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A critical
analysis of
the
requirements
of the South
African
General Anti
Avoidance
Rule

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Section 80A of the Income Tax Act 58 of 1962

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Statement

Research dissertation presented for the approval of the Senate in fulfilment of part of the requirements for the Postgraduate Diploma: Tax Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Postgraduate Diploma: Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of the University, and this dissertation conforms to those regulations.

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University of Cape Town

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Summary of abbreviations used

1. "Act" means Income Tax Act 58 of 1962
2. "Broomberg" means Advocate Eddie Broomberg, S.C.
3. "CIR" means the Commissioner for Inland Revenue
4. "D Clegg" means Advocate David Clegg
5. "Commissioner" means the Commissioner for SARS
6. "Companies Act" means the Companies Act No 61 of 1973 (as amended)
7. "GAAR" means the General Anti-Avoidance Rule
8. "Income Tax Act" means Income Tax Act 58 of 1962
9. "IRC" means the Inland revenue Commissioner
10. "Ltd" means Limited
11. "Meyerowitz" means Advocate David Meyerowitz, S.C.
12. "Predecessor" means section 103(1) of the Income Tax Act 58 of 1962
13. "Pty" means Private
14. "SARS" means the South African Revenue Services
15. "Section 80A-80L" means Section 80A-80L of the Income Tax Act 58 of 1962
16. "Section 103(1)" means Section 103(1) of the Income Tax Act 58 of 1962
17. "Silke" means Silke on South African Income Tax
18. "SCA" means the Supreme Court of Appeal
19. "SIR" means the Secretary for Inland Revenue
20. "UK" means the United Kingdom
21. "US" means the United States of America
22. "VAT" means Value Added Tax

Foreword

I welcome you in reading this research dissertation looking at the South African General Anti Avoidance Rule. I hope that this paper will shed some light on the complex requirements of the GAAR as contained in section 80A, read together with relevant sections.

I would like to thank my husband and family for being so supportive and encouraging me at all times and especially my friend, Sallie Ellis for her valuable contribution.

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1. Introduction

For many years tax evasion and tax avoidance have been popular and controversial topics, not only in South Africa, but all over the world. As early as the 17th century, England imposed a tax on horses which led people to ride tax-free cows.¹

The current economic recession has played a significant role in the continued focus on tax avoidance. SARS is continually trying to reduce the impact of tax avoidance and tax evasion on the tax revenue collections, whilst the taxpayer is struggling to survive financially. Faced daily with rising living costs, people have become more reluctant to part with their hard earned money. However, tax evasion and tax avoidance 'undermines the achievement of the public finance objective of collecting revenues in an efficient, equitable and effective manner'² and therefore is 'economically undesirable and inequitable'.³

It is important to differentiate between tax evasion and tax avoidance. Tax evasion is the use of illegal means to reduce a tax liability.⁴ An attempt to evade tax is a criminal offence punishable under section 104(1) of the Income Tax Act 58 of 1962 by a fine, imprisonment or both; additional tax of up to 200% may be payable as well as interest.⁵ Tax avoidance is where the taxpayer orders his affairs in a legal manner to pay the least amount of tax possible.⁶

There is, however, a distinction between someone who orders his affairs so that he has no income which would expose him to the liability of income tax, and that of one who orders his affairs so that he escapes from liability for tax which he ought to pay on income which in reality is his.⁷

It is common law that a taxpayer may arrange his affairs in order to pay fewer taxes.⁸ A taxpayer can donate an interest bearing investment, under a R100 000, to his major child and not pay donations tax or be affected by section 7(3) of the Income Tax Act 58 of 1962.⁹

¹ Matsheru, M. 1991. Income Tax made Simple. Ch. 12.

² Garg, R. 2012. Removing the fences: Looking through GAAR at 8.

³ Ibid.

⁴ Haupt, P. 2012. Notes on South African Income Tax. Ch. 17 at 499.

⁵ Broomberg, E.B. 2012. Evasion v avoidance at 104.

⁶ Van Schalkwyk, L. 2011. Silke: South African Income Tax. Ch. 25 at 727.

⁷ CIR v King 1947 (2) SA 196 (A), 14 SATC 184 at 194.

⁸ Matsheru, M. 1991. Income Tax made Simple. Ch. 12.

⁹ Van Schalkwyk, L. 2011. Silke: South African Income Tax. Ch. 25 at 727.

In Duke of Westminster¹⁰ it was held 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 and that the validity of the transaction is not affected merely because the tax consequences which it attracts are advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage.'

However not all lawful tax avoidance arrangements are permissible in terms of the Income Tax Act.

The legislature enacted South Africa's first GAAR in 1941, to define and limit impermissible tax avoidance arrangements. Section 90 of the Income Tax Act 31 of 1941 was later replaced by section 103(1) of the Income Tax Act 58 of 1962.

In 2005, SARS proposed amendments to enhance the effectiveness in eliminating impermissible tax avoidance agreements.¹¹ It was the view of SARS that section 103(1) contained certain 'inherent weaknesses'.¹² Revised proposals in October 2006 included new provisions to ensure a GAAR broad enough to prevent complex tax avoidance arrangements. The aim was to achieve a balance between the need for a strong and effective GAAR, and in contrast, the certainty of taxpayers involved in bona fide business activities.¹³

Section 103(1) was accordingly repealed by section 36(1)(a) of the Revenue Laws Amendment Act 2006 and replaced by a new GAAR found in section 80A-80L of the Income Tax Act 58 of 1962.¹⁴

As there has been no relevant case law since the introduction of the new GAAR, there is a level of uncertainty within the business world regarding the potential impact on sound commercial transactions, which was also a weakness of its predecessor.

For a GAAR to be effective, it is important to have a clearly drafted rule that provides the taxpayer, SARS and the judicial system with certainty.

This dissertation is therefore aimed at exploring the effectiveness of the current legislation in comparison to its predecessor, by analysing the requirements as set out in section 80A read together with relevant sections.

¹⁰ (1936) 51 TLR 467.

¹¹ SARS. 2006. Tax Avoidance and Section 103 of the Income Tax Act, 1962: Revised Proposals at 2.

¹² Ibid.

¹³ Ibid.

¹⁴ Van Schalkwyk, L., Geldenhuys, B. 2009. Meditari Accountancy Research at 167.

2. The General Anti Avoidance Rule requirements

Section 80A refers to an impermissible tax avoidance arrangement. This confirms that not all tax avoidance arrangements are prohibited in terms of the GAAR.

To constitute an impermissible avoidance arrangement ALL four of the below listed requirements have to be met in terms of section 80A of the Income Tax Act 58 of 1962:

- There must be an arrangement as defined in Section 80L;
- The arrangement results in a tax benefit and constitutes an avoidance arrangement entered into on or after 2nd of November 2006;
- The sole or main purpose of the avoidance arrangement is to obtain a tax benefit;
- Any one of the following tainted elements is present (abnormality element):
 - Abnormality regarding means and manner.
 - A lack of commercial substance in whole or in part.
 - Creating abnormal rights or obligations.
 - Leading to the misuse or abuse of the provisions of the Income Tax Act.

All four requirements will be critically analysed in sections 3 to 6.

3. An arrangement as defined in section 80L

The first requirement to be met in terms of the GAAR is that there must be an 'arrangement' as defined in Section 80L. In this section I will discuss what constitutes an 'arrangement'.

The term 'arrangement' is new to the GAAR. This term is found in foreign GAAR's like China, Ireland and New Zealand.¹⁵

AP de Koker¹⁶ submits that the term 'arrangement':

'...has been interpreted as requiring a conscious involvement of two or more participants who arrive at an understanding. It cannot exist in a vacuum and presuppose a meeting of minds, which embodies an expectation by each that the other will act in a particular way.'

It therefore means that the GAAR will find application where there is consensus between two or more parties to an 'arrangement'.

The predecessor of the section 80A, section 103(1) read as follows:

'...(1) Where any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation and scheme involving the alienation of property) has been entered into or carried out which has the effect of avoiding or postponing liability for any tax, duty or levy on income (including any such tax, duty or levy imposed by a previous Act), or of reducing the amount thereof, and which in the opinion of the Secretary, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out -'

Section 80L defines an 'arrangement' as:

'... any transaction, operation, scheme, agreement or understanding, whether enforceable or not, including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.'

