# AN ANALYSIS OF THE INTERPRETATION AND APPLICATION OF ANTI-TAX AVOIDANCE LEGISLATION IN THE INCOME TAX ACT, 58 OF 1962 (AS AMENDED)

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## ABSTRACT

Assessed losses provide opportunities to avoid taxation by using various arrangements or transactions. Legislation has been introduced to combat these forms of tax avoidance, in the form of sections 20, 20A, 103(2) and 103(4), and sections 80A to 80L. These sections have also frequently been considered by the courts. The research problem was therefore the analysis of the interaction and effect of the provisions in the Income Tax Act dealing with the use of assessed losses for the purpose of tax avoidance, and the case law interpretation of these provisions. The main goal of the research was to critically analyse the scope and effect of sections 20, 20A, and 103(2) and 102(4), and sections 80A to 80L of the Income Tax Act, dealing with assessed losses, together with the interpretation by the courts.

The research was situated within the interpretative paradigm, adopted a qualitative approach, with a doctrinal methodology. As the research was carried out using only publicly available documents, no ethical considerations applied.

In addressing the goal of the research, the thesis first discussed the concept of tax avoidance and its consequences. The two main interpretative approaches adopted by the courts, including with regard to tax provisions – the strict literal and the purposive approaches – were described. The thesis then proceeded to analyse sections 20, 20A, 103(2) and 103(4), and sections 80A to 80L, together with the relevant case law, and in the case of sections 80A to 80L, with the use of a hypothetical example, to illustrate the application of the sections.

The conclusion arrived at was that the sections discussed in the thesis are adequate to address the problem of the misuse of assessed losses to avoid tax.


Key words: Income tax, assessed losses, tax avoidance, anti-avoidance legislation, interpretation of statutes.

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# CHAPTER 1: INTRODUCTION

## 1.1 RESEARCH CONTEXT

Cassidy (2012:321) considers that the sustainability of a taxation system relies in part upon reducing tax avoidance as far as possible. She states that tax avoidance harms the economy in that it causes revenue loss and diverts resources away from the *fiscus*. Companies (as well as individuals, trusts, and other juristic persons) may have accumulated assessed losses for tax purposes. Section 20(2) of the Income Tax Act, 58 of 1962, (as amended) (referred to as "the Income Tax Act") defines an assessed loss as follows: "(2) For the purposes of this section 'assessed loss' means any amount by which the deductions admissible under sections 11 to 19, inclusive, exceeded the income in respect of which they are so admissible." Companies with large assessed losses are often the target for mergers and acquisitions. Where the company that is the object of the merger or acquisition has ceased to carry on a trade for a financial year, the carry forward of the assessed loss will be denied (section 20(1) of the Income Tax Act), to prevent the use of the assessed loss for tax avoidance purposes. Section 20A of the Income Tax Act is a further anti-avoidance provision that restricts the use of an assessed loss in the case of individuals whose taxable income is taxed at the maximum marginal rate of tax, and who carry on a second loss-making trade.

Hogan Lovells (2017: Online) explains that shareholders wishing to acquire the business of a company with a large assessed loss are often attracted by the assessed loss and its potential tax benefits. An assessed loss cannot be sold and purchased like other assets because the assessed loss attaches to the company in terms of section 20(1)(b) of the Income Tax Act. Only the ownership of the company will change hands. It is in this context that section 103(2) of the Income Tax Act (and its predecessors) was introduced. The section aims to prevent the acquisition of companies or trusts with assessed losses for tax avoidance purposes, by providing that an assessed loss or assessed capital loss in a company, close corporation, or trust, will not be available if an agreement or transaction affecting that company, close corporation, or trust, or a change in shareholding, membership, trustee or beneficiaries, results in income or capital income accruing to that entity, and was effected solely or mainly to obtain access to the assessed loss or assessed capital loss. According to Stewart (1970:189), it is the interpretation of the applicability of section 103(2) that has become the subject of contention between the

taxpayer and the Commissioner. Although some of the sources used are quite old, they are necessary for the purposes of the narrative as they provide the required historical context.

A weakness in section 103(1) – the predecessor to the present sections 80A to 80L – was that it was not an effective deterrent to abusive avoidance schemes and other impermissible forms of tax avoidance, and this resulted in the provision frequently failing to stand up to the rigours of court, due to aggressive and increasingly sophisticated schemes entered into by taxpayers (Olivier, 1996:378). The abnormality and purpose requirements were identified as the most critical areas of weakness. The limited success of section 103(1) created the need for a new general anti-avoidance rule. In the South African context, sections 80A to 80L (the "new GAAR") of the Income Tax Act have filled this need. Although the present thesis deals with assessed losses, it is shown in chapter 4, that sections 80A to 80L can also be applied to avoidance schemes using assessed losses.

## 1.2 ANTI-AVOIDANCE LEGISLATION

The present research discusses four provisions in the Income Tax Act that prevent the misuse of assessed losses:

- section 20, which limits the carry-forward of an assessed loss of a company, when a trade is not carried on in the year of assessment subsequent to the year of assessment in which the assessed loss was established;
- section 20A, which "ring-fences" assessed losses in the case of an individual, where the individual pays tax at the maximum marginal rate of tax and carries on a second hobby-like "trade" that operates at a loss;
- section 103(2), read with section 103(4), which denies the use of an assessed loss by a company, close corporation, or trust where, as a result of an agreement or change in shareholding, income is channelled to the company in order to utilise the assessed loss to reduce the tax liability; and
- sections 80A to 80L, referred to as the "new GAAR", which deal with impermissible avoidance arrangements.

Cassidy (2009: 773) states that the effectiveness of a general anti-avoidance rule (GAAR) is dependent on the content of the rule as well as the interpretative approach adopted by the courts.

Although there is only one case that was heard in relation to the "new GAAR": Absa Bank Limited and United Towers (Pty) Ltd v C: South African Revenue Service, 2021 (3) SA 513 (GP), case law interpreting terms used that are the same as in the previous section 103(1) (replaced by the "new GAAR") are still relevant.

The problem addressed in this thesis is the analysis of the interaction and effect of the provisions in the Income Tax Act dealing with the use of assessed losses for the purpose of tax avoidance, and the case law interpretation of these provisions.

## 1.3 GOALS OF THE RESEARCH

The goal of this research is to critically analyse the scope and effect of sections 20, 20A, and 103(2) and 103(4), and sections 80A to 80L of the Income Tax Act, dealing with assessed losses, together with the interpretation by the courts. The sub-goals are:

1. Briefly discuss the concept of tax avoidance and the interpretation of statutes, as background to the analysis of the anti-avoidance sections.
2. Analyse section 20 of the Income Tax Act and interpretations of the section by the courts, and the tax avoidance section 20A of the Income Tax Act.
3. Analyse the tax avoidance section 103(2), read with section 103(4) of the Income Tax Act, and the interpretation by the courts, as well as the GAAR embodied in sections 80A to 80L of the Income Tax Act.

## 1.4 METHODS, PROCEDURES AND TECHNIQUES

This study adopts an interpretative approach to provide a true South African perspective on the tax legislation regarding tax avoidance. Bhattacherjee (2012:103) explains that interpretive researchers assume that access to reality is through social constructions such as language, shared meanings, and instruments. As the present research uses language, the shared "social meaning" of tax legislation enacted in a democratic process, and "instruments" in the form of documentary data, the interpretative paradigm is appropriate. According to Creswell (2014:6), this paradigm is appropriate because it is cognisant of the fact that reality cannot be divorced from its social context and can only be imperfectly observed in order to gain understanding.

The research method that will be adopted for the study is a legal interpretive approach, and more specifically a doctrinal research methodology. McKerchar (2014:Online) describes this approach as providing a systematic exposition of the rules governing tax provisions, including tax avoidance measures, analysing the relationship between these rules, explaining areas of difficulty, such as the interpretation of these rules, and possibly predicting future developments. Williams (1998:Online) defines qualitative research as that which uses natural language arguments as opposed to numbers and figures. The research is therefore qualitative in nature and the documentary data for the research include sections 20, 20A, 103(2) and 103(4), and 80A to 80L of the Income Tax Act, together with court decisions, published articles, academic texts, authoritative writings, and other appropriate literature on the topic.

## 1.5 ETHICAL CONSIDERATIONS

As the documents to be used for the research are all publicly available, no ethical considerations arise in relation to their use. No application for ethical clearance will therefore be submitted using the Rhodes University Ethical Review Application System.

## 1.6 OVERVIEW OF THE CHAPTERS

The present chapter briefly described the context of the research, identified the research question, set out the main goal and sub-goals of the research, described the research methodology applied to the research, and confirmed that no ethical considerations apply to the research, which is based purely on documentary data.

Chapter 2 provides the background to the research. The chapter discusses tax avoidance, its impact on the economy and revenue collection for the fiscus, and its negative implications. The chapter also includes a discussion of the right of taxpayers to avoid tax, and the common law remedies that can be used by SARS to combat tax avoidance, such as the “sham” or “disguised” transaction principle. The differences between tax planning, tax avoidance, and tax evasion are discussed, together with the consequences that each attracts. The distinction between permissible and impermissible avoidance arrangements is highlighted, in order to understand the importance of the role played by anti-avoidance legislation. The differences between the specific and general anti-avoidance measures are set out. Finally, the chapter briefly discusses the two main approaches to the interpretation of statutes, and tax legislation in particular.

Chapter 3 analyses section 20 and the approach to the interpretation of section 20 by the courts. The chapter illustrates, through case law, the success of the revenue authority in applying the provisions of section 20. Chapter 3 also discusses the ring-fencing provisions in section 20A that are applicable to the assessed losses flowing from secondary trades carried on by high-income individual taxpayers.

Chapter 4 analyses section 103(2) and 103(4), and illustrates the success (or lack of success) of the revenue authority in applying the anti-avoidance provisions in light of the developments in the interpretation of fiscal legislation. Chapter 4 also discusses the possible application of sections 80A to 80L to the use of assessed losses, in the alternative to section 103(2). This is achieved through the application of the provisions of sections 80A to 80L to a hypothetical example.

Chapter 5 provides a summary of the key findings in each chapter and concludes the research.

# CHAPTER 2: BACKGROUND DISCUSSION

## 2.1 INTRODUCTION

Chapter 1 provided an introduction to the concept of tax avoidance and tax avoidance legislation in South Africa. The goal of the research is to critically analyse the scope and effect of sections 20, 20A, and 103(2) and 103(4), and sections 80A - 80L of the Income Tax Act, dealing with assessed losses, together with the interpretation by the courts of tax avoidance legislation. This chapter addresses the first sub-goal of the research – to briefly discuss the concept of tax avoidance and the interpretation of statutes, as background to the analysis of the anti-avoidance sections. The chapter focuses on tax avoidance, its impact on the economy and revenue collection for the fiscus, and its negative implications. In order to provide an understanding of the complex nature of tax avoidance and the efforts required to combat it, this chapter also includes a discussion of the right of taxpayers to avoid tax, and the common law remedies that can be used by SARS to combat tax avoidance, such as the "sham" or "disguised" transaction principle. An example of a sham or disguised transaction is *Commissioner for South African Revenue Service v NWK Limited* 2011 (2) SA 67 (SCA) (at par. 31), where the court held that arrangements were put in place by the parties to inflate the amount of the loan to facilitate an enhanced interest deduction. The differences between tax planning, tax avoidance, and tax evasion are discussed, and the different consequences that each attracts. In addition, the distinction between permissible and impermissible avoidance arrangements is highlighted, in order to understand the importance of the role played by anti-avoidance legislation. This chapter sets out the differences between the specific and general anti-avoidance measures contained in the Act.

In addition, the chapter briefly discusses the two main approaches to the interpretation of statutes – the strict literal approach and the purposive approach. The literal approach only considers the words of the statute, unless it leads to an absurdity. The purposive approach is aptly explained by Goldswain (2012:38), who emphasises that the application of the purposive approach also requires the consideration of the historical context in which a provision was enacted, in addition to the explanatory memoranda, the broad objects of the provision and its relationship with other sections of the statute, all without violating the language in which it is couched. Case law is used to illustrate the application of the two interpretative approaches.

Case law also establishes that the interpretation of fiscal legislation is no different, but that the interpretation should aim to prevent the mischief that the legislation is designed to prevent.

## 2.2 TAX AVOIDANCE AND TAX EVASION

It is often said that nothing is certain except death and taxes; however, the amount of tax to be paid by each entity or individual is not certain (Hoffman, 1960:678). Hoffman notes that factors such as the distribution of wealth in society affect how the tax responsibility will be portioned out, and comments that some taxpayers will always be dissatisfied with the amount of tax that they have to pay, and are willing to legitimately avoid tax, or unlawfully evade tax. Hoffman concludes that the alert individual cannot be blamed for, and should in fact exhaust all available lawful avenues to minimize the incidence of tax on his or her part.

The difference between tax evasion and tax avoidance can sometimes be blurred. According to MacDonald JP in *Commissioner of Taxes v Ferera,* 38 SATC 66, 1976 (2) SA 653 (SR)), at 656E-G.:

> The avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the fiscus, but the effect must necessarily be to cast an additional burden on taxpayers who, imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice and set up the necessary tax-avoidance machinery, fail to do so. Moreover, the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that "good citizens" will always fare badly. While undoubtedly the short-term effects of the practice are serious, the long-term effects could be even more so.

Ngalwana (1998:212) submits that the judge's displeasure with the concept of tax avoidance was misplaced; tax avoidance is a legal and legitimate means of reducing taxable income. Ngalwana notes that it involves using applicable legislation and tax practices to the best advantage. He also comments that tax evasion, on the other hand, is an illegal practice that involves, *inter alia*, falsifying records, lying, and fraudulent behaviour in order to avoid paying tax.

### 2.2.1 Tax Avoidance Defined

The South African Revenue Service (SARS, 2005:3) defined tax avoidance as "the use of artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate or exploit perceived 'loopholes' in the tax laws in order to achieve results that conflict with or defeat the intention of Parliament."

### 2.2.2 Tax Avoidance Compared to Tax Evasion

The distinction between tax avoidance and tax evasion has been described by the former Chancellor of the Exchequer in the United Kingdom, Denis Healy as: "the difference between tax avoidance and tax evasion is the thickness of a prison wall" (Xuereb, 2015:217). In *Commissioner for Inland Revenue v Challenge Corporation,* 1987 AC 155, at 561, which was a case heard in New Zealand, the court noted that evasion occurs when the Commissioner is not informed of all the relevant information pertaining to an assessment of tax, and that innocent "evasion" may lead to a reassessment, while fraudulent evasion may result in criminal sanction. Tax evasion involves fraud, whereas tax avoidance does not. A further distinction should be drawn between tax avoidance and tax evasion. Tax evasion is blatantly illegal and attracts criminal sanctions and fines, as provided for in the Tax Administration Act, 28 of 2011, as amended. It involves not paying the correct amount of tax under the applicable laws. It requires an element of culpability in the form of either intent or negligence, and hiding information from the revenue authorities.

### 2.2.3 The Implications of Tax Avoidance

In the previous chapter it was noted that the sustainability of a taxation system relies partly on the reduction of tax avoidance. Cassidy (2009:773) explains that tax avoidance impacts the economy negatively because it results in revenue losses for the *fiscus,* and it encourages taxpayers to devise schemes and arrangements rather than focusing on investing in the economy. According to Cassidy, this also weakens the Revenue Authority's ability to formulate fiscal policies and in turn negatively affects the integrity of a tax system, which is necessary for its long-term sustainability. Another argument against tax avoidance is the one stated by the learned Judge MacDonald (in *COT v Ferreira*, at 554) that it is only available to the wealthy and that it increases the tax burden on the poor. Tax avoidance is therefore

concerned with conduct on the part of the taxpayer that is *prima facie* lawful, but that produces tax benefits that are unacceptable, or at the very least, unethical.

Steenkamp (2012:227) recognises that one of those mechanisms for combatting tax avoidance that is available to governments is the introduction of anti-avoidance legislation. Although tax avoidance is legal, it is necessary to create a distinction between acceptable and unacceptable tax avoidance arrangements and schemes. Steenkamp explains that a difficulty in implementing effective anti-avoidance measures is that discerning which activities are unacceptable or impermissible is not something usually characterized by unanimity. According to Atkinson (2012:7) whether an arrangement or scheme is unacceptable or impermissible is a conclusion and not a test, therefore, the methods and approaches to reaching that conclusion may differ. Atkinson emphasises that even though difficult, the distinction is of particular importance because it is authoritative in determining which side of the line certain actions fall. Therefore, a GAAR, being targeted at avoidance, and not tax mitigation or planning, and where abnormality is involved, must contain explicit or implicit tests to be used to determine whether a particular scheme or arrangement is impermissible or not. The opinion of Lord Nolan is an appropriate definition of avoidance in this regard (*Commissioner of Inland Revenue v Willoughby,* 1997 STC 995, (1997) 4 ALL ER 65, at 73):

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.

It can be concluded, therefore, that avoidance refers to conduct that reduces, eliminates, or defers a tax liability by using the specific provisions of the tax statute in a manner which they were not intended to be used.

