

**THE NEW GENERAL ANTI-AVOIDANCE RULE: A
COMPREHENSIVE DISCOURSE ON THIS STATUTE**

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STATEMENT

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

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

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1. FOREWORD TO PROPOSAL

'Many countries have general anti-avoidance rules (GAARs). These provisions seek to overturn tax-motivated transactions violating economic substance despite the legal form. Section 103 of the Income Tax Act, the South African GAAR is based on antiquated notions of legal form and intent. The problem is exacerbated by formalistic judicial interpretations that undermine the legislation's ultimate goal of curtailing tax avoidance schemes that undermine the Income Tax Act's underlying policy, which is to tax in full the enhancement of net economic wealth'.¹

¹ Extract of 2005 Budget Review quoted in *The Taxpayer*, Volume 54 No. 4, April 2005, p 61

2. ABBREVIATIONS

- 2.1. "2005 paper" means the SARS Discussion paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962, 3 November 2005;
- 2.2. "Australian ITA" means the Australian Income Tax Assessment Act, 1936;
- 2.3. "Australian GAAR" means Part IVA of the Australian ITA;
- 2.4. "Broomberg" means Advocate Eddie Broomberg, S.C.;
- 2.5. "Canadian ITA" means the Canadian Income Tax Act, RSC 1985, c.1 (5th Supp);
- 2.6. "Canadian GAAR" means section 245 of the Canadian ITA;
- 2.7. "CGT" means capital gains tax;
- 2.8. "Companies Act" means the Companies Act No 61 of 1973 (as amended);
- 2.9. "Eighth Schedule" means the Eighth Schedule of the ITA;
- 2.10. "GAAR" means a general anti-avoidance rule;
- 2.11. "old GAAR" means the now repealed section 103(1) of the ITA;
- 2.12. "Meyerowitz" means Advocate David Meyerowitz, S.C.;
- 2.13. "new GAAR" means the new GAAR provisions contained in sections 80A to 80L of the ITA, as amended by the Taxation Laws Amendment Act No 8 of 2007;
- 2.14. "ITA" means the Income Tax Act No 58 of 1962 (as amended);
- 2.15. "LSSA" means the Law Society of South Africa;
- 2.16. "Republic" means the Republic of South Africa;
- 2.17. "Revised proposal" means the SARS paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 - Revised Proposals;
- 2.18. "SAFA" means the South African Fiscal Association;

- 2.19. "SARS" means the South African Revenue Service;
- 2.20. "UK" means the United Kingdom;
- 2.21. "USA" means the United States of America; and
- 2.22. "VAT" means Value Added Tax.

3. INTRODUCTION

On 3 November 2005, the Minister of Finance explicitly recognised the need for a revised GAAR stating: ‘What we can't accommodate is a rule which is intended to limit avoidance that is so abused and tatty with wear.’²

This paved the way for the SARS launching their 2005 discussion paper on GAAR. SARS, in their introduction, discussed and pointed out the ramifications of aggressive tax avoidance structures.³

SARS held further that not only do such structures, *inter alia*, affect the short-term revenue loss of the fiscus, but also influence the economy negatively from a longer-term perspective and weaken National Treasury's ability to successfully implement and govern economic policy.

The result – the much-anticipated new GAAR measures, incorporated in twelve new sections of the Act, viz sections 80A – 80L, which came into effect for schemes or arrangements entered into, on, or after 2 November 2006.

² Keith Engel, Chief Director, Tax Legislation – National Treasury, “The GAAR proposal: A National Treasury Perspective”, Slide 3

³ SARS, 2005 Discussion Paper on Tax Avoidance, p. 1

4. OBJECTIVE OF THIS REPORT

The primary objective of this report is to provide an overview of the new GAAR in the South African context.

The report further sets out the necessary steps that should be contemplated in an analysis of whether a particular avoidance arrangement will fall foul of the new GAAR.

The writer aims to achieve the objectives of this report by:

- 4.1. Discussing the two concepts – “tax evasion” versus “tax avoidance”;
- 4.2. Providing an overview of the old GAAR, its weaknesses, the SARS justifications for the proposed new GAAR set out in their 2005 discussion paper and the consequential revised proposals, and problems in the drafting of a GAAR;
- 4.3. Referring to the manner in which tax avoidance is dealt with in other countries;
- 4.4. Providing an introduction to the new GAAR and looking at the aspects borrowed from foreign jurisdictions that have been introduced; and
- 4.5. Analysing the steps prescribed by the new GAAR to determine whether a particular avoidance arrangement is impermissible;

5. A DISCUSSION OF TAX EVASION VERSUS TAX AVOIDANCE

It is crucial to distinguish between “tax avoidance” and “tax evasion”. Tax evasion, an illegal offence resulting in severe penalties and possible imprisonment, involves the usage of fraud or deceit to reduce a tax liability through the non-disclosure of income and overstating deductions.⁴

Conversely, tax avoidance is the manner whereby a taxpayer would legitimately organise his affairs in such way that would result in the minimum tax liability imposed by the Act.⁵

Taxpayers, as often cited, are entitled to arrange their affairs in such manner with the result that the tax payable is less than it otherwise would have been, provided there is no provision in the law designed to prevent or counter the avoidance of tax by means of that specific scheme.

Lord Tomlin stated (at 520) in *IRC v Duke of Westminster*, 1936, 19 TC 490:

‘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.’

6. ROAD TO THE NEW GAAR

Following is a discussion of the road to the new GAAR.

6.1. The SARS view

SARS launched their 2005 paper on 3 November 2005, following the announcement in the 2005 Budget Review that section 103(1) is to be revised. Reasons cited included the GAAR being antiquated, and ‘exacerbated by formalistic judicial interpretations that undermine the legislation’s ultimate goal of curtailing tax avoidance schemes that undermine the Income Tax Act’s underlying policy...’

⁴ Huxham, K & Haupt, P “Notes on South African Income Tax – 2007”, p. 350

⁵ Op. Cit. n. 4, p. 351

Meyerowitz, amongst others, criticised SARS and National Treasury for such improper comment on the function of the courts in the interpretation and application of the old GAAR.⁶ Meyerowitz indicated that the function of the courts extends to the protection of the taxpayer, as well as that of the fiscus, and that the old GAAR's inadequacy cannot be blamed on the interpretation thereof by the courts. Broomberg echoed such a view⁷ stating that the old GAAR could not be viewed as a deterrent, as section 103(1) was not a penalty section.

SARS further contended that the old GAAR did not keep up with international standards. Commenting thereon, Broomberg noted that it was misleading to indicate that South Africa has fallen behind, as the leaders in tax legislation (ie the UK and USA) refrained from enacting a form such as a GAAR.⁸

6.2. The Old GAAR – a brief overview

In brief, the old GAAR provided that the Commissioner could *only* apply section 103(1) of the Act when satisfied that the following four sets of criteria existed, each required to be present:⁹

6.2.1. A transaction, operation, or scheme had to exist;

6.2.2. which resulted in the avoidance, reduction or postponement of a tax liability levied in terms of the ITA;

6.2.3. the “abnormality requirement” must be present having regard to its circumstances, either, in relation to a manner not normally employed for *bona fide* business purposes other than obtaining a tax benefit, or it created abnormal rights and obligations; and

6.2.4. the transaction, operation, or scheme must have been entered into solely or mainly to obtain a “tax benefit”.

⁶ The Taxpayer, Volume 54 No 4, April 2005, p. 61 / 2

⁷ SAFA seminar, The New General Anti-Avoidance Rule, p. 1

⁸ Ibid

⁹ Confirmed in *SIR v Geustyn, Forsyth and Joubert*, 1971 (3) SA 567 (A), 33 SATC 113, 1971 Taxpayer 148 that all four criteria must be present for the section to be applied successfully

Such tax benefit would incorporate 'any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner.'¹⁰

Once established, section 103(4) would place the onus on the taxpayer to prove that the sole or main purpose of the transaction was other than to avoid tax.

6.3. Weaknesses of the old GAAR

Despite the fact that the old GAAR was an "ineffective deterrent", SARS cited the additional weaknesses as follows.¹¹

6.3.1. The "abnormality requirement"

SARS held that where a transaction was normally employed for *bona fide* business purposes, such particular form of transaction was "hijacked" and widely used for tax avoidance purposes.

Such transactions had the potential of gaining commercial acceptability, citing plausible *bona fide* business purposes, and to such extent, their utilisation may become "normal" – the "everyone's doing it defence".

6.3.2. The "purpose requirement"

It is submitted that SARS was smarting after the judgment passed in the *Conhage* case¹² held that where a dual purpose exist for entering into a transaction, SARS could not attack under section 103(1), if the main reason for entering into such transaction was business and commercially orientated.

