test is an objective determination to be made from all the facts. It acknowledges that the relevant factors to be considered in making such a determination will differ according to the nature and extent of the activity or undertaking.

In *Kaye v. The Queen (1998)* Bowman J emphasised [at paragraphs 4 to 5] that one cannot view the reasonableness of the expectation of profit in isolation. He rightly stated that the question to be asked by the court should be:

> *"Would a reasonable person, looking at a particular activity and applying ordinary standards of commercial common sense, say 'yes, this is a business'?"*

In answering this question, Bowman J stated that the hypothetical reasonable person would look at such things as capitalisation, knowledge of the participant and time spent. One would also have to consider whether the person claiming to be in business has gone about it in an orderly, businesslike way and in the way that a business person would normally be expected to do.

The *Kaye* case affirmed that the REOP test boils down to a common sense appreciation of all of the factors, in which each is assigned its appropriate weight in the overall context. Bowman J acknowledged that, even though entrepreneurial vision and imagination should not be discounted, they are hard to evaluate at the outset. He concluded by stating [at paragraph 7]:

> *"Simply put, if you want to be treated as carrying on a business, you should act like a businessman."*

The CRA also acknowledges that it is possible that a taxpayer may not realise a profit during his lifetime but may still have a REOP. However, the bulletin emphasises that in order to have a REOP, the endeavours must be carried on in a manner such that, based on the criteria above, they may be considered for income tax purposes to be the carrying on of a business, rather than a hobby.

In *Nichol v. The Queen (1993)* Bowman J expressed his doubts as to the singular importance the CRA placed on the REOP concept. He stated [at paragraph 1218] that:

> *"[The taxpayer] made what might, in retrospect, be seen as an error in judgment but it was a matter of business judgment and it was not one so patently unreasonable as to entitle this Court or the Minister of National Revenue to substitute its or his judgment for it, or penalize him for having made a judgment call that, with the benefit of 20-20 hindsight, that Monday morning quarterbacks always have, I or the Minister of Revenue might not make today."*

Despite the fact that the CRA and courts have established objective factors for consideration, Steenkamp (2010:79) contends that the vague language of the REOP test left the door wide open for subjective and inconsistent interpretation. Some of these anomalies are explored in the following paragraphs.

4.6.1 Meaning of Profit

The first question to arise is what is meant by "profit". The REOP test is a common law concept that was developed by the courts. But, according to Fien (1995:1304), the Canadian common law has no regime of calculating income or profit. Thus, in applying the REOP test, accounting principles must be used in determining a profit (Steenkamp 2010:79).

Canada has its own set of GAAP that regulates its accounting rules and provisions. It should be noted that, according to the Canadian Institute of Chartered Accountants (CICA), the implementation process for the adoption of IFRS and IAS provisions is underway. Mandatory adoption of IFRS relating to accounting years beginning on or after 1 January 2011 applies to any Canadian company that qualifies as a publicly accountable enterprise[40] (CICA 2010). Private enterprises and not-for-profit organisations will be permitted to adopt IFRS, but are not yet required to do so.

Thus, in order to determine the meaning of profit, the IAS definition applies. As was previously discussed in Chapter 3, an accounting "profit" is defined in paragraph 7 of *IAS 1, Presentation of Financial Statements* (IASB 2010a), as the total of income less expenses, excluding the components of other comprehensive income. Chapter 3 elaborated on the elements "income", "expenses" and "comprehensive income".

[40] According to CICA's "20 Questions Directors and Audit Committees Should Ask about IFRS Conversions" (CICA 2010:3), a publicly accountable enterprise is defined as an entity, other than a not-for-profit organisation, or a government or other entity in the public sector that:

(i) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market; or

(ii) holds assets in a fiduciary capacity for a broad group of outsiders as one of its ordinary businesses.

A fairly recent Canadian Tax Court case further expounded on the meaning of "profit" for income tax purposes. In *BBM Canada v. Canada (Minister of National Revenue) (2008)* the court considered the meaning of the term "profit" in a variety of contexts. The court examined the ordinary commercial meaning of profit found in various dictionaries and concluded that these definitions did not make express reference to an activity related to commerce or business.

Section 9(1) of the ITA states that a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year. Although the term "profit" is not defined in the ITA, the court interpreted it in the *BBM Canada* case [at paragraph 24] to mean the difference between the receipts in a period and the expenditures laid out to earn those receipts. It further found that the commercial and accounting definition of "profit" concurred.

As was previously stated, income is based on the source rule. If no source can be identified, then an amount is excluded from the tax calculation. In addition, income (as defined by the ITA) does not include capital gains from the disposal of property. In other words, capital gains are not regarded to be derived from a source. Thus, the potential to generate capital gains does not create a source. A prospect of generating a profit other than an expectation of a capital gain must therefore exist (Steenkamp 2010:80).

Furthermore, the Supreme Court stated that the capacity for profit is to be determined after taking into account any capital allowances (*Moldowan v. The Queen 1977*). In the case of assets that are subject to accelerated write-off rates, the CRA deems it appropriate to amortise the cost of the asset under GAAP to determine whether an activity has a REOP (Fien 1995:1304).

In *The Queen v. Matthews (1974)*, the treatment of non-depreciating assets, such as farm land, is identified as follows [at paragraph 6197]:

> *"the conduct of a business whose profits are not expected to reimburse the capital cost of an asset that is not subject to waste or depreciation in the process of production nor to obsolescence by the passage of time or the development of technology does not violate ordinary commercial principles*

> *so as to lead to the conclusion that the business is not being carried on for profit or with a reasonable expectation of profit".*

Therefore, the business treatment of non-depreciating assets is also in accordance with ordinary commercial principles and should not adversely affect the determination of a REOP.

4.6.2 Commercial Profit

Fien (1995:1304) is of the opinion that recent (at that stage) Canadian case law has tilted in the direction of first identifying a commercial profit in order for there to be a source. According to this line of thinking, the prospect of tax savings is in itself not sufficient to qualify as a source. *Moloney v. The Queen (1992:6570)* confirmed this view by stating that in order for an activity to qualify as a business (and thus a source of income) it:

> *"must not only be one engaged in by the taxpayer with a reasonable expectation of profit, but that profit must be anticipated to flow from the activity itself rather than exclusively from the provisions of the taxing statute."*

Steenkamp (2010:80) therefore notes that not only must a taxpayer prove a REOP, their profit must also fulfil the "commercial" criterion in order for it to qualify as a source.

4.6.3 How Much Profit?

In formulating the REOP test, neither the courts nor the CRA has stated the amount of profit that will be deemed sufficient. When one considers the losses incurred during the past or the amount of capital or time invested in an activity, how much profit must be anticipated in order to pass the REOP test?

In *The Queen v. Matthews (1974:6197)*, the court suggested that the prospect of only a few revenue-generating years over a period even longer than a lifetime did not necessarily preclude the existence of a business. The court also pointed out that the term "reasonable expectation of profit" was not synonymous with the "expectation of a reasonable profit".

Also, in *Keeping v. The Queen (2001),* it was concluded that the taxpayer should be allowed a reasonable period of time to get the business established.

Thus, it is not the anticipated profit that must be reasonable, only the expectation thereof. This viewpoint further exacerbates the problem of determining the amount of profit. After all, how does one determine what a reasonable profit is for each specific activity or business venture? In *Kuhlmann et al. v. The Queen (1998),* the Court pointed out that for an expectation of profit to be reasonable, it has to be not "irrational, absurd and ridiculous".

Furthermore, is the taxpayer's expectation assessed on an objective basis, or will subjective expectations also be relevant? Even the CRA is ambiguous in its *Interpretation Bulletin IT-504R2, Visual Artists and Writers* (CRA 1995), acknowledging the fact that even though a taxpayer may not realise a profit during his lifetime, he still could have a reasonable expectation of profit.

Steenkamp (2010:80) disparagingly concludes that is evident that there is no clear answer to this dilemma.

4.6.4 Proportion of Profit to Risk

In high-risk, high-return industries, for example the mining industry, there is a slim chance of generating a very large profit (Steenkamp 2010:80). Obviously, these types of taxpayers face an uphill battle to prove a REOP at the outset of their ventures. It has been held in various Canadian court cases that the venture's ability to produce large revenues could justify the undertaking of large risks and losses (Fien 1995:1305).

As Steenkamp (2010:81) observes: once profits have been earned, it is easy, in hindsight, to prove that an activity was a business from the outset. Conversely, if a business failed to generate profits, it is difficult, in hindsight, to prove that the activity had any REOP. In the case of *Belec v. The Queen (1995:123),* it was stated quite succinctly that the CRA should not be able to say to a taxpayer:

"the fact that you lost money…proves that you did not have a reasonable expectation of profit, but as soon as you earn some money, it proves that you now have such an expectation".

Clearly, there is a need to objectively test for REOP in high-risk industries, while making allowance for the fact that it may take a number of years before a profit might reasonably be expected.

4.6.5 Financing

In the *Moldowan* case, one of the factors identified by the court to determine the REOP, was the capability of the venture, as capitalised, to show a profit after charging capital cost allowance (refer to paragraph 4.6.1). Steenkamp (2010:81) notes that the success of a business venture often depends on the manner in which the taxpayer has financed the business. For example, it may be highly geared, or there may be other external factors, such as market interest rates.

Fien (1995:1306) questions the extent to which a source for income tax purposes should depend on the debt-to-equity ratio. Or, phrased differently, why should a *bona fide* commercial venture as a source depend on whether the owner capitalises it with his own funds or with borrowed funds?

Another practical implication is the manner in which financing is structured, where each way has a dramatic effect on the entity's bottom line. Consider a partnership, for example. The revenue projections for the partnership will differ greatly if the partners finance themselves externally (and contribute capital to the partnership) as opposed to a situation where the partnership is financed internally. On what level should the REOP test be applied? Is it at the partnership level or at the partner level?

4.6.6 Annual Test

Although the REOP test is applied annually, it applies to the entire period that the taxpayer can reasonably be expected to carry on the business (Cannon & Silverman 2004:23). This raises the question of whether or not a cumulative profit has to be proven. A taxpayer could have a reasonable expectation of realising a cumulative profit in the year it

commences with the business, but may cease to have such an expectation in a subsequent year (Steenkamp 2010:81). Does this then imply that the taxpayer has failed the REOP test? After all, as the Court acknowledged in *Milewski v. The Queen (1999)*, the period to establish a business will vary with the circumstances and may well be lengthy.

Consider the following practical example (Cannon & Silverman 2004:24): a taxpayer acquires a business in year one and incurs substantial losses in years one to four. The taxpayer may reasonably expect the tide to turn and the business to become profitable in year five. However, if the expected hold period is not sufficiently long to allow prior year losses to be recouped, the taxpayer may not have a reasonable expectation of a cumulative profit in year five. Thus, he fails the REOP test and the CRA will disallow the deduction of his business losses.

A further implication of the annual test arises when a taxpayer considers disposing of or discontinuing a business (Cannon & Silverman 2004:24). The period during which the taxpayer is reasonably expected to carry on the business is used in the REOP test. If the taxpayer no longer expects to carry on the business, the relevant period for applying the test may be shortened accordingly (Steenkamp 2010:82). The Court pointed out, in *Nichol v. The Queen (1993)* that the start-up and discontinuance of a business are decisions in which neither the taxing authorities nor the court should intervene.

4.6.7 Subsidiaries

In Steenkamp (2010:82), the scenario where a business is carried on through various operating subsidiaries was considered. For example, the parent company owns four subsidiaries. One of the subsidiaries is operating at a loss, or to state it differently, without a reasonable expectation of generating a profit. The parent company allows the unprofitable subsidiary to carry on business as it supports the other subsidiaries' businesses. The other three subsidiaries are all earning profits. So, from a group perspective, the consolidated companies are profitable. But, at what level should the REOP test be applied?

Cannon and Silverman (2004:24) state that the REOP test is applied on an entity-by-entity basis. Thus, an unprofitable subsidiary may not be entitled to claim losses, despite the fact that it is a member of a profitable group.

4.7 Objective Factors to be Used in Applying the REOP Test

Table 4.1 below lists a number of objective factors identified and used by the Canadian courts in the application of the REOP test. The criteria was identified from various sources, including, *inter alia*, the *Moldowan* case, the CRA's *Interpretation Bulletin IT-504R2* and contributions by tax consultants in *Informative Tax* (2009:6-8). The table compiled in Steenkamp (2010:83) is used as a basis and is expounded on in this study.

Table 4.1: Checklist of objective factors for the REOP test

General factors	Detailed elements
Manner in which the activity is operated	✓ Activity operated in a business-like manner ✓ Activity held out to community as a business ✓ Activity operated in a manner similar to comparable profitable businesses ✓ Unsuccessful methods discontinued and new ones adopted ✓ Formal books and records maintained ✓ Separate bank account maintained ✓ Record keeping system can determine segment profits and relevant costs ✓ Detailed non-financial records maintained ✓ Operating methods changed to improve profitability ✓ Development plan formulated, followed and adjusted ✓ Scale of operations sufficient to be profitable ✓ Level of advertising or promotion undertaken
Expertise of the taxpayer or advisors	✓ Experience prior to the activity ✓ Profit potential determined prior to entry ✓ New or superior techniques developed ✓ Taxpayer belongs to business-related associations ✓ Membership in professional association ✓ Pre- and post-entry advice sought and followed ✓ Taxpayer's qualifications and education ✓ Recognition from public and peers ✓ Honours, awards and prizes received
History of income or loss	✓ Number of years activity has been in operation ✓ Average ratio of receipts to disbursements ✓ Average magnitude of losses ✓ Reasonable start-up period

	✓ Percentage of years with profits ✓ Trend of losses declining ✓ Trend of gross revenue ✓ Losses due to circumstances beyond the taxpayer's control
Time and effort expended	✓ Competent and well-trained manager employed ✓ Competent labour employed ✓ Average time spent on activity by taxpayer ✓ Taxpayer withdrew from another business and devotes most of his time to the activity ✓ Taxpayer did physical labour ✓ Time devoted to promoting and marketing the work
Financial status of taxpayer	✓ Taxpayer's average income before activity loss ✓ Extent of tax savings from net losses ✓ Average ratio of activity losses to other income ✓ Extent of other net assets of taxpayer ✓ Amount of capital invested in the operation
Success of taxpayer in other activities	✓ Extent of experience in similar successful business ✓ History of losses in similar activity ✓ The absence of planning and the failure to adjust
Amount of occasional profits	✓ Ratio of average profit to average loss ✓ Ratio of net losses to net assets ✓ Amount of largest profit earned ✓ The type of expenditures claimed ✓ Relevance of expenditures to the endeavours
Sale or discontinuance of activity	✓ Activity sold or discontinued due to no chance of profit ✓ Activity sold or discontinued for any reason
Expected appreciation of asset value	✓ Taxpayer expected property to appreciate in value as the major source of investment return

4.8 Conclusion

The Canadian income tax system is based on the "source of income" rule. The REOP test is a judicial doctrine that identifies a source of income and was developed as part of the "personal and living" expenses provisions of the Canadian tax laws. The definition of "personal and living" expenses refers to expenses incurred in connection with a business that is not maintained with a reasonable expectation of profit.

The source concept was subsequently analysed and was found to mean the originating cause of receipts. "Business" is a term defined in the ITA and it was concluded that the concept of business was consistent with the concept of source. It was noted that in earlier

case law, it did not appear that the REOP test was a condition precedent to the existence of a source.

The evolution of the interpretation of the REOP test was also briefly explored as part of the legislative history of the REOP test. There appears to be a lack of consensus regarding the significance of the REOP test, with some courts considering it to be only one of many indicia which determine a business. The landmark case of *Moldowan* affirmed the status of the test and held that in order to have a source of income, the taxpayer must have a REOP.

Due to the confusion and litigation caused by the REOP test, the need for an alternative test was soon realised. The *Stewart* case gave rise to a two-step approach in determining whether or not a taxpayer had a source of income. This alternative test was, however, never submitted to, or adopted by, the courts.

Despite the fact that the REOP test is referred to as an objective standard, the reality is that the terminology is subjective. Some of the anomalies encountered by Canadian taxpayers were explored; these included the meaning of profit, commercial profit, the amount of profit, the proportion of profit to risk, financing, the annual test and subsidiaries.

Lastly, a number of objective factors to be used in the application of the REOP test were listed. Chapter 5 will incorporate these objective factors into the development of a workable, usable model to assist South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement.

CHAPTER 5

Developing a Workable Model for the Identification and Application of a Section 80M(1)(*d*) Reportable Arrangement

"The flowchart aims to simplify decision making..."

~ SARS (2010:32)

CHAPTER 5

Developing a Workable Model for the Identification and Application of a Section 80M(1)(*d*) Reportable Arrangement

5.1 Introduction

The decision process in determining whether or not an arrangement is reportable in terms of section 80M(1)(*d*) is somewhat tricky, due to the fact that the terminology of section 80M(1)(*d*) (as was discussed in Chapter 3) is subjective and could lead to much uncertainty in practice.

