

**TAX AVOIDANCE IN SOUTH AFRICA:  
AN ANALYSIS OF GENERAL ANTI-AVOIDANCE RULES  
IN TERMS OF THE INCOME TAX ACT 58 OF 1962,  
AS AMENDED**

By

**DEAN JOHN BENN**

Student Number:

**BNNDEA002**

Dissertation submitted in partial fulfillment of the requirements  
for the Post Graduate Diploma in Tax Law ( PG. Dip. Tax Law)  
at the  
**UNIVERSITY OF CAPE TOWN**

Prepared under the supervision of Prof T.S. Emslie

September 2013

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

## **DISCLAIMER**

I, Dean John Benn, hereby declare that this dissertation is my own work. It is being submitted in partial fulfillment of the prerequisites for the Post Graduate Diploma in Tax Law at the University of Cape Town. It has not been submitted before for any other degree or examination at any other University.

---

Dean John Benn

2013

University of Cape Town

## TABLE OF CONTENTS

1. Introduction
2. The difference between tax evasion, tax avoidance and tax planning
  - 2.1 Introduction
  - 2.2 Tax evasion
  - 2.3 Tax avoidance
  - 2.4 Tax planning
  - 2.5 Conclusion
3. The General Anti-Avoidance Rules (GAAR)
  - 3.1 History of the General Anti-Avoidance Rules in South Africa
  - 3.2 The previous General Anti-Avoidance Rules (GAAR) regime under Section 103(1) of the Act
    - 3.2.1 Introduction
    - 3.2.2 The Scheme Requirement
    - 3.2.3 The Tax Effect Requirement
    - 3.2.4 The Abnormality Requirement
    - 3.2.5 The Purpose Requirement
    - 3.2.6 The inherent weaknesses of Section 103(1)
    - 3.2.7 Conclusion
  - 3.3 Substance over form and the Common Law
  - 3.4 The General Anti-Avoidance Rules under Section 80A-L of the Act
    - 3.4.1 Introduction
    - 3.4.2 Avoidance Arrangement
    - 3.4.3 The meaning of 'arrangement'
    - 3.4.4 'Transaction, operation or scheme'
    - 3.4.5 'Including all steps therein or parts thereof'
    - 3.4.6 Effective date

### 3.4.7 Sole or main purpose was to obtain a tax benefit

#### 3.4.7.1 The meaning of 'sole or main purpose'

#### 3.4.7.2 The test: objective v subjective

### 3.4.8 Tax Benefit

#### 3.4.8.1 The meaning of 'tax benefit'

#### 3.4.8.2 The test to determine a 'tax benefit'

#### 3.4.8.3 The onus of proof in determining a 'tax benefit'

### 3.4.9 Tainted elements

#### 3.4.9.1 Introduction

#### 3.4.9.2 Abnormality

#### 3.4.9.3 In the context of business

#### 3.4.9.4 The Business Purpose Test

#### 3.4.9.5 The Lack of Commercial Substance test

#### 3.4.9.6 General Test

#### 3.4.9.7 Commercial substance indicators

#### 3.4.9.8 Substance v Form

#### 3.4.9.9 Round trip financing

#### 3.4.9.10 Accommodating or tax indifferent parties

#### 3.4.9.11 Elements that offset or cancel each other

#### 3.4.9.12 In a non-business context

#### 3.4.9.13 In any other context

### 3.5 Conclusion

### 3.6 Bibliography

## 1. Introduction

In South Africa, as in many countries around the world, there has always been an ongoing struggle of balancing the needs of the government against the needs of taxpayers when it comes to the principles of tax avoidance. On the one hand, taxpayers seek new and innovative ways to structure agreements in such a way to reduce the tax burden imposed on them, and on the other hand the government tries to keep legislation up to date in order to curtail this new and innovate ways of tax avoidance.

Tax avoidance involves the use of legitimate means of paying less tax. It has always been stated that a taxpayer may structure his affairs in a manner that would allow him to pay the least amount of tax.

Tax evasion on the other hand, involves the use of illegal means of paying the least amount of tax.

South Africa incorporated general anti-avoidance rules (GAAR) in the tax legislation in order to combat tax avoidance and to ensure taxpayer compliance. At the outset, these rules were not perfect and the GAAR have been amended numerous times to address certain weaknesses that were exploited by taxpayers.

The aim of this research is to provide a view of the general anti-avoidance rules as it evolved in South Africa.

I will look at the differences between tax avoidance, tax evasion and legitimate tax planning. I will also provide a brief overview of the now repealed section 103(1) as it was used in court cases that contained important interpretations of some of the concepts in the current general anti-avoidance provisions. Lastly, I will look at the requirements of the new general anti-avoidance provision as found in section 80A to L in the Income Tax Act 58 of 1962.

## **2. The difference between Tax Evasion, Tax Avoidance and Tax Planning**

### **2.1 Introduction**

Impermissible tax avoidance involves arrangements that fall in the category between tax evasion on the one hand and legitimate tax planning on the other.<sup>1</sup> Before an analysis of the anti-avoidance rules can be done, it is important to define and give meaning to these broad concepts that are sometime very loosely used and sometimes fused like in the recent decision of *C: SARS v NWK Ltd.*<sup>2</sup>

### **2.2 Tax Evasion**

Tax evasion usually involves the use of fraud or deceit to reduce a tax liability through the non-disclosure of income and the exaggeration of expenditure claimed as deductions. It normally refers to unlawful methods of paying less tax, or no tax at all, to the Revenue. Tax evasion has also been referred to as 'illegal arrangements through or by means of which liability to tax is hidden or ignored.'<sup>3</sup>

Examples of tax evasion can include but is not limited to:

- The creation of falsified financial statements;
- Deliberate failure to disclose correct amounts of revenue received by a business receiving cash;
- Presenting false information on a tax return

Tax evasion thus constitutes fraud, which is a criminal offence, and the Income Tax Act<sup>4</sup> prescribes clear penalties for taxpayers found guilty of tax evasion. Imprisonment is one of the possible consequences of tax evasion.

### **2.3 Tax Avoidance**

---

<sup>1</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p. 2.

<sup>2</sup> 2011 (2) SA 67 (SCA).

<sup>3</sup> OECD, International Tax Terms for the participants in the OECD Programme of Co-operation with Non-OECD Economies.

<sup>4</sup> Act 58 of 1962.

Tax avoidance is *prima facie* lawful, and it amounts to an attempt by a taxpayer to minimize his tax liability legally. It involves the use of legitimate means to structure ones affairs in such a manner to end up paying less tax.

The term 'tax avoidance' in itself can be very problematic in the sense that where a taxpayer's activities fall within the charging provisions, in certain circumstances, he will be liable for tax. If his activities fall outside the charging provisions, the taxpayer will not be liable for tax.

In the case of *Smith v CIR*<sup>5</sup> it was held that the ordinary meaning of avoiding liability for a tax on income was,

*'to get out of the way of, escape or prevent an anticipated liability'.*

In the case of *C of IR v Challenge Corp Ltd*,<sup>6</sup> Lord Templeman held that tax avoidance relates to more than merely getting out of the way of an anticipated liability and said that:

*'Income tax is avoided and a tax advantage is derived for an arrangement when the taxpayer reduces his liability to tax without involving him [sic] in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a deduction in his liability as if he had.'*

It should thus be noted that there is a very fine line between tax evasion and legitimate tax avoidance.

## **2.4 Tax Planning**

Tax planning and tax avoidance are very similar concepts in that a taxpayer can organize his affairs in such a way that he pays a minimal amount of tax.

Tax planning is where the taxpayer takes advantage of a more attractive option offered to him by the legislation and arranges his or her tax affairs in the most tax efficient manner, where he will be liable to a reduced tax burden.