The court, citing Watermeyer CJ in *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184 at 209, reiterated that although section 103(1) was designed to enable the Commissioner to deal with tax avoidance

¹⁰ Section 103(7) of the ITA

¹¹ Op cit n. 3, p. 42

¹² *CIR v Conhage (Pty) Ltd* (formerly *Tycon (Pty) Ltd*), 1999 (4) SA 1149 (SCA), 1999 Taxpayer 173, 1999 (12) JTLR 337

schemes in an effective manner, it could only operate in the circumstances stipulated in its provisions.

SARS, clearly not in agreement with the subjective test being applied to the “purpose requirement”, quoted RC Williams at 44 in the 2005 paper:

‘... a taxpayer could with impunity enter into a transaction with the (subjective) sole purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner or in the rights and obligations which it created. Conversely, a taxpayer could with impunity enter into a transaction which was objectively ‘abnormal’ provided that he did not, have the sole or main purpose of tax avoidance’

6.3.3. SARS cited, as a final measure at 44, that the procedural and administrative issues concerning the uncertainty relating to the extent to which the Commissioner could apply the old GAAR to certain steps within a large transaction, and whether the old GAAR could be applied “in the alternative”.

6.4. Drafting a GAAR

Prior to identifying the problems in drafting a GAAR, the writer deems it necessary to reflect on the purpose of a GAAR in the South African context.

6.4.1. The purpose of a GAAR

The LSSA raised, *inter alia*, the following principles following on the purposes of a GAAR in its response to the 2005 paper.¹³ The writer deems it necessary to highlight a few thereof.

The LSSA firstly submitted whether a GAAR served a purpose in the South African context, when common law and the taxing statutes dealt sufficiently with such misconduct. Secondly, the courts dealt ‘adequately with attempts to manipulate the tax laws by means of

¹³ LSSA, “Comments to the Portfolio Committee on Finance on the Discussion Paper on Tax Avoidance Issued by SARS during November 2005”, p. 1

artificial and contrived schemes that have little economic substance'. As a third measure, they commented on the 'drastic and intrusive' power arising on SARS, and commented that the debilitating effect thereof would emasculate the taxpayer in ordering his affairs in an appropriate manner as to diminish the tax burden.

6.4.2. Problems in drafting a GAAR

The biggest obstacle in drafting a GAAR is establishing the boundaries, and the manner in which to distinguish between the taxpayer ordering his affairs in the most appropriate manner to minimise the tax liability arising on him, and transactions deemed an "impermissible avoidance arrangement".¹⁴

SARS introduced the "impermissible tax avoidance" concept in its 2005 paper. At 2.2.2 they refer to the term as '*artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer*', and, at 6, further elaborate on such concept as '*an attempt to defer or eliminate a potential liability by manipulating or exploiting perceived "inconsistencies" or "discontinuities" in the tax system through various "tax arbitrage" techniques.*'

Schreiner JA encapsulated the concept of a GAAR, and its consequential objective, in his separate judgment delivered in *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184, where he cited the following on the then section 90.¹⁵

'I do not read s 90 as a penalty section or as widening the net beyond the general scope of the Act. It seems to aim at a truer or fairer determination of the liability to the taxes imposed by the Act and at their due payment when so determined. It is intended, I think, to deal with cases in which the Commissioner, as representing the fiscus, is properly aggrieved by a transaction or operation designed to enable one of the parties thereto to escape

¹⁴ Section 80A of the ITA

¹⁵ Quoted from Emslie, Davis, Hutton, Olivier: "Income Tax, Cases & Materials", The Taxpayer, 3rd edition, April 2001, p. 905

tax. The Commissioner is not properly aggrieved merely because at a stage before income has accrued to a taxpayer it might have been predicted with confidence amounting even to certainty, that if the taxpayer took no steps in the matter such income would accrue to him and because he then takes the avoiding steps. But the Commissioner would be properly aggrieved if a transaction or operation were entered into which prevented income from accruing to the taxpayer, while leaving him in the position of one to whom the income would normally and naturally accrue. The section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer's affairs which will result in his getting less income; it is designed to meet the Commissioner's objections to the creation of abnormal or unnatural situations, to the detriment of the fiscus.' (Emphasis added)

The LSSA¹⁶ elaborating on the same point, stated further at 2.5 that 'a GAAR normally does not confer an unfettered discretion on revenue officials; it usually contains appropriate safeguards against the abuse of the drastic powers conferred thereby'.

It is crucial that that some middle way had to be found between what SARS called "legitimate tax planning" and "impermissible tax avoidance". An answer thereto was summarised concisely by Meyerowitz¹⁷ stating that in the genetic makeup of a GAAR, the retention of the "abnormality" and "purpose" requirements would be essential.

In conclusion and as many writers submitted, including Broomberg, Meyerowitz, the LSSA *et al* there are numerous dangers inherent in drafting a GAAR too widely. The consequential effect would empower the Commissioner not only to override the specific provisions of the ITA, but would create an atmosphere of uncertainty

¹⁶ Op. cit. n. 13, p. 4

¹⁷ Op. cit. n. 6, p. 64

that may act as a disincentive to economic activity in the country. Finally, should the ambit of a GAAR be too wide, a danger exists that “legitimate tax planning transactions” would suddenly be caught in the GAAR net.

7. DOES A GAAR CONCEPT EXIST IN OTHER COUNTRIES?

Following is an overview of tax avoidance in other countries and whether the GAAR exists.

7.1. Australia

GAAR provisions are present in Australian and Canadian (discussed below) income tax law.

Broomberg¹⁸ notes that these are widely considered less than satisfactory. He advises that both the courts and the tax administrators inconsistently apply the general anti-avoidance provisions in those countries and that they are 'replete with unanswered questions'.

To apply the Australian GAAR successfully, three basic requirements must be met.¹⁹

Firstly, there must be a "scheme".²⁰ Secondly, the taxpayer must derive a tax benefit from such scheme.²¹ Thirdly, having regard to the following eight matters set out in section 177D of the Australian ITA, the scheme, or any part of such scheme, must have been entered into for the sole or dominant purpose of obtaining a tax benefit.

The eight matters are:²²

7.1.1. The manner in which the scheme was entered into or carried out;

7.1.2. The form and substance of the scheme;

¹⁸ Op. cit. n. 7, p. 1

¹⁹ Australian Taxation Office, "Part IVA: the general anti-avoidance rule for income tax - Basic principles about how and when it applies", NAT 14331-12.2005

²⁰ Section 177A

²¹ Section 177C

²² Op. Cit. n. 19, p. 1

- 7.1.3. The time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- 7.1.4. The result achieved by the scheme under the income tax law if part IVA did not apply;
- 7.1.5. Any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result from the scheme;
- 7.1.6. Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, that has resulted, will result, or may reasonably be expected to result, from the scheme;
- 7.1.7. Any other consequences for the relevant taxpayer, or for any person referred to under matter 6 (above) of the scheme having been entered into or carried out; and
- 7.1.8. The nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to under matter 6.

It follows that the “purpose” question set out above does not concern the taxpayer’s actual purpose, but requires an ‘objective conclusion to be reached about the purpose of a relevant person, and is determined after considering the eight specified matters.’²³

7.2. Canada

The application of the Canadian GAAR also involves three steps.²⁴ The first step is ‘to determine whether there is a “tax benefit” arising from the “transaction”’.²⁵ Secondly, it must be determined whether the transaction is an avoidance transaction under section 245(3) in the sense of ‘not being

²³ Ibid

²⁴ Held in *Canadian Trustco Mortgage Co v Canada*, 2005 SCC 54, para 17, for definitions and terminology refer section 245 of the Canadian Income Tax Act

²⁵ Ibid

arranged primarily for *bona fide* purposes other than to obtain the tax benefit'.²⁶ Thirdly, it must be determined 'whether the avoidance transaction is abusive under section 245(4)'.²⁷ All three requirements must be fulfilled before the GAAR is applicable to deny the relevant tax benefit.

7.3. The UK and the USA

The UK and the USA do not have a GAAR, and both countries have adopted disclosure requirements in respect of 'potentially abusive tax avoidance schemes'.²⁸

The UK, for instance, has developed specific sets of broad anti-avoidance rules addressing, *inter alia*, financial avoidance and double tax avoidance. Meyerowitz notes that the UK courts would look at the total steps of the arrangement as well as the ultimate result thereof. Should any artificial steps be present with no consequential commercial purpose, and the taxpayer only benefited as a result from the tax saving, the taxpayer is to be denied the tax saving. The courts have taken this approach by considering the purpose of the legislation and not merely the literal language of the relevant provisions.²⁹

The American courts on the other hand have developed 'robust judicial doctrines', closely related to one another, and designed to counter tax avoidance schemes, not only through the application of such doctrines, but by applying legal analysis with common sense in interpreting facts and rules.³⁰

8. THE NEW GAAR: AN INTRODUCTION

As regards the South African context, section 90 of Act 31 of 1941 was amended subsequent to the *King*³¹ judgment to improve its construction, and, on

²⁶ *Ibid*

²⁷ *Ibid*

²⁸ *Op. Cit.* n. 3, p. 36

²⁹ *The Taxpayer*, Volume 55 No 4, April 2006, p. 64

³⁰ *Op. Cit.* n. 3, p. 37

³¹ *CIR v King* 1947 (2) SA 196 (A), 14 SATC 184

recommendation of the Katz commission, further amendments were again made resulting in the now repealed the old GAAR.³²

The provisions of the new GAAR, contained in sections 80A to 80L, was inserted by section 34(1) of Act 20 of 2006, and applies to any arrangement (or any steps therein or parts thereof) entered into on or after 2 November 2006. Conversely, the old GAAR would apply to a transaction, operation or scheme entered into before 2 November 2006.

