A comparison of the substantive aspects of impermissible tax arrangements under South Africa's General Anti-Avoidance Rule and the Principal Purpose Test with specific reference to the examples found within the 2017 OECD Model Tax Convention.

by

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DECLARATION

I, Bradley Arthur Zebert, hereby declare that the work on which this minor 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. I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

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ABSTRACT

The Organisation for Economic Cooperation and Development released the 2017 Model Tax Convention on Income and on Capital (hereafter "Convention") which contains a Principal Purpose Test under article 29(9). The practical application of this test is explained with the use of various examples within the accompanying commentary to the Convention. However, various ambiguities both in the Convention and the accompanying commentary exist.

The author raises these ambiguities and contrasts them with the general anti-avoidance rule (hereafter "GAAR") found within S80A of the Income Tax Act 8 of 1962. In doing so, the author asked which areas of the Principal Purpose Test are vague and can be interpreted in light of the South African GAAR to assist with attributing a meaning to it.

The key findings from this paper identified various areas of the Principal Purpose Test where the GAAR could be used to assist in the interpretation and application of the Principal Purpose Test being the phrases "the principal purpose", "benefit" and "arrangement". Other areas of ambiguity which were also interpreted with the assistance of the GAAR related to whether the Principal Purpose Test contained a business reality test as well as the further aspects of the test relating to its interpretative aspect, subjective enquiry and burden of proof. It was argued that these areas may indicate how the South African courts may apply the Principal Purpose Test in the South African context.

CHAPTER 1 INTRODUCTION

"There are only two things certain in life, tax and death".[1] This connotes that taxation is in various circumstances, not optional. It is imposed by the government along with consequences of the failure to pay. However, it does come with certain exemptions and benefits to lessen the impact of mandatory payments. These are at times often taken advantage of by taxpayers to avoid or limit the amount of tax payable. A better line to thus reflect the reality of the relationship between tax and taxpayers is the well known quotation attributed to W.E Gladstone "all taxation is in the long run voluntary".

1.1. The General Anti Avoidance Rule

Tax evasion is an inherently illegal activity. This is where the taxpayer breaks the law which can be shown as having been done with the intention to avoid paying tax.[2] The illegality arises through a failure to declare an appropriate amount of assessable income which arose from either a legal or illegal transaction.[3] One can contrast this to tax avoidance which is distinguishable by a fine line. This is where a taxpayer reduces a tax burden that does not constitute illegal behavior.

These avoidance schemes at times often have certain features which assist to identify them, but there is no single rule in this regard which captures all forms of tax avoidance. Rather it requires an analysis of all the factors at hand along with various legal devices to assist in making this determination.

On the South African front, a multitude of these devices exist within the common law to combat tax avoidance, examples being substance over form, *fraus legis* and sham doctrines.[4] Legislative measures have also been implemented to aid in this effort, which are together known as the general anti avoidance rule (hereafter "GAAR") which is currently housed within section 80A-L of the Income Tax Act 58 of 1962 (hereafter "ITA"). The GAAR is not a taxing measure nor does it relate to the taxes imposed by the ITA, rather it is a device that suppresses mischief that lies behind avoidance schemes, therefore protecting the charge to tax.[5] The GAAR does this by preventing the recognition of transactions which have as their main or sole

[1] James N. Kirkpatrick et al 'Death Is Just Not What It Used to Be' (2010) 19 *Cambridge quarterly of healthcare ethics* at 7.
[2] Paulus Merks 'Tax Evasion, Tax Avoidance and Tax Planning' (2006) 34 *Intertax* at 273.
[3] Ibid.
[4] Beric Croome *Tax law: an introduction* (2013) Cape Town Juta at 489.
[5] *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 1975 (4) SA 715 (A) 626.

purpose the avoidance of tax and which exhibit a list of various features, such as a lack of commercial substance.

This is not the first time that the GAAR has appeared in a legislative provision. Its predecessor, section 90, first appeared in the ITA in 1941, followed by section 103 and was subjected to various amendments.[6]

1.2. Principal Purpose Test

On the international front, there have been various developments. There too are various devices to combat avoidance, which are available to countries. An important device that appears to express some similarity with the GAAR is the Principal Purpose Test. This aims to make treaty benefits unavailable for arrangements or transactions which have as their sole or main purpose the obtaining of a treaty benefit that is not in line with the object and purpose of the respective treaty provision.[7]

However, this is not the first time that the Principal Purpose Test or any similar derivatives have found their way into treaty networks. It has been argued elsewhere that the Principal Purpose Test was first established in the treaty network of the United Kingdom which contained similar provisions which denied benefits with regards to interest and royalties where the treaty was taken advantage of.[8] Such a provision has also been found prior to this in the Organisation for Economic Co-operation and Development (hereafter "OECD") action report 6 (2015)[9] and Multilateral Convention under article 7(1)[10] which recognize a general anti avoidance provision based on the Principal Purpose Test.

1.3. Are anti avoidance measures important?

Why is addressing tax avoidance important in the South African context? Tax avoidance results in a lower amount of tax gathered, through methods such as profit shifting.[11] This is logical as the less tax paid in a jurisdiction, the lower the amount of tax gathered will be. It has been estimated that this may cause a total annual revenue loss for 79 countries amounting to 125

[6] David Clegg *Income Tax in South Africa Commentary* (2019) Lexis Nexis at ch 26.3.
[7] OECD Model Tax Convention on Income and on Capital (2017) Article 29.
[8] Ian Zahra 'OECD/International - The Principal Purpose Test: A Critical Analysis of Its Substantive and Procedural Aspects – Part 1' (2019) *Bulletin for International Taxation* at 610. Also see David G. Duff 'Tax Treaty Abuse and The Principal purpose Test—Part 1' (2018) *Canadian Tax Journal* at 668.
[9] OECD Action 6 Final Report 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances' (2015) at 55.
[10] Op cit note 8 at 609.
[11] Petr Janský & Miroslav Palanský 'Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment' (2019) *International Tax and Public Finance* at 1.

billion dollars.[12] With South Africa in particular, some authors have estimated that this could cause a loss of almost 4% to the South African GDP.[13] Although, it must be noted that these amounts are contested with various and large ranging figures from 0.02%[14] to just over 6%.[15] Furthermore, the shortfall in the collection of revenue is not new to South Africa and has happened in previous years.[16] It could also be argued that in current times, due to weak economic growth that is forecast, currently even worse at the time of writing this paper due to the COVID-19 pandemic, economic growth will significantly decline in the next few years, furthering the necessity of maintaining a tax base.[17]

Understanding the Principal Purpose Test against the lens of the GAAR will provide clarity on the major components of these devices which will provide support not only to taxpayers in structuring their affairs but also to the tax authorities with regards to the effect and ambit of such regulations in the practical sphere of their application.

1.4. Problem statement

The focus of this paper asks the following question: How might the South African courts apply the Principal Purpose Test, against the background of OECD model commentary examples and the South African case law in relation to the GAAR (in its previous versions)?

As already stated, article 29(9) in the OECD Model Tax Convention on Income and Capital 2017 (herein "OECD model commentary") provides for the Principal Purpose Test to counter tax avoidance by denying treaty benefits in certain instances. A major aid in the use of the OECD treaties is the accompanying commentary. This assists in the interpretation of the respective treaty by attempting to shed light on what is required from the specific article, usually with the use of examples. The commentary provides 13 examples in this regard to assist with its application. However, this has been critiqued as mostly unhelpful, leaving the application of the Principal Purpose Test uncertain.[18]

[12] Ibid Petr table 2.
[13] Ibid Petr figure 5.
[14] Reynolds, Hayley; Wier, Ludvig 'Estimating profit shifting in South Africa using firmlevel tax returns' (2016) *World Institute for Development Economics Research* at 12.
[15] Op cit note 12.
[16] National Treasury Republic of South Africa 2020 budget review for South Africa available at http://www.treasury.gov.za/documents/National%20Budget/2020/review/FullBR.pdf
[17] See the South African Revenue Service on the preliminary 2019/2020 revenue outcome with reference to the COVID-19 current effects on the economy available at https://www.sars.gov.za/Media/MediaReleases/Pages/1-April-2020-Preliminary-revenue-outcome-for-2019-20.aspx.
[18] Op cit note 8.

The re-enacted GAAR is also new in the sense that there is limited case law in which the provision has been analysed. Thus, both on the international front and the domestic front, taxpayers are left with very little certainty in the structuring of their tax affairs. More so, the tax authorities also do not have much guidance in this regard. This could partly explain the reluctance to rely on the GAAR when challenging tax avoidance schemes and instead relying on the common law, even though the former grants more power to the tax authorities.[19]

1.5. Justification of this paper

As has already been stated above, it could be argued that the existing commentary and material to assist with the application of the Principal Purpose Test remain vague. However, South Africa's current GAAR has some considerable precedent in South African case law dealing with the previous versions of the GAAR.

This is thus an area rife for necessary development. This paper will aid in exploring the potential meaning behind both tests with regard to their substantive components and practical application. This will shed some light on how, based on the GAAR and accompanying sources, we might see treaty avoidance in the same way as explained in the OECD model commentary on the Principal Purpose Test.

This will make it easier for the taxpayer to structure their affairs in a way that does not violate either of the tests and avoid taxation. For the tax authorities, this will provide guidance in applying domestic or international law to prevent its incorrect application and far-reaching negative effects.

1.6. Limitations

As the South African courts have not yet given guidance on these terms of the Principal Purpose Test, it is not clear if the views herein would be followed by the courts in such scenarios, making this paper hypothetical in so far as they are the views of the author.

1.7. Structure of this paper

The paper will begin by explaining and analysing the substantive pieces of the current GAAR in chapter 2. The paper will also undertake a substantive analysis of the Principal Purpose Test as found in the 2017 OECD model commentary in chapter 3. The analyses are undertaken to lay a foundation for the exercise in chapter 4 of contrasting the Principal Purpose Test and GAAR against the various examples found within the 2017 OECD model commentary with a focus on how a South African court might apply the Principal Purpose Test. It must be noted

[19] Income Tax Act 58 of 1962 at section 80B.

that chapters 2 and 3 will not contain a conclusion after each chapter as these are an analysis of multiple components of the GAAR and Principal Purpose Test. Rather, in chapter 5, this paper will summarise each of the conclusions that arose from the comparative exercise in chapter 4.

CHAPTER 2 THE SOUTH AFRICAN GENERAL ANTI-AVOIDANCE RULE

Section 80A-G of the ITA houses the general anti-avoidance rules. The section is found in the ITA as follows:

"**80A. Impermissible tax avoidance arrangements:** An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit **and**—

(a) in the context of business

(i) …..

(ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;

(b) …..

(c) in any context:

(i) …..

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

2.1. Introduction.

From what can be seen above, there are two major components of the GAAR, the first being the sole or main purpose to obtain a tax benefit and the second which must be met being either a lack of commercial substance or a misuse and abuse of the provision.

Case law seems to indicate that the main attack on avoidance schemes has not been undertaken with the new GAAR. It has been argued elsewhere that this is due to a multiplicity of reasons

such as its complexity.[20] What this indicates is that there is limited guidance on section 80A. However, there is much case law on the previous versions of the GAAR. The challenge here will be to work out which precedents survived the change. The author will thus rely on case law that dealt with substantively similar provisions.

Each of the components of the GAAR that are relevant to this paper will be unpacked and analysed below.

2.2. Components of the GAAR

2.2.1. Interpretation of the GAAR

As with any provision, before one can understand its meaning, it must be interpreted. The paper will thus begin by highlighting the correct approach to interpreting tax legislation in South Africa.

The South African courts have developed a correct approach to statutory interpretation, as was done in *Natal Joint Municipal Pension Fund v. Endumeni Municipality* 2012 (4) SA 593 (SCA). It should be noted that this was not a tax case. In effect, the "correct approach" requires one to follow a process which would consist of taking the following into account:

- the text itself, taking into consideration the language used and the ordinary rules of syntax,
- the context: the document as a whole and the circumstances of it coming into existence,
- the provisions apparent purpose,
- the materials known to the drafters, and
- results that are unbusinesslike or undermine the apparent purpose must be avoided.

[20] See Ed Liptak ' The New GAAR 10 Years On – Part II: Mistakes and Missed Opportunities' (2017) *TaxTalk* accessed at https://www.thesait.org.za/news/326188/The-New-GAAR-10-Years-On--Part-II-Mistakes-and-Missed-Opportunities-.htm on the 2 September 2020.

This case was later reaffirmed in *C:SARS v. Bosch*[21] which was the first tax case to confirm the "correct approach" when dealing with the interpretation of the ITA.[22] Thus, this is the approach that the courts would follow in determining whether there was a misuse or abuse taking place.

This approach is also relevant to this paper as this will be used in interpreting the various terms of both the Principal Purpose Test and GAAR as well as the commentary surrounding these mechanisms.

