THE DISTINCTION BETWEEN TAX EVASION, TAX AVOIDANCE AND TAX PLANNING

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Abstract

Tax avoidance has been the subject of intense scrutiny lately by both the South African Revenue Service ("the SARS") and the media. This attention stems largely from the recent withdrawal of section 103(1) together with the introduction of section 80A to 80L of the South African Income Tax Act. However, this attention is not limited to South Africa. Revenue authorities worldwide have focused on the task of challenging tax avoidance.

The approach of the SARS to tackling tax avoidance has been multi-faceted. In the Discussion Paper on Tax Avoidance and Section 103(1) of the South African Income Tax Act they begin with a review of the distinction between tax evasion, tax avoidance and tax planning. Following a call for comment the SARS issued an Interim Response followed by the Revised Proposals which culminated in the withdrawal of the long-standing general anti-avoidance rules housed in section 103(1) and the introduction of new and more comprehensive anti-avoidance rules. In addition, the SARS has adopted an ongoing media campaign stressing the importance of paying tax in a country with a large development agenda like that of South Africa, the need for taxpayers to adopt a responsible attitude to the management of tax and the inclusion of responsible tax management as the greatest measure of a taxpayer's corporate and social investment. In tandem with this message the SARS have sought to vilify those taxpayer who engage in tax avoidance. The message is clear: tax avoidance carries reputational risks; those who engage in tax avoidance are unpatriotic or immoral and their actions simply result in an

unfair shifting of the tax burden. The SARS is not alone in the above approach. Around the world tax authorities have been echoing the same message.

The message appears to be working. Accounting firms speak of a "creeping conservatism" that has pervaded company boardrooms. What is not clear, however, is whether taxpayers, in becoming more conservative, are simply more fully aware of tax risks and are making informed decisions or whether they are simply responding to external events, such as the worldwide focus by revenue authorities and the media on tax avoidance. Whatever the reason, it is now critical, particularly in the case of corporate taxpayers, that their policies for tax and its attendant risks need to be as sophisticated, coherent and transparent as its policies in all other areas involving multiple stakeholders, such as suppliers, customers, staff and investors.

How does a company begin to set its tax philosophy and strategic direction or to determine its appetite for risk? A starting point, it is submitted would be a review of the distinction between tax evasion, avoidance and planning with a heightened sensitivity to the unfamiliar ethical, moral and social risks. The goal of this thesis was to clearly define the distinction between tax evasion, tax avoidance and tax planning from a legal interpretive, ethical and historical perspective in order to develop a rudimentary framework for the responsible management of strategic tax decisions, in the light of the new South African general anti-avoidance legislation. The research methodology entails

a qualitative research orientation consisting of a critical conceptual analysis of tax evasion and tax avoidance, with a view to establishing a basic framework to be used by taxpayers to make informed decisions on tax matters.

The analysis of the distinction in this work culminated in a diagrammatic representation of the distinction between tax evasion, tax avoidance and tax planning emphasising the different types of tax avoidance from least aggressive to the most abusive and from the least objectionable to most objectionable. It is anticipated that a visual representation of the distinction, however flawed, would result in a far more pragmatic tool to taxpayers than a lengthy document. From a glance taxpayers can determine the following: That tax avoidance is legal; that different forms of tax avoidance exist, some forms being more aggressive than others; that aggressive forms of tax avoidance carry reputational risks; and that in certain circumstances aggressive tax avoidance schemes may border on tax evasion. This, it is envisaged, may prompt taxpayers to ask the right questions when faced with an external or in-house tax avoidance arrangement rather than simply blindly accepting or rejecting the arrangement.

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1 Chapter 1: Introduction

1.1 Introduction

The simple distinction of unlawful tax evasion, lawful, but arguably irresponsible tax avoidance and legally acceptable tax planning is becoming increasingly less clear cut in today's complex business world. In reality the distinction is far more complicated and increasingly under scrutiny following a world-wide focus on tax-avoidance and the effectiveness of current anti-avoidance legislation.

As a direct consequence of the perceived effects of aggressive tax avoidance, the South African Revenue Service (*hereinafter*, "the SARS") in conjunction with National Treasury issued the Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act (*hereinafter*, "the Discussion Paper") calling for comment on the contents thereof. Comments were received from a number of significant stakeholders by 28 February 2006 and an Interim Response to the Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act (*hereinafter* 'the Interim Response"), based on the comments received, was issued by the SARS and National Treasury in March 2006.

During September 2006 the SARS and National Treasury issued the Revised Proposals on Tax Avoidance and Section 103 of the Income Tax Act (*hereinafter*, "the Revised Proposals") which proposals were included in the Revenue Laws Amendment Bill, No. 33 of 2006 and subsequently the Revenue Laws Amendment Act, No. 20 of 2006 (Government Gazette GG29603). The effect of the new legislation was a complete withdrawal of the anti-avoidance provisions housed in section 103(1) and their replacement with a new Part IIA consisting of sections 80A to 80L. The effective date of the new provisions was 2 November 2006.

In the Discussion Paper the SARS revisits the distinction between tax evasion, tax avoidance and tax planning and begins with an attempt to define and distinguish three broad topics, namely "tax evasion", "*impermissible* tax avoidance" and "*legitimate*

tax planning" (SARS, 2005a:1). The SARS states that whilst generally there is consensus on the meaning of "tax evasion" the meaning of the other two categories is more contentious. This is not surprising as, to this author's knowledge, the term "*impermissible*" has never been referred to in any case law, in any of the commentaries thereto or by any authoritative South African writers on matters of taxation. The SARS further states that whilst precise line drawing may not be possible, these categories help to distinguish types of behaviour which may range from plain "vanilla" tax planning to criminal tax evasion (SARS, 2005a:2).

In the Interim Response to the Discussion Paper the SARS notes that some commentators took exception to their understanding of the distinction of evasion, avoidance and planning with some arguing for a simple dichotomy of "*unlawful*" tax evasion and "*lawful*" tax avoidance with relatively little if anything in between (SARS, 2006a:4). The SARS notes that one commentator dismissed the whole notion of "*impermissible tax avoidance*" and its consequences as little more than "*risible "nonsense*" advocated by a "*string of ministers of finance and revenue commissioners over the years*" (SARS, 2006a:4). Further, the SARS notes that it has been blamed of "*accusing the hardworking taxpayer of something that they perceive to be impermissible when parliament has never legislated against it*" (SARS, 2006a:4).

From the judgments handed down in the multitude of South African cases it is clearly evident that the SARS is not always considered correct in its views. Maeve Kolitz (2002a) in researching and writing a number of extensive articles on the recently withdrawn section 103(1) noted that there was still an underlying confusion on this topic amongst many people, even in the minds of the Minister of Finance and the Commissioner for the SARS. In light of the more efficient, proactive and aggressive SARS, it is a distinction that must be revisited and finally understood.

In the past any review or analysis of the distinction between tax evasion, tax avoidance and tax planning would typically focus mainly on the legality of each of the categories thereof. Proponents of Corporate Social Responsibility (*hereinafter*,

"CSR") have recently elevated the distinction through the inclusion of responsible tax as part of a firm's measure of its commitment to CSR. Their reasoning can be summed up as follows: "*...payment of one's dues is a social obligation. If that is true, then surely failing to pay one's tax dues must be socially irresponsible. Moreover, arranging affairs so as to minimise or eliminate those dues must also be socially irresponsible*" (Swinson, 2004:26). As a result the management of tax will change dramatically in the future (Erle, 2004). Certainly its public profile has become much more conspicuous. Quite suddenly (although through the collective efforts of revenue collection agencies around the world and non-governmental bodies such as the Tax Justice Network), the distinction has acquired moral, ethical and social dimensions that have elevated the case for responsible tax. For this reason, the business management issues associated with tax have become more complicated, more subtle, more inherently risky and much more challenging (Erle, 2004). What is evident is that "*a company's policies for tax and its risks need to be as sophisticated, coherent and transparent as its policies in all other areas involving multiple stakeholders, such as the environment, its suppliers, customers, staff and investors*" (Erle, 2004:3).