The new GAAR does not address instances where part of a transaction, operation or scheme was entered into before 2 November 2006, with certain steps or parts of such arrangement concluded after such date. The writer submits that a common sense approach should be applied, and the relevant GAAR should be applied (depending on the date of conclusion of the arrangement in question) regardless of when it is carried out.

The writer has thought it useful to summarise the differences between the old and new GAAR, before dealing with the provisions of the new GAAR in detail.

The new GAAR introduced a series of new definitions set out in section 80L that defined the concepts “arrangement”, “avoidance arrangement”, “impermissible avoidance arrangement”, “party”, “tax” and “tax benefit”.

The new GAAR represents a restructuring of the now repealed section 103(1), and while retaining certain conceptual components of section 103(1), it introduces a number of new components, which are:

- 8.1. The “commercial substance” test that will be measured against a number of non-exclusive indicators,³³
- 8.2. The misuse or abuse of the provisions within the ITA;³⁴
- 8.3. Widening the Commissioner’s remedies and making it less vague,³⁵
- 8.4. The “presumption of purpose” test,³⁶

³² Op. Cit. n. 29, p. 63

³³ Section 80A(a)(ii) – taking into account the provisions of section 80C

³⁴ Section 80A(c)(ii)

³⁵ Section 80B

- 8.5. The ability to apply the provisions of the new GAAR to individual steps within a larger scheme³⁷, and to present the Commissioner with an option whereby he could apply the new GAAR provisions in the alternative for or in addition to any other basis for raising an assessment;³⁸
- 8.6. Introducing a “connected person’s” test³⁹ and the concept of accommodating or tax indifferent parties;⁴⁰ and
- 8.7. Introducing the notice provisions and affording the taxpayer reasons why the GAAR provisions should not be applied.⁴¹

To conclude, the new GAAR requires the following three elements to be present before it can be applied successfully.

Firstly, an “avoidance arrangement” must be present. Secondly, the sole or main purpose of such avoidance arrangement must have been to *obtain* a “tax benefit”. Finally, in addition to obtaining a tax benefit, one of the tainted elements must be present, which are – the “abnormality” element, or, “lack in commercial substance” element, or, “misuse or abuse of the provisions of the Act” element.

9. REQUIREMENT 1: AN “AVOIDANCE ARRANGEMENT”

The first requirement necessary to apply the new GAAR successfully is the presence of an “avoidance arrangement”.⁴²

Section 80L defines an “arrangement” as ‘any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property’. Should such arrangement result in a “tax benefit”, such arrangement would constitute an “avoidance arrangement”.

Silke, at 19-4, states that *“arrangement” has been interpreted as requiring a conscious involvement of two or more participants who arrive at an understanding. It*

³⁶ Section 80G

³⁷ Section 80H

³⁸ Section 80I

³⁹ Section 80F

⁴⁰ Section 80E

⁴¹ Section 80J

⁴² Preamble to section 80A

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.⁴³

The term “transaction, operation or scheme” was considered in *Meyerowitz v CIR*.⁴⁴ The judgment held that the test to apply is whether the different steps when examined retrospectively, appear to be so connected with one another that they could ultimately lead to tax avoidance, and, the fact that the avoidance of tax only appears at subsequent steps is of no consequence.

”Agreement or understanding (whether enforceable or not)” appears to mirror the wording of the definition of “scheme” as per section 177A(1) of the Australian ITA (the definition provision of the Australian GAAR).⁴⁵ According to Broomberg⁴⁶, the expansion of the “arrangement” definition is useful in the sense that on the part of the Commissioner and the taxpayer, it draws the need to identify precisely the transaction, operation, or scheme, or to which steps or parts of a scheme, the Commissioner has applied the GAAR.

Moreover, the ambit of an “arrangement” could now include a verbal understanding or agreement, and that it is not required for such understanding or agreement to be in writing.

9.1. Applying the new GAAR to individual steps within a larger scheme

The reference to “including all steps therein or parts thereof” makes it clear that steps or parts of an “arrangement” are deemed arrangements. Section 80H reiterates that the Commissioner may apply GAAR to steps in or parts of an arrangement, and, section 80G(2) provides that the purpose of a step or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.

It appears that the purpose of the application of the GAAR to any step or part of an avoidance arrangement is to defeat the effect of the established principle in our existing jurisprudence that the old GAAR could not be

⁴³ Silke on South African Income Tax, (Last updated: August 2007) LexisNexis Butterworths – electronic version

⁴⁴ 1963 (3) SA 863 (A), 25 SATC 287, 1963 Taxpayer 126. Also Ibid

⁴⁵ Op. Cit. n. 3, Annexure B, p. 62 (The Australian GAAR)

⁴⁶ Op. Cit. n. 7, p. 3

applied where the taxpayer was able to establish an overriding non-tax reason for the conclusion of the transaction in question.⁴⁷

Broomberg⁴⁸ submits that the new arrangement definition does not address problems that have arisen in the jurisdictions from which the wording of this new definition was borrowed. He questions whether the Commissioner could apply the GAAR to a step or part in an arrangement where it loses its commercial substance as a result of being considered in isolation, and concludes that the answer to such question will have to await consideration in court.

9.2. Tax benefit

The term “tax benefit” is not only a requirement for an “arrangement” to be deemed an “avoidance arrangement”, but also arises in the preamble to section 80A. Moreover, for the new GAAR to be invoked, an arrangement must result in a tax benefit, and, the main purpose of such arrangement must be to obtain a tax benefit.

Section 80L defines “tax” to include ‘any tax, levy or duty imposed by this Act or any other law administered by the Commissioner’.⁴⁹ A “tax benefit” includes any ‘avoidance, postponement or reduction of any liability for tax’. It is submitted that the avoidance, postponement, or reduction of a tax liability for any of the taxes, levies, or duties, would constitute a tax benefit, and, could trigger the new GAAR in relation to income tax provided that a tax benefit in relation to income tax exists as well.

The *King*⁵⁰ judgment held that the tax liability addressed by a GAAR is not an existing liability for tax, but an anticipated tax liability.

In determining the existence of a tax benefit, no defined test exists. In *ITC 1625*, the judgment held that a possible test to apply in determining such

⁴⁷ Ibid

⁴⁸ Ibid, p. 4

⁴⁹ Other taxes administered by the Commissioner include Estate Duty under the Estate Duty Act, value-added tax under the Value-Added Tax Act, stamp duty under the Stamp Duties Act, marketable securities tax under the Uncertificated Securities Tax Act, customs and excise duties under the Customs and Excise Act, and skills development levies under the Skills Development Levies Act.

⁵⁰ CIR v King 1947 (2) SA 196 (A), 14 SATC 184. Quoted from Emslie et al at p. 895

existence was whether the taxpayer 'would have suffered tax but for the transaction'.⁵¹

The onus thus would rest on the Commissioner to show that a tax benefit has arisen as a result of an arrangement. Hence, the presence of the so-called "but-for" test⁵² should be for him to establish, and the nature of an alternative position in order to quantify the tax benefit must be sufficiently clear in his mind.

9.3. Considering the taxpayer's onus as to the existence of a tax benefit

In terms of section 82 of the ITA the burden of proof in all tax disputes is placed on the taxpayer. However, the judgment in the *Conhage*⁵³ case held that section 82 does not apply to section 103(1). Moreover, it was incumbent on the Commissioner to establish the facts upon which he had invoked the old GAAR, subject only to the proviso that as soon as the tax avoidance effect of the transaction was proved, the onus shifted to the taxpayer to prove his main purpose was not tax avoidance.

By contrast, there is no equivalent wording in the new GAAR indicating that section 82 does not apply to it, and, should the courts follow such approach, the onus will rest on the taxpayer to prove that at least one of the requirements for the application of the GAAR is missing.

Broomberg⁵⁴ contends that one of the consequences of the new wording in section 80G, may be a major change in the onus of proof relating to the whole GAAR.