It is clear from the above comparison that the legislature expanded the GAAR by introducing various new components and implementing a very detailed definition. The definition was expanded by including the terms 'agreement' and 'understanding', 'whether enforceable or not' and affirming that it will now also apply to steps and parts of an 'arrangement'.

¹⁵ PWC. 2012. Tax Controversy and Dispute Resolution Alert at 12.

¹⁶ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.36.

The different components of the term 'arrangement' as defined in section 80L, will be discussed in sections 3.1 to 3.5.

3.1. Transaction, operation, scheme, agreement and understanding

The Income Tax Act does not define the terms: 'transaction', 'operation', 'scheme', 'agreement' and 'understanding'.

The words 'transaction', 'operation' and 'scheme' were also found in the revoked section 103(1) and the established judicial principles will continue to apply as no new case law is found and there has not been any considerable changes to the definition.

In *Meyerowitz v CIR*¹⁷ it was stipulated by the court that the term 'scheme' is a wide term covering a series of transactions. In *CIR v Louw*¹⁸ it was found that the term 'scheme' is wide enough to cover situations in which later steps in a course of action were left unresolved at the outset.

The terms 'agreement' and 'understanding' are new components and the meaning and scope of these terms must still be determined by the courts.

AP de Koker¹⁹ described an 'understanding' as 'the meeting of minds'. It means there needs to be consensus between the parties.

According to SARS²⁰ these terms include any form of side letter, moral obligation under the so-called gentlemen's agreement, and letters of wishes. It should further be interpreted to include verbal, written and tacit agreements or understandings.²¹

It would be my submission that the terms provided in section 80L overlap each other in definition. The common characteristic found in a transaction, operation, scheme, agreement and understanding is an element of consensus. The insertion of the terms 'agreement' and 'understanding' is unnecessary as it does not contribute to expanding the scope of an 'arrangement' in view of the fact that the courts have established the term 'scheme' has a wide scope and covers almost every form of 'arrangement'.

¹⁷ 1963 (3) SA 863 (A), 25 SATC 287 at 300. This was confirmed in *CIR v Louw* 1983 (3) SA 551 (A) 45 SATC 113.

¹⁸ 1983 (3) SA 551 (A) 45 SATC 113.

¹⁹ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch 19.36.

²⁰ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule, at 14

²¹ *Ibid.*

3.2. Whether enforceable or not

The phrase 'whether enforceable or not' inserted by the legislature in the definition of 'arrangement' was not present in section 103(1).

SARS provides a non-exhaustive list of agreements to be considered an 'arrangement' which are not normally legally enforceable:²²

- *An agreement between parties to agree in future on reasonable terms and condition to effect a merger;*
- *The gentleman's agreement;*
- *Heads of agreement between parties which sets out the intended result the parties wish to achieve but not necessarily binding at the time; and*
- *An agreement binding in honour only, binding only in conscience, letter of intent.*

It is therefore clearly not required that an agreement should be legally enforceable for it to be regarded as an 'arrangement'.²³

It is suggested that it is irrelevant whether an agreement is a written document, containing all necessary essentials, or whether it simply creates a verbal understanding of any proposed future acts.²⁴ It could still constitute an 'arrangement'.

It is unclear how this phrase contributes to the definition as it will still be difficult to show the existence of an 'arrangement' where unenforceable methods, for example verbal arrangements, are used by parties, regardless of the inclusion of the phrase.

3.3. Steps or parts

Section 80L concludes that the GAAR applies to all steps or parts of an 'arrangement'. The phrase is not defined in the Income Tax Act and it is suggested that each 'connotes a distinct transactional element of the whole'.²⁵ In terms of section 80H, the Commissioner can apply the GAAR to each such step or part of an arrangement.²⁶

This is a new addition to the definition of an 'arrangement'.

In *CIR v Conhage*²⁷ the court held that where a taxpayer can demonstrate that the dominant reason for entering into a merged transaction was not to obtain a tax

²² SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule, at 14.

²³ Ibid.

²⁴ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.2.

²⁵ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.36.

²⁶ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.2.

²⁷ 1999 (4) SA 1149 (SCA), 61 SATC 391 at 393.

benefit, the GAAR would not be invoked.²⁸ However, it must also be shown that there would not have been any transaction at all, if not for the non-tax purpose.²⁹

In *Meyerowitz v CIR*³⁰ the court found the test to be whether the different steps appear to be so connected that they could ultimately lead to tax avoidance. It is of no significance if a taxpayer develops the intention to avoid tax in later steps.³¹ This was confirmed in *CIR v Louw*³² where the court further held that there 'must be some unity amongst the various steps'. The Louw-judgment stressed the importance of considering whether an individual step might be vulnerable to attack under the GAAR.³³

Where a composite transaction was entered into, a single agreement could constitute a scheme in terms of section 103(1) Trolip JA held:³⁴

"That does not mean, however, that the... agreement must be looked at with blinkers on...have regard to the circumstances under which the transaction, operation or scheme is entered into..."

However, the purpose of a step in, or part of an arrangement, may differ from the purpose attributable to the arrangement as a whole.³⁵ The phrase, 'steps or parts', was inserted to overcome the above established case law.³⁶ A step or part with the sole or main purpose of obtaining a tax benefit may thus no longer be 'camouflaged by a legitimate purpose of the arrangement as a whole'.³⁷

This phrase was aimed at tax driven, abnormal steps, lacking a commercial purpose, and misuse or abuse the provisions of the Act.³⁸ This would be where a transactional element has been inserted mainly for a tax benefit.³⁹ The Commissioner could then ignore the sole or main purpose of the arrangement when considering the purpose of a step. The GAAR would then only apply to that step where all requirements are satisfied.

SARS could potentially invoke the GAAR on a step of an 'arrangement' which seems driven by a tax benefit, irrespective of it being essential to the agreement as a whole, which lacks a main tax avoidance purpose.

²⁸ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.2.

²⁹ *CIR v Conhage* 1999 (4) SA 1149 (SCA), 61 SATC 391 at 393.

³⁰ 1963 (3) SA 324 (A), 25 SATC 287 at 299.

³¹ *Ibid.*

³² 1983 (3) SA 551 (A), 45 SATC 113 at 122.

³³ Emslie, 2001. T.S. Income Tax Cases and Materials at 960.

³⁴ *Hicklin v SIR* 1980 (1) SA 481 (A), 41 SATC 179 at 192.

³⁵ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 15.

³⁶ *Ibid.*

³⁷ SARS Explanatory Memorandum at 65.

³⁸ *Ibid.*

³⁹ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.2.

It would be my submission that the application should be limited to situations where a step is immaterial to the agreement or abnormal. D Clegg suggests correctly that the question should be whether the particular step is commercially necessary in achieving the intended final commercial result, or whether it could be dispensed with without affecting the commercial end result.⁴⁰

3.4. Alienation of property

An 'arrangement' involving the 'alienation of property' was specifically included.⁴¹ The reasons for this inclusion were partly to counter the effect of the King-judgment⁴² and to cover the frequent occurrence of property arrangements using tax aggressive methods.⁴³ In *CIR v King*⁴⁴ it was held that the expectation of a dividend attached to a share, when alienated with the share, must be regarded as capital and not income. The court further held that:

*'The expectation of a dividend attached to a share is an attribute of the share which may enhance its temporary value but it cannot for that reason be regarded as income.'*⁴⁵

The transaction therefore did not have the effect of avoiding tax and is therefore not a transaction as defined.⁴⁶ The GAAR could therefore not find application.

3.5. General

The exact meaning of the terms held in section 80L is yet to be established and it does not appear that the new additions to the definition of an 'arrangement' will significantly contribute to the success of the definition. Therefore it would be my submission that there is no substantial change to the definition and the legislature failed to create more clarity, which was a weakness in the predecessor.

Before an arrangement will attract the application of the GAAR, three more requirements have to be met. The arrangement must result in a tax benefit, it must be the sole or main purpose of such arrangement to obtain a tax benefit and it requires the presence of an abnormality element.

⁴⁰ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.2.

⁴¹ Section 80L.

⁴² *CIR v King* 1947 (2) SA 196 (A). (Cited in SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 14).

⁴³ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 14.

⁴⁴ *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184 at 196.

⁴⁵ *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184 at 196 -7.