No consensus has yet emerged on how companies and their tax functions can or should accommodate the unfamiliar ethical and social issues now associated with tax. A starting point, it is submitted, would be a review of the distinction between tax evasion, tax avoidance and tax planning with a heightened sensitivity to corporate governance and responsibility issues.

1.2 Worldwide concern

There is no doubt that worldwide tax avoidance has grown significantly in the past few decades (Evans, 2006; SARS, 2005a). Braithwaite (2005) describes tax avoidance as a problem of globalisation driven by increasingly aggressive competition. For the first time Braithwaite (2005) explains, English tax accountants and lawyers find that they are having to compete with New York accounting firms for the provision of international tax advice to British companies. Manhattan, it is claimed, is the single most important tax haven in the world through which a great deal of international tax

advice is now provided (Braithwaite, 2005). Such competition, Braithwaite (2005) claims, has forced the professions, which once conducted their activities within certain norms that respected the spirit of the law, to become increasingly aggressive in order to promote themselves and secure profits.

Recently accounting firms have been under increasing scrutiny for the role they play in the mass marketing of aggressive avoidance schemes (Sikka and Hampton, 2006). In their joint paper 'The Role of Accountancy Firms in Tax Avoidance: Some Evidence and Issues', Prem Sikka of the University of Essex and Mark Hampton of the University of Kent discuss the extent to which KPMG went in the past in promoting their avoidance schemes. Prior to the WorldCom scandal KPMG's organisational structure included a 'Tax Innovation Centre' whose sole mission was to develop new tax products. It operated, according to Sikka and Hampton (2006:13), as a 'Tax Services Idea Bank' and invited staff to submit new ideas for tax products on an internal form which also asked the submitter to explain the revenue potential, typical buyer and key target markets. In addition to the 'Tax Innovation Centre', KPMG maintained an innovative marketing centre which included a telemarketing centre staffed with people trained in making cold calls. Aggressive marketing tactics were also employed with staff being advised to tell some clients that some products were no longer available or that the firm had decided to cap the strategy, thus employing "reverse psychology" (Sikka et al, 2006). Guidance was provided on how to convince sceptical clients with standard phrases which were parroted when required.

There is no doubt that avoidance pays (Hawkes, 2006). Despite the clamp-down on anti-avoidance in the United Kingdom, the tax departments of the various accounting firms are described as being in "*rude health*" with many of the larger accounting and legal firms reporting double digit growth (Hawkes, 2006:18). It seems that anti-avoidance crackdowns are welcomed by tax advisors who admit that complexity, often driven by anti-avoidance moves, has driven demand for tax services (Hawkes, 2006).

In the Discussion Paper, SARS highlights a number of reasons for the substantial increase in tax avoidance, most notably, globalisation, deregulation and rapid advances in the computer and telecommunications technology. To this is added increasing complexity of domestic legislation giving rise to structural discontinuities through different tax treatments for the same transaction in different nations (Braithwaite, 2005). Such structural discontinuities allow multi-national corporations to "double-dip", for example, having interest on a convertible loan treated as deductible in one jurisdiction whereas in another jurisdiction the same convertible loan will be treated as equity with interest received treated as dividends and thus exempt from tax. In the same way cross-border derivatives may be characterised in different ways and are seen as an emerging area of tax avoidance (Braithwaite, 2005). Former International Monetary Fund tax policy chief Vito Tanzi believes that the twenty-first century may not have been a good century for tax. He identified eight "*fiscal termites*" which have contributed to tax avoidance. They are electronic commerce, electronic money, intra company trade (transfer pricing), tax havens, derivatives and hedge funds, highly mobile and tax sensitive capital, growing foreign activities (globalisation) and foreign shopping (Braithwaite, 2005:89).

The harm caused by tax avoidance is described as varied and pervasive (SARS, 2005a) of which the most immediate is short term revenue loss. Other harmful effects noted by the SARS in the Discussion Paper (2005a) include a growing disrespect for the tax system, complexity, the uneconomic allocation of resources, an unfair shifting of the tax burden and an undermining of the ability of National Treasury and Parliament to set and implement economic policy.

The short term revenue loss from tax avoidance is substantial (SARS, 2005a). Whilst it is impossible to conclude on any figures, United States economists calculate that the annual loss to the fiscus through tax avoidance in the United States is staggering[1]

[1] Figures for the US are estimated to be as high as $311 billion each year , whereas those for Britain approximate £100 billion. Developing countries are estimated to be losing $50 billion each year (Sikka et al:2006).

(Evans, 2006). The Tax Justice Network, a network of researchers and activists with a shared concern about the harmful impacts of tax avoidance, estimate that an equivalent amount of money to pay for the entire primary health and education needs of the world's developing countries are being siphoned off each year through offshore companies and tax havens (Campbell, 2004). It is estimated by the Tax Justice Network that offshore companies (formed with the intention of exploiting loopholes in tax law) are being formed at the rate of around 150 000 per year (Campbell, 2004). Further, whilst in the 1970s there were only in the region of twenty-five tax havens that figure has more than doubled to nearly sixty-three today (Campbell, 2004). The pervasiveness of tax avoidance is clearly evident when one considers that tax havens contain only 1.2 percent of the world's population and earn only three percent of the world's Gross Domestic Product, but that twenty-six percent of the assets and thirty-one percent of the profits of United States multinationals are held there (Campbell, 2004).

Tax avoidance is also economically costly (SARS, 2005a). To begin with, tax avoidance results in increasingly complex legislation which translates into increased reporting requirements, higher administrative costs and compliance burdens for both taxpayers and government (SARS, 2005a). The professional fees which accompany complex tax avoidance schemes can also be very costly (SARS, 2005a). With the collapse of Enron a United States Senate Joint Committee on Taxation prepared a 2,700 page report on the tax avoidance schemes entered into by Enron (Sikka et al, 2006). The complex schemes in which Enron participated were designed by Arthur Andersen, Deloitte & Touche, Chase Manhattan, Deutsche Bank, Bankers Trust and other law firms for which they earned fees in the region of $88 million (Sikka et al, 2006). Indeed so complex were the schemes that the 2,700 page report prepared by the Senate was only of sufficient length to highlight the schemes (Sikka et al, 2006). Tax avoidance schemes can also severely distort trade and investment flows in an economy by affecting investment decisions (SARS, 2005a). Investments which would not otherwise be entered into because of being only marginally profitable on a pre-tax basis are adopted given the considerable tax benefits (SARS, 2005a).

In countries with a significant development agenda like that of South Africa, where a backlog of social initiatives such as the provision of clean water, electricity and housing exist, tax avoidance can seriously undermine the efforts of government to set and implement national economic policy. In South Africa (as in other countries) tax legislation is a mix of fiscal, social and economic policy objectives (SARS, 2005a). The most obvious way in which tax avoidance may adversely affect the efforts of government is through short term revenue losses which limit government's ability to pursue its economic and social objectives.

1.3 Research question

The research question addressed in the research is how to clearly define the distinction between tax evasion, tax avoidance and tax planning from a legal interpretive, ethical and historical perspective in order that those confronted with strategic tax decisions can make informed decisions on transactions to be undertaken.

The goal of this thesis is to revisit the distinction between tax evasion, tax avoidance and tax planning in order to provide a rudimentary framework for the responsible management of strategic tax decisions. There is no doubt that although tax responsibility within CSR has a long way to go, it has established a basic tenet that legality in itself is not enough and that clear reputational risks may arise for irresponsible firms (Baker, 2006). It seems, now more than ever, that firms need a clear idea of the distinction between simple avoidance and abusive or aggressive avoidance (as described in the SARS' Discussion Paper on tax avoidance) as presumably the line between responsibility and irresponsibility lies somewhere in between (Baker, 2005).