The government needs to balance legitimate commercial transactions against the need to combat tax avoidance arrangements. This balancing act filters through to the South African courts where

---

<sup>5</sup> 1964 (1) SA 324 (A); 26 SATC 1.

<sup>6</sup> [1986] 2 NZLR 513 (PC) at 561–562.

they strive to decide tax matters in a manner that is equitable to both the taxpayer and the government.

This concept is observed in the case of *CIR V Nemojim*<sup>7</sup> that states obiter that:

*'...there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus'.*

In the case of *IRC v Duke of Westminster*<sup>8</sup>, Lord Tomlin stated the following:

*'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax'*

In the case of *CIR v King*,<sup>9</sup> Watermeyer CJ confirmed the taxpayer's freedom to structure his or her affairs so that they give rise to the minimum tax liability by holding the following:

*'In a wide sense also the amount of a man's income tax can be reduced from what it was in previous years if he earns less income than in previous years, but here again it is absurd to suppose that the Legislature intended to impose a penalty upon a man who enters into a transaction which reduces the amount of his income from what it was in previous years merely because his purpose was to reduce the amount of his income and consequently of his tax. These two types of cases may be uncommon but there are many other ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or freeing himself from taxation of some part of his future income.'*

## 2.5 Conclusion

It is thus clear from the above quoted passages that taxpayers may minimize their tax liabilities by structuring their affairs in a suitable manner. It has always been the principal that businesses are entitled to minimize the tax burden which it is legally required to bear. It is also important to note that even where tax avoidance is regarded as legitimate and falling within the law, the conduct itself may sometimes be seen as unacceptable behaviour.

---

<sup>7</sup> 1983 (4) SA 935 (A).

<sup>8</sup> 1936 A.C. 1 (HL)

<sup>9</sup> 1947 (2) SA 196 (A).

It is thus clear that there is a difference between the consequences of tax evasion, tax avoidance and legitimate tax planning. The Commissioner will rely on the provisions contained in the General –Anti Avoidance Rules (GAAR) to distinguish between these three concepts and to determine the consequences of each.

### **3. The General Anti- Avoidance Rules (GAAR)**

The discussion of the General Anti-Avoidance Rules will be done in three parts. I will first discuss the history and evolution of the Anti-Avoidance Rules in South Africa. I will then move on to discuss the General Anti-Avoidance Rules as it applied under section 103(1) of the Act. I will lastly discuss the GAAR in its current form under section 80A – L.

#### **3.1 History of the General Anti-Avoidance Rules in South Africa**

It can be noted, as discussed above, that there is a very fine line between tax avoidance and tax evasion, which distinguishes between permissible and impermissible tax avoidance. In order to address this problem, South Africa incorporated General Anti-Avoidance Rules (GAAR) in the tax legislation.

The Income Tax Act<sup>10</sup> has many provisions targeting specific schemes aimed at the avoidance of taxation. There are many examples of these provisions and some of the examples are:

- The way to deal with income that is received by one person for the services rendered by another;<sup>11</sup>
- The way to deal with private consumption of trading stock.<sup>12</sup>

The first general anti-avoidance provision introduced in South Africa was section 90 of the old Income Tax Act.<sup>13</sup> Since 1941, a number of changes have been made to section 90 and its successor section 103(1).

Section 103(1) did not deviate very much from section 90, and both the 1986-Margo Commission and the 1995-Katz Commission<sup>14</sup>, noted that section 103(1) had certain inherent weaknesses.

---

<sup>10</sup> 58 of 1962.

<sup>11</sup> Par (c) of Section 1 Definition of “Gross Income”.

<sup>12</sup> Section 22(8).

<sup>13</sup> Act 31 of 1941.

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006<sup>15</sup> the reason section 103(1) was repealed and replaced with section 80A to 80L, was that it “has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated form of impermissible tax avoidance.”

The new anti-avoidance rules apply to all arrangements entered into on or after 2 November 2006.

It is important that we discuss and understand the ‘old’ General Anti-Avoidance Rules in terms of section 103(1) as it will help us gauge a better understanding of the ‘new’ General Anti-Avoidance Rules as contained in section 80A-L of the Act. Many conceptual ideas and interpretations of section 103(1) have been retained in section 80A-L.

## **3.2 The previous General Anti-Avoidance Rules (GAAR) regime under Section 103(1) of the Act**

### **3.2.1 Introduction**

The General Anti-Avoidance Rules in the now-repealed s 103(1) does not apply to a transaction, operation or scheme entered into on or after 2 November 2006, being the date that the ‘new’ General Anti-Avoidance Rules came into force. It is nonetheless important to discuss and analyze this section as the ‘new’ General Anti-Avoidance Rules has borrowed many terms from section 103(1). There is also important case law on the interpretation of certain terms in section 103 (1) and it is inevitable that the courts will turn to those decisions for guidance, when they seek to interpret similar terms in the new General Anti-Avoidance Rules.

Whilst it was still contained in the Act, section 103(1) read as follows:

*‘103. Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amount of taxes on income.-*

*(1) ‘Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)—*

*(a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and*

---

<sup>14</sup> Third Interim Report of the Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa (November 1995).

<sup>15</sup> WP 2006 at 62.

- (b) *having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out—*
- (i) *was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or*
- (ii) *has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and*
- (c) *was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, duty or levy (whether imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of such liability,*

*the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out or in such a manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'*

The previous GAAR regime consisted of four key elements that can be summarized as follows:

- There must have been a transaction, operation or scheme entered into or carried out (the Scheme Requirement);
- with the effect of avoiding or postponing or reducing the liability for the payment of any tax (the Tax Effect Requirement);
- and was entered into or carried out in a manner not normally employed for business purposes, other than obtaining a tax benefit (commonly referred to as the Abnormality Requirement/Arm's Length Test); and
- the transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit (the Purpose Requirement).

All of elements as listed above had to be simultaneously present in order for the Commissioner to rely on the General Anti-Avoidance Rules.<sup>16</sup>

### **3.2.2 The Scheme Requirement**

The Act stated that an arrangement included a transaction, operation or scheme involving the alienation of property which has been entered into or carried out which has the effect of avoiding or

---

<sup>16</sup> SIR v Geustyn, Forsyth and Joubert 1971 3 SA 567 (A) at 571-572.

postponing liability<sup>17</sup>. The Commissioner had to be satisfied that a transaction, operation or scheme had been entered into or carried out.

In the case of *Meyerowitz v CIR*<sup>18</sup> the question arose whether various transactions amounted to “schemes” within the meaning of section 90 of the Income Tax. Counsel was of the view that ‘a scheme may consist of several transactions but they must be connected in the sense of being parts of a preconceived plan, whatever the object of such plan may be.’

The court held that a transaction which did not form part of the scheme when it was entered into can become part of the scheme if it is later ‘*pressed into the service of the scheme*’.

In *CIR v Louw*<sup>19</sup> Corbett JA approved and applied the interpretation that the term “scheme” is wide enough to cover situations in which later steps in a course of action were left unresolved at the outset.

In *Ovenstone v SIR*,<sup>20</sup> Trollip JA stated that ‘*entered into*’ does not mean ‘*formulated*’ but has a connotation of implementation that is similar to ‘*carried out*.’ The court held that ‘it is only when a transaction, operation or scheme is implemented or carried out, and not at the time it was formulated (i.e conceived, decided or agreed upon) that it becomes a practical reality concerning the fiscus.’

Therefore, even if a transaction does not have as its purpose that avoidance of tax at the time when entering into the transaction, it may have the effect when it is carried out and therefore fall within the scope of section 103(1).