The LSSA⁵⁵ submitted at 5.2 that the 'most fundamental and salutary safeguard enshrined in the current section 103 is the requirement that in any proceedings involving its application the burden of proving the alleged abnormality of the transaction lies with SARS'.

⁵¹ 59 SATC 383

⁵² Op Cit n. 7, p. 4

⁵³ CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd), 1999 (4) SA 1149 (SCA), 1999 Taxpayer 173, 1999 (12) JTLR 337

⁵⁴ Op Cit n. 7, p. 5

⁵⁵ Op. Cit. n. 13

Moreover, to place such incumbency on the Commissioner was an 'appropriate safeguard against abuse and consistent with established procedural rules that the burden of proof in relation to an allegation of abnormality should be on SARS'.⁵⁶

10. REQUIREMENT 2: SOLE OR MAIN PURPOSE TO OBTAIN A TAX BENEFIT

10.1. Sole or main purpose

Meyerowitz, at 29-11, points out that "solely or mainly" means "for the most part; principally; chiefly", and that the phrase conveys the idea of dominance, ie to ascertain the weighting of each purpose of an avoidance arrangement.⁵⁷

The sole or dominant purpose test to which section 177D of the Australian GAAR refers, provides that the "scheme" must have been entered into for the purpose of obtaining a tax benefit.⁵⁸

The test is applied by having regard⁵⁹ to the manner in which the scheme was implemented, the consequential effects of such scheme, and the connection between the parties to such scheme.

The Canadian GAAR refers to section 245(3), which provides for the transaction to have been reasonably 'considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit'.⁶⁰ In the *Canadian Trustco Mortgage Co. v Canada*, 2005 SCC 54, judgment the Court provided some much-needed guidance as to avoidance transactions.⁶¹

'Whether a transaction is an avoidance transaction is also a factual inquiry. It requires an examination of the relationships between the parties and the relevant transactions leading to an objective assessment

⁵⁶ Ibid

⁵⁷ Meyerowitz, D Meyerowitz on Income Tax 2005-2006ed, The Taxpayer. Refer also Meyerowitz reference to CIR v King 1947 (2) SA 196 (A), 14 SATC 184

⁵⁸ Op. Cit. n. 3, p. 29

⁵⁹ Op. Cit. n. 19, p. 2

⁶⁰ Op. Cit. n. 3, Annexure C, p. 69 (Section 245(3) of the Canadian GAAR)

⁶¹ Osler, Hoskin & Harcourt LLP Update, "Canada's Highest Court Interprets the General Anti-Avoidance Rule in Income Tax Appeals", October 27, 2005, p. 3

of the relative importance of the purposes of the transaction. A transaction that may reasonably be considered to have been undertaken or arranged primarily for non tax purposes is not an avoidance transaction, but a transaction is not an avoidance transaction merely because an alternative transaction might have achieved the same result at a higher tax cost. A non tax purpose is broader than a business purpose and may include family or investment purposes.'

Much can be learnt from the likes of Australia and Canada as to considering the "sole or main purpose" of an arrangement, and it is proposed that such guidelines be adopted (and amended where necessary) in determining the "sole or main purpose" of the arrangement.

10.2. The "purpose" test – subjective or objective

The South African courts have held on numerous occasions that a subjective test must be applied in the attempt to apply the old GAAR.⁶² Corbett JA, in the *SIR v Gallagher*⁶³ judgment, held the following.

'It is submitted in the heads of argument of appellant's counsel that in determining the purpose of a transaction, operation or scheme an "objective" test should be applied. By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a "subjective" test which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme... In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one.' (Emphasis added)

SARS, not surprisingly, favoured the approach of an "objective" test followed by countries such as Australia, Canada, and New Zealand, and indicated such preference in their 2005 paper⁶⁴ and revised proposal.⁶⁵

⁶² *SIR v Gallagher* 1978 (2) SA 463 (A), *SIR v Geustyn, Forsyth and Joubert*, 1971 (3) SA 567 (A) at 57G-H, and, *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 730H.

⁶³ 1978 (2) SA 463 (A), 40 SATC 39, 1978 Taxpayer 148 quoted from Emslie et al at page 933

⁶⁴ Op. Cit. n.3, p. 48

⁶⁵ SARS "Tax Avoidance and Section 103 of the Income Tax Act, 1962 - Revised Proposals", September 2006, p. 21

Such change is highlighted, as pointed out by Broomberg⁶⁶, with the “onus of proof” wording of section 80G and the insertion of the word “it” in the preamble to section 80A.

The change in wording indicates that when applying the “purpose” test, regard must be had to the effect of the arrangement, and not the purpose of the taxpayer. Such change could result in that our courts will have to apply an objective test when determining the “purpose”, and ascertain from the relevant facts and circumstances if tax avoidance was the sole or main purpose of the arrangement.

Having regard to the *Gallagher*⁶⁷ judgment, such action would disadvantage the taxpayer, as no regard will be had to the intent or purpose of the taxpayer when entering into such avoidance arrangement.

10.3. Presumption of purpose

Section 80G(1) currently provides that once SARS has established the existence of an "avoidance arrangement", the presumption is created that the sole or main purpose of the avoidance arrangement was to obtain such tax benefit unless the taxpayer can prove to the contrary. Meyerowitz indicates that it could become a logical impossibility for the taxpayer to prove an objective purpose, when the purpose is to be presumed.⁶⁸ As regards such purpose, Lord Devlin said the following in *Chandler v Director of Public Prosecutions* (1962) AER 142 (HL) ‘A purpose must exist in the mind. It cannot exist somewhere else’.

Such presumption, and its consequential rebuttal, could arise in relation to the entire arrangement, or, in respect of any part or any step thereof. It is submitted that where, for instance an arrangement has a main business purpose, and a subsidiary step thereof was inserted for tax efficiency, such subsidiary step would fail this test, and would then be considered under the “tainted element” tests.

⁶⁶ Op. Cit. n.7, p. 5

⁶⁷ SIR v Gallagher 1978 (2) SA 463 (A)

⁶⁸ The Taxpayer, Volume 54 No. 11, November 2005, p 205

It is submitted that where a taxpayer is presented with a choice between two transactions, both transactions achieving the same business and commercial result, but with different tax consequences, the main purpose of such transaction could not be to obtain a tax benefit, but remains that of achieving the commercial result, as encapsulated by the *Conhage*⁶⁹ case.

Notwithstanding the above, and the “choice principle” summarised by the *IRC v Duke of Westminster*⁷⁰, the new presumption contained in section 80G places a heavy burden of proof on the taxpayer. The judgment in *Ovenstone v SIR*⁷¹ held that in determining a sole or main purpose, the time of implementation of such arrangement must be looked to in determining the purpose, but that held true in a subjective test. The taxpayer must now not only provide compelling reasons for entering into such arrangement, but must possibly satisfy a court that ‘reasonably considered in light of the relevant facts and circumstances’, the sole or main purpose was other than a tax benefit.⁷²

The writer notes that the courts have not considered how to determine the main purpose, and can only speculate that the ‘robust judicial doctrines’ prevalent in the American courts⁷³, *inter alia*, could provide some type of insight as to an appropriate manner.

11. REQUIREMENT 3: ONE OR MORE OF THE FOUR “TAINTED ELEMENTS”

Meyerowitz⁷⁴ notes that the onus as to proving the existence of the “tainted elements” falls upon SARS, but that SARS will be assisted in discharging such onus to the extent that they would be able to point to the indicators contained in section 80C to 80E. This means, and the writer concurs with Meyerowitz⁷⁵, that the onus of proof that tax avoidance was not the sole or main purpose falls on the taxpayer, but SARS must establish the prevalence of the “tainted elements”, for the successful application of section 80A.

⁶⁹ CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd), 1999 (4) SA 1149 (SCA), 1999 Taxpayer 173, 1999 (12) JTLR 337

⁷⁰ 1936, 19 TC 490

⁷¹ 1980 (2) SA 721 (A), 42 SATC 55, 1980 Taxpayer 166

⁷² Clegg, D & Stretch, R Income Tax in South Africa, p. 26-13

⁷³ Refer clause 7.3 above

⁷⁴ Meyerowitz, D, “Meyerowitz on Income Tax” 2006-2007 edition, The Taxpayer, at 29-11

⁷⁵ *Ibid*, at 29-13

The four tainted elements in the new GAAR are analysed below under the following headings:

- 11.1. Abnormality element;
- 11.2. Commercial substance element;
- 11.3. Creation of non-arm's length rights and obligations; and
- 11.4. The statutory purpose element.

12. TAINTED ELEMENT ONE: ABNORMALITY ELEMENT

The problem presenting itself when drafting an “abnormality element” is to draft the requirement in such manner that it fits in a meaningful manner within the GAAR context without weakening its provisions.⁷⁶

The two abnormality tests (in a “business” and “non-business” context) contained in Section 80A(a)(i) and (b) retain certain conceptual components of the abnormality tests in the repealed section 103(1)(b)(i). The abnormality test relating to the creation of abnormal rights or obligations (section 103(1)(b)(ii)) is discussed under chapter 15. The tests are not presumptive in nature, and the onus is on the Commissioner to prove the presence of abnormality.