2.2.2. What are impermissible tax avoidance arrangements?

The heading of S80A titled as "impermissible tax avoidance arrangements", by implication recognises that there are some permissible avoidance arrangements.[23] Interestingly, SARS has stated that legitimate tax planning would include the use of tax incentives, as long as these are not exploited by the taxpayer.[24]

An arrangement is defined widely in the ITA 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."[25]

An avoidance arrangement is an arrangement undertaken for a tax benefit.[26]

It must be noted that this applies to the steps of a single transaction. Although the overriding scheme might be for a commercial purpose, a single step in the transaction could be for a sole or main purpose of obtaining a tax benefit. This express provision seems to be a response to the case *Commissioner for Inland Revenue v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd*[27]*,* where the court decided to focus on the main purpose of the transaction (sale and leaseback transaction) in determining whether tax avoidance had taken place.[28]

2.2.3. Is the sole of main purpose enquiry subjective or objective?

The requirement that the sole or main purpose was to obtain a tax benefit comprises the first component of the GAAR which needs to be fulfilled. This can be seen from the word "and" in

[21] *SARS v. Bosch* 2015 2 SA SCA 174 (SCA).
[22] The case dealt with the interpretation of the 'right to acquire a security' in Section 8A of the ITA.
[23] E. Mazansky 'New Anti-Avoidance Provision and Tax Planning for Non-Residents' (2018) 72 *Bull. Intl. Taxn.* 2 at 161.
[24] South African Revenue Service 'Discussion paper on tax avoidance and section 103 of the Income Tax Act Act No. 58 of 1962' (2005) at 5.
[25] Supra 19 section 80L.
[26] Ibid.
[27] 1999 JOL 5363 (A).
[28] E Mazansky, A new GAAR for South Africa - the Duke of Westminster is struck a blow, 60 Bull. Intl. Taxn. 3 (2006), Journals IBFD (accessed 2 Mar. 2020) at 127.

section 80A indicating that the sole or main purpose to obtain a tax benefit must be present before any impermissible tax avoidance arrangement can be said to exist. The onus rests here with the taxpayer to disprove this, as seen by section 80G which creates a presumption that the arrangement was entered into for the sole or main purpose to obtain a tax benefit.[29]

It has been argued that the test to determine the taxpayers purpose requires an objective assessment to be undertaken in applying the test.[30] This can be seen from the wording of section 80A referring to the purpose of the arrangement and not the taxpayer who devised the arrangement. The position of the subjective test being removed has been supported by the same reasoning in the SARS draft comprehensive guide to the GAAR.[31]

The apparent removal of the subjective test appears to be positioning the new GAAR to avoid two certain problems that might have arisen from a subjective test. The first relates to that of evidence, as it is difficult to prove a taxpayer's intention as one of undertaking a transaction with the sole or main purpose of obtaining a tax benefit.[32] Quite clearly this is because one's intention can never truly be known by another. With regards to a corporate entity, the same could be said for information asymmetry and the tax authorities.

The second problem relates to that of an anomaly that might exist where there are various taxpayers. This may lead to the result where one taxpayer is found to have a subjective intention whilst the other is not, even though they were party to the same transaction that was subject to the anti-avoidance rules.[33]

However, it has been questioned whether the GAAR does in fact now include a subjective test, when compared against the prior GAAR found under section 103 of the ITA. The prior section was worded as:

"any transaction, operation or scheme which has been entered into or carried out which has the effect of avoiding or postponing liability and was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability."

[29] Supra note 19 at section 80G.
[30] David Clegg '*Income Tax in South Africa'* LexisNexis SA (2019) at ch 26.3.4.
[31] South African Revenue Service 'Draft Comprehensive Guide to The General Anti-Avoidance Rule' (2010) at 21.
[32] AP de Koker '*Silke on South African Income* Tax' (2020) LexisNexis SA at Ch 19.38.
[33] Ibid.

This phrase has been interpreted by the court in *Secretary for Inland Revenue v Gallagher*[34] where it was stated that "the test is undoubtedly a subjective one."[35] The court reasoned that section 103 draws a clear distinction between purpose and effect which therefore prevents a finding that purpose should be interpreted as requiring an objective enquiry. The word "purpose" relates to the reason behind the transaction whilst the word "effect" relates to what was achieved by the transaction.[36] It has been argued by Dachs that when one compares this against the current GAAR under section 80A, the provisions are similar and should be interpreted in the same light. The GAAR refers to a sole or main purpose as well as the *result* of the arrangement, which can be contrasted to "effect". In the case of *Newton v COT*[37]*, the* court stated that the effect of the transaction means the "end accomplished or achieved", that is the "result of an action".[38] As already stated above, it is often at times unclear how purpose can be discovered, if it is in the mind of the taxpayer. Will the court merely accept what the taxpayer says?

This raises the question of whether recourse can be had to the *ipse dixit* (say-so) of the parties involved. Where courts are purely doing a subjective analysis, the *ipse dixit* is taken into account and tested against other objective factors.[39] The converse should also be true, being that where the courts take objective factors into account, subjective factors should also be taken into account.

The only difference between these two approaches is the focus areas of the enquiry and the weight given to each.[40] This is important as it means that the taxpayer can personally adduce evidence to prove the purpose behind the transaction, which will have more weight behind it in persuading the court. This can be contrasted against the approach by some civil law countries, for example Italy, where taxpayers are precluded from adducing oral evidence and the tax courts must base their decisions on documentary evidence alone.[41]

The author here leans towards the approach by Dachs. Quite clearly, the wording of the new GAAR does differ as it refers to the purpose of the transaction. However, in the view of the

[34] *Secretary for Inland Revenue v Gallagher* 1978 (2) SA 463 (AD).
[35] Peter Dachs 'Anti Tax-Avoidance Provision – is the Purpose Test Subjective or Objective?' (2013) 62 *The Taxpayer* at 184.
[36] Van Schalkwyk & Geldenhuys 'The nature of the purpose requirement of an impermissible tax avoidance arrangement' (2010) 35(1) *Journal for Juridical Science* at 75.
[37] *Newton v COT* 1958 2 All ER 759.
[38] Op cit note 36.
[39] Income Tax Case No 1185 (1972) 35 SATC 122(N),
[40] Op cit note 32 at ch 46.19.
[41] Gerard Meussen '*The Burden of Proof in Tax Law*' (2013) IBFD at 173.

author, one must not forget that behind transactions, there is a human mind that will be involved. Thus, transactions are man-made and a purpose can only exist in the mind of the taxpayer, which should therefore be the starting point.[42] Upon an analysis of the section, it could also be argued that the section also calls for this. Section 80G allows for the presumption of a transaction with a purpose of obtaining a tax benefit, until the taxpayer can prove otherwise, *reasonably considered in light of the relevant facts and circumstances* (emphasis added). It can thus be argued that the subjective intention of the taxpayer could also fall into the circumstances that should be taken into account by the court on an analysis of the facts.[43]

The court will need to undertake and test what was provided by the taxpayer against the facts at hand. This should not be taken as an objective test, as the taxpayer's intention will remain the centre of the enquiry. The court will merely undertake an analysis to determine if there is any "impunity" behind the purpose. This will require the taxpayer to put forward their intention which will be evaluated against the facts of the case to determine if there is any inconsistency. Mere statements that are not reinforced by any evidence will, in most cases, be insufficient to discharge the onus and sway the court.[44]

In the *Gallagher* case, a taxpayer had entered into a scheme to avoid income tax which SARS contended satisfied the conditions of the previous GAAR.[45] The taxpayer had put forward that the main purpose of entering into the transaction was to reduce estate duty. The court evaluated this *ipse dixit* along with various objective factors such as that the attorney who they had consulted was not asked about obtaining income tax benefits as well as that if the taxpayer had wanted to obtain a tax benefit, there were certain refinements that could be used. In the case of *Geustyn, Forsyth And Joubert*[46] three engineers practicing as a partnership formed an unlimited liability company which purchased the partnership for a goodwill amount. This was credited to the loan account of the engineers who became both directors and shareholders.[47] SARS attacked this scheme under the old GAAR due to a reduction on the amount of income tax that was payable. The court found for the taxpayer who stated that there was no main purpose to

[42] Op cit note 36 at 82.
[43] Op cit note 6.
[44] Op cit note 36 at 90.
[45] Op cit note 34 which dealt with section 103 of the Income Tax Act 58 of 1962.
[46] *Secretary for Inland Revenue v Geustyn* 1971 (3) SA 567 (A).
[47] Benjamin T Kunjinga LLD Thesis *"A Comparative Analysis of the Efficacy of the General Anti-Avoidance Rule as a Measure Against Impermissible Tax Avoidance in South Africa"* (2013) University of Pretoria at 77.

obtain a tax benefit. In coming to this conclusion, the court evaluated this *ipse dixit* against various objective factors, such as that:

1. there were valid non-tax reasons for a move to a company as the partnership would dissolve upon one of the partners death; and
2. this was the accepted practice in the engineering industry at the time, which had been approved by the South African Association of Consulting Engineers.[48]

Although the SARS draft comprehensive guide states that there has been a move to an objective test, in the SARS Revised Proposals on Tax Avoidance in South Africa and Section 103[49], it was stated that it was never the intention to completely remove the intention of the taxpayer from being taken into account. What this in effect shows, is that the position of the courts on previous versions of the GAAR is merely being confirmed and that there has been no change in the way the purpose test is to be dealt with.[50]

2.2.4. What does sole or main purpose mean?

The meaning behind a sole or main purpose is not clear from the ITA itself as it remains undefined. One must then to turn to case law to define this term, although as already stated, it must be kept in mind that there is limited guidance in terms of section 80A.[51] The word "main" indicates, by implication, that there is also a subsidiary part to the transaction. The question is how one should determine which is the main or subsidiary purpose underlying that transaction. This is an important consideration as most transactions will be undertaken that contain various commercial purposes and result in a tax benefit.

In the case of *SBI v Lourens Estate*,[52] the court held that it is a purely quantitative measure of 50% or more. This thus means that the purpose must be dominant.[53] This approach was followed in the case of *CIR v King 1947* (2) SA 196 (A) where the court stated that "mainly" conveys the idea of dominance. A different way to put this would be that the purpose of entering into the transaction was more than anything else to obtain a tax benefit.[54]

[48] Op cit note 36 at 75.
[49] South African Revenue Services 'Tax Avoidance and Section 103 of the Income Tax Act, 1962 Revised Proposals' (2006) at 21.
[50] Op cit note 36 at 79.
[51] Op cit note 6 at Ch 26.3.4.
[52] *SBI v Lourens Estate (Edms) Bpk* 1966 (4) SA 434 (A). Also see Op cit note 4 at 493.
[53] South African Revenue Service 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 Act No. 58 of 1962 (2005) at 43. See also See also *CIR v Bobat and Others* 2005 67 SATC 47 (N).
[54] Op cit note 31 at 22.

2.2.5. What is a tax benefit?

Tax is defined as a tax or a penalty imposed in terms of the ITA.[55] A tax benefit is defined widely by the ITA as including any avoidance, postponement or reduction of any liability for tax.[56] This should arise from the arrangement or transaction. In the case of *King*[57], the court further stated that this must be taken to refer to the actual avoidance of anticipated liabilities for tax. In other words, it can only be a current or future benefit which the taxpayer must have anticipated. This was further confirmed in the case of *Smith.*[58]

To determine this, the courts pose a question enquiring into the taxpayer's notional state of affairs which asks whether a taxpayer would have obtained a tax benefit had the income accrued to (or had not accrued with regard to expenses) them had the transaction been structured differently.[59]

The recent case of *Sasol Oil v CSARS*[60] dealt with the term "tax benefit". In this case, the Sasol group had undergone a restructuring which resulted in certain back-to-back transactions for the supply of crude oil from a group company in the Isle of Man, to a group company in London which then went to a group company in South Africa. As an alternative argument, SARS relied on the use of the previous GAAR (the transactions had taken place when it was still in effect) on the basis that the back-to-back transactions had been done with the sole or main purpose to obtain a tax benefit. The tax benefit, it was argued by SARS was that the residence-based taxation under the Controlled Foreign Company (herein "CFC) rules had been avoided.[61] The CFC rules provided an exemption where a CFC purchased goods within its country of residence from unconnected persons.[62] Thus the oil should have been sold directly to Sasol in South Africa.

The Old GAAR's use of a "tax benefit" mirrors the definition of a tax benefit in the current GAAR and is thus insightful. In determining whether there was a tax benefit, the court stated that one must ascertain: "what liability for tax Sasol Oil had avoided by entering into the

[55] Supra note 19 at section 1.
[56] Ibid.
[57] *Commissioner for Inland Revenue v King* 14 SATC 184.
[58] *Smith v Commissioner for Inland Revenue* 1964 (1) SA 324 (AD).
[59] Op cit note 30, Op cit note 32 at ch 19.37. Also see Income Tax Case No 1625 59 SATC 383 where this was referred to as a "but for" test; *Smith v CIR* 1964 (1) SA 324 (A); *Hicklin v SIR* 1980 (1) SA 481 (A), *Commissioner for Inland Revenue v Louw* (1983) 45 SATC 113 (A).
[60] *Sasol Oil Pty Ltd v Commissioner for the South African Revenue Service* 2019 1 All SA 106 (SCA).
[61] J. Hattingh and A. Titus, 'Judicial Reinterpretation of Legal Doctrine to address Tax Avoidance in South Africa: Sasol Oil v CSARS', (2020) British Tax Review at 177.
[62] Ibid at 178.

impugned transactions".[63] In deciding this, the court stated that in order to get a tax benefit, being the avoidance of tax, one must have anticipated such liability and avoided it through such transaction. In doing so, the court asked the question of whether Sasol would have had a tax benefit, had it not entered into the transactions. The court found here that the CFC exemption applied as Sasol did not hold participation rights in the group company in the Isle of Man. Even if it had purchased the oil directly from it, tax would not be charged under the exemption in the CFC rules.