In summary, a transaction, operation or scheme must therefore have been entered into or carried out.

### **3.2.3 The Tax Effect Requirement**

After establishing the existence of a transaction, operation or scheme, the Commissioner had to determine whether, the transaction, operation or scheme had the effect of avoiding or postponing

---

<sup>17</sup> Section 103 (1)(a).

<sup>18</sup> 1963 3 SA 863 (A).

<sup>19</sup> 1983 (3) SA 551 (A).

<sup>20</sup> 1980 (2) SA 721 (A).

or reducing the liability for the payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act.

The terms “avoiding”, “postponing” and “reducing the liability for payment of tax” has been considered in case law and still applies under GAAR.

In *CIR v King*<sup>21</sup>, it was held that the tax liability addressed by section 90, is not an existing liability for tax, but an anticipated liability. Watermeyer CJ looked at the meaning of the words “*which has the effect of avoiding or postponing liability for any tax, duty or levy on income*” of section 90(1). He held that the section refers to anticipated liabilities for tax either in respect of a current tax year or in respect of future years.

This interpretation held in the *King* case was confirmed in the case of *Smith v CIR*<sup>22</sup> where the court held that the ordinary meaning of avoiding liability for tax on income was ‘to get out of the way of, escape or prevent an anticipated liability.’ Steyn CJ held that:

*“The ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability .... The Afrikaans rendering of the phrase is wat die uitwerking het dat die aanspreeklikheid vir die betaling van ‘n belasting ... op inkomste vermy’. The ordinary meaning of ‘vermy’ is ‘ontwyk’ or ‘voorkom’. That wider meaning is the meaning to be ascribed to the phrase, unless it is clear that a different meaning is intended.”*

The above case thus stated the avoidance of tax only relates to an anticipated liability. This could potentially create some confusion as SARS will strive to levy tax on current liabilities as well.

#### **3.2.4 Abnormality Requirement**

Under section 103(1)(b) the transaction, operation or scheme had to be entered into ‘by means or in a manner which would not normally be employed’ or it had to ‘create rights or obligations which would not normally be created between persons dealing at arm’s length’, in order to satisfy the abnormality requirement. This was interpreted as an objective test that had to be applied to the transaction, operation or scheme.

The test was objective in respect of the abnormality of two aspects:

---

<sup>21</sup> 1947 (2) SA 196 (A).

<sup>22</sup> 1964 (1) SA 324 (A); 26 SATC 1.

- (i) The means and manner in which transaction, operation or scheme was entered into or carried out; and
- (ii) The rights and obligations not normally created between persons' dealing at arms' length under such a transaction, operation or scheme.<sup>23</sup>

In *Hicklin v SIR*<sup>24</sup> the court dealt with 'dealing at arm's length'. The court held that in an arm's length agreement, each party was independent of each other and would strive to get the uttermost possible advantage out of the transaction for themselves. The rights and obligations that are created are most likely to be regarded as normal as would the manner and means employed also be regarded as normal.

The courts would need to use evidence and a factual enquiry to establish whether the parties dealt at arm's length or not.

### **3.2.5 The Purpose Requirement**

In order to satisfy the purpose requirement of section 103(1)(c), the sole or main purpose of the transaction, operation or scheme, had to have been for the purpose of avoiding, postponing or reducing the liability for tax.

This was a subjective requirement that needed to be satisfied in order to meet all the other requirements as was set out in section 103(1). It appeared from the section, that where the taxpayer had more than one purpose of equal weight or significance, where one is the avoidance of tax, the requirement would not have been satisfied.

In the case of *CIR v Bobat and Others*<sup>25</sup>, the court held that 'a main purpose is obviously one which is dominant over any other'.

An interpretation of the above would mean that where a taxpayer had two or more purposes of equal importance or significance, section 103(1) could not be applied.

### **3.2.6 The inherent weaknesses of section 103(1)**

---

<sup>23</sup> Section 103(1) (3)(a) and (b).

<sup>24</sup> 1980 1 SA 481 (A).

<sup>25</sup> 2005 67 SATC 47 (N).

Whilst section 103(1) was on the statute book, it had certain inherent weaknesses that caused problems in interpretation and application.

The subjective nature of the 'purpose requirement' or 'main purpose test,' was one of the weaknesses in the eyes of the Commissioner. The court was required to look into the mind of the taxpayer to determine whether the requisite purpose was present at the time the taxpayer entered into the transaction, operation or scheme. This proved very difficult to do and it was thus presumed that the transaction was entered for the purpose of avoiding or postponing tax, unless the taxpayer proved otherwise.<sup>26</sup> It meant that even if there was a tax purpose for entering into a transaction, it would not be in conflict with GAAR, if this tax purpose was not the sole or main purpose of the transaction. Thus, if an arrangement had a commercial or business purpose as its main purpose, it would have been sanctioned by the courts as parties are allowed to structure transactions in the most beneficial manner.<sup>27</sup>

This criticism of the 'purpose requirement' was confirmed in the judgement of *CIR v Conhage*<sup>28</sup> where it was held that a transaction entered into with a dual purpose, would not satisfy the 'purpose requirement' if the main reason for the transaction was a commercial or business purpose. This has rendered the GAAR as ineffective and toothless as it became very easy for taxpayers to justify a commercial purpose of a transaction or arrangement. SARS found it very difficult to prove that the dominant purpose of the transaction was to obtain a tax benefit.<sup>29</sup>

The objective nature of the "abnormality test" was also perceived to be a weakness in section 103(1). If a particular kind of transaction, operation or scheme, that was once viewed as 'abnormal', became acceptable in the eyes of public it would then stop to be an 'abnormal' transaction, operation or scheme under section 103(1).<sup>30</sup>

---

<sup>26</sup> S 103(4)(a).

<sup>27</sup> IRC v Duke of Westminster 1936 19 TC 490.

<sup>28</sup> 61 SATC 391.

<sup>29</sup> Werksmans Tax. 2006:1

<sup>30</sup> Report of the Katz Commission into Tax Reform, Chapter 11 at 11.2.2.

A taxpayer could thus enter into a transaction, operation or scheme with the subjective purpose of avoiding tax, provided that the transaction is not objectively abnormal. This was possible as all the requirements had to be simultaneously present.<sup>31</sup>

The powers of the Commissioner were also one of the inherent weaknesses of section 103(1), as uncertainty existed as to whether the Commissioner had the authority to apply GAAR in the alternative where another provision was also in dispute.<sup>32</sup>

The Legislature tried to address the above weaknesses under section 80 of the Act.

### **3.2.7 Conclusion**

It can thus be concluded that the provisions of section 103(1) was very weak which made it difficult for the Commissioner to successfully apply section 103(1) to certain transactions, and which made it easy for taxpayers to escape liability. Although section 103(1) was perceived as weak, it was a good starting point for the Legislature to draft section 80A-L and to address certain of the weaknesses that presented itself in section 103(1).

### **3.3 Substance over Form and the Common Law**

Before I move onto the discussion of the new GAAR regime under Part IIA, I think it is appropriate that the common law position with regards to substance over form be discussed.

It was widely believed that if a transaction, operation or scheme did not fall within the reach of section 103(1), effect would be given to it even if it the outcome of the transaction, operation or scheme was intended to avoid or postpone a liability for tax.

The principles of our common law dictate that substance will prevail over form.<sup>33</sup> Wessels ACJ confirmed this in the case of *Kilburn v Estate Kilburn*<sup>34</sup>, where he held that:

---

<sup>31</sup> South African Revenue Service Law Administration. November 2005. *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 58 of 1962*.

<sup>32</sup> South African Revenue Service Law Administration. November 2005. *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 58 of 1962*.