## 2.3 IMPERMISSIBLE TAX AVOIDANCE

In *Commissioner for Inland Revenue v Challenge Corporation* (at 561), impermissible tax avoidance was described as follows: "… [t]he taxpayer reduces his liability to tax without

involving him in the loss or expenditure which entitles him to that reduction", and therefore "does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had".

SARS (2005:16) has described impermissible tax avoidance as:

(i) the deferral of a tax liability;
(ii) the conversion of the character of an item, for example from revenue to capital;
(iii) the permanent elimination of a tax liability; and
(iv) the shifting of income from a higher marginal rate to a lower marginal rate.

However, these are also the goals of a permissible tax avoidance arrangement and so it would be misleading to believe that they are only applicable to impermissible arrangements. For example, in the case of *African Life Investment Corporation v Secretary for Inland Revenue*, 31 SATC 163, 1969 (4) SA 259 (A), the shifting of income was done purely for administrative purposes without a tax saving incentive.

The definition of tax avoidance may also include the following characteristics (SARS, 2005:19):

(i) abuse of a statute;
(ii) the lack of a business purpose;
(iii) artificial or contrived transactions; and
(iv) claiming deductions without incurring an expenditure or loss.

Although many attempts have been made to define tax avoidance, no consensus has been reached on its actual meaning (Prebble & Prebble 2010:705). This is partly because of the increasingly sophisticated tax "products" developed by taxpayers and their advisers to avoid tax. The methods that are used by the taxpayer to avoid tax are also a relevant indicator of whether the scheme or arrangement is impermissible or not (SARS, 2005:19). These methods contain features that have been identified from previous well-known tax avoidance schemes. SARS (2005:19) has identified these as:

(i) a lack of economic substance;

(ii) the use of tax-indifferent accommodating parties or special purpose entities;
(iii) unnecessary steps and complexity;
(iv) high transaction costs; and
(v) fee variation clauses or contingent fee provisions.

However, these features are not only indicative of impermissible arrangements as they have also been used in legitimate transactions. For example, high transaction costs may occur even where a motive for tax avoidance is absent. While these features are helpful, they are not conclusive evidence of the existence of an impermissible anti-avoidance scheme.

## 2.4 SHAM OR DISGUISED TRANSACTIONS

Identifying transactions as sham or disguised is one way in which certain tax avoidance schemes can be addressed. Just because a transaction is entered into for improper purposes, however, it cannot be assumed that it must be a sham or a disguised transaction. In *Commissioner of Customs and Excise v. Randles Brothers & Hudson Ltd,* 33 SATC 48, 1941 AD 369 (at 395-396), the court held that:

> A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor…

With tax avoidance, the taxpayer does not conceal or misrepresent the true state of affairs but aims to order them in such a way that when presented to the authorities, the details of the activities show that there is no income or there is less income on which to charge tax (Stewart, 1970:169). The taxpayer aims to stress the letter of the law rather than its spirit or purpose, which is why tax avoidance practices are of questionable morality.

In South Africa, the contribution of common law principles to the fight against tax avoidance is limited to “sham” or “disguised” transactions. The court will give effect to the true transaction, and will focus on its substance rather than its form. A “sham” or “disguised” transaction is described as a transaction in which the parties to the transaction have intentionally disguised its true nature by adopting a form that is not a true reflection of their

intentions (De Koker & Williams, 2015:par. 19.2). In *Kilburn v Estate Kilburn,* 1931 AD 501, the court held (at 507) that: "courts 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."

In the case of *Zandberg v Van Zyl*, 1910 AD 302, the court noted (at 309) that:

> As a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have.

The court continued to provide guidance on how such transactions should be dealt with and held (at 309) that:

> When a court is asked to decide any rights under such an agreement, it can only do so by giving effect what the transaction really is: not what in form it purports to be. The maxim then applies *plus valet quod agitur quam quod simulate concipitur*. [The maxim *plus valet quod agitur quam quod simulate concipitur* translated is: "What is actually done is more important than that which seems to have been done".] But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that the contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.

This is a confirmation of the principle that the substance of a transaction is more telling of its true nature than the form in which it is couched. In *Commissioner: South African Revenue Service v NWK Ltd,* 73 SATC 55, 2011 2 All SA 347 (SCA), the court reiterated (at 357) that a taxpayer is entitled to arrange his affairs so as to pay the least amount of tax possible but if the transaction is a "sham" or "simulated" that would make it an impermissible arrangement. Therefore, a transaction being a "sham" or "simulated" serves as an indicator that an arrangement is probably impermissible. The court held (at 357) that:

> It is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective. But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not, especially if that has the purpose of tax evasion, or the avoidance of a peremptory rule of law.

The court also commented (at 361) that the test should go one step further and inquire whether the transaction had real commercial purpose, or its only object was to achieve tax evasion. Even if the parties do perform the terms of the contract, it will still be regarded as an impermissible arrangement.

The conclusion (at 361) of the court is an indicator that the purpose of a transaction must be considered in establishing its substance over its form. This test empowers the judiciary by adding another weapon to its arsenal in the fight against tax avoidance.

## 2.5 THE DIFFERENT APPROACHES TO COMBATTING TAX AVOIDANCE

There are different approaches to combatting tax avoidance – judicial and legislative approaches. The judicial approach is illustrated by the identification by the courts of sham or artificial transactions. In terms of the legislative approach, South Africa approaches the problem of tax avoidance from two perspectives (Steenkamp, 2012:229). These are in terms of specific anti-avoidance legislation and general anti-avoidance legislation.

### 2.5.1 Specific Anti-Avoidance Rules

Stewart (1970:168) draws the line between specific and general anti-avoidance rules. He explains that specific anti-avoidance rules were the initial response of the authorities, which was to plug each hole as it appeared, in other words, respond to each type of avoidance activity by enacting legislation targeted at that specific activity. He notes that this has proved to be largely unsuccessful, and the assistance of a more general anti-avoidance provision has been necessary. Specific anti-avoidance rules operate in such a way as to regulate or prohibit tax avoidance in specific situations or in relation to a specific transaction. As their role is to provide rules that are aimed at the prohibition of impermissible tax avoidance schemes in terms of particular transactions, their reach is limited. They are intended to close loopholes that are exploited by taxpayers in the Taxing Acts. One such example is section 103(2) of the Income

Tax Act, which is aimed at preventing the trafficking in assessed losses. Certain aspects of section 20, together with section 20A, are also examples of specific anti-avoidance rules.

### 2.5.2 General Anti-Avoidance Rules

In the New Zealand tax case of *Commissioner for Inland Revenue v BNZ Investments*, 2002 1 NZLR 450, the court held (at par. 39) that:

> A GAAR is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature through the GAAR has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn. ... The function of the GAAR is to protect the liability for the income tax established under the other provisions of the legislation.

The form of GAAR is unique to each jurisdiction but, generally, the most common features in GAARs are as follows (sections 80A to 80L of the Income Tax Act):

(i) A transaction, operation, arrangement or scheme must exist in the instance under dispute.
(ii) There should be a tax benefit derived from this transaction, operation, arrangement or scheme. This requirement can be implied as it would be impossible to avoid tax if there were no tax benefit to be derived by the taxpayer by entering into the transaction, operation, arrangement or scheme.
(iii) The sole or main purpose for entering into the transaction, operation, arrangement or scheme must be to avoid tax. This is a critical characteristic as its absence would allow the revenue authority to apply the GAAR to a transaction that has no tax avoidance purpose, thereby expanding the scope of the rule beyond that intended by the relevant legislature.

Dabner (2012:237) explains that the main differences between the GAARs of different jurisdictions are those relating to how the courts determine the impermissibility of a transaction. Dabner notes that two main approaches have been identified. These are the

acceptability of the form of the transaction in terms of the taxpayer's objective, and the second focuses on the purpose for which the transaction was entered into. If it can objectively be said that the taxpayer's intention or purpose was to avoid tax, then the arrangement is an impermissible one, especially if there is no sound commercial purpose.

The approaches to the interpretation of fiscal legislation also play a role in the effective application of anti-avoidance provisions. The two main approaches are discussed below.

## 2.6 APPROACHES TO THE INTERPRETATION OF LEGISLATION

According to Goldswain (2008:28): "Interpretation in the context of fiscal legislation is the cornerstone on which the revenue authorities can assess and collect tax and correspondingly, the foundation on which a taxpayer's rights are built." It is submitted that, in light of the consequences of tax avoidance and evasion for the economy and other taxpayers, the approach that the courts take to the interpretation of fiscal legislation, including anti-avoidance rules, is of importance, as it directly affects how the laws are applied.

Du Plessis (2002:18) describes statutory interpretation as being: "[about] construing enacted law-texts with reference to and reliance on other law-texts, concretising the text to be construed so as to cater for the exigencies of an actual or hypothetical concrete situation". Of all the theories identified by Du Plessis, two are prominent. These theories are the formalistic or literal approach, and the purposive approach. Before discussing these approaches, it is important to establish whether there is a difference between the interpretation of fiscal legislation and other legislation.

In *Cape Brandy Syndicate v IRC*, 1921 (1) KB 64, the court held (at 71) that when dealing with fiscal legislation, attention must be given only to the wording that is used. There is no room to consider what might have been intended because there is no equity about tax. Nothing should be read in or implied, only the plain language should be considered when giving effect to legislation. This strict interpretation tended to favour the fiscus, because equity and fairness did not play a part in the decision-making process. However, this strict interpretation tended to serve the taxpayer well in cases where tax avoidance was involved. This is because the principle that was applied in *Partington v the Attorney General,* 1869 LR 4 HL 100, 21 LT 370, and in

*Ayrshire Pullman Motor Services and Ritchie v IRC*, 1929 14 TC 754, that taxpayers are entitled to arrange their affairs so as to enable them to pay the least amount of tax possible.

In 1936, Lord Tomlin, in the House of Lords, stated the following (at 520) in his speech in the well-known English case of *Inland Revenue Commissioners v Duke of Westminster*, 1935 ALL ER 259:

> Every man is entitled if he can to order his affairs so as 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 Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

The issue of the interpretation of fiscal legislation was directly dealt with in the case of *Glen Anil Development Corporation Ltd v SIR*, 37 SATC 319, 1975 (4) SA 715 (A). The court stated (at 727H-728A) that:

> [A]part from the rule that in the case of an ambiguity, a fiscal provision should be interpreted *contra fiscum* … which is but an application of the general rule that all legislation imposing a burden upon the subject should, in the case of an ambiguity, be construed in the favour of the subject, there seems to be little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation.

The views of the court in the *Glen Anil* decision were applied in the case of *Secretary for Inland Revenue v Kirsch*, 40 SATC 95, 1978 (3) SA 93 (T), where the court held (at 94D) that: "There is no particular mystique about tax law. Ordinary legal concepts and terms are involved and the ordinary principles of the interpretation of statutes fall to be applied." The judgments of *Glen Anil* and *Kirsch* are clear authority for the proposition that tax law should be interpreted in the same way as any other law, and by applying the same rules.

As noted by Du Plessis (2002:93), there are two main approaches to the interpretation of legislation – formalistic literalism and the purposive approach.

### 2.6.1 The Formalistic Literalism Approach

Du Plessis (2002:100-101) identifies the formalistic approach as being a form of devotion to literalism. This is because it requires the interpreter to maintain an approach that is as close to the linguistic tenet of the provision as possible. The literalism approach maintains that the meaning of a provision must be extracted from the words of the provision. Devenish (1992:26) notes that the true meaning of a text is to be sought in the *ipissima verba* [the very words] used by the legislature.

In *Cape Brandy Syndicate* (at 71), the court held that when dealing with fiscal legislation, attention must be given only to the wording that is used. Nothing should be read in or implied, only the plain language should be considered when giving effect to legislation. This is also known as the literal approach.

In *Partington v the Attorney General* the court held (at 375) that:

> If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case may otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

The court applied the principle applied in *Cape Brandy Syndicate*, where the court held (at 71) that: "…in a taxing Act one has to look at what it clearly said. There is no room for intendment, there is no equity about a tax. There is no presumption as to a tax. Nothing is said to be read in, nothing is to be implied. One can only look at the language used."

However, ordinary language is not always coherent, and a strict application of this approach may yield results that are so absurd that they cannot have been the intent of legislature. In *Poswa v Member of the Executive Council for Economic Affairs, Environment and Tourism, Eastern Cape*, 2001 3 SA 582 SCA, the court held (at par. 10) that in terms of the "golden rule":

> The cardinal rule of construction of a statute is to endeavour to arrive at the intention of the lawgiver from the language employed in the enactment. . . . In construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship, or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the legislature could not have intended.

According to Devenish (1992:29), where there is an absurdity, the courts can also apply the "mischief rule". The "mischief rule" was established in *Heydon's Case*, 1854 76 ER 637, and stipulates that the role of the courts is to suppress the mischief the statute is aimed at and to advance the remedy. Devenish (1992:28) concludes that the absurdity must be obvious and extracted from the instrument as a whole and must exist in the wording of the provision, as opposed to being a consequence of its application to a set of particular facts.

The "mischief rule" as recognised in *Heydon's Case*, is the classic approach to purposivism in South African Law. The court held (at 638) that the purpose of legislation is to suppress mischief and in order to achieve this a court must ask four questions:

(i) What was the common law before the enactment of the provision?
(ii) What was the mischief and what was the defect for which the common law did not provide?
(iii) What remedy did Parliament resolve to deal with the mischief? And
(iv) What was the true reason for the remedy?

The literal approach has been subject to much criticism in the context of the constitutional interpretation. However, in the case of *S v Zuma and Others*, 1995 (2) SA 642, the court held (at par. 18) that "the Constitution does not mean whatever we might wish it to mean." In other words, the court emphasised the importance of the language used by the legislator when interpreting a provision.

Du Plessis (2002:93) noted that the courts are inconsistent in their approach and seem to vacillate between narrow, formalistic literalism and the purposive approach. Devenish (1992:31) has criticized the literal approach on the basis that it is a rigid approach and does not make room for the context in which laws were made.

### 2.6.2 The Purposive Approach

The purposive method of interpretation was described by the court in *Commissioner: South African Revenue Service v Airworld* CC, 70 SATC 48, 2007 SCA 147 (SA) 23 (at par. 25), as follows:

> … the question is whether the word, properly considered in its context, is…ambiguous. Most of the rules of interpretation have been devised to resolve apparent ambiguity and arrive at an interpretation that accords as well as possible both with the language which the Legislature has used and with the apparent intention with which Legislature has used it. In recent years courts have emphasized the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation that gives effect to such purpose. The purpose, (which is usually clear or discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide to ascertain the Legislature's intention.

According to Du Plessis (2011: 274), the purposive approach is the process of attributing a meaning to a provision in light of the purpose it was created to address, and in the context of the statute in which it is embodied. To the extent that the language of the provision and its purpose conflict, the purpose should be regarded as authority. Devenish (1992:36) acknowledges that a real purposive approach is one that aims to interpret the legislative provision in accordance with its purpose regardless of whether there is an ambiguity or not.

The purposive approach was described by Devenish (1992:36) as: "an interpretative theory which requires the judge to engage in an imagined dialogue with the departed legislature to reconstruct how legislative purpose should be applied to the facts of the case." This approach was applied by the court in *A Company v the Commissioner for the South African Revenue Service* (IT 24510) [2019] ZATC 1 (at par.13).

Popkin (2000:222) comments that this approach requires that legal interpretation should not be exclusively dependent on words and their literal meaning. An interpreter should apply a contextual approach which allows an examination of internal and external sources. Du Plessis (2002:97) confirms that the purpose of legislation and the intention of parliament cannot be different. According to Du Plessis, purposivism allows the courts to deviate from the literal and unambiguous language of the statute.

In *Income Tax Case 1384*, 46 SATC 95, the court described the new approach as follows (at 106):

> … the statute would have to be nevertheless construed subject to the presumption of a fair, just and reasonable lawgiver's intention and in consequence with the "new approach" to interpretation of fiscal statutes, in terms whereof such measures are neither to be subjected to eviscerating formalism or strictness nor to be treated with fawning respect as "holy cows" and not as emanating from some revenue-hungry dragon, but as coming "from a reasonable lawgiver intent, even in matters fiscal, upon ordering its community fairly and justly.

The court also held (at 107-108) that:

> taxing statutes have by their very nature great social import and may therefore cause great damage to the aforementioned vital social requirement if unwisely framed and improperly administered…fiscal statutes are, as mentioned above, not a specially privileged category of legislation and must be approached and dealt with in the same manner as other statutes. Nor is there any special virtue in revenue-raising measures, and the oft repeated remark there is no "equity" in tax laws merely underlines that fact and certainty does not mean that fairness must make way for administrative expediency or fiscal advantage.

In the case of *Commissioner: South African Revenue Service v Airworld CC*, the court approached the issue by identifying the "mischief" that legislature intended to address. The court stated (at par. 23) that: "The legislator in this imperfect world must ever be alert to thwart the relentless ingenuity of accountants, tax consultants, lawyers and even the lay person, by anticipating possible ways and means by which the prescripts of tax legislation might be avoided."