It is submitted that the abnormality tests should be objectively applied, based on the removal of the phrases ‘having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out’ and the nature of the transaction in question.⁷⁷

The first abnormality test relating to the “business purpose test” in a “business context”⁷⁸, must determine whether the arrangement was entered into, or carried out, by a means or a manner that would not normally be employed for *bona fide* business purposes other than a tax benefit purpose. This means that where an arrangement is entered into which constitutes a “normal” *bona fide* business transaction, and it results in a subsequent tax saving, such achievement would be of no consequence.

⁷⁶ The Taxpayer, Volume 54 No. 11, November 2005, p 205

⁷⁷ Op. Cit. n. 7, p. 6

⁷⁸ Section 80A(a)(i)

The test does not require the arrangement to have a primary business purpose, and merely requires the arrangement to be conducted in a normal business manner to satisfy the test.

It is true that no universal test has been formulated to determine the “normality” of a transaction, and it has been left to the Courts to formulate the criteria in determining the “normality” of any particular transaction.

In *ITC 1712*⁷⁹, the Court accepted that the “business purpose test” would encompass a comparison between the taxpayer’s transaction, and a hypothetical model of how such transaction would be structured in a *bona fide* business manner in the absence of a tax consideration.

The “business purpose test” in a “business context“, has been expanded to incorporate a “commercial substance” test (discussed under chapter 13). Should a transaction be considered “normal” in terms of the business context test, the “commercial substance test” must still be satisfied.

The abnormal element is satisfied in the “non-business context” test⁸⁰ if the avoidance arrangement ‘was entered into or carried out by means or in a manner which would not normally be employed for *bona fide* purposes, other than obtaining a tax benefit’, and does not refer to the nature of the arrangement in question.

Broomberg⁸¹ submits that the amendments to the abnormality element of the old GAAR were intended to overcome the effects of the *SIR v Geustyn, Forsyth and Joubert*⁸², and *Hicklin v SIR*⁸³ judgments, in which the courts had to consider whether abnormal rights and obligations had been created (discussed later on). Save as mentioned above, the old GAAR contained almost identical requirements, and much of the case law in which the tests have been formulated could still be relevant.

It is submitted that in determining whether a transaction is normal, applying a combination of sound business principles and common sense should suggest a

⁷⁹ 63 SATC 499

⁸⁰ Section 80A(b)

⁸¹ Op. Cit. n. 7, p. 6

⁸² 1971 (3) SA 567 (A), 33 SATC 113, 1971 Taxpayer 148

⁸³ 1980 (1) SA 481 (A), 41 SATC 179, 1980 Taxpayer 49

useful start, whilst still having regard for the “choice principle” summarised by the *Duke of Westminster*.⁸⁴

13. TAINED ELEMENT TWO: COMMERCIAL SUBSTANCE ELEMENT

The “lack of commercial substance” test is expanded on in sections 80C to 80E. The test is essentially an expansion of the abnormality element, with the apparent intention to “beef up” the “business context” abnormality requirement.⁸⁵ It is noted that the test would apply irrespective of whether ‘a transaction would be considered “abnormal” under current law.’⁸⁶ The UK courts defined the presence of a commercial purpose (substance) as a benefit (other than a benefit arising from a tax saving) obtained by the taxpayer.⁸⁷

The test comprises two parts, viz the general rule in set out in section 80C(1), and, a non-exclusive list of characteristics indicative of transactions that would lack commercial substance.

13.1. The general test

The general test in section 80C(1) provides that an avoidance arrangement would lack commercial substance if it would result in a significant tax benefit for a party, but has no significant effect upon either business risks or net cash flows of that party, aside from such implied effect attributable to the tax benefit. The term “significant” creates a problem, as there is no indication as to what constitutes a ‘significant tax benefit’, or a ‘significant effect’ on either business risks or net cash flows. Moreover, it is noted that the general test is a presumptive test, and cannot be rebutted once it is established.

Broomberg⁸⁸ notes that the test should be self-contained and is a ‘black and white issue’. In the event that the taxpayer derives a ‘significant tax benefit’, without a (significant) effect upon either business risks or net cash flows of that party, such arrangement is an “impermissible avoidance

⁸⁴ 1936, 19 TC 490

⁸⁵ Op. Cit. n. 61, p. 6

⁸⁶ Ibid, p 7

⁸⁷ Op. Cit. n. 29, p. 64

⁸⁸ Op. Cit. n. 7, p. 9

arrangement”. Conversely, should the arrangement consequentially either result in a ‘significant effect’ on business risks or net cash flows of that party, the test is passed, and is not a “tainted element”.

Broomberg⁸⁹ comments that the general rule is effectively ‘an articulation of the so-called “economic substance doctrine”. Such doctrine forms the basis of the general anti-avoidance rule in many Western countries, whether that rule is of statutory or judicial origin’.

13.2. The indicator tests

Section 80C(2) refers to characteristics of an “avoidance arrangement”, which are indicative of a lack of commercial substance, but states that whilst including these, it is not limited to these characteristics. The introductory commentary⁹⁰ of the revised proposals states that the original abnormality factors were reduced from eleven to five, focusing on those indicative of a lack of commercial substance. This creates a situation where the number of indicators has been reduced, but the replacement provision brings with it the uncertainty that the current list is by no means exhaustive, and leads to great confusion amongst taxpayers.

The words of the opening sentence “For purposes of this part”, make it clear that subsection 80C(2) is *not* a deeming provision, and, it is not clear whether the subsection could operate independently from the general test. For instance, should an arrangement demonstrate one of the indicators (without failing the general test) would the arrangement be automatically deemed to lack commercial substance or, would the test fail due to the failure of the general test , or, does the Commissioner have the discretion to apply them in the tests in the alternate? Moreover, should the general test be met, on what basis would the “indicator tests” be applied?

Broomberg⁹¹ is of the opinion that the subsection sets out a “facts and circumstances” approach whereby a structured approach or methodology could be provided when querying a certain aspect of an arrangement or

⁸⁹ Ibid

⁹⁰ Op. Cit. n. 65, p. 1

⁹¹ Op. Cit. n. 7, p. 10

intricate transactions, which illustrate SARS' appetite for "objective" tests. Broomberg⁹² submits further that the two subsections read together are nonsensical. Each would have made sense on its own, and even if the sections are interpreted on the basis that they give the Commissioner a discretion to apply subsection (2) where subsection (1) does not apply, all he is left with is a transaction with indicators of lack of commercial substance, and nothing more. From the writer's perspective, it is nonsensical that the presence of such indicator could indicate the presence of a "tainted element" where the general test has not been satisfied. The purpose of the indicator tests surely must have been to highlight or indicate certain characteristics (using a "checklist format") that could indicate the absence of commercial substance when applying the general test.

To conclude Broomberg⁹³ suggests (from a practical perspective) that the anomalies should be ignored for the time being and the arrangement in question should be evaluated as if subsections 80C(1) and (2) postulate separate tests, and, should the arrangement fail either of the general or indicator tests, such arrangement is at risk of attack by SARS.

14. AN ANALYSIS OF THE COMMERCIAL SUBSTANCE INDICATORS

14.1. Indicator One: The "Substance over form" doctrine

The "substance over form" doctrine is an established principle in our courts, and the substance of a transaction rather than its form must be recognised and enforced. This may arise either where the parties to a transaction deliberately conceal or disguise the true nature of their transaction or where they, in good faith, attach the wrong label to it. In the former case, a Court will refuse to recognise or enforce the transaction. Conversely, in the latter, it will recognise the substance rather than the form of such transaction.⁹⁴

The nature of disguised or simulated transactions was also considered in the case of *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR*.⁹⁵ The court

⁹² Ibid

⁹³ Ibid p 16

⁹⁴ Quoted from Emslie et al, p. 897 also *SIR v Hartzenberg* 28 SATC 94

⁹⁵ 1996 (3) SA 942 (A), 58 SATC 229, 1996 Taxpayer 206

reconciled two principles, viz that a taxpayer is entitled to arrange his affairs so as to remain outside the provisions of a particular statute, and that courts are not to be deceived by the form of a transaction but must examine its substance.

The meaning of a disguised transaction was explained in the decision of *CCE v Randles Bros & Hudson Ltd*.⁹⁶ The court held that a dishonest transaction is a disguised transaction and is dishonest in as much as the parties to it do not really intend it to have, *inter partes*, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. For instance, should the parties wish to hide the fact that their real agreement or transaction would be subject to tax, and they therefore dress it up in a guise that conveys the impression that it is not subject to tax.