<sup>33</sup> Kanamugire J, *A Critical Analysis of Tax Avoidance in the Income Tax Act 58 of 1962, as amended* (2008).

<sup>34</sup> *Kilburn v Estate Kilburn* 1931 AD 501.

*'it is a well known principle of our law that courts of law will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance.'*<sup>35</sup>

An example of where the court gave effect to the common law doctrine can be found in the case of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue*.<sup>36</sup>

The facts of this case were as follows:

The taxpayer company wanted to erect a factory in a tax-efficient manner. It concluded a series of agreements with other parties regarding the building of this factory. The taxpayer entered into an agreement whereby it leased certain vacant land to the Board of Executor Pension Fund, which is a tax-exempt entity. In terms of the lease, the lessee was entitled to erect buildings on the leased premises at its own expenses. The lessee was however not obliged to erect these buildings. The lessee then went on to sub-lease the vacant land to a subsidiary of the taxpayer. In terms of the sub-lease the tenant was obliged to erect buildings on the vacant land.

The Commissioner argued that the lease and sub-lease agreement were entered into by the taxpayer to receive a tax benefit in building a factory on its own land. The Commissioner held that the series of agreements did not set out the true agreement between the various parties. He contended that the taxpayer had attempted to hide the true agreement in a series of agreements, which pretended to deal with something else.

Hefer JA held that the lease contained a simulation which concealed the real intention of the parties.

In the case of *C SARS v NWK*<sup>37</sup>, the court confirmed the doctrine of substance over form, but also went further to say that the test to determine simulation cannot simply be whether there is an intention to give effect to the contract in accordance with its terms. The test should go further and lead into an examination of the commercial sense and the reason for the transaction to determine its real substance and purpose. If it is determined that the only purpose of the transaction is to achieve a tax benefit, it will be regarded as simulated.<sup>38</sup>

---

<sup>35</sup> *Kilburn v Estate Kilburn* 1931 AD 507.

<sup>36</sup> 1996 3 SA 942 (A).

<sup>37</sup> 2011 (2) SA 67 (SCA).

<sup>38</sup> P Dachs and B du Plessis: *The Interpretation of substance over form*.

Both cases mentioned above are evidence that the courts will not hesitate to apply the common law doctrine of substance over form to agreements with intentional avoidance, even though the Income Tax Act may not be applicable.

### **3.4 The General Anti-Avoidance Rules under section 80A-L of the Act**

#### **3.4.1 Introduction**

For a number of years section 103(1) contained the general anti-avoidance rules in the Income Tax Act. Section 103(1) did however contain certain inherent weaknesses, as described above that resulted in the incorporation of the new provisions into the Act.

The Income Tax Act was amended to enable SARS to combat tax avoidance more effectively. These new provisions can be found in Part IIA of Chapter III of the Income Tax Act, sections 80A to 80L and applies to any arrangement entered into on or after 2 November 2006.

These new sections have incorporated most of the requirements set out in section 103(1). Certain of the new provisions, however find their origin in other parts of the world.<sup>39</sup> Although the new sections contain many of the same concepts as section 103(1), it does not mean that these concepts apply in the same context or in the same manner, or has the same meaning.<sup>40</sup>

In this part will strive to provide an overview and analyse each of the elements of the new General Anti-Avoidance Rules as it is contained in section 80 A-L.

For the Commissioner to rely on the new General Anti-Avoidance Rules, there are four requirements that has to be established -

1. The existence of an avoidance arrangement;<sup>41</sup>
2. The arrangement must have been entered into on or after the effective date, 2<sup>nd</sup> November 2006.<sup>42</sup>

---

<sup>39</sup> Haffejee Y, *A critical analysis of South Africa's general anti avoidance provisions in income tax legislation* 2009

<sup>40</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p.5.

<sup>41</sup> S 80A (preamble).

<sup>42</sup> S 80A (preamble).

3. The sole or main purpose was to obtain a tax benefit.<sup>43</sup>
4. The arrangement must include an abnormality element.<sup>44</sup>

I will now discuss each of these elements.

### **3.4.2 Avoidance Arrangement**

The provisions of the new General Anti-Avoidance Rules will apply where there is an impermissible avoidance arrangement as defined in the Act in section 80A.

The focus of the following parts will be to determine what constitutes an arrangement in the event that there was avoidance by the taxpayer. It will also look at what constitutes steps or parts of an arrangement.

### **3.4.3 The meaning of 'arrangement'**

The Act defines an arrangement as:

*'Any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.'*<sup>45</sup>

By looking at the definition it is very clear that although the definition contains similar components as its predecessor in section 103(1), but there are some differences.

An 'arrangement' is often described and interpreted according to the case of *FCT v Newton*<sup>46</sup> where the court held that:

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

---

<sup>43</sup> S 80A (preamble).

<sup>44</sup> S 80A (a)-(c).

<sup>45</sup> S 80L definitions.

<sup>46</sup> 1958 2 All ER 759.

This interpretation of the court leads one to believe that consensus between all parties must exist with regards to the terms and conditions of the arrangement, before a valid arrangement exists.

The determination of an 'arrangement' is but the first step to determine whether the outcome of the engagement constitutes impermissible tax avoidance.

The definition of "arrangement" has however gone a step further in the clarification, by including the words "enforceable or not." This effectively means that it is not required for a transaction, operation or scheme to be legally enforceable for the new GAAR to apply. SARS in its *Draft Comprehensive Guide to the General Anti-Avoidance Rule (GAAR)*<sup>47</sup> have included some examples of agreements that are not legally enforceable, but which will as per section 80A, be included in the definition of an 'arrangement'. These agreements are<sup>48</sup>,

- 'Agreements between parties to agree in future on reasonable terms and conditions to effect a merger.
- the so-called gentleman's agreement;
- heads of agreement between parties which sets out the intended result the parties wish to achieve but which is not necessarily legally binding at the time;
- an agreement binding in honour only, binding only in conscience, letter of intent and the like.'

In the event that agreements like these mentioned above end up in court, it will be easy enough to establish the intention of the parties, but it will be difficult to prove that there was an agreement if there is no documentation.

#### **3.4.4 'Transaction, operation or scheme'**

This part of the definition was also contained in the now repealed section 103(1). The rules laid down by the courts in the cases of *Meyerowitz*, *Louw* and *Ovestone*, where the definition of "transaction", "operation" and "scheme" has been interpreted, shall continue to apply under the new GAAR.

---

<sup>47</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p14.

<sup>48</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)*p.14. par 3.2.3.

In *Meyerowitz v CIR*<sup>49</sup>, the court held that,

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

In *CIR v Louw*<sup>50</sup>, the court approved the interpretation above and held that,

*'... the term scheme is wide enough to cover situations in which later steps in a course of action were left unresolved at the outset.'*

In *Ovenstone v CIR*<sup>51</sup> the court looked at the term 'entered into' and stated that,

*'It was held that 'entered into' does not mean formulated because of its context it has, I think, a connotation of implementation that is similar to 'carried out'. Probably both expressions were used because it was considered that 'carried out' is more appropriate to connote the implementation of a scheme, while 'entered' into is more apposite to connote the implementation (i.e. the taxpayer's actually engaging in) of a transaction or operation...'*

Having regard to the above cases, it is clear in the way that the definition of an "arrangement" was drafted, that the words "transaction, operation or scheme" should be interpreted very wide to assist the Commissioner, so that the definition of "arrangement" can be applied to any possible transaction or scheme that has the intention to avoid tax.

Broomberg<sup>52</sup> however submits that there has never been a reported case where the Commissioner has failed on the basis that there was no 'transaction, operation or scheme'.