⁴⁶ *Ibid.*

4. The tax benefit

The second requirement to be met in terms of the GAAR is that the arrangement should result in a tax benefit. Where an arrangement results in a tax benefit it constitutes an 'avoidance arrangement'.⁴⁷

A tax benefit is any avoidance, postponement or reduction of any liability for the payment of any tax, duty or levy imposed by the Act⁴⁸ or by any other Act administered by the Commissioner.⁴⁹ Taxes included are normal and donations tax, as well as secondary tax on companies. Examples of other Acts administered by the Commissioner are the Estate Duty-, Value-added Tax- and Transfer Duty Acts.⁵⁰ An arrangement therefore implemented for the sole or main purpose of avoiding estate duty, or any other tax administered by the Commissioner such as VAT or Transfer Duty, can be attacked if its effect is also to avoid tax levied in terms of the Income Tax Act.

The meaning of a 'tax benefit' has been considered judicially, and established case law would still apply.⁵¹

In *Smith v CIR*⁵² the court explained that a 'tax benefit' means that the taxpayer gets 'out of the way, escapes or prevents an anticipated liability'.

In *Hicklin v SIR*⁵³ it was said that the anticipated liability for tax can 'vary from an imminent certain prospect to some vague, remote possibility'.

Section 80F, which relates to connected persons and accommodating or tax-indifferent parties, plays a role when determining a tax benefit. In terms of the related section, the Commissioner may treat connected persons in relation to each other and accommodating or tax-indifferent parties, as one and the same person, and disregard any accommodating or tax-indifferent parties. A tax liability will therefore still arise where an existing income stream was shifted to a connected person.

In *CIR v King*⁵⁴ the court concluded that a 'tax benefit' exists where a transaction results in reducing income to less than it was in the past or freeing the taxpayer from taxation on part of his future income. The court further cited numerous ordinary and legitimate transactions whereby the taxpayer reduces his income and

⁴⁷ Section 80L.

⁴⁸ Section 1 of the Income Tax Act 58 of 1962.

⁴⁹ Section 80L.

⁵⁰ Meyerowitz, D. 2008. Meyerowitz on Income Tax: Ch. 29.3 at 5.

⁵¹ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 16.

⁵² 1964 (1) SA 324 (A), 26 SATC 1 at 12.

⁵³ 1980 (1) SA 481 (A), 41 SATC 179 at 193.

⁵⁴ 14 SATC 184 at 191.

thereby reduced his tax liability.⁵⁵ An example is where a taxpayer sells his investments and buys shares producing no income, or giving it away to the poor.⁵⁶ The court, correctly it is submitted, held that the legislature could not have intended such absurdity.⁵⁷

The Income Tax Act does not provide a test to determine the existence of a tax benefit, but the test used by the courts are the 'but for' test. The test simply asks whether, but for the existence of a transaction, would tax have been suffered?⁵⁸

It is confirmed in the cases, *ITC 1625*⁵⁹ and *CIR v Louw*⁶⁰ that the courts applied the interpretation of whether 'the taxpayer would have suffered tax but for the transaction' to determine the existence of a 'tax benefit'. The Commissioner bears the onus to show, on a balance of probabilities, that a tax benefit has arisen as a result of the arrangement entered into.⁶¹ This test, however, forces the Commissioner to predict what the taxpayer would have done if the taxpayer did not enter into the specific arrangement, which is subjective in nature and difficult to determine by the Commissioner.

Furthermore, in *CIR v Louw*⁶² using the 'but for' test the court accepted that in the alternative, salaries would have been paid to the taxpayers if the company did not allow for loan accounts.⁶³ This is the creation of a notional income which means that the taxpayer is taxed on income which in reality is not his. This is an absurd outcome.⁶⁴

It would create certainty if the legislature prescribed guidelines as to how a 'tax benefit' should be determined. This would prevent the courts from using their own interpretation which could prove difficult to use in practice.

Before the avoidance arrangement will attract the application of the GAAR, two more requirements have to be met, the first of which is that it must be the sole or main purpose of the avoidance arrangement to obtain a tax benefit and it requires the presence of an abnormality element.

⁵⁵ 14 SATC 184 at 191.

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

⁵⁸ *ITC 1625* 59 SATC 383.

⁵⁹ 59 SATC 383.

⁶⁰ 1983 (3) SA 551, 45 SATC 113 at 142-3.

⁶¹ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 18.

⁶² 1983 (3) SA 551, 45 SATC 113 at 142-3.

⁶³ *Ibid.*

⁶⁴ Clegg, D., Stretch, R. 2009. *Income Tax in South Africa* at 26.3.3

5. Sole and main purpose requirement

The third requirement to be met in terms of the GAAR is that the sole or main purpose of the avoidance arrangement must be to obtain a tax benefit. Where this is established it constitutes an 'impermissible avoidance arrangement'.⁶⁵

The meaning of the terms 'sole' and 'main' have been reviewed in previous case law and continues to apply in section 80A.

In *SIR v Lourens Erasmus (Edms) Bpk*⁶⁶ the court found:

"...the word 'mainly' establishes a purely quantitative measure of more than 50%..."

The court further held that the word 'solely' "does not detract from the interpretation but differs in meaning as it is the only purpose."⁶⁷

In *CIR v King*⁶⁸ the court said that the words 'the purpose' meant a "dominant purpose" and not merely a subsidiary purpose.

The test to determine the 'sole or main purpose' use to be a subjective test.⁶⁹ Corbett JA⁷⁰ based his finding on earlier case law.⁷¹ Ogilvie Thompson CJ in *SIR v Geusteyn, Forsyth and Joubert*⁷² and *Glen Anil Development Corporation Ltd v SIR*⁷³, adopted a subjective test

*"in applying that section 103 (1) draws a clear distinction between the "effect" of a scheme and the "purpose" thereof...and this virtually rules out an interpretation...of an objective connotation."*⁷⁴

Corbett JA, in *SIR v Gallagher*⁷⁵, further also explained the difference between the subjective and objective test:

'By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a subjective test which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme.'

⁶⁵ Section 80A, 80L.

⁶⁶ 1996 (4) SA 434 (A). (Cited in De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 25.7E).

⁶⁷ Ibid.

⁶⁸ 1947 (2) SA 196 (A) at 206.

⁶⁹ *SIR v Gallagher* 1978 (2) SA 463 (A), 40 SATC 39 at 48.

⁷⁰ Ibid.

⁷¹ Cited in De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch 19.38.

⁷² 1971 (3) SA 567 (A).

⁷³ 1975 (4) SA 715.

⁷⁴ Cited in De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch 19.38.

⁷⁵ 1978 (2) SA 463 (A) at 471B.

Section 80A refers to the purpose of the avoidance arrangement itself, as opposed to the intention of the parties. The wording of the new GAAR therefore indicates a shift towards an objective test by way of not referring to the purpose of the parties as was used in the predecessor.

The reason behind this change was to resolve an inconsistency which existed under section 103(1) as recognised by RC Williams⁷⁶:

“...a taxpayer could with impunity enter into a transaction which was objectively ‘abnormal’ provided that he did not, subjectively, have the sole or main purpose of tax avoidance....”

This was a weakness of the predecessor. The subjective intention of the parties has therefore been removed ‘to create a uniform treatment of identical transactions’.⁷⁷

However, section 80G(1) determines that the purpose of the avoidance arrangement should be ‘reasonable considered in light of the relevant facts and circumstances’, implying that a subjective test should be used.

It is therefore unclear which test the legislature intended to be used. If an objective test should be used it remains unclear what would be considered admissible and how the court will ignore the subjective purpose, seeing as the test requires of the Commissioner to consider the surrounding circumstances.⁷⁸

Trevor Emslie, Advocate of the High Court of South Africa, correctly alleged that it is illogical to use an objective approach and that it should in fact be a subjective test. An agreement cannot have a purpose on its own, but rather conveys the purpose and intention of the parties to the agreement and therefore it is important to consider the intention of the parties involved.

Where the Commissioner has successfully shown that a tax benefit has been obtained by the taxpayer, section 80G provides a rebuttable presumption. There is a presumption that the sole or main purpose of the taxpayer entering into the arrangement was to obtain a tax benefit. In terms of the predecessor the Commissioner had to show that the intention of the taxpayer was to obtain a tax benefit, however, the taxpayer now bears the onus to prove the contrary. This was altered by the legislature given that the taxpayer could easily escape a tax liability where the Commissioner had to determine the subjective intention of the taxpayer. The new position places a heavy burden on the taxpayer, since the taxpayer’s

⁷⁶ Williams, R.C. 1997. The 1996 Amendments to the General Anti Avoidance section of the Income Tax Act. (Cited in SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 21).