This thesis critically analyses the distinction between tax evasion, tax avoidance and tax planning taking into account the Discussion Paper, the Interim Response thereto and the Revised Proposals as well as the multitude of case law and commentaries that have developed over the years in this regard. This examination is imperative given the aggressive stance of SARS towards broadening the tax base, the increasing intolerance to tax avoidance by taxation authorities worldwide, the increased focus on

responsible tax management as falling within Corporate and Social Responsibility and the recently enacted section 80M which governs reportable arrangements. Further, in establishing a framework, this thesis aims to highlight the essence of tax avoidance and the various forms it takes from the simple to the complex and from the least objectionable to the most objectionable in such a way that those making strategic tax decisions can make informed decisions on the aggressiveness of transactions undertaken.

1.4 Research methods and design

The research methodology entails a qualitative research orientation consisting of a critical conceptual analysis of tax evasion and tax avoidance, with a view to establishing a basic framework to be used by taxpayers to make informed decisions on tax matters.

The research is literature-based and carried out by means of a study of written material published by, *inter alia*, authoritative South African and international authors on matters of taxation; South African tax statutes; explanatory memoranda published by the SARS; discussion documents relating to proposed legislative changes; and South African and international court decisions. As all data are in the public domain, no ethical considerations arise.

As the data is sourced from enacted laws of Parliament and the documents accompanying them, records of cases heard in the courts and the work of acknowledged experts, the data is assumed to be reliable. Every effort is made to ensure the validity of the conclusions and recommendations by avoiding bias caused by either a pro- or anti-South African Revenue Service view. This is achieved through a fair and impartial presentation of both views.

1.5 Overview of the thesis

This thesis consists of five chapters of which the remaining four are devoted to achieving the research goal. In chapter two 'tax evasion' is explored with particular

focus on the meaning of 'intent'. In addition the various remedies available to the Commissioner for SARS to combat tax evasion are set out.

Chapter three explores the concept of tax avoidance from an historical, legal and ethical perspective. In doing so the essence of tax avoidance as it is understood by various authoritative writers and the SARS is set out together with the various forms tax avoidance may take, from the simple to the complex and from the least objectionable to the most objectionable. Expressions such as "impermissible avoidance", "abusive avoidance", "aggressive avoidance", etc. are discussed and differentiated and examples given of each 'category' of avoidance. Chapter three also discusses the social and ethical considerations which are worthy of consideration by taxpayers before engaging in a tax avoidance arrangement. Lastly, the remedies available to the Commissioner for SARS to combat tax avoidance are set out and their provisions discussed, namely the specific anti-avoidance provisions which are literally scattered throughout the Act as well as the newly enacted general anti-avoidance rule housed in sections 80A to 80L of the Act.

Chapter four explores the concept of tax planning and sets out the meaning of tax planning as it is understood by the SARS.

Finally, chapter five concludes on the thesis as a whole.

2 Chapter 2: Tax Evasion

In the context of the simple distinction between 'tax evasion, tax avoidance and tax planning', tax evasion is the easiest to define and understand. For this reason it appears that very little is written on tax evasion in the context of the distinction other than that it is illegal. It is this author's opinion, however, that tax evasion is as, if not more, pervasive than tax avoidance. Consequently a more detailed discussion of its meaning is warranted.

2.1 Definition

Tax evasion may be described as the use of illegal means to reduce a tax liability (Huxham and Haupt, 2006). As such, tax evasion is a fraud committed against the fiscus (Kolitz, 1999a).

2.2 Criminal sanction

As tax evasion is a criminal offence it requires no specific provisions in the South African Income Tax Act, No. 58 of 1962 (*hereinafter*, "the Act") to make it illegal. Nevertheless section 104 of the Act makes it clear that where any person with the *intent* to evade or to assist any person to evade assessment or taxation, makes a false statement or entry in a return or signs the statement or return without reasonable grounds for believing it to be true; or gives a false answer, verbally or in writing, to any request for information; or prepares or maintains or authorises the preparation or maintenance of false records; or makes use of fraud, art or contrivance or authorises its use, shall be guilty of an *offence* and liable on conviction to a fine or to imprisonment for a period not exceeding five years.

Section 104(2) of the Act further provides that where it is proved in any proceedings that a false statement or entry has been made in any return whether by the taxpayer or on behalf of the taxpayer, the taxpayer shall be presumed, until he proves otherwise, to have made that false statement or entry or to have allowed that false statement or entry to be made with *intent*. Similarly, any other person who assisted in the

preparation of the return shall be presumed to have made the false statement or entry with the *intent* to assist the taxpayer to evade taxation.

The word 'intent' has a particular legal meaning and requires that the taxpayer in fact assisted in or, at most, had knowledge that tax was not being paid when it was required to be paid. In Ramsay v Minister van Polisie 1981 4 SA 802 (A) 807, it was said that intent is a legally reprehensible state of mind or mental disposition encompassing the direction of the will to the attainment of a particular consequence, and consciousness of the fact that such result is being achieved in an unlawful or wrongful manner. The concept of intent is entirely subjective, that is, intent is present only if the defendant in fact intended to bring about a particular result and was, at the same time, subjectively aware of the wrongful character of his conduct. Furthermore, it was said in S v Sigwahla 1967 4 SA 566 (A) 570B-C that for intent to be present, it is not enough that one should reasonably have foreseen the possibility of other consequences ensuing; one must actually and subjectively have foreseen this possibility. The question is, therefore, not whether the result of non-compliance in respect of payment of any tax was reasonably foreseeable, but whether a person indeed foresaw it. If not, the taxpayer did not act with intent.

A clear distinction is drawn between 'intent' and 'negligence', as the two terms are mutually exclusive from a legal perspective. For negligence, the courts adopt an objective test: what would the reasonable person have foreseen and which preventative or corrective steps would he or she have taken, which he or she did not foresee and/or take? If someone neglects to perform some duty because he was ignorant about it, but he should have been aware of it because the reasonable person would have been aware, negligence is present.

2.3 Penalty on default

In addition to the criminal sanction of section 104 of the Act, section 75 provides that any person will be guilty of an offence and liable to a fine or to imprisonment of up to 24 months, or both where he:

- fails or neglects to submit any return required by the Act;
- fails to register as a taxpayer or fails to inform the Commissioner of a change in address;
- fails to register as a tax practitioner in terms of section 67A;
- refuses or neglects, without just cause, to furnish information or reply, or to attend and give evidence when required to do so by the Commissioner or any officer, or fails to answer any questions truly and fully, or to produce books and papers when requested to do so;
- omits any portion of gross income received by or accrued to him or fails to disclose material facts;
- fails, in a return prepared by him, on behalf of any other person, to show an amount of gross income or to disclose any facts that might have resulted in an increase in taxation;
- obstructs or hinders any officer in the discharge of his duties;
- fails to retain all records for a period of five years;
- submits or furnishes a false report or statement under section 73;
- holds himself out as an officer engaged in carrying out the provisions of the Act;
- obtains approval of any project (a qualifying industrial project) in terms of section 12G where approval was based on any fraudulent information or material misrepresentation made by him;
- fails to comply with the provisions of section 99, where he has been declared the agent of another person; or
- fails, in his fiduciary capacity or in the capacity as the accounting officer of a public benefit organisation, to comply with the provisions of section 18A or 30 or the constitution or will or other written document under which the public benefit organisation was established.

In addition, the section provides that where a person is convicted of failing to furnish any return, information or reply, and if he fails within a reasonable time to furnish the return, information or reply, he shall be guilty of an offence and liable on conviction

to a fine of R50 a day for each day he continues to be in default or to imprisonment without the option of a fine up to 12 months.

2.4 Additional taxes

In addition to the criminal sanction imposed by sections 104 and 75, the Act makes provision for additional taxes by way of section 76.