#### **3.4.5 'Including all steps therein or parts thereof'**

The definition of "arrangement" includes 'all steps therein or parts thereof' and makes it clear that all steps or part of an arrangement would also constitute as an arrangement.

The term 'step' or 'part' is however not defined in the Act, and it is suggested by Clegg and Stretch<sup>53</sup> that each relates to a distinct transactional element of the whole.

---

<sup>49</sup> 1963 (3) SA 863 (A).

<sup>50</sup> 1983 (3) SA 551 (A).

<sup>51</sup> 1980 (2) SA 721 (A).

<sup>52</sup> EB Broomberg SC 'Then and Now –II' (2007) 21 *Tax Planning Corporate and Personal*.

<sup>53</sup> 2013 D Clegg, R Stretch *Income Tax South Africa* (Online version) at p 26 3.2.

Section 80H also now gives the Commissioner the power to apply the provisions of General Anti-avoidance Rules in its entirety to 'steps in or parts of an arrangement'.

Section 80H of the Act states that,

*'The Commissioner may apply the provisions of this part to steps in or parts of an arrangement.'*

All steps or parts of an arrangement will now be deemed to be an avoidance arrangement if they result in providing a tax benefit.

The insertion of section 80H goes against the principle laid down in *CIR v Conhage*<sup>54</sup> where the court ruled that,

*'the courts would look at the whole of the transaction as opposed to reviewing individual steps to ascertain if tax avoidance has taken place'.*

The insertion of section 80H widens the scope of what can be considered as tax avoidance. It appears that section 80H was inserted to rectify to the scenario that existed where there taxpayer only had to prove that the overriding reason for entering into a composite transaction was not a tax reason. Under section 103(1) the taxpayer would have escaped liability even if parts of the transaction were to avoid tax.

It is thus clear that every step in a transaction will have to be analysed and examined to ascertain whether they were so connected to one another that they lead to the avoidance of tax. Clarity is however still needed to cater for the scenario where one step in a composite transaction will lead to the avoidance of tax, and the rest does not lead to the avoidance of tax. SARS will have to define what it considers to be a 'step' or 'part' of a composite transaction to which it wishes to apply GAAR.

Broomberg<sup>55</sup> holds the view that section 80H will now force the Commissioner to formally disclose to the taxpayer exactly which aspects of the arrangement he is questioning, which in turn can be used by the taxpayer to his advantage.

---

<sup>54</sup> 1999 (4) SA 1149 (SCA).

<sup>55</sup> EB Broomberg SC 'Then and Now –II' (2007) 21 *Tax Planning Corporate and Personal*.

### 3.4.6 Effective Date

The preamble of section 80A requires that there must be an arrangement entered into on or after 2<sup>nd</sup> November 2006 for the new provision to apply.

A scenario can however exist where the taxpayer was involved in an avoidance arrangement that consist of several different parts or steps. A few of the steps could have happened before the effective date and the rest after the effective date. As discussed above, section 80H allows the Commissioner to apply the provisions of General Anti-avoidance Rules in its entirety to 'steps in or parts of an arrangement'.

A strict interpretation of the Act would then see the Commissioner apply the repealed section 103(1) of the Act to all steps that were taken before the effective date and apply the new GAAR to all steps or parts taken after the effective date.

### 3.4.7 The sole or main purpose was to obtain a tax benefit

#### 3.4.7.1 The meaning of 'sole or main purpose'

In terms of section 80A, 'an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit'.

In *SBI v Lourens Erasmus (Edms) Bpk*<sup>56</sup>, the court looked at the meanings of the words 'solely' and 'mainly'. The court held that,

*'... in the context under consideration, the word 'mainly' establishes a purely quantitative measure of more than 50% and the associated use of the word 'solely' or mainly is inserted, ex abundante cautela, to circumvent the possibility that what may be described as being 'solely' of a particular character would not qualify as being 'mainly' of that character.'*<sup>57</sup>

The court held that 'solely' refers to the only purpose of the taxpayer, whereas 'mainly' will refer to a quantitative measure of more than 50%. From a quantitative perspective solely would mean 100%.

In *CIR V Bobat*<sup>58</sup> the court held that,

---

<sup>56</sup> 1996 (4) SA 344 (A).

<sup>57</sup> 1996 (4) SA 344 (A) at pg 242.

<sup>58</sup> 67 SATC 47.

‘... a main purpose is obviously one which must be dominant over any other, because in ordinary language ‘mainly’ means for the most part, principally or chiefly’.

### 3.4.7.2 The test: objective v subjective

Under section 103(1) the purpose of a transaction, operation or scheme, was determined by applying a subjective test. Section 103(1)(c) referred to the purpose for *which* a transaction, operation or scheme was carried out, as opposed to the purpose of an arrangement.

This subjective approach was confirmed in *SIR v Gallagher*,<sup>59</sup> where Corbett JA held that,

*‘... the criterion to be applied was, not objective, but subjective; that where a taxpayer wishes to negate tax avoidance as one of the purposes of a scheme, it is generally incumbent upon him to establish positively what the purpose, or scheme in fact were’.*

The implication of the above meant that one had to take into account the purpose of the taxpayer when determining whether a transaction, operation or scheme was entered into for the purpose of obtaining a tax benefit.

It was required to look into the mind of the taxpayer who entered into the transaction, under the subjective test. This may result in problems as it is very difficult to determine the intention of the taxpayer with regards to certain transactions.

In the case of *Newton v FCT*<sup>60</sup> it was decided that an objective test should be used to determine the purpose for which a transaction was entered into. The court stipulated that,

*‘... the word purpose used in the context of an arrangement, regard must be had to the objective effect of the arrangement. Purpose in this sense means not intention, but the effect with which it sought to achieve the end accomplished or achieved’.*

An objective test would thus require the court to look at whether the terms of the arrangement have the effect of creating a tax benefit.

In section 80A it is stated that an avoidance arrangement is impermissible if ‘its sole or main purpose’ was to obtain a tax benefit. In a very strict interpretation of this section the word “its”

---

<sup>59</sup> 1978 (2) SA 463 (A), 40 SATC 39 at 48-49.

<sup>60</sup> 1958 2 All ER 759 (PC).

would force one to look at the purpose of the arrangement and not to the purpose of the taxpayer. This can then be viewed as the move towards an objective test for purpose, as one cannot determine the state of mind of an arrangement.

In section 80G however lies a rebuttable presumption, in that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of a tax benefit, unless and until the party obtaining the tax benefit proves that, reasonably considered in the light of the relevant facts and circumstances, that obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

Once the Commissioner has thus proved that an avoidance arrangement exists, it will automatically be presumed that the sole or main purpose of the arrangement was to obtain a tax benefit. The onus will then be shifted to the taxpayer to prove otherwise.

The inclusion by the Legislature of the words, 'reasonably considered in light of the relevant facts and circumstances' means that the taxpayers intention must be considered, taking into account the facts and circumstances of the case at hand.<sup>61</sup>

It can thus be seen that more explicit direction from the Legislature is needed, in terms of what test should be used, as it is still unclear if one should use the subjective or objective test to determine 'purpose'.

### **3.4.8 Tax Benefit**

In order for an arrangement to be an "avoidance arrangement" under the new GAAR, there must be a tax benefit, and the sole or main purpose for entering into such arrangement must have been to acquire a tax benefit.

#### **3.4.8.1 The meaning of 'tax benefit'**

Section 1 of the Act describes a tax benefit as follows:

*'it includes any avoidance, postponement or reduction of any liability for tax'.*

Tax is defined in section 80L to include,

---

<sup>61</sup> Museka CP, *A Critical Analysis of the Requirements of Section 80A of the New General Anti Avoidance Rule*, November 2011, p.39.