Section 80C(2)(a), the first of the lack of commercial substance indicators, provides that the legal substance or effect of the avoidance arrangement as a whole must differ from the legal form of its steps. Such wording is nonsensical and it is difficult to grasp what it aims to achieve, as the “substance over form” principle⁹⁷ should have been completed prior to considering whether the GAAR provisions are applicable or not, resulting in the GAAR to be applied to the true rights and obligations of the parties.

Turning to the Australian GAAR guide⁹⁸ for some type of possible answer, the guide, sets out that the eight specific (under the third requirement) matters embrace three overlapping sets of tests. The first test looks at how such scheme was implemented, analysing the manner of implementation, form and substance, and certain timing issues. The guide states the following regarding form and substance.⁹⁹

‘This looks past the form of a scheme to consider the substance of what is being done. A discrepancy between the business and practical

⁹⁶ 1941 AD 369, 33 SATC 48

⁹⁷ Op. Cit. n. 7, p. 11

⁹⁸ Op. Cit. n. 19, p. 1

⁹⁹ Ibid, p. 2

effect of a scheme, on the one hand, and its legal form on the other may indicate the scheme has been implemented in a particular form to obtain the tax benefit. This will be the case particularly if the substance of the scheme may be achieved in a more straightforward or commercial way.
(Emphasis added)

Such test in the context of section 80C(2)(a) would have made sense, as Broomberg¹⁰⁰ muses over the anomaly in the subsection's wording. He points out that '*...the word "legal", is used in relation to both the 'substance' of the avoidance arrangement as a whole and in relation to the 'form' of its individual steps, whereas in common and also in juridical parlance the phrase "legal" is usually used in order to draw a contrast between, on the one hand, the legal effects of an arrangement and, on the other hand, its economic or commercial effect.*'

Broomberg¹⁰¹ suggests that the draftsman may have intended to achieve a test to determine whether the economic effect of an avoidance arrangement as a whole differs from the legal effect of its individual steps, similarly to the Australian version thereof (refer above).

14.2. Indicator Two: Round trip financing

Section 80C(2)(b)(i) states that the inclusion or presence of round trip financing described under section 80D indicates a lack of commercial substance.

Section 80D(1) describes round trip financing to include avoidance arrangements in which funds ("round tripped amounts") are transferred between the parties, and, where such transfer would result (directly or indirectly) in a tax benefit, and, significantly reduce, eliminate or offset any business risk for any party to such avoidance arrangement.

It is submitted that the intention of the section was probably to identify (avoidance) arrangements whereby a transfer, between affected parties, amounts to the same monetary amount, with the result that one, or more,

¹⁰⁰ Op. Cit. n. 7, p. 11

¹⁰¹ Ibid

parties has transferred the same amount as received by it in such (avoidance) arrangement. The provisions of subsections (2) and (3) reinforce such intention. It requires the test to ignore where funds can be specifically traced, the timing or sequence of the transfer of such funds, the means or manner in which such funds were transferred or received, and that the funds constitute any cash, cash equivalents or any right or obligations in relation to such funds.

It seems as if the round tripping concept was formulated on the Australian GAAR. The Australian GAAR guide¹⁰², in the second of three overlapping sets of tests, analyses the effect of the scheme, and considers the tax results, financial changes, and other consequences for the affected parties.

The latter requirements of subsection (1) is reminiscent of the section 80C(1) provisions. To this regard, Broomberg submits¹⁰³ that the difference is that in section 80C(1) the question is being asked of the taxpayer, whereas in section 80D, the question is being asked in relation to other parties to the arrangement.

The writer comes to a similar conclusion but for different reasons. Section 80C(1) sets out the general test casting the tax net wide as regards to the “commercial substance” test, whereas with section 80D (read together with section 80C(2)), the indicator tests are generally indicative of avoidance arrangements that would lack commercial substance, and testing for such element would expand to any party to such avoidance arrangement.

Broomberg¹⁰⁴ comments on the effect of sections 80C(2)(b)(i) and 80C(1) read together, and the inference drawn there from, highlighting the discussion raised under chapter 13.2 dealing with the interpretation of the wording of such sections.

One can only hope that clarity thereon will be provided sooner, rather than later.

¹⁰² Op. Cit. n. 19, p. 1

¹⁰³ Op. Cit. n. 7, p. 12

¹⁰⁴ Ibid, p. 13

14.3. Indicator Three: Accommodating or tax-indifferent parties

Section 80C(2)(b)(ii) states that the inclusion or presence of an accommodating or tax-indifferent party described under section 80E indicates a lack of commercial substance.

The main characteristics of “tax-indifferent parties” are set out in section 80E(1), with subsection (2) stating that there is no requirement that a person should be connected with another party to an arrangement to be deemed an accommodating or tax-indifferent party.

SARS, as to the nature of the inclusion, held in their 2005 paper that *‘Tax-indifferent parties, by design, work to disable and defeat that mechanism. In South African planning circles, these tax-indifferent parties are sometimes referred to as “washing machines”, an apt description of their true role in these schemes’* and *‘...these parties typically receive a fee (often in the form of an above-market return on investment) for the service of absorbing income or otherwise “selling” their tax-advantaged status to the other participants in the scheme.’*¹⁰⁵

Section 80E(3) sets out the exclusion criteria, which will be ignored when applying the provisions of the section, and would not apply to a party in the following circumstances. Firstly, if either the amounts received by that party are cumulatively subject to foreign taxes equal to at least two-thirds of the taxes that they would have been subject to in the Republic, or, secondly such party participated directly in substantive active trading activities in connection with the avoidance arrangement for at least 18 months. Moreover, such trading activities must be attributable to a “foreign business establishment” for purposes of section 9D of the ITA, if it was located outside the Republic.

The section requires that for purposes of subsection (3)(a), the amount of tax imposed by the foreign country must be determined after taking into account any assessed loss, credit, rebate, or other right of recovery to which that party or any connected person in relation to that party may be

¹⁰⁵ Op. Cit. n. 3, p. 21

entitled. The writer notes that the subsection does not make any mention, nor provide for Double Taxation Agreements.

Broomberg¹⁰⁶ notes the absurdity of the requirements and mulls over how a taxpayer should attempt to discharge the onus of proof that another party to the arrangement had a “foreign business establishment” as defined in section 9D(1) of the ITA, and conducted substantive trading activities for at least 18 months. Broomberg notes further that the “foreign business establishment” definition raises some of the most difficult factual issues in the ITA, and the fact that the tax-indifferent party may be a stranger to the taxpayer¹⁰⁷ makes the requirements absurd.

It is difficult to comprehend the reasoning for such intricate legislation, especially when considering that the indicator tests would (possibly) only become relevant¹⁰⁸ once the general test under section 80(1) was passed. The writer deems it appropriate to quote Broomberg¹⁰⁹ at 14 stating that ‘This kind of detailed prescription has no place in jurisprudence when a facts and circumstances test is to be applied’.

14.4. Indicator Four: Elements that offset or cancel one another

Section 80C(2)(b)(iii) states that the inclusion or presence of elements that have the effect of cancelling or offsetting one another indicates a lack of commercial substance.

Broomberg¹¹⁰ notes in this regard that such mechanism was a feature of the type of tax avoidance scheme considered in *Furniss v Dawson*¹¹¹, wherein Lord Brightman reiterated that four steps or conditions must be satisfied before a series of transactions could be taxed as a composite transaction. The four steps that Lord Brightman referred to are:¹¹²

¹⁰⁶ Op. Cit. n.7, p. 14

¹⁰⁷ Ibid

¹⁰⁸ Ibid

¹⁰⁹ Ibid

¹¹⁰ Ibid, p. 16

¹¹¹ [1984] AC 474 HL

¹¹² The Chartered Institute of Taxation: Recent Cases article: <http://www.tax.org.uk/showarticle.pl?id=99&n=379>, article published in the January 2001 issue of "Tax Adviser"

14.4.1. The series must be pre-ordained to produce a given result;

14.4.2. There must have been no purpose other than tax mitigation;

14.4.3. There was no practical likelihood that the events would not take place as planned; and

14.4.4. The events must have taken place.

In *Griffin (HMIT) v Citibank Investments Ltd* [2000] STC 1010 the judgment¹¹³ held that the *Ramsay*¹¹⁴ and *Furniss v Dawson* principles do not present the Court with the necessary freedom to go behind legal transactions, merely to ignore self-cancelling or artificially inserted ones. In the absence of self-cancelling or inserted steps, the *Ramsay* doctrine (which held that a taxpayer will be taxed on the effect of his transactions, not upon the way he has chosen to organise them for tax purposes) has no application.