In the *Reportable Arrangements Guide* (SARS 2005), a decision tree (or flowchart) is provided to assist the taxpayer in determining whether or not an arrangement is reportable. As was mentioned in Chapter 3, this flowchart is outdated as it still refers to the repealed section 76A requirements and does not take into account the new sections 80M to 80T of the Act.

In an attempt to provide greater clarity on the majority of the issues that are likely to arise in practice due to the "new" reportable arrangements provisions, SARS (2010:31) included an updated flowchart in its Draft Guide to enable taxpayers to determine when an arrangement should be disclosed to the Commissioner.

Despite SARS' well-meaning intention for the flowchart to simplify decision-making (SARS 2010:32), it is submitted that, due to the ambiguities contained in the wording of the Act as well as numerous anomalies in the Draft Guide model, this model is flawed and inappropriate for use by taxpayers.

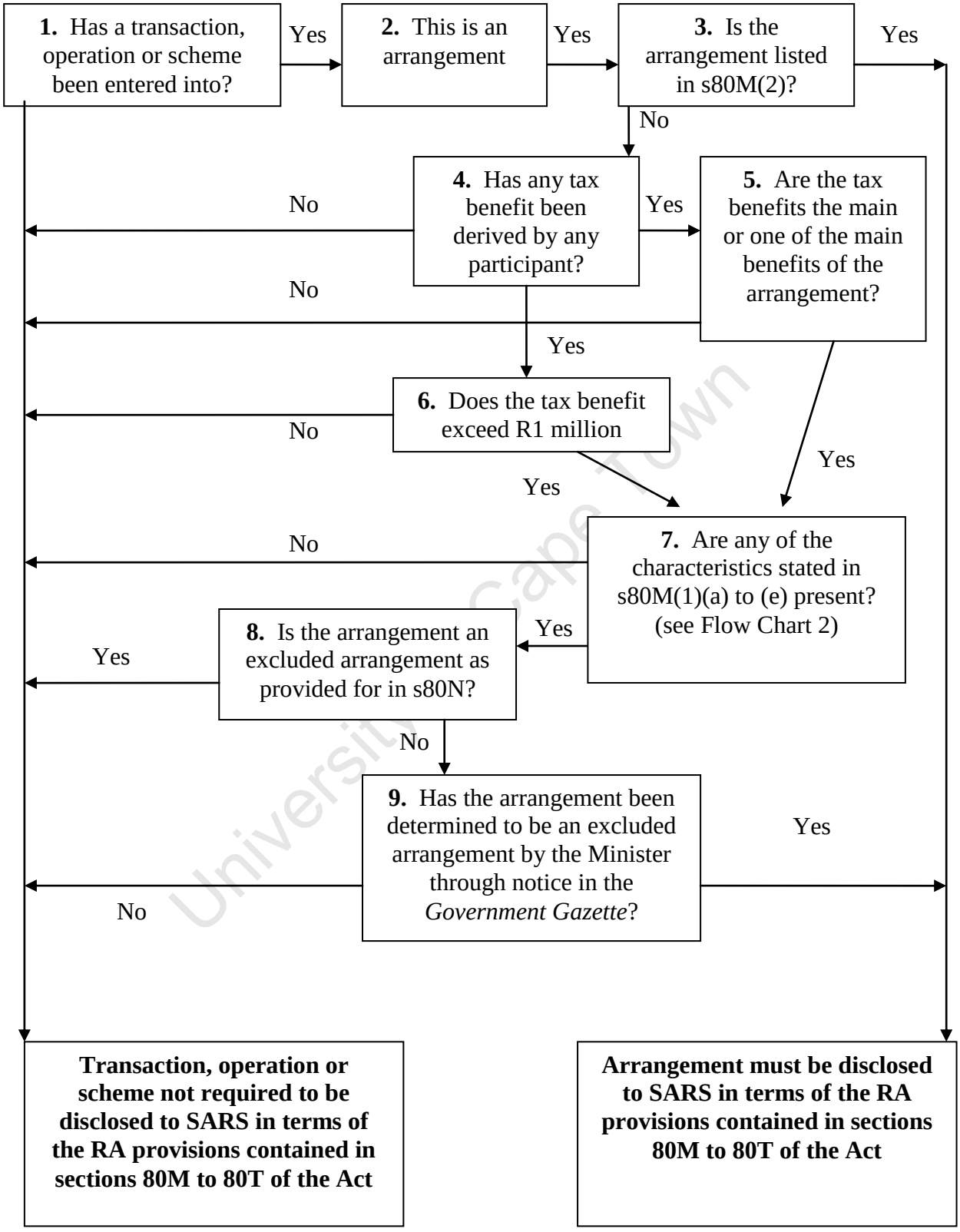
Thus, it is the purpose of this chapter to develop a workable, easily-understandable model to serve as a quick-reference, usable guide for South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement. The Draft Guide model will be used as a starting-point and will be critically examined to identify any errors or anomalies.

5.2 The SARS Draft Guide Model

The Draft Guide model (SARS 2010:31) consists of nine text boxes which are to be addressed in a specific order. It is submitted that the model is not user-friendly and is not arranged in the optimal order. Tax practitioners following this model may spend precious time answering certain questions that were unnecessary to address in the first place. As a result, taxpayers may be overcharged when attempting to comply with the reportable arrangements provisions.

Figure 5.1 (on the following page) is an exact copy of the Draft Guide model and all the wording was copied *verbatim*. For the sake of clarity, numbers were inserted in the text boxes, but the Draft Guide model is unaltered in all other respects.

Figure 5.1 The Draft Guide Model (SARS 2010:31)



**Note, that for the sake of clarity, the researcher has inserted numbers in the text boxes. The model is unaltered in all other respects. All the wording was copied verbatim.*

5.2.1 Text box 1 and 2: "Has a transaction, operation or scheme been entered into?"

An arrangement is defined in section 80T so as to include any transaction, operation or scheme. Question one is not problematic as the term is defined and adequately addressed in the Draft Guide. This is also the correct starting point for the decision tree, as there would be no potential reportable arrangement if no arrangement was entered into. If the answer to this question is "yes", the model states in the second text box "This is an arrangement". Text box 2 makes a statement and does not pose a question. Yet, the arrow flowing from text box 2 indicates "yes", despite the fact that no question was posed.

It is proposed that a better phrasing of text box 1 would be: "Has an arrangement been entered into?" The second text box should then be deleted.

5.2.2 Text box 3: "Is the arrangement listed in s80M(2)?"

The model indicates that if the arrangement is listed in section 80M(2), the arrangement should be disclosed. It is submitted that this depiction is incorrect. As previously stated, section 80N(4) (by way of the *Government Gazette*) excludes any arrangement where the tax benefit is not the main or one of the main benefits or where the tax benefit does not exceed R1 million. Thus, irrespective of which category an arrangement falls into, namely sections 80M(1) or (2), the section 80N(4) exclusions prevail.

However, the Draft Guide model does not allow for these exclusion provisions to apply to a section 80M(2) reportable arrangement. SAICA (2010a) is also of the view that the Act and the Draft Guide are potentially inconsistent and that this discrepancy should be addressed in greater detail.

It is proposed that this question be moved and addressed after text box 6 (refer to paragraph 5.2.3 below), *i.e.* after it has been determined whether or not a tax benefit was obtained and whether the section 80N(4) exclusions were applicable.

5.2.3 Text box 4: "Has any tax benefit been derived by any participant?"

If the answer to question three above is negative, question four addresses whether or not a tax benefit (as defined) was derived. Notwithstanding the problems surrounding the term "tax benefit" which were discussed earlier, it is furthermore submitted that the subsequent order of the questions in text boxes 4, 5 and 6 is incorrect. The reasons for this assertion are set out in paragraph 5.2.4 below.

5.2.4 Text box 5: "Are the tax benefits the main or one of the main benefits of the arrangement?" and text box 6: "Does the tax benefit exceed R1 million?"

Text boxes 5 and 6 are related to text box 4 and refer to the section 80N(4) exclusions already mentioned. If no tax benefit was derived, then the arrangement is not reportable – in this case the model at text box 4 is correct. However, if a tax benefit was derived, the arrows flowing from text box 4 to text boxes 5 and 6 both state "yes". It is unclear which question should be addressed first. Despite the fact that text boxes 5 and 6 must both be addressed, the current order is unclear and potentially misleading.

If the tax benefit is not the main or one of the main benefits (at text box 5), the model correctly indicates that the arrangement is not reportable. However, if the answer is "yes", the arrow flows directly from text box 5 to 7 and does not allow for the R1 million exclusion in text box 6 to apply. It is submitted that this treatment is incorrect as the notice in the *Government Gazette* allows for two exceptions: either the tax benefit is not the main benefit or the tax benefit is below R1 million.

It is proposed that text boxes 5 and 6 be combined in one question that is addressed after text box 4. Thus, if either of the Gazetted exclusions is applicable, the arrangement is not reportable. If neither of the exclusions applies, text box 7 should then be addressed.

Furthermore, text box 5 refers to "tax benefits". Although probably just a typing error, the plural use of the word "benefits" is incorrect, due to the fact that the *Government Gazette* uses the singular word "benefit" and also because "benefits" (plural) cannot be the "main benefit" (singular) of the arrangement.

5.2.5 Text box 7: "Are any of the characteristics stated in s80M(1)(*a*) to (*e*) present? (see Flow chart 2)"

The Draft Guide contains two flowcharts. The second flowchart (which is referred to in text box 7) and which appears in the Draft Guide (SARS 2010:32) seems to be aimed at further elucidating the first flowchart. However, and this view is supported by SAICA (2010a), these two models are substantively identical. It is proposed that the second model be deleted as it does not provide any additional guidance to the section 80M(1) reportable arrangements.

If any one of the five scenarios of section 80M(1) is applicable, the arrangement is potentially reportable and the model then correctly flows to text box 8. If none of the scenarios apply, the model correctly indicates that the arrangement is not reportable.

5.2.6 Text box 8: "Is the arrangement an excluded arrangement as provided for in s80N?"

As previously stated, section 80N(2) contains "stand-alone" requirements that must first be met in order for an arrangement to be excluded. Furthermore, section 80N(3) negates the exclusions if the main (or one of the main) benefits was to obtain or enhance a tax benefit.

It is submitted that the wording in text box 8 is incomplete. Text box 8 correctly indicates that if an arrangement is excluded, it is not reportable. However, the question in text box 8 refers to section 80N as a whole, but text box 9 again refers to the Gazetted exclusions of section 80N(4). The model thus duplicates the question in text box 8 by once again referring to section 80N in text box 9.

It is proposed that the wording of text box 8 should be more specific and refer to sections 80N(1), (2) and (3) and not to section 80N as a whole. The final text box then correctly refers to the section 80N(4) exclusions.

5.2.7 Text box 9: "Has the arrangement been determined to be an excluded arrangement by the Minister through notice in the *Government Gazette*?"

As discussed in paragraph 5.2.6 above, text boxes 8 and 9 should refer to the particular subsections of section 80N. It is proposed that the reference to section 80N(4) be inserted in this text box 9. It is submitted that there are two errors pertaining to the final question in text box 9. These are:

(a) The section 80N(4) exclusions in text box 9 are addressed earlier in the model by text boxes 5 and 6. The model thus repeats a question that has already been addressed.

(b) The "yes" and "no" answers to this last question have been transposed. The model incorrectly indicates that if the arrangement was excluded by the Minister, it must be disclosed as a reportable arrangement.

It is evident from the above analysis that the Draft Guide model contains numerous anomalies. It is therefore submitted that this model is flawed and inappropriate for use by taxpayers. An alternative model is presented in the remainder of the chapter. The next paragraph provides a checklist of factors that may be of use as part of the application of the model developed in this study.

5.3 Checklist of Objective Factors

This paragraph provides a table of the few objective factors used by South African courts as identified in Chapter 3 (see Table 5.1 on the following page). This, together with the comprehensive checklist of Canadian objective factors identified in Chapter 4 (see Table 4.1 on page 106), could assist taxpayers in determining whether or not they satisfy the "reasonable expectation of a pre-tax profit" requirement. These objective factors are to be used when the taxpayer considers question seven of the proposed model in paragraph 5.4. If the taxpayer can prove that there is a reasonable expectation of a pre-tax profit, the arrangement is not reportable. If, however, the taxpayer fails to meet this requirement (which is the last requirement in the model), the arrangement is reportable in terms of

section 80M(1)(*d*). The next paragraph will discuss the seven questions posed in the model.

Table 5.1: Checklist of South African criteria to determine a reasonable expectation of profit
Taxpayer must consider the viability of the proposition.
Taxpayer must have a genuine intention to earn a profit.
As the intention is always subjective, the taxpayer's *ipse dixit* is not decisive, but must be supported by objective facts.
Taxpayer must have a real hope to make a profit.
Such hope must not be based on fanciful expectations, but on reasonable probability.
Even though the taxpayer might not have a reasonable expectation in each year, he may have a reasonable prospect of making a profit in the future.

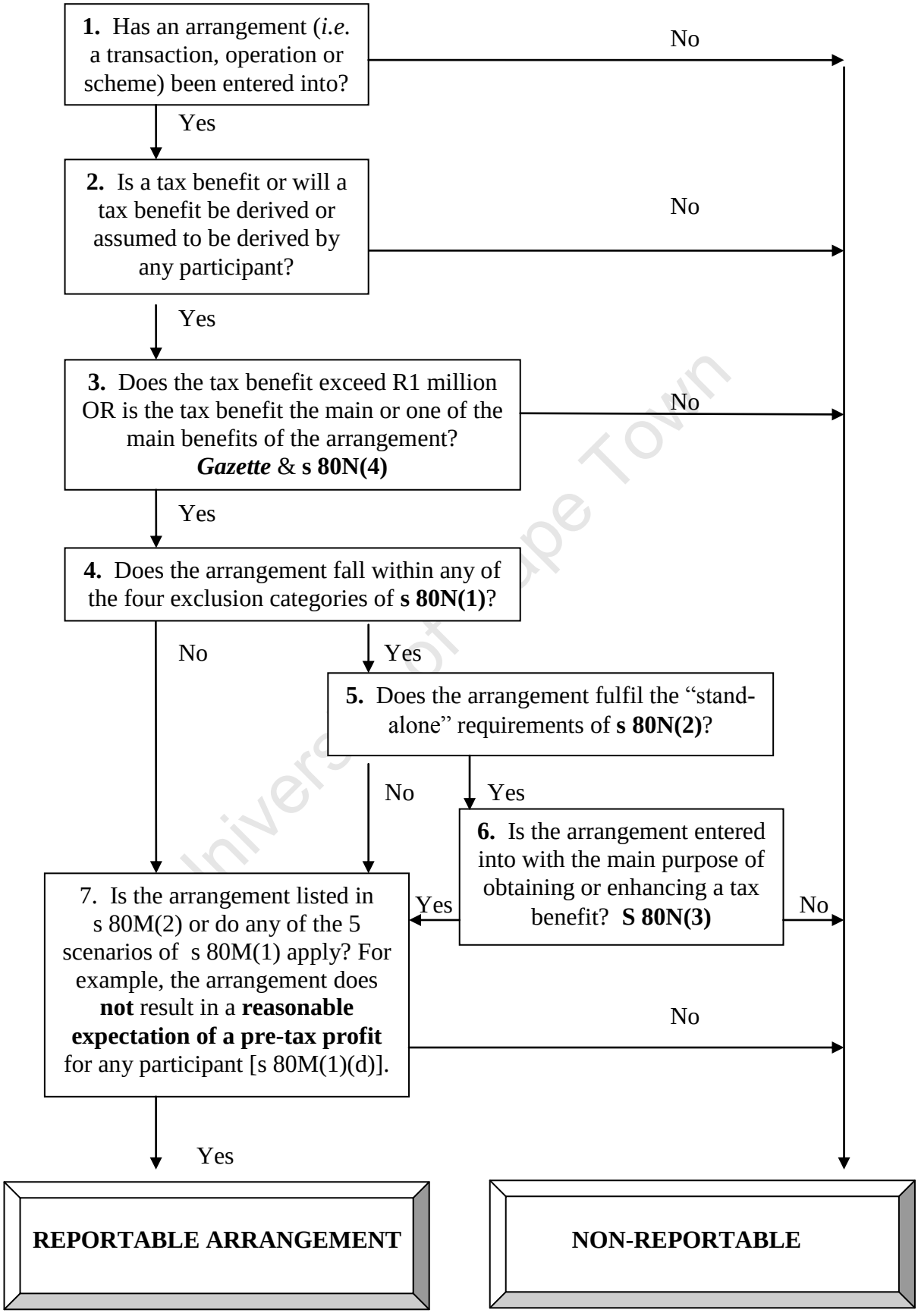
5.4 The Proposed Workable Model

The model developed in this study is adapted from the Draft Guide model. Note that the Draft Guide model is applicable to all five scenarios contained in section 80M(1)), and not just to section 80M(1)(*d*), which is the focal point of this study. This paragraph will not expound on the terminology contained in the proposed model, as the meaning of the words of section 80M(1)(*d*) was examined in Chapter 3.