*'any tax, levy or duty imposed by the Income Tax Act or any other Act administered by the Commissioner'.*

It can thus be noted that the definition of 'tax benefit' can be interpreted very widely and can potentially include any transaction by the taxpayer that has the effect of reducing his tax liability. It can also indicate that a tax benefit in respect of the avoidance of tax could relate to a current, accrued or a past liability. This can create uncertainty and it can be said with respect that such a wide interpretation could not have been the intention of the Legislature.

This notion is confirmed in *CIR v King*<sup>62</sup> where the court stated,

*"There are many . . . ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or of freeing himself from taxation on some part of his future income. For example, a man can sell investments which produce income subject to tax and in their place make no investments at all, or he can spend the proceeds in buying a house to live in, or in buying shares which produce no income but may increase in value ... He might even have conceived such a dislike for the taxation under the Act that he sells all his investments and lives on his capital or gives it away to the poor in order not to have to pay such taxation. If he is a professional man he may reduce his fees or work for nothing ... He can carry out such operations for the avowed purpose of reducing the amount of tax he has to pay, yet it cannot be imagined that Parliament intended by the provisions of section 90 to do such an absurd thing as to levy a tax upon persons who carry out such operations as if they had not carried them out"*

In the case of *Smith v CIR*,<sup>63</sup> it was stated that,

*'to avoid liability in this sense is to get out of the way of, escape or prevent an anticipated liability, GAAR will find application when a taxpayer enters in to an arrangement which has the effect of avoiding liability which will result in a tax benefit.'*

If strict regard had to be given to the case above, it would create the impression that the avoidance of taxation relates only to an anticipated or future liability. This would surely create confusion for the taxpayer as well as for the Revenue Service.

---

<sup>62</sup> 1947 2 SA 196 (A), 14 SATC 184 at 191.

<sup>63</sup> 1964 (1) SA 324 (A), 26 SATC 1 at 2.

### 3.4.8.2 The test to determine a 'tax benefit'

It should be submitted that there is no formal test to determine the existence of a tax benefit, neither is there any section in the Income Tax Act that expressly provides for a test to be applied in determining a tax benefit.

In *ITC 1625*,<sup>64</sup> the court held that a possible test to determine the existence of a tax benefit was whether the taxpayer would have suffered tax but for the transaction. The Commissioner would then need to determine or predict another transaction or scheme that the taxpayer would have entered into.

The court also made reference to *CIR v Louw*,<sup>65</sup> where it was held that,

*'another way the question has been posed by the courts as follows; had it not been for the transactions.....detailed above, the dividend by the IMC to the SA company and the letter to the Rhodesian company, would have come into the appellants hands and he would have been liable for tax thereon'.*

In this case there was no income that accrued. The directors of the company caused the entity to make loans to them instead of issuing them with dividends that would have been subject to tax. The court held that taxable salaries would have been paid if the loans had not been paid. The Commissioner then raised tax payable in respect of those salaries that would have been paid.

*Clegg and Stretch*<sup>66</sup> held that this approach was incorrect as the court created notional income on which tax would have been paid.

I find the approach in both of the abovementioned cases problematic, as it would require the court to make a subjective inquiry into predicting what the taxpayer could have done. The situation could also very well exist where the taxpayer would not have entered into any transaction that gets predicted by the Commissioner.

It is thus clear that although there is no clear test for the determination of a tax benefit to be found in the legislation, the courts have adopted their own test and enunciated that a "but for" test is used.

---

<sup>64</sup> 1996 59 SATC 383.

<sup>65</sup> 1983 3 SA 551 (A), 45 SATC 113.

<sup>66</sup> 2013 D Clegg, R Stretch *Income Tax South Africa* (Online version) at p 26.3.3.

### 3.4.8.3 Onus of proof in determining 'tax benefit'

In *ITC 1625*<sup>67</sup> it was stated that the Commissioner bears the onus of proving a tax benefit. The Commissioner needs to prove on a balance of probabilities that a tax benefit was derived as a result of an arrangement being entered into or carried out.

### 3.4.9 Tainted elements

#### 3.4.9.1 Introduction

The last requirement that must be met in order to hold that an avoidance arrangement is an impermissible avoidance arrangement is that the arrangement must include an abnormality element.

In this section I will review the requirement in the context of business<sup>68</sup>, non-business context<sup>69</sup> and in any other context<sup>70</sup>. SARS in their *Draft Comprehensive Guide to the General Anti-Avoidance Rule*, refers to these requirements as 'tainted elements'.

The previous abnormality test contained similar wording to that of the abnormality test in the new GAAR and all the contextual components of the previous GAAR has been retained in the new abnormality requirement. It is however important to note that the new GAAR has excluded the term "*having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out*"<sup>71</sup> from its preamble when determining the abnormality of an avoidance arrangement.

This omission thus implies that the new abnormality requirement must be considered to be an objective test.

#### 3.4.9.2 Abnormality

Section 80A (a) states that,

---

<sup>67</sup> 1996 59 SATC 383.

<sup>68</sup> Section 80A (a).

<sup>69</sup> Section 80A (b).

<sup>70</sup> Section 80A (c).

<sup>71</sup> Repealed Section 103(1)(b).

**'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) it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or
- (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;

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

(c) in any context—

- (i) It has created rights or obligations that would not normally be created between persons dealing at arm's length; or
- (ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).'

It is thus clear that there are three ways to determine the abnormality of a transaction in terms of the Act, namely:

- In the context of business.
- In a non-business context and
- In any other context.

#### **3.4.9.3 In the Context of Business**

The business context approach can be divided into two further tests, namely:

- The Business purpose test, and
- The Lack of commercial substance test.

#### **3.4.9.4 The Business Purpose Test**

The business purpose test was also included in the now repealed section 103(1), and is not a new concept in the new GAAR.

This test requires that an arrangement must, in a business context, have been entered into and carried out by means or manner that would not normally be employed for bona fide business purposes other than obtaining a tax benefit. The test is thus whether the manner in which the

transaction was entered into or carried out in a manner that would normally be used for business purposes other than to obtain a tax benefit. If it is thus established that, in the context of business, an avoidance arrangement was entered into or carried out in a manner not normally employed for bona fide business purposes, a presumption will exist that the avoidance of tax was the sole or main purpose for the transaction.

A distinction should be drawn between this test and the business purpose test used in the United States of America (USA). The USA's test was set out in the case of *Gregory v Helvering*<sup>72</sup> in 1935, and in terms of this test the courts need to determine if the transaction the taxpayer entered into, was driven by commercial consideration or purely to obtain tax benefits. The business purpose test in section 80A entails a comparison between the transaction that the taxpayer entered into and the way in which that type of transaction would normally be entered into. The test in the USA correlates more closely to the 'sole or main purpose test' that applies in South Africa.

A problem that we find in the business purpose test is that the term '*bona fide business purpose*' is not defined in the Act. Clegg<sup>73</sup> is of the view that the term means that the transaction must be real and not imaginary, but it is also submitted that the term bears the judicial interpretation of '*good faith*'.<sup>74</sup>

The term '*bona fide*' was discussed by in Silke<sup>75</sup> and it was stated that,

*'The term relates to the business purpose so that, even if the arrangement is entered into or carried out in a bona fide manner the method employed may nevertheless be found to be abnormal in a business context.'*

De Koker<sup>76</sup> in Silke holds the view that the reference in section 80A (a) to '*bona fide business purpose*' is the result of poor draftsmanship and will invite confusion. He states the term 'purpose' has already been dealt with in the opening words of section 80A and to use the word again in a different sense is creating confusion. He also states,

---

<sup>72</sup> 293 US 465 (1935).

<sup>73</sup> Clegg.D. (2002) Business Purpose Test. *Tax Planning Corporate and Personal*, vol.16.