Pidduck has also highlighted elsewhere that in determining whether a tax benefit was obtained, one can consider arguments in relation not only to historical transactions of the entity but also alternative transactions that would have taken place i.e. what should have taken place.[64]

However, this often raises issues with regards to how far taxpayers can structure their arrangements without being seen as receiving a tax benefit in terms of section 80A. Take for example a person who sells all of their income producing assets as they are bitter and tired of paying income tax to the South African government and would rather pay tax on a single capital gain. Assume further that in the long run, this reduces the tax paid to the government as the assets produced large amounts of income. Surely this cannot be taken as one obtaining a tax benefit. As stated above in Sasol Oil v CSARS[65], a tax benefit is not a literal concept but a conceptual one: it requires the postulation of a scenario to be measured against the actual behavior of the taxpayer. Avoiding such a literal interpretation would therefore avoid such absurd results. It would be absurd to assume this is what the government meant by tax avoidance.[66]

2.2.6. When can a taxpayer be considered to misuse or abuse the ITA?

This provision is new and has been inspired by the Canadian misuse or abuse test.[67] In Canada, the courts have developed a two-fold test to determine whether this condition has been met. The first stage of the test is an objective analysis into the purpose of the provision that is supposedly being misused or abused by the taxpayer.[68] The Second stage is a factual

[63] Supra note 60.
[64] Teresa M. Pidduck 'The Sasol Oil case – Would the present South African GAAR stand up to the rigours of the court?' (2020) *South African Journal of Accounting Research* at 261.
[65] Supra note 59.
[66] *Commissioner for Inland Revenue v King* 14 SATC 184.
[67] A. Titus 'Designing a General Anti-Avoidance Rule for the East African Community – A Comparative Analysis' (2019) 11 *World Tax J*. at 287.
[68] Benjamin T Kujinga, 'Factors That Limit the Efficacy of General anti-Avoidance Rules in Income Tax Legislation: Lessons from South Africa, Australia, and Canada' (2014) 47 *Comp & Int'l LJ S Afr* at 446. Also see *Canada Trustco Mortgage Company v Canada* 2005 SCC 54.

determination into whether the transaction is consistent with such a purpose.[69] If it is not consistent with such a purpose, it can be said that the transaction is misusing or abusing a particular section of the ITA.

It is not clear though whether misuse and abuse are the same concept. The draft bill asked the question of whether the actions "would *frustrate* the purpose of any provision of this Act".[70] The move from the use of a single word to two words raises the question of whether this was intentional.[71] However, it is unlikely that the words "misuse or abuse" are to be interpreted differently.[72] Both terms denote a concept of wrongful use. It could therefore be argued that the legislature used synonyms to promote clarity in the concept.[73]

2.2.7. The commercial substance test

One of the second legs of the provision that needs to be met, as stated above, is that the transaction must lack commercial substance, in whole or in part, taking into account the provisions of section 80C.

Section 80C states that:

> **"Lack of commercial substance:** 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."

As can be seen, a lack of commercial substance is defined as a transaction which results in a significant tax benefit, but that does not have a significant effect upon the business risks or net cash flows. Firstly, what constitutes "significant" is not clear as it is not defined in the ITA. It has been argued elsewhere that this term should be taken to mean material and relevant in relation to the taxpayer's financial affairs.[74] Although, without an authoritative ruling on the matter, the term will bring uncertainty with it. Furthermore, the reference to the business risk

[69] Ibid.
[70] Draft Revenue Laws Amendment Bill (2006) at 68.
[71] Teresa Calvert; Justin Dabner, "GAARs in Australia and South Africa: Mutual Lessons," *Journal of the Australasian Tax Teachers Association* 7 (2012) at 64.
[72] Van Schalkwyk & Geldenhuys 'Section 80A(c)(ii) of the Income Tax Act and the interpretation of tax statutes in South Africa' (2009) Meditari *Accountancy Research* Vol. 17 No.2 at 172.
[73] Ibid.
[74] Olivier, L. & Davis, D.M. & Uruquhart, G. 'Juta's Income Tax' (2009) Durban: LexisNexis at 80C-2. Also see Op cit note 6 at ch 26.3.5.

criteria leads to difficulty as it is at times often difficult to measure.[75] Even more so that many business transactions hedge business risk which may limit or completely offset the risk.[76]

The SARS draft guide states that commercial substance will generally be lacking where "a disproportionate relationship between the actual economic expenditure or loss incurred by a party and the value of the tax benefit that would have been obtained by that party but for the provisions of the GAAR or a loss claimed for tax purposes that significantly exceeds a measurable reduction in the party's net worth."[77]

Section 80C contains characteristics of transactions that lack commercial substance to aid in identifying them:

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

It should be noted that this is not a closed list and merely an aid in identifying such transactions. This can be seen from the wording "but are not limited to."

Section 80C(2)(a) uses the term "legal substance or effect" which is not defined in the ITA, however, the SARS draft comprehensive guide has stated that the term effect should be taken as meaning "economic, commercial or practical effect."[78] Furthermore, it is not clear whether this is incorporating the legal substance over form doctrine.[79] According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006, it expands the common law doctrine of substance over form.[80] It has thus been argued elsewhere that this concept of substance over form should be interpreted in line with the legislation and therefore taken to require an analysis of whether: the true intention of the parties is reflected in the agreement and whether the taxpayer remained insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary.[81]

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[75] Op cit note 32 at ch 19.39.
[76] Ibid.
[77] Op cit note 31. Also see Ibid.
[78] Ibid.
[79] Erf 3183/1 Ladysmith (Pty) Limited and Another v Commissioner for Inland Revenue 1996 (3) SA 942 (SCA) speaks of a taxpayer artificially structuring their transactions. Also see Ernest Mazansky 'South Africa's new general anti-avoidance rule - the final GAAR' (2007) *Bulletin for International Taxation* at ch 4.3.
[80] Explanatory Memorandum of the Revenue Laws Amendment Bill (2006) at 64.
[81] Teresa Michelle Calvert Pidduck PHD Thesis 'The South African General Anti-Tax Avoidance Rule and Lessons from the First World: a Case Law Approach' Rhodes University (2017) at 117.

Further factors as listed in section 80C of the GAAR are:

"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 GAAR further explains each of these concepts in section 80D, such as round-trip financing where it lists further characteristics to consider such as whether:

a) "funds are transferred between or among the parties (commonly referred to as 'round-tripped amounts');
b) the transfer of the funds would result directly or indirectly in a tax benefit; and
c) the transfer would significantly reduce, offset or eliminate any business risk for any party in connection the avoidance arrangement."

In the author's opinion, it is not necessary to go into a further analysis of the meaning behind them for the purposes of this paper.

2.3. The legal relationship between the GAAR and tax treaties

One can question whether the GAAR could be used as a tool to deny tax treaty benefits. In 2003 the OECD expressly addressed this question at a general level for the first time in the model commentary. It was stated that domestic anti-abuse rules could apply to a treaty (the so-called guiding principle).[82] The reasoning behind this was that an abuse of a tax treaty could be seen, by some states, to be an abuse of domestic law because this is used to enforce taxation.[83] It was further stated that treaties should not be seen as precluding or restricting the use of anti-abuse provisions as the latter determines which facts give rise to a tax liability which is not addressed in tax treaties and are therefore not affected.[84] At this time, this answer was a lot simpler as the model did not include a Principal Purpose Test as an article within the treaty and therefore a conflict with this was not discussed.

According to the 2017 OECD model commentary, this reasoning remains being that domestic anti-abuse rules can be used to deny treaty benefits.[85] This view is also supported by the BEPS Action 6 report where it is stated that the GAAR could be applied where a person tries to circumvent the application of the treaty.[86] The commentary goes on to highlight that there

[82] Vikram Chand " The Guiding Principle and the Principal Purpose Test" (2015) *International Taxation* at 486.
[83] OECD Model Tax Convention on Income and on Capital Commentary (2003) Para. 9.2 on article 1. Also see K. Vogel et al. "Tax Treaties and Domestic Law" (2006) IBFD at ch 5.3.
[84] Ibid.
[85] OECD Model Tax Convention on Income and on Capital Commentary (2017) article 1 commentary para 66.
[86] OECD 'Action 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances' (2015) introduction at para 16.

would be no conflict between the treaty and anti-abuse laws: Firstly, the treaty may specifically allow the application of domestic law.[87] Secondly, many treaty provisions application depend on domestic law and in that sense, the domestic law will impact how the treaty provisions are applied instead of producing conflicting results.[88] Lastly, it is stated that there will be no conflict with the Principal Purpose Test as this confirms the guiding principle:

"benefits…should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."[89]

Therefore, the main aspects would be the same and thus they would apply in the same circumstances.[90]

However, these remarks seem to be simplistic. It is possible that a conflict may arise between a domestic GAAR and the Principal Purpose Test, even though they share the same goal, as they may apply differently due to a difference in wording.[91] Furthermore, what underlies this wording is policy which could signify different notions of tax avoidance that are tolerated. For example, the word variation can reflect policy differences about the scope of a GAAR, on which party the evidentiary burdens must rest for the various elements, the type of factors that are to be considered, and which of these are decisive.

The author thus agrees with the opinion of *Chand* that where conflicts do arise, the treaty should prevail in line with article 26 of the VCLT which holds the state to account in application of the treaty in line with *pacta sunt servanda*.[92] It would also not make sense to apply both the GAAR and the Principal Purpose Test as "either the Principal Purpose Test applies first and there is no need to apply the domestic rules, or the domestic rules apply first and their compatibility with the treaties must be determined in the course of interpreting the treaty provisions."[93] Furthermore, one can question whether domestic law should be applied to a

[87] Supra note 85 article 1 commentary at para 72.
[88] Supra note 85 article 1 commentary at para 73.
[89] Supra note 85 at article 29 commentary para 61.
[90] Supra note 85 article 1 commentary at para 77.
[91] For example, words can vary which reflect policy differences about the scope of a GAAR, on which party the evidentiary burdens must rest for the various elements, the type of factors that are to be considered, and which of these are decisive in its application.
[92] Vikram Chand 'The Interaction of the Principal purpose Test (and the Guiding Principle) with Treaty and Domestic Anti-Avoidance Rules' (2018) *Intertax* at 122.
[93] Kuźniacki B, 'The Principal Purpose Test in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application' (2018) *World Tax J* at ch 1.1.

treaty context as it is in effect a unilateral application of law which may lead to double taxation.[94] It could however be said that such an argument is broad as tax treaties usually say very little about how tax law in the domestic context ought to be administered.

Another area for concern in states having the option to apply domestic law in an international context is that it could be seen as giving the state an opportunity to select the provision that is the most favourable in that context, giving them wide discretion.

However, one would also need to consider the specific country's legislation. In Canada for example, the definition of tax benefits under the GAAR expressly includes a reference to benefits that would have been derived under a tax treaty.[95]

In the South African context, it could be argued that the broad definition of impermissible tax arrangements above is wide enough to allow the GAAR to apply to treaties.[96] It was concluded by the interim Davis Tax Committee report that the South African GAAR could apply to tax treaties as the courts rely on the model tax treaty commentary which's view has been discussed above.[97]

In the case of *Glen Anil*[98] it was stated above that the GAAR is more of an administrative provision to protect the right to charge tax instead of being a measure to impose tax. It could thus be argued that the imposition of the GAAR is not actually charging a tax contrary to a tax treaty. According to Cilliers, no conflict would arise to the extent that the invocation of the GAAR would not involve a deviation from the true facts of the case.[99] The reasoning behind this is that SARS has been given wide powers under S80B of the GAAR, to for example, re-allocate amounts of gross income which could cause the party to not qualify as a recipient under the tax treaty.[100] Thus, the application of the GAAR should be done with caution.

[94] Op cit note 92 at 123
[95] Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) at section 245.
[96] Davis Tax Committee Interim Report 'Addressing Base Erosion And Profit Shifting In South Africa' (2014) at 65.
[97] ibid.
[98] Supra note 5.
[99] Chris Cilliers 'Silke on International Tax' (2018) ch 46.35.
[100] Ibid.

CHAPTER 3 THE PRINCIPAL PURPOSE TEST

Article 29(9) of the 2017 OECD model on income and capital makes provision for the Principal Purpose Test and states:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention." [101]

3.1. Introduction

The entitlement to benefits article is a new addition to the OECD model treaty network in the sense that it now finds its place in the form of an entirely separate article dedicated to such matters. The previous OECD model did not expressly include such a provision. This article now houses a Principal Purpose Test which has the purpose of preventing treaty abuse in general, including treaty and rule shopping.[102] It appears that the reasoning behind the inclusion of this into the treaty is also aimed at encouraging states to conclude treaties that had previously feared these treaties would be abused.[103]

The Principal Purpose Test, as found in the OECD model, will be broken down into two components, the first being the principal purpose requirement and the second being whether granting the treaty benefits would be in accordance with the object and purpose of the treaty provision.

3.1.1. The interpretation of model-based tax treaties

International law provides guidance in determining the purpose of the provisions of the treaty, which can be found within the Vienna Convention on Law Treaties (hereafter VCLT).[104] The VCLT is an international agreement between various states which has the aim of regulating treaties that have been entered into. Although South Africa is not a signatory to this, the Supreme court of Appeal has accepted that articles 31-33 reflect customary law and are binding on South Africa.[105]

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[101] Supra note 7 at article 29(9).

[102] B. Kuźniacki 'The Artificial Intelligence Tax Treaty Assistant: Decoding the Principal purpose Test' (2018) 72 *Bull. Intl. Taxn*. 9 at ch 3. Also see supra note 85 at commentary on article 29 para 4.

[103] Ibid.

[104] United Nations Vienna Convention on the Law of Treaties (1969).

[105] *Krok v Commissioner for the South African Revenue Service* 2015 (6) SA 317 (SCA). See also section 232 of the Constitution of the Republic of South Africa (1996).

Section 3 of the VCLT deals with the interpretation of treaties, of which articles 31 and 32 will be relevant here. Article 31(1) states that in interpreting a treaty, this must be done in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. The Context includes the treaty's preamble and annexures.[106] This includes any subsequent agreements and practice between the states.[107] Once this has been undertaken, recourse may also be had to supplementary materials to either confirm the meaning arrived at or to assist with interpretation in cases of ambiguity. Some authors have argued that the commentary should fall under context, but this has been rejected by others.[108] Although the VCLT does not expressly refer to the OECD model commentary as supplementary material, it would at the very least fall in here.[109] The commentary of the 2017 model will thus be used in this regard.