⁷⁷ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 21.

⁷⁸ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.38.

intention does not carry a lot of weight where an objective test is used to determine the purpose of the avoidance arrangement.⁷⁹

To determine the purpose of an arrangement one should refer to the time of implementation and not to the time when it was formulated.⁸⁰ The purpose of the arrangement can change over time, from when it was formulated, to date of implementation.⁸¹ The variation of the terms of the arrangement could affect the purpose.⁸²

The purpose of an individual step or part of an arrangement could also differ from the purpose from of the arrangement as a whole. Section 103(1) applied the GAAR to the whole agreement.⁸³ Section 80A allows the Commissioner to apply GAAR to individual steps and parts of the agreement.⁸⁴ This would be the case where an arrangement has a main purpose unconnected to a tax benefit, but a step of the arrangement has been inserted principally for its tax effectiveness.⁸⁵

Where a taxpayer is presented with two alternative methods of achieving the same commercial end result, resulting in different tax consequences, it is considered that, irrespective of which method is selected, the 'main purpose' of that transaction cannot be to obtain a tax benefit.⁸⁶ This flows from the principle of 'choice' established in *Duke of Westminster v IRC*⁸⁷ by Lord Tomlin and confirmed in *CIR v Conhage (Pty) Ltd*⁸⁸:

'Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attract less tax.'

To exercise the choice principal effectively the main purpose should be to achieve a commercial result and not a tax benefit.⁸⁹ Therefore, where the taxpayer's main purpose is to obtain a tax benefit the GAAR will find application.

⁷⁹ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.4.

⁸⁰ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.4.

⁸¹ *Ovenstone v SIR* 1980 (2) SA 721. (Cited in Emslie, T.S. 2001. *Income Tax Cases and Materials* at 945).

⁸² De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

⁸³ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.4.

⁸⁴ Section 80B.

⁸⁵ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.4.

⁸⁶ *Ibid.*

⁸⁷ (1936) 51 TLR 467.

⁸⁸ 1999 (4) SA 1149 (SCA), 61 SATC 391 at 392.

⁸⁹ *Ibid.*

This is based on the view that the GAAR 'intends only to protect the general provisions of the Act from frustration, and not to deny to the taxpayer any right of choice between alternatives'.⁹⁰

Where an impermissible avoidance arrangement has been established there is one more requirement that has to be met before the GAAR will be invoked. It must be confirmed that the avoidance arrangement is abnormal.

6. The Abnormality requirement

The GAAR requires the avoidance arrangement to include an element of abnormality as the fourth and last requirement to successfully invoke the GAAR.

This requirement was retained from the predecessor, despite continued uncertainty surrounding the meaning of the term 'normal'.⁹¹

The current Abnormality element has been expanded and consists of four tainted elements of which only one has to be established to invoke the GAAR as listed in section 80A:

- Abnormality regarding means and manner.
- A lack of commercial substance in whole or in part.
- Creating abnormal rights or obligations.
- Leading to the misuse or abuse of the Act.

The abnormality element retains all conceptual components as contained in the predecessor, with the exception that it should now be applied more objectively.⁹² It is suggested that the abnormality element should be applied more objective subsequent to the legislature omitting the words in the new GAAR, 'having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out', as contained in its predecessor.⁹³

The legislature broadened the abnormality element by including a 'misuse or abuse of the Act' provision.⁹⁴ This tainted element and the 'creating abnormal rights and obligations' provision are intended to remedy the well-recognised weaknesses in the predecessor and to expand the scope of the GAAR to address as many forms of impermissible tax avoidance as possible.⁹⁵

⁹⁰ De Koker, A.P. Silke on South African Income Tax. Ch. 19.37.

⁹¹ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.4.

⁹² SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 23.

⁹³ Ibid.

⁹⁴ Section 80A (C)(ii).

⁹⁵ SARS Explanatory Memorandum at 63.

To determine the existence of an abnormality element the Act differentiates between arrangements entered into in the context of business and arrangements not entered into in the context of business.

The first step would therefore be to determine whether an arrangement was entered into in the context of business or not, where after only one of the tainted elements in the category concerned must be met in order to satisfy the abnormality requirement.⁹⁶

In the sections following the tainted elements within their relevant contexts will be discussed.

6.1. Avoidance arrangement in the context of business

The 'business context'⁹⁷ approach makes provision for where an avoidance arrangement is entered into in a manner not normal for bona fide business purposes,⁹⁸ or it lacks commercial substance,⁹⁹ the abnormality requirement will be satisfied.

The terms 'business context' and 'business', are not defined within the Income Tax Act, although a 'trade' is defined as including a 'business' within the Income Tax Act.¹⁰⁰ A 'trade' is defined as:

*'every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent...'*¹⁰¹

It is important to note that carrying on a business is not the same as carrying on a trade. A trade is more widely defined and includes a business.¹⁰²

Although no definition is found in the Income Tax Act, relevant tax case law provides guidelines to determine the meaning of 'carrying on a business'.

In *Modderfontein Deep Levels Ltd v Feinstein*¹⁰³ the court held that the meaning of 'carrying on a business' must be determined on the circumstances of each particular case:

'...No doubt as a rule a trade or a business is carried on for the purpose of making a profit, but profit-making is not of the essence of trading...to

⁹⁶ Van Schalkwyk, L. 2011. *Silke on South African Income Tax*. Ch. 25.2 at 730.

⁹⁷ Section 80A(a).

⁹⁸ Section 80A(a)(i).

⁹⁹ Section 80A(a)(ii).

¹⁰⁰ Section 1.

¹⁰¹ *Ibid.*

¹⁰² Zulman, R.H. & Stretch, R. 2012. *Income Tax Practice Manual Commentary*. LexisNexis: A:B22.

¹⁰³ 1920 TPD 288 at 291,294.

constitute a business there must either be a definite intention at the first act to carry on similar acts from time to time if opportunity offers, or the acts must be done not twice but successively, with the intention of carrying it on, so long as it is thought desirable’.

*Morrison v CIR*¹⁰⁴ confirmed that ‘carrying on a business’ is a factual question.

When determining whether someone was ‘carrying on a business’, consideration should be given to the intention of the taxpayer, profit and frequency of such act, including the requisite for a series of actions to obtain the income.¹⁰⁵

In an unreported case in 1959 the court concluded that the normal commercial meaning should be attached to the term ‘business’.¹⁰⁶

The Business purpose- and Commercial substance test will be discussed in sections 6.1.1 and 6.1.2.

6.1.1. Abnormality regarding means and manner (Business purpose test)

This tainted element, found in Section 80A(a)(i), requires an objective approach to determine whether the arrangement was entered into or carried out, by means or in a manner, which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit.¹⁰⁷ This entails a comparison between the taxpayer’s transaction, and the way in which a similar type of transaction would normally be carried out.¹⁰⁸

The test does not require that an arrangement should have a business purpose as described, but merely that the method by which the transaction was entered into should be normal in a business context.¹⁰⁹

SARS confirms that:

“...the section does not mandate an enquiry into whether or not the particular taxpayer entered into the particular transaction for bona fide purposes, but that it necessitates an enquiry into a hypothetical situation: whether the manner in which the transaction was entered into ‘would not normally be employed’ for bona fide business purposes.”¹¹⁰

¹⁰⁴ (1950) 2 SA 449 (A), 16 SATC 377 at 387-8.

¹⁰⁵ Zulman, R.H., Stretch, R., Silke J. 2012. Income Tax Practice Manual Commentary. A:B22.

¹⁰⁶ *Smith v Anderson* (188-) 15 ChD 247 (CA), where the court held that a man who lets portions of one building in the circumstances of the present case would not be carrying on the business of letting property in the ordinary commercial sense.

¹⁰⁷ Van Schalkwyk, L. 2011. Silke on South African Income Tax. Ch. 25.2 at 730.

¹⁰⁸ Ibid

¹⁰⁹ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.5.

¹¹⁰ Williams, R.C. 1997. The 1996 Amendments to the General Anti-Avoidance Section of the Income Tax Act. (Cited in SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule, at 24).