In *Standard General Insurance Co Ltd v Commissioner for Customs and Excise*, 2004 2 SA 376 (SCA), the Supreme Court of Appeal concluded (at par. 25) that: "a word must take its colour, like a chameleon from its setting and surrounds in the Act." In *Metropolitan Life Ltd v Commissioner: South African Revenue Service*, 70 SATC 162, 2009 (3) SA 484 (C), the Cape High Court (at par. 30) considered that repetitive legislation was commonplace and that it was prudent to seek to understand a statute in its entirety. The court took the Explanatory

Memorandum into account in respect of the amendment effected to section 11 of the Value-Added Tax Act, 89 of 1998, in terms of Act 27 of 1997 as it then was and held that it could not have been the intention of legislature to change the nature of the relationship between section 14(5)(b) and section 11(2)(k) (in the Value-Added Tax Act, 89 of 1991, as amended).

### 2.6.3 The Approaches by the Courts in the Interpretation of Fiscal Legislation

The judgment of the Supreme Court of Appeal (at par. 9) in *Commissioner: South African Revenue Service vs. Bosch*, 77 SATC 61, 2015 (2) SA 174 (SCA), is important in the context of the interpretation of fiscal legislation. It is clear authority for the fact that a literal interpretation to legislation should not be adopted, as the so-called plain meaning approach is not helpful. Where more than one meaning is possible, the context in which the legislation applies must be given due consideration. The court reasoned that the surrounding circumstances, such as the reason for the legislation and the way SARS has interpreted the provisions in the past, should be considered. The court also held that words of the provision must be considered in the light of their context, the apparent purpose of the provision, and any relevant background material.

The relevance of the *Bosch* judgment is evident in the case of *Conshu (Pty) Ltd v Commissioner for Inland Revenue*, 57 SATC 1, 1994 (4) SA 603 AD, in which the court faced a difficulty in the interpretation of section 103(2). The taxpayer argued that the Commissioner should have applied the provisions of section 103(2) in the year the relevant agreement was entered into and not the subsequent year in which the assessed loss was utilised. The court was divided on this, and the majority applied a more purposive approach to the interpretation of the provision, that was aimed at suppressing the mischief envisioned by section 103(2). The majority decision of the court was that the interpretation of section 103(2) should be applied purposefully and that the provision was wide enough to include income earned in a year subsequent to the relevant agreement or change in shareholding.

## 2.7 CONCLUSION

This chapter discussed the factors that are used to distinguish between permissible and impermissible tax avoidance arrangements. The concepts of “tax avoidance”, “tax mitigation or planning”, and “tax evasion” were discussed. A distinction was also drawn between

permissible and impermissible arrangements, although it has been established that these terms are difficult to define and distinguish. Research indicates that there are conflicting views in this regard, as seen in the different conclusions by the courts in *Commissioner of Taxes v Ferera*, 38 SATC 66, 1976 (2) SA 653, and *Partington v the Attorney General*, 21 CT 370. The role that specific anti-avoidance legislation and the GAAR are intended to play in combatting tax avoidance were set out. The common law principles in respect of the "sham" or disguised" transactions as an indicator of impermissible tax avoidance were discussed. As the interpretation by the courts of anti-avoidance legislation plays a role in its effective application, the two main approaches to the interpretation of legislation were discussed, namely the formalistic/ literal approach and the purposive approach to interpretation, as well as their applicability to fiscal legislation.

This chapter provided the context to understanding the background, uncertainties, role, and importance of anti-avoidance legislation in South African tax legislation. The next chapter will analyse the provisions of sections 20 and 20A of the Income Tax Act.

# CHAPTER 3: ANTI-TAX AVOIDANCE – SECTIONS 20 AND 20A OF THE INCOME TAX ACT

## 3.1 INTRODUCTION

Chapter 1 set out the main goal of this thesis, which is to explore the role of anti-avoidance provisions in the Income Tax Act in preventing the avoidance of tax using assessed losses, together with case law interpretation of these provisions. Chapter 2 introduced the concept of tax avoidance and explained the differences between tax avoidance and tax evasion. The chapter also dealt with the developments in the interpretation of fiscal legislation, particularly the shift from a literal to a purposive approach of interpretation. This chapter will address the second sub-goal, which is to analyse the specific tax avoidance section 20 and interpretations of the section by the courts, and the tax avoidance section 20A of the Income Tax Act.

In achieving this goal, this chapter will:

(i) explain the concept of assessed losses in general;
(ii) set out the requirements in section 20(1) for the utilisation of an assessed loss;
(iii) illustrate, through case law, the approach the courts take when applying and interpreting section 20; and
(iv) describe the anti-avoidance ring-fencing provisions in relation to assessed losses incurred by natural persons in terms of section 20A of the Act.

## 3.2 SECTION 20 OF THE INCOME TAX ACT

In certain respects, section 20 also acts as an anti-tax avoidance provision. Section 20 defines the term “assessed loss” and regulates the determination and carry forward of an assessed loss. An important *caveat* in the section is the requirement that the carry forward of an assessed loss by a company depends on the company carrying on a trade in the year of assessment and earning income from that trade. These aspects are discussed below.

### 3.2.1 The Provisions of Section 20

Section 20(1) of the Income Tax Act deals with the set-off of assessed losses and provides as follows:

> (1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person –
>
> (a) any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment …;
>
> (b) any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares …

Section 20 of the Income Tax Act was introduced to regulate the carry forward and set-off of assessed losses. It allows a taxpayer that incurs an assessed loss to carry forward the balance of an assessed loss incurred, to be set off against taxable income earned in, or added to losses incurred in future years.

Assessed losses are defined in section 20(2) of the Act as follows: "For the purposes of this section 'assessed loss' means any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible." In *Sub Nigel Ltd v Commissioner for Inland Revenue*, 15 SATC 381, 1948 (4) SA 580 (A), the court described an assessed loss (at 590) as an amount that will arise where the income derived from trading during a year of assessment is not enough to absorb the allowable deductions, and where no income has been derived from the year's trading activities, the assessed loss will be equal to the sum of the allowable deductions.

According to Pillay (2012:ix), the application of section 20 raises complex issues regarding the carry forward and set-off of assessed losses. A company is only entitled to set off its assessed loss from the previous year against its taxable income in the current year, if the company has carried on a trade and has derived income from that trade. The issues arising from the interpretation of these requirements and the case law relating to the application of the requirements are dealt with in this chapter.

Section 18 of the Taxation Laws Amendment Act, 20 of 2021 (published in the *Government Gazette* No. 45787 on 19 January 2022) introduced the following amendment, which limits the carry forward of an assessed loss by a company:

> (1) Section 20 of the Income Tax Act, 1962, is hereby amended by the substitution in subsection (1) for paragraph (*(a)* of the following paragraph:
>
> *(a)* (i) that is a company, and balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment to the extent that the set-off does not exceed the higher of R1 million and 80 per cent of the amount of taxable income determined before taking into account the application of this provision …
>
> (2) Subsection (1) comes into operation on the date on which the rate of tax in respect of the taxable income of a company is first reduced after announcement by the Minister of Finance in the annual Nation Budget and applies in respect of years of assessment commencing on or after that date.

According to SARS (2022), for the years of assessment ending on any date between, or on, or after 31 March 2023, the rate of corporate income tax will be 27%. The South African Institute of Tax (SAIT, 2022:4) confirmed that the remaining portion that is not allowed to be set off may be carried forward to the subsequent year. This means that it will not be lost to the company for as long as the company meets the requirements of section 20.

According to the Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2021 (the Draft Explanatory Memorandum), issued by the National Treasury (2021: 21), the reason for this amendment is to create the fiscal space to allow for a proposed reduction in the corporate tax rate from 28% to 27%, in order to neutralise the loss to the *fiscus* as a result of the reduction of the corporate tax rate.

According to Ngalwana (1998: 195), before a company can utilize its assessed loss to reduce its taxable income it must first meet the following requirements:

> (a) It must earn the income from trade against which such assessed loss in terms of section 20(1) may be set-off;

(b) It must carry on a trade; and

(c) It must not conclude any agreement, whether it pertains to the administration of the company's business or a change of shareholding in the company, the sole or main purpose of which is to utilize the company's assessed loss or balance of assessed loss to reduce or avoid the company's liability to pay any tax in terms of section 103(2).

In addition to the above requirements, the Income Tax Act, in section 20(1)(a), also stipulates that no person, including a company, may carry forward an assessed loss to the following year that was incurred prior to the date of final liquidation, unless the final liquidation order is then set aside, in which case the amount to be carried forward is reduced by an amount which was allowed to be set off against the income of the insolvent estate from carrying on of any trade.

Each of the requirements for the utilisation of an assessed loss and the issues arising are now dealt with.

### 3.2.2 The Income from Trade Requirement

One of the requirements for the set off of an assessed loss in terms of section 20(1), is that the taxpayer must have earned income from a trade against which the assessed loss may be set off. In terms of section 20(2A) of the Income Tax Act, the income from trade requirement only operates in respect of companies, and individuals can still utilise an assessed loss even if no income is earned. There are conflicting views as to whether the income from trade is an absolute requirement and whether a taxpayer company will be able to set off an assessed loss if it has not earned any income from trade (Swart, 2001:458). There are judgments that argue in favour of the income requirement being absolute, such as *Income Tax Case 1679*, 62 SATC 294, and there are judgments that are in favour of the income requirement not being necessary for the carry forward of an assessed loss, such as *Income Tax Case 777*, 19 SATC 320.

According to SARS (2017:33), those that argue in favour of the income requirement, rely on the wording of section 20(1) for this view. They hold that the provision clearly envisions a set-off against some amount and that this cannot happen if the amount in question is *nil*. SARS (2017:14) also notes that those that argue against the income requirement do so on the strength

of section 11(a). In terms of this provision, an amount will be deducted even though the relevant income was earned in a subsequent year.

In *Income Tax Case* 664, 16 SATC 124 (at 126-127), the facts were that the taxpayer had carried on a trade and derived income from it. For the year of assessment ended 30 June 1929, it had an assessed loss. The company then ceased trading for the years 1930 to 1944. Therefore, the company did not earn any income from trade. The taxpayer then only resumed trading in 1945 and earned income which it sought to set off against the 1929 assessed loss. The Commissioner determined that the taxpayer's assessed loss was *nil* for each of the years from 1930 to 1945. The taxpayer contended that it was entitled to have the assessed loss carried forward in each succeeding year up until the 1945 year in which the set off was attempted. The court, in hearing this matter, held that the taxpayer had not traded since the 1930 year and had therefore not satisfied the requirement that a taxpayer must be carrying on a trade in the year in which it attempts to set off an assessed loss. The court stated (at 126-127) that:

> In the case where [the balance of assessed loss] has been ascertained ... and has been carried forward from the preceding year of assessment, then such balance is to be set off against the income of the next succeeding year of assessment for the purpose of arriving at the taxable income of the year ... But it is to be noted that to allow the set-off to operate, the balance must be carried forward from the preceding year of assessment. The Act does not contemplate the set-off of a balance of assessed loss not so derived.

The court had to determine whether in a year where the company had not traded and therefore, had earned no income, the assessed loss could still be set off against the *nil* income. To this effect, the court held that:

> … It follows, therefore, that in any given year, there must be some income, i.e. an amount received in terms of s 7, against which the set-off can operate. Further, the income must be derived from trade. If, therefore, the taxpayer has not traded and has received no income from trade, as in the present case, it cannot invoke the provisions of the section. The same would be the case if the taxpayer had relinquished his trade for more than a year and had resumed it at a later stage. Here again he is precluded from setting off a balance of set-off assessed in a previous year, because such loss has not been carried forward from the preceding year of assessment.

The court adopted a literal interpretation of section 20(1), and particularly the term "set-off". The court held that the term envisioned the striking of one amount against another. This would not be possible where one of the amounts was a *nil* balance. It is clear that the court did not consider it necessary or even justifiable to deviate from the ordinary meaning of the words couched in section 20(1). The court applied the principle developed in the *Partington* and *Cape Brandy Syndicate* cases, that where a taxpayer falls within the confines of the law, he must be taxed accordingly and that the words in a taxing act must be applied as they are with no room for reading in any other meaning.

In *Income Tax Case 777*, 19 SATC 320, the court held differently, and decided (at 322) that no income from trade is required in order for the taxpayer to be able to set-off the assessed loss. In this case, the taxpayer company, which was a property-owning company, derived no income despite its attempts to let its property. It was held that the company should be allowed to carry forward its assessed loss. The reasoning of the court was that an unsuccessful effort to let property is sufficient to satisfy the requirement that that a company should be carrying on a trade, even if no expenditure is incurred. The issue of income from trade itself was not decided directly as it was not at issue before the court. From this judgment it can be inferred that the court indirectly decided that income from trade was not an absolute requirement for the carry forward or utilisation of an assessed loss, provided a trade was being carried on.

In *Commissioner: South African Revenue Service v Megs Investments (Pty) Ltd & Another*, 66 SATC 175, 2005 (4) SA 328 (SCA), the Supreme Court of Appeal considered the "income from trade" requirement. The taxpayer companies carried on the business of a central buying organisation on behalf of their members. Their income was the difference between the discounts they received and the discounts they gave to their members. The company's year of assessment in question ended on 31 December 1995. On 1 January 1996 the appellants sold their entire business as a going concern. The proceeds from the sale were distributed as follows:

- R6 million – placed on call with ABSA Bank;
- R6 million – distributed as a dividend; and
- R9 million – lent interest-free to three Namibian companies.

The appellant's activities during 1996 consisted of:

• considering the possibility of starting a similar business in other countries; and
• attempting to exploit certain firearm and liquor licences.

Time and effort by the directors of the company were put into these activities but no contracts were concluded, no organisation was established, and there was no trade, and therefore no income. For the year ended 31 December 1996, the companies sought to set off their assessed losses brought forward from 1995 against their interest income. This was disallowed by the Commissioner on the grounds that the company had not traded or earned income from trade during the 1996 year. On appeal, the court held that the time and effort expended on the activities constituted trading, but held that the interest was not income derived from trade as an investment company. The taxpayer conceded that in order for a set-off to occur, there must be some income from trade. The court upheld the appeal and the set-off of the assessed losses was disallowed. However, the court made it clear that the decision was arrived at on the strength of the concession by the respondents that in order for a set-off to be allowed, there must be income derived from trade.

Although the court did not directly address the issue, the fact that it made a decision that reflects that the income from trade is an absolute requirement for a set off to be allowed, can be taken as supporting the requirement that it is indeed absolute.

In *Income Tax Case 1679,* 62 SATC 294, a case decided in 1999, the court took the position (at 300A-C) that income from trade was an absolute requirement. In this case the taxpayer, in 1994, changed the nature of its business, and at the end of the 1994 year of assessment, it had an assessed loss. The taxpayer generated no income in 1995, but incurred expenditure to produce promotional material and to pay for its only member to fly abroad in an effort to recruit clients for the business. Counsel for the appellant contended that only the trade requirement was needed in order to be allowed a set-off. The appellant relied on the conflict between the judgments of *Income Tax Case 664* and *Income Tax Case 777*. The appellant held that the judgment in the latter was the correct one and the court should follow it.

In arriving at its decision, the court quoted from *New Urban Properties Ltd v Secretary for Inland Revenue*, 27 SATC 175, 1966 (1) SA 217 (A), (at 224): "In other words, not having

traded in that year, and therefore not having earned any income from trade, there was nothing against which the balance of assessed could be set off in that year". The court also quoted from the judgment of *Robin Consolidated Industries Ltd v CIR*, 59 SATC 199, 1997 (3) SA 654 (SCA) (at 665C): "[There is] a series of decisions in this court, which have construed section 20(1) as meaning that if there is no income or loss from trading in a given year the machinery for setting off an assessed loss cannot operate, with the result that the assessed loss disappears". The court then applied these *dicta* to the facts and, although these statements were *obiter dictum*, the court made reference to them and used them to come to the decision that the taxpayer would not be allowed to set-off its assessed loss because it had not earned any income. Musi JP said (at 299-300A-C):

> I therefore agree with counsel for the respondent that there is indeed this additional requirement of "income from trade" that the appellant must meet in order that it can bring forward the assessed loss from its 1994 tax year. The only income that the appellant derived in the 1995 tax year is interest amounting to R4 703. That amount, was however, not derived from the appellant's normal trade.

SARS (2017:15) issued an interpretation note regarding the application of section 20(1) and in particular the "income from trade requirement". The interpretation note was intended to guide taxpayers regarding concessions on the utilisation of assessed losses. SARS stated that it would not disallow a company's assessed loss when it has genuinely traded but has derived no income from that trade. However, SARS cautions taxpayers that the concession is not absolute and that the income from trade requirement may still be applied where the taxpayer has not carried on *bona fide* trading operations. The interpretation note also informs taxpayers that in genuine cases where companies have been trading in a *bona fide* manner, SARS will most likely not disallow the utilisation of assessed losses simply because the trade did not create income. SARS warns taxpayers that, in order to take advantage of the concession, the taxpayer company must be able to prove that a trade has been carried on during the current year of assessment to set off the balance of its assessed loss from the preceding year, even though no income would have been earned from the carrying on of such trade.