3.2. Was the transaction undertaken with a principal purpose to obtain a treaty benefit?

The first component requires one to take all relevant factors into account, in terms of a reasonable consideration, to determine whether the obtaining of a benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

The relevant terms from this component will now be analysed in the following sections below.

[106] Ibid at article 31(2).
[107] Ibid at article 31(3).
[108] Ulf Linderfalk and Maria Hilling 'The Use of OECD Commentaries as Interpretative Aids - The Static/Ambulatory–Approaches Debate Considered from the Perspective of International Law' (2015) *Nordic Tax Journal* at 47.
[109] See M Lang ' The Role of the OECD Commentary in Tax Treaty Interpretation' (2008) 23 *Australian Tax Forum* at 98. Also see *Thiel v Federal Commissioner of Taxation* 171 (1990) CLR 338.

3.2.1. What is meant by one of the principal purposes?

The commentary states that in determining what one of the principal purposes of the transaction or arrangement are, an objective analysis of the aims and objectives of all persons involved in putting the transaction into place or being a party to it must be undertaken.[110] All of the facts and circumstances must be reasonably considered to determine what the intent was.

The commentary further states that the effect of the transaction should not be used to determine its purpose unless the transaction can only reasonably be explained by the benefit obtained therefrom.[111]

A similar question arises as was discussed above in chapter 2.2.3: does this test require one to undertake a subjective or an objective consideration in determining the principal purpose? From a first glance, it appears that it is a subjective test. For example, the OECD commentary refers to the aims and objects of all persons involved in the transaction.[112] It appears that other authors have also indicated such an approach.[113]

However, this is not so clear as the commentary makes further references to an objective test that needs to be undertaken. Some authors have argued otherwise elsewhere that this test is actually results based. When one looks at the wording used, it refers to the purpose of the transaction and not the taxpayer.[114] This would seem to indicate that what the taxpayer intended here is not the focus of the enquiry. It also requires that it must be "reasonable to conclude". This would indicate that the test is aimed at an objective undertaking.[115]

It has also been argued that the use of the word purpose instead of intention would indicate a results-based approach.[116] In New Zealand in the case of *Plimmer*[117] the Privy Council in 1957

[110] Supra note 85 commentary on article 29 para 178.
[111] Ibid.
[112] Ibid para 178.
[113] L. De Broe & S. Gommers 'Article 29: Entitlement to Benefits (European Union) – Global Tax Treaty Commentaries' (2020*) Global Topics IBFD* at ch 4.3.1; S. Buriak 'Chapter 2: The Application of the Principal purpose Test under Tax Treaties in Tax Treaty Entitlement' (2015) *IBFD* at ch 2.1.4; Michael Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties" (2014) 74:7 Tax Notes International at 658. Van Weeghel 'Deconstruction of the Principal Purpose Test' (2019) *World Tax Journal* at 11.
[114] Op cit note 8 at 614. Also see M.L. Gomes 'The DNA of the Principal purpose Test in the Multilateral Instrument' (2019) 47 *Intertax* 1, p. 79; David G Duff 'Tax Treaty Abuse and the Principal Purpose Test - Part II' (2018) Canadian Tax Journal/Revue Fiscale Canadienne at 32. Also see C. Elliffe 'The Meaning of the Principal purpose Test: One Ring to Bind Them All?' (2019) 11 *World Tax J*. 1, sec. 4.2.2.
[115] Ibid Duff. Also see Dennis Weber 'The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law' (2017) *Erasmus Law Review* 1 at ch 2.3.1.
[116] Op cit note 8 at 614.
[117] Ibid.

had to determine the meaning of the taxpayer's "purpose for selling" certain property in regards to a domestic taxing provision.[118] It was stated that although one cannot have a purpose without an intention, indicating interconnectedness, they are not synonymous.[119] It could thus be said that the purpose of the transaction requires a more objective analysis.

The meaning behind the "principal purpose" should not be taken to mean that a dominant or sole purpose is required. There may thus be multiple purposes behind a transaction or an arrangement.[120] However, it has been argued that if one of the principal purposes is to obtain a treaty benefit, this would satisfy the requirements of this article.[121]

In determining what the principal purpose was, one must determine whether obtaining the benefit was a principal reason for entering into the arrangement and whether it justified entering into the transaction or arrangement.[122]

The use of the term "principal purpose" has been critiqued as being grammatically incorrect as it is impossible to have more than one principal purpose.[123] This can be contrasted with the South African GAAR which refers to the main purpose, of which there can only be one. However, with the Principal Purpose Test, it seems as though theoretically, one could have three principal purposes each comprising of 1/3 of the reason for entering into the transaction. It could thus be argued that, as long as one of these purposes was to obtain a tax benefit, the Principal Purpose Test would be met. This is discussed further in the next chapter below in relation to the examples.

However, where an arrangement or transaction is inextricably linked to a commercial activity, without being driven by the considerations of obtaining a tax benefit, it is unlikely that this requirement would have been met.[124] This seems to imply that in applying the Principal Purpose Test, regard must be had to whether there is any commercial substance underlying the transaction.

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[118] *Plimmer v. Commissioner of Inland Revenue* NZ: Privy Council, 2 Dec. 1957 [1958] NZLR 147. Also see C. Elliffe op cit note 114.
[119] Op cit note 113 Lang at 997.
[120] Op cit note 8 at 614.
[121] Supra note 85 at para 180.
[122] Ibid at para 181. Also see op cit note 8 at 614.
[123] E. Mazansky 'New Anti-Avoidance Provision and Tax Planning for Non-Residents' (2018) 72 *Bull. Intl. Taxn*. 2 at 162.
[124] Supra note 85 at para 181.

3.2.2. Does the Principal Purpose Test implicitly imply a business reality test?

As the OECD model tax treaty commentary states that a purpose can only be determined by having recourse to all of the circumstances surrounding an arrangement, a question can be raised with whether there is an overall business reality test incorporated into the Principal Purpose Test as a relevant circumstance.[125] The reference to the business reality test here can be taken to mean that the arrangement is akin to the commercial reality of the situation and has commercial substance to it. [126]

It is argued here that such a test is an aspect of the Principal Purpose Test. Firstly, the commentary states that "where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit".[127] In essence then, the commentary appears to create a safe harbor by implying that as long as there is commercial substance, it can be assumed that the Principal Purpose Test has not been met.

Secondly, this can be seen from the numerous examples found within the commentary which rely on whether there is any commercial substance behind the decision that was taken. Example C within the commentary is a good illustration of this so called "test" being applied. In this example, RCO is a company in state R which is looking to expand their business operations and needs to choose between various countries. RCO clearly chooses to undertake operations in a state S as there is the benefit of a double tax convention between state R and S. However, the commentary states the principal purpose here is actually the expansion of RCO and the location because of low manufacturing costs (i.e. a legitimate business purpose) and therefore the Principal Purpose Test was not met. Thus, in this example, the economic substance is an important factor to take into consideration in determining whether the Principal Purpose Test has been met. [128]

These examples are important as there is no clear requirement of what would constitute a business purpose which could thus lead to further uncertainty when applying the Principal

[125] Supra note 86 at para 178.
[126] Op cit note 8 at 614.
[127] Supra note 85 article 29 para 181.
[128] Antonio Cuoco 'The Principal Purpose Test as Introduced by the OECD MLI: Is It Time for a Compromise with EU Tax Law' (2019) *Interntax* at 883.

Purpose Test.[129] As can be seen from this discussion, commercial reasons that drive the arrangement assist in making this determination.[130]

It is noted that there is clearly some literal divergence with regards to the wording of the commentary and article 29(9) on this point. At a first glance of article 29(9), one does not find the words referencing a business reality test. However, the commentary adds further clarification in this regard which makes sense as transactions which contain no commercial substance are likely to have been undertaken for reasons of obtaining a tax benefit. It should be noted however, that the terms are not synonymous, and it is possible to have both a principal purpose to obtain a tax benefit and commercial substance. For example, the treaty refers to a company with shareholding at 24% which increases shareholding to 25% to obtain a treaty benefit. The commentary states that this is allowed, even though it was principally done to obtain a treaty benefit as it was a genuine transaction i.e. it has substance to it.[131] Thus, in the author's opinion, this is only a factor to consider, albeit a major factor, in determining whether the Principal Purpose Test has been satisfied. The business reality test will be discussed further in chapter 4.3 below.

One must be careful of this leading to the creation of an additional requirement that is not found within the treaty article. This could have the potential to undermine the powers of the states that have elected to use such a treaty but did not have a business reality test in mind. Setting clearer standards would be beneficial and reduce the chance of disputes.

3.2.3. Arrangement or transaction

These terms are defined broadly as including any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable.[132]

One could ask what the difference is between an arrangement or a transaction. It appears that this answer can be found when analyzing the commentary. An arrangement is explained further with the use of an example of where active steps are taken to obtain a tax benefit, such as ensuring that the meeting of directors takes place in a specific country to obtain residence therein. Looking at the wording it could be said that a transaction is a single action undertaken to obtain a tax benefit. This can be seen from the definition first referring to a "transaction"

[129] See Patrick Vanhaute 'The Genuine Economic Business Purpose Test and International Tax Planning in Belgium' (1995) *Int'l Tax J.* at 55
[130] Supra note 85, see examples C, F and H.
[131] R.J. Danon 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' (2018) *Bull. Intl. Taxn* Ch 3.3.4.
[132] Ibid at para 177.

followed by "a series of transactions" which indicates that a transaction is a singular action. Thus, it would appear that an arrangement and transaction are not synonymous as the former incorporates the latter. Although UK case law has indicated that arrangement here connotes some degree of a clear cut plan from the outset, in the sense of being preordained, it is argued here that a wide meaning should be given to this term which would be in line with the approach of the provision which has a wide scope as its aim to cover all transactions, including new or innovative ones.[133]

Such an interpretation would seem to be accepted in the South African context as the term arrangement is defined in the ITA as including a transaction.[134] However, one should not take this as stating that an arrangement only contains transactions. As per the United Kingdom GAAR and the South African GAAR, it includes in its definition, schemes, agreements and understandings.[135]

3.2.4. THE WIDE NET OF OBTAINING A BENEFIT

The first aspect of the phrase "that resulted directly or indirectly in that benefit" highlights that there needs to be a connection between the transaction or arrangement and the benefit. The term indirectly highlights that there is a wide net in capturing the benefit which results to prevent a taxpayer obtaining a tax treaty benefit where means are employed which makes it appear as though the taxpayer has not obtained the tax benefit but when in reality, they have. This may take the form of company A shifting loan repayments to a jurisdiction where a double taxation agreement is in place which allows for an exemption of withholding tax on interest payments. For example, ACO in state A which has a debtor in state C who needs to repay a loan, reconfigures loan repayments so that they go to its subsidiary BCO in state B as there is a treaty in place between state B and C which allows for no withholding tax on interest repayments.[136] ACO then gets promissory notes from BCO, which would give ACO the opportunity to on sell such notes to avoid withholding tax on interest.[137]

Furthermore, as already discussed above, it could be argued that such an example also takes the business reality into consideration.

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[133] *Inland Revenue Comrs v Payne* (23 Tax Cas 610) and *Crossland (Inspector of Taxes) v Hawkin* [1961] 2 All ER 812. Also see op cit note 8 Duff at 974 and Zhara at 621.
[134] Op cit note 19 section 80L.
[135] Ibid. Also see The Finance Act (No.2) 2017 Schedule 16.
[136] Supra note 85 at commentary on article 29 para 176.
[137] Ibid.

3.2.5. The entitlement to treaty benefits

The term benefit is referred to widely by the commentary as including all limitations (such as a tax reduction, exemption, deferral or refund) on taxation imposed under the convention, the relief from double taxation, and the protection afforded to residents and nationals of a contracting state under the convention or any other similar limitations.[138]

As the commentary does not expressly deal with this, it could be said that many countries without a domestic GAAR might attempt to argue here any reduction in tax constitutes a tax benefit.

A question that can be raised here is whether the provision of any article of the double tax treaty would result in a tax benefit, as the allocation of taxing rights necessarily prevents the imposition of double taxation, which would almost certainly result in less tax being imposed upon the taxpayer.

3.3. When would granting the benefits be in line with the object and purpose of the treaty provision?

The second question that needs to be asked when applying the Principal Purpose Test is whether granting the treaty benefits would be in line with the object and purpose of the treaty provision. Even if the party has undertaken the transaction with the principal purpose to obtain a treaty benefit, the party will still be entitled to the benefit if it would be in line with the object and purpose of the tax treaty. This can be seen from the word "unless" found within the test.

It is not clear where the onus lies under this component of the test. It has been argued elsewhere that, although the commentary is not clear, it requires the tax authority to prove the existence of a principal purpose whilst the taxpayer must prove that granting the benefit would be in line with the purpose.[139] The reasoning behind this can be found in the commentary where it was stated with reference to this question:

"Where this is the case, however, the last part of the paragraph [of the Principal Purpose Test] allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this convention."[140]

[138] Supra note 85 at commentary on article 29 para 175.
[139] Craig Elliffe 'The Meaning of the Principal Purpose Test: One Ring to Bind Them All?' (2019) *World Tax Journal* at 24.
[140] Supra note 85 article 29 commentary para 170.

3.3.1. Interpretation of the treaty provision

In determining the purpose of the provisions when applying the second question of the Principal Purpose Test, one would need to turn to interpretation. In determining the purpose of the provision, one needs to have recourse, not only to the article in consideration, but to the entire treaty including its preamble.[141] This needs to be done with the use of the Vienna Convention on the Law of Treaties, which has been discussed above.[142]

It has been argued elsewhere that the way that this provision is structured unnecessarily limits a purposive consideration of the treaty and its articles, which shows that this could not have been intended to provide a legal basis to deny treaty benefits.[143] Rather, it only signals an overall approach that already exists in the VCLT towards denying treaty benefits in all cases where their attainment is not in line with the object and purpose of the treaty. This argument is supported by the following reasoning: since the second test acts as an exception to the first, one cannot apply a purposive interpretation to the consideration of object and purpose in cases where the first component of the Principal Purpose Test has not been met. One would need to fulfil the first requirement of this test before a purposive interpretation could be undertaken. Therefore, this interpretation is illogical and therefore a different meaning must attach to the provision.