D Clegg¹¹¹ correctly submits that it should rather be named the ‘bona fide business method test’ as the current description, the ‘business purpose test’ is misleading.

Where a method is construed as normal business practise, it will therefore fall short of the GAAR’s application, irrespective of a tax benefit being obtained.¹¹²

The term ‘bona fide’ is not defined in the Act, but it is a general concept. The recognized judicial meaning is ‘good faith’. Even when a transaction is entered into by means of a bona fide method, the method employed can still be found to be abnormal in a business context.¹¹³

It is unclear as to how it will be determined what constitutes normal business practice within a complex and diversified business world. It could be difficult to apply this in practice and this is problematic, not only for the taxpayer but also for SARS. In 1986 the Margo commission recognised that where a ‘particular form of transaction is widely used for tax avoidance purposes it may gain a commercial acceptability’ which would make it normal in the business world.¹¹⁴ This could have an adverse effect, surely not intended by the legislature. In this situation SARS will therefore not be able to invoke the GAAR irrespective of the taxpayer’s sole or main purpose to avoid tax, thus, in doing so, leaving the GAAR potentially ineffective, like its predecessor.¹¹⁵

A further difficulty raised by the Margo Commission was based on the interpretation of the GAAR by the courts:¹¹⁶

In *Hicklin v SIR*¹¹⁷ the court found that what may be interpreted as normal as a result of the surrounding circumstances of an agreement, may be abnormal in a similar agreement in the absence of such circumstances. The question of normality is therefore a factual one and the courts may potentially consider relevant circumstances.¹¹⁸ This has the effect of similar transactions being treated differently, which was a weakness of the predecessor. It is still unclear whether this weakness will be resolved by the objective test despite the presence of specific circumstances, for example where parties to an agreement have a special relationship.

¹¹¹ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.5.

¹¹² Meyerowitz, D. 2008. Meyerowitz on Income Tax: Ch. 29.5 at 29-7.

¹¹³ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.39.

¹¹⁴ SARS. 2006. Revised Proposals on Tax Avoidance and Section 103 of the Income Tax Act, 1962.

¹¹⁵ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.4.

¹¹⁶ Report of the Katz Commission into Tax Reform: Tax Avoidance. Ch 11. Para. 11.2.2-11.2.4.

¹¹⁷ 1980 (1) SA 481 (A), 41 SATC 179 at 195. As confirmed in *CIR v Louw*.

¹¹⁸ *Ibid.*

However, Trollip JA further noted in the *Hicklin's case* that the test for normality is whether the transaction was conducted at arm's length and when conducted accordingly it will not create abnormal rights and obligations.¹¹⁹

The concept of 'at arm's length' was described in *Hicklin v SIR*¹²⁰:

'It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself...Hence, in at arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by s 103(1)(b)(ii)...'

6.1.2. A lack of commercial substance

The commercial substance test is determined by a general rule contained in section 80C(1), assisted by a non-exclusive list contained in section 80C(2). The list contains characteristics, indicative of a lack of commercial substance. Both of which are new concepts and expand the scope of the GAAR:¹²¹

6.1.2.1. *General Rule*

Section 80(C)(1) reads:

'For purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.'

According to the general rule, an arrangement lacks commercial substance where it results in a significant tax benefit without having a significant effect on the business risks or net cash flows.

AP De Koker¹²² contends that the benefit must be significant in the context of the taxpayer's annual net profit, net assets or even his financial affairs in general.

The application of the test is challenging as no guidance is provided as to what constitutes a 'significant' tax benefit.¹²³ It is implied that the term could be defined as material or relevant to a specific taxpayer.¹²⁴ It would be my submission that the

¹¹⁹ 1980 (1) SA 481 (A), 41 SATC 179 at 195. As confirmed in *CIR v Louw*.

¹²⁰ *Ibid.*

¹²¹ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 25.

¹²² De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹²³ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.5.

¹²⁴ Olivier, L., Roeleveld, J., Davis, M., Uruquhart, G. 1999. *Juta Income Tax at 80C-2*.

legislature should define how a 'significant' benefit or effect will be determined to create certainty.

6.1.2.2. *Non-Exhaustive list of Commercial substance indicators*

Section 80(C)(2) reads:

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

(a) The legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or

(b) The inclusion or presence of—

(i) Round trip financing as described in section 80D; or

(ii) An accommodating or tax indifferent party as described in section 80E; or

(iii) Elements that have the effect of offsetting or cancelling each other'.

The four commercial substance indicators are discussed in section (a) to (d).

(a) Substance over form

It is important to understand the 'substance over form' concept before analysing section 80C(2)(A).

A distinction must be drawn between the simulation principle and the label principle. The former refers to where parties deliberately conceal or disguise the true nature of the transaction, which constitutes a sham.¹²⁵ The latter refers to where parties act in good faith, but attach the wrong label to the transaction.¹²⁶ The common law principle that applies in South-Africa, which was challenged in the case of *SARS v NWK Ltd*¹²⁷, determines that a transaction will not be regarded as simulated, if the parties genuinely intended their contract to have effect in accordance with its tenor.¹²⁸ It applies even if the transaction is devised solely for the purpose of avoiding tax.¹²⁹

¹²⁵ Emslie, 2001. T.S. Income Tax Cases and Materials at 897.

¹²⁶ Ibid.

¹²⁷ 2011 (2) SA 67 (SCA).

¹²⁸ Broomberg, E.B. 2012. Evasion v avoidance at 103.

¹²⁹ Ibid.

In the *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd*¹³⁰ the court held that:

'A transaction devised for that purpose, if the parties honestly intend it to have the effect according to its tenor, is interpreted by the court according to its tenor and then the only question is whether so interpreted, it falls within or without the prohibition or tax.'

This principle of law has prevailed since the decision in *Zandberg v Van Zyl*¹³¹ which concluded that:

'...the court must be satisfied there is a real intention, definitely ascertainable, which differs from the simulated intention'.

This was reaffirmed by the Supreme Court of Appeal multiple times.¹³²

In 2010 Lewis JA seemingly created a new requirement for simulated transactions in the recent case *SARS v NWK Ltd*¹³³:

*'In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms...The test should ... go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax or of a peremptory law, then it will be regarded as simulated.'*¹³⁴

Lewis JA created an objective test. The test does not focus on the intention of the parties but examines the commercial sense of the transaction based on a tax benefit.¹³⁵ The mere fact that a transaction was implemented in accordance with its terms would not preclude a finding that it was a sham.¹³⁶ This is a direct contradiction of the Practice Note No 5 of 1 April 1987 which determines that:

*"A taxpayer who has carried out a legitimate tax avoidance scheme, i.e. who has arranged his affairs so as to minimise his tax liability, in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner will have met his duties and obligations under the Act..."*¹³⁷

¹³⁰ 1941 AD 369 at 359-6.

¹³¹ 1910 AD 302.

¹³² Erf 3183/1 Ladysmith (Pty)Ltd & another v CIR 1996 (3) SA 942 (A), 58 SATC 229. (Cited in Broomberg, E.B. 2012. Evasion v avoidance at 104).

¹³³ 2011 (2) SA 67 (SCA).

¹³⁴ It is correctly submitted by EB Broomberg that the words 'evasion' and 'avoidance' are incorrectly used as substitutes since the Income Tax Act itself differentiates between the two concepts. It is therefore assumed that the court intended to use the term avoidance.

¹³⁵ Ibid.

¹³⁶ Bowman Gilfillan Attorneys. 2011. So, is NWK the new buzz in the world of tax?

¹³⁷ Broomberg E.B. 2011. NWK and Founders Hill.

This could therefore lead to agreements being struck down as shams where there is no 'apparent commercial purpose', although parties were acting in good faith, and lacked the intention to disguise any element of the arrangement.¹³⁸ This was clearly not the intention of the legislature.

Traditionally SARS found it difficult to prove 'substance over form' where agreements were implemented in accordance with their form. The ability to attack transactions in terms of this doctrine¹³⁹ has possibly been increased by the NWK-judgement if the courts decide to apply the objective test. It would be easier for SARS to succeed than where the finding is dependent on the biased and subjective intention of the party.

However, the findings of the NWK-judgement were not established by using the objective test, but rather the common law principle whereby one looks at the intention of the parties.¹⁴⁰ EB Broomberg¹⁴¹ therefore concludes correctly that the 'new law' was made obiter and not binding on other courts in the future. The common law approach therefore still prevails.