Figure 5.2 (on the following page) contains the workable model and poses seven questions to be addressed in that particular order to determine whether or not an arrangement is reportable. Note that in question 7 of the model, any of the five scenarios of section 80M(1)(*a*) to (*e*) could be inserted and addressed at this stage. Due to the fact that this study specifically focuses on the "reasonable expectation of a pre-tax profit" criterion, section 80M(1)(*d*) was inserted as an example.

The model developed in this study is similar to the Draft Guide model, but the questions are presented in a revised order with the primary focus on the section 80N exclusions. It is submitted that the revised order (whereby the taxpayer first seeks to apply the exclusions) will result in less time wasted on addressing unnecessary questions where it is clear from the outset that the arrangement is non-reportable. Also, the Draft Guide model makes no reference to (nor provides any guidance on) the objective factors necessary to satisfy the "reasonable expectation of a pre-tax profit" requirement.

Figure 5.2 The workable model developed in this study



The "reasonable expectation of a pre-tax profit" requirement is addressed in the last question, as it is the most onerous, time-consuming (and therefore most expensive) question in the model to address. By leaving this question for last, the participant to the arrangement may qualify for an exclusion earlier in the model and the arrangement might already become non-reportable at that stage. There would therefore be no need then for the participant to determine whether or not section 80M(1)(*d*) is applicable.

The taxpayer could therefore be prevented from spending valuable time and money on obtaining costly tax advice to determine whether there is a "reasonable expectation of a pre-tax profit".

Question 1: Has an arrangement been entered into?

An arrangement is defined in section 80T so as to include any transaction, operation or scheme. If an arrangement was entered into, the next step is to determine whether or not a tax benefit was obtained. Obviously, if no arrangement was entered into, the arrangement is automatically non-reportable.

Question 2: Is a tax benefit or will a tax benefit be derived or assumed to be derived by any participant?

The section 80T definition of a "tax benefit" includes any avoidance, postponement or reduction of any liability for tax. If no tax benefit was obtained, the arrangement is already non-reportable at this stage. In the Draft Guide model, this question was only posed after it was determined whether or not the arrangement was listed in section 80M(2). By rearranging the questions in the proposed model, any arrangement may be excluded from being reportable if it complies with the exclusion provisions found in the following question.

Question 3: Does the tax benefit exceed R1 million or is the tax benefit the main or one of the main benefits of the arrangement?

The third question is posed earlier than in the case of the Draft Guide model. It is proposed that it is less time-consuming and thus more cost-effective to apply the exclusions at this point than later on.

Section 80N(4) (by way of the *Government Gazette*) excludes any arrangement where the tax benefit is not the main or one of the main benefits or where the tax benefit does not exceed R1 million. In the Draft Guide model the two exclusions are listed separately. It was proposed in paragraph 5.2.4 that the two questions be combined as the section 80N(4) exclusion contains an "either…or" requirement.

If the tax benefit does not exceed R1 million or the tax benefit is not the main or one of the main benefits of the arrangement, then the arrangement is non-reportable and there is no need to work through the rest of the model. If neither of the two section 80N(4) exclusions are applicable, question four must be addressed.

Question 4: Does the arrangement fall within any of the four exclusion categories of section 80N(1)?

Question four refers to the "plain-vanilla" transactions listed in section 80N(1) and is not to be confused with the Gazetted exclusions of section 80N(4) contained in question three. If none of the section 80N(1) exclusions apply, the transaction could be regarded as reportable (if the rest of section 80M(1)(*d*) is complied with). If, however, any of the section 80N(1) exclusions are applicable, the arrangement must still meet the requirements of sections 80N(2) and (3). These requirements are addressed by questions five and six respectively.

Question 5: Does the arrangement fulfil the stand-alone requirements of section 80N(2)?

Section 80N(2) contains "stand-alone" requirements that must first be met in order for an arrangement to be excluded. Furthermore, section 80N(3) negates the exclusions if the main (or one of the main) benefits was to obtain or enhance a tax benefit. If the arrangement is directly or indirectly dependent upon any other arrangement, the stand-alone requirement is not met and the arrangement is potentially reportable. If the arrangement complies with section 80N(2), question six must then be addressed.

Question 6: Is the arrangement entered into with the main purpose of obtaining or enhancing a tax benefit?

Section 80N(3) determines that the excluded list of section 80N(1) does not apply to any arrangement that is entered into with the main purpose of obtaining or enhancing a tax benefit. If the taxpayer can prove that the arrangement was not entered into with the main purpose of obtaining or enhancing a tax benefit, then that arrangement is non-reportable. Failing this, the arrangement is considered to be a reportable arrangement if question seven is answered in the positive.

Question 7: Is the arrangement listed in section 80M(2) or do any of the five scenarios of section 80M(1) apply?

Question 7 determines, for example, that an arrangement is reportable in terms of section 80M(1)(*d*) if the participant has no reasonable expectation of a pre-tax profit resulting from that arrangement. The list of objective factors referred to in paragraph 5.3 might be of value to assist taxpayers in objectively determining whether there is a reasonable expectation of a pre-tax profit.

If the participant does have a reasonable expectation, the arrangement is non-reportable. If, however, the "reasonable expectation of a pre-tax profit" requirement is not met, the answer to question 7 is "yes". The arrangement is then reportable and the disclosure obligation of section 80O must be complied with.

The disclosure requirements of a reportable arrangement are addressed in the next paragraph.

5.5 The Effect of Section 80M(1)(*d*)

The main effect or implication of an arrangement that is deemed to be reportable in terms of section 80M(1)(*d*), is the disclosure of certain information. Any participant to a section 80M(1)(*d*) reportable arrangement who fails to comply with the disclosure obligation shall be liable to a penalty of R1 million in terms of section 80S. It is therefore of the utmost importance that taxpayers and tax planners fully understand the precise meaning of the requirements of a section 80M(1)(*d*) reportable arrangement.

5.5.1 Disclosure Obligation

The disclosure requirements are contained in section 80O and are as follows:

> *" 1) The promoter must disclose such information in respect of a reportable arrangement as is contemplated in section 80P.*
>
> *2) If there is no promoter in relation to an arrangement or if the promoter is not a resident, all other participants must disclose the information contemplated in section 80P in respect of the reportable arrangement."*
>
> *3) A participant need not disclose the information in respect of a reportable arrangement if that participant obtains a written statement from—*
>
> *a) the promoter that the promoter has disclosed that reportable arrangement as required by this Part; or*
>
> *b) any other participant, if subsection (2) applies, that the other participant has disclosed that reportable arrangement as required by this Part.*
>
> *4) The reportable arrangement must be disclosed within 60 days after any amount is first received by or accrued to any participant or is first paid or actually incurred by any participant in terms of the arrangement.*
>
> *5) The Commissioner may grant extension for disclosure for a further 60 days, if reasonable grounds exist for that extension."*

Thus, the rather onerous burden of reporting and disclosing the necessary arrangement falls on the promoter. In the absence of there being a promoter, all the other participants have the obligation to disclose the arrangement to SARS. SARS (2010:27) concedes that this may seem onerous, but simultaneously states that an escape clause is included in section 80O(3), which provides that a participant is relieved of the disclosure obligation, if such participant obtains a written statement (from either the promoter or any other participant) that the promoter or other participant has disclosed the arrangement to SARS as required.

The information that must be disclosed is stipulated in section 80P. The promoter or participant, as the case may be, must submit, in relation to the reportable arrangement, in the form and manner (including electronically) and at such place as may be prescribed by the Commissioner —

- a detailed description of all its steps and key features;
- a detailed description of the assumed tax benefits for all participants, including, but not limited to, tax deductions and deferred income;
- the names, registration numbers and registered addresses of all participants;
- a list of all its agreements; and
- any financial model that embodies its projected tax treatment.

SARS (2010:27) notes that the initial disclosure requirement applies only to a list of the agreements to be submitted, therefore alleviating the administrative burden on participants compared to the repealed section 76A, which required all agreements to be submitted at an early stage.

The duties of the Commissioner are set out in section 80Q:

> *"1) The Commissioner must, after receipt of the information contemplated in section 80P, issue a reportable arrangement reference number to each participant.*
> *2) The issuing of a reportable arrangement reference number is for administrative purposes only."*

The disclosure obligation is further widened by the requirements of section 80R in terms of which the Commissioner may request certain information. These requirements are:

> *"1) The Commissioner may, in relation to any arrangement, require a participant or any other person to furnish such information (whether orally or in writing), documents or things as the Commissioner may require.*
>
> *2) The information, documents or things must be submitted to the Commissioner in such form and manner (including electronically) and at such place as may be prescribed by the Commissioner."*

In the Response Document released by SARS (2006b:17), BASA commented on the disclosure obligation as follows:

> *"A reportable arrangement must be reported within 60 days of inception. However, at that time, the parties will not necessarily know if one or more of them will be disclosing the arrangement as a liability for accounting purposes. It may only be on finalisation of the audit that the accounting disclosure is finally determined."*

This study agrees with the comment made by BASA. SARS, however rejected the comment, noting that ordinary ongoing transactions are generally well catered for by GAAP. With respect to more exotic arrangements, it is SARS' experience that both the accounting treatment and tax benefits of these arrangements are considered when they are conceived.

Moreover, for the purposes of these provisions, SARS (2010:27) does not require that the financial model be specially prepared for purposes of meeting the disclosure requirements. However, SARS may request such information at any time, particularly for more complex arrangements and in circumstances where it is apparent that a model was in fact prepared. A participant not having a readily available financial model should indicate the reason for this when the initial submission is made in terms of the RA-01 form.[41]

Failure to comply with the disclosure requirements can lead to a substantial penalty imposed by the Commissioner. The next paragraph will discuss the wording of the penalty clause.

[41] The RA-01 form is to be completed when reporting reportable arrangements.

5.5.2 Penalty

The penalty clause is found in section 80S and is determined as follows:

> *"1) Any participant who fails to disclose the information in respect of a reportable arrangement as required by section 80O or section 80R shall be liable to a penalty of R1 million.*
> *2) The Commissioner may reduce the penalty contemplated in subsection (1), if—*
> *a) there are extenuating circumstances and the participant remedies the non-disclosure within a reasonable time; or*
> *b) if the penalty is disproportionate to the assumed tax benefit."*

The penalty is a fixed amount imposed upon any person who fails to disclose. It is submitted that this penalty is not determined by an objective standard. SAICA (2007b) suggests that the penalty be based on a percentage, for example 10%, of the potential tax benefits and limited to a maximum of R1 million. The Commissioner should then be given the discretion to reduce the penalty due to extenuating circumstances. SARS (2010:29) notes that as a safeguard for taxpayers, SARS' discretion to reduce the penalty is subject to objection and appeal. The penalty does, however, carry interest.

Furthermore, if there are several promoters to an arrangement, all of them may be subject to the penalty, as section 80S(1) imposes the penalty on "any participant". However, SARS (2010:28) is of the opinion that this is counterbalanced by the fact that any promoter incurring a penalty may raise extenuating circumstances to request its reduction.

The wording of section 80S(2)(*a*) is unclear as to what exactly is meant by a "reasonable time". Is the time period calculated from the date the transaction was entered into or from the time SARS indicates that the transaction is a reportable arrangement? If the first option is applicable, and SARS only challenges the transaction a few years later, it could be argued that the taxpayer did not remedy the non-disclosure within a reasonable time and SARS could not then exercise its discretion of reducing the penalty (however extenuating the circumstances might be). Obviously, the best option (from the taxpayer's point of view) is whereby the period is calculated from the time the agreement is deemed to be reportable.

SARS (2010:29) states that it will notify a taxpayer in writing that the penalty has been raised. Scenarios that will trigger the penalty are instances where –

- the arrangement has been disclosed to SARS but the disclosure is deficient in a material respect;
- the arrangement has not been disclosed to SARS in circumstances where SARS has valid reasons to believe that the arrangement should have been disclosed in terms of the reportable arrangement provisions; and
- additional information is requested but not supplied.

This penalty may increase significantly should the TAB be promulgated. The TAB contains a revised penalty clause in section 212, which reads as follows:

> *"(1) A 'participant' who fails to disclose the information in respect of a reportable arrangement as required by section 37 is liable to a 'penalty', for each month that the failure continues (up to 12 months), in the amount of—*
> *(a) R50 000, in the case of a 'participant' other than the 'promoter'; or*
> *(b) R100 000, in the case of the 'promoter'.*
> *(2) The amount of 'penalty' determined under subsection (1) is doubled if the amount of anticipated 'tax benefit' for the 'participant' by reason of the arrangement (within the meaning of section 35) exceeds R5 000 000, and is tripled if the benefit exceeds R10 000 000."*

The TAB penalty is thus also a fixed amount. Note that the penalty is levied on a monthly basis (up to a 12 month period). The total proposed penalty could therefore be as high as R600 000 per year in the case of a participant not reporting the transaction or a penalty of up to R1.2 million if the promoter does not report the transaction. Moreover, these penalties may *double* if the tax benefit exceeds R5 million or *triple* if the tax benefit exceeds R10 million.

In the Draft Explanatory Memorandum on the Draft Tax Administration Bill, SARS (2009:16) states that these penalties essentially target non-compliance with an obligation under a tax act that does not include elements of tax evasion (since tax evasion is addressed under the additional tax provisions). According to this Explanatory Memorandum, the administrative penalty of R1 million (under section 80S of the Act) has been changed to

"ensure that the amount of the penalty is imposed on a more proportionate basis". Also, remittance remedies available to other administrative penalties are now available to this penalty.[42]

Whilst it is beyond the scope of this study to expound on these remittance remedies, it should be pointed out that they do not contain the requirements included in section 80S(2), *viz.* if the participant remedies the non-disclosure within a reasonable time or if the penalty is disproportionate to the assumed tax benefit. Instead, SARS may remit the penalty if it is the first incidence of non-compliance or if the non-compliance is nominal. Also, SARS may remit the penalty if non-compliance was due to exceptional circumstances (for example, due to serious illness).

Therefore, although the remittance remedies of the TAB provide more clarity than those of section 80S(2), it is submitted that the imposition of the proposed penalty is still not determined by an objective standard and is thus not an improvement on the penalty clause of section 80S(1). Actually, the proposed penalty is potentially stricter than section 80S (especially is the tax benefit exceeds R10 million). One could perhaps argue that if the penalties were more reasonable (such as the percentage based method suggested earlier), SARS would be able to act on it more, thus enhancing the effectiveness of the reportable arrangements provisions.

The effect of an arrangement that is reportable in terms of section 80M(1)(*d*) is therefore twofold: firstly, the arrangement must be disclosed to SARS within 60 days after the arrangement has been entered into. Secondly, if the participant fails to meet the disclosure obligation, it could result in a R1 million penalty.

The application of section 80M(1)(*d*) to an arrangement could have numerous practical implications. Some of these practical considerations are addressed in the next paragraph.

[42] The procedure to request remittance of the penalty is set out in section 215 of the TAB. The remedies available to the taxpayer are contained in sections 216 to 220 of the TAB and include, amongst others, the right to object or appeal against the imposition of the penalty or SARS' refusal to remit the penalty.

5.6 Practical Considerations

The problematic wording and rather complicated application of section 80M(1)(*d*) give rise to a number of practical implications. These implications include the determination of a pre-tax profit by applying the reasonable expectation of profit test and the inclusion of routine transactions.

(a) Pre-tax profit

If a company sells items as a loss leader, it has an overall profit motive, but for a particular transaction there might not be a reasonable expectation of a pre-tax profit. Assume that a company purchases a million units of product X at R100 per unit and sells it at R70 per unit.

The R70 selling price is included in gross income, being a non-capital cash amount that was received by the company. The R100 cost price of product X is deductible in terms of section 11(*a*). Thus, the loss of R30 per unit effectively decreases the taxable income. This, in turn, leads to a decrease in the tax owed to SARS. A tax benefit (as defined in section 80T) includes the reduction of a liability for tax. This transaction has therefore resulted in a tax benefit of R8.4m, *viz.* one million units multiplied by the R30 loss per unit multiplied by the company's tax rate of 28%.

The tax benefit exceeds the R1 million threshold provided for in the Gazetted exclusions and if the company fails to prove that the tax benefit was not the main benefit of the transaction, neither of the section 80N(4) exclusions are available. Furthermore, due to the fact that the company has no reasonable expectation of a pre-tax profit from this particular transaction, the purchase and sale are both reportable in terms of section 80M(1)(*d*).

Another questions to arise, is how much profit is considered to be enough? What if the company had sold product X for R110 or R150 per unit? As was the case with the Canadian REOP test discussed in Chapter 5, no clear answer is evident.

(b) Routine transactions

Due to the wide definition of a tax benefit, many routine transactions could become reportable in terms of section 80M(1)(*d*) if none of the exclusions in terms of section 80N are available. An example is an asset which is sold at a loss.

When an asset is sold below market value (*i.e.* its tax value exceeds the proceeds from the transaction), the asset is sold at a loss. This means that the seller has no reasonable expectation of a pre-tax profit. Furthermore, if the seller is entitled to a scrapping allowance in terms of section 11(*o*), the taxable income decreases. This, in turn, leads to a decrease in the tax owed to SARS, or, to state it differently: a tax benefit has arisen. Moreover, due to the fact that the company has no reasonable expectation of a pre-tax profit from this particular transaction, the sale is reportable in terms of section 80M(1)(*d*).