In *Income Tax Case 1830,* 70 SATC 123, the learned judge, Gildenhuys J (at 27), ignored the concession granted by SARS in Interpretation Note 33. In this case, the taxpayer had traded but had not derived any income from that trade. SARS disallowed the set off of the loss,

contending that the taxpayer did not receive income from that trade during the year of assessment in question. The taxpayer appealed to the Tax Court and argued that the accrual of income from trade was not a prerequisite for the set-off of an assessed loss. The court held that a balance of assessed loss brought forward from a previous year of assessment could not be set off against a loss in the current year of assessment if there was no income earned during the current year of assessment. The court also held that despite the anomalies, if legislature intended for there to be a requirement that a company must continuously trade, then it would make sense that there would also be a requirement that there must be a continuity of income.

Therefore, Interpretation Note 33 cannot change the law by making concessions. Pillay (2012: xi) acknowledges that, unlike decisions of the High Court and other superior courts, the decisions of the Tax Court do not create binding precedent. Therefore, the decision in *Income Tax Case 1830* is not binding and is still open up to review.

Section 20(2A) of the Income Tax Act provides that taxpayers other than companies do not need to have earned income from trade in order to be allowed to carry forward an assessed loss. On the other hand, section 20(1) provides explicitly that a company must earn income from trade in order to be allowed to carry forward an assessed loss. Swart (1996:135) alleges that this might raise the constitutional question of whether there is a rational policy justification for the differential treatment of companies and persons other than companies. Swart states (1996:135) that:

> … [different treatment] violates the precept of horizontal equity where taxpayers in the same position should be treated in the same way. This may render the requirement susceptible to constitutional attack under s 8 of the Constitution of the Republic of South Africa Act 200 of 1993 unless the discriminatory aspect of s 20(1) can be justified in terms of s 33(1) of the constitution.

In light of the constitutional argument, the issue is whether there is a rational policy justification for the differential treatment of individual and company taxpayers. It is clear from the provision and the inclusion of section 103(2) (which operates in conjunction with section 20), that the intention is to prevent the misuse and abuse of assessed losses by companies. Therefore, there is a clear rational justification, as section 20 should be interpreted in a way that promotes the aim of the provision and suppresses the mischief against which it is targeted.

It is clear that the shift from a literal approach to a purposive approach to the interpretation of fiscal statutes in relation to the carry forward of assessed losses benefits the revenue authorities and makes it more difficult for taxpayers to avoid tax. The courts apply the principle established in *Glen Anil*, that anti-avoidance legislation should not be restricted unnecessarily by interpretation and most importantly that the provisions should be interpreted to give effect to the intention of legislature.

### 3.2.3 The Trade Requirement

Section 20(1)(a) of the Income Tax Act requires that a company must be carrying on a trade in order to utilise an assessed loss. Therefore, the main issue is whether the company's activities constitute a trade in respect of timing and the nature of activities. In order to be able to set off an assessed loss incurred in a particular year against income earned in a future year, the company should have been and should be carrying on a trade. A company that fails to carry on a trade in any year subsequent to that in which it incurred an assessed will then lose the assessed loss permanently.

#### *3.2.3.1 Ceasing to trade*

In *SA Bazaars v Commissioner for Inland Revenue*, 18 SATC 240, 1952 (4) SA 505(A), the taxpayer company had incurred trading losses that led to the closure of the business. The closure of the company was completed in November 1941. For the year of assessment ending on 30 June 1942 the taxpayer had an assessed loss of £7 623. It was not in dispute that during the 1943 to 1947 years of assessment the taxpayer did not trade. The Commissioner determined the taxpayer company's assessed loss for each year to be *nil*. The taxpayer resumed trade in 1948 and 1949 and earned income against which it tried to set off the assessed loss it had incurred in 1941and 1942. The Commissioner disallowed this.

The taxpayer company argued that although there was no active trade during the five years in which it was closed, it had maintained its banking account, had obtained transfer of its trading licences to different premises and renewed these licences annually, had also paid income tax and licence duty, held annual general meetings, and prepared annual accounts in which it disclosed that its assessed loss had been brought forward from year to year in its books. The

court held (at 245), that all these activities did not amount to trade and that they only amounted to the taxpayer "keeping itself alive", despite the fact that the taxpayer intended to resume trade in the future. Therefore, the court held that an intention to trade is not sufficient, the company must actually trade.

In *Income Tax Case 1476*, 52 SATC 141, the court had to determine whether the taxpayer carried on a trade during the year of assessment in which income was earned. The company was incorporated in 1969. In 1970, it had purchased immovable property, erected a block of flats and offices on it, opened a sectional-title register, and then sold off the units. By 1982, another company acquired all the shares in the taxpayer. The taxpayer was subsequently utilised as an investment vehicle for property speculating companies. The taxpayer then invested in a number of companies and made interest free loans to them.

Between 1982 and 1987 the taxpayer did not call back the loans or the interest applicable to them. At the end of 1986, it had incurred an assessed loss. In 1987, it derived interest of R574 from amounts it had deposited at a bank. It had no other income for that year. The taxpayer attempted to set off the 1986 assessed loss against its income for the 1987 year. The Commissioner disallowed the set-off and the taxpayer appealed. The court held that the carrying on of a trade involves an "active step", that is, something more than merely watching over existing investments that are not, and are not intended or expected to be, income producing. The court took into consideration the taxpayer's activities during the 1986 year of assessment and held (at 141) that:

> In the year of assessment the only income the [taxpayer] enjoyed was a small amount of interest which, on the probabilities, was derived from money in the bank; this amounted to approximately 2,5 per cent of the money on deposit with the bank, hardly a profitable investment. ... The audit fees were less in 1987 than they were in 1986 and the secretarial expenses for the year amount to R2,29. All this indicates inactivity by the [taxpayer]. The only other expense was "printing, stationery, telephone, sundries" which in 1986 had amounted to R248 but in 1987 was less than half, i.e. R120 or R10 per month. What business endeavour does this expenditure indicate? It barely covers the rental of a telephone let alone the use of a telephone. The [taxpayer] incurred no expense for office rent or salaries. There were no travelling or advertising expenses. This is all an indication of no activity at all and the R10 per month is indicative merely of a nominal charge under a globular heading.

The court concluded (at 149) that the taxpayer was inactive during the 1987 year, which was the year immediately following the one in which the assessed loss was incurred.

Ngalwana (1998:198) remarked that the decision of the court in this case indicates that if a taxpayer company incurs an assessed loss that it then wants to set off against future income, it must ensure that it continues trading until the assessed loss has been exhausted. It is not mandatory that the taxpayer should carry on a trade throughout the year following the one in which the assessed loss was incurred. Even trading for a period of time within the year is sufficient. Ngalwana notes that it is not clear whether the court will consider the length of the period of trading or the volume of trade that was carried out in determining whether the taxpayer has carried on a trade.

#### *3.2.3.2. Post liquidation income*

In *Robin Consolidated Industries Limited v Commissioner for Inland Revenue*, 59 SATC 199, (1997) 2 All SA 195 (A), the court established (at par. 36) that a company in liquidation will be considered to have ceased carrying on trade on the day it is liquidated. The assessed losses it may have incurred in previous years will not be available to be carried forward after the date of liquidation. Even if a company earns income post liquidation, for example, from the collection of debts, this will not be considered as income from trade as the company would have ceased trade. This income cannot be set off against previous assessed losses.

In *Timberfellers (Pty) Limited v Commissioner of Inland Revenue*, (1994 (N)), 59 SATC 153, the appellant was a subsidiary of a company, Sharon Air (Pty) Limited, which was wholly owned by Mr MB McCarthy. In 1982, the taxpayer was in financial difficulties and was provisionally placed under liquidation, and this was made final on the 20th of September 1982. In 1983 the appellant was removed from liquidation. While in liquidation, the taxpayer lost all its franchises, and it also had no employees or equipment. The only assets the company held were pre-liquidation debts and an assessed loss that was incurred before liquidation. For the year of assessment ended 1985, the appellant sought to set off against income the balance of assessed losses amounting to R2 336 568. The Commissioner disallowed the assessed loss to be carried forward from the 1983 tax year to 1984, contending that the appellant did not carry on a trade. The taxpayer appealed the decision all the way to the Natal Provisional

Division. The court dismissed the appeal and held that the collection of outstanding debts after liquidation did not constitute carrying on a trade. The company ceased carrying on a trade on the day it was liquidated.

It is evident from the judgments referred to above that, in terms of section 20, both the income from trade requirement and the carrying on a trade requirement are of the utmost importance. It is also clear that while the courts are divided on whether the income from trade requirement is absolute, it is a unanimous belief that the carrying on of a trade requirement is essential.

## 3.3 SECTION 20A: THE RING-FENCING OF ASSESSED LOSSES OF NATURAL PERSONS

Section 20A of the Income Tax Act is an anti-tax avoidance provision, aimed at the prevention of the misuse of an assessed loss to reduce taxable income.

### 3.3.1 Reasons for the Introduction of Section 20A

Section 20A was introduced with effect from 1 March 2004. It is a ring-fencing provision that limits the utilisation of an assessed loss from a tainted trade to the income from that trade. It only applies to natural persons. Cliffe Dekker Hofmeyr (2018: Online) describes the purpose of section 20A as the ring-fencing of assessed losses of individuals to prevent the taxpayers from setting off expenditures and losses from their hobbies against other income, which is usually from salaries or other professional income. The firm also notes that the attempt to deduct hobby-like expenses undermines the integrity and fairness of the Income Tax system because wealthier individuals have more means to disguise hobby expenses as a trade. Therefore, the introduction of a more stringent “facts and circumstances” test is necessary.

SARS (2005:5) notes that another aim of section 20A is to improve the integrity of the tax system by preventing expenditures and losses that are usually associated with suspect trades, that is, those trades that are more likely to be disguised hobbies. The provision prevents expenditures and losses associated with these suspect trades from being deducted as a means to reduce the individual taxpayer’s taxable income. SARS also notes that subsection (1) of section 20A sets out the general rule which seeks to ring-fence these assessed losses as they

are described in subsection (2). SARS concludes that under this section, natural persons are still able to use losses from a suspect trade against income from that same suspect trade.

According to the National Treasury (2003:6), it is not every activity that a taxpayer embarks upon that constitutes a trade, even if the taxpayer intended it to be, or has labelled it as such. National Treasury further stated that whether or not an activity can be construed as a trade is a question of law and the answer is dependent on the "facts and circumstances" of each case. National Treasury explained that taxpayers sometimes masquerade private consumption as trade, therefore the "facts and circumstances" test should be applied with caution.

### 3.3.2 The Provisions of Section 20A

Section 20A(1) of the Income Tax Act provides that, subject to subsection (3), the circumstances in subsection (2), and notwithstanding section 20(1)(b) (these subsections are discussed below): "… in respect of any trade carried on by a natural person, any loss incurred during that year [the year of assessment] in carrying on a trade may not be set off against any income of that person derived during that year otherwise than from carrying on that trade …".

Section 20A(2) ring-fencing provisions include a two-part threshold that determines the level of taxable income at which the taxpayer will become subject to scrutiny. The first part of the threshold focuses on the taxpayer's taxable income level, and the second part focuses on the loss-generating activity, including a list of suspected trades.

#### *3.3.2.1 Maximum marginal rates*

In terms of section 20A(2), ring-fencing applies only to natural persons whose taxable income equals or exceeds the amount at which the maximum marginal tax rate becomes applicable. The National Treasury (2003:2) stipulates that this part of the threshold is determined before set-offs of any assessed losses that are incurred from any trade (not just from suspect trades). Where a taxpayer does not have taxable income that exceeds the maximum marginal rate, section 20A will not apply.

### *3.3.2.2 Three out of five-year loss trades*

Section 20A(2)(a) applies the "three out of five year" rule. The rule is stated as follows:

> Subsection (1) applies where the sum of the taxable income of a person for a year of assessment (determined without having regard to the other provisions of this section) and any assessed loss and balance of assessed loss which were set off in terms of section 20 in determining that taxable income, equals or exceeds the amount at which the maximum marginal rate of tax chargeable in respect of the taxable income of individuals becomes applicable, and where—
>
> *(a)* that person has, during the five year period ending on the last day of that year of assessment, incurred an assessed loss in at least three years of assessment in carrying on the trade contemplated in subsection (1) (before taking into account any balance of assessed loss carried forward); …

This is an indicator of a suspect trade, as natural persons would not continue with trades that are consistently generating losses, as this does not make business sense. The only reasonable explanation would be an existing tax motive. Generally, the aim of any trade is to make a profit. Where an individual persists with a so-called trade that is not profitable for more than three consecutive years, it is reasonable to suspect that there might be a tax-avoidance motive.

### *3.3.2.3 Listed suspect trades*

Section 20A(2)(b) lists the suspect trades. These are:

(i) any sport practised by that person or any relative;
(ii) any dealing in collectibles by that person or any relative;
(iii) the rental of residential accommodation, unless at least 80 per cent of the residential accommodation is used by persons who are not relatives of that person for at least half of the year of assessment;
(iv) the rental of vehicles, aircraft or boats as defined in the Eighth Schedule, unless at least 80 per cent of the vehicles, aircraft or boats are used by persons who are not relatives of that person for at least half of the year of assessment;
(v) animal showing by that person or any relative;

(vi) farming or animal breeding, unless that person carries on farming, animal breeding or activities of a similar nature on a full-time basis;
(vii) any form of performing or creative arts practised by that person or any relative;
(viii) any form of gambling or betting practised by that person or any relative; or
(ix) the acquisition or disposal of any crypto asset.

The listed activities will be suspect if they are practised by the taxpayer or a relative of the taxpayer. An activity is treated as suspect if it falls within one of the nine categories on the list. According to the National Treasury (2003:8), the items on the list have been selected based on past experience and with reference to experience with revenue enforcement and international comparative administrative approaches. Sub-paragraph (ix) was added by section 37 of Act No. 23 of 2018, and substituted by section 23 of Act No. 23 of 2020. The National Treasury also notes that this suggests that natural persons use these activities to generate limited gross income and actually incur more expenses in an effort to disguise their private consumption.

According to SARS (2005:21), unless the provisions of a section indicate otherwise, the words must be given their ordinary dictionary meaning. However, section 20A is a ring-fencing provision, and therefore the meaning to be attached to the term "full-time" (in relation to farming or animal breeding) should be a meaning that would advance the purpose of legislature. SARS also notes that the use of the words "that person" is a direct reference to the taxpayer and not anyone who might be acting on behalf of the taxpayer.

#### *3.3.2.4 "Facts and circumstances" – the escape clause*

Section 20A(3) provides an escape clause that allows a natural person to prevent the ring-fencing of an assessed loss that fails either the "three out of five-year rule" or is a listed suspect trade. According to SARS (2010:9): "… a taxpayer will be subject to potential ring-fencing if either section 20A(2)(a) [the "three-out-of-five-years" pre-requisite] or section 20A(2)(b) [the suspect trade requirement] applies." This represents the "either or test", where a taxpayer satisfies the requirement that they have sustained a loss in three out of five years, or their trade is listed under the suspect trades. The National Treasury (2003:10) states that the taxpayer is not subject to the ring-fencing of the loss if he or she can prove that the activity in question is a legitimate trade, despite failing the "either or" test.

In order to qualify for the escape clause, the activity must qualify as a trade that constitutes a "business" as opposed to being a hobby. The question of whether taxpayer has satisfied these requirements is an objective test rather than a subjective test that merely focuses on the taxpayer's intent. The "facts and circumstances" that are referred to are listed in section 20A(3)(a)-(f). These are:

(a) the proportion of the gross income derived from that trade in that year of assessment in relation to the amount of the allowable deductions incurred in carrying on that trade during that year;
(b) the level of activities carried on by that person or the amount of expenses incurred by that person in respect of advertising, promoting or selling in carrying on that trade;
(c) whether that trade is carried on in a commercial manner, taking into account—
(i) the number of full-time employees appointed for purposes of that trade (other than persons partly or wholly employed to provide services of a domestic or private nature);
(ii) the commercial setting of the premises where the trade is carried on;
(iii) the extent of the equipment used exclusively for purposes of carrying on that trade; and
(iv) the time that the person spends at the premises conducting that business;
(d) the number of years of assessment during which assessed losses were incurred in carrying on that trade in relation to the period from the date when that person commenced carrying on that trade and taking into account—
(i) any unexpected events giving rise to any of those assessed losses; and
(ii) the nature of the business involved;
(e) the business plans of that person and any changes thereto to ensure that taxable income is derived in future from carrying on that trade; and
(f) the extent to which any asset attributable to that trade is used, or is available for use, by that person or any relative of that person for recreational purposes or personal consumption.

According to SARS (2010:9) the facts and circumstances represent various essentials and details that are taken into account when considering whether the trade is a business in respect of which there is a reasonable possibility of deriving income within a reasonable period.

SARS (2010:9) notes that when determining whether or not an activity constitutes a trade, the intention of the individual is important, combined with the reasonable prospect of deriving a profit from that trade. If immediate profit is not attainable, the prospect of deriving an ultimate profit from that trade should be based on reasonable grounds. The test for these special facts and circumstances is a combination of a subjective test in terms of the intention of the taxpayer and an objective test in terms of whether the facts and circumstances show that there is a reasonable prospect of deriving a profit. SARS also notes that section 20A does not indicate what constitutes a "reasonable prospect" or a "reasonable period" for any trade.