This author disagrees with this reasoning. Although it is true that the second component is an exception to the first component, it does not state that no other purposive interpretation should take place unless the requirements of article 29 are met.

The provision does not state that the purpose of an article may not be taken into consideration when analysing a treaty provision. It should be seen as a separate enquiry when one determines whether to grant treaty benefits. The commentary seems to call for such a limited application of this article and its overlap with other articles which can be seen from it stating that the commentary should not be used to interpret the other provisions found within article 29.[144] In other words, the VCLT would still apply to all provisions including that of article 29(9).[145]

[141] Supra note 85 commentary article 29 Para 173.
[142] Op cit note 8 617.
[143] Michael Lang 'The Signaling Function of Article 29(9) of the OECD Model – The "Principal Purpose Test"' (2020) *Bulletin for International Taxation* 74.
[144] Supra note 85 para 171.
[145] See Danon 'The Principal Purpose Test in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!' (2020) *Bulletin for International Taxation* 74 at ch 3.3.2

The argument by Lang also seems to imply that there are not two components to the Principal Purpose Test, but only one as the question of whether granting the treaty benefit would be in line with the object and purpose of the treaty does not add anything as such a principle is already in existence throughout the entire treaty.[146] The author does agree that Article 29(9) does not provide any new information but solidifies it as a legally enforceable article providing clarity and unity in an approach against the misuse of tax treaties. Furthermore, such a question is specifically incorporated into the wording of the test and should therefore always be asked during its application. Lastly, the commentary itself recognizes two components to the Principal Purpose Test:

"Where this is the case…*the last part of the paragraph* [of the Principal Purpose Test] allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this convention."[147]

It is also argued here the inclusion of the second component of the Principal Purpose Test not only acts as a signal but adds further legitimacy to its invocation which is necessary as its invocation will likely be an area rife for dispute between the taxpayer and tax authority. It does this by providing a clear authority with the denial of benefits. It also somewhat limits the extent of the tax authority by being drafted in such a way that a process needs to be followed before a benefit can be denied meaning that the purpose will be considered only in those schemes that have the principal purpose of obtaining a tax benefit.[148]

Such an approach as argued here would reconcile the VCLT and the preamble statements with article 29(9) without ignoring the express inclusion of an article into the treaty and the commentary which refers to specific articles object and purpose.[149]

There has also been debates between various authors on whether the purpose of the overall treaty can be considered or whether only that selected provision within the treaty can be considered to determine the purpose. Danon has argued here that upon analysis of the Principal Purpose Test, the object and purpose of the treaty provision should solely be taken into account.[150] The reasoning here is that proper respect should be given to the wording of the

[146] Op cit note 143.
[147] Supra note 140.
[148] Ibid.
[149] Supra note 85 example J in OECD commentary para 182 with Ibid Danon at ch 3.3.4.
[150] Op cit note 145 at ch 4.3.2. Also see op cit note 8 at 617.

Principal Purpose Test which refers to the object and purpose of the treaty *provision*.[151] This is a clear departure from section 31(1) the VCLT which requires the provision to be interpreted in the *context* of its object and purpose.[152] The preamble states that context includes the preamble and its annexes. Danon does acknowledge that some of the OECD examples seem to create further confusion as two of the examples, example E and J,[153] rely on the object and purpose of the specific treaty provision whilst the others refer to the object and purpose of the overall treaty.[154]

Chand,[155] Duff[156] and De Broe[157] have however argued that one needs to have recourse as well to the overall purpose of the treaty. However, it would be hard to determine the purpose of a treaty provision in isolation from the overall context and purpose of the treaty as a whole.[158] Instead, one should interpret the reference to the particular object and purpose of the treaty provision as being purposively ambiguous to avoid such a result.[159] Furthermore, merely relying on the purpose of a specific provision in isolation from the overall purpose of the treaty can lead to the use of simplistic arguments to obtain a treaty benefit. For example, in the Canadian case of *Alta Energy*[160] the Canada-Luxembourg treaty prevented Canada from taxing a gain made by a taxpayer which resulted from a transaction involving the disposition of shares. This was attacked by the tax authorities as an avoidance arrangement. In having to interpret the purpose of the relevant provision of the treaty, the court refused to give weight to the OECD model commentary and instead relied on the literal meaning of the treaty words which eventually resulted in the court finding in favor of the taxpayer.[161] In the author's opinion, such an approach should be cautioned as it may result in an overly simplistic reading of a provision. This approach can be compared to the South African context with reference to the case of *Bosch*, discussed above under section 2.2.1.[162] In the author's opinion, such a literal approach would be avoided, and the provision would be interpreted fully, with for example, reference to

[151] Ibid.
[152] Ibid.
[153] Supra note 85 Para 182 2017 MTC.
[154] Op cit note 145.
[155] V. Chand & C. Elliffe 'The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties in the Post-BEPS and Digitalized World' (2020) 74 *Bull. Intl. Taxn*. at ch 2.4.
[156] Op cit note 114 at 58.
[157] De Broe Op cit note 113 at Ch 3.3.3.
[158] Op cit note 8 at 617.
[159] Ibid.
[160] *Canada v. Alta Energy Luxembourg S.A.R.L.,* 2020 FCA 43.
[161] Ibid.
[162] Supra note 21.

its context and information available to the drafters.[163] The author does however acknowledge that it may be difficult to determine the purpose of certain provisions at times, particularly with regards to the question of what evidence would be acceptable and provide sufficient guidance.

CHAPTER 4 OECD EXAMPLES

4.1. Background and overview

The Commentary on art 29(9) to the 2017 OECD model contains various examples which are meant to illustrate the application of the principal purpose.

The OECD model contains examples A-M which totals 13. These are all based on the examples found within the BEPS action 6 report, with the exception of K, L and M which appear to be further additions to the commentary. Interestingly, the United Nations model mirrors these examples in its commentary. The OECD commentary states that the examples are purely illustrative and should not be taken as providing conditions or requirements that need to be met. Rather, each case needs to be dealt with according to its specific set of facts.[164] However, in the author's opinion, the examples are important as they put the theoretical components into practice and thus it is highly likely that they will carry a lot of weight.

In summary, each of the examples below highlight when treaty benefits could be denied where there is no business purpose, the transaction was undertaken with the principal purpose of obtaining tax benefits or the granting of the benefit would not be in line with the purpose of the treaty.[165]

More specifically in relation to examples A-M, examples A, B and J are where the transactions are made on "paper" and are in fact artificial that have been undertaken to obtain treaty benefits.[166] Examples, C, D, F, G, H, I, K, L and M are transactions where transactions and arrangements are undertaken to achieve treaty benefits but they fulfil the business reality test as primarily undertaking genuine business transactions.[167]

In relation to the conduit examples A-F, examples A, C and D are also only made on "paper", whilst examples B, E and F are transactions or arrangements that are undertaken to achieve treaty benefits but they are not conduit arrangements.

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[163] Ibid.

[164] Supra note 85 art 29 commentary para 182.

[165] Błażej Kuźniacki 'The Principal Purpose Test in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application' (2018) *World Tax Journal* at 267.

[166] Ibid.

[167] Ibid.

This author will select a few of these examples that highlight how the GAAR may influence the interpretation of the PPT.

The layout in the sections below will consist of the example being explained, followed by an analysis of that example which will then finally be compared to the GAAR.

4.2. Example E: Manipulation of shareholding level to obtain tax treaty benefits

In example E of the commentary, RCO in state R has held 24% of the shares in SCO of state S. However, as a new treaty is entered into between state R and S, RCO subsequently increases this shareholding to 25% in SCO which, upon investigation into the facts and circumstances shows that this was done primarily to obtain the benefits of the lower rate of tax provided by article 10(2)(a) which states:

> 2) "However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
>
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period…"

Thus, as the Principal purpose requirement has been met, the commentary then goes on to state that the benefit of article 10(2)(a) should be made available as this would be in line with the object and purpose of that article. This is because the paragraph uses an arbitrary threshold of 25% and the shareholding was genuinely increased to achieve this. Along the same lines then, although not addressed in the treaty, it could also be stated that if the company then chooses to sell the shares back exactly 365 days after obtaining the shares, this would not change the outcome, as this is exactly what the provision provides for.[168]

4.2.1. Analysis of example E

In this section, the author intends to highlight various aspects of example E which remain uncertain or interesting factors which may assist with the comparison of various components of the GAAR.

[168] Vikram Chand 'The Interaction of the Principal purpose Test (and the Guiding Principle) with Treaty and Domestic Anti-Avoidance Rules' (2018) *Intertax* at 120.

The first significance of this example is that it is one of the only two examples[169] which actually refers to a specific provision of the treaty and goes on to discuss the purpose of such a provision which has been stated in the example above.

Starting at the first step of the application to this Principal Purpose Test, one needs to discover the principal purpose. The commentary refers to this as having been done to "primarily" obtain the benefits of the reduced rate of the article. Quite clearly, "primarily" is a higher standard than a principal purpose, as the former refers to an overall purpose whilst the latter implies a single principal purpose. Interestingly, it is not clear why the commentary refers to this term, when all that is required is a principal purpose. This seems to create some confusion with regards to the application of such a test and whether a principal purpose does in fact require a primary purpose, as discussed above. Chand has argued elsewhere that, the "principal purpose" should be interpreted in a similar light. Here he argues that, even if there are multiple principal purposes, one of which is to obtain a treaty benefit, the test should not be met where the principal purpose to obtain a treaty benefit has been outweighed by other purposes which do not aim to obtain a treaty benefit i.e. the enquiry is one of a dominant or main purpose and not a principal purpose.[170] His argument relies on a quote in the commentary where it is stated that:

"Where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit."

Chand relies on examples in support of this interpretation, such as example C. Here, RCO has three potential countries to invest in to expand its business. They all offer the same opportunities, but RCO chooses state S as there is a tax treaty between state R and S. The commentary states that although the investment into state R was made in light of treaty benefits, the decision to invest was driven by the principal purpose of wanting to invest and expand the business. Thus, in this example, the purpose to obtain a treaty benefit has been outweighed by the other purposes i.e. to expand the business.

However, one cannot turn a blind eye to the commentary which clearly states the purpose need not be dominant but would be fulfilled if at least one of the principal purposes were to obtain

[169] The other example is example is, example J in para 182 supra note 85.
[170] Vikram Chand 'The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis' (2018) *Intertax* at 23. Also see Marcus Livio Gomes ' The DNA of the Principal Purpose Test in the Multilateral Instrument' (2019) *Intertax* at 80 who agrees with Chand.

a tax benefit. As already stated previously, this seems to imply a lower threshold in determining whether a principal purpose has been met.

It thus appears though that the clear wording of the commentary seems to contradict the application of the test in the examples.

Furthermore, what is interesting in example E which may cause further uncertainty is its application of the second component of the Principal Purpose Test, even though there was no principal purpose to obtain a treaty benefit. Here the commentary states that the purpose of the treaty is to encourage cross border investment and such a decision would be in line with the object and purpose of the treaty.

The example does however seem to indicate the type of enquiry here is an objective one, which can be seen from the commentary expressly stating that the primary purpose was obtained from an examination of the facts and circumstances, which further highlights an objective test.

On analysis of the application of the second component of the test, this author does not plan to go into much detail as this is an interpretative exercise that requires further research and consideration. It has been argued elsewhere that this can be taken to mean that where the wording operates so mechanically, it is of little use to have recourse to the purpose beyond the literal wording. One would instead need to change the wording of the provision to change the outcome. [171] The author agrees with this to an extent, but highlights the fact that the purpose of even a mechanical provision can be determined in certain circumstances. In this case, one could rely on the wording of the OECD commentary which states that the rationale behind this provision is to not only encourage cross border investment but to also lessen the cascading of corporate income tax from the dividends flowing through multiple cross border corporations.[172] On par with the article acting mechanically, another questionable aspect is the use of commentary referring to the threshold as arbitrary, as generally 20-25 % signify effective control in some modern investment scenarios.

This example has been critiqued by some authors. Zahra raises the question of what can be considered as "genuine".[173] This relates to whether it will still be considered genuine if the taxpayer raised the shareholding following the entry into force of a treaty and not before the

[171] Op cit note165.
[172]Supra note 85 at art 10 para 10. See also P.A. (Peter) Harris 'Article 10: Dividends - Global Tax Treaty Commentaries' (2019) *Global Topics IBFD* at ch 3.1.3.3.
[173] Op cit note 8 at 618.

distribution of a dividend. Whether the situation would have been different had it been the latter, is not clear. The consistency with other examples provided in the commentary has also been raised by van Weeghel[174] particularly in relation to the commentary on article 1: in this example, a taxpayer changes his residence to a different state before the sale of shares. Is it in accordance with the treaty to still deny treaty benefits if it is done genuinely?[175] Although this example was labelled by the commentary as an improper use of the convention one should not dwindle on this inconsistency too much as the facts are extremely bare and do not mention whether the residence was changed genuinely. Furthermore, the Principal Purpose Test was not invoked in such a provision. As already stated above, it is this authors opinion that the Principal Purpose Test has the inclusion of a business reality test which asks whether the transaction was considered to be to be genuine as it was akin to the commercial reality of the situation and had substance to it. Thus, if it can be concluded that the increase of shares before the transaction, an increase of 15 to 25% or change of residence, has substance to it then the treaty benefit could very well be granted.