Although SARS has stated that it is not the intention to include routine transactions in the reportable arrangements provisions (refer to Chapter 3), a strict interpretation of section 80M(1)(*d*) has this cumbersome effect. It is therefore recommended that these examples of routine, day-to-day transactions must also be specifically excluded as part of section 80N.

5.7 Conclusion

In an attempt to provide greater clarity on the majority of the issues that are likely to arise in practice due to the "new" reportable arrangements provisions, SARS released a Draft Guide to replace the previous, outdated guide. However, due to numerous anomalies in the Draft Guide, it was submitted that SARS' model is flawed and inappropriate for use by taxpayers. This chapter therefore proposed an alternative, workable model to serve as a quick-reference, usable guide.

The workable model consists of seven questions that must be answered in a specific order. It was submitted that the revised order, whereby the taxpayer first seeks to apply the exclusions and lastly to satisfy the "reasonable expectation of a pre-tax profit" criteria, would be less time-consuming and thus more cost-effective because unnecessary questions

would not be addressed where it was clear from the outset that the arrangement was non-reportable.

The main effect of a section 80M(1)(*d*) reportable arrangement is the disclosure of certain information within 60 days after its inception. The disclosure obligation of section 80O was examined. Failure to comply with the disclosure requirement can lead to a R1 million penalty in terms of section 80S. It was submitted that the determination of the penalty was not objective and it was proposed that the penalty be based on a percentage of the tax benefit. Also, the meaning of the phrase "reasonable period" was found to be unclear. The penalty provisions contained in the TAB were also examined and were found to be potentially stricter that the section 80S penalty. Some practical implications of section 80M(1)(*d*) were considered and it was submitted that these ordinary, routine transactions should also be specifically excluded as part of the section 80N exclusions.

Having developed the workable model, it was necessary to test its accuracy, completeness and ease-of-use. This was done by means of a survey in which tax partners at a sample of leading audit and legal firms completed a questionnaire which incorporated the proposed model and compared it with SARS' Draft Guide model. Chapter 6 will discuss the sampling methodology, the questions contained in the questionnaire as well as the results of the survey.

CHAPTER 6

The Empirical Study

"The self-administered questionnaire is ubiquitous in modern living."

~ Cooper & Schindler (2011:250)

CHAPTER 6

The Empirical Study

6.1 Introduction

It was noted in Chapter 5 that the decision process in determining whether or not an arrangement is reportable in terms of section 80M(1)(*d*) is somewhat tricky, due to the fact that the terminology of section 80M(1)(*d*) (as was discussed in Chapter 3) is subjective and could create considerable uncertainty in practice.

In an attempt to address the subjective nature of the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(*d*), a workable model was developed in Chapter 5. It is therefore the purpose of Chapter 6 to determine whether the workable model is a usable guide for South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement.

The completeness, accuracy and relevance of the model as well as the objective factors identified in the literature study to address the "reasonable expectation of a pre-tax profit" requirement, will be tested by a self-administered questionnaire to be completed by tax partners at selected audit and legal firms. This chapter will examine and interpret the results of the survey.

6.2 Background

The model developed in this study poses seven questions in order to determine whether or not an arrangement is reportable in terms of section 80M(1)(*d*). Although this model is based on the Draft Guide model proposed by SARS (2010), the questions are presented in a revised order with the primary focus on the section 80N exclusions. Also, the Draft Guide model makes no reference to (nor provides any guidance on) the objective factors necessary to satisfy the "reasonable expectation of a pre-tax profit" requirement.

It was submitted in the previous chapter that the revised order, whereby the taxpayer first seeks to apply the exclusions and lastly to satisfy the "reasonable expectation of a pre-tax

profit" criteria, would be less time-consuming and thus more cost-effective because unnecessary questions would not be addressed where it was clear from the outset that the arrangement was non-reportable.

Chapter 3 examined the language of section 80M(1)(*d*) in order to determine the meaning of the words contained therein. Due to the subjective nature and somewhat vague language of the provision, a number of research submissions were made (see Annexure C). Many of these research findings will also be tested as part of the survey, as the proposed model contains all of the problematic terminology discussed in Chapter 3. As such, the questionnaire will include many of these research submissions in order to ensure that the model is indeed accurate, complete and usable. The next paragraph will describe the research orientation followed in the survey.

6.3 Research Orientation

This study is qualitative by nature and specifically adopts an interpretive approach, which seeks to develop understanding through detailed description and to develop theory or build models which can be tested empirically in later research (Cooper & Schindler 2011:162).

Although the research is mainly qualitative in its approach, it also has a positivist underpinning, as it is based on the broad premise that an ideal norm or standard exists against which to identify and apply the requirements of a section 80M(1)(*d*) reportable arrangement (Stiglingh 2008:19). The study does not merely seek to understand, but to develop a model based on an ideal standard.[43]

6.4 The Unit of Analysis and the Population

The unit of analysis and the population consist of highly qualified professionals who are experts in the field of tax.

[43] Thanks is extended to Prof. Martin Kidd, director of Stellenbosch University's Centre for Statistical Consultation, for his assistance in the design of the questionnaire, the selection of the most appropriate sample methodology and his guidance in the statistical analysis of the results.

Venter and Stiglingh (2006) conducted a survey to obtain empirical evidence to clarify uncertainties surrounding the timing of the recognition of a liability for STC and the timing of the recognition of an asset for unused STC credits. Questionnaires were distributed to accounting lecturers teaching students at the post-graduate level at South African universities, the partners specialising in technical accounting matters and the leading tax partners at the eight largest audit firms in South Africa. The purpose of the questionnaire was to test the conclusions reached in the literature study against the opinions of accounting and tax specialists in South Africa (Venter & Stiglingh 2006:113).

A similar methodology is adopted in this study, but with the following differences in the approach:

(a) Accounting Lecturers and Partners Specialising in Technical Accounting Matters

In Venter and Stiglingh's survey (2006:113), the accounting lecturers and the partners specialising in technical accounting matters were chosen as they were actively involved with accounting standards on a day-to-day basis and were expected to have in-depth knowledge of the accounting requirements of *IAS 12 Income Taxes* (which interacts with the STC requirements of the Act). However, in this study, the focus is on a purely taxation topic, *viz.* section 80M(1)(*d*). Although the accounting definitions of "liability" and "profit" were examined in Chapter 3 and are included in the questionnaire, an in-depth accounting knowledge is not necessary to understand these basic accounting definitions.

The accounting and tax syllabi followed by South African universities who offer courses to students wanting to qualify as chartered accountants (CAs) are based on the "List of Examinable Pronouncements" updated and issued by SAICA each year. In Venter and Stiglingh's study in 2006, *IAS 12* and STC were prescribed accounting and tax topics respectively and accounting lecturers could therefore be expected to have an in-depth knowledge of these topics.

The reportable arrangements provisions, however, are excluded from the list of examinable taxation pronouncements for SAICA's Qualifying Examination Part I in January 2011 (SAICA 2010b:3) as well as in 2012 (SAICA 2011:13). This tax topic therefore does not

have to be presented at universities and taxation lecturers are thus not required to have an in-depth knowledge of the workings of section 80M(1)(*d*). Furthermore, one would not expect partners specialising in technical accounting matters to have an in-depth knowledge of specialised taxation provisions.

It is therefore considered unnecessary to include university lecturers and accounting partners in the sample for this study, as it probably will not result in an increase in the quality of answers received in the questionnaire.

(b) Tax Partners at Leading Audit and Legal Firms

As was the case in Venter and Stiglingh's study, tax partners are also included in this study, as they are indeed expected to be actively involved with taxation legislation and should have in-depth knowledge of compliance with the reportable arrangements provisions. Tax partners at audit, as well as legal, firms were included in the survey.

Another reason why this study targets tax partners at audit firms especially, is because all qualified accountants entering public practice (*i.e.* those who become registered auditors), are required to register with the Independent Regulatory Board for Auditors (IRBA) and are governed by its regulations (IRBA 2011:iv). These audit firms are therefore subject to the requirements stipulated by IRBA.[44]

IRBA's Code of Professional Conduct requires a registered auditor to comply with a number of fundamental principles. Section 100.5(c) contains the fundamental principle of Professional Competence and Due Care (IRBA 2011:4-19), which is described as follows:

> *"to* ***maintain professional knowledge and skill*** *at the level required to ensure that a client receives competent professional services* ***based on current developments in practice, legislation*** *and techniques and act diligently and in accordance with applicable technical and professional standards."* [Own emphasis].

[44] The Board is the statutory body controlling that part of the accountancy profession involved with public practice in South Africa. The Board functions in terms of the Auditing Profession Act No. 26 of 2005 (IRBA 2011:iv).

Auditors are therefore required to maintain their professional knowledge and skills, based on current developments in taxation legislation and practices.[45] Venter and Stiglingh's sample included seven tax partners, but the sample in this study includes 40 tax partners. The basis for the selection of the sample is explained in the next paragraph.

6.5 The Sample

6.5.1 Non-probability Sampling

This study will make use of non-probability sampling, and more specifically, judgement sampling. Judgement sampling is one of the two types of purposive sampling (the other type being quota sampling). According to Cooper and Schindler (2011:385), judgement sampling occurs when a researcher selects sample members to conform to some criterion.

It was submitted that the wording in section 80M(1)(*d*) is ambiguous and difficult to interpret. It was also noted that one of the ways to qualify for the non-disclosure of an arrangement is whereby the tax benefit does not exceed R1 million (section 80N(4)). One would expect larger companies to fall within the ambit of the reportable arrangements provisions more often, as they are more likely to frequently conclude transactions whereby the tax benefit exceeds R1 million.

One could therefore argue that the persons best able to address the statements in the questionnaire, are those tax professionals who are actively involved in complex, technical tax matters and who are involved in providing tax advice for larger companies. Moreover, tax partners or directors are frequently individuals who have obtained advanced tertiary qualifications and who have many years of practical experience in complicated tax issues. They are therefore best suited to provide commentary on the subjective interpretation of tax provisions.

[45] The Council of the Law Society of South Africa (LSSA) has approved mandatory Continuing Professional Development (CPD) for attorneys at its meeting on 29 November 2010 (LSSA 2011). The proposal and implementation plan indicate that this mandatory CPD will apply to all practising attorneys, subject to certain exemptions that may be granted in exceptional cases. Although the proposals are not yet effective, it stands to reason that legal firms, especially the leading firms which are included in this survey, also require their attorneys to maintain the requisite level of professional knowledge and skills.

Based on the above arguments, the criteria for the selection of the sample are

- Tax partners or tax directors at
- Leading audit and legal firms.

Due to the fact that probability sampling is based on the concept of random selection, proponents of probability sampling could argue that non-probability sampling is arbitrary and subjective, as, with the latter, one chooses the sample with a certain pattern in mind. Although a random sample will give a true cross section of the population, this is not the objective of the present research. The objective is to test the accuracy, completeness and usability of the proposed model, as well as some of the research submissions made in this study.

As will be seen from the next paragraph, the sample selected includes all of the audit firms who audit companies listed on the Johannesburg Stock Exchange (JSE) as well as the ten largest audit firms globally. The sample also includes the ten largest South African legal firms. Non-probability sampling, specifically judgement sampling, is therefore considered to be both appropriate and adequate for this present study. This is also in line with the methodology followed by Venter and Stiglingh, wherein the eight largest audit firms were identified.

6.5.2 Audit Firms Selected for the Sample

This study comprises a sample of 30 audit firms. These firms were selected on the following bases:

- A listing of the top ten audit firms in the world, based on the most recent available fee income figures (for 2009 and in US Dollar), was obtained from *World Accounting Intelligence* (2011). Following a number of extensive Internet searches, no listing of the top ten South African audit firms could be obtained. However, all of the top ten global firms have offices in South Africa. The so-called "Big Four" audit firms are naturally included in this list. Table 6.1 indicates the global top-ten listing of audit firms as well as the names of the South African branches.

Table 6.1: Global top-ten ranking of audit firms		
Global ranking	**Organisation name: Global**	**Organisation name: South Africa**
1	PricewaterhouseCoopers	PricewaterhouseCoopers
2	Deloitte	Deloitte and Touche Inc
3	Ernst & Young Global	Ernst & Young Inc
4	KPMG International	KPMG
5	BDO International	BDO South Africa
6	RSM International	RSM Betty & Dickson
7	Grant Thornton International	Grant Thornton South Africa
8	Baker Tilly International	Baker Tilly Morrison Murray
9	Crowe Horwath International	*Horwath Zeller Karro (Cape Town) *Horwath Leveton Boner (Johannesburg)
10	Nexia International	Nexia Southern Africa

- A list of JSE accredited auditors was obtained from the JSE website. According to the JSE's Listing Requirements (JSE 2011a:3-12), an applicant issuer may only appoint as its auditor and reporting accountant an audit firm, individual auditor and reporting accountant who is accredited as such on the JSE list of Auditors and their advisors. The list contains 29 IRBA registered audit firms as well as five foreign registered firms. This study only includes South African audit firms registered in terms of IRBA. Table 6.2 (on the following page) indicates the 29 accredited auditors, in alphabetical order, in the most recently issued list of the JSE (at the time when the survey was conducted during June and July 2011), which is effective from 28 February 2011 (JSE 2011b).

- There are a number of duplications in Table 6.1 and Table 6.2. Also, where an audit firm has more than one branch in South Africa, only the firm itself will be included in the sample (*i.e.* the individual branches will not be included separately). This is the case for "Nolands Jhb Inc" and "Nolands (Cape Town)", entries number 21 and 22 of Table 6.2, and Horwath Leveton Boner and Horwarth Zeller Karro, entry number nine in Table 6.1.

Table 6.2: The JSE list of accredited auditors (alphabetical order)	
Number	**Organisation name**
1	ACT Audit Solutions Inc
2	AM Smith & Co
3	BDO Spencer
4	Certified Master Auditors (South Africa) Inc
5	Charles Orbach
6	Deloitte & Touche Inc
7	Ernst & Young Inc
8	Grant Thornton
9	Greenwoods Chartered Accountants
10	Horwath Leveton Boner
11	IAPA
12	KPMG
13	LDP Inc
14	Logista International Incorporated
15	Mahdi Meyer
16	Mazars
17	Middel & Partners
18	Moore Stephens
19	Ngubane Zeelie Incorporated
20	Nkonki Inc
21	Nolands Jhb Inc
22	Nolands (Cape Town)
23	PKF South Africa
24	PricewaterhouseCoopers
25	RSM Betty & Dickson
26	SAB&T Chartered Accountants
27	SizweNtsaluba VSP
28	TAG Incorporated
29	Tuffias Sandberg KSI

- The final sample of audit firms is therefore a combination of the global top-ten audit firms and the JSE list of accredited auditors, after the above-mentioned duplicate entries were removed. Table 6.3 (on the following page) contains the list of the 30 audit firms, in alphabetical order, that are included in the sample.

Table 6.3: The sample of audit firms (alphabetical order)	
Number	**Organisation name**
1	ACT Audit Solutions Inc
2	AM Smith & Co
3	Baker Tilly Morrison Murray
4	BDO Spencer
5	Certified Master Auditors (South Africa) Inc
6	Charles Orbach
7	Deloitte & Touche Inc
8	Ernst & Young Inc
9	Grant Thornton
10	Greenwoods Chartered Accountants
11	Horwath Leveton Boner
12	IAPA
13	KPMG
14	LDP Inc
15	Logista International Inc
16	Mahdi Meyer
17	Mazars
18	Middel & Partners
19	Moore Stephens
20	Nexia Southern Africa
21	Ngubane Zeelie Incorporated
22	Nkonki Inc
23	Nolands
24	PKF South Africa
25	PricewaterhouseCoopers
26	RSM Betty & Dickson
27	SAB&T Chartered Accountants
28	SizweNtsaluba VSP
29	TAG Incorporated
30	Tuffias Sandberg KSI

6.5.3 Legal Firms Selected for the Sample

This study also comprises a sample of ten legal firms. These firms were selected on the following basis:

- A listing of the ten largest legal firms in South Africa, based on the most recent available number of attorneys in their employ (at the time when the survey was conducted during June and July 2011), was obtained from Internet searches.[46] Table 6.4 indicates the top-ten listing of legal firms of South Africa (in alphabetical order).

[46] Wikipedia (2011) combined the information of major South African legal firms by using data from their websites to compile a listing of the rankings.

Table 6.4: Top-ten ranking of legal firms in South Africa (alphabetical order)	
Number	**Organisation name**
1	Adams & Adams
2	Bell Dewar
3	Bowman Gilfillan
4	Cliffe Dekker Hofmeyer
5	Edward Nathan Sonnenbergs
6	Eversheds
7	Norton Rose South Africa
8	Shepstone & Wylie
9	Webber Wentzel
10	Werksmans

6.6 Results of the Empirical Study

The tax partners of the audit and legal firms in South Africa were identified either from information contained on the websites of the firms or by means of a telephone call to the firms to obtain the names and e-mail addresses of the relevant parties. Where a firm did not have a specialist tax partner or department, the questionnaire was sent to the contact partner with a request to forward it to the most appropriate (senior) individual in the firm.