Section 76 is essentially a penalty provision and provides for the payment of additional tax on default or omission. The section provides for additional tax under the following circumstances:

- If the taxpayer neglects to submit a return in respect of any year of assessment, he shall be liable for additional tax equal to twice the tax chargeable in respect of that year of assessment.
- If the taxpayer omits an amount from his return that should have been included, he shall be liable for an additional tax equal to twice the difference between the tax that would be chargeable on his total income, including this amount, and the tax chargeable on the taxable income returned by him.
- If the taxpayer makes an incorrect statement in any return which would result in the assessment of normal tax at an amount which is less than the tax that should have been chargeable, he shall be liable for additional tax amounting to twice this difference.

This additional tax is known as treble tax, because it amounts to three times the difference in tax: the tax on the amount omitted, understated or not returned at all, calculated in the normal way, plus a further amount of twice this tax. Thus a taxpayer who pays tax at the maximum marginal rate of 40 percent and who omits an amount of R10 000 from his return, is liable for tax of R4 000 on this amount, plus additional tax of R8 000. An omission of R10 000 therefore costs the taxpayer an amount of R12 000 in tax.

Section 76 also provides for the payment of additional tax where the Commissioner has estimated the taxpayer's income in terms of section 78. Where any assessed loss is greater than it would have been had it been correctly calculated, additional tax will also be levied at twice this difference, as if it had arisen from an omission. The Commissioner's power to impose additional tax is in addition to his power to impose any other penalty provided for in the Act. The Commissioner is also empowered by section 76(2) to remit the additional tax or any part thereof as he may think fit, provided there are extenuating circumstances, even if the taxpayer's act or omission was accompanied by an *intent* to evade taxation.

2.5 Tax evasion and morality

Simply stated, tax evasion is illegal and immoral. As such, the concept of tax evasion does not raise any complex moral or ethical questions, except in the most obscure circumstances. In the United Kingdom case of Cheney v Conn (1968) All ER 779, an individual objected to paying tax that, in part, would be used to procure nuclear arms in unlawful contravention, he contended, of the Geneva Convention. His claim was dismissed, the Judge ruling that "*What the [taxation] statute itself enacts cannot be unlawful, because what the statute says and provides is itself the law, and the highest form of law that is known in this country.*"

Of concern to the SARS is that tax evasion may garner a certain acceptance amongst taxpayers in light of the well documented cases of tax avoidance undertaken by wealthy taxpayers. Braithwaite (2005) cites growing evidence that when taxpayers believe that the rich are getting away with paying very little tax it impacts on their compliance with the tax laws. In Australia it was reported by Annette Sampson (2003) the editor of Personal Finance that more than three quarters of Australians believe that company CEOs are not paying their fair share, of tax according to research by the Centre for Tax System Integrity at the Australian National University. According to Braithwaite (Sampson, 2003) Australia is at a critical point (as are many other countries) where honest taxpayers are deciding they may as well cheat as everyone else is. Michael Inglis, an Australian tax barrister, believes this may already be

happening (Sampson, 2003). Comments such as those made by Leona Helmsley only serve to exacerbate the situation. United States property and hotel tycoon Leona Helmsley became infamous during her tax avoidance case in 1989 for having allegedly said, "*Only little people pay tax*" (Crotty, 2006:1).

2.6 Conclusion

Tax evasion is a deliberate, calculated attempt to reduce one's tax burden through fraudulent means. Where an instance of tax evasion is patently obvious the SARS may seek a criminal conviction in addition to raising additional taxes, penalties and interest.

Problems may arise in that different people have different appetites for risk, including tax risk (in this case the risk of detection). Whilst a board of directors may be conservative, the financial manager responsible for the tax function may have a high appetite for tax risk and may, unbeknown to the board, engage in tax evasion. This is often the case, it is submitted, in large multinational groups with a weak in-house tax function and little board intervention in tax matters.

In order to ensure that this does not take place it is imperative that company boards establish an overall tax philosophy. The 'tone from the top' should clearly state that any form of tax evasion will not be tolerated. In addition, the established tone should be exemplified by the board of directors by adopting appropriate behaviour patterns, such as the adoption of appropriate controls in the tax function and calling for independent reviews of the tax function.

These measures may, to some extent, be considered by the SARS as extenuating circumstances when considering whether to remit additional taxes. In addition, these measures, together with other appropriate steps may go a long way to detect and address any risks created through engaging in tax avoidance. Other steps include the appropriate staffing of the tax function, the active oversight of tax strategy and timely reporting to the board on material tax risk matters (Erle, 2004).

The concept of tax avoidance is discussed further in the following chapter.

3 Chapter 3: Tax Avoidance

Whereas the concept of tax evasion is fairly easy to describe and understand, tax avoidance is far more complicated. Whilst most authoritative authors on matter of taxation, tax practitioners and taxpayers share the same view on the legality of tax avoidance, many differ on the various forms that tax avoidance may take and on the acceptability of each form thereof. Of all stakeholders the SARS is most vehemently opposed to tax avoidance in any form. It is essential that taxpayers educate themselves on the essence of tax avoidance and the various forms it takes from the simple to the complex and from the least objectionable to the most objectionable so that they will be able to make informed decisions on the underlying risks of transactions undertaken. In attempting to address the research question, a clear definition of the distinction between tax evasion, tax avoidance and tax planning, this chapter discusses the concept "tax avoidance" from various perspectives.

3.1 Introduction

The SARS, in the Discussion Paper (2005a:3) include the definition of tax avoidance provided by Lord Templeman in CIR v Challenge Corporation Ltd (1987) AC155:

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

Also included in the Discussion Paper is a definition of tax avoidance provided by the Ralph Review of Business Taxation (2005a:3):

> Tax avoidance [is] a misuse or abuse of the law [that] is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by Parliament but also includes the manipulation of the law and a focus on form and legal effect rather than substance.

The distinction between avoidance and evasion has long been recognised although there was no accepted terminology to express it (Wikepedia Online, 2006). According to Wikepedia (Wikepedia Online, 2006) the technical use of the word "avoidance" as opposed to "evasion" originated in the United States of America where its use was

long established by the 1920s. The very first reference to the distinction in case law in the United States can be traced back to 1916. Although slow to be accepted in the United Kingdom, by the 1950s the expression was frequently used by writers knowledgeable on matters of taxation (Wikepedia Online, 2006). Despite research undertaken it could not be established clearly when the distinction was adopted in South Africa. Suffice is to say, that by 1952 renowned South African authors on matters of taxation were making use of the distinction in various articles written (Meyerowitz, 1952:105).

3.2 Anatomy of tax avoidance

Over the past few decades many forms of avoidance have been identified (impermissible, abusive, aggressive, unacceptable, avoision, etc.) which indicate increasingly objectionable forms of avoidance. Lord Walker of Gestingthorpe, in an unpublished paper presented after the decision in the case WT Ramsay Ltd v Inland Revenue Commissioners (1982) AC300 attempted to produce a taxonomy (Evans, 2006) of the anatomy of avoidance activity which describes its essence and the form it takes. He identified seven types of avoidance which proceed from the simple to the complex and from the least objectionable to the most objectionable. These are:

1 using a relief;
2 finding a gap;
3 exploiting (or abusing) a relief;
4 anti-avoidance karate (by which taxpayers are able to turn anti-avoidance provisions to their own advantage);
5 unnatural assets or transactions
6 pre-ordained transactions; and
7 dodgy offshore schemes.

3.2.1 Using a relief

Evans argues (2006) (and notes that Lord Walker readily concurs with the view) that making use of an express relief is not avoidance at all and that it falls within tax mitigation. This may be the case, but the revenue authorities of various countries are not always in agreement. The ineffectiveness of the current section 103(1) is, in part, the fault of the SARS and can be ascribed to their somewhat jaundiced historic view of the distinction between tax evasion, tax avoidance and tax planning and in particular their view of what is acceptable and unacceptable avoidance (Arendse, 2006). The ineffectiveness, in part, came about as the SARS persisted in attacking schemes which, although having tax benefits, were commercially sound. For example, in ITC 1636 60 SATC 267 (commonly referred to as the Tycon case) the arrangement did not involve an elaborate or contrived scheme, but simply a finance leasing company taking advantage of a fiscally afforded lease, giving rise to capital allowances. The SARS attacked the arrangement despite the lack of abnormality (sale-and-lease-back arrangements being fairly common) and despite a clear non-tax motivated purpose.