Interestingly, this example only refers to the purpose of the specific provision unlike the other examples where it refers to the overall treaty purpose which is to "encourage cross border investment."[176] However, as this seems to be one of the general purposes of the tax treaties, according to the examples, it could be said that it is the case here. This also seems plausible considering that the threshold would encourage companies to meet it in order to obtain the benefit. However, the author cautions against such a purpose being used without highlighting the caveats associated with it. There has been much debate on the link between treaties and foreign direct investment (herein "FDI"). Some authors argue that tax treaties lead to FDI.[177] However, it has been argued elsewhere that the link between FDI varies depending on the country, with developed countries benefitting the most whilst developing countries benefitting the least.[178] The treaty cannot also be a replacement for the infrastructure and policy of the country which will also impact investment.[179] This has been attributed to various factors, such

[174] Op cit note 113 Weeghel at 33.
[175] Ibid.
[176] Supra note 85 para 182 examples C, D and L.
[177] For example, see Eric Neumayer 'Do double taxation treaties increase foreign direct investment to developing countries?' (2007) *The Journal of Development Studies*, 43:8, 1501-1519. Lejour, A. 'The Foreign Investment Effects of Tax Treaties' (2014) *Oxford University Centre for Business Taxation*.
[178] See Paul L. Baker 'An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment' (2014) *International Journal of the Economics of Business* at 361.
[179] See Hallward-Driemeier, M. 'Do Bilateral Investment Treaties Attract FDI? Only a Bit … and They Could Bite' (2009) *Oxford University Press*.

as a lack of an additional benefit from the treaty due to its existence within domestic law.[180] The author thus highlights that such a purpose should be given caution when used to justify the purpose of a tax treaty.

4.2.2. Comparison of example E with the GAAR

In this section, the author will compare certain aspects of the GAAR with example E in the OECD model commentary, being the:

- sole or main purpose enquiry and how this compares with the Principal Purpose Test,
- whether such an enquiry is objective or subjective,
- the burden of proof in applying this enquiry,
- how the misuse and abuse test can be compared to determining the object and purpose of a treaty provision in the application of the Principal Purpose Test, and lastly
- how the shareholding threshold could be interpreted in the South African context.

4.2.2.1. Sole or main purpose compared to one of the principal purposes

The first place to start with the GAAR would be to determine what the sole or main purpose of this transaction was. Would the taxpayer have raised the shareholding percentage had there been no treaty benefit available to them? Quite clearly, and in agreement with the example, RCO would not have undertaken such an increase. This was done purely to obtain the benefits offered by article 10. The author highlights that although the result is the same in this example, one needs to analyse the similarities or differences between both tests on how that conclusion was arrived at. As has been stated above, it is not fully clear whether the principal purpose requires a single dominant purpose, as argued by Chand, or whether multiple principal purposes can exist. One can assume that due to the ambiguity with which position should be followed, the South African position with respect to the GAAR would have an influence on a South African court if they were presented with the matter.

Such an approach would not be unique according to the international sphere. Article 23, paragraph 6 of the treaty between the United States and the United Kingdom contains a limitation on benefits clause which also contains a Principal Purpose Test where it is stated that:

"A resident of a Contracting State…..shall nevertheless, be granted benefits of this Convention with respect to such item if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations *did not have as one of its principal purposes the obtaining of benefits under this Convention."*[181]

[180] Ibid.

[181] United Kingdom - United States Income Tax Treaty (2001)

In the technical explanation to the treaty, it has expressly been agreed upon between the contracting states that the term "principal" in the United States domestic law and the term "main" in the United Kingdom's domestic law are synonymous.[182] Interestingly, it appears that the further 6 examples listed by the commentary which deal with conduit examples, drew these examples word for word from the technical explanation. It also appears that there is some overlap with the fact set of the examples that have been used to explain the Principal Purpose Test examples.[183] This could give such an interpretation more force for seeing the term "principal" as requiring a dominant purpose. In any event, it could also support a South African courts interpretation to see the terms "principal" and "main" as synonymous when applying the Principal Purpose Test. Furthermore, Canadian courts interpreted the word "Principal" in a similar light. Here, in regard to the phrase "principal activity" under the Excise Tax Act, the court found that the word "principal" should also be taken to mean first in rank or importance", or "main or leading."[184] This indicates that South Africa would not be alone in such an approach.

In the author's view, such an approach would avoid the difficulty of having an extremely low threshold which would in most instances be met. It would not be difficult to imagine that in most business transactions, the existence of a treaty or tax benefit would be an important consideration before entering into such a transaction. Although, it is noted that one could argue that this need not be a concern as there is still the second component to fulfil in the Principal Purpose Test. However, it can be said that it would unnecessarily expose taxpayers to having to undertake a purpose interpretation which in certain instances would not be as clear cut, as already discussed above.

It is thus the opinion of the author that although there exists some ambiguity with reference to "one of the principal purposes" at stated in the commentary, the South African courts would rely on the same test that is found within the GAAR, being a consideration of a single dominant purpose when applying the Principal Purpose Test.

4.2.2.2 How is the enquiry into the taxpayer's intention dealt with under the Principal Purpose Test and GAAR: objectively or subjectively?

As has already been stated above, it appears that only objective reasoning was used when this test was applied. No statements or opinions of the taxpayer were mentioned. Rather, the

[182] United Kingdom - United States Technical Explanation to the 2001 Treaty at article 29.
[183] Supra note 85 at example A under para 182 and example A under para 187.
[184] The *Colleges of Applied Arts and Technology Pension Plan v. The Queen* 2003 TCC 618.

reasoning relied upon an analysis of the "facts and circumstances". It appears that the facts and circumstances relied on here would constitute the fact that upon the treaty coming into force, the taxpayer increased the shareholding from 24% to 25%. As stated previously, a purely objective approach is non-viable. If a taxpayer stated their subjective approach for the transaction and this statement was ignored to the effect that it was not objective, it would seem hard to ignore as transactions are all "manmade" with an intention behind them.

As argued above, the GAAR has not changed from its previous position. That is, it is a subjective enquiry which takes the taxpayer's *ipse dixit* into account which is then evaluated against the surrounding circumstances to determine whether it is a correct reflection of the taxpayer's purpose. The first question here to ask is then, how does this compare to the Principal Purpose Test? As already argued above, there are two different approaches by authors in interpreting the test. There is the results-based approach and there are also some authors that argue it is a subjective test. It is important to determine this, as it can influence the outcome of a case: under a subjective approach more weight will be given to the intention of the taxpayer, making it more likely that the case would be decided in their favor, assuming their intention can be corroborated with objective evidence. This is because the court starts from the subjective enquiry and looks at objective considerations to prove it (or potentially relies on the *ipse dixit* itself), opposed to starting out at the result of the transaction and using purely objective factors to decide the case.

In light of South Africa's prior case law, it is in the view of this author that the courts would interpret the Principal Purpose Test in line with the GAAR. Firstly, it is impossible to imagine a purpose purely independent of an intention. This has already been echoed by the court in *Plimmer*[185] above which would then seem to agree with this approach. Secondly, in relation to the wording "reasonable to conclude" in the Principal Purpose Test, it has already been stated in relation to the South African GAAR that such wording indicates that all circumstances should be taken into account. Such an approach would reconcile the approach of the commentary making reference to the aims and objectives of the taxpayers involved. This approach of taking all relevant factors into account is further supported by the OECD model commentary stating that the *ipse dixit* of the taxpayer should not automatically be accepted without weighing all of the evidence.[186] This would also indicate an approach whereby the taxpayer's intention may be heard, but it cannot merely be accepted. It would need to be

[185] Supra note 117.
[186] Supra note 85 article 29 paragraph 179.

corroborated with the existing circumstances. Such approaches have also been taken by the Canadian courts which have stated that "purpose" is a question of fact to be determined by having regard to all of the factors.[187]

Most importantly, in the view of the author, the commentary states:

"It should not be lightly assumed, however, that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or transaction and merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes."[188]

This appears to be similar to the reasoning taken by the South African courts in the case of *Gallagher*[189] where the court drew a distinction between the purpose and the effect of a transaction. This indicates that the commentary actually takes a stance against a purely objective approach where it is stated that the effect of the transaction will not usually be sufficient to entail a conclusion that the Principal Purpose Test has been satisfied.

Thus, the author submits that if the court were to apply the Principal Purpose Test in light of what has been said above, a similar approach to the GAAR would be taken. That is, subjective considerations would be corroborated against objective factors which would be different from the approach as taken in the example.

The benefits of retaining a subjective test, as already discussed previously, have further been argued by Van Weegel to protect the taxpayer's interests in the context of legal certainty.[190] This could be because determining the principal purpose is not always easy and could give rise to uncertainty. Retaining the test here would have the benefit of giving the taxpayer extra protection against tax authorities. It would also pave the way in determining whether such a transaction would be in line with the object and purpose of the treaty as transactions that are undertaken in bad faith would not pass this component of the Principal Purpose Test. [191]

It must further be noted that the understanding of intention may vary between various judications, which is important in an international tax law context. Intention may even differ between various areas of law within the same jurisdiction. Take for example, a man who shoots another. Here, the motive underlying this intention plays a pivotal role in deciding the case.

[187] M.N. Kandev & J.J. Lennard 'The OECD Multilateral Instrument: A Canadian Perspective on the Principal Purpose Test' (2020) 74 *Bull. Intl. Taxn*. 1 at 57.
[188] Supra note 85 article 29 paragraph 178.
[189] Supra note 34.
[190] Op cit note 113 Weeghel at 11.
[191] Ibid.

Was the man's motive one of revenge or was it one of self-defense? The former may result in a conviction of murder whilst the latter may result in no charge.[192] This differs from intention in the realm of tax law in South Africa. In the case of *CIR v Pick 'n Pay Employee Share Purchase Trust*[193], an employee share purchase trust scheme acquired various shares and sold them to employees without an intention to make a profit. If, however, employees resigned within 5 years or were dismissed then the trust would repurchase the shares. The trust ended up making a profit due to this specification. The court thus had to determine whether the profit was of a capital or income nature and in doing so, considered whether it was the intention of the taxpayer to conduct a business and therefore undertake a scheme of profit making.[194] In deciding this, the court stated that intention is not to be confused with contemplation, rather what is important is the taxpayer's, object, aim and actual purpose. Thus, one would not be concerned with motive in deciding the outcome of the case.

However, in the New Zealand case of *Plimmer,* the Privy Council stated that:

"A man's purpose is usually, and more naturally, understood as the object which he has in view or in mind, but in ordinary language purpose connotes something added to intention and the two words are not ordinarily regarded as synonymous." [195]

Thus, purpose, object, aim and intention appear to be distinct contrary to what has been alluded to in *CIR v Pick 'n Pay Employee Share Purchase Trust.*[196] What the author has highlighted here is that the flow of information in determining what factors are to be considered relevant when determining the subjective intention of individuals may differ between jurisdictions when dealing with the purpose under the relevant treaty division as these may each be influenced by their own domestic law.

4.2.2.3. How might a court interpret the burden of proof of the Principal Purpose Test?

Although this area is not the focus of this paper, how the burden of proof may influence the interpretation of the Principal Purpose Test will briefly be discussed, as this is relevant to determining the intention of the taxpayer, as has been discussed in relation to Example E. It appears that the burden of proof under the Principal Purpose Test only requires that it is

[192] Guy Kabot *'Purpose and effect: 'the role of a taxpayer's intention in tax legislation'* University of Cape Town (2014), available at https://open.uct.ac.za/bitstream/handle/11427/9166/thesis_law_2014_kabot_g.pdf?sequence=1&isAllowed=y, accessed on the 20 September 2020 at 4.
[193] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (AD).
[194] L. Olivier 'Capital versus revenue: some guidance' (2012) *De Jure* at 173.
[195] Supra note 117; see also op cit note 192.
[196] Supra note 193.

"*reasonable to conclude* having regard to all the relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction" (emphasis added). This would seem to highlight that a less stringent burden of proof is required, as opposed to the South African legislation where this must be proved on a balance of probabilities.[197] In the author's view, the South African courts would require a balance of probabilities instead of requiring a reasonable belief. This would be from the low threshold of mere reasonableness behind the test as well as that it would seem to provide SARS with a less stringent burden then what they would ordinarily experience. At the crux of all of this is the Constitution[198] which is there to safeguard taxpayers' rights, potentially opening up arguments that a lower burden than a balance of probabilities in civil trials may infringe some of the constitutional rights.[199]

What this in effect will mean is that the court may require more evidence to prove that the elements have been met, being that the principal purpose of the transaction was to obtain a treaty benefit. This would be beneficial because it ensures a more certain outcome as further proof needs to be furnished than would be done ordinarily. It would also prevent the tax authorities from unnecessarily challenging transactions unless there is more convincing evidence or factors which would indicate a principal purpose to obtain a treaty benefit.

It is not clear where the burden of proof may lie under the Principal Purpose Test, although when considered with the South African Case of *Glen Anil*[200], this would be considered an administrative provision as it is not a penalty measure nor a measure to impose tax. It could be argued further then that as an administrative provision, the onus should be borne by the state. However, this is not the focus of this paper and this area will require further research.

4.2.2.4. Misuse and abuse and the Principal Purpose Test?

As already stated, in example E, the second component of the Principal Purpose Test was applied. The question then becomes how might this enquiry happen with the influence of the GAAR?