The partners were initially contacted by a telephone call to determine their willingness to participate in the survey; those that could not be reached telephonically, were contacted via e-mail. The questionnaires were distributed to the parties by e-mail. Respondents returned the completed questionnaires via e-mail or fax (directly to the researcher).

6.6.1 Background to the Questionnaire

Another document, e-mailed in conjunction with the questionnaire, was included to present a general background on the topic. Due to the fact that the questionnaire included questions on SARS' Draft Guide model, an exact copy of the Draft Guide model was included in the background document, as well as the link to the original document on SARS' website.

The first part of the questionnaire (Part A) consisted of general questions about the profile of the respondent. The second part (Part B) contained 12 questions relating to the

terminology in sections 80M to 80T. The third part (Part C) consisted of 18 questions which analysed the Draft Guide model and compared it with the workable model proposed in this study. The proposed model was referred to as the "Alternative Model" in the questionnaire.

6.6.2 Profile of Respondents

The profile of the respondents was as follows:

Table 6.5 Profile of respondents

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Tax director	25	80	41
Tax partner	17	20	18
Tax manager	25	0	18
Other	33	0	23
Total	**100**	**100**	**100**

- 59% of the respondents are partners or directors at their firms, while 18% are tax managers. Where the tax partner was unable (for example due to time constraints) to complete the questionnaire, it was requested that the questionnaire be forwarded to an appropriate senior staff member. Senior staff members who did not hold office as tax partner, director or manager, but who had practical experience with the reportable arrangements provisions, were grouped together in the category "Other"; examples include the position of audit partner (where firms did not have a designated tax department), tax administrator and consulting counsel;
- 29% of the respondents have less than ten years experience in South African tax legislation, 24% have between ten and 15 years experience and 47% have more than 15 years experience; and
- 53% of the respondents considered their knowledge of the reportable arrangements provisions as "good", 29% considered it to be "fair", while 18% considered their knowledge to be "poor".

6.6.3 Response Rate

In total, 40 questionnaires were distributed – 30 to audit firms and ten to legal firms. The response rate in both categories is set out in Table 6.6 below.

Table 6.6 Response rate

	Actual number of responses	Response rate %
Audit firms	12	40
Legal firms	5	50
Total responses	**17**	**43**

Questionnaires that were not completed by the deadline were followed up with additional e-mails and/or telephone calls. Although one would usually prefer a higher response rate in empirical studies of this nature, it is not the intention of this study to acquire results that give a true cross section of the population (refer to the earlier discussion of judgement sampling in 6.5.1).

Instead, this study relies on the quality of feedback received from the respondents; the majority (71%) of respondents have at least ten years of experience in South African tax legislation, while 82% considered their knowledge of the reportable arrangements provisions as good to fair (see 6.6.2 above). In light of the expertise of the respondents, it can therefore be assumed that their responses are of great value and add credibility to the results. The response rate of 43% is accordingly considered to be adequate.

6.6.4 Statistical Summary of Results

The tables below set out the results on the responses received to the questionnaire.

Question 1: *According to International Accounting Standards (IAS), an "anticipated" liability (as interpreted by the tax courts) is not a liability to be recognised in the financial statements, but, at most, a contingent liability to be disclosed.* Do you agree with this statement?

Table 6.7 Results of Question 1

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	50	20	41
Agree	42	40	41
Neutral	0	20	6
Disagree	8	20	12
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The results of the questionnaire confirmed the conclusion drawn from the literature study (see 3.5.1), namely that, in terms of IAS, an "anticipated" liability – as interpreted by the tax courts – is not a liability to be recognised in the financial statements. A high percentage (82%) of the respondents agreed or totally agreed that an "anticipated" liability is, at most, a contingent liability to be disclosed in the financial statements.

Question 2: *Based on the recognition criteria of IAS 37, the distinguishing factor between an "existing" liability and an "anticipated" liability, is the requirement of an entity having a "present obligation".* Do you agree with this statement?

Table 6.8 Results of Question 2

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	42	20	35
Agree	42	40	41
Neutral	0	20	6
Disagree	16	20	18
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The majority of the respondents (76%) agreed with the statement made earlier in the literature study (see 3.5.1), *i.e.* that the distinguishing factor between an "existing" liability and an "anticipated" liability is the requirement of an entity having a "present obligation".

Question 3: *Which one of the following two criteria do you consider to be the most appropriate for determining whether a "liability for tax" was avoided, postponed or reduced?*

Table 6.9 Results of Question 3

	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
The accounting criteria of the IASB *Framework* and *IAS 37*	8	0	6
The interpretation followed by the tax courts and SARS	67	100	76
Both (they are equally appropriate)	25	0	18
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The results obtained for Question 1 and 2 seem to indicate support for the submission made in Chapter 3, namely that the accounting and ordinary, grammatical meaning of a "liability for tax" differs from the meaning attached to it by the courts, *i.e.* that an "anticipated" liability is, by accounting principles, not a liability, but a contingent liability.

However, the majority of respondents (76%) selected the criteria of the tax courts and SARS' interpretation to be the most appropriate for determining whether a "liability for tax" was avoided, postponed or reduced. Surprisingly, 18% of the respondents indicated that both the accounting criteria of the IASB *Framework* and *IAS 37* as well as the interpretation followed by the tax courts and SARS, are appropriate. It is interesting to note that of the 18% respondents who selected both criteria, l00% were audit firms.

This could suggest that, given the audit environment and perhaps more frequent exposure to accounting-related matters (compared to legal firms), the seemingly opposing accounting and tax criteria could cause a conflict in judgment. This, in turn, could result in an arrangement not correctly identified as a reportable arrangement.

Question 4: *Even though the Minister has excluded arrangements where the tax benefit does not exceed R1 million, some taxpayers could easily exceed this cut-off amount with just a few routine transactions.* Do you agree with this statement?

Table 6.10 Results of Question 4			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	34	40	35
Agree	50	40	47
Neutral	8	0	6
Disagree	8	20	12
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A high percentage (82%) of the respondents agreed or totally agreed with the conclusions drawn from the literature study (see 3.5.4) that even though the Minister has excluded arrangements where the tax benefit does not exceed R1 million, some taxpayers could easily exceed this cut-off amount with just a few transactions.

Question 5: *If none of the section 80N exclusions are applicable, the term "any" in the definition of a "tax benefit" is too wide and results in the cumbersome effect of ordinary, routine transactions becoming reportable.* Do you agree with this statement?

Table 6.11 Results of Question 5			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	17	0	12
Agree	58	80	64
Neutral	17	0	12
Disagree	8	20	12
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The results of the questionnaire confirmed the conclusion drawn from the literature study (see 3.5.4), namely that the term "any" in the definition of a "tax benefit" is too wide. The majority of respondents (76%) agreed or totally agreed that if none of the section 80N exclusions are applicable, the definition of a "tax benefit" results in the cumbersome effect of ordinary, routine transactions becoming reportable.

Question 6: *The list of "plain-vanilla" transactions in section 80N(1) should be extended to include other routine, operating transactions which do not give rise to an undue tax benefit, such as the acquisition of any asset, trading stock, consumables and services on credit.* Do you agree with this statement?

Table 6.12 Results of Question 6

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	17	0	12
Agree	75	100	82
Neutral	8	0	6
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

An overwhelming majority (94%) of respondents agreed or totally agreed that the list of "plain-vanilla" transactions in section 80N(1) should be extended to include other routine, operating transactions which do not give rise to an undue tax benefit. The results obtained from the empirical study confirm the research proposals made in the literature study (see 3.5.4), namely that the section 80N(1) list of exclusions should be extended to also include, for example, the acquisition of any asset, trading stock, consumables and services on credit.

Question 7: *The meaning of the requirement "undue tax benefit" in section 80N(4) is unclear, as neither the Act nor SARS provides clarity on how the "undue" amount should be determined and by whom.* Do you agree with this statement?

Table 6.13 Results of Question 7

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	42	60	47
Agree	42	40	41
Neutral	8	0	6
Disagree	8	0	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The results of the questionnaire confirmed the conclusion drawn from the literature study (see 3.9.3), namely that the meaning of the requirement "undue tax benefit" in section 80N(4) is unclear. The vast majority of respondents (88%) agreed or totally agreed that as neither the Act nor SARS provides clarity on how the "undue" amount should be determined and by whom, the meaning of the requirement is unclear.

Question 8: *The introductory requirement of section 80M(1) states, inter alia, that an arrangement is reportable if any tax benefit is "assumed to be derived by any participant". Who do you consider must assume that a tax benefit is or will be derived?*

Table 6.14 Results of Question 8

	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
The Commissioner of SARS	17	40	24
Any participant to the arrangement	75	60	70
Question not answered by respondent	8	0	6
Total	**100**	**100**	**100**

The majority of respondents (70%) believe that the onus to assume that a tax benefit is or will be derived rests on any participant to the arrangement. Only 24% of respondents agreed with the results obtained from the literature study (see 3.6), namely that the onus to assume that a tax benefit is or will be derived, lies upon the Commissioner of SARS. The inconsistent results might indicate an uncertainty as to who must bear the onus of making an assumption that a tax benefit is or will be derived. The results therefore appear to contradict the statement made by SARS (2010:9), *i.e.* that there "is little room for debate as to what is meant by 'assumed'".

Question 9: *Not all parties to a transaction are always given insight to the financial model contained in the arrangement and it is therefore possible that a participant may not be aware of the assumed tax treatment of the arrangement.* Do you agree with this statement?

Table 6.15 Results of Question 9			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	25	60	35
Agree	75	40	65
Neutral	0	0	0
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The results of the questionnaire confirmed the conclusion drawn from the literature study (see 3.6), namely that it is possible that a participant may not be aware of the assumed tax treatment of the arrangement. All of the respondents (100%) agreed or totally agreed with the research findings, due to the fact that not all parties to a transaction are always given insight to the financial model contained in the arrangement.

In light of the results of the questionnaire, the submission made in the literature study appears to be particularly relevant, namely that SARS should specifically address circumstances where not all the parties are given insight to the financial models contained in the arrangements. This will assist in ensuring that participants will not be expected to make assumptions relating to arrangements to which they are not fully privy.

Question 10: *To cover situations where it is uncertain whether any tax benefit will flow, a more appropriate wording of section 80M(1) would be where the words "assumed to be derived" are replaced by "may be derived".*
Do you agree with this statement?

Table 6.16 Results of Question 10			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	8	20	12
Agree	34	60	41
Neutral	8	0	6
Disagree	42	20	35
Totally disagree	0	0	0
Question not answered by respondent	8	0	6
Total	**100**	**100**	**100**

A slight majority of respondents (53%) agreed or totally agreed that a more appropriate wording of section 80M(1) would be where the words "assumed to be derived" are replaced by "may be derived". 35% of respondents did not consider this proposal to be appropriate in removing any uncertainty.

Question 11: *If a person, for example an outside party appointed by a bank to act as a facility agent, played no part in setting up the transaction and is merely there to ensure that the interests of the parties are adequately catered for, there is no reason to include them in the definition of promoter, and as such, the word "managing" should be deleted from the section 80T definition of "promoter".* Do you agree with this statement?

Table 6.17 Results of Question 11

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	0	20	6
Agree	25	40	29
Neutral	34	20	30
Disagree	33	20	29
Totally disagree	0	0	0
Question not answered by respondent	8	0	6
Total	**100**	**100**	**100**

The results from the empirical study are inconclusive for this question: 35% of respondents agreed or totally agreed with the statement, 30% remained neutral in this regard and 29% disagreed with the statement. As the results of the questionnaire neither corroborate nor contradict the submission made in the literature study (see 3.8.1), it would appear that SARS' (2010:26) recommendation of obtaining a letter from the disclosing promoter if any doubt exists as to whether a particular participant is the promoter, is perhaps the safest route to follow.

Question 12: *Neither the Act nor SARS addresses the scenario where the promoter is also a lawyer, and as such, SARS should specifically take the client/attorney privilege into consideration for the disclosure obligation of section 80O.* Do you agree with this statement?

Table 6.18 Results of Question 12			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	8	60	24
Agree	33	20	29
Neutral	0	0	0
Disagree	42	20	35
Totally disagree	8	0	6
Question not answered by respondent	9	0	6
Total	**100**	**100**	**100**

A slight majority of respondents (53%) agreed or totally agreed that SARS should specifically take the client/attorney privilege into consideration for the disclosure obligation of section 80O. However, 80% of legal firms agreed or totally agreed with the statement. This seems to suggest a greater appreciation of the implications of a possible infringement upon the client/attorney privilege among lawyers (compared with auditors).

As such, the results of the questionnaire confirmed the conclusion drawn from the literature study (see 3.8.1), namely that as neither the Act nor SARS addresses the scenario where the promoter is also a lawyer, SARS should specifically take the client/attorney privilege into consideration for the disclosure obligation of section 80O.

Question 13:

Text box 2 of the Draft Guide model makes a statement and does not pose a question. Yet, the arrow flowing from text box 2 indicates "yes", despite the fact that no question was posed.

A better phrasing of text box 1 would be: "Has an arrangement been entered into?" and the second text box must then be deleted. Do you agree with this statement?

Table 6.19 Results of Question 13			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	33	40	35
Agree	50	60	53
Neutral	0	0	0
Disagree	17	0	12
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A significant majority of respondents (88%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.1), namely that a better phrasing of text box 1 of the Draft Guide model would be: "Has an arrangement been entered into?" and that the second text box had to be deleted.

Question 14:

Text box 3 of the Draft Guide model indicates that if the arrangement is listed in section 80M(2), the arrangement should be disclosed. The section 80N(4) exclusions (by way of the *Government Gazette*) excludes any arrangement where the tax benefit is not the main or one of the main benefits or where the tax benefit does not exceed R1 million.

Irrespective of which category an arrangement falls into, namely sections 80M(1) or (2), the section 80N(4) exclusions prevail and the depiction in text box 3 (the 'yes' arrow) is therefore incorrect.
Do you agree with this statement?

Table 6.20 Results of Question 14

	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	58	60	59
Agree	17	40	23
Neutral	25	0	18
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A high percentage of respondents (82%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.2), namely that the "yes" arrow of text box 3 of the Draft Guide model is incorrect, as the section 80N(4) exclusions prevail irrespective of which category an arrangement falls into.

Question 15:

Text boxes 5 and 6 are related to text box 4 and refer to the section 80N(4) exclusions already mentioned. If no tax benefit was derived, then the arrangement is not reportable – in this case the model at text box 4 is correct. However, if a tax benefit was derived, the arrows flowing from text box 4 to text boxes 5 and 6 both state "yes".

Despite the fact that text boxes 5 and 6 must both be addressed, it is unclear which question should be addressed first and the order of the questions is thus potentially misleading. Do you agree with this statement?

Table 6.21 Results of Question 15			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	25	60	35
Agree	58	20	47
Neutral	17	0	12
Disagree	0	20	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A significant majority of respondents (82%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.4), namely that the order of the questions in text boxes 5 and 6 of the Draft Guide model are potentially misleading, as it is unclear which question should be addressed first.

Question 16:

The Draft Guide model correctly indicates (at text box 5) that the arrangement is not reportable if the tax benefit is not the main or one of the main benefits. However, if the answer is "yes", the arrow flows directly from text box 5 to 7 and does not allow for the R1 million exclusion in text box 6 to apply.

This treatment is incorrect as the notice in the Government Gazette allows for two exceptions: either the tax benefit is not the main benefit or the tax benefit does not exceed R1 million. Do you agree with this statement?

Table 6.22 Results of Question 16			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	50	60	53
Agree	50	40	47
Neutral	0	0	0
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

All of the respondents (100%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.4), namely that the R1 million exclusion in text box 6 of the Draft Guide model is incorrectly omitted if the answer to the question in text box 5 is "yes" (as the arrow flows directly from text box 5 to text box 7).

The results of the questionnaire therefore appear to corroborate the proposal made in Chapter 5, *i.e.* that text boxes 5 and 6 should be combined in one question that is addressed after text box 4. Thus, if either of the Gazetted exclusions is applicable, the arrangement is not reportable. This proposal is utilised in Question 3 of the workable model.

Question 17:

Text box 5 of the Draft Guide model refers to the "tax benefits". *Although probably just a typing error, the plural use of the word "benefits" is incorrect, due to the fact that the Government Gazette uses the singular word "benefit" and also because "benefits" (plural) cannot be "the main benefit" (singular) of the arrangement.* Do you agree with this statement?

Table 6.23 Results of Question 17

	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	42	60	47
Agree	42	20	35
Neutral	16	20	18
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A high percentage of respondents (82%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.4), namely that the plural use of the word "benefits" is incorrect, due to the fact that the *Government Gazette* uses the singular word "benefit" and also because "benefits" (plural) cannot be "the main benefit" (singular) of the arrangement.