SARS (2010:22) notes that the meaning of the word "business" is not provided for in the Act, however, "trade" is defined in section 1 of the Act. Although an employee is considered to be carrying on a "trade", this does not constitute a business. To determine whether a trade constitutes a business, its activities must be examined. According to SARS, the features of a trade that may indicate that a business is being conducted include the size or scale of the activities, whether the activities are planned and organised, whether they are regular and continuous, whether the object is to make a profit, whether the property acquired is movable or fixed, *et cetera*. Each case depends on its own facts and circumstances.

In *Smith v Anderson*, (1880), 15 ChD 247, the court held (at 258) that the word "business" means: "anything which occupies the time and attention and labour of a man for the purpose of profit is business."

#### *3.3.2.5 "Six out of ten year loss trades"*

In terms of section 20A(4) the "facts and circumstances" escape clause provided for in sub-section (3) of section 20A does not apply if the taxpayer has engaged in a "suspect trade" referred to in section 20(2)(b), other than farming, and has incurred six years of losses during the last ten years of assessment, including the current year of assessment. According to SARS 2005:29), this test is applied in the same manner as the "three out of five" year rule. The "six out of ten" year rule is based on the principle that a person cannot envisage running at a loss indefinitely, and if they do so voluntarily, the motive must be a tax benefit. Hobbies generally incur losses. Losses falling within this category are permanently ring-fenced. SARS concludes that farming is explicitly excluded from this rule because many forms of legitimate

farming are not successful from the beginning, and it is quite possible to incur losses for very long periods.

#### *3.3.2.6 Permanent ring-fencing*

In terms of section 20A(5), ring-fenced losses from carrying on a suspect trade are permanently ring-fenced and taxpayers will only be able to use these ring-fenced losses against income from carrying on the same trade during either the current or subsequent years of assessment.

#### *3.3.2.7 Multiple farming activities deemed to qualify as a single trade*

In terms of section 20A(7) "… all farming activities carried on by a person shall be deemed to constitute a single trade carried on by that person …". The National Treasury (2003:13) explains that when the question arises as to whether one or more related activities constitute the same trade, the issue will be decided on a case-by-case basis.

#### *3.3.2.8 Reporting requirement*

Section 20A(8) creates a reporting obligation. In terms of this subsection, the taxpayer must report each suspect trade on the prescribed tax return, where section 20A(2) applies.

## 3.4 CONCLUSION

This chapter has addressed the second sub-goal of this thesis, which is to analyse the specific tax avoidance section 20 and interpretations of the section by the courts, and the tax avoidance section 20A of the Income Tax Act. Assessed losses provide the opportunity for the reduction of the tax liability, and certain provisions in section 20 of the Income Tax Act are aimed at preventing this. Companies with assessed losses are often the target for take-overs and mergers. Where the target company has not traded and produced income during a year of assessment, section 20 prohibits the carry forward of the loss. After analysing the provisions of section 20, the chapter illustrated through case law the success of the revenue authority in applying the anti-avoidance measures in section 20 of the Act to combat the misuse of assessed losses. The conflicting views on whether the income from trade requirement in section 20 is absolute or

not have been highlighted. The trade requirement was discussed with reference to the activities the court accepts as constituting a trade. It was noted that a company will be considered to have ceased trading on the day it is put in liquidation. Post liquidation income will not be regarded as income from trade for the purposes of meeting the requirements of section 20 of the Income Tax Act.

The application of the anti-avoidance provision in section 20A in the form of the ring-fencing of assessed losses of individuals was also discussed. The aim of this section is to prevent high-income individuals from deducting losses from a secondary hobby-like trade in order to reduce their taxable income. The "suspect trades" were discussed, and the "three-year" and "six-year" rules restricting the carry forward of losses incurred for these periods were analysed. The effect of the "escape" clauses was discussed, as well as the concessions relating to farming.

The next chapter will deal with sections 103(2) and 103(4) of the Income Tax Act, which prohibit the utilisation of assessed losses by companies for tax avoidance purposes, together with the case law interpretation of the sections. The chapter will also discuss the possible application of sections 80A to 80L of the Income Tax Act to the use of assessed losses.

# CHAPTER 4: ANTI-TAX AVOIDANCE – SECTION 103(2) AND 1O3(4), AND SECTIONS 80A TO 80L

## 4.1 INTRODUCTION

The previous chapter discussed sections 20 and 20A of the Income Tax Act, which regulate the utilisation of assessed losses by individuals and companies. The previous chapter also illustrated, through case law, the issues arising from the interpretation and application of section 20. This chapter deals, firstly, with section 103(2) and 103(4), which are the anti-avoidance measures that prohibit the utilisation of assessed losses by companies, close corporations and trusts, for the purpose of tax avoidance. The chapter therefore addresses the third sub-goal of the research: to analyse the specific avoidance section 103(2) and 103(4) of the Income Tax Act, and the interpretation by the courts, and the GAAR embodied in sections 80A to 80L of the Income Tax Act. The chapter illustrates, through a discussion of relevant case law, the application of the anti-avoidance provision in combatting the abuse of assessed losses for tax avoidance purposes. This chapter then discusses, using a hypothetical example, the application of sections 80A to 80L of the Income Tax Act in the alternative to section 103(2), to transactions that are aimed at the utilisation of assessed losses to avoid tax.

## 4.2 SECTION 103(2)

Swart (1996:124) recognises that section 20 and section 103(2) are complementary. Section 20 provides for the set-off of an assessed loss against income, while section 103(2) prohibits such set-off in circumstances where the Commissioner is of the opinion that an agreement or a change in shareholding, membership of a close corporation, or a trustee or beneficiaries of a trust was entered into for the sole or main purpose of utilising the assessed loss to avoid tax. Swart also notes that section 103(2) has significant consequences for the taxpayer, and therefore case law judgments, and even *obiter dicta* by the judges, play a significant role in applying the provisions of the section to the facts of each case. This section of the chapter focuses on the provisions of section 103(2) and the application of the section to the facts of selected case law.

Section 103(2) of the Income Tax Act is a specific anti-avoidance provision that is aimed at limiting the utilisation of assessed losses by companies, close corporations and trusts. The provision states that:

> (2) Whenever the Commissioner is satisfied that –
>
> (*a*) any agreement affecting any company or trust; or
>
> (*b*) any change in –
>
> (i) the shareholding in any company; or
>
> (ii) the members' interests in any company which is a close corporation; or
>
> (iii) the trustees or beneficiaries of any trust,
>
> as a direct or indirect result of which –
>
> (A) income has been received by or has accrued to that company or trust during any year of assessment; or
>
> (B) any proceeds received by or accrued to or deemed to have been received by or to have accrued to that company or trust in consequence of the disposal of any asset, as contemplated in the Eighth Schedule, result in a capital gain during any year of assessment,
>
> has at any time been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company or trust, in order to avoid liability on the part of that company or trust or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof—
>
> (*aa*) the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed;
>
> (*bb*) the set-off of any such assessed loss or balance of assessed loss against any taxable capital gain, to the extent that such taxable capital gain takes into account such capital gain, shall be disallowed; or
>
> (*cc*) the set off of such capital loss or assessed capital loss against such capital gain shall be disallowed.

In *Income Tax Case 1123*, 31 SATC 48, the court set out the requirements of section 103(2) as follows (at 52):

> 1. that [an agreement or] a change of shareholding in the company has taken place;
> 2. that as a direct or indirect result thereof income has been received by or has accrued to that company during the year of assessment: and

3. that the change in shareholding was effected solely or mainly for the purpose of utilizing the company's assessed loss in order to avoid liability on the part of the company or any other person for tax on such income; the onus of proving that the agreement or change in shareholding was not entered into for the purposes of avoiding tax lies with the taxpayer in terms of section 103(4) 0f the Act.

According to Stewart (1970: 189) the reason for the promulgation of section 103(2) is to be found elsewhere in the Act, particularly in section 20. Section 20 recognises that compartmentalising a single taxpayer's business is a largely artificial exercise because the income belongs to one person or entity even if it is earned from different business endeavours. Stewart also notes that section 20 provides that where in one year, for a natural person or entity, allowable deductions exceed income, the taxpayer may carry the balance of deductible excess forward as an "assessed loss." This loss may be deducted from income earned in the next or subsequent years. He concludes that, as a result, certain taxpayers, whose businesses have failed to profit, build up large assessed losses.

Stewart (1970: 189) goes on to explain that where these taxpayers are individuals, the issue of tax avoidance in the context of section 103(2) does not arise because the assessed loss is not transferable, as is the case with companies whose shares can easily change hands. New shareholders will most likely attach themselves to a company with a large assessed loss and inject new income into it to take advantage of the assessed loss. Stewart concludes that this has been referred to as "trafficking in assessed losses", and section 103(2) is the legislature's response to this undesirable practice.

In *Glen Anil Development Corporation Ltd,* the court stated (at 727H-728A) that: "… there seems to be little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation." The taxpayer in this case argued that the Secretary for Inland Revenue was not entitled to apply section 103(2) because the court should follow the literal approach to interpretation. It was held (at 727H-727A) that:

> … I do not understand the rule to be that every provision of a fiscal statute, whether it relates to the tax imposed or not, should be construed with due regard to any rules relating to the interpretation of fiscal statutes. Section 103 of the Act is clearly directed at defeating

> tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefore or to the incidence thereof, but rather to the schemes designed for the avoidance of liability therefore. It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided for the section and suppress the mischief against which the section is directed *(Hleka v Johannesburg City Council 1949(1) SA 842 (A)* ... The discretionary powers conferred upon the secretary should, therefore, not be restricted unnecessarily by interpretation.

Swart (1996: 26) raises the question whether the disallowance of the set off of an assessed loss will sterilise the assessed loss in that it falls away completely, or it falls away only in respect of “tainted” income. In other words, can the assessed loss be carried forward to be set off against “untainted” income in that particular year? "Tainted" income refers to income that has arisen as a result of the agreement or change in shareholding.

In *Conshu (Pty) Ltd*, the majority decision held (at 614B-C) that a taxpayer company would be able to set off the assessed loss against untainted income. The minority held the same opinion but did not discuss the issue. In this case, the court established that the application of section 103(2) results in the ring-fencing of the assessed loss and not a complete sterilisation, and that the utilisation of the assessed loss against untainted income will be allowed, subject to the requirements of section 20(1) (that is, the company must be carrying on a trade and must earn income from that trade). As this was a decision of the Appellate Court, this case has created precedent and settled the question.

Swart (1996:24) notes that the preservation of the ring-fenced assessed loss will depend on whether the company has carried on untainted trading activities during the year in which the set-off is attempted. In other words, the company must have carried on a trade that is capable of producing income that does not directly or indirectly result from the agreement or change in shareholding that attracted the application of section 103(2) by the Commissioner. Only when the company did not carry on any trading activities that are capable of producing untainted income will the assessed loss be irretrievably lost, as was established in *New Urban Properties* (at 224A-H).

### 4.2.1 The First Requirement of Section 103(2)

The first requirement of section 103(2) is that there must be a change in shareholding of a company, membership of a close corporation, trustees or beneficiaries of a trust, or an agreement. The utilisation of the assessed loss must be a consequence of the agreement or the change. In *Conshu (Pty) Ltd* (614D-E), the taxpayer argued that the Commissioner should only have applied section 103(2) in 1985, which is the year in which the relevant agreement was concluded and in respect of the 1984 assessed loss, because the provision applied to an assessed loss already incurred and not one to be incurred.

With regard to the timing of the application, the court followed the approach adopted by the court of appeal in *Glen Anil Development Corporation Ltd* (at 727-728), in which it was held that section 103(2) was directed at defeating tax avoidance schemes. It therefore needed to be construed in such a way as to advance the remedy provided by the section and suppress the mischief against which it was directed. The Commissioner's powers were thus not to be restricted unnecessarily by interpretation.

In *Conshu (Pty)* Ltd, the court also considered (at 611B-F) the judgment in *Commissioner for Inland Revenue v King*, 14 SATC 184, 1947 (2) SA 196 (A), and held that the Commissioner was not restricted to applying section 103(2) in respect of the year in which the agreement was entered into, which was 1985. The court noted that the predecessor of section 103(2) had, upon its introduction in 1946, applied to any agreement entered into at any time before or after the commencement of the Income Tax Act, 1946. On this basis, the court held (at 611-612) that:

> This meant, at the time, that the Commissioner was entitled to apply, say during 1947, this provision in relation to an agreement entered into during 1945. The 1962 Act came into operation on 1 July 1962 and, on the plain wording of the section, the Commissioner was entitled to apply s 103(2) thereafter to an agreement entered into before that date. That being so, it is difficult to understand why ... he was not entitled to apply it during 1986 in respect of an agreement entered into in the preceding tax year. Furthermore, the quoted phrase contains a tautology because the words "at any time" encompass the balance of it. The use of a tautology is a device often used in order to emphasize a point.

The majority of the court accordingly concluded (at 614C-D) that it had been competent for the Commissioner to apply section 103(2) for the first time in respect of the 1986 tax year. The view of the minority of the court (at 617-618E-F), particularly in relation to the timing of the application of section 103(2) and whether the Commissioner could invoke it in the year subsequent to the year in which the agreement was concluded, was that section 103(2) could only be applied in respect of an assessed loss already incurred and existing in the year in which the relevant agreement is concluded. The minority (at 620- 622A-B) also disagreed with the majority's view of the significance of the wide language used in section 103(2), especially the repetition of the words “any” and “whenever”. The minority held that the tautology was of no significance.

### 4.2.2 The Second Requirement of Section 103(2)

The second requirement of section 103(2) is that the income or capital proceeds must be a direct or indirect result of the change in shareholding, membership, trustee or beneficiary, or the agreement. According to Silke (1958:517), section 90(1)(b) of the 1946 Income Tax Act was obscure and unclear and the language did not give effect to its purpose. The correct interpretation may have been that the section only applied to cases where income was diverted and could not be applied in cases where the company’s assessed loss was used as a set-off against income that belonged to the company. In this case, the purpose of Parliament would not have been achieved as taxpayer companies with large assessed losses would have been able to alienate income-producing assets to subsidiary companies with large assessed losses.

With regard to the current Income Tax Act and section 103(2), in *Income Tax Case 1123*, the learned Trollip J remarked (at 52) that the section was broad enough to capture both types of income. He held:

> That the section was intended to apply when income was diverted from another person to a company in order to avoid liability for tax on the part of that person is clear from its very language. But its wording is wide and there is no warrant for limiting its application to such cases. It refers in the first place to “income ... received by or ... accrued to that company during any year of assessment ...”; that is wide enough to include income produced by its own activities in contradistinction to income diverted to it. Secondly, the section speaks of avoiding liability for tax “on the part of that company” in addition to

> and in contradistinction to avoiding liability for tax "on the part of... any other person"; that shows that not only diverted income but income produced by the company's own activities can fall within the ambit of the section if its other requirements are fulfilled.

In *Commissioner: South African Revenue Service v Digicall Solutions (Pty) Ltd*, 80 SATC 125, 2019 (4) SA 312 (SCA) (par. 5-6), there were two changes in shareholding that were the subject of the application of section 103(2). It was common cause between the parties that only the first change in shareholding was relevant to the determination of the appeal. The issue was whether the income that had accrued to the taxpayer with the first change in shareholding was a direct or indirect result of the change in shareholding.

In *Conshu (Pty) Ltd* (at 611E-612A), the court indicated that section 103(2) was intended to be cast as widely as possible, this was justified by the use of the words "whenever" and "any". In addition, in *Commissioner for Inland Revenue v Ocean Manufacturing Ltd*, 52 SATC 157, 1990 (3) SA 610 (A), the court stated (at par. 24) that "any" was a word of wide and unqualified generality, which could be limited by the particular facts and circumstances but was, *prima facie*, unlimited, and more specifically: "In regard to the subject-matter there is nothing in section 103(2) to suggest that the word 'any' was used in a limited sense."

In the *Digicall Solutions* case, the Commissioner argued (at par. 53) that if he was not permitted to apply section 103(2) in respect of the first change in shareholding, the effect of this decision would be that taxpayer companies could simply artificially effect more than one agreement or change in shareholding to escape the provisions of section 103(2). According to the Commissioner, to allow this would be contrary to the principle that the subsection should be considered in a manner that advances the remedy and suppresses the mischief of "trafficking" in shares of companies with assessed losses.

Section 103(2) stipulates that the change in shareholding must result, directly or indirectly, in income being received by, or accruing to the taxpayer, during "any" year of assessment. Therefore, it is clear that the direct or indirect receipt of income does not have to occur in the same year of assessment as the change in shareholding. All that matters is that the income received must be a direct or indirect result of the change in shareholding.