As the courts in certain instances have been forced to justify their decisions in finding in favour of the taxpayer, over time they have effectively narrowed the ambit of the section. This could have been avoided had the SARS restricted the application of section 103(1) to instances where tax avoidance was blatant. Had this been the case the courts may very well have interpreted the provisions of the section more widely resulting in greater application for the SARS (Arendse, 2006).

3.2.2 Finding a gap

'Gaps' often arise in tax legislation through legislative amendments which are passed with little thought given to the consequences. One such recent amendment which prompted accounting firm KPMG to package and sell a tax saving opportunity in South Africa was the amendment to section 25D of the Act which forced firms to translate foreign denominated income and expenditure at an average rate of exchange.

The requirement that taxpayers translate foreign exchange gains and losses at an average rate of exchange was completely foreign to South African taxpayers, particularly in view of the fact that generally accepted accounting practice requires companies to translate these gains at the spot rate on the date of the transaction. It is presumed that the legislation was amended to translation at an average rate to allow the SARS to more accurately project revenue collections, particularly as the amendment was made in the year 2000 when the local exchange rate had fluctuated significantly against other currencies.

KPMG although slow to identify the tax saving opportunities afforded by such a legislative requirement was nevertheless the first of all the accounting firms to identify the savings potential and marketed the potential savings aggressively. Engagements were taken on a risk basis with the standard fee clause of twenty-five percent savings identified payable to KPMG. Essentially the scheme involved all the foreign denominated purchases and sales of a taxpayer being run against a database of published exchange rates by nine reputable banks in South Africa. As the legislation allowed for six different ways in calculating the Rand amount (simple or weighted daily, weekly or monthly rate), fifty-four possible permutations were achieved of which the most favourable was selected. By way of example, a company with a $500 million turnover in foreign sales transactions that reported R3 billion for accounting purposes would only report R2.5 billion for tax purposes.

The translation of foreign denominated income and expenditure at an average rate of exchange was recently amended bringing to an end any further possible savings. The amending legislation again requires that companies use the ruling spot rate on the date of the transaction and accordingly is in conformity with generally accepted accounting practice.

3.2.3 Exploiting or abusing a relief and anti-avoidance karate

A very good example of the abuse of a relief and anti-avoidance karate took place recently in South Africa and saw the loss of billions of Rands in revenue to the fiscus.

The avoidance technique relied on the non-discrimination clause in double tax agreements which culminated in amending legislation being passed as an act of emergency by Parliament.

Secondary tax on companies (*hereinafter*, "STC") is charged at the rate of 12.5 percent on dividends declared net of dividends received. To allow groups of companies to transfer profits within the group, legislation has provided in terms of section 64B(5)(f) of the Act that, at the election of the company declaring the dividend, no STC is payable by the company declaring the dividend, but that the recipient shareholder company cannot then deduct the dividend when calculating its net STC liability when the dividend is on-declared. In the past, in order for the exemption to apply the shareholder company had to have its place of effective management in South Africa and at least 90 percent of its profits had to be from a South African source. In 2002 amending legislation was passed and in order for companies to be able to elect that the exemption apply the company declaring the dividend and the shareholder had to form part of the same group of companies and the shareholder had to be a resident of South Africa. The requirement that 90 percent of the profits from which the dividend was declared had to be from a South African source still applied. In 2003, however, the requirement was dropped prompting certain advisors to speculate that the provision was in breach of the non-discrimination clauses in the double taxation agreements into which South Africa had entered.

The relevant provisions of these double tax agreements read as follows:

> Enterprises of a contracting state, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected. (OECD, 2005:40)

The SARS have indicated that they will challenge this interpretation in court. In the meanwhile they have amended the exemption so that it now only applies where the shareholder itself is subject to STC should it on-declare any dividend received. According to Ernest Mazansky of Werkmans attorneys (2005) only South African

companies are liable to STC and thus it is not certain whether the amendment is not simply imposing the residence criterion using different words.

3.2.4 Unnatural assets or transactions

A report produced by WorldCom's bankruptcy examiner highlighted a particular scheme which allowed the United States telecom giant to pay reduced taxes on an estimated $20 billion of 'questionable' royalty charges (Sikka et al, 2006). The scheme was based on the creation of an intangible asset in a low tax jurisdiction which the parent company could then license to the various subsidiary companies for exorbitant fees. A problem for WorldCom was that no such intangible asset existed which they could license and charge for across all the subsidiaries. This was not seen to be a problem, however, for the accounting firm which classified the 'foresight of management' among a variety of other trademarks and trade names as intangible assets and for which the accounting firm earned nearly $10 million in fees. As Prem Sikka (2006:11) points out the 'foresight of management' is unlikely ever to satisfy the requirements for capitalisation as, in accounting, for something to be capitalised it must meet a number of tests including severability and the ability to be sold to third parties for cash.

3.2.5 Preordained transactions and dodgy offshore schemes

Generally these two types of avoidance schemes go hand-in-hand. A good example would be a scheme devised by KPMG London to avoid Value-Added Tax ("VAT") on certain gaming and amusement operations in the United Kingdom (Sikka et al, 2006). The basis of the scheme was that the place of supply of the gaming machine services to customers would be shown to be in Guernsey and that the Channel Islands company would be entitled to repayment of input tax on supplies made to it without being liable to any output tax. In order to effect the scheme 83 steps were listed as necessary of which the incorporation of a company in Guernsey, a tax haven, was one. The scheme hinged on the interpretation of certain European Union Directives incorporated into the United Kingdom domestic law and was entered into despite the

fact that the United Kingdom had six hundred employees compared to two full-time and two part-time directors in Guernsey. After implementing the scheme refunds of £6.6 million were claimed which were refused. Both KPMG and the taxpayer took the matter to the European Court of Justice where the European Advocate General declared the avoidance scheme to be 'unacceptable' on the grounds that it would distort competition within the European Union (Sikka et al, 2006:19).

3.3 The anatomy of tax avoidance and SARS

The SARS, in the Discussion Paper, provide their understanding of the "anatomy" (2005a:16) of tax avoidance. The SARS states that, in practice, tax avoidance has four basic goals: (1) the deferral of a tax liability, (2) the conversion of a character of an item, (3) the permanent elimination of a tax liability and (4) the shifting of income from a high tax jurisdiction to a low tax jurisdiction.

3.3.1 The deferral of a tax liability

Johnston (2003) reports that in 2003 two hedge fund managers had in excess of $2 billion each in an untaxed deferral account offshore. Another two each had in excess of $1 billion.

> Deferral, the tax lawyers say, is ninety percent of tax planning. Delay a tax for thirty years and its cost in today's money is almost nothing. Inflation and investing the unpaid tax should cover the whole bill (Johnston, 2003:117).

In the Discussion Paper (2005a) SARS highlights the significant effect which the deferral of a tax liability can have in a high interest environment like South Africa. For example, the present value of a R100 000 liability postponed for ten years is R35 554. The SARS (2005a) likens the net effect to an interest free loan from the government for the duration of the scheme.

3.3.2 The conversion of the character of an item

The conversion of an item from taxable to non-taxable or from non-deductible to deductible is seen as a coup for the tax advisor or financial manager. Such an

arrangement reduces the overall tax burden on the company and lowers the effective tax rate (two of the many possible indicators by which a financial manager's performance may be measured).