Question 18:

Text box 8 of the Draft Guide model correctly indicates that if an arrangement is excluded, it is not reportable. However, the question in text box 8 refers to section 80N as a whole, but text box 9 again refers to the Gazetted exclusions of section 80N(4).

The Draft Guide model duplicates the question in text box 8 by once again referring to section 80N in text box 9; the wording of text box 8 should therefore be more specific and refer to sections 80N(1), (2) and (3) and not to section 80N as a whole. Do you agree with this statement?

Table 6.24 Results of Question 18			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	33	60	41
Agree	59	20	47
Neutral	0	20	6
Disagree	8	0	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A significant majority of respondents (88%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2.6), namely that the wording of text box 8 in the Draft Guide model should be more specific and should refer to sections 80N(1), (2) and (3) individually and not to section 80N as a whole. The results of the questionnaire therefore appears to corroborate the use of the three separate text boxes in the workable model in Chapter 6, each one addressing a requirement of section 80N.

Question 19:

The "yes" and "no" answers to the last question (in text box 9) of the Draft Guide model have been transposed, as the model incorrectly indicates that if the arrangement was excluded by the Minister, it must be disclosed as a reportable arrangement.
Do you agree with this statement?

Table 6.25 Results of Question 19			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	67	40	59
Agree	25	60	35
Neutral	0	0	0
Disagree	8	0	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

An overwhelming majority of respondents (94%) agreed or totally agreed with the research findings of the literature study (see 5.2.7), namely that the "yes" and "no" answers to text box 9 of the Draft Guide model have been transposed, as the model incorrectly indicates that if the arrangement was excluded by the Minister, it must be disclosed as a reportable arrangement.

Question 20:

The Draft Guide model contains numerous anomalies and as such is flawed and inappropriate for use by taxpayers. Do you agree with this statement?

Table 6.26 Results of Question 20			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	42	60	47
Agree	42	40	41
Neutral	8	0	6
Disagree	8	0	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The vast majority of respondents (88%) agreed or totally agreed with the conclusions drawn from the literature study (see 5.2), namely that, due to numerous anomalies, the Draft Guide model is flawed and inappropriate for use by taxpayers.

Question 21:

The Alternative Model proposed in this questionnaire presents the questions in a revised order (as compared with the Draft Guide model) whereby the first questions to address relate to the section 80N exclusions.

The revised order of the Alternative Model (whereby the taxpayer first seeks to apply the exclusions) will result in less time wasted on addressing unnecessary questions later in the model where it is clear from the outset that the arrangement is non-reportable.
Do you agree with this statement?

Table 6.27 Results of Question 21			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	50	60	53
Agree	42	40	41
Neutral	0	0	0
Disagree	8	0	6
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

An overwhelming majority of respondents (94%) agreed or totally agreed with the submission made in the literature study (see 5.4), namely that the revised order of the workable model will result in less time wasted on addressing unnecessary questions later in the model where it is clear from the outset that the arrangement is non-reportable.

Question 22:

Questions 4, 5 and 6 of the Alternative Model expound on the Draft Guide model's text box 8 where reference was only made to section 80N.

Due to the relative complexity of the section 80N exclusions, the Alternative Model provides better guidance as it states each exclusion requirement as a separate question.
Do you agree with this statement?

Table 6.28 Results of Question 22

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Totally agree	33	60	41
Agree	67	40	59
Neutral	0	0	0
Disagree	0	0	0
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

All of the respondents (100%) agreed or totally agreed with the submission made in the literature study (see 5.4), namely that, due to the relative complexity of the section 80N exclusions, by stating each exclusion requirement as a separate question, the workable model provides better guidance.

Question 23:

Do you consider the Alternative Model to be more accurate than the Draft Guide model?

Table 6.29 Results of Question 23

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Yes	92	100	94
No	0	0	0
Don't know	8	0	6
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

An overwhelming majority of respondents (94%) considered the workable model to be more accurate than the Draft Guide model, whereas 6% of the respondents did not know the answer to this question. The results of the questionnaire therefore confirmed the submission made in the literature study (see 5.4), *i.e.* that the workable model is more accurate than the Draft Guide model.

Question 24:

Do you consider the Alternative Model to be more helpful than the Draft Guide model?

Table 6.30 Results of Question 24

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Yes	92	80	88
No	0	0	0
Don't know	8	20	12
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

A significant majority of respondents (88%) considered the workable model to be more helpful than the Draft Guide model, whereas 12% of the respondents did not know the answer to this question. The results of the questionnaire therefore confirmed the submission made in the literature study (see 5.4), *i.e.* that the workable model is more helpful than the Draft Guide model.

Question 25:

Do you consider the Alternative Model to be more user-friendly than the Draft Guide model?

Table 6.31 Results of Question 25

	Audit firms (n=12)	Legal firms (n=5)	Total (n=17)
	%	%	%
Yes	92	100	94
No	0	0	0
Don't know	8	0	6
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

An overwhelming majority of respondents (94%) considered the workable model to be more user-friendly than the Draft Guide model, whereas 6% of the respondents did not know the answer to this question. The results of the questionnaire therefore confirmed the submission made in the literature study (see 5.4), *i.e.* that the workable model is more user-friendly than the Draft Guide model.

Question 26: *Due to the fact that the term "reasonable expectation" in section 80M(1)(d) is not defined in the Act and that SARS has not issued any guidance on the application of this requirement, the interpretation of what constitutes a "reasonable expectation" is subjective.* Do you agree with this statement?

Table 6.32 Results of Question 26

	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	25	60	35
Agree	42	0	29
Neutral	8	0	6
Disagree	17	40	24
Totally disagree	0	0	0
Question not answered by respondent	8	0	6
Total	**100**	**100**	**100**

The majority of respondents (64%) agreed or totally agreed with the conclusions drawn from the literature study, namely that, due to the fact that the term "reasonable expectation" is not defined in the Act and because SARS has not issued any guidance on the application of this requirement, the interpretation of what constitutes a "reasonable expectation" is subjective.

Question 27: *By applying the common law principles of a "reasonable person", one could infer that a reasonable person's expectation of a pre-tax profit is similar to a person having a "reasonable expectation of a pre-tax profit".*
Do you agree with this statement?

Table 6.33 Results of Question 27			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	8	0	6
Agree	25	60	35
Neutral	34	0	23
Disagree	25	20	24
Totally disagree	8	20	12
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

Only 41% of the respondents agreed or totally agreed with the submission made in the literature study (see 3.10), namely that by applying the common law principles of a "reasonable person", one could infer that a reasonable person's expectation of a pre-tax profit is similar to a person having a "reasonable expectation of a pre-tax profit". However, 60% of the legal firms agreed with this statement.

These results seem to contradict the approach recommended by some Canadian courts (see Chapter 4), *i.e.* that the REOP test should not be viewed in isolation, but that one should also consider the behaviour of a reasonable person who applied commercial common sense. The inconsistent results appear to corroborate the submission made in the study that the "reasonable expectation of a pre-tax profit" test is subjective; the survey results seemingly underscore the need for a more objective approach.

Question 28:

Question 7 of the Alternative Model refers to any of the five scenarios of section 80M(1). One such scenario is the "reasonable expectation of a pre-tax profit" requirement as contained in section 80M(1)(d).

By leaving this question for last, the taxpayer might be able to determine earlier on in the model that the arrangement is not reportable and could therefore be prevented from spending valuable time and money on obtaining costly tax advice to determine whether there is a "reasonable expectation of a pre-tax profit". Do you agree with this statement?

Table 6.34 Results of Question 28			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Totally agree	17	0	12
Agree	42	60	47
Neutral	33	20	29
Disagree	8	20	12
Totally disagree	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The majority of the respondents (59%) agreed or totally agreed with the submission made in the literature study (see 5.4), namely that by leaving the "reasonable expectation of a pre-tax profit" requirement for last in the workable model, the taxpayer might be able to determine earlier on in the model that the arrangement is not reportable.

This, in turn, corroborates the submission that the workable model could prevent a taxpayer from spending valuable time and money on obtaining costly tax advice to determine whether there is "reasonable expectation of a pre-tax profit".

Question 29:

How helpful did you find the "rental loss" criteria identified by the South African courts to be in determining whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(d) is met?

Table 6.35 Results of Question 29			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Very helpful	0	0	0
Somewhat helpful	83	60	76
Not really helpful	17	40	24
Not helpful at all	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The majority of the respondents (76%) found the "rental loss" criteria identified by South African courts to be helpful in determining whether the "reasonable expectation of a pre-tax profit" requirement is met.

Question 30:

How helpful did you find the extended criteria identified by the Canadian courts to be in determining whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(d) is met?

Table 6.36 Results of Question 30			
	Audit firms (n=12)	**Legal firms (n=5)**	**Total (n=17)**
	%	**%**	**%**
Very helpful	42	40	41
Somewhat helpful	50	60	53
Not really helpful	8	0	6
Not helpful at all	0	0	0
Question not answered by respondent	0	0	0
Total	**100**	**100**	**100**

The overwhelming majority of the respondents (94%) found the extended criteria identified by the Canadian courts to be helpful in determining whether the "reasonable expectation of a pre-tax profit" requirement is met. The results of the questionnaire therefore confirm the relevance and usefulness of including the Canadian criteria in the workable model.

6.7 Conclusion

Chapter 6 discussed the research design and the process followed in analysing the responses for the qualitative research performed. An interpretive approach was adopted, and a non-probability sampling method was considered appropriate. The tax partners of 30 audit firms and ten legal firms were included in the sample.

This chapter described the data collection method and process, the design of the data collection instrument (the self-administered questionnaire) and provided a statistical summary of the responses. In nearly all of the questions, the majority of respondents agreed with the conclusions drawn from the literature study. Notably, compared with SARS' Draft Guide model, an overwhelming majority of respondents (94%) considered the proposed model to be more accurate and user-friendly and a significant majority (88%) considered the proposed model to be more helpful.

Also, the vast majority of respondents (94%) found the extended criteria identified by Canadian courts to be helpful in determining whether the "reasonable expectation of a pre-tax profit" requirement is met.

Based on the empirical results, it is therefore submitted that the proposed model is indeed accurate, complete and relevant. As such, this is a workable model which can serve as a usable guide for South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement.

CHAPTER 7

Conclusion

"We stand ready to take agreed action against those jurisdictions which do not meet international standards in relation to tax transparency."

~ G20 Countries (OECD 2009)

CHAPTER 7
Conclusion

7.1 Chapter 1: Introduction

Chapter 1 provided the background to the problem statement of this study. It was noted that across the globe, revenue authorities regard the concept of tax evasion and tax avoidance as a serious threat to government revenue. In light of the OECD's call for greater transparency and exchange of information for tax purposes, SARS required a more aggressive reporting system. Consequently, the new reportable arrangements provisions were introduced in sections 80M to 80T of the Act with effect 1 April 2008.

This study focused on a section 80M(1)(*d*) reportable arrangement and noted that if the following requirements were met, the arrangement was reportable:

1. An "arrangement" (as defined) is entered into,
2. A "tax benefit" (as defined) is or will be derived or is assumed to be derived,
3. By any "participant" (as defined) by virtue of that arrangement and
4. The arrangement does not result in a reasonable expectation of a "pre-tax profit" (as defined) for any participant.

Regrettably, the concept of a "reasonable expectation of a pre-tax profit" has not been defined in the Act; it has not been considered by our courts (in the context of reportable arrangements) and SARS has not issued any guidance or an Interpretation Note as to the application of section 80M(1)(*d*).

The objective of this study was therefore to conduct a critical analysis of the language of section 80M(1)(*d*) in order to determine its nature and scope. The rules of interpretation and the development of section 80M(1)(*d*) were also addressed. The Canadian REOP test was examined to identify objective guidelines for the application of the "reasonable expectation of a pre-tax profit" requirement. These guidelines were incorporated in the workable model developed in this study. The accuracy, completeness and usability of the

proposed model were tested in a survey conducted among tax partners at a sample of leading audit and legal firms.

Chapter 1 furthermore described the research design, method and scope of the study and set out the structure of the dissertation.

7.2 Chapter 2: History and Development of Section 80M(1)(*d*) of the Act

Chapter 2 analysed the history and development of section 80M(1)(*d*) from its initial inception as section 76A on 1 March 2005 to its current format as part of the reportable arrangements provisions. It was determined that the "reasonable expectation of a pre-tax profit" requirement did not evolve from previous legislation.

7.3 Chapter 3: Examining the Language of Section 80M(1)(*d*) of the Act

After exploring the development of section 80M(1)(*d*), Chapter 3 examined the meaning of the words contained therein. The definitions and interpretations attached to the words in section 80M(1)(*d*) were analysed by first noting their ordinary, grammatical meaning and thereafter by examining the meaning the courts have ascribed to them.

Despite the fact that many of the terms are defined in section 80T, some of these definitions are difficult to apply in practice and other terms have not been defined at all. The "reasonable expectation of a pre-tax profit" concept as a whole is not defined, nor has SARS issued any guidelines as to the interpretation of this requirement. This could lead to considerable uncertainty among tax practitioners.

Consequently, this chapter made numerous submissions and recommendations in an attempt to clarify the meaning of the words in section 80M(1)(*d*). It became evident that the interpretation of section 80M(1)(*d*) is subjective and that a more objective approach was required.

Using Constitutional principles as a backdrop to interpreting legislation, it was ascertained that South African courts are allowed to consider foreign law. Although foreign case law (and by implication the Canadian REOP test) is not binding on South African courts, they do have persuasive value. Also, because the wording of the REOP test is similar to the wording of section 80M(1)(*d*), it was submitted that South African courts may consider applying the Canadian REOP test to a section 80M(1)(*d*) reportable arrangement.

7.4 Chapter 4: Examining the Reasonable Expectation of Profit test in Canada

Chapter 4 accordingly examined the Canadian REOP test and consequently identified a comprehensive checklist of objective factors used by Canadian tax practitioners in applying the REOP test. An exposition of the legislative history and development of the REOP test was provided, along with a discussion of the practical problems encountered by Canadian taxpayers in the application of the REOP test.

The objective guidelines identified in this chapter were incorporated in the workable model proposed in this study and were also included in the survey conducted among a sample of tax partners.

7.5 Chapter 5: Developing a Workable Model for the Identification and Application of a Section 80M(1)(d) Reportable Arrangement

Despite SARS issuing an updated Draft Guide on Reportable Arrangements, the model contained therein is flawed. Chapter 5 examined SARS' model and identified a number of anomalies. The workable model proposed in this study is based on SARS model, but the questions (of which there are seven) are presented in a different order. It was submitted that the revised order, whereby the taxpayer first seeks to apply the exclusions of section 80N and leaves the "reasonable expectation of a pre-tax profit" requirement for last, would be less time-consuming and thus more cost-effective. The effect of section 80M(1)(*d*), *viz.* the disclosure requirements and penalty provisions, were also discussed.

7.6 Chapter 6: The Empirical Study

Having developed the workable model in the previous chapter, Chapter 6 tested the accuracy, completeness and usability of the model by means of a survey. The tax partners at a sample of leading audit and legal firms completed a self-administered questionnaire which also tested many of the research submissions made in Chapter 3.

In almost all of the questions, the majority of respondents agreed with the research findings submitted in the literature study. Notably, compared with SARS' Draft Guide model, an overwhelming majority of respondents (94%) considered the proposed model of this study to be more accurate and user-friendly and a significant majority (88%) considered the proposed model to be more helpful. Also, the vast majority of respondents (94%) found the extended criteria identified by Canadian courts to be helpful in determining whether the "reasonable expectation of a pre-tax profit" requirement is met.

7.7 Areas for Future Research

Although this study critically analysed the wording of the reportable arrangements provisions, the focus was on section 80M(1)(*d*). The other four scenarios contemplated in section 80M(1) and the specific arrangements enumerated in section 80M(2) were excluded from the scope of this study. As such, future research could also include these reportable arrangements provisions. Their interaction with the GAAR provisions could also be explored.

It is recommended that the tax shelter or disclosure provisions of other countries, especially those of Canada, the UK, the USA and Australia, be analysed in order to develop a best-practice framework within which SARS could operate. The reportable arrangements provisions are certainly a step in the right direction; however, it remains to be seen whether the "new" reportable arrangements provisions will indeed serve SARS' purpose of acting as an early warning system of potential tax-aggressive products.

To this end, the main research findings and recommendations of this study will be shared with SARS' Legal and Policy division as a starting point for at least clarifying the existing reportable arrangements provisions. It is hoped that this will eventually lead to the publication of a properly updated and accurate guide by SARS as well as the issue of objective guidelines for the application of the "reasonable expectation of a pre-tax profit" requirement in section 80M(1)(*d*).

7.8 Concluding Remarks

A thorough examination of the reportable arrangements provisions of the Act, particularly section 80M(1)(*d*), shows that the interpretation of these provisions is subjective and difficult to apply in practice. This is evidenced by the number of submissions that SAICA has made to SARS (see Chapter 3), the conflicting results to some of the survey questions (see Chapter 6) and the lack of accurate, helpful guidance from SARS.