As already stated, there is a "misuse or abuse" test. From the analysis above, it was stated that although phrased differently, this in effect requires an analysis into the object and purpose of

[197] Vita Apriliasari 'Interpretation Issue of The Principal Purpose Test' (2020) *Indonesian Tax Journal* at 16. Also see op cit note 31 at 19.
[198] Constitution of the Republic of South Africa, 1996.
[199] For example, section 34 of the Constitution which states that everyone has the right to have access to courts for a *fair* public hearing.
[200] Supra note 5.

the provision followed by a factual analysis into whether the actions of the taxpayer would be consistent with that. This in effect requires the same approach as the Principal Purpose Test when determining whether granting the treaty benefit would be in line with the object and purpose of the treaty provision. Although as stated above in section 3.3.1, there are varying views on when determining the purpose of the provision, one can have recourse not only to the article in consideration, but to the entire treaty including its preamble. It is thus submitted that a South African court would undertake an interpretative approach in the two-step manner as required by the misuse and abuse test to determine the object and purpose of a particular provision. This would also be in line with the "correct" interpretation approach as reaffirmed by the court in *Bosch*[201] which requires the court to look at the context of the document which would include the document as a whole. Such an approach is also reaffirmed by the SARS draft comprehensive guide where it is stated that:

"The introduction of the misuse or abuse concept is intended to reinforce the emerging trend in South Africa (which mirrors similar trends in other jurisdictions) towards a *contextual* ….. approach to tax statutes"[202]

The use of the VCLT in interpreting tax treaties has been affirmed by the Supreme Court of Appeal in *Krok v commissioner for the South African Revenue Service*.[203] Thus, the VCLT as discussed above, would play an important role here as it too requires a document to be considered in totality, which includes its preamble and context.

4.2.2.5. Shareholding thresholds in the South African context

In the South African context, there are various legislative provisions which provide tax incentives. For example, certain benefits are available to companies who establish headquarter companies in South Africa. To qualify as a headquarter company, certain requirements need to be met. One of these is that the company needs to have 80% or more of the cost of the total assets of the company attributable to any interest in equity shares in any foreign company in which that company held at least 10% of the equity shares and voting rights.[204] The SARS interpretation note states that this was done to promote international investment so that corporations would establish headquarter companies in South Africa.[205] It could also be argued that the numbers found within the provision are also arbitrary as it is a threshold.

[201] Supra note 21.
[202] Op cit note 31 at 44.
[203] *Krok v Commissioner for the South African Revenue Service* 2015 (6) SA 317 (SCA).
[204] Supra note 19 at section 9I(2)(b).
[205] SARS Interpretation Note 87 Head Quarter Companies (Issue 3) 2020.

One can then question whether the same reasoning would then be applied by the South African courts. As the treaty has already stated the said purpose here and because there are similar provisions within South African law, it is likely that similar reasoning would be applied as stated by the commentary.

As discussed above, the commentary relied on the increase of shareholding being genuine which was critiqued by some of the authors above. One can question how this would be dealt with in South African law. The author is of the same view as the commentary. If the taxpayer undertook a non-genuine increase, being where the substance of the transaction did not reflect the reality of the transaction, the courts would not enforce such a transaction. This would constitute a misuse or abuse of the provision. It is not difficult to see how a sham would not be in line with the object or purpose of any legislative provision. It would also lack commercial substance, which will be discussed in example G below.

Lastly, on a more general front, SARS expressed the view that it is seen as legitimate tax planning to make use of certain tax incentives as long as taxpayers do this without attempting to exploit the provision.[206] This further reinforces the similarity between the approach between South Africa and the tax treaty context when favourable tax treatment is bilaterally agreed between states for the purpose to incentivise taxpayers to behave in a certain way.

4.3. Example G: revealing the concepts of a tax benefit and a business reality test

The next example that will be discussed here is example G.[207] TCO is a publicly traded company that is a resident of state T. TCO directly or indirectly owns subsidiaries in other countries, many of which carry on the business of TCO in their local markets. TCO owns the shares of 5 different companies in a single region, each of them being in neighboring states. In order to provide group services to these companies, such as accounting, legal advice and human resources, TCO is considering establishing a regional group company. After considering various jurisdictions, TCO chooses to establish the group company in state R for a variety of reasons such as: a sophisticated banking industry, skilled labor forces, a business-friendly environment and a tax treaty network which results in low withholding tax rates for the companies within that region. It could thus be said that the treaty network which TCO has chosen is the most beneficial when compared to the other options.

[206] Op cit note 24.
[207] Supra note 85 Example G, para 182.

The treaty states that the benefit of the treaty should not be denied in this instance. The reasoning behind this is that one should not rely on the effect of the treaty, being the benefit of reduced withholding tax on future payments with the subsidiaries to deny a treaty benefit. The commentary then concludes by stating that, upon considering the substantive economic functions, use of real assets, the assumption of real risks, and that the business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties, unless other facts would indicate that RCO has been established for other tax purposes. Interestingly, these phrases that related to real risks, real assets and economic functions appear to be a reference to transfer pricing terminology.[208]

4.3.1. Analysis of Example G

The reasoning of the OECD raises questions with regards to clarity. The factors relied on by the commentary seem to indicate that the location was chosen for real economic reasons such as the work force, infrastructure, business friendly environment, banking industry and its treaty network. However, at no point in the explanation of the reasoning that the decision to grant treaty benefits was reached was any reference made to the first component of the Principal Purpose Test, being whether the transaction was undertaken with the principal purpose to obtain treaty benefits. It could be said that this was a missed opportunity to highlight how the test would interact with multiple different purposes. Additionally, no reference is also made to the second component of the Principal Purpose Test either, making it unclear whether this was also applied.[209]

Various other questions remain with regards to Example E, being whether this example highlights the application of the business reality test and whether there was in fact a treaty benefit that was obtained by the party. These will be discussed below.

4.3.1.1. The reliance on the business reality test

What can easily be deduced is the importance of the factors which led to such a conclusion. These factors were the commercial reasons which led to the creation of RCO in state R as well as the real economic activity, real risk, the use of real assets and the use of RCOs own personal. In essence then, it appears that the business reality test had a major role to play here. That is, there was real substance to the transaction with commercial reasons. It has been argued above that such a test does in fact exist within the Principal Purpose Test.

[208] Op cit note 8 at 615.
[209] Op cit note 113 Van Weeghel at 34.

One can then ask whether the existence of business reality is sufficient to cancel out the principal purpose? It has been argued by Chand elsewhere that this is the case and that the first component of the Principal Purpose Test has not been satisfied in this example due to the existence of these factors.[210] In arriving at this, Chand only relies on the conclusion reached by the commentary, which is that treaty benefits should not be denied. As already stated, the commentary is not clear as it merely arrived at a conclusion without expanding on which component of the test was not fulfilled. Thus, Chand did not take this lack of clarity into account.

It was argued above that the term "one of the principal purposes" should be taken to require a main purpose. Taking this into account, it would seem possible that in this example, the existence of 'business reality' outweighed the consideration of the tax treaty network. However, the author would like to add here that he does not find this reasoning by the commentary convincing due the decision clearly resting on the tax treaty in existence. Rather, the OECD model tax treaty commentary should have rather stated that the principal purpose included treaty benefits, but that the treaty nonetheless applies because it is in line with its object and purpose to stimulate real cross-border economic investment.

However, what raises further concern is the inconsistency that such reasoning has with article 29(3) which:

"provides treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income emanates from, or is incidental to that business."

The active conduct of a business is stated to expressly exclude operating as a holding company, providing overall administration or supervision of a group of companies, the provision of group financing and the making and management of investments.[211] One can then question as to why this example granted the benefit of the treaty, which would be at odds with conducting active business.[212]

[210] Op cit note 170 at 33.
[211] Supra note 85 article 29(3) para 3. The making and management of investments has its own exceptions "if these activities are carried on by a bank or [financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such."
[212] Op cit note 113 Van Weeghel at 34.

It could be argued that as the provision is found in a different sub-article, it is irrelevant, but this is not the case because as already argued above, one needs to consider the context of the treaty when interpreting it. It is, however, noted that the provision of article 29(3) is presented as an optional provision to be included in the treaty.

The author also raises the question here whether transfer pricing factors can be relied upon when applying the business reality test. As already mentioned, this can be deduced from the clear reference to such transfer pricing terms. The OECD guidelines on transfer pricing rely on substance with regards to intercompany transactions:

"Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction" [213]

The use of relying on such guidelines would be that the 'business reality test' is given further meaning. Take for example the term "risk". This is discussed at length, with methods of determining and delimiting risks under the OECD transfer pricing guidelines and therefore contains more guidance which may limit the discretion of the tax authorities of the various states.[214] The author does note however that the reliance on such is not expressly prescribed by the OECD when applying the Principal Purpose Test and therefore if they are applied, this should be done with caution.

4.3.1.2. Treaty benefit

The next question one can discuss with this example is what treaty benefit was obtained? The question to be asked here has already been discussed above: whether the same benefit or reduction of taxes would have been available under the domestic rules or another applicable treaty provision? The commentary is not clear in this regard as no mention is made of an express benefit being received by RCO. It has been argued elsewhere that it is rational to assume that the benefit being received was the restriction of the other state's domestic laws on withholding tax under various intra group payments, under the various treaty provisions. For example, assume that the source state has domestic withholding tax of 20% on profits: a taxpayer could contend that article 7 places a restriction on taxing the profits, until a permanent establishment has been established therein.[215] However, it is in the author's opinion that it is

[213] OECD 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (2017) ch 1.46.
[214] Ibid See for example part D ch1.2.1 in the OECD guidelines.
[215] Op cit note 170 at 33.

still unclear what the anticipated tax liability is that was avoided in establishing the companies in the treaty jurisdiction. This will be discussed below.

4.3.2. Comparison with the GAAR

In this section, the author will compare the concepts of a tax benefit and a business reality test as found in Example G of the OECD model with the GAAR.

4.3.2.1. Tax benefit

As stated above under chapter 3.2.1, as there is a lack of detail provided by the OECD model commentary with regards to what could constitute a tax benefit, this could lead states to argue that any reduction of tax would constitute a benefit, especially if they do not have a domestic GAAR.

As seen from the South African perspective, it could be said that what one needs to ask here is whether the taxpayer anticipated a liability that was avoided by the actual transaction. This then leads one into an investigation into a notional state of affairs by asking whether the same benefit or reduction of taxes would have been available under the domestic rules or another certainly applicable treaty provision, had the arrangement or transaction not been undertaken in the way it was.[216]

The reasoning for this interpretation is that the definition of a tax benefit also contains the phrase "under a covered tax agreement" which would highlight that one needs to consider what the benefit would be under the domestic law, had there been no agreement.[217]

The next question to ask here would be whether a benefit would be recognized under the GAAR, according to this fact set. One can firstly question what anticipated tax liability was being avoided by establishing the companies in the manner in the example. By the taxpayer establishing the companies in these jurisdictions it could be argued that no anticipated tax liability is being avoided. The taxpayer is instead subjecting himself to further tax, albeit in a lower jurisdiction than the others.

For argument's sake, even if there was an anticipated tax liability which was avoided, one would need to undertake an analysis into the taxpayer's notional state of affairs. One would thus need to question whether the taxpayer would have still received a reduction in tax under the tax treaty, had the arrangement or transactions been structured differently. The author is of the opinion that the taxpayer did not receive a benefit. The reasoning behind this is that assume

[216] Duff op cit note 114 at 32. See also Lang op cit note 113.
at 657.
[217] Ibid Duff at 32.

the amounts were paid over to the taxpayer through a dividend, what would the alternative be. Should the taxpayer decline the dividend or refuse a rights issue? One is also constrained to argue that they should not have incorporated the company in the other country as this would remove the need to rely on the treaty in the first place. How the taxpayer could structure this differently is not clear. In other words, there does not appear to be any clearly available benefit. This highlights the issue which was stated above being that at times it is often difficult to postulate a future behavior to the taxpayer.

What this may indicate in reference to a South African court is that the commentary should be understood with caution and that the concept of a tax benefit should not be applied too generally to a set of facts.

4.3.2.2. Business reality test

The commercial reality tests as found in the GAAR have already been discussed above. It has also been argued that example G highlights that the component of the Principal Purpose Test which appears to incorporate a business reality test. Quite clearly from the commentary, there appears to be valid commercial reasons for the operations with real cash flows and risks. In other words, there was commercial substance and no offsetting, roundtrip financing or accommodating a tax indifferent party.

However, the question then becomes how this compares to the South African GAAR. A major problem with the incorporation of a business reality test in terms of the model commentary is that there is no stated substance that is to accompany it in its application, making it unclear what this exactly entails and what tests can be employed to discover it. For example, it has also been argued elsewhere that reducing the amount of tax is a business purpose in itself as this would increase turnover.[218] Arguably this reasoning would hinder the application of the Principal Purpose Test. However, it highlights the vagueness in the test's application. It thus appears then that should SARS in theory apply this, they would have a free range of factors to consider without any limitations to argue what would constitute business reality.[219] Although, the importance of the factors in guiding what could be seen to be as a lack of commercial substance should not be understated.

[218] Błażej Kuźniacki 'The Limitation on Benefits Provision in BEPS Action 6/Multilateral Instrument: Ineffective Overreaction of Mind-Numbing Complexity – Part 2' *Intertax* (2018) at 134.

[219] Supra note 19, it can be said that S80C(2) does not limit SARS to the various factors found therein "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."

One can also question where this question of business reality becomes important. Is it in the first enquiry into whether the taxpayer had a principal purpose to obtain a treaty benefit or is it in the enquiry of whether to grant the treaty benefit despite the existence of principal purpose to obtain a tax benefit or is it relevant to both? With the formulation of the commercial substance test as found in the GAAR, this does not assume that there was no sole or main purpose to obtain a tax benefit where there is commercial substance. Rather, the commercial substance justifies the existence of the sole or main purpose to obtain a tax benefit by preventing the successful application of the GAAR by SARS.

It is likely that in the application of the test, a South African court will be influenced by the application of the GAAR's commercial substance test in two aspects.