One arrangement which was common in the late 1980s in South Africa and which led to the introduction of section 8E to the Act, was the so-called preference share financing scheme arrangement. In terms of the arrangement participants would seek to convert taxable interest income into non-taxable dividend income. The arrangement became a favourite with banks and still exists today, albeit in an amended form.

Another scheme which sought to convert the character of an item, and which proliferated very quickly amongst South Africa's large multi-national corporations, was the so-called cross-border hybrid debt equity instrument arrangement. Under the arrangement South African corporates exploit the different tax treatment of cumulative redeemable preference shares by South Africa and other trading partner countries. For example, in South Africa the law affords no recognition of the fact that certain cumulative redeemable preference shares may in substance be debt. In other countries, however, their law might treat cumulative redeemable preference shares as debt. In such countries any preference dividend paid would be re-characterised as interest for which a deduction would normally be allowed.

South African multi-national corporates took advantage of this different treatment by financing certain of their offshore subsidiary companies (where the foreign law treated cumulative redeemable preference share capital as debt) with preference share capital. As a result the foreign owned subsidiary company would be entitled to an interest deduction on the preference dividend paid whilst in South Africa the amount received would be treated as a non-taxable dividend receipt.

3.3.3 The permanent elimination of a tax liability

The scheme entered into by KPMG (discussed under heading 3.2.2 above) is an example of the permanent elimination of a tax liability. By way of example, a

company with a $500 million turnover in foreign sales transactions that reported R3 billion for accounting purposes would only report R2.5 billion for tax purposes. The balance of R500 million would never be subject to tax and thus R145 million (R500 million multiplied by the standard corporate tax rate of twenty-nine percent) would be permanently eliminated.

3.3.4 The shifting of income from a high tax jurisdiction to a low tax jurisdiction

Possibly the most visible manner in which a company may shift income from a high tax jurisdiction to a low tax jurisdiction is through transfer pricing or thin capitalisation. The term 'transfer pricing' describes the "*process by which entities set the prices at which they transfer goods or services between each other*" (SARS, 1999:5). A more comprehensive definition is afforded by Arnold and McIntyre (Olivier et al, 2005:399) who define 'transfer pricing' as follows:

> A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo organized in Country B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons.

Transfer pricing is fundamental to any multinational company as the prices set by these corporations impacts directly on the amount of profit the multinational makes in each country in which it operates. Similarly, as an increasing proportion of international trade is carried out by multinational companies which span many countries, the introduction and policing of transfer pricing is fundamental to the protection of a country's tax base.

South Africa's transfer pricing provisions, contained in section 31 of the Act, require South African companies to trade at arm's length with foreign related parties. The legislation applies where:

- goods and/or services are supplied or acquired in terms of an "international agreement";

- the acquirer is a connected person in relation to the supplier; and
- the goods or services are supplied or acquired at either more or less than what the price would be if the parties were independent persons dealing at arm's length.

Where these conditions are satisfied the Commissioner may, in determining the taxable income of either the acquirer or the supplier, adjust the consideration for the transaction to reflect an arm's length price for the goods or services.

An "international agreement" means, inter alia, a transaction, operation or scheme entered into between:

- a person who is a resident of South Africa; and
- any other person who is not a resident of South Africa,

where one of the parties to the transaction is a "permanent establishment" as defined.

The transfer pricing provisions of section 31 are essentially anti-avoidance provisions. Whilst the general deduction formula does arm the revenue authorities in South Africa with the means to attack expenditure which is grossly excessive, it is limited in application as it only applies to expenditure and does not provide for an adequate adjustment mechanism (Olivier et al, 2005). The general anti-avoidance provisions contained in section 80A to 80L of the Act similarly do not provide for an adequate adjustment mechanism where transfer pricing is evident. Further, the provisions of section 80A to 80L may only be applied where there is a tax avoidance 'purpose'. Notwithstanding these limitations, Practice Note No. 7 states (SARS, 1999) that an application of the transfer pricing provisions of section 31 does not limit or exclude the application of the general anti-avoidance provisions.

By way of example, if an excessive amount is charged for the cross-border supply of goods from one connected person to another, a disproportionate amount of income will be received by the seller country (disproportionate in terms of its economic

contribution) and a disproportionate expense will be incurred by the purchasing country. The transfer price set impacts directly on the taxable income of both the seller and purchaser. Where the seller company is located in a low tax jurisdiction and the purchaser in a high tax jurisdiction, tangible fiscal benefits may be derived by the multinational company at the expense of the participating countries.

Set out below is the numerical equivalent of the above example:

ACo and BCo are subsidiaries of XCo and together form part of a multinational group of companies.

ACo operates in Country A and produces kitchen sinks which it sells wholesale both to third parties in Country A and to a foreign connected affiliate, BCo in Country B. Country A has a corporate statutory tax rate of 30% whereas country B has a corporate statutory tax rate of 10%.

ACo sells kitchen sinks to third party retailers in its domestic market for R800 per sink. The marginal cost of production is R270 per sink and accordingly the marginal gross profit per sink is R530. After deducting fixed costs the net profit per sink amounts to R400. The tax liability per sink is calculated at R400 * 30% = R120.

3.3.4.1 Scenario 1

Similarly ACo sells kitchen sinks to its connected foreign affiliate retailer, BCo. ACo, however, charges BCo R400 per sink. After deducting the marginal costs of production together with the allocated fixed costs ACo breaks even on its sales to BCo. The tax liability (per sink exported) in country A amounts to nil.

BCo retails the sinks it purchases from ACo for R1000 per sink. Each sink contributes R500 to the net profit of BCo (R1000 – R400 [cost of each sink from ACo] – R100 [fixed costs] = R400]). The tax liability per sink in country B amounts to R500 * 10% = R50.

As is evident from a group perspective the total tax charge incurred by company A and company B on the sale of kitchen sinks in country B amounts to R50.

3.3.4.2 Scenario 2

Contrast the above with the position had ACo sold its product to BCo for the price ACo sells sinks within its domestic market. In this scenario, ACo would sell to its foreign connected affiliate for R800 per sink.

ACo would no longer simply break even on its sales to BCo, but instead would generate a profit of R400 per sink. The tax liability per sink is calculated at R400 * 30% = R120.

BCo would acquire the sink for R800 and would sell it for R1000 within its domestic market, country B. Each sink would now contribute only R100 to the taxable income of BCo (R1000 – R800 – R100 = R100). The tax liability per sink in country B now amounts to R100 * 10% = R10.

Under scenario 2, the total tax charge incurred by company A and company B (from a group perspective) on the sale of kitchen sinks in country B amounts to R130.

Faced with a group tax charge of R130 as opposed to a group tax charge of R50 there is strong financial motivation for XCo to manipulate the prices which ACo charges BCo to achieve the best possible outcome from a group perspective.

It is this type of arrangement that section 31 is designed to combat.

3.4 Impermissible avoidance

The SARS (2005a:19) describes impermissible avoidance as, "*an attempt to defer or eliminate a potential liability by manipulating or exploiting perceived 'inconsistencies' or 'discontinuities' in the tax system through various 'tax arbitrage' techniques.*"

The SARS further notes (2005a:4) that the term impermissible avoidance refers generally to "*artificial or contrived arrangements, with little or no 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 the Interim Response the SARS states that the term 'impermissible' was chosen because "*it was in keeping with the plain meaning of the language and the case law under section 103.*" In Smith v CIR1964 (1) SA 324(A), 26 SATC 1 (at p.14) Steyn CJ stated as follows:

> In so far as the exaction of tax in such circumstances may be said to be something in the nature of a penalty for entering into or carrying out such a transaction, operation or scheme, it would not be a penalty designed to exceed the amount by which the taxpayer would otherwise have enriched himself by outwitting the fiscus, and the means by which he would have done so may, because of its abnormal features, well be described as *not permissible* in the contest between the taxpayer and the tax-gatherer. [Emphasis added]

In choosing the word, 'impermissible' the SARS, it is submitted, is waging a clever psychological war with taxpayers. Tax advisors also took the same view and blamed the SARS for "*accusing the hardworking taxpayer of something that they perceive to be impermissible when Parliament has never legislated against it.*" (SARS, 2006a:4). It seems the SARS is seeking to make a shift from the previous simple dstinction of illegal tax evasion, legal, but arguably irresponsible tax avoidance and legally and morally acceptable tax planning. Through the inclusion of the word 'impermissible' the SARS over time will engender the thought in taxpayers' minds that tax avoidance is impermissible.