The study had as its objective the critical analysis of the language of section 80M(1)(*d*). The meaning of the words contained in section 80M(1)(*d*) were examined and interpreted in order to determine the nature and scope of section 80M(1)(*d*). The Canadian REOP test was analysed to identify objective criteria to be used in the application of section 80M(1)(*d*). This detailed literature review served as a theoretical underpinning for the model developed in Chapter 5 and tested in Chapter 6.

Based on the empirical results in Chapter 6, it is submitted that the proposed model is accurate, complete and usable. As such, this is a workable model which can serve as a usable guide for South African taxpayers in the identification and application of a section 80M(1)(*d*) reportable arrangement. It is hoped that this model will serve as an aid to prevent taxpayers from spending valuable time and money on obtaining costly tax advice to determine whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(*d*) is met. Indeed, if the survey results are any indication, the workable model is expected to prevent taxpayers from incurring unnecessary costs in order to comply with the disclosure obligation when in fact they were under no obligation to report such an arrangement.

The G20 countries, who support the OECD's work on transparency and exchange of information, issued this rather dire warning (OECD 2009):

> *"We stand ready to take agreed action against those jurisdictions which do not meet international standards in relation to tax transparency."*

SARS will in all likelihood come under increasing pressure from South Africa's trade and investment partners to cultivate a cooperative tax environment. The reportable arrangements provisions and other non-compliance measures will probably fall under SARS' spotlight to a greater extent in the future. Despite SARS' (2010:5) intention, it is questionable whether their Draft Guide and model have in fact provided greater certainty to participants and promoters in determining whether arrangements should be disclosed to the Commissioner.

Until such time as SARS adequately addresses the anomalies in the wording of the reportable arrangements provisions and issues a properly revised guide, it is incumbent upon taxpayers to carefully consider whether their arrangements fall within the ambit of sections 80M to 80T. It is hoped that the results of this study will assist in affording taxpayers greater clarity on the identification and application of the reportable arrangements provisions. The workable model proposed in this study could be of value to taxpayers when considering the tax implications of the reportable arrangements provisions.

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Stubard Investments Limited v. The Queen 84 DTC 6305

Tonn *et al*. v. The Queen 96 DTC 6001 (FCA)

The Queen v. Bronfman Trust 87 DTC 5059 (SCC)

The Queen v. Kuhl *et al*. 74 DTC 6024

The Queen v. Matthews 74 DTC 6193 (FCTD)

Walls v. Canada 2002 SCC 47

Walls *et al.* v. The Queen 96 DTC 6142 (FCTD)

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IRC v. Duke of Westminster 1936 51 TLR 467, 19 TC 490

Jaques v. FCT 1924 (34) CLR 328

The Queen v. Bishop of Oxford 1897 4 QB 245

WT Ramsay Ltd v. IRC 1981 1 All ER 865 (HL)

Australian Court Cases

FCT v. Spotless Services Ltd 1996 ATC 5201

New Zealand Court Cases

BNZ Investments Ltd v. CIR 2000 19 NZTC 15

Newton v. COT 1958 2 All ER 759 (PC)

ANNEXURE A

Sections 80M to 80T of the Act

ANNEXURE A

Sections 80M to 80T of the Act

Section 80M. Reportable Arrangements

1) An arrangement is a reportable arrangement if it is listed in subsection (2) or if any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement and the arrangement—

a) contains provisions in terms of which the calculation of 'interest' as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the assumptions relating to the tax treatment of that arrangement (otherwise than by reason of any change in the provisions of this Act or any other law administered by the Commissioner);

b) has any of the characteristics or characteristics which are substantially similar to those contemplated in section 80C(2)(b);

c) is or will be disclosed by any participant as giving rise to a financial liability for purposes of Generally Accepted Accounting Practice but not for purposes of this Act;

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

e) results in a reasonable expectation of a pre-tax profit for any participant that is less than the value of that tax benefit to that participant if both are discounted to a present value at the end of the first year of assessment when that tax benefit is or will be derived or is assumed to be derived on a consistent basis and using a reasonable discount rate for that participant.

2) The following arrangements are reportable arrangements:

a) Any arrangement which would have qualified as a 'hybrid equity instrument' as defined in section 8E, if the prescribed period had been 10 years;

b) any arrangement which would have qualified as a 'hybrid debt instrument' as defined in section 8F, if the prescribed period in that section had been 10 years, but does not include any instrument listed on an exchange regulated in terms of the Securities Services Act, 2004 (Act No. 36 of 2004); or

c) any arrangement identified by the Minister by notice in the Gazette as an arrangement which is likely to result in any undue tax benefit.

3) This section does not apply to any excluded arrangement contemplated in section 80N.

Section 80N. Excluded arrangements

1) An arrangement is an excluded arrangement if it is—

a) a loan, advance or debt in terms of which—

i) the borrower receives or will receive an amount of cash and agrees to repay at least the same amount of cash to the lender at a determinable future date; or

ii) the borrower receives or will receive a fungible asset and agrees to return an asset of the same kind and of the same or equivalent quantity and quality to the lender at a determinable future date;

b) a lease;

c) a transaction undertaken through an exchange regulated in terms of the Securities Services Act, 2004 (Act No. 36 of 2004); or

d) a transaction in participatory interests in a scheme regulated in terms of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002).

2) Subsection (1) applies only to an arrangement that—

a) is undertaken on a stand-alone basis and is not directly or indirectly connected to, or directly or indirectly dependent upon, any other arrangement (whether entered into between the same or different parties); or

b) would have qualified as having been undertaken on a stand-alone basis as required by paragraph (*a*), were it not for a connected arrangement that is entered into for the sole purpose of providing security and where no tax benefit is obtained or enhanced by virtue of that security arrangement.

3) Subsection (1) does not apply to any arrangement that is entered into—

a) with the main purpose of obtaining or enhancing a tax benefit; or

b) in a specific manner or form that enhances or will enhance a tax benefit.

4) The Minister may determine an arrangement to be an excluded arrangement by notice in the Gazette, if he or she is satisfied that the arrangement is not likely to lead to an undue tax benefit.

Section 80O. Disclosure obligation

1) The promoter must disclose such information in respect of a reportable arrangement as is contemplated in section 80P.

2) If there is no promoter in relation to an arrangement or if the promoter is not a resident, all other participants must disclose the information contemplated in section 80P in respect of the reportable arrangement.

3) A participant need not disclose the information in respect of a reportable arrangement if that participant obtains a written statement from—

a) the promoter that the promoter has disclosed that reportable arrangement as required by this Part; or

b) any other participant, if subsection (2) applies, that the other participant has disclosed that reportable arrangement as required by this Part.

4) The reportable arrangement must be disclosed within 60 days after any amount is first received by or accrued to any participant or is first paid or actually incurred by any participant in terms of the arrangement.

5) The Commissioner may grant extension for disclosure for a further 60 days, if reasonable grounds exist for that extension.

Section 80P. Information to be submitted

The promoter or participant, as the case may be, must submit, in relation to the reportable arrangement, in the form and manner (including electronically) and at such place as may be prescribed by the Commissioner —

a) a detailed description of all its steps and key features;

b) a detailed description of the assumed tax benefits for all participants, including, but not limited to, tax deductions and deferred income;

c) the names, registration numbers and registered addresses of all participants;

d) a list of all its agreements; and

e) any financial model that embodies its projected tax treatment.

Section 80S. Penalties

1) Any participant who fails to disclose the information in respect of a reportable arrangement as required by section 80O or section 80R shall be liable to a penalty of R1 million.

2) The Commissioner may reduce the penalty contemplated in subsection (1), if—

a) there are extenuating circumstances and the participant remedies the non-disclosure within a reasonable time; or

b) if the penalty is disproportionate to the assumed tax benefit.

Section 80T. Definitions

'arrangement' means any transaction, operation or scheme;

'financial benefit' means any reduction in the cost of finance, including interest, finance charges, costs, fees, and discounts in the redemption amount;

'participant' in relation to a reportable arrangement means—

a) any promoter; or

b) any company or trust which directly or indirectly derives or assumes that it derives a tax benefit or financial benefit by virtue of a reportable arrangement;

'pre-tax profit' in relation to an arrangement, means the profit of a participant resulting from that arrangement before deducting any normal tax, which profit must be determined in accordance with Generally Accepted Accounting Practice after taking into account all costs and expenditure incurred by that participant in connection with the arrangement and after deducting any foreign taxes paid or payable by that participant;

'promoter' in relation to a reportable arrangement means any person who is principally responsible for organising, designing, selling, financing or managing that reportable arrangement;

'reportable arrangement' means any arrangement as contemplated in section 80M;

'tax' includes any tax, levy, duty or other liability imposed by this Act or any other Act administered by the Commissioner;

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

ANNEXURE B

Summary of the Tax Disclosure Rules of the UK, USA and Canada

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Summary of the Tax Disclosure Rules of the UK, USA and Canada

Chapter 3 alluded to the tax disclosure rules of the foreign countries mentioned in the original *Reportable Arrangements Guide* (SARS 2005). Annexure B briefly summarises these rules. It is, however, beyond the scope of this study to expound on these foreign tax disclosure rules or to examine the various definitions contained in these rules.

1. The United Kingdom (UK)

The disclosure requirements for the UK came into effect on 1 August 2004. Promoters, and in some instances, users of certain tax schemes and arrangements, are obliged to disclose details of those arrangements when they are first available for implementation.

Her Majesty's Revenue and Customs (HMRC) office widened the scope from tax arrangements concerning employment or certain financial products to the whole of Income Tax, Corporation Tax and Capital Gains Tax with effect from 1 August 2006 (HMRC 2010).

Briefly, the tax arrangement must be disclosed when:

- It will, or might be expected to, enable any person to obtain a tax advantage;
- That tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement; and
- It is a tax arrangement that falls within any description ("hallmarks") prescribed in the relevant regulations.

In most situations where a disclosure is required it must be made by the scheme "promoter" within five days of it being made available. However, the scheme user may need to make the disclosure where:

- the promoter is based outside the UK; or
- the promoter is a lawyer and legal privilege applies; or
- there is no promoter.

The HMRC identified the following hallmarks for disclosure:

- Wishing to keep the arrangements confidential from a competitor;
- Wishing to keep the arrangements confidential from HMRC;
- Arrangements for which a premium fee could reasonably be obtained;
- Arrangements that include off market terms;
- Arrangements that are standardised tax products;
- Arrangements that are loss schemes;
- Arrangements that are certain leasing arrangements; and
- Arrangements for certain pension benefits.

Upon disclosure, HMRC issues the promoter with an eight-digit scheme reference number for the disclosed scheme. By law the promoter must provide this number to each client that uses the scheme, who in turn must include the number on his or her tax return. A person who designs and implements their own scheme must disclose it within 30 days of implementation.

2. The United States of America (USA)

The USA has adopted formalised rules in their tax code which define tax shelters and require the registration of these tax shelters and the maintenance of investor lists by promoters and which also levy penalties for non-compliance (SARS 2005:2).

As of 28 February 2000, USA taxpayers and tax shelter organisers have been required to disclose certain "reportable transactions". These regulations were finalised three years later and became effective for all transactions entered into on or after 28 February 2003 (IRS 2011).

"Reportable transactions" are defined in Regulations to the Internal Revenue Code. Consequently, in order to identify tax-advantaged products which have been sold to individual and corporate taxpayers, the Internal Revenue Service (IRS) issued Regulations which require taxpayers to identify certain "reportable transactions" which have the potential for tax avoidance. These categories include listed transactions, confidential transactions, transactions with contingent fees, loss transactions, transactions with significant book or tax differences and transactions involving tax credits (Tooma 2008:112). If such a "reportable transaction" exists, the taxpayer must report the transaction as part of the tax return (Korb 2008:30).[47]

3. Canada

Canada also has well developed reportable transaction legislation in the form of tax shelter rules (SARS 2005:2). The tax shelter provisions were enacted in 1989 to ensure the more effective audit of certain tax-advantaged investments. To that end, the "promoter" of a property that is a "tax shelter" is required to obtain an identification number from the Canada Revenue Agency (CRA) before the sale of an interest in the property. Failure to do so will result in the promoter being subject to a monetary penalty, and the investor will be denied any tax deductions claimed in respect of the property (Wertschek & Wilson 2008:282).

In very general terms, a tax shelter includes either a gifting arrangement or the acquisition of property, where it is represented to the purchaser or donor that the tax benefits and deductions arising from the arrangement or acquisition will equal or exceed the net costs of

[47] During December 2010, Germany's largest bank, Deutsche Bank, agreed to pay a fine of US $553 million and to admit to criminal wrongdoing, settling a long-running investigation of the IRS into tax shelter fraud that prosecutors said generated billions of dollars in "bogus tax benefits" (Protess & Browning 2010). The investigation into Deutsche stemmed from an earlier inquiry into the US branch of accounting firm KPMG, which marketed tax shelters. The inquiry into KPMG resulted in KPMG agreeing to pay US $456 million in a deferred prosecution agreement in 2005. Three people associated with KPMG were convicted on criminal charges in 2008. Clearly, the US government views the use of tax shelters in a very serious light, as is evidenced by a recently revised version of the "Stop Tax Haven Abuse Act" which was introduced in the US Senate on 12 July 2011 (KPMG 2011). This version of the bill (not yet enacted) aggressively targets offshore tax shelters.

entering into the arrangement or the property. Also, a gifting arrangement where the donor incurs a limited recourse debt related to the gift will be a tax shelter (CRA 2010). [48]

The CRA (2010) considers and investment in property or the gifting arrangement as a tax shelter if:

- it is promoted as offering income tax savings; and
- it is reasonable to consider, based on statements or representations made or proposed to be made, that within the first four years of buying an investment in the property or entering into the gifting arrangement, the buyer or donor will have losses, deductions, or credits.

[48] A limited recourse debt is one where the borrower is not at risk for the repayment.

ANNEXURE C

Submissions and Recommendations Made in respect of the Wording of Section 80M(1)(*d*)

ANNEXURE C

Submissions and Recommendations Made in respect of the Wording of Section 80M(1)(*d*)

Chapter 3 analysed the wording of section 80M(1)(*d*). The following submissions and recommendations were made in Chapter 3, many of which were included in the survey conducted among tax partners at a sample of leading audit and legal firms:

- ☑ Amend the section 80T definition of "arrangement" to align it with the section 80L GAAR definition of "arrangement" so as to widen the scope of the reportable arrangements provisions.
- ☑ Based on the recognition criteria of *IAS 37*, the distinguishing factor between an "existing" liability and an "anticipated" liability, is the requirement of an entity having a "present obligation".
- ☑ The accounting definition and ordinary, grammatical meaning of "liability" imply an existing liability, and not an anticipated (or contingent) liability.
- ☑ As regards an "anticipated liability", the accounting meaning differs from the interpretation followed by the tax courts, as an "anticipated liability" is not a liability to be recognised in the financial statements, but rather a contingent liability to be disclosed.
- ☑ The insertion of the word "any" in the section 80T definition of "tax benefit", has the cumbersome effect of potentially including an indefinitely large number of ordinary, routine transactions.
- ☑ Although arrangements where the tax benefit does not exceed R1 million are excluded from the reportable arrangements provisions, some taxpayers could easily exceed this cut-off amount with just a few routine transactions.
- ☑ The section 80N(1) list of "plain-vanilla", excluded transactions should be extended to also include other routine, operating transactions such as the acquisition of any asset, trading stock, consumables and services on credit.
- ☑ The onus of proof rests on the Commissioner of SARS to assume that a tax benefit has been or will be derived; the onus to disprove this assumption will accordingly rest on the taxpayer.

- ☑ To cover scenarios where it is uncertain whether any tax benefit will flow, the words "assumed to be derived" should be replaced by "may be derived".
- ☑ SARS should specifically address circumstances where not all the parties are given insight to the financial models contained in the arrangements.
- ☑ The phrase "by virtue of" in the introductory requirement of section 80M(1) implies that a causal link has to be established between the arrangement entered into and the tax (or financial) benefit that was obtained; the "but-for" criterion of factual causation could be helpful in indicating a causal link.
- ☑ The section 80T definition of "promoter" should be amended by deleting the word "managing"; in doing so, a person who played no part in setting up the transaction and who merely acted as a facilitator, would not be regarded as a "promoter".
- ☑ As regards the term "promoter", SARS should specifically address circumstances where the promoter is not based in South Africa or where there is no promoter.
- ☑ SARS should specifically take the client/attorney legal privilege into consideration to adequately address the scenario where the promoter is also a lawyer.
- ☑ Legal professional privilege should also be extended to accountants who act as tax advisors.
- ☑ The two methods prescribed by SARS to determine the existence of a tax benefit (*viz.* the comparative method and the control transaction method) could also be used to determine whether or not a tax benefit was enhanced.
- ☑ The meaning of the requirement "undue tax benefit" in section 80N(4) is unclear, as neither the Act nor SARS provides clarity on how the "undue" amount should be determined and by whom. As such, the term "undue tax benefit" should be replaced with the term "reporting requirement".
- ☑ By applying the common law principles of a "reasonable person", one could infer that a reasonable person's expectation of a pre-tax profit is similar to a person having a "reasonable expectation of a pre-tax profit".
- ☑ Based on the Canadian REOP test, a reasonable expectation is not to be determined by the presence of subjective hopes or aspirations, nor of an expectation that the taxpayer in good faith believes to eventually realise a profit; the expectation must be proven by objective factors.