In *Conshu (Pty) Ltd*, the court held (at 610G-I) that section 103(2) was enacted to prevent the "trafficking" in of assessed losses in the form of new proprietors attaching themselves to the company and injecting new income so as to exploit the assessed loss. In light of this view, the court in *Digicall Solutions* held (at par. 58) that the second shareholding would preclude a finding that the income was a direct result of the change in shareholding but not a finding that it was an indirect result of the first change in shareholding. The court held (at par. 56) that:

> The subsection provides that the change in shareholding must result, directly or indirectly, in income being received by, or accruing to the taxpayer, during any year of assessment. It is therefore clear that the direct or indirect receipt of income by the taxpayer, does not have to occur in the same tax year as the change in shareholding of the taxpayer. It may occur in any year of assessment, provided it results directly or indirectly from the change in shareholding.

The court in the *Digicall Solutions* case followed the wide and purposive interpretational approach to section 103(2) that was applied in the *Conshu (Pty) Ltd* case.

### 4.2.3 The Third Requirement of Section 103(2)

The third requirement of section 103(2) is that the sole or main purpose of the scheme was to utilise an assessed loss or balance of assessed loss. In *ITC 13164* (*ABC (Pty) Ltd v Commissioner: South African Revenue Service*), 2016 TCIT (WC), the court (at par. 72) concluded that the "sole or main purpose" requirement is a subjective requirement. The court (at par. 77) stated that: "those taxpayer companies that can show a sound commercial purpose for the acquisition of the shares will have less difficulty in establishing that they don't fall foul of this section". In this case, the court was satisfied that the taxpayer company had successfully discharged the onus, in terms of section 103(4), of showing that the sole or main purpose in the change in shareholding was not to acquire the company to utilise its assessed loss. The court also stated (at par. 100) that: "when the facts are considered in totality, then the … group's vision and projected business plan dovetailed with the existing … business that the taxpayer company had been engaged in, prior to the acquisition of the shares in the taxpayer company". The court held that there were sufficient commercial reasons for the decision to acquire the shares in the company with the assessed loss, and section 103(2) could not be applied.

Hogan Lovells (2017: Online) notes that the courts have previously established that the word "mainly" entails a quantitative measure of "more than 50%", while in the context of tax avoidance, the word establishes the idea of dominance. Hogan Lovells also notes that the application of section 103(2) depends on whether the parties to the transaction (the acquisition of the shares in the company with the assessed loss or any agreement affecting such company) are able to prove that the sole or main purpose for entering into the transaction was not to utilise the assessed loss, but that there were sound commercial reasons for the transaction.

## 4.3 SECTION 103(4): THE PURPOSE REQUIREMENT AND THE BURDEN OF PROOF

Section 103(4) of the Income Tax Act acts as a presumption. Its effect is that, until the taxpayer proves the contrary, the sole or main purpose of the transaction in question was to utilise the assessed loss and avoid tax. Section 103(4) reads as follows:

> If in any objection and appeal proceedings relating to a decision under subsection (2) it is proved that the agreement or change in shareholding or members' interests or trustees or beneficiaries of the trust in question would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner, or in the reduction of the amount thereof, it shall be presumed, until the contrary is proved in the case of any such agreement or change in shareholding or members' interests or trustees or beneficiaries of such trust, that it has been entered into or effected solely or mainly for the purpose of utilising the assessed loss, balance of assessed loss, capital loss or assessed capital loss in question in order to avoid or postpone such liability or to reduce the amount thereof.

Section 103(2) provides that before the Commissioner can disallow the utilisation of an assessed loss, he must be of the opinion that the agreement or change in shareholding was entered into for the sole or main purpose of avoiding tax. According to Stewart (1970:188), the legislature has recognised the difficulty in proving that the avoidance of tax was the sole or main purpose of the transaction. Therefore, the onus rests on the taxpayer to prove that the utilisation of the assessed loss was only an ancillary consideration.

Van Schalkwyk and Geldenhuys (2010:75) are of the opinion that, although a subjective test must be applied, the taxpayer's subjective intention must be weighed against the objective surrounding facts. This introduces the concept of objectivity into the interpretation of the purpose requirement.

In relation to the now repealed section 103(1), in *Secretary for Inland Revenue v Gallagher,* 40 SATC 39, 1978 (2) SA 463 (A), in respect of the correct approach to the purpose requirement, the court held (at 48-49) that:

> 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. Although appellant's counsel did not press this submission in argument before us, he did not abandon it. In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one. Section 103(1) draws a clear distinction between the 'effect' of a scheme and the 'purpose' thereof … and this virtually rules out an interpretation which seeks to give 'purpose' an objective connotation and to equate it, more or less, to 'effect'. If the subjective approach be adopted (as it must), then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of respondent, the progenitor of the scheme, as to why it was carried out.

This approach would probably also apply to section 103(4). With regard to the taxpayer's *ipse dixit*, Rabie CJ stated (at 76-77) in *Malan v KBI,* 45 SATC 59, 1981 (2) SA 91 (C):

> The taxpayer's own evidence about his intention and his credibility will be considered by a court but, because of subjectivity, self-interest, the uncertainties of recollection and the possibility of mere reconstruction, it will test that evidence against the surrounding facts and circumstances in order to establish his true intention.

According to Van Schalkwyk and Geldenhuys (2010:78), the effect of these judgments is that a taxpayer's *ipse dixit* will be considered. However, taxpayers cannot simply claim they did not intend to obtain a tax benefit, because the application of the objective inquiry intends that the taxpayer's *ipse dixit* must match the external evidence considered. Therefore, the test is not a true subjective test.

Purpose and intention are usually inferred from the external features of an agreement such as its terms and conditions and their effect. In *Commissioner of Taxes v Newton,* 1958 2 All ER 759, the court held (at 763) in this regard:

> The purpose of a contract, agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms. Those terms may be oral or written or may have to be inferred from the circumstances but, when they have been ascertained, their purpose must be what they effect.

## 4.4 THE APPLICATION OF SECTIONS 80A TO 80L TO THE USE OF ASSESSED LOSSES

Swart (1996:138) addresses the question whether an agreement or scheme that is done in such a way that it falls beyond the ambit of section 103(2), can be attacked in terms of the previous section 103(1) (which was replaced by the current sections 80A to 80L). In *Conshu (Pty) Ltd,* the court held (at 620E-F) that this was not possible. The court was of the opinion that the scheme would not be able to meet the requirements of the provision.

Swart (1996:138) seems inclined to believe that this might be possible and notes that in *Conshu (Pty) Ltd* the Commissioner actually first relied on section 103(1) and then changed his mind and relied on section 103(2). Swart concludes that the ambit of the two sections should be determined in the context of their histories and the fact that they are included in the same Act. It can be concluded that although the matter is not settled, these views warrant a discussion of the current General Anti-Avoidance Rules (referred to as the GAAR) in sections 80A to 80L of the Income Tax Act by examining the elements of each section and applying them to the use of assessed losses.

At the time of writing this thesis, only one tax case has been heard in relation to sections 80A to 80L (discussed below). As many of the terms used in the sections are the same as the terms used in the predecessor section 103(1), case law dealing with these terms, where relevant, is discussed.

### 4.4.1 The Reasons Why the Commissioner May Elect to Apply Sections 80A to 80L to the Use of Assessed Losses

There are a number of reasons why the Commissioner may elect to apply sections 80A to 80L of the Income Tax Act to the use of an assessed loss to avoid tax. Firstly, section 103(2) only applies to companies, close corporations, and trusts, and there may be other taxpayer entities that may attempt to utilise assessed losses for the purposes of avoiding tax, for example, partnerships, joint ventures and individual sole traders. Section 103(2) would not apply in these instances and a more general anti-avoidance rule will be needed. Secondly, in terms of section 80I of the Income Tax Act, the Commissioner is entitled to apply sections 80A to 80L in the alternative to any other sections and in addition to any other basis for raising an assessment. Another reason is that section 80H permits the Commissioner to attack any steps in or parts of an arrangement, and not necessarily the whole arrangement, while section 103(2) contemplates "an arrangement". The Commissioner may also choose to do so in view of the heavier burden of proof placed upon the taxpayer in terms of section 80G. Lastly, the common law principle of "substance over form" has been legislated into section 80C(2)(a) and it may be easier to attack a transaction that may be targeted at utilising an assessed loss for the purpose of avoiding tax in terms of this section, together with section 80G, as opposed to relying on section 103(2).

The hypothetical example below illustrates the circumstances in which sections 80A to 80L could be applied to the use of an assessed loss. Mr A's arrangement with Mr B, his son in law, may be classified as an avoidance arrangement.

Mr A is a successful building contractor, operating as a sole trader, and paying tax at the maximum marginal rate of tax. His son-in-law, Mr B, is also a sole trader building contractor but has been unsuccessful in attracting customers and, after deducting expenses and wear-and-tear on his expensive equipment, has a substantial assessed loss. During the current year of assessment, Mr A has transferred a large number of his existing contracts to Mr B to carry out the work, leaving some of his own employees idle, thus reducing his own taxable income while allowing his son-in-law to earn additional income and reduce his assessed loss.

### 4.4.2 Impermissible Arrangements in the Context of Assessed Losses

Section 80A of the Income Tax Act deals with impermissible avoidance arrangements. The section provides the basic test for determining whether or not an avoidance arrangement is impermissible. In particular, it applies if there is (1) an arrangement, (2) a tax benefit attributable to that arrangement; (3) a "tax avoidance" purpose; and (4) any one or more "tainted elements". Section 80A of the Income Tax Act reads as follows:

> 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).

Section 80A is applicable to an arrangement, and section 80L defines "arrangement" as including, *inter alia*, any transaction, scheme or agreement. In respect of the hypothetical example above, there is an arrangement in the form of Mr A's transfer of his existing contracts to his son-in-law, and there is a tax benefit for both parties because Mr A reduces his taxable income, while his son earns income to set off against his assessed loss. The transaction lacks commercial substance and was entered into in a means that is not normally employed for *bona fide* business purposes. However, it is not clear whether the sole or main purpose of the arrangement was to avoid tax, as it may simply have been out of generosity to provide more income for his son-in-law. If the purpose of the transaction was not solely or mainly to avoid

tax, then sections 80A to 80L will not apply, as all four of the requirements listed above need to be met.

#### *4.4.2.1 Arrangement*

The presence of an "arrangement" is the first element that is required in order for the GAAR to be applicable. The term is defined in section 80L of the Income Tax Act, which provides: "'Arrangement' means 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". In Mr A's case, the agreement he has made with his son-in-law falls within the definition of arrangement in section 80L.

Section 80L also provides that an arrangement includes "all steps therein or parts thereof". It is clear that the section has a very wide scope and individual steps in a transaction or arrangement are also liable to an attack under the GAAR. A wide interpretation of the word "arrangement" would include even those agreements that are informal, as is the case with the agreement of Mr A and Mr B, but which result in a tax benefit in accordance with the requirements of the GAAR.

#### *4.4.2.2 Tax benefit*

Section 80A of the Income Tax Act stipulates that in order for an arrangement to qualify as impermissible, it must result in a tax benefit. The term tax benefit is defined in section 1 of the Income Tax Act as: "any avoidance, postponement or reduction of any liability for tax."

In terms of section 80L, the term tax benefit is inclusive of "any avoidance, postponement or reduction of any liability for tax". In *Commissioner for Inland Revenue v King*, the court established (at 190) that a tax benefit arises where taxpayers avoid tax that they normally would have been liable to pay by entering into transactions that reduce their income relative to what it would have been. In *Smith v Commissioner for Inland Revenue*, 26 SATC 1, 1964 (1) SA 324(A), the court interpreted the term (at 14) "to avoid an anticipated liability," to mean when a taxpayer steps out of the way, escapes or contrives to prevent an anticipated tax liability. In the hypothetical example, Mr A has transferred some of his contracts to his son-in-law. This agreement falls within the definition of a tax benefit. Mr A has stepped out of the way of a tax

liability by effectively reducing his taxable income. Furthermore, his son-in-law has also received a tax benefit in the form of income that is to be set off against his assessed loss.

In *Income Tax Case 1625,* 59 SATC 383, the court (at 395) introduced the "but for" test. This test determines the existence of a tax benefit. The question that the "but for" test seeks to answer is whether the taxpayer would have suffered the tax liability if it were not for the transaction in question. If it were not for Mr A transferring his contracts to his son-in-law, he would have received the taxable income and have been liable to pay more tax. De Koker and Williams (2020: par. 19.37) note that the Commissioner would have to determine what other arrangement the taxpayer could have entered into to achieve the same commercial result, without avoiding the liability for tax. This alternative will be compared to the actual arrangement that the taxpayer elected to enter into. The authors explain that to determine whether a tax benefit is in existence, the courts will question whether the taxpayer stepped out of the way of an anticipated tax liability and whether the taxpayer would have been liable for an amount of tax were it not for the transaction.

In the case of Mr, A and Mr B, the Commissioner may argue that, if Mr A's intention was simply prompted by generosity to assist his son-in-law financially, he could have donated money to him, or entered into a partnership with him. This would substantiate the fact that the agreement resulted in a tax benefit.

#### *4.4.2.3 Sole or main purpose*

De Koker and Williams (2020:par. 19.4) explain that, once it has been determined that an arrangement that resulted in a tax benefit is in existence, it must then be determined whether the sole or main purpose of the arrangement was to obtain the tax benefit in terms of section 80G of the Act, which states:

> (1) An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

(2) The purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.

According to Meyerowitz (2005:205), a purpose requirement is essential to any general anti-avoidance rule. In terms of section 80A, an avoidance arrangement is impermissible if its sole or main purpose is to obtain a tax benefit. Section 80A makes reference to the purpose of an arrangement as opposed to the previous section 103(1) of the Income Tax Act, which referred to the purpose for which a transaction, operation or scheme was entered into or carried out, which essentially involved a subjective inquiry into the taxpayer's intention (emphasis added).

It is submitted that the purpose test in the GAAR is stronger than the purpose test in section 103(4) for the reason that it focuses on objective factors appearing from the transaction itself, rather than the taxpayer's *ipse dixit.* SARS (2005:56) proposed that the purpose requirement in the new GAAR should reflect an objective inquiry so as to agree with the practice internationally. Satumba (2011:27) suggests, however, that it is still unclear whether section 80G reflects this approach.

SARS (2005:48) has also indicated that the proposed amendments will not prevent a taxpayer's explanation of the reasons for an arrangement from being taken into account. Rather, the new amendments are meant to ensure that a taxpayer's statements are tested thoroughly against the relevant facts and circumstances. Section 80G contains a rebuttable presumption that the avoidance has been entered into or carried out solely or mainly to obtain a tax benefit. Therefore, if a tax benefit is present, it is presumed that its sole or main purpose was to obtain a tax benefit. However, according to Meyerowitz (2005: 205) it is illogical to expect a taxpayer to prove an objective purpose when there is already a presumption as to the purpose.

In *Commissioner for Inland Revenue v Conhage (formerly Tycon)*, 61 SATC 39, 1999 (4) SA 1149 (SCA), the court established (at 1151) that if a taxpayer can achieve a commercial result in numerous ways, it is perfectly acceptable for the taxpayer to elect to choose the method and transaction that attracts the least tax. In such a case, the sole or main purpose of the transaction cannot be considered to be to avoid tax.

In the hypothetical example provided, an objective enquiry into the circumstances surrounding the transaction between Mr A and Mr B will reveal that there is no sound commercial purpose

for the transaction, however, Mr A may claim that he did not intend to avoid tax but simply to genuinely assist his son-in-law's struggling business. SARS's attitude towards the taxpayer's *ipse dixit* and the subjective inquiry in general suggests that this transaction will be regarded as being for the sole or main purpose of avoiding tax.

Satumba (2011:33) alleges that the concurrent use of the terms "sole" and "main" are redundant, however this does not appear to be the case because the two words do not mean the same thing. "Sole" means the only reason, while "main" means the dominant of multiple reasons. Brinker (2001:160) states that: "While a purpose may still be 'a' main purpose even though another purpose is more important, to be 'the' purpose it must supersede any other purpose."

### 4.4.3 Tainted Elements

If it has been established that there is an arrangement that resulted in a tax benefit, which was entered into for the sole or main purpose of avoiding tax, the final step in determining whether the GAAR is applicable would be to determine whether one of the tainted elements is present. In terms of section 80A, impermissible avoidance arrangements arise in three circumstances – arrangements that were entered into in the context of business (section 80A(a)((i)), in a context other than business (section 80A(A)(ii)), and in any context (section 80A(A)(iii)). Entering into arrangements involving the utilisation of an assessed loss would typically be carried out in a business context.

According to De Koker and Williams (2020: par. 19.10), the elements that would be considered as tainted in a business context would be abnormality and/or a lack of commercial substance. The authors also note that the burden of proving that one of the tainted elements is present lies with the Commissioner. Kujinga (2013:111) confirms that the Commissioner may make use of the indicators in sections 80C to 80E to discharge this burden.

#### *4.4.3.1 Abnormality*

Both sub-sections 80A(a)(i) and (ii)) contemplate abnormality. Section 80A(a)(i) refers to an impermissible avoidance arrangement in the context of business "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", and section 80A(a)(ii) refers to a context other than business, where the tax avoidance arrangement "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" (emphases added). In the example of Mr A and Mr B, it would be abnormal for a businessman to channel income into another's business. It may, however, be normal in the context of the family connection between the two. The "but for" test would, however, prevent this being used as a defence.