It is submitted that the true meaning of 'impermissible avoidance' is an avoidance arrangement which contravenes the provisions of the GAAR. To the extent to which an avoidance arrangement contravenes the provisions of the GAAR it may be set aside by the Commissioner. Support is found for this meaning in the Interim Response to the Discussion Paper (2006a) where the SARS states, "*it is hard to see how a scheme that contravenes section 103 could be considered anything other than*

impermissible tax avoidance". Further, the proposed new General Anti-Avoidance Rule begins with, "*An avoidance arrangement is an impermissible avoidance arrangement if...*".

Should 'impermissible avoidance' exist only to the extent that one contravenes the GAAR, those schemes which satisfy the above definitions of avoidance, but which do not fall foul of the GAAR may be termed 'permissible avoidance' schemes. Importantly, whilst such avoidance may be permissible in terms of the law, the SARS will still view such avoidance as impermissible avoidance should it bring about, in their eyes, an unintended result.

3.5 Abusive / aggressive avoidance

Abusive avoidance may be found in the most aggressive avoidance schemes (SARS, 2005a). Many aggressive schemes share a number of common characteristics which the Australian authorities term the "hallmarks" or "badges" of avoidance. These common characteristics include (SARS, 2005a:19):

1 the lack of economic substance;
2 the use of tax-indifferent or accommodating parties or special purpose vehicles;
3 unnecessary steps and complexity;
4 inconsistent treatment for tax and financial accounting purposes;
5 high transaction costs; and
6 fee variation clauses or contingent fee provisions.

In the Discussion Paper (2005a:19) the SARS states that those schemes which posses "*most, if not all*" of these features will be deemed to be abusive avoidance schemes. Thus for an avoidance arrangement to considered to be an aggressive or abusive avoidance arrangement it must include most, if not all of the above "hallmarks".

It is important to note that an arrangement may be an impermissible arrangement (in terms of the SARS' understanding) and an abusive arrangement (in that it includes

most, if not all of the above "hallmarks"), but still may not be set aside in that it does not satisfy the relevant anti-avoidance provisions contained in the recently enacted sections 80A to 80L.

Whilst the SARS is correct in their view that many tax avoidance arrangements include one or more of the above characteristics, it is important for taxpayers to note that their inclusion is not necessarily indicative of either an avoidance arrangement or an abusive avoidance arrangement. Many everyday routine arrangements include elements of the characteristics in one form or another.

3.5.1 The lack of economic substance

The SARS (2005a:20) states that a lack of economic substance is one of the most important characteristics of abusive avoidance schemes. One should remember, however, that many taxpayers structure their transactions to take advantage of perceived anomalies in the Act (Arendse, 2006). For example, interest incurred on loans to acquire shares may not be deducted whilst interest incurred on loans to acquire the underlying assets may. The SARS (2005a) describes in great detail and with great resentment the *bare dominium* schemes which taxpayers entered into forgetting that the very reason why taxpayers entered into such schemes was to obtain a write-off against commercial properties acquired.

Many arrangements entered into which lack economic substance are aimed at introducing a type of limited group taxation, something which the South African tax legislation sorely lacks. Similarly, many family-owned companies may enter into an arrangement which makes no financial sense, but which is motivated by other non-economic considerations. These types of transactions too would have little or no economic substance and typically would not be held to be abusive.

Schemes entered into which lack economic substance need to be assessed in light of the above and what the scheme ultimately seeks to achieve. However unfavourably the SARS views the arrangement it cannot be held to be abusive if it brings about an equitable result for both the taxpayer and the fiscus.

3.5.2 The use of tax-indifferent or accommodating parties or special purpose vehicles

Tax-indifferent or accommodating parties are often an accomplice in an avoidance arrangement. Lord Diplock in IRC v Burmah Oil Co. Ltd [1982] STC 30 (HL) (at p.32) observed: "*The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years...involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single mastermind.*"

Special Purpose Vehicles are such a regular part of finance that they cannot be held to be indicative of abusive avoidance simply by their inclusion in an arrangement. Rather, their abusiveness and hence their inclusion should be measured in terms of the function they perform. Where a Special Purpose Vehicle's function is solely to act as a tax-indifferent or accommodating party with a view to obtaining a tax benefit, its inclusion may be indicative of an abusive avoidance arrangement. The extent of any abusiveness needs to be measured in light of the quantum of benefit obtained and whether any other indictors of abusiveness are present.

3.5.3 Unnecessary steps and complexity

To claim that an avoidance arrangement is an abusive avoidance arrangement simply through the inclusion of unnecessary steps or complexity is absurd. Where, however, the inclusion of the unnecessary steps or complexity is a result of an attempt to inject a credible business purpose or an attempt to mislead the authorities, then the scheme may clearly be abusive. Any ultimate decision on the nature of the scheme would rest on the quantum of the saving and the presence of other indicators.

3.5.4 Inconsistent treatment for tax and financial accounting purposes

It is not clearly understood why the SARS included this as an indicator of an abusive avoidance arrangement. Generally the tax and accounting treatment of an item are similar, but may not necessarily be the same as the treatment of a transaction for financial accounting purposes is governed by International Financial Reporting

Standards whereas the treatment for tax purposes is governed by the South African Income Tax Act.

International Accounting Standard 12 covers the accounting treatment of deferred taxes. Deferred tax arises as a result of the difference in the accounting and tax treatment of an item. It is difficult to see how an avoidance arrangement can be characterised as an abusive avoidance arrangement simply through the inconsistent treatment of an item for tax and financial accounting purposes.

In ITC 1636 60 SATC 267 the court went into detail regarding the legal principles related to disguised transactions in the context of sale and lease back transactions. The court also had an opportunity to consider the accounting treatment of the sale and leaseback transaction which is normally treated as a finance lease. In its conclusion the court held that the accounting treatment used to record an arrangement is not decisive in the determination of the substance or otherwise of the arrangement:

> In short that explanation was that from an accounting point of view the transactions had the same effect as a loan, i.e. when regard is had to the economic substance. Whether or not their legal substance was that of a loan would have to depend on not only their economic substance but also all the other relevant circumstances viewed in their entirety. In our view therefore the manner in which the financial statements were drawn does not, and cannot, found any adverse influence against appellant. ITC 1636 60 SATC 267

3.5.5 High transaction costs

High transaction costs are a common feature of tax mitigation and avoidance arrangements. Such costs are inevitable given the level of technical competency, knowledge and skill required to navigate the complexity of the growing tax legislation. An American judge, Mr. Justice Story, wrote over a hundred and sixty years ago (Kerr, 2002):

> The mass of law is...accumulating with an almost incredible rapidity...It is impossible not to look without some discouragement upon the ponderous volumes which the next half century will add to the groaning shelves of our jurists.

As in 3.4.4 above, it is uncertain, in this author's opinion, why the SARS included high transaction costs as an indicator of abusive avoidance. A more appropriate indicator, it is submitted, would be fee variation clauses, as set out below.

3.5.6 Fee variation clauses or contingent fee provisions

Fee variation clauses are, it is submitted, a strong indicator of an aggressive or abusive avoidance arrangement. Fee variation clauses are typically used by banks in structured finance arrangements and provide that if the arrangement is successfully challenged by the SARS certain agreed rates will be reset to market. The clause provides protection to the bank should the arrangement be set aside.