<sup>74</sup> Jarvis J (1996). Things are Seldom What They Scheme. *Juta's Business Law*, vol.4.

<sup>75</sup> De Koker, A.P., Williams R.C. (2013). *Silke on South African Income Tax* Chapter 19 (online version).

<sup>76</sup> De Koker, A.P., Williams R.C. (2013). *Silke on South African Income Tax* Chapter 19.39 (online version).

*'What s 80A(a) is really talking about, it is submitted, is not purpose (either subjective or objective) but method, that is to say, the overt means or manner by which the taxpayer has entered into or carried out the arrangement in question. If that means or manner was such as would not normally be employed in the context of business, then s 80A(a) component of an impermissible avoidance arrangement is present.'*

It is thus clear that without proper guidance on this term, the doors for arbitrary and discretionary application of GAAR will be open to SARS.

#### **3.4.9.5 The Lack of commercial substance test**

The commercial substance test applies to transactions in the context of business only. This test is considered to be an extension of the business purpose test and it is divided into two parts as follows:

- A general test<sup>77</sup>
- A list of indicators that indicates a lack of commercial substance.<sup>78</sup>

#### **3.4.9.6 General test**

Section 80C states as follow:

- (1) *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.*
- (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; or*
  - (b) *the inclusion or presence of—*
    - (i) *round trip financing as described in section 80D; or*
    - (ii) *an accommodating or tax indifferent party as described in section 80E; or*

---

<sup>77</sup> Section 80C (1).

<sup>78</sup> Section 80C (2).

(iii) *elements that have the effect of offsetting or cancelling each other.*

Section 80C (1) contains the general commercial substance test, also known as the 'presumptive' commercial substance test<sup>79</sup>.

This section lays out the definition for the lack of commercial substance which the Commissioner will rely on to determine if an arrangement lacks commercial substance. It is clear from the definition that the arrangement must result in a tax benefit and that it must have a significant effect on the business risks or net cash flows.

This part of the new GAAR addresses the fact where tax avoidance schemes often create a façade of substantial investments which serve largely as an illusion and insulate the taxpayer. A significant tax benefit must exist, and the existence of a mere tax benefit will not be enough.

It will thus need to be determined what constitutes a '*significant tax benefit*' as it is not defined in the Act. Clegg and Stretch<sup>80</sup> submits that,

*'application of this term is problematic since there is no indication of what would constitute a significant tax benefit. Furthermore, the same difficulty applies in determining whether there is a significant effect on business risk or net cash flow.'*

A possible definition to this term could be that it connotes an arrangement to be *material* and *relevant* to a particular taxpayer.<sup>81</sup>

SARS<sup>82</sup> states that commercial substance will be lacking where there is-

- *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*

---

<sup>79</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p.25.

<sup>80</sup> 2013 D Clegg, R Stretch *Income Tax South Africa* (Online version) at p 26 3.5.

<sup>81</sup> L Olivier, DM Davis, G Uruquhart. *Juta Income Tax (2009)* at 80C-2.

<sup>82</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p.26.

- *a loss claimed for tax purposes that significantly exceeds any measurable reduction in that party's net worth.*

I feel that an Interpretation Note should be produced by the Commissioner to attach a definition to this term as it will eventually lead to confusion once the courts start applying their own definition and interpretation. What the Commissioner might regard as material, might not be material in the eyes of the taxpayer.

#### **3.4.9.7 Commercial substance indicators**

In determining if an arrangement lacks commercial substance, as per section 80C (1), the Commissioner will be assisted by the indicators as contained in section 80C (2).

The list of indicators or indicative test is not an exhaustive list and none of them are more important in relation to any other indicator. If the Commissioner establish that one of the indicators are present, it may be sufficient to hold an avoidance arrangement as impermissible, subject that the general test in section 80C (1) is satisfied.

The Act states that the indicators include, but are not limited to, the following:

- The legal substance or effect differs from the legal form of the steps (substance v form);
- The inclusion or presence of round trip financing;
- Accommodating or tax indifferent parties; or
- Elements that offset or cancel each other.

I will now go on to briefly discuss these indicators.

#### **3.4.9.8 Substance v Form: The legal substance or effect differs from the legal form of the steps**

Section 80C (2)(a) provides that an arrangement will lack commercial substance, if either 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.

This test was introduced into the Act, as it is a common practice for taxpayers who want to avoid tax, to insert unnecessary and artificial steps into an arrangement in order to disguise the true substance of the overall arrangement.

'Legal substance' can be taken to mean the actual legal rights and obligations flowing from the avoidance arrangement as a whole and reflects the true reality or substance of the arrangement. It refers to the real agreement of the taxpayer or the effect of the agreement.

The 'legal form' of an arrangement will refer to what the taxpayer actually did.

In the case of *NWK v C SARS*<sup>83</sup> the court laid down a few important principles relating to substance over form. In this case NWK entered into a series of complicated transactions with First National Bank. NWK had a loan from FNB and had to pay interest. NWK was claiming for deduction for the expenses incurred when paying this interest. The Commissioner disallowed the claim for deductions and raised further assessment on the basis that the agreements concluded between NWK, FNB and its subsidiary did not reflect the true substance of the agreement. The court stated that,

*'... the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. The test should go further and require an examination of the commercial sense of the transaction i.e. its real substance and purpose.*

*If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.'*

It was thus submitted that the real purpose of the agreement must be established to see whether the agreement was simulated.

When faced with an arrangement where the substance of the arrangement differs from its form, the Commissioner must first apply the principle of substance over form.

#### **3.4.9.9 Round trip financing**

The existence of round trip financing will indicate that there is a lack of commercial substance as stated in section 80C(2)(i).

Section 80D defines round trip financing and states that round trip financing includes any avoidance arrangement in which funds are transferred between parties and the transfer of the funds would –

- Result, directly or indirectly, in a tax benefit but for the provisions of GAAR; and

---

<sup>83</sup> 2011 (2) All 347 (SCA).

- Significantly reduce, offset or eliminate any business risk incurred by any part in connection with the avoidance arrangement.

For purposes of section 80D, 'funds' are defined as including any cash, cash equivalents or any right or obligation to receive or pay the same

This section has the potential to create a lot of absurdities, as the Commissioner will be able to apply it whenever funds, as defined, are transferred between parties, which are almost the case in every transaction or arrangement.

Also, the inclusion of the terms 'tax benefit' and the reduction of 'business risk' in the test for round trip financing, creates a duplication of the test laid out in section 80C(1) for the determination of a tax benefit. This also has the potential to create confusion.<sup>84</sup>

#### 3.4.9.10 Accommodating or tax indifferent parties

The inclusion of an accommodating or tax indifferent party will indicate a lack of commercial substance as per section 80C (2)(b)(ii).

The characteristics of an accommodating or tax indifferent party can be found in section 80E (1).

It reads as follows:

**80E. Accommodating or tax-indifferent parties.**—(1) A party to an avoidance arrangement is an accommodating or tax-indifferent party if—

- (a) any amount derived by the party in connection with the avoidance arrangement is either—
  - (i) not subject to normal tax; or
  - (ii) significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and
- (b) either—
  - (i) as a direct or indirect result of the participation of that party an amount that would have—
    - (aa) been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party; or

---

<sup>84</sup> Haffejee Y. (2009). *A critical Analysis of South African General Anti Avoidance Provisions in Income Tax Legislation* p.27.

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

Section 80E (2) makes it clear that any party can be an accommodating or tax indifferent party and the parties need not be connected to each other.

SARS<sup>85</sup> states that the mere presence of an accommodating or tax indifferent party in an avoidance arrangement, where the sole or main purpose was to obtain a tax benefit, will be enough to hold that arrangement as impermissible.