In terms of section 80C(2)(A) it is an indication of a 'lack of commercial substance' and therefore abnormal, where the legal substance or effect of an avoidance arrangement as a whole differs from the legal form of its steps.

SARS¹⁴² directs that the term 'effect' includes 'economic, commercial and practical effect of an arrangement.

This provision draws upon a precedent in both the UK and the US, adopting an 'unblinkered' approach to complex multi-step composite transactions and expanding the scope of the constricted common law doctrine of substance over form.¹⁴³

It is unclear how a legal substance or a commercial effect of the entire arrangement could be compared to a single step in the arrangement. This could not have been the intention of the legislature. Several commercial end results cannot be achieved through a single step and this provision accordingly puts all multi-step arrangements potentially at risk.¹⁴⁴

¹³⁸ Ger, B. 2011. Supreme Court of Appeal a-'maize'-s tax planners with watershed judgment.

¹³⁹ Dachs, P., Du Plessis, B. 2012. The interpretation of substance over form. ENS in Practice.

¹⁴⁰ Broomberg E.B. 2011. NWK and Founders Hill at 206.

¹⁴¹ Ibid.

¹⁴² SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 29.

¹⁴³ SARS Explanatory Memorandum at 64.

¹⁴⁴ Clegg, D., Stretch, R. 2012. Income Tax in South Africa. Ch. 26.3.5.

RC Williams¹⁴⁵ suggests that before invoking the GAAR, the Commissioner should first attempt to halt an arrangement by means of the common law principle. Firstly, the sections in GAAR are found to be more complex with more requirements to be satisfied and secondly, the common law principle would even apply in the absence of the intention to obtain a tax benefit.¹⁴⁶ The common law remedy is therefore more powerful than the provision found in the GAAR. However, the GAAR can be raised in the alternative.¹⁴⁷

(b) Round trip financing

The concept of 'round trip financing' is similar to the concept of 'round robin financing', found in Australia and 'circular cash flows', as used in the United States.¹⁴⁸

Section 80D appears to ensure a wide application. However, the definition provided seems to limit the application of section 80D.¹⁴⁹

Round trip financing refers to avoidance arrangements in which¹⁵⁰

- *Funds are transferred between or among parties; and*
- *The transfer would*
 - ❖ *Result in a direct or indirect tax benefit; and*
 - ❖ *Significantly reduce, offset or eliminate any business risk by any connected party*

In terms of section 80D(2) the provision will apply irrespective of whether round trip amounts can be traced back, the timing or sequence thereof and the means or manner it was transferred in. The fact that the flow of funds takes place during different assessment years is therefore irrelevant.¹⁵¹

The term 'funds' includes not only cash and cash equivalents but also any right or obligation to receive or pay the same.¹⁵² The term would therefore cover the cession of monetary amounts but does not include non-monetary fungibles.¹⁵³ SARS¹⁵⁴ confirms that it includes promissory notes, amounts paid in foreign currencies and derivative financial instruments where the obligations are settled in cash.

¹⁴⁵ Williams, R.C. 2009. Smoke and mirrors or genuine commercial venture? PWC Synopsis at 2-4.

¹⁴⁶ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.39.

¹⁴⁷ SARS v NWK Ltd 2011 (2) SA 67 (SCA).

¹⁴⁸ SARS Explanatory Memorandum at 64.

¹⁴⁹ Morphet, A. 2006. Tax Avoidance: by jove, we think they've got it!

¹⁵⁰ Income Tax Act 58 of 1962.

¹⁵¹ Van Schalkwyk, L. 2011. Silke: South African Income Tax. Ch. 25 at 731.

¹⁵² Section 80D(3).

¹⁵³ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.39.

¹⁵⁴ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule, at 30.

The concept 'round trip financing' was discussed in the case *Ramsey v IRC*¹⁵⁵:

'Although sums of money, sometimes considerable, are supposed to be involved in individual transactions, the taxpayer does not have to put his hands in his pocket.'

Section 80D supposedly should only apply where money is passed between parties, although the funds simply travel in a circle. Everyone is therefore restored to the positions held prior to the start of the avoidance arrangement.¹⁵⁶ However, it is submitted by EB Broomberg¹⁵⁷, that almost all arrangements will involve the transfer of funds. It could potentially have the effect of all fund transfers being regarded as round trip financing in terms of the phrasing of section 80D and creates uncertainty.

D Clegg¹⁵⁸ correctly it is submitted, suggests that the round trip financing provision is an example of 'offsetting or cancelling elements' and therefore a duplication of section 80C(2)(b)(i) as discussed in section 6.1.2.2(d). Both these provisions results in offsetting of steps and results in disguising the real effect and outcome of an arrangement.

(c) Accommodating or tax-indifferent parties

Section 80C(2)(b)(ii) refers to the presence of an 'accommodating or tax indifferent party'.

Section 80E provides a description of the term 'accommodating or tax indifferent parties':

- '80E(1) A party to an avoidance arrangement is an accommodating or tax indifferent party if -*
- (a) Any amount derived by the party in connection with the avoidance arrangement is either:

 - (i) Not subject to normal tax; or*
 - (ii) Significantly offset by either any expenditure or loss incurred by the party in connection with the avoidance arrangement or any assessed loss of the party; and**
 - (b) Either

 - (i) As a direct or indirect result of the participation of that party involves an amount that would have:

 - (aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another***

¹⁵⁵ (1982)A.C.300 at 322.

¹⁵⁶ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹⁵⁷ Broomberg, E.B. 2008. *Then and now* at 31.

¹⁵⁸ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.5.

party would be included in the gross income or receipts and accruals of a capital nature of that party;

- (bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party;*
- (cc) constituted revenue in the hands of another party would be treated as capital by that other party; or*
- (dd) given rise to taxable income to another party would either be not included in gross income or be exempt from normal tax; or*
- (ii) the participation of that party directly or indirectly involves a prepayment by any other party.*

Section 80E(2) further provides for the inclusion of parties not defined as a 'connected persons' in section 1 of the Income Tax Act.

To limit this tainted element the legislature has included two safe harbours:

- The amounts derived by that party are also subject to foreign taxes equal to at least two-thirds of the amount of tax that they would be subject to in South Africa.¹⁵⁹ The reasoning for this exception is to counter double taxation. This could be problematic for the taxpayer as it requires of him to have extensive knowledge of the relevant foreign tax laws.¹⁶⁰
- That party continues to engage directly in substantive trading activities in connection with the avoidance arrangement for a period of at least 18 months¹⁶¹ and provided those activities are attributable to a place of business that would constitute a foreign business establishment for the purposes of section 9D^{162, 163}. The phrase 'substantive trading activities' has not been defined in the Act¹⁶⁴ and it is unclear what activities will be included. Having regard for the fact that this can differ from taxpayer to taxpayer, the Commissioner should indicate which factors will be looked at. Furthermore the complicated test and exceptions impose a significant

¹⁵⁹ Section 80E(3)(a). Section 80E(4).

¹⁶⁰ De Koker, A.P. 2012. Silke on South African Income Tax. Ch. 19.39.

¹⁶¹ Presumably from the date of the transaction under investigation.

¹⁶² Section 9D(c)(a) of the Income Tax Act 58 of 1962 requires a fixed place of business in RSA; section 9D(c)(a)(i) the foreign business establishment must be suitable staffed with on-site managerial and operation employees; s9D(c)(a)(ii) suitable equipped and proper facilities; s9D(c)(a)(iii) located outside RSA for bona fide business purposes) if it were located outside South Africa.

¹⁶³ Section 80E(3)(b).

¹⁶⁴ Income Tax Act 58 of 1962.

burden on the taxpayer to adduce facts in respect of the other foreign party's business activities that may well be unknown to the taxpayer.¹⁶⁵

In terms of section 80F the Commissioner may treat connected persons in relation to each other and accommodating or tax-indifferent parties as one and the same person and disregard any accommodating or tax-indifferent parties. The consequence of this section is that any transaction between connected persons with a tax-haven is potentially subject to the application of the GAAR unless the taxpayer can prove that the sole or main purpose of the avoidance arrangement was not to obtain a tax benefit.¹⁶⁶

(d) Elements that offset or cancel each other

In terms of Section 80C(2)(b)(iii), where elements have the effect of offsetting or cancelling each other, it indicates a 'lack of commercial substance'.