#### *4.4.3.2 Lack of commercial substance*

The second tainted element is the lack of commercial substance. The elements of a lack of commercial substance are set out in section 80C(1). Section 80C(2) provides a list of indicators of a lack of commercial substance. In the case of Mr A and Mr B, the indicator that is relevant to the utilisation of the assessed loss to avoid tax is contained in section 80C(2)(b)(ii): "the inclusion or presence of … an accommodating or tax indifferent party … as described in section 80E".

Accommodating or tax indifferent parties, are defined in section 80E(1) of the Income Tax Act as follows:

> 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

> (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 …

In the example of Mr A and Mr B, the arrangement includes Mr B as an accommodating or tax indifferent party, as the amount received by Mr B as a result of the arrangement is significantly offset by an assessed loss of Mr B. Another factor of the arrangement that warrants the application of section 80E(1) is that the amount would have been taxable income in Mr A's hands were it not for the arrangement in which he diverted his contracts to Mr B's business.

Pidduck (2017: 96) notes that the wording of section 80E(1) makes it clear that the term tax indifferent party is widely interpreted. Section 80E(2) of the Income Tax Act provides that it is possible for a person to be an accommodating or tax indifferent party whether or not they are a connected person to any party in the arrangement.

#### *4.4.3.3 Treatment of connected persons and accommodating parties*

Section 80F provides that, in the case of connected persons or accommodating parties, the Commissioner may –

> (a) treat parties who are connected persons in relation to each other as one and the same person; or
> (b) disregard any accommodating or tax-indifferent party or treat any accommodating or tax-indifferent party and any other party as one and the same person.

In the case of Mr A and Mr B, the Commissioner may disregard Mr B as the accommodating party and treat the income flowing from the former clients of Mr A as being that of Mr A.

### 4.4.4 Other Elements of Sections 80A to 80L

While the discussion has dealt with a hypothetical example to illustrate the potential application of sections 80A to 80L to trafficking in assessed losses, there may be other

arrangements that indicate a lack of commercial substance, such as where the form of the transaction or transactions does not reflect the "legal substance".

### 4.4.5 Absa Bank Limited and United Towers (Pty) Ltd v C:SARS

*Absa Bank Limited and United Towers (Pty) Ltd v C: South African Revenue Service,* 2021 (3) SA 513 (GP) (collectively referred to as "Absa" in the judgment) was a review application decided in the High Court in Gauteng. The facts of the case were somewhat complex, but involved a preference share investment by Absa in PSIC 3, a South African company. PSIC 3 invested the funds in shares in PSIC 4 and, eventually through a series of transactions, the funds were invested in Brazilian Government Bonds. In terms of Article 11(4) of the Double Tax Agreement between South Africa and Brazil, only Brazil has the right to tax the interest on the bonds, and the interest is also exempt from tax in Brazil. The interest on these bonds was distributed to PSIC 4, which declared dividends to PSIC 3, and the dividends were then declared to Absa.

Two questions needed to be decided by the court: was Absa party to an "impermissible arrangement", and did Absa obtain a "tax benefit"? The section 80J notice issued by SARS, in essence contended that a non-taxable income stream had been created, and that every party to the arrangements, including Absa, is a "party" as defined in section 80L. Sutherland, ADJP held (at 39), regarding Absa being "party" to the arrangement, that:

> The section requires a taxpayer to 'participate or take part'. Such conduct requires volition. A taxpayer has to be, not merely present, but participating in the arrangement. The fact that it might be an unwitting recipient of a benefit from a share of the revenue derived from an impermissible arrangement cannot constitute 'taking part' in such arrangement …

Regarding whether the acquisition by Absa of the preference shares was part of an "arrangement", it was held (at 39) that:

> The 'arrangement' contended for must encompass all the transactions described …[and] must therefore be a scheme. It is plain that the scheme requires a unity to tie the several transactions into a deliberate chain (*CIR v Louw* 1983 (3) SA 551 (A) at pp 572ft). A mere series of subsequent events does not constitute a chain.

In deciding whether there was a tax benefit, the court invoked the "but for" test (*Income Tax Case 1625*; *Hicklin v Commissioner for Inland Revenue,* 41 SATC 179, 1980 (1) SA 481 (A)), and held (at 41): "… but for the purchase of preference shares in PSIC 3, how might an anticipated tax liability be evaded? No foundation is set out that demonstrates such a result".

In discussing this case, Mandy (2021 :4) considers that the judgment has provided guidance on a part of the Income Tax Act that has not been deeply interpreted, and refers to the principles involved:

- a chronological series of transactions will not constitute and "arrangement", there must be a unity, indicating a deliberate chain;
- by being a party to a single transaction, a person does not, without more, "participate or take part" in an arrangement;
- the purpose of tax avoidance must be established subjectively by reference to the taxpayer and not objectively by reference to the "arrangement"; and
- the avoidance of tax must be established subjectively using the "but for" test.

A taxpayer may approach a high court in exceptional circumstances, such special circumstances including a case where the only point of dispute is a question of law; in this case that point of law was the interpretation of section 80L as to "party" and "arrangement" in relation to a set of facts. In this case, the court held that on the facts, the applicant's review in the High Court was appropriate. At the time of writing, this case has not yet been taken on appeal. It is submitted that this may be because the outcome of the case was so obvious. The principles established in the case have not been tested in the courts.

## 4.5 CONCLUSION

This chapter has discussed sections 103(2) and 103(4), which are anti-avoidance measures that prohibit the utilisation of assessed losses by companies, close corporations, and trusts for the purpose of tax avoidance. In particular, the chapter set out the courts' approach to the interpretation of the requirements of section 103(2), and their scope and effect. The chapter also explained the weight of evidence a taxpayer needs to provide to discharge the onus in terms of section 103(4). The chapter has, with regard to section 103(2), illustrated, through a

discussion of relevant case law, the application of the anti-avoidance provisions in combatting the abuse of assessed losses for tax avoidance purposes.

This chapter also discussed the possible application of sections 80A to 80L of the Income Tax Act in the alternative to section 103(2), to transactions that are aimed at the utilisation of assessed losses to avoid tax, using a hypothetical example for illustrative purposes. The application of the hypothetical example to the relevant provisions of the GAAR, has shown that an attempted set-off of an assessed loss may successfully be attacked in terms of sections 80A to 80L.

The following chapter concludes the research by providing a summary and setting out the findings.

# CHAPTER 5: SUMMARY AND FINDINGS

## 5.1 INTRODUCTION

According to Evans (2008:13) tax avoidance threatens to erode the tax base, weakens the integrity of the tax system, encourages non-compliance by taxpayers, and distorts economic behaviour in society. Therefore, it is of the utmost importance to ensure that anti-avoidance legislation is effective in combatting this problem. Assessed losses present the opportunity to reduce the tax burden in various ways. Companies with assessed losses are often the target for a take-over or merger, and this is frequently accompanied by the channelling of income into the company in order to absorb the assessed loss. High-income individuals may carry on a secondary loss-making activity, setting off the losses against their taxable income. The present research analysed various provisions in the Income Tax Act that aim to curtail the use of these assessed losses to avoid taxation.

Therefore, the problem addressed in this thesis was the analysis of the interaction and effect of the provisions in the Income Tax Act dealing with the use of assessed losses for the purpose of tax avoidance, and the case law interpretation of these provisions. The goal of this research was to critically analyse the scope and effect of sections 20, 20A, and 103(2) and 103(4), and sections 80A to 80L of the Income Tax Act, dealing with assessed losses, together with the interpretation by the courts. Case law was discussed in light of the shift from the literal to the purposive approach to the interpretation of fiscal legislation. The sub-goals that were set out to address the main goal of the research were as follows:

1. Briefly discuss the concept of tax avoidance and the interpretation of statutes, as background to the analysis of the anti-avoidance sections.
2. Analyse section 20 of the Income Tax Act and interpretations of the section by the courts, and the tax avoidance section 20A of the Income Tax Act.
3. Analyse the tax avoidance sections 103(2) and 103(4) of the Income Tax Act, and the interpretation by the courts, as well as the GAAR embodied in sections 80A to 80L of the Income Tax Act.

Chapter 1 of the thesis provided the context for the research, resulting in the development of the research question, stated the goals and sub-goals of the research, briefly described the

research methodology adopted for the research, and the ethical approach. That the sustainability of a taxation system relies in part upon reducing tax avoidance as far as possible was stated, and that tax avoidance harms the economy in that it causes revenue loss and diverts resources away from the *fiscus*.

Companies (as well as individuals, trusts, and other juristic persons) may have accumulated assessed losses for tax purposes. Companies with large assessed losses are often the target for mergers and acquisitions. Where the company that is the object of the merger or acquisition has ceased to carry on a trade for a financial year, the carry forward of the assessed loss will be denied in terms of section 20(1) of the Income Tax Act, and this will prevent the use of the assessed loss for tax avoidance purposes. In the case of individuals, section 20A of the Income Tax Act restricts the use of an assessed loss where individuals whose taxable income is taxed at the maximum marginal rate of tax, carry on a second loss-making trade.

Companies, close corporations or trusts wishing to acquire the business of a company are often attracted by the assessed loss and its potential tax benefit. It is in this context that section 103(2) and 103(4) of the Income Tax Act (and its predecessors) was introduced. The section aims to prevent the acquisition of companies, close corporations, or trusts with assessed losses for tax avoidance purposes, by providing that an assessed loss or assessed capital loss in a company, close corporation, or trust, will not be available if an agreement or transaction affecting that company, close corporation, or trust, or a change in shareholding, membership, trustee or beneficiaries, results in income or capital income accruing to that entity, and was effected solely or mainly to obtain access to the assessed loss or assessed capital loss. The General Anti-Avoidance Rules (GAAR) in sections 80A to 80L could also be applied to prevent the use of assessed losses for tax avoidance purposes.

These anti-avoidance provisions, together with case law interpreting the provisions, gave rise to the research question and research goals addressed in this thesis.

## 5.2 ACHIEVING THE RESEARCH GOALS

The goals of the research were addressed in chapters 2 to 4 of the thesis.

### 5.2.1 Chapter Two

The second sub-goal of the research was addressed in chapter two – to briefly discuss the concept of tax avoidance and the interpretation of statutes, as background to the analysis of the anti-avoidance sections.

Chapter two commenced by discussing and comparing tax avoidance and tax evasion. It was established, in the words of Hoffman (1960:678), that the alert individual cannot be blamed for, and should in fact exhaust all available lawful avenues to minimize the incidence of tax on his or her part. This is in contrast with the view of MacDonald JP in *COT v Ferera* that tax avoidance is an evil. Ngalwana (1998:678) describes tax avoidance as involving the use of applicable legislation and tax practices to the best advantage, but that tax evasion is an illegal practice that involves, *inter alia*, falsifying records, lying, and fraudulent behaviour in order to avoid paying tax that is proportionate to the income earned. The South African Revenue Service (SARS, 2005:3) defined tax avoidance as "the use of artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate or exploit perceived 'loopholes' in the tax laws in order to achieve results that conflict with or defeat the intention of Parliament."

In discussing the impact of tax avoidance, Cassidy (2009:773) explains that tax avoidance impacts the economy negatively because it results in revenue losses for the *fiscus,* and it encourages taxpayers to devise schemes and arrangements rather than focusing on investing in the economy. According to Cassidy, this also weakens the Revenue Authority's ability to formulate fiscal policies and in turn negatively affects the integrity of a tax system, which is necessary for its long-term sustainability.

Because of the negative effects of tax avoidance, measures are introduced into tax legislation to combat it. Steenkamp (2012:227) identified one of the mechanisms available to governments as the introduction of anti-avoidance legislation, but that a difficulty in implementing effective anti-avoidance measures is that discerning which activities are unacceptable or impermissible is not something usually characterized by unanimity. According to Atkinson (2012:7) whether an arrangement or scheme is unacceptable or impermissible is a conclusion and not a test, therefore, the methods and approaches to reaching that conclusion may differ, and that even though difficult, the distinction is of particular importance because it is authoritative in

determining which side of the line certain actions fall. Therefore, an anti-avoidance measure, being targeted at avoidance, and not tax mitigation or planning, and where abnormality is involved, must contain explicit or implicit tests to be used to determine whether a particular scheme or arrangement is impermissible or not.

While tax avoidance is legal, SARS (2005:16) described impermissible tax avoidance as the deferral of a tax liability; the conversion of the character of an item, for example from revenue to capital; the permanent elimination of a tax liability; and the shifting of income from a higher marginal rate to a lower marginal rate. Impermissible tax avoidance may also include certain identifying characteristics (SARS, 2005:19): abuse of a statute; the lack of a business purpose; artificial or contrived transactions; and claiming deductions without incurring an expenditure or loss, together with features that have been identified from previous well known tax avoidance schemes, identified by SARS (2005:19) as: a lack of economic substance; the use of tax-indifferent accommodating parties or special purpose entities; unnecessary steps and complexity; high transaction costs; and fee variation clauses or contingent fee provisions.

Identifying transactions as sham or disguised is one way in which certain tax avoidance schemes can be addressed. With tax avoidance, the taxpayer does not conceal or misrepresent the true state of affairs but aims to order them in such a way that when presented to the authorities, the details of the activities show that there is no income or there is less income on which to charge tax (Stewart, 1970:169). A "sham" or "disguised" transaction is described as a transaction in which the parties to the transaction have intentionally disguised its true nature by adopting a form that is not a true reflection of their intentions (De Koker & Williams, 2015:par. 19.2). In *Kilburn v Estate Kilburn,* the court held (at 507) that: "courts 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."

Measures to combat tax avoidance fall into two groups – specific anti-avoidance legislation and general anti-avoidance legislation. Specific anti-avoidance rules regulate or prohibit tax avoidance in specific situations or in relation to a specific transaction. One such example is section 103(2) of the Income Tax Act, which is aimed at preventing the trafficking in assessed losses. Certain aspects of section 20, together with section 20A, are also examples of specific anti-avoidance rules. General Anti-avoidance Rules were described in the New Zealand tax case of *Commissioner for Inland Revenue v BNZ Investments* (at par. 39) as follows: "… the

legislature through the GAAR has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn. ... The function of the GAAR is to protect the liability for the income tax established under the other provisions of the legislation."

Having discussed the background to anti-avoidance measures, the important role played by the courts in interpreting these measures was discussed. According to Goldswain (2008:28): "Interpretation in the context of fiscal legislation is the cornerstone on which the revenue authorities can assess and collect tax and correspondingly, the foundation on which a taxpayer's rights are built." The approach that the courts take to the interpretation of fiscal legislation, including anti-avoidance rules, is of the utmost importance, as it directly affects how the laws are applied.

Du Plessis (2002:18) identifies two prominent theories as the formalistic or literal approach, and the purposive approach. With regard to whether fiscal legislation is interpreted in the same way as other legislation, in *Cape Brandy Syndicate v IRC*, the court held (at 71) that when dealing with fiscal legislation, attention must be given only to the wording that is used. There is no room to consider what might have been intended because there is no equity about tax. Nothing should be read in or implied, only the plain language should be considered when giving effect to legislation. This is an example of the strict literal approach. The issue of the interpretation of fiscal legislation was directly dealt with in the case of *Glen Anil Development Corporation Ltd v SIR*, where the court stated (at 727H-728A) that: "… there seems to be little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation."

According to Du Plessis (2002:100-101), the formalistic approach is a form of devotion to literalism, as it requires the interpreter to maintain an approach that is as close to the linguistic tenet of the provision as possible. The literalism approach maintains that the meaning of a provision must be extracted from the words of the provision. The *Cape Brandy Syndicate* case and *Partington v the Attorney General* applied the literal approach to the interpretation of tax statutes. Devenish (1992:29) explained that, where there is an absurdity, the courts can also apply the "mischief rule" established in *Heydon's Case*, which stipulates that the role of the courts is to suppress the mischief the statute is aimed at and to advance the remedy.

The literal approach has been subject to much criticism in the context of the constitutional interpretation. Devenish (1992:31) criticized the literal approach on the basis that it is a rigid approach and does not make room for the context in which laws were made.

The purposive method of interpretation was described by the court in *Commissioner: South African Revenue Service v Airworld* (at par. 25), as follows:

> In recent years courts have emphasized the purpose with which the Legislature has enacted the relevant provision. The interpreter must endeavour to arrive at an interpretation that gives effect to such purpose. The purpose (which is usually clear or discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide to ascertain the Legislature's intention.

According to Du Plessis (2002:97), purposivism allows the courts to deviate from the literal and unambiguous language of the statute. Goldswain (2012:38) emphasises that the application of the purposive approach also requires the consideration of the historical context in which a provision was enacted, in addition to the explanatory memoranda, the broad objects of the provision and its relationship with other sections of the statute, all without violating the language in which it is couched.

As examples, the following two tax cases applied the purposive approach - *Commissioner: South African Revenue Service vs. Bosch*, and *Conshu (Pty) Ltd v Commissioner for Inland Revenue*.

### 5.2.2 Chapter Three

This chapter dealt with the second sub-goal of the research, which was to analyse the specific tax avoidance section 20 and interpretations of the section by the courts, and the tax avoidance section 20A of the Income Tax Act. This chapter explained the concept of assessed losses in general; set out the requirements in section 20(1) for the utilisation of an assessed loss; illustrated, through case law, the approach the courts take when applying and interpreting section 20; and described the anti-avoidance ring-fencing provisions of assessed losses incurred by natural persons in terms of section 20A of the Act.