Section 80E (3) describes the situations where the rules regarding accommodating or tax indifferent parties will not apply and grants exemption to these situations.

#### **3.4.9.11 Elements that offset or cancel each other**

Section 80C (b)(iii) holds that a lack of commercial substance is presumed when elements that offset or cancel each other are present. An arrangement will thus be an impermissible avoidance arrangement, if the arrangement was entered into or carried out in the context of business, a tax benefit was derived and the sole or main purpose of the arrangement was to derive this tax benefit and the arrangement contained elements that had the effect of offsetting or cancelling each other.

This is one of the new sections added by the Legislature to the GAAR, and there is thus no guidance on how to interpret this section. SARS, in the Draft Comprehensive Guide to GAAR<sup>86</sup>, used the following example to illustrate this section:

*'An agreement, which forms part of a composite arrangement, creates rights and obligations which are cancelled by virtue of another agreement, which forms part of the same arrangement. If the presumptive test contained in section 80C (1) is satisfied, this cancelling or offsetting of rights and obligations further indicates that the arrangement is an impermissible avoidance arrangement.'*

<sup>85</sup> South African Revenue Service (SARS).2010. Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR) p.30.

<sup>86</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule* (GAAR) p.35.

It should be noted that the elements that offset or cancel each other, may take any form, and is not only confined to be amounts, but can also be rights and obligations, as seen in the example used by SARS.

#### **3.4.9.12 In a Non-Business Context**

Section 80a (b) holds that an avoidance arrangement is an impermissible avoidance arrangement if in a *context other than business*, it was entered into or carried out by a means or manner not normally employed for a bona fide purpose other than obtaining a tax benefit.

It is submitted that the test to be used in this context would be an objective test<sup>87</sup>, as it has to be determined whether the arrangement was entered into or carried out by means or manner which would not normally be employed for *bona fide* purpose.

The term 'bona fide purpose' was discussed earlier and it was established that this term was not defined properly. The Commissioner will now be able to take a bona fide business arrangement and use section 80A(b) to assess it as opposed to section 80A(a) given that the term is not properly defined.

#### **3.4.9.13 In any other context**

Section 80A (c) states that an avoidance arrangement will be held to be an impermissible avoidance arrangement if *in any context* it:

- has created rights or obligations that would not normally be created between person dealing at arm's length<sup>88</sup>; or
- it would result directly or indirectly in the misuse or abuse of the provisions of the Act<sup>89</sup>.

This provision is one of the provisions that were retained from the now repealed section 103(1). The test would then stay the same as used under section 103(1) save for the removal of the terms "*under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question*", and of "*having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out*".

---

<sup>87</sup> 2013 D Clegg, R Stretch *Income Tax South Africa* (Online version) at 26.3.5.

<sup>88</sup> Section 80A(c)(i).

<sup>89</sup> Section 80A(c)(ii).

Although there is no longer an explicit benchmarking to the surrounding circumstances or the legal nature of arrangements, as seen from the omissions above, the surrounding circumstances will still be considered in determining the abnormality of arrangements.<sup>90</sup>

The use of the term 'any context' indicates that this provision has a very wide application. This test could thus then be used in instances where avoidance arrangements will pass either or both of the test covered above under abnormality, as an alternative test.

### **3.5 Conclusion**

This report focused on the General Anti-Avoidance Rules as contained in the now repealed section 103(1) of the Act and as currently found in section 80A to L of the Act. It was found that section 103(1) of the Act contained certain inherent weakness that rendered the general anti-avoidance provisions ineffective against certain avoidance transactions by taxpayers.

The Legislature intended to curb these "loopholes" in section 103(1) by introducing section 80A to L into the statute books.

An overview of the different provisions and test as introduced by section 80 was done and it could be seen that there was indeed evidence that the Legislature tried to remedy the gaps left by section 103(1). It was discovered that section 80A to L retained a lot of provisions from section 103(1) and contained few new provisions. It was also found during the analysis of section 80A to L that the new provisions provided for a new set of interpretive problems that needs to be addressed. Certain terms in section 80A to L have the potential to cause confusion amongst taxpayers as well as for the Revenue. I recommend that the Legislature should introduce an Interpretation note on section 80A to L to define certain undefined terms in the provisions, to erase any confusion in the application of the new GAAR, and help the revenue combat tax avoidance.

As South African taxpayers will always seek new and innovative ways of avoiding tax, the effectiveness of the South African General Anti-Avoidance Rules remains an area of concern, despite attempts to address its weaknesses.

---

<sup>90</sup> South African Revenue Service (SARS).2010. *Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR)* p.37.

### **3.6 Bibliography**

#### **Legislation**

Income Tax Act 58 of 1962, as amended

#### **Books and Journals**

Broomberg, E.B. 'Then and Now-II '(2007) 21 Tax Planning Corporate and Personal (Online Version)

Clegg.D. Business Purpose Test (2002) 16 Tax Planning Corporate and Personal

Clegg, D. Stretch, R. (2013) Income Tax in South Africa (Online Version)

Dachs, P. and Du Plessis, B. The Interpretation of substance over form. (Online article)

De Koker, A.P., Williams R.C. (2013). Silke on South African Income Tax (online version).

Haffejee, Y. (2009) A critical analysis of South Africa's general anti avoidance provisions in income tax legislation

Jarvis J (1996). Things are Seldom What They Scheme. Juta's Business Law, vol.4

Kanamugire J. (2008) A Critical Analysis of Tax Avoidance in the Income Tax Act 58 of 1962, as amended.

Katz Commission 1995. Third Interim Report of the Commission of Enquiry into Certain Aspects of the Tax Structure of South Africa (November 1995).

Museka, C.P. (2011) A Critical Analysis of the Requirements of Section 80A of the New General Anti Avoidance Rule

OECD (Organisation for Economic Co-operation and Development), International Tax Terms for the participants in the OECD Programme of Co-operation with Non-OECD Economies

Olivier, L. Davis, DM. Uruquhart, G. Juta Income Tax (2009).

South African Revenue Service (SARS)(2010). Draft Comprehensive Guide to General Anti-Avoidance Rule (GAAR).

South African Revenue Service (SARS). 2005. Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act 58 of 1962.

South African National Treasury. 2006. Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006.

Werksmans Tax.2006. New general anti-avoidance rule in the works. International Tax Review, February 2006

### **Case Law**

C: SARS v NWK Ltd 2011 (2) SA 67 (SCA)

C of IR v Challenge Corp Ltd [1986] 2 NZLR 513 (PC)

CIR v Nemojim 1983 (4) SA 935 (A)

CIR v King 1947 (2) SA 196 (A)

CIR v Bobat and Others 2005 67 SATC 47 (N)

CIR v Conhage 61 SATC 391

CIR v Louw 1983 (3) SA 551 (A)

Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue 1996 3 SA 942 (A)

FCT v Newton 1958 2 All ER 759

Gregory v Helvering 293 US 465 (1935)

Hicklin v SIR 1980 1 SA 481 (A)

IRC v Duke of Westminster 1936 A.C. 1 (HL)

ITC 1625 1996 59 SATC 383

Kilburn v Estate Kilburn 1931 AD 501

Meyerowitz v CIR 1963 3 SA 863 (A)

Ovenstone v SIR 1980 (2) SA 721 (A)

SBI v Lourens Erasmus (Edms) Bpk 1996 (4) SA 344 (A)

SIR v Geustyn, Forsyth and Joubert 1971 3 SA 567 (A)

SIR v Gallagher 1978 (2) SA 463 (A)

Smith v CIR 1964 (1) SA 324 (A)

University of Cape Town