This concept seems to draw on a precedent in the UK associated with the 'fiscal nullity' doctrine derived at in *Ramsey Ltd v IRC*.¹⁶⁷ The Ramsey principle says that where steps with no commercial purpose are inserted to avoid a tax liability the steps are to be disregarded for fiscal purposes.¹⁶⁸

The provision attempts to flush out intentionally misleading steps inserted in complex schemes. An example is the extinction of rights and obligations by way of confusion that occurred in *SARS v NWK*.¹⁶⁹ According to a signed agreement, NWK had borrowed capital of R96 million from a subsidiary of FNB Bank, to be repaid after 5 years by delivering maize.¹⁷⁰ The interest was payable over the 5 year period of the loan as calculated on the R96 million loan, however the economic effect of the entire arrangement resulted in NWK only receiving a loan of R50 million.¹⁷¹ The Commissioner correctly disallowed the interest deductible from income on the grounds that it was a sham and in the alternative, tax avoidance.¹⁷² This was a complex multi-step arrangement leading to the cancelling of rights and obligations.

(e) More indicators of a lack of commercial substance

SARS¹⁷³ indicates that the above listed tainted elements are not an exhaustive list and lists more examples likely to be considered:

¹⁶⁵ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹⁶⁶ Van Schalkwyk, L. 2011. *Silke: South African Income Tax*. Ch. 25 at 731.

¹⁶⁷ (1982)A.C.300 at 322. (Cited in De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39).

¹⁶⁸ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹⁶⁹ 2011 (2) SA 67 (SCA).

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

¹⁷² *Ibid.*

¹⁷³ SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule at 35.

- *Anticipated pre-tax profit insignificant in comparison to value of the anticipated tax benefit;*
- *Paying more or less than market value for assets or services;*
- *Inconsistent characterisation by the parties;*
- *Significant book or tax differences;*
- *Unnecessary steps or complexity;*
- *High transaction costs;*
- *Fee variation clause or other provisions; and*
- *Timing and duration of arrangement or failure to adhere to normal business practices.*

6.2. Avoidance arrangement in a non-business context

The 'non-business context' test contained in section 80A(b), refers to an avoidance arrangement carried out by means not normally employed for a bona fide purpose other than obtaining a tax benefit.

Refer to section 6.1 where these elements are discussed and views expressed apply equally.

The only difference between section 80A(a) and section 80A(b) is that the latter does not refer to a 'business' purpose and consequently any bona fide purpose will suffice.¹⁷⁴

There is no enquiry into a 'lack of commercial substance' as this would be inappropriate in a non-business context but the use of 'normal' in the provision indicates it entails a comparison with a hypothetical scenario.¹⁷⁵

6.3. Avoidance arrangement in any context

Section 80A(c)(i) reads:

'Where an avoidance arrangement has created rights or obligations that would not normally be created between persons dealing at arm's length'.

And section 80A(c)(ii) reads:

'Where an avoidance arrangement would result directly or indirectly in the misuse or abuse of the provisions of this Act'.

Both these requirements would be applicable in a business context, a non-business context and any other context not covered by the Act specifically.

¹⁷⁴ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹⁷⁵ *Ibid.*

6.3.1. Creating abnormal rights and obligations

Section 80A(c)(i) reads

‘Where an avoidance arrangement has created rights or obligations that would not normally be created between persons dealing at arm’s length’.

This tainted element existed in the predecessor, with the exception of considering ‘...the nature of the transaction, operation or scheme in question’, therefore suggesting that an objective test has been created in the new GAAR.

The test for whether an avoidance arrangement has created rights or obligations not normally created between parties dealing at arm’s length is a factual inquiry, considered against the hypothetical normal transaction.¹⁷⁶

The concept ‘at arm’s length’ as described in *Hicklin v SIR*¹⁷⁷ was discussed in section 6.1.1 as where both parties strive for the utmost advantage.¹⁷⁸

*CIR v Louw*¹⁷⁹ established that where parties to a transaction are related, one should ask whether in the context of that type of relationship, each party was seeking to extract the greatest possible advantage for himself. AP de Koker¹⁸⁰ correctly it is submitted, suggests that the courts will, in all likelihood, follow the same test in regard to section 80A(c)(i) despite the test being of an objective nature.

However, in view of the fact that the Commissioner has to show on a balance of probabilities that the arrangement created abnormal rights and obligations, EB Broomberg¹⁸¹ held that where surrounding circumstances are taken into account, the Commissioner is not likely to succeed. It is therefore still unclear whether this tainted element will contribute to enhancing the scope of the GAAR. It will be dependent on how strictly the objective test is applied by the courts.

¹⁷⁶ Garg, R. 2012. Removing the fences: Looking through GAAR at 47.

¹⁷⁷ 1980 (1) SA 481 (A), 41 SATC 179 at 195; Supported in *SIR v Geustyn, Forsyth and Joubert* 1971 (3) SA 567.

¹⁷⁸ *Ibid.*

¹⁷⁹ 1983 (3) SA 551 (A), 45 SATC 113 at 145. (Cited in De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39)

¹⁸⁰ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.39.

¹⁸¹ Broomberg, E.B. 2008. *Then and now.*

6.3.2. Misuse or abuse of the provision of the Act

Section 80A(c)(ii) reads:

‘Where an avoidance arrangement would result directly or indirectly in the misuse or abuse of the provisions of this Act’.

This provision was inserted to protect the general provisions of the Act from frustration.¹⁸²

The concept of ‘misuse or abuse’ is new to the South African GAAR and the rationale behind this insertion was to reinforce the modern approach to the interpretation of tax statutes “in order to find the meaning that harmonizes the wording, object, spirit and purpose of the provisions of the Income Tax Act”.¹⁸³ There are, however, no guidelines in the Act nor has it been judicially considered. Therefore it has to be seen in the context of existing South African legal principles and guidance found in foreign jurisdictions.¹⁸⁴

It originates from section 245(4) in the Canadian Federal Income Tax Act:¹⁸⁵

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

This section is used to limit the GAAR found in the Canadian section 245(2) which empowers the Commissioner to override unambiguous provisions which creates uncertainty and causes restrictive judicial interpretation.¹⁸⁶ The Canadian GAAR may therefore not be applied where a transaction does not result in the misuse or abuse of the provisions of the Act.¹⁸⁷

The South African legislature has drafted the phrase in a positive language rather than negative, as found in the Canadian section 145(4).¹⁸⁸ The South African provision therefore has the opposite effect and makes provision for the application of the GAAR when it results in the misuse or abuse of the provisions of the Act. This has stripped the GAAR of any limitations¹⁸⁹ and created an excessively broad GAAR

¹⁸² SARS. 2006. Tax Avoidance and Section 103 of the Income Tax Act, 1962: Revised Proposals at 15.

¹⁸³ SARS Tax Avoidance and Section 103 of the Income Tax Act, 1962: Revised Proposals. Quoted from Canada Trustco Mortgage Company v Canada 2005 SCC 54.

¹⁸⁴ Garg, R. 2012. Removing the fences: Looking through GAAR at 47.

¹⁸⁵ SARS Explanatory Memorandum at 63.

¹⁸⁶ Broomberg, E.B. 2008. Then and now at 31.

¹⁸⁷ Van Schalkwyk, L., Geldenhuys, B. 2009. Meditari Accountancy Research at 167-183.

¹⁸⁸ Cilliers, C. Thou shalt not peep at the neighbours’ wife. (Cited in ASA. 2009. Section 8A(c)(ii) of the Income Tax Act and the scope of part IIA).