Section 20 of the Income Tax Act was introduced to regulate the carry forward and set-off of assessed losses. It allows a taxpayer that incurs an assessed loss to carry forward the balance of assessed loss incurred, to be set off against taxable income earned in, or added to losses incurred in future years. A company is only entitled to set off its assessed loss from the previous year against its taxable income in the current year, if the company has carried on a trade and has derived income from that trade, whereas this restriction does not apply to individuals. One of the requirements for the set off of an assessed loss in terms of section 20(1), is that the taxpayer must have earned income from a trade against which the assessed loss may be set off.

Swart (2001:458) explains that there are conflicting views as to whether the income from trade is an absolute requirement and whether a taxpayer company will be able to set off an assessed loss if it has not earned any income from trade. There are judgments that argue in favour of the income requirement being absolute and there are judgments that are in favour of the income requirement not being necessary for the carry forward of an assessed loss. According to SARS (2017:33), those that argue in favour of the income requirement, rely on the wording of section 20(1) for this view, holding that the provision clearly envisions a set-off against some amount and that this cannot happen if the amount in question is *nil*. SARS (2017:14) also notes that those that argue against the income requirement do so on the strength of section 11(a), in terms of which an amount will be deducted even though the relevant income was earned in a subsequent year.

In *Income Tax Case* 664 (at 126-127), the court held that a taxpayer must be carrying on a trade in the year in which it attempts to set off an assessed loss. The court adopted a literal interpretation of section 20(1), and particularly the term "set-off". In *Income Tax Case 777*, the court held differently, and decided (at 375) that no income from trade is required in order for the taxpayer to be able to set-off the assessed loss, and that an unsuccessful effort to let property was sufficient to satisfy the requirement that that a company should be carrying on a trade, even if no expenditure is incurred.

In *Commissioner: South African Revenue Service v Megs Investments (Pty) Ltd & Another*, the Supreme Court of Appeal considered the "income from trade" requirement. The case involved taxpayer companies that, on 1 January 1996, sold their entire business as a going concern and R6 million of the proceeds was placed on call, R6 million was distributed as a dividend, and R9 million was lent interest-free to three Namibian companies. The appellant's

activities during 1996 consisted of considering the possibility of starting a similar business in other countries, and attempting to exploit certain firearm and liquor licences. Time and effort by the directors of the company were put into these activities but no contracts were concluded, no organisation was established, and there was no trade, and therefore no income. The court held that the time and effort expended on the activities constituted trading, but that the interest was not income derived from trade as an investment company. The court disallowed the set-off of the assessed losses, but made it clear that the decision was arrived at on the strength of the concession by the respondents that in order for a set-off to be allowed, there must be income derived from trade. Although the court did not directly address the issue, it made a decision that reflects that the income from trade is an absolute requirement for a set off to be allowed.

Section 20(1)(a) of the Income Tax Act requires that a company must be carrying on a trade in order to utilise an assessed loss. A company that fails to carry on a trade in any year subsequent to that in which it incurred an assessed will then lose the assessed loss permanently. With regard to this requirement, it was established that a company that ceased to trade and only engaged in activities that amounted "keeping itself alive", despite intending to resume trade in the future, was not entitled to carry the assessed loss forward. An intention to trade is not sufficient, the company must actually trade. It was further established that where a company is in liquidation, the company will be considered to have ceased carrying on trade on the day it is liquidated.

The chapter then proceeded to analyse section 20A and its role in addressing the utilisation of assessed losses by high-income individuals carrying on a secondary loss-making trade. It was established that where a natural person was taxed at the maximum marginal rate of tax and carried on a secondary trade that was operating at a loss, the assessed loss would by ring-fenced in three circumstances – where the "three-out-of-five year" rule applies, where the trade is a listed "suspect" trade, and where the "six-out-of-ten year rule" applies.

In the case of the "three-out-of-ten year" rule, where an assessed loss has been incurred in three out of five years ending on the last day of the year of assessment in carrying on the secondary trade, the assessed loss will be ring-fenced and can only be set off against future taxable income from that trade.

There are nine listed "suspect" trades, and any assessed loss incurred in respect of these trades is also ring-fenced and can only be set off against taxable income earned in future years of assessment from that trade. The listed "suspect" trades are those engaged in by the person or any relative, and are any sport, any dealing in collectibles, the letting or rental of residential accommodation, vehicles, boats, or aircraft, that are not occupied to the extent of 80% for at least half of the year of assessment by non-relatives, animal showing, farming or animal breeding or activities of a similar nature, unless carried out on a full-time basis, any form of performing or creative arts, any form of gambling or betting, and the acquisition or disposal of any crypto asset.

In terms of the "six-out-of-ten-year rule", where assessed losses are incurred in at least six of the ten years ending in the current year of assessment in relation to the listed suspect trades (excluding farming), the assessed loss is permanently ring-fenced and may not be carried forward to be set off against future taxable income from that trade. All forms of farming are deemed to be a single trade.

The ring-fencing will not apply where the "suspect" trades constitute a business in respect of which there is a reasonable prosect of deriving taxable income (other than a taxable gain) within a reasonable period. Special considerations apply in order to determine whether this is achievable, including the proportion of gross income, the level of activities or the amount of expenses, whether the trade is carried on in a commercial manner, the number of years since the commencement of the trade in which assessed losses were incurred, and whether business assets are available for personal use by the person or a relative.

The provisions of section 20 and 20A address the use of assessed losses for the purpose of reducing the entity's taxable income and in that way protect the *fiscus* from tax avoidance schemes.

### 5.2.3 Chapter Four

Chapter Four dealt with the last sub-goal of the research: to analyse the tax avoidance sections 103(2) and 103(4) of the Income Tax Act, and the interpretation by the courts, as well as the GAAR embodied in sections 80A to 80L of the Income Tax Act.

Section 103(2) of the Income Tax Act is a specific anti-avoidance provision that is aimed at limiting the utilisation of assessed losses by companies, close corporations and trusts. It applies where there is a change in the shareholding of a company, the membership of a close corporation, or the trustees or beneficiaries of a trust, or an agreement, and as a direct or indirect result, income or any capital proceeds have been received by or accrued to the company or trust, and was entered into or effected solely or mainly for the purpose of utilising any assessed loss, balance of assessed loss, or capital loss. In this case, the set-off of the assessed loss, balance of assessed loss, or capital loss will be disallowed.

The courts have been called upon the interpret this section on many occasions, and in some of the cases the courts applied the literal interpretation and in others the purposive interpretation. In *Glen Anil Development Corporation Ltd,* the taxpayer argued that the Secretary for Inland Revenue was not entitled to apply section 103(2) because the court should follow the literal approach to interpretation. The court decided that the rule that every provision of a fiscal statute should be construed with due regard to any rules relating to the interpretation of fiscal statutes should be construed in such a way that it will advance the remedy provided for the section and suppress the mischief against which the section is directed. The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation.

A question arises whether the disallowance of the set-off of an assessed loss will sterilise the assessed loss in that it falls away completely, or it falls away only in respect of "tainted" income. In *Conshu (Pty) Ltd*, the majority decision held that a taxpayer company would be able to set the assessed loss off against untainted income, and that the application of section 103(2) results in the ring-fencing of the assessed loss and not a complete sterilisation. As this was a decision of the Appellate Court, this case has created precedent and settled the question.

In *Conshu (Pty) Ltd* the taxpayer also argued that the Commissioner should only have applied section 103(2) in 1985, which is the year in which the relevant agreement was concluded and in respect of the 1984 assessed loss, because the provision applied to an assessed loss already incurred and not one to be incurred. With regard to the timing of the application, the court followed the approach adopted by the court of appeal in *Glen Anil Development Corporation Ltd*, in which it was held that section 103(2) was directed at defeating tax avoidance schemes, and therefore needed to be construed in such a way as to advance the remedy provided by the section and suppress the mischief against which it was directed. The Commissioner's powers

were thus not to be restricted unnecessarily by interpretation. This was clearly a purposive approach to the interpretation of the section.

According to Silke (1958:517), section 90(1)(b) of the 1946 Income Tax Act was obscure and unclear and the language did not give effect to its purpose. The correct interpretation may have been that the section only applied to cases where income was diverted and could not be applied in cases where the company's assessed loss was used as a set-off against income that belonged to the company. In this case, the purpose of Parliament would not have been achieved as taxpayer companies with large assessed losses would have been able to alienate income-producing assets to subsidiary companies with large assessed losses. in *Income Tax Case 1123*, it was held that section 103(2) was broad enough to capture both types of income.

In the *Digicall Solutions* case there were two changes in shareholding that were the subject of the application of section 103(2). The issue was whether the income that had accrued to the taxpayer with the first change in shareholding was a direct or indirect result of the change in shareholding. It was held that the second shareholding would preclude a finding that the income was a direct result of the change in shareholding but not a finding that it was an indirect result of the first change in shareholding. The court held that it was clear that the direct or indirect receipt of income by the taxpayer does not have to occur in the same tax year as the change in shareholding of the taxpayer, and may occur in any year of assessment, provided it results directly or indirectly from the change in shareholding. The court in the *Digicall Solutions* case followed a wide and purposive interpretational approach to section 103(2).

The third requirement of section 103(2) is that the sole or main purpose of the scheme was to utilise and assessed loss or balance of assessed loss. In *ITC 13164* (*ABC (Pty) Ltd v Commissioner: South African Revenue Service*), the court concluded (at par. 70) that the "sole or main purpose" requirement is a subjective requirement. The court stated that "those taxpayer companies that can show a sound commercial purpose for the acquisition of the shares will have less difficulty in establishing that they don't fall foul of this section". Where there were sufficient commercial reasons for the decision to acquire the shares in the company with the assessed loss, section 103(2) could not be applied.

Section 103(4) of the Income Tax Act acts as a presumption. Its effect is that, until the taxpayer proves the contrary, the sole or main purpose of the transaction in question was to utilise the

assessed loss and avoid tax. In *Secretary for Inland Revenue v Gallagher*, in respect of the correct approach to the purpose requirement, the court held (at 48-49) that:

> 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. Section 103(1) draws a clear distinction between the 'effect' of a scheme and the 'purpose' thereof … and this virtually rules out an interpretation which seeks to give 'purpose' an objective connotation and to equate it, more or less, to 'effect'. If the subjective approach be adopted (as it must), then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of respondent, the progenitor of the scheme, as to why it was carried out.

As this was a decision by the Appellate Division, it has created precedent and settled the question.

The chapter then analysed sections 80A to 80L and whether it could be applied to combat the misuse of assessed losses. In *Conshu (Pty) Ltd,* the court was of the opinion that the scheme would not be able to meet the requirements of the provision. The reasons why the Commissioner would choose to apply the GAAR to the misuse of assessed losses were, however, suggested in the chapter. Section 103(2) only applies to companies, close corporations, and trusts, and there may be other taxpayer entities that may attempt to utilise assessed losses for the purposes of avoiding tax, for example, partnerships, joint ventures and individual sole traders. In terms of section 80I of the Income Tax Act, the Commissioner is entitled to apply sections 80A to 80L in the alternative to any other sections and in addition to any other basis for raising an assessment. Section 80H also permits the Commissioner to attack any steps in or parts of an arrangement, and not necessarily the whole arrangement. The Commissioner may also choose to do so in view of the heavier burden of proof placed upon the taxpayer in terms of section 80G. Lastly, the common law principle of "substance over form" has been legislated into section 80C(2)(a) and it may be easier to attack a transaction that may be targeted at utilising an assessed loss for the purpose of avoiding tax, in terms of this section, together with section 80G, as opposed to relying on section 103(2).

A hypothetical example was used to illustrate the circumstances in which sections 80A to 80L could be applied to the use of an assessed loss. In the example, Mr A is a successful building contractor, operating as a sole trader, and paying tax at the maximum marginal rate of tax. His son-in-law, Mr B, is also a sole trader building contractor but has been unsuccessful in attracting customers and, after deducting expenses and wear-and-tear on his expensive equipment, has a substantial assessed loss. During the current year of assessment, Mr A has transferred a large number of his existing contracts to Mr B to carry out the work, thus reducing his own taxable income while allowing his son-in-law to earn additional income and reduce his assessed loss.

It was established that there was an arrangement in the form of a tacit agreement that resulted in a tax benefit. In terms of the decision in *Smith v Commissioner for Inland Revenue*, Mr A has stepped out of the way of a tax liability by effectively reducing his taxable income. His son-in-law has also received a tax benefit in the form of income that is to be set off against his assessed loss. *Income Tax Case 1625* introduced the "but for" test to determine the existence of a tax benefit. The question that the "but for" test seeks to answer is whether the taxpayer would have suffered the tax liability if it were not for the transaction in question. If it were not for Mr A transferring his contracts to his son-in-law, he would have received the taxable income and have been liable to pay more tax. In the case of Mr, A and Mr B, the Commissioner may argue that, if Mr A's intention was simply prompted by generosity to assist his son-in-law financially, he could have donated money to him, or entered into a partnership with him. This "but for" test would substantiate the fact that the agreement resulted in a tax benefit.

The transaction lacks commercial substance and was entered into in a means that is not normally employed for *bona fide* business purposes. However, it is not clear whether the sole or main purpose of the arrangement was to avoid tax, as it may simply have been out of generosity to provide more income for his son-in-law. In *Commissioner for Inland Revenue v Conhage (formerly Tycon)*, the court established that if a taxpayer can achieve a commercial result in numerous ways, it is perfectly acceptable for the taxpayer to elect to choose the method and transaction that attracts the least tax. In such a case, the sole or main purpose of the transaction cannot be considered to be to avoid tax. In the hypothetical example provided, there is no sound commercial purpose for the transaction between Mr A and Mr B, and therefore the main purpose was to reduce Mr A's taxable income.

If it has been established that there is an arrangement that resulted in a tax benefit, which was entered into for the sole or main purpose of avoiding tax, the final step in determining whether the GAAR is applicable would be to determine whether one of the tainted elements is present. The arrangement between Mr A and Mr B is in a business context and the elements that would be considered as tainted in a business context would be abnormality and/or a lack of commercial substance. In the example of Mr A and Mr B, it would be abnormal for a businessman to channel income into another's business. It may, however, be normal in the context of the family connection between the two. The "but for" test would, however, prevent this to be used as a defence.

Section 80C(2) provides a list of indicators of a lack of commercial substance. In the case of Mr A and Mr B, the indicator that is relevant to the utilisation of the assessed loss to avoid tax is contained in section 80C(2)(b)(ii): "the inclusion or presence of … an accommodating or tax indifferent party … as described in section 80E". In the example of Mr A and Mr B, the arrangement includes Mr B as an accommodating or tax indifferent party, as the amount received by Mr B as a result of the arrangement is significantly offset by an assessed loss of Mr B. Another factor of the arrangement that warrants the application of section 80E(1) is that the amount would have been taxable income in Mr A's hands were it not for the arrangement in which he diverted his contracts to Mr B's business. In the case of Mr A and Mr B, the Commissioner may disregard Mr B as the accommodating party and treat the income flowing from the former clients of Mr A as being that of Mr A.

Using the hypothetical example, it is submitted that it has been demonstrated that sections 80A to 80L can be applied to combat the use of assessed losses for the purpose of avoiding tax.

Finally, the only tax case dealing with the application of sections 80A to 80L was discussed – *Absa Bank Limited and United Towers (Pty) Ltd*. Two questions needed to be decided by the court: was Absa party to an "impermissible arrangement", and did Absa obtain a "tax benefit"? Mandy (2021) refers to the principles involved in the case:

- a chronological series of transactions will not constitute and "arrangement", there must be a unity, indicating a deliberate chain;

- by being a party to a single transaction, a person does not, without more, "participate or take part" in an arrangement;
- the purpose of tax avoidance must be established subjectively by reference to the taxpayer and not objectively by reference to the "arrangement"; and
- the avoidance of tax must be established subjectively using the "but for" test.

These principles remain to be tested by the courts.

## 5.3 CONCLUSION

It is submitted that the thesis has answered the research question – the analysis of the interaction and effect of the provisions in the Income Tax Act dealing with the use of assessed losses for the purpose of tax avoidance, and the case law interpretation of these provisions – and the main goal of the research – to critically analyse the scope and effect of sections 20, 20A, and 103(2) and 102(4), and sections 80A to 80L of the Income Tax Act, dealing with assessed losses, together with the interpretation by the courts. The thesis has demonstrated that the application of these sections of the Income Tax Act, together with case law, are effective in preventing the misuse of assessed losses for the purpose of avoiding tax.

The distinction between tax avoidance and tax evasion has been described by the former Chancellor of the Exchequer in the United Kingdom, Denis Healy as: "the difference between tax avoidance and tax evasion is the thickness of a prison wall" (Xuereb, 2015:217). This analogy may be criticised on the grounds that tax evasion is characterised by fraud and non-disclosure, while tax avoidance involves neither of these. The transactions addressed by the sections discussed in this thesis clearly do not amount to tax evasion.

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