14.5. Conclusion

The indicator tests are expressly stated to be non-exclusive and taxpayers should purposefully consider the relevant facts (in a manner akin to the three set overlapping Australian GAAR test)¹¹⁵ prior to entering that arrangement, such as, how the arrangement will be implemented, how the results will be obtained, the consequential effects, and timing, of the arrangement considered.

15. TAINTED ELEMENT THREE: NON-ARM'S LENGTH RIGHTS AND OBLIGATIONS

Section 80A(c)(i) encapsulates the third "tainted element" test which enquires whether the avoidance arrangement has created non-arm's length rights or obligations.

The test retains most of its conceptual components from the repealed section 103(1), (but omits the reference to the circumstances under which it was entered into) and is

¹¹³ Ibid

¹¹⁴ W. T. Ramsay Ltd. v. Inland Revenue Commissioners [1982] AC 300

¹¹⁵ Op. Cit. 19, p. 1 & 2

applied in both a business and non-business context. For instance, should an avoidance arrangement pass the first two “tainted element” tests, this test would be applied alongside the abovementioned tests.

The test is now clearly objective, and the omission of the reference to the circumstances under which it was entered into was considered to neutralise the paralysing effect of the judgments held in *SIR v Geustyn, Forsyth and Joubert*¹¹⁶, and *Hicklin v CIR*.¹¹⁷ The result of these two judgments was that, if the circumstances in which the transaction was entered into were taken into account, SARS would lose whether the parties were acting at arm’s length or not.¹¹⁸

Trollip JA, in *Hicklin* at 495, defined the term ‘between persons dealing at arm’s length’ as follows:

‘[I]t connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. Indeed in the Afrikaans text the corresponding phrase is “die uiterste voorwaardes beding”.’

Trollip JA made the following remark regarding abnormality that must be determined in relation to a transaction, operation, or scheme of the nature of that in question.

‘[W]hat may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances.’

It is submitted that with the refurbished test, it is highly unlikely that the judgments would not have held in favour of the Commissioner, as the abnormality in relation to rights or obligations created would most probably not pass the new objective test.

¹¹⁶ 1971 (3) SA 567 (A), 33 SATC 113, 1971 Taxpayer 148; also refer chapter 12, and Broomberg’s submission in this regard at Op. Cit. n. 7, p. 6

¹¹⁷ 1980 (1) SA 481 (A), 41 SATC 179, 1980 Taxpayer 49 Op. Cit. n. 7, p. 6

¹¹⁸ Op. Cit. n. 7, p.6. Also refer chapter 15 which deals with abnormality in respect of the creation of non-arms length rights and obligations

Broomberg came to a similar conclusion¹¹⁹ when he mused over the effect of the amended test on the *Geustyn* and *Hicklin* cases, before he concluded that such amendments were the only requirements to put the old GAAR in good health.¹²⁰

16. TAINTED ELEMENT FOUR: STATUTORY PURPOSE ELEMENT

Section 80A(c)(ii) which contains the fourth “tainted element” test, enquires whether the avoidance arrangement would result directly or indirectly in the abuse or misuse of the ITA, including the GAAR provisions.

The last “tainted element” test is applied in both a business and non-business context (similarly to the “third “tainted element” test), and according to the revised proposal¹²¹, is intended to bring the new GAAR in line with international best practice. The revised proposal refers to a broad movement to an approach to interpretation which requires a “contextual and purposive approach ... in order to find the meaning that harmonises the wording, object, spirit and purpose of the [tax laws]”.¹²²

Section 245(4) of the Canadian ITA imposes a “misuse” or “abuse” limitation on the application of the Canadian GAAR to deny the tax benefits associated with an avoidance transaction. The section (amended on 13 May 2005 with retrospect to the introduction of the Canadian GAAR) provides¹²³ that the GAAR would apply to a misuse or abuse of, *inter alia*, the Canadian ITA. The wording of the refurbished section also amended the initial provision to that of a positive test stipulating that the GAAR would apply only to a transaction, if it may reasonably be considered that such transaction would result in a misuse or abuse. The significance of the section is that it will not deny a tax benefit where ‘it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively’.¹²⁴

¹¹⁹ Op. Cit. n. 7, p. 7

¹²⁰ Ibid

¹²¹ Op. Cit. n. 65, p. 15

¹²² Ibid, p. 16 quoting *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 54, at para 44

¹²³ Duff, D, “The Supreme Court and the General Anti-Avoidance Rule: *Canada Trustco and Mathew*” (2006), p2

¹²⁴ *Canada Trustco Mortgage Company v. Canada*, 2005 SCC 54, at para 62

The facts in *Canada Trustco Mortgage Company v. Canada* concerned¹²⁵ the leveraging of sale and leaseback of trailers, resulting in deferring the tax liability on leasing income by deducting capital cost allowances in respect of the affected property, for which the taxpayer assumed little or no economic risk.

The Crown¹²⁶, acknowledging that an ordinary sale and leaseback did not abuse the capital cost allowance regime, maintained that the taxpayer was not entitled to such allowances, as the manner in which the transactions were structured and financed contravened the object, spirit, or purpose of such allowance regime, resulting in abusive tax avoidance. The Crown submitted¹²⁷ that the allowance regime was only intended to permit deductions based on the 'real', or 'economic' cost (ie the purchase price) incurred by the taxpayer and not on the 'legal' cost.

The taxpayer's argument¹²⁸ was based on specific rules contained in the allowance regime, and that the tax rules prescribed that 'cost' did not necessarily equate to a purchase price, but meant the amount that was 'at risk'. The taxpayer concluded that the GAAR could not be applied, as it would negate the Parliament's decision to use the amount 'in risk' in specific formulated instances.

The Supreme Court (SCC), in its analysis, pointed out that provision must be made according to a textual, contextual, and purposive analysis, to find the meaning that is harmonious with the ITA as a whole when interpreting a statutory provision, and further noted that Parliament intended taxpayers to rely on such provisions to accomplish the desired result.¹²⁹ The SCC noted that the provisions of the ITA must be applied in a fair, consistent, and predictable manner, and that the GAAR can only be applied, when the abusive nature of a transaction is real, denying the consequential tax benefits.¹³⁰

The SCC set out a two-part inquiry in determining whether abuse has occurred.¹³¹ The first step would be to interpret the provisions giving rise to the tax benefit in order to determine their object, spirit, and purpose (this statutory interpretation issue

¹²⁵ Op. Cit. n. 123, p. 3

¹²⁶ Op. Cit. n. 61, p. 2

¹²⁷ Ibid

¹²⁸ Ibid

¹²⁹ Ibid, p. 3

¹³⁰ Ibid, p. 3

¹³¹ Ibid, p. 4

is a question of law). The statutory interpretation principle is purposive, as Parliament would confer tax benefits to promote a variety of commercial, family, and social purposes. The second step would determine whether (based on the facts of the particular case) it would be reasonable to conclude that the transaction in question is consistent with the purpose of the provisions of the Canadian ITA (as relied on by the taxpayer) or whether it frustrates such purpose.

The SCC concluded that the transaction would be considered abusive only in the latter case, and, that the onus rests on the Crown to establish that the affected transaction frustrates, or defeats, the purpose of the provisions relied on by the taxpayer, as the Crown is the relevant party wanting to apply the GAAR.

Turning the reader's attention to the South African context, Broomberg¹³² in his observation of the new subsection, points out that in the Canadian aspect, their ITA allows for the limitation of the GAAR consequential on the wording employed by section 245(4). However, such wording is not present in the South African version, which would result in the equilibrium to be disturbed (between the power of the fiscus and a taxpayer conducting his business) and would put the GAAR into a similar predicament it was in before the *King*¹³³ judgment when its ambit was too wide. Broomberg muses¹³⁴ that the Courts could look negatively at the GAAR should its ambit be too wide, which could lead the Courts to provide a very narrow and restricted interpretation of the statute and frustrate the fiscus.

The so-called "textual, contextual, and purposive" method of interpretation stands in sharp contrast with South African jurisprudence, which mostly relates to the "textual" meaning.¹³⁵ The *dictum* of Rowlatt J in *Cape Brandy Syndicate v IRC*¹³⁶ stating that 'It simply means that in a taxing Act one has to look at what is clearly said. There is no room for any intendment...One can only look fairly at the language used' makes it clear that the new test would find it difficult to fit into the South African juridical milieu.

¹³² Op. Cit. n. 7, p. 8

¹³³ CIR v King 1947 (2) SA 196 (A), 14 SATC 184

¹³⁴ Op. Cit. n. 7

¹³⁵ Ibid

¹³⁶ 1921 1 KB 64 at 71, 12 TC 358

17. USE IN THE ALTERNATIVE

Section 80I provides that the Commissioner could apply the GAAR in the alternative for, or in addition to another basis whereby an assessment is raised on the taxpayer, This amendment, as noted in the revised proposal, leads to the omission of references dealing with the “Commissioner’s satisfaction”.¹³⁷

The judgment in *ITC 1625*¹³⁸ held that should the Commissioner argue¹³⁹ that specific expenditure is non-deductible the Commissioner would not be able to rely in the alternative on section 103(1) as he could not be satisfied of the presence of tax avoidance as required by the old GAAR.