¹⁸⁹ Broomberg, E.B. 2008. Then and now at 32.

whereby SARS can override provisions of the Act. EB Broomberg¹⁹⁰ states that the new misuse and abuse test will only effect limited transactions, particularly transactions that qualify for tax benefits in terms of a provision of the Act. An example is the tax benefits introduced by the Government to induce taxpayers to invest capital towards development of poor areas.¹⁹¹ In this instance the purpose would most probably be the tax benefit, which will satisfy the requirements of the GAAR.¹⁹² This could potentially result in a disturbance of the equilibrium between the power of the fiscus and a taxpayer conducting his business.¹⁹³ This section could possibly put the GAAR in the same predicament as its predecessor before the CIR v King-judgment¹⁹⁴ when its 'ambit was considered to be too wide',¹⁹⁵ which could result in a narrow and restricted interpretation of the GAAR by the courts.¹⁹⁶

EB Broomberg alleged that to determine whether a provision of the Act has been misused or abused, the purpose of such provision needs to be determined, which creates a further problem.¹⁹⁷ In Canada, the courts make use of the textual, contextual and purposive method of interpreting statutes irrespective of the wording of a provision being clear, certain and unambiguous.¹⁹⁸ This makes it easy to apply the misuse and abuse provision and determine the purpose of the provision. The interpretation methods used in relation to the South African tax law differs considerably from the method used in Canada as concluded in *Cape Brandy syndicate v CIR*¹⁹⁹:

"In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."

Where the meaning of the words of the Income Tax Act is clear and unambiguous, the courts therefore do not look into the purpose of the provision. It is therefore unclear how the courts will apply the misuse and abuse provision, considering the interpretation methods entrenched in the South African tax law.

¹⁹⁰ Broomberg, E.B. 2008. Then and now at 32.

¹⁹¹ Ibid.

¹⁹² Ibid.

¹⁹³ ASA. 2009. Section 8A(c)(ii) of the Income Tax Act and the scope of part IIA.

¹⁹⁴ 1947 (2) SA 196 (A).

¹⁹⁵ ASA. 2009. Section 8A(c)(ii) of the Income Tax Act and the scope of part IIA.

¹⁹⁶ Broomberg, E.B. 2008. Then and now at 32.

¹⁹⁷ Broomberg, E.B. 2008. Then and now at 32.

¹⁹⁸ Ibid.

¹⁹⁹ (1921) 12 TC 358 1KB 64 at 71. (Cited in Broomberg, E.B. 2008. Then and now at 32).

7. Conclusion

“The short-term behaviour of aggressive tax avoidance and evasion by multinationals is likely to result in a backlash and a retreat to protectionism which would make the world poorer.”²⁰⁰

Tax avoidance by taxpayers is a serious problem as it leads to the ‘erosion of the tax base’²⁰¹ and promotes unfair sharing of taxes. It is therefore desirable for countries to employ a GAAR to successfully prevent tax avoidance and to enforce the law. However, for a GAAR to be effective, it is just as important to have a clear and simply drafted rule that provides the taxpayer, SARS and the judicial system with certainty. In the recent foreign ruling, Vodafone International Holdings B.V v Union of India & Anr., the court held that:

‘Certainty is integral to the rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayer (including foreign investors) to make rational economic choices in the most efficient manner...’²⁰²

This dissertation was aimed at exploring the effectiveness of the current GAAR in comparison to its predecessor, by analysing the requirements as set out in section 80A, read together with relevant sections.

In terms of section 80A the following four requirements must be met before the GAAR can be invoked:

- There must be an arrangement entered into on or after 2 November 2006;
- The arrangement results in a tax benefit which constitutes an avoidance arrangement;
- The sole or main purpose of the avoidance arrangement is to obtain a tax benefit; and
- Any one of the tainted elements must be present to indicate abnormality:
 - Abnormality regarding means or manner.
 - A lack of commercial substance.
 - Creating abnormal rights or obligations.
 - Leading to the misuse or abuse of the Act.

Apparent from the requirements is that the legislature implemented various new concepts, creating confusion and uncertainty regarding the interpretation and application of the GAAR:

²⁰⁰ Trevor Manual cited in Aggressive tax avoidance by multinationals makes world poorer.

²⁰¹ Garg, R. 2012. Removing the fences: Looking through GAAR at 8.

²⁰² Civil Appeal No. 733 of 2012.

The legislature expanded the GAAR by employing a detailed definition of an 'arrangement'. The definition is wide enough to apply the GAAR to a single tax driven step forming part of an arrangement, regardless of the dominant purpose of the whole arrangement. This approach creates uncertainty and therefore it is submitted that the legislature should limit the application of this definition to steps which are not commercially essential to achieve an intended end result.²⁰³

Where the existence of an arrangement has been established the GAAR requires the Commissioner to determine the existence of a tax benefit. However, the GAAR does not prescribe a test to determine the existence of a tax benefit. The 'but for' method established and implemented by the courts could have the absurd outcome of a taxpayer being taxed on income which in reality is not his.²⁰⁴ The 'but for' test is subjective, making it challenging for the Commissioner to prove the existence of a tax benefit.

Subsequent to the Commissioner showing the existence of a tax benefit, section 80A suggests the use of an objective test to determine the purpose of an arrangement, deviating from the problematic subjective test traditionally recognised. However, when section 80A is read together with section 80G(1), which indicates that surrounding circumstances should be considered, it is unclear whether the legislature intended it to be a subjective or an objective test. If the legislature intended for an objective test to be used, it remains unclear which surrounding circumstances would be admissible and how the court will succeed in applying an objective test when taking into account subjective circumstances.²⁰⁵ The burden of showing the purpose has shifted from the Commissioner to the taxpayer. This change removed the weakness found in the predecessor where the Commissioner had the difficult task of showing that the taxpayer's intention was to obtain a tax benefit. However, the new position makes it difficult for the taxpayer to resist an attack where the taxpayer's intention does not carry a lot of weight.²⁰⁶ This creates uncertainty for the taxpayer.

For the GAAR to be successfully invoked the arrangement has to be abnormal. A weakness of the predecessor was found in the abnormality requirement. It was alleged that where a method or transaction is widely used, it becomes normal and commercially acceptable. In this situation SARS will not be able to invoke the GAAR irrespective of the taxpayer's sole or main purpose to avoid tax. Despite the lingering uncertainty, the legislature retained the tainted element in the current GAAR without further defining the term 'normal' and thus, in doing so, has left the GAAR potentially ineffective, like its predecessor.

²⁰³ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.2.

²⁰⁴ *Ibid.*

²⁰⁵ De Koker, A.P. 2012. *Silke on South African Income Tax*. Ch. 19.38.

²⁰⁶ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.2.

In terms of section 80C(2)(A) it is an indication of a 'lack of commercial substance' and therefore abnormal, where the legal substance or effect of an avoidance arrangement as a whole differs from the legal form of its steps. It was submitted that several commercial end results cannot be achieved through a single step and this provision accordingly puts all multi-step arrangements potentially at risk, yet again creating uncertainty.²⁰⁷

It was further submitted that the round trip financing provision, indicating abnormality, is an example of 'offsetting or cancelling elements' and therefore a duplication of section 80C(2)(b)(i) as discussed in section 6.1.2.2(d).²⁰⁸ Both these provisions result in the offsetting of steps and disguising the real effect and outcome of an arrangement. It was submitted that the Commissioner should remove the duplication as it creates confusion.

When determining whether abnormal rights and obligations were created, the legislature once more deviated from the traditional subjective test approach. It could prove to be problematic to apply an objective test to determine whether the parties are dealing at arm's length where parties are, for example, related.

The legislature implemented a new 'misuse or abuse of the provisions of the Act' provision to show abnormality. This provision allows SARS to override provisions of the Act which leads to uncertainty for the taxpayer. This could possibly result in the GAAR's scope being construed as being too wide, with the courts implementing a narrow and restricted interpretation.²⁰⁹ It is also unclear how this provision will find application, when considering the South African interpretation methods.²¹⁰

From the research and the concerns as discussed above, it is evident that the South African GAAR is a complex piece of legislation, which results in much uncertainty. Although the new GAAR has succeeded in removing most of the weaknesses found in its predecessor, it is fair to conclude that the legislature has failed to provide a more effective GAAR, when taking into consideration the difficulties in applying it in practice, its wide scope, undefined terms essential to its application and uncertainty surrounding the interpretation of the requirements. A great deal is left open to interpretation by the courts and as suggested, where the GAAR is construed as being too wide it could result in a narrow interpretation. South Africa needs a clearly drafted and simple GAAR that can be easily upheld by SARS and the courts, one which, unlike the current GAAR, does not create any loopholes to escape accountability for tax avoidance as a result of complexity and uncertainty.

²⁰⁷ Clegg, D., Stretch, R. 2012. *Income Tax in South Africa*. Ch. 26.3.2.

²⁰⁸ *Ibid.*

²⁰⁹ Broomberg, E.B. 2008. *Then and now* at 32.

²¹⁰ *Ibid.*

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