ANNEXURE D

Summary of the Case Law Principles of the REOP test post-*Moldowan*

ANNEXURE D

Summary of the Case Law Principles of the REOP test post-*Moldowan*

As was discussed in Chapter 4, the status of the REOP test has shifted continuously over the past few decades. For a period of time after the *Moldowan* case, Canadian tax assessors were zealously disallowing losses, that with the benefit of hindsight, they thought resulted from an activity with no REOP (Williamson & Chapman 2010:181).

Due to a large volume of litigation, the REOP principles have evolved over the period subsequent to the *Moldowan* case. Many of these principles, and the court cases from which they have evolved, are found in Bowman J's judgment in *Shaughnessy v. R (2002)* and are summarised in the table on the following page. It is beyond the scope of this study to expound on the facts of the cases listed in the table. Although the court cases are alluded to, it is the principles established in those court cases which are considered to be of significance.

In the *Stewart* case, Iacobucci and Bastarache JJ offered several reasons why a REOP should not be viewed as a general test for the existence of a business or property as a source of income [at paragraphs 36 to 39]:

- The REOP test should be understood as a sufficient condition for a source of income, not a necessary requirement for a business or property source;
- Equating the term "business" with the phrase "reasonable expectation of profit" does not accord with the traditional common law definition of business, which is that "anything which occupies the time and attention and labour of a man for the purpose of profit is a business"; and
- The limited use of the phrase "reasonable expectation of profit" in the definition of "personal and living expenses" in section 248(1) of the ITA does not support its use as a stand-alone source test.

Table D.1 Case law principles of the REOP test post-*Moldowan*		
	REOP principle	**Court cases**
1	Where there is no personal element the REOP test should be applied sparingly.	Belec v. The Queen (1995) Tonn *et al*. v. The Queen (1996) Walls v. The Queen (1996) Keeping v. The Queen (2001)
2	The absence of a personal element does not establish conclusively that the REOP test cannot be invoked, but such an absence is a factor that carries a great deal of weight.	A.G. of Canada v. Mastri *et al*. (1997)
3	The court should not, with the benefit of hindsight, second-guess the business acumen of a taxpayer who embarks upon a business venture in good faith.	Nichol v. The Queen (1993) Belec v. The Queen (1995) Smith v. The Queen (1996) Tonn *et al*. v. The Queen (1996) Kuhlmann *et al*. v. The Queen (1998) Keeping v. The Queen (2001)
4	The fact that a business or property is 100% financed is not in itself a reason for applying the REOP test.	Mohammad v. The Queen (1997) Saunders v. R. (1998) Milewski v. The Queen (1999)
5	A taxpayer should be allowed a reasonable period of time to get the business established.	Keeping v. The Queen (2001)
6	The period to establish a business will vary with the circumstances and may well be lengthy.	Milewski v. The Queen (1999)
7	The REOP test should not be invoked as a substitute for analysis. Before invoking REOP the assessor should examine the expenses to determine whether they are reasonable or for any other reason not deductible.	Belec v. The Queen (1995) Tonn *et al*. v. The Queen (1996) Walls *et al* v. The Queen (1996) Keeping v. The Queen (2001)
8	For an expectation of profit to be reasonable it has to be not "irrational, absurd and ridiculous".	Kuhlmann *et al*. v. The Queen (1998)
9	The fact that an investment or a business is motivated in part by tax considerations is not relevant in determining whether there is a business, nor is tax motivation in itself relevant in determining the deductibility of expenses if a business exists.	Stubard Investments Limited v. The Queen (1984)
10	The REOP is only one factor in the determination of whether a "business", and therefore a source of income, exists.	Kaye v. The Queen (1998)
11	Reasonableness operates both in the context of the existence of a business, where the deduction of expenses to the extent that they are unreasonable, is disallowed, and also at the liminal stage of determining whether there is a business.	Kaye v. The Queen (1998)
12	If what is ostensibly a rental property was acquired and held in the course of an adventure	Roopchan v. The Queen (1996)

	in the nature of trade and it was reasonable to expect a profit on the resale, the rental losses should not be disallowed on the basis of REOP.	
13	If the taxpayer has several rental properties, some yielding a profit and some a loss, it is improper to apply REOP to the losing properties and ignore the profitable ones. The entire investment picture should be considered.	Smith v. The Queen (1996)
14	When to start a business and when to abandon it are business decisions in which neither the taxing authorities nor the court should intervene.	Nichol v. The Queen (1993)
15	Despite the principle listed in point 14 above, if losses go on being incurred year after year for an inordinate length of time, sooner or later one has to apply what Bowman J calls the "enough is enough" principle and decide that what might have been a viable business has, with the effluxion of time, become hopeless. Nonetheless, a businessman's judgement to maintain a business must be treated with great respect.	Shaughnessy v. R (2002)

ANNEXURE E

The Questionnaire Used in the Empirical Study

UNIVERSITY OF CAPE TOWN
IYUNIVESITHI YASEKAPA · UNIVERSITEIT VAN KAAPSTAD

ANNEXURE E

The Questionnaire Used in the Empirical Study

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QUESTIONNAIRE

Title of the study:

"The development of an accurate, user-friendly model for the identification of reportable arrangements"

- **Prior to answering** the questionnaire, please read the attached "Background" document. This should not take more than 30 minutes of your time.
- This questionnaire consists of **Part A, Part B and Part C** and contains **30 questions**.
- Please answer all of the questions as accurately as possible. This should not take more than 15 minutes of your time.
- Your name will not appear on the questionnaire and the answers you give will be treated as strictly confidential. Neither the name of your firm nor your name will appear in the research findings of the survey. You can not be identified in person based on the answers you give.
- Your feedback on this tax topic is of immense value, as this research study seeks to provide more clarity and certainty in the interpretation of the reportable arrangements provisions, especially that of the "reasonable expectation of a pre-tax profit" criterion.
- You will be provided with a summary of the findings on request. The results of the study might also be considered for future research purposes.
- By completing the questionnaire you are consenting to participate in the study.
- Please e-mail Lee-Ann Steenkamp at dplessis@sun.ac.za if you have any questions or comments regarding the study.

PART	QUESTIONS
A: Profile of the respondent	
B: Terminology in sections 80M to 80T	1 – 12
C: Comparative models	13 - 30

ADMINISTRATIVE INFORMATION

Name of firm	

PART A: PROFILE OF RESPONDENT

Your position at the firm	Tax director	Tax partner	Tax manager	Other (please specify)
Mark "X" in the appropriate box.				

Years of experience in South African tax legislation	< 10 years	10 – 15 years	> 15 years
Mark "X" in the appropriate box.			

How would you rate your knowledge of the reportable arrangements provisions contained in sections 80M to 80T of the Income Tax Act?	Good	Fair	Poor
Mark "X" in the appropriate box.			

PART B: TERMINOLOGY IN SECTIONS 80M TO 80T

NB: Please refer to p5-6 of the "Background" document. Part B of the survey examines some of the terminology contained in the reportable arrangements provisions of sections 80M to 80T. This terminology is also contained in the model developed in this study. The results of the survey will be used to assist in the interpretation of the terminology to further enhance the workability of the model in order to ensure that it is indeed accurate and user-friendly.

Questions 1 to 3 refer to the term "liability for tax" as contained in the section 80T definition of a "tax benefit". See p5 of the "Background" document.

Question 1: *According to International Accounting Standards (IAS), an "anticipated" liability (as interpreted by the tax courts) is not a liability to be recognised in the financial statements, but, at most, a contingent liability to be disclosed.* Do you agree with this statement?

Question 1	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 2: *Based on the recognition criteria of IAS 37, the distinguishing factor between an "existing" liability and an "anticipated" liability, is the requirement of an entity having a "present obligation".* Do you agree with this statement?

Question 2	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 3: *Which one of the following two criteria do you consider to be the most appropriate for determining whether a "liability for tax" was avoided, postponed or reduced?*

Question 3	The accounting criteria of the IASB *Framework* and *IAS 37*	The interpretation followed by the tax courts and SARS	Both (they are equally appropriate)
Mark "X" in the appropriate box.			

****

Questions 4 to 7 refer to the exclusions of section 80N. See p6 of the "Background" document.

Question 4: *Even though the Minister has excluded arrangements where the tax benefit does not exceed R1 million, some taxpayers could easily exceed this cut-off amount with just a few routine transactions.* Do you agree with this statement?

Question 4	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 5: *If none of the section 80N exclusions are applicable, the term "any" in the definition of a "tax benefit" is too wide and results in the cumbersome effect of ordinary, routine transactions becoming reportable.* Do you agree with this statement?

Question 5	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 6: *The list of "plain-vanilla" transactions in section 80N(1) should be extended to include other routine, operating transactions which do not give rise to an undue tax benefit, such as the acquisition of any asset, trading stock, consumables and services on credit.* Do you agree with this statement?

Question 6	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 7: *The meaning of the requirement "undue tax benefit" in section 80N(4) is unclear, as neither the Act nor SARS provides clarity on how the "undue" amount should be determined and by whom.* Do you agree with this statement?

Question 7	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

***

Questions 8 to 12 refer to terminology contained in section 80M(1). See p6 of the "Background" document.

Question 8: *The introductory requirement of section 80M(1) states, inter alia, that an arrangement is reportable if any tax benefit is "assumed to be derived by any participant". Who do you consider must assume that a tax benefit is or will be derived?*

Question 8	The Commissioner of SARS	Any participant to the arrangement
Mark "X" in the appropriate box.		

Question 9: *Not all parties to a transaction are always given insight to the financial model contained in the arrangement and it is therefore possible that a participant may not be aware of the assumed tax treatment of the arrangement.* Do you agree with this statement?

Question 9	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 10: *To cover situations where it is uncertain whether any tax benefit will flow, a more appropriate wording of section 80M(1) would be where the words "assumed to be derived" are replaced by "may be derived".* Do you agree with this statement?

Question 10	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 11: *If a person, for example an outside party appointed by a bank to act as a facility agent, played no part in setting up the transaction and is merely there to ensure that the interests of the parties are adequately catered for, there is no reason to include them in the definition of promoter, and as such, the word "managing" should be deleted from the section 80T definition of "promoter".* Do you agree with this statement?

Question 11	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 12: *Neither the Act nor SARS addresses the scenario where the promoter is also a lawyer, and as such, SARS should specifically take the client/attorney privilege into consideration for the disclosure obligation of section 80O.*
Do you agree with this statement?

Question 12	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

[Part C continues on the next page…]

PART C: COMPARATIVE MODELS

NB: Please refer to p7-11 of the "Background" document. Part C of the survey compares the model provided in SARS' *Draft Guide to Reportable Arrangements* with the Alternative Model (flowchart) developed in this study.

Questions 13 to 20 refer to the Draft Guide model of SARS. See p8 of the "Background" document.

Question 13:

Text box 2 of the Draft Guide model makes a statement and does not pose a question. Yet, the arrow flowing from text box 2 indicates "yes", despite the fact that no question was posed.

A better phrasing of text box 1 would be: "Has an arrangement been entered into?" and the second text box must then be deleted. Do you agree with this statement?

Question 13	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 14:

Text box 3 of the Draft Guide model indicates that if the arrangement is listed in section 80M(2), the arrangement should be disclosed. The section 80N(4) exclusions (by way of the *Government Gazette*) excludes any arrangement where the tax benefit is not the main or one of the main benefits or where the tax benefit does not exceed R1 million.

Irrespective of which category an arrangement falls into, namely sections 80M(1) or (2), the section 80N(4) exclusions prevail and the depiction in text box 3 (the 'yes' arrow) is therefore incorrect.
Do you agree with this statement?

Question 14	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 15:

Text boxes 5 and 6 are related to text box 4 and refer to the section 80N(4) exclusions already mentioned. If no tax benefit was derived, then the arrangement is not reportable – in this case the model at text box 4 is correct. However, if a tax benefit was derived, the arrows flowing from text box 4 to text boxes 5 and 6 both state "yes".

Despite the fact that text boxes 5 and 6 must both be addressed, it is unclear which question should be addressed first and the order of the questions is thus potentially misleading. Do you agree with this statement?

Question 15	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 16:

The Draft Guide model correctly indicates (at text box 5) that the arrangement is not reportable if the tax benefit is not the main or one of the main benefits. However, if the answer is "yes", the arrow flows directly from text box 5 to 7 and does not allow for the R1 million exclusion in text box 6 to apply.

This treatment is incorrect as the notice in the Government Gazette allows for two exceptions: either the tax benefit is not the main benefit or the tax benefit does not exceed R1 million. Do you agree with this statement?

Question 16	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 17:

Text box 5 of the Draft Guide model refers to the "tax benefits". *Although probably just a typing error, the plural use of the word "benefits" is incorrect, due to the fact that the Government Gazette uses the singular word "benefit"and also because "benefits" (plural) cannot be "the main benefit" (singular) of the arrangement.* Do you agree with this statement?

Question 17	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 18:

Text box 8 of the Draft Guide model correctly indicates that if an arrangement is excluded, it is not reportable. However, the question in text box 8 refers to section 80N as a whole, but text box 9 again refers to the Gazetted exclusions of section 80N(4).

The Draft Guide model duplicates the question in text box 8 by once again referring to section 80N in text box 9; the wording of text box 8 should therefore be more specific and refer to sections 80N(1), (2) and (3) and not to section 80N as a whole. Do you agree with this statement?

Question 18	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 19:

The "yes" and "no" answers to the last question (in text box 9) of the Draft Guide model have been transposed, as the model incorrectly indicates that if the arrangement was excluded by the Minister, it must be disclosed as a reportable arrangement.
Do you agree with this statement?

Question 19	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 20:

The Draft Guide model contains numerous anomalies and as such is flawed and inappropriate for use by taxpayers. Do you agree with this statement?

Question 20	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

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Questions 21 to 25 refer to the Alternative Model developed in this study. See p9 of the "Background" document.

Question 21:

The Alternative Model proposed in this questionnaire presents the questions in a revised order (as compared with the Draft Guide model) whereby the first questions to address relate to the section 80N exclusions.

The revised order of the Alternative Model (whereby the taxpayer first seeks to apply the exclusions) will result in less time wasted on addressing unnecessary questions later in the model where it is clear from the outset that the arrangement is non-reportable.
Do you agree with this statement?

Question 21	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 22:

Questions 4, 5 and 6 of the Alternative Model expound on the Draft Guide model's text box 8 where reference was only made to section 80N.

Due to the relative complexity of the section 80N exclusions, the Alternative Model provides better guidance as it states each exclusion requirement as a separate question.
Do you agree with this statement?

Question 22	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 23:

Do you consider the Alternative Model to be more accurate than the Draft Guide model?

Question 23	Yes	No	Don't know
Mark "X" in the appropriate box.			

Question 24:

Do you consider the Alternative Model to be more helpful than the Draft Guide model?

Question 24	Yes	No	Don't know
Mark "X" in the appropriate box.			

Question 25:

Do you consider the Alternative Model to be more user-friendly than the Draft Guide model?

Question 25	Yes	No	Don't know
Mark "X" in the appropriate box.			

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Questions 26 to 30 refer to the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(d). See p10-11 of the "Background" document.

Question 26: *Due to the fact that the term "reasonable expectation" in section 80M(1)(d) is not defined in the Act and that SARS has not issued any guidance on the application of this requirement, the interpretation of what constitutes a "reasonable expectation" is subjective.* Do you agree with this statement?

Question 26	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 27: *By applying the common law principles of a "reasonable person", one could infer that a reasonable person's expectation of a pre-tax profit is similar to a person having a "reasonable expectation of a pre-tax profit".*
Do you agree with this statement?

Question 27	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 28:

Question 7 of the Alternative Model refers to any of the five scenarios of section 80M(1). One such scenario is the "reasonable expectation of a pre-tax profit" requirement as contained in section 80M(1)(d).

By leaving this question for last, the taxpayer might be able to determine earlier on in the model that the arrangement is not reportable and could therefore be prevented from spending valuable time and money on obtaining costly tax advice to determine whether there is a "reasonable expectation of a pre-tax profit". Do you agree with this statement?

Question 28	Totally agree	Agree	Neutral	Disagree	Totally disagree
Mark "X" in the appropriate box.					

Question 29:

How helpful did you find the "rental loss" criteria identified by the South African courts to be in determining whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(d) is met?

Question 29	Very helpful	Somewhat helpful	Not really helpful	Not helpful at all
Mark "X" in the appropriate box.				

Question 30:

How helpful did you find the extended criteria identified by the Canadian courts to be in determining whether the "reasonable expectation of a pre-tax profit" requirement of section 80M(1)(d) is met?

Question 30	Very helpful	Somewhat helpful	Not really helpful	Not helpful at all
Mark "X" in the appropriate box.				

END OF QUESTIONNAIRE

Thank you for your time and assistance!