Firstly, it seems more plausible to rather consider the business reality test in determining whether to grant the treaty benefit despite the existence of a principal purpose to obtain a treaty benefit. Such reasoning would be in line with the layout of the commercial substance test in the GAAR and makes more sense than to rather cancel out the existence of a clear principal purpose to obtain a treaty benefit. In the author's view, a South African court would follow such reasoning.

Secondly, the indicators in the commercial substance test of the GAAR could be used to determine whether there is business reality in the transaction. The reasoning behind this is that although the business reality test is somewhat undefined, both tests take into consideration whether there is commercial substance to the transaction which matches the reality of the situation. This can be seen from the GAAR's commercial substance test, which has been discussed already in chapter 2.2.1. With reference to this specific example, an overlap can be found in the reliance on the use of transfer pricing terminology discussed above, which places an emphasis on factors that would affect the cash flow and risks of the business which is already incorporated into the GAAR. The use of the further factors in the GAAR would assist in determining whether the business reality test had been met and limit the tax authorities from having unlimited discretion in its application.

It should also not be forgotten that the commercial substance test also has its limits. It has been stated by Kujinga that the commercial substance as found in the GAAR is based on the economic substances test as found in the United States.[220] With the economic substance test,

[220] Benjamin Kujinga 'searching for certainty - regular // tax thesis' *TAXtalk* 63 (2017) at 44.

the courts have had contradictory views with regards to its application in recent years.[221] Thus, the application of the commercial substance test under the GAAR could raise concerns of uncertainty as one can question the point where there are enough elements to satisfy the court that there is commercial substance to a transaction. A better approach would be to apply the test as mechanically as possible instead of weighing up various factors and therefore solely determine whether there has been an effect on the net cash flows and risks of the business.[222]

One could raise the additional question of what would happen with examples where a business or commercial purpose cannot be sought? Take for example pensions or transactions involving capital gains. This distinction is recognized by the GAAR, as section 80A(b) provides an additional test where it is stated that an arrangement is impermissible where:

"*in a context other than business*, it was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit."

This raises the question of the place of the business reality test where such transactions have taken place. Although the business reality test has only been used in examples pertaining to commercial transactions, it could be argued that it will not encompass non-commercial transactions.[223] However, it seems as though there is some overlap between non-business transactions in so far as they pertain to the substance of the transaction that matches the reality of the situation i.e. one could say this would not be for a bona fide purpose in non-business transactions.

The second is that, though the business reality test may not be applicable to non-business transactions, this is not devastating as there are still existing elements, such as the determination of a purpose, which would need to be fulfilled and does not make the Principal Purpose Test inapplicable. In other words, the business reality test only assists in determining whether to grant treaty benefits.

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[221] See Kujinga ibid and *Cottage Savings Association v Commissioner* (49 US 554 1991) and *Compaq Computers Corporation v Commissioner of Inland Revenue* (2001 USCA 5 507) where it has been argued that the courts in these cases should have applied the economic substance test but did not.

[222] Benjamin Kujinga 'The Economic Substance Doctrine Against Abusive Tax Shelters In The United States: Lessons For South Africa' *SAMLJ* (2015) at 245. The author here does however acknowledge that the mechanical application of a test has its own deficiencies, for example not being able to adapt to the circumstances of a transaction.

[223] For example, all of the examples refer to companies and not individuals, which would have had more chance being non-business related. The examples found in the commentary related to investments, real estate funds and subsidiaries which all center around different forms of commercial transactions.

4.4. Example K: the meaning behind an arrangement or transaction?

In this example, the author intends to keep the description brief as only the element of an arrangement will be focused on. Herein, RCO is a resident in state R and is a wholly owned subsidiary of an institutional investor fund which is resident in state T. RCO manages a diverse investment portfolio and was established to generate an investment return by operating as a platform for a regional investment for the fund in state R. Although one of the factors for establishing this was to obtain the benefits of a treaty network, there are various other commercial purposes which highlight economic substance. RCO invests in state S which results in a reduction of withholding tax due to the treaty benefits available between state R and S, which also appears to be undertaken for valid commercial reasons with substance. The commentary concludes that in the absence of other factors which show that the:

"*investment is part of an arrangement or relates to another transaction* undertaken for a principal purpose of obtaining the benefit"

it would be unreasonable to deny treaty benefits.

4.4.1. Analysis: the separation of steps within a transaction

In this example, one can see a reference to an arrangement or transaction. More specifically, the example highlights the separation of the steps within a transaction by referring to the investment not forming part of an arrangement or a transaction undertaken to obtain a treaty benefit.[224] How this can be compared to the GAAR will be discussed in the section below.

4.4.2. Comparison with the GAAR: the context in which a scheme or arrangement can be considered?

It has already been argued above that the definition of an arrangement found under the Principal Purpose Test commentary and the GAAR are similar. What the author highlights here is the possible uncertainty with regards to the application of the arrangement component. Australia and Canada contain provisions with common elements which allow the commissioner to attack a step within an arrangement.[225] However, in these jurisdictions, there have been divergent decisions leading to uncertainty. In the Australian case of *FCT v Peabody*[226], in considering a scheme, the court stated that a step may only be considered on its own without being robbed

[224] Here the commentary, supra note 85, clearly states at article 29 paragraph 177 that " one transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit."
[225] Op cit note 68 at 435.
[226] *FCT v Peabody* (1994) 94 ATC 4663.

of practical meaning and if it is able to be considered as a scheme of its own.[227] Although, the reasoning was also due to the enabling provision not expressly making reference to a step within the definition of a "scheme".[228] A similar approach was also undertaken in the Australian case of *Hart v FCT*,[229] which was overturned on appeal with a statement that a step within a scheme can be considered.[230] In Canada, there were also decisions which involved uncertainty with regards to whether a single step in an arrangement can be considered, where it was initially stated that a step cannot be isolated and have a separate purpose, whilst the supreme court stated that it can as long as it is considered in the context of a series of which it is part and the overall result which is achieved.[231]

In South Africa, the GAAR clearly states that a step within an arrangement can be considered.[232] The draft guidance to the GAAR states that the inclusion of the provision is to overcome the situation where the GAAR did not apply because the taxpayer could show the overall purpose of the arrangement was not to obtain a tax benefit.[233]

In the author's opinion, the pure isolation of a step cannot be sustainable and instead its isolation must be considered within the context of the series of which it is part and the overall result which is achieved in order to ensure that all relevant factors are considered in the application of the test.[234] In the case of *Hicklin*,[235] whilst the court found that a single agreement in a composite transaction constituted a scheme, the court looked at various other components of the composite transaction and considered the agreement therein. One should also keep in mind that the presumption of a purpose found within the GAAR[236] requires one to take all relevant facts and circumstances into account, even though the purpose of one step may be different from the purpose of the transaction as a whole. It is thus submitted that, as there are potentially differing interpretations in various jurisdictions and that although the commentary

[227] Op cit note 68 at 42. Also see Julie Cassidy 'Peabody v FCT and Part IVA.' (1995) *Revenue Law Journal* at 200 and 208.
[228] Ibid Cassidy.
[229] *Hart v FCT* 2002 50 ATR 369.
[230] Op cit note 68 at 42.
[231] Op cit note 68 at 42. *Makay v Canada* (2008 FCA 105); *Copthorne Holdings Ltd v The Queen* (2011 SCC 63)
[232] Op cit note 19 section 80H states that: The Commissioner may apply the provisions of this Part to steps in or parts of an arrangement.
[233] Op cit note 31 at 15.
[234] Op cit note 68 at 42.
[235] *Hicklin v Secretary for Inland Revenue 1980* (1) SA 481 (AD) at 308.
[236] Op cit note 19 section 80G.

is not entirely clear on how to apply the definition of an arrangement, the court would do so with the GAAR and consider any steps therein in light of the transaction as a whole.

4.5. The path to development of the Principal Purpose Test

What is of further interest is how these and other particular concepts tied into the legislation may differ over time and from jurisdiction to jurisdiction. These were all initially concepts that were developed through case law leading to foundations for the current GAAR. For example, the case of *CIR v King*[237] was the first major GAAR case under the initial version of the GAAR found under section 90 of the ITA. In this case the court had much room to interpret the then section 90 of the GAAR. In this case, section 90 merely referred to a purpose. It did not state the degree of such a purpose that is required (sole or main) nor did it state whether this were to be subjective or objective. In determining the ambit of the GAAR, Schreiner AJ stated that it is to thus be limited to unnatural or abnormal transactions.[238] Shortly after, section 90 was amended to include a requirement of a sole or main purpose.[239] In effect then, this requirement was initially case law developed. Throughout the years, the courts gave further meaning to it. The same thing can be said about the Principal Purpose Test. As has been discussed, there are various terms on which there is no explicit meaning within the commentary. Rather, these will need to be developed through domestic and foreign case law as well as the commentary to give them meaning.

CHAPTER 5: CONCLUSION AND SUMMARY

It is hard to imagine a piece of legislation that is void of all uncertainty. This is because it is man-made, expressing the intention of a certain group of individuals, which may be open to another individual to use the art of interpretation to their advantage. This can be seen with reference to the Principal Purpose Test, which has various terms that have a certain degree of ambiguity attached.

This ambiguity was met with the examples found within the commentary to attempt to shed light on its application. The use of the examples is a beneficial and practical explanation of the Principal Purpose Test which should clarify its application. Unfortunately, the commentary states that these should not be seen as creating any principles or rules on the application of the Principal Purpose Test. It should also be remembered that each of the examples only dealt with specific situations in which taxpayers may not find themselves.

[237] Op cit note 57.
[238] Op cit note 68 at 68.
[239] Op cit note 81 at 62.

In the author's opinion, it is very likely that courts and tax authorities will at the very least put much weight on these in their understanding and the application of the Principal Purpose Test. This is where a specific country's domestic law will remain important in setting a foundation in which to understand the Principal Purpose Test and its application.

In the South African context, certain elements of the GAAR that were relevant to this paper have been explained and analysed in the first chapter. The same has been done with the Principal Purpose Test, in which an analysis and explanation took place with a focus on similar elements. From the outset, it appeared that the two tests were in various respects similar.

Once an understanding of both the GAAR and Principal Purpose Test had been explained, the paper went on to critique both the GAAR and Principal Purpose Test in various respects and undertake an analysis of their application to examples found within the commentary.

It has been submitted that there are various areas where the GAAR could influence the interpretation of the Principal Purpose Test, with a focus on the examples found in the commentary.

Specifically, it was argued that a South African court may be influenced by the GAAR precedent and South African law when applying the Principal Purpose Test, in relation to:

1. One of the principal purposes: it was argued that a South African court would follow the approach of that found in the GAAR, which could be seen as the equivalent of requiring a main or sole purpose. The reasoning behind this focused on the lack of clarity found within the Principal Purpose Test, particularly with regard to the explanation of example E and the references underlying the commentary which would seem to indicate that a primary or dominant purpose is what is required.
2. The subjective test of intention: it was argued that the GAAR contains a subjective test when focusing on the case of *Gallagher*[240] and the wording of the prior GAAR. It was thus proposed that as the Principal Purpose Test is not entirely clear in this regard, that the South African courts would rely on the GAAR in their interpretation of this and follow the subjective approach, which would be more beneficial to the taxpayer as a purpose cannot be devoid of a human mind.
3. The business reality test: it was proposed that this is in effect a disguised test that is found within the Principal Purpose Test. Upon an analysis of the examples, it became

[240] Supra note 34.

evident that there was an underlying reliance on the business substance and economic reality in determining whether granting the benefit would be in line with the object and purpose of the treaty provision. The author has further cautioned on the reliance of this test as it may be seen as the creation of an additional test that was not intended when the Principal Purpose Test was created.

4. The misuse and abuse test and the interpretation of the Principal Purpose Test: it was argued here that as there is little guidance on how to determine the purpose of the treaty provision provided by the Principal Purpose Test, the South African courts would follow the two-step approach as required by applying the misuse and abuse test as found within the GAAR. As stated by the court in *Bosch*[241], this would require the court not only to consider the treaty provision but the entire context that the treaty provision finds itself in being the preamble and the other articles.
5. A tax benefit: it was argued here that with reference to example E of the commentary, 'a tax benefit' was not satisfactorily applied or explained by the example. Although the two concepts seemed similar in various respects, it was in the author's opinion that it was not clear what tax benefit was being obtained due to the application of the Principal Purpose Test. A South African court could be reluctant in interpreting the concept of a tax benefit in the same light as the commentary and instead err on the side of caution with the use of the examples.
6. An arrangement: it was argued here that although this term is defined in the commentary to some extent, some uncertainty remains in relation to the practical aspect of determining an arrangement. This was due to divergent case law in Canada and the UK with regards to whether a step within a transaction could be attacked solely without reference to the overall purpose. It was submitted that although the Principal Purpose Test does not directly address this question, a South African court would be influenced by the GAAR which expressly allows the isolation of a step within a transaction but only in so far as it is considered within the context of the series of transactions it finds itself in.
7. The burden of proof: here it was argued that the Principal Purpose Test appears to provide a much less stringent burden as it need only be reasonable to conclude. It was submitted that in the author's opinion, the South African courts would apply domestic

[241]Supra note 21.

law which would require this to be proven on a balance of probabilities otherwise it may lead to injustice for the taxpayer.

What can be seen from this is that there are various areas in which the GAAR may be of assistance in giving meaning to certain terms of the Principal Purpose Test which will have an impact on the application of such a test on the arrangements or transactions of taxpayers.

It should be remembered though that as the concept of tax avoidance has been developed in the South African context over the many years, the same may also hold true for the Principal Purpose Test in the future when it is invoked before the courts in multiple jurisdictions. The most favorable outcome from this would be for a universal meaning to be attributed to these terms to avoid reliance on each country's domestic law, which creates a complex situation for taxpayers in structuring their international affairs. This universal meaning would further limit the ability of tax authorities to give their own meanings to such terms which would in effect further undermine certainty for the taxpayer.

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