Broomberg notes (in the South African context) that the Commissioner could not apply the GAAR should a specific provision of the ITA address a certain matter or type of transaction.¹⁴⁰ Broomberg refers further to the current jurisprudence in other countries where the tax authorities have the option to apply their GAAR, or, a specific provision of their ITA, or, both.

It is submitted that the power would be conferred on SARS to apply the GAAR as follows. Firstly, as an alternative to a specific anti-avoidance provision in the ITA (provided the GAAR provisions are satisfied), or secondly, in addition to another basis whereby the taxpayer is assessed.

Broomberg highlighted the ambiguity of the wording in section 80I¹⁴¹ before suggesting that one would have to turn to the Courts for a proper interpretation thereof.

18. NOTICE

The effect of section 80I whereby the Commissioner could apply the GAAR, *inter alia*, in the alternative, led to the introduction of the new section 80J, in which SARS is required to issue a written notice to any taxpayer prior to invoking the provisions of the new GAAR.

¹³⁷ Op. Cit. n. 65, p. 18

¹³⁸ ITC 1625 59 SATC 383, 1995 Taxpayer 151

¹³⁹ Quoted from Emslie et al at page 896

¹⁴⁰ Op. Cit. n. 7, p. 2

¹⁴¹ Ibid, p. 3

The process can be summarised as follows:

- 18.1. The notice must set out SARS' reasons as to why the GAAR could be applicable to a particular arrangement;
- 18.2. This would give the taxpayer the opportunity to submit reasons within 60 days (or a longer period as agreed upon by SARS) as to why they believe the GAAR should not be applied;
- 18.3. SARS must then within 180 days (after the taxpayer submitted such reasons) request additional information in order to determine whether or not the GAAR should be applied, or, inform the taxpayer that they would withdraw such notice, or, determine the liability of the taxpayer under the GAAR based upon the information available; and
- 18.4. In the event of additional information coming to SARS' attention after such notice was issued, SARS could revise, or modify their reasons for applying the GAAR.

The writer notes that it is unclear from reading the section whether "days" refer to calendar days or "days" as contemplated in Part III (Objections and appeals) of the ITA.

19. TAX CONSEQUENCES OF IMPERMISSIBLE TAX AVOIDANCE

SARS' current remedy provisions (in terms of the old GAAR) although broad, focus exclusively on neutralising any undue tax benefits obtained¹⁴², and, as such this is not a penalty section. Contrary to the proposal in their 2005 paper¹⁴³, the inclusion of a penalty section was omitted from the new GAAR. The writer is musing on the reasoning for such absence as the new GAAR is based on methodologies and processes applied by countries such as Australia, where a penalty provides for an effective deterrent.¹⁴⁴

SARS submits in their revised proposal, that the new remedy provisions (under section 80B) set out the specific actions available to the Commissioner in order to

¹⁴² Op. Cit. n. 65, p. 22

¹⁴³ Op. Cit. n. 3, p. 57

¹⁴⁴ Op. Cit. n. 7, p. 1

determine the tax consequences for any party to an “impermissible avoidance arrangement”.¹⁴⁵

SARS submits further that the specific remedy provisions are designed *inter alia* to permit the Commissioner to determine the tax consequences of such affected parties by eliminating the specific elements attributable to the impermissible avoidance arrangement, that otherwise would have resulted in a tax benefit. This would result in that the Commissioner would be required to make appropriate compensating adjustments that are necessary to ensure the consistent treatment of all parties to an impermissible avoidance arrangement.¹⁴⁶

The powers conferred on the Commissioner are alarming from a sense that it could result in an “abuse” of power. For instance, the Commissioner could re-characterise any “avoidance arrangement” or step therein / thereof, to his own interpretation (thereby classifying such “avoidance arrangement” as impermissible in nature) even if such interpretation is not in accordance with the taxpayer’s interpretation or intention.

Such interpretation could lead to grave consequences for the taxpayer, should he not be able to satisfy the Commissioner during the applicable notice period¹⁴⁷, as a lengthy and costly court battle could ensue. The writer submits that such power on the side of the Commissioner could disturb the equilibrium between the power of the fiscus and the right of the taxpayer to conduct his business according to the “Westminster” principle.

20. FACTORS TO CONSIDER IN ANY ARRANGEMENT

The Australian Taxation Office¹⁴⁸ suggested the following two questions to determine whether the Australian GAAR could apply (both to be answered in the affirmative). Firstly, whether the taxpayer obtained a tax benefit from a scheme that he would not have obtained had he not entered into such scheme, and, secondly whether it could objectively be determined that the parties entered into the scheme for the sole or dominant purpose of obtaining a tax benefit.

¹⁴⁵ Ibid

¹⁴⁶ Ibid

¹⁴⁷ Section 80J

¹⁴⁸ Op. Cit. n. 19, p. 1

Broomberg suggested employing the following questions:¹⁴⁹

- 20.1. Was there a realistic possibility of a profit?
- 20.2. Did the taxpayer have non-tax reasons to conclude the transaction?
- 20.3. Were the economic consequences of the transaction adequately researched?
- 20.4. Did the taxpayer genuinely invest capital in the transaction?
- 20.5. Did the parties transact at arm's length?
- 20.6. Was the arrangement a once off transaction between the parties, or did they have an ongoing business relationship?
- 20.7. Have the parties carried out their rights and obligations as provided for in terms of the transaction?
- 20.8. Did the entities who were party to the transaction continue to exist after its completion?
- 20.9. Was the arrangement marketed as a tax shelter?

Broomberg concluded that 'it is the answers to these questions that will probably determine the outcome and this were the case before the introduction of the new general anti-avoidance rule and it remains the case still.'¹⁵⁰

21. CONCLUSION

The old GAAR was deplorably in need of repair¹⁵¹, and the methodology applied in the reform thereof is questionable. Not only, as Broomberg observes, has intricate legislation been introduced, but 'the adopting of these problem children and including them in our Act may be questioned'.¹⁵²

The objective methodology introduced by the new GAAR, will force the Courts to change from their current subjective approach, to that of an objective one, and will

¹⁴⁹ Op. Cit. n. 7, p 17

¹⁵⁰ Ibid, p. 18

¹⁵¹ Ibid, p. 2

¹⁵² Ibid

more than likely result in much litigation as discussed above. Lord Hoffmann held the following as regards the rule of interpretation:¹⁵³

‘The lesson, in my opinion, is that tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by a statute which means that such a tax is to be imposed. If that is what Parliament means, the Courts should be trusted to give effect to its intention. Any other approach will lead us into dangerous and unpredictable territory’.

The warning from such a valuable lesson should be heeded; that legislation itself must be addressed, and that the onus cannot be placed on the judiciary to perform such purposive and interpretative duty to suit the fiscus.

Broomberg ponders over the necessity of a GAAR and whether its purpose¹⁵⁴ is achieved for the following reasons.

Firstly, he intimates the inconsistency levels in judgments, starting at the liberalism in the *Westminster*¹⁵⁵ case (a taxpayer could organise his affairs in any way he wishes to minimise tax, provided it is legal). The liberal approach changed to a purposive approach in the *Ramsay*¹⁵⁶ case (a taxpayer would be taxed on the effect of his transactions and not the way he has chosen to organise them for tax purposes). Such approach was then adopted in favour of the legalistic approach in the *Barclays*¹⁵⁷ case (which reiterated the importance of examining the relevant statutory provision.) This clearly indicates a shift in approach by the judiciary, which results from; amongst others, the “flavour of the month” philosophies, and the judiciary view on tax avoidance (do they favour the fiscus or the taxpayer).

Secondly, the global attitude displayed by the Courts in respect of the economic substance doctrine and what the Courts subscribe to, *inter alia*, does the transaction illustrate an economic benefit or not (ie can you make a profit), does the transaction contain a “legal substance”, or, does the transaction illustrate a business purpose?

¹⁵³ The Taxpayer, Volume 55 No. 6, June 2006, p 112

¹⁵⁴ Ibid, p. 16

¹⁵⁵ IRC v Duke of Westminster [1936] A.C. 1, 19 T.C. 490

¹⁵⁶ W. T. Ramsay Ltd. v. Inland Revenue Commissioners [1982] A.C. 300

¹⁵⁷ Barclays Mercantile Business Finance Limited v Mawson (Inspector of Taxes) [2005] 1 All ER 97

The writer notes in conclusion that the presence of the sole or main purpose test is fundamental to the successful application of the new GAAR, and without its presence an “avoidance arrangement” or step therein, or part thereof (even where a tainted element is present) cannot be deemed impermissible.

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