Whilst a strong indicator of an abusive avoidance arrangement, the inclusion of a fee variation clause does not provide conclusive proof that an avoidance arrangement is an abusive avoidance arrangement. In today's complex business world it is prudent for parties to an arrangement to include a fee variation clause should certain unforeseen circumstances arise, one such circumstance being a successful challenge by the SARS.

Contingent arrangements are also an indicator that an avoidance arrangement may be an abusive avoidance arrangement, but to a lesser extent than fee variation clauses. A contingent fee is one where the size of the fee depends on the size of the tax benefit generated (SARS, 2005a).

3.6 Corporate Social Responsibility and its relationship with tax avoidance

Corporate Social Responsibility (*hereinafter*, "CSR") is a relatively new field that has united a variety of campaigning groups, including environmentalists, poverty campaigners, charities, unions and minority groups in a collective call for business to support their agenda (Teather, 2003). The merits surrounding CSR can lead to a protracted and heated debate. Regardless of the merits or lack thereof of CSR there is no doubt that the business case for responsible tax within the context of CSR is an

emerging issue (Baker, 2006). Monitored press mentions of tax and CSR within the United States have risen steadily over the last five years, from just over 20 in 2000 to around 100 in 2005 (Baker, 2006).

CSR proponents make their case for CSR and responsible tax through the fact that corporate tax payments are the largest and most obvious contributions by firms to non-shareholders and non-employees (Desai et al, 2006). Their reasoning can be summed up as follows: "*...payment of one's dues is a social obligation. If that is true, then surely failing to pay one's tax dues must be socially irresponsible. Moreover, arranging affairs to so as to minimise or eliminate those dues must also be socially irresponsible.*" (Swinson, 2004:26).

Hardline proponents of tax responsibility within CSR, such as Pravin Gordhan, the Commissioner for the SARS, believe that CSR indices should take into account the extent of a company's unwillingness to pay tax as a sign of irresponsibility that should be set against and may outweigh all of the methods by which a business might otherwise demonstrate responsibility (Swinson, 2004). The outcome of such a negative rating (it is envisaged) would impact on the reputational risk of the company arising from negative press coverage of the company's approach to tax planning, regime risk, with the risk of litigation (or tax audits, themselves a costly exercise) from the country's tax authorities increasing as well as business risk, such as the loss of government contracts (Baker, 2006).

According to Baker (2006), companies have already begun to make general statements within their CSR reports as to the amounts of tax they pay. Disclosure, however, has been fraught with difficulty and has been vigorously resisted by companies, many of them the leaders in their fields. A thinktank (consultancy), *Sustainability*, recently released a publication termed "Taxing issues: Responsible business and tax" (Baker, 2006:1). In it they propose a number of arguments following a comprehensive literature review: firstly, that there is a business case for responsible tax practices, secondly that key principles should underpin the tax agenda,

namely accountability, transparency and consistency and thirdly that there are five levels in the ways in which companies report on their approach to tax, ranging from 'compliance' to 'integrated'. At the media release of their findings, *Sustainability* stated that there was widespread resistance to their findings, with many companies believing the issue should not be raised at all (Baker, 2006:1).

A significant problem in practising responsible tax within CSR is the spectrum of approaches to tax planning. As Baker (2006) states, on the one hand there is evasion and the other avoidance. Avoidance, Sustainability claim is technically legal, but arguably irresponsible. Within the category of avoidance itself *Sustainability* claims there is blurred boundary between irresponsible and responsible. When one crosses this divide one ends up in tax mitigation, a perfectly legal and responsible form of tax planning (Baker, 2006).

There is no doubt that financial managers and directors will vigorously oppose paying more tax than they are legally obliged to do. Tax is a cost of doing business or earning income and as such it is legitimate to expect business to minimise its tax cost (Arendse, 2006). Only in the event that a very clear business case is presented for the company itself will taxpayer behaviour change. This is unlikely to happen for some time either following comments from respected academics such as David Vogel, a University of California, Berkeley professor who in his publication "The market for virtue: The Potential and Limits of Corporate Social Responsibility" argued that there is no clear evidence that corporate social responsibility initiatives help the bottom line or lead to higher stock prices (Entine, 2006). KPMG London, following a symposium hosted and attended by representatives of its firm, academics, multi-nationals and Her Majesty's Revenue and Customs ("HMRC") officials, suggested that tax avoidance may not damage a corporate's reputation, but may in fact even enhance it (Hawkes, 2006). This remark prompted outrage from Dave Harnett, director general of HMRC who responded by saying that, "*Involvement with tax avoidance increasingly poses reputational risk for business which is why so many are now putting tax on their boardroom agendas.*" (Hawkes, 2006:1).

In South Africa, Trevor Manuel, has emphasised corporate accountability many times, not only to shareholders, but to the nation at large (Hamlyn, 2006). Manuel explains that the need for more complex anti-avoidance legislation has arisen partly due to his pleas falling on deaf ears. He also mentions that as a direct result of government action, the culmination if which is the new avoidance legislation, equity will be achieved amongst taxpayers (Ensor, 2006).

Baker (2006) makes the point that although tax responsibility within CSR has a long way to go, it has established a basic tenet that legality in itself is not enough and that clear reputational risks may arise for irresponsible firms. It appears, now more than ever, that firms need a clear idea of the distinction between simple avoidance and abusive or aggressive avoidance, as presumably the line between responsibility and irresponsibility lies somewhere in between.

3.7 Is paying less tax unjust?

Many articles which discuss the fairness or otherwise of tax avoidance use the words, "fair" / "unfair", "just"/ "unjust", "moral" / "immoral" and "patriotic" / "unpatriotic" interchangeably. In fact these words all have different meanings each of which requires separate discussion under the topic of tax avoidance.

The Compact Oxford Dictionary (Soanes, 2002) defines "fair" as "*just, unbiased, equitable, legitimate, above-board, according to the rules, equal conditions for all*"; "just" as "*equitable, fair, deserved*"; "moral" as "*concerned with character or disposition, or with the distinction between right and wrong, virtuous as regards general conduct*" and "patriot" as "*one who defends or is zealous for his country's freedom or rights*".

An argument on the justification for avoidance usually begins with the question, "is paying less tax unjust / unfair. At some point, however, the author will make a crossover (either through ignorance or by design) to the question of morality and at

some point will slip in a quote or two, normally that of Lord Tomlin in the now notorious (or acclaimed, depending which side you align yourself with) United Kingdom House of Lords case, IRC v. Duke of Westminster (1936) 19 TC 490, AC 1 (*hereinafter*, "IRC v Duke of Westminster"):

> Every man is entitled if he so 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.

In the United Kingdom in the 1930s the above quote was put on the back of business cards of those marketing avoidance schemes, to the consternation of the Inland Revenue (Wikipedia Online, 2006).

In Helvering v. Gregory, 69F.2d 809, 13 AFTR. 806 (*hereinafter*, "Helvering v. Gregory") the view expressed by the majority of the judiciary in the United States of America was as follows:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

The mindset of the judiciary expressed in the above cases cannot be considered in isolation. At the time that these decisions were taken the marginal rates of tax imposed on individuals in the United Kingdom and the United States was 98 and 96 percent respectively (Likhovski, 2006). It is no wonder then that the judiciary felt as they did. With the reduction in marginal rates during the 1970s and 1980s the sentiment towards tax avoidance expressed by the judiciary changed radically as will be evident later in the discussion.

> When public concern declines the courts tend to favour the taxpayer. This argument is illustrated by contextualizing the history of the Westminster case. Based on official documents as well as a variety of non-legal sources...reconstructs the administrative, political and social setting in which the case was decided. It shows that public interest in avoidance grew and then declined between the early 1920s and the mid-1930s...In the immediate period before the case was decided in 1935 the

> public (though not professionals) took little interest in the issue of tax avoidance. This together with the traditional reluctance of British courts to intervene in matters of taxation, was one of the factors that led the law lords to reach a pro-taxpayer result in the Westminster case. (Likhovski, 2006:1).

The question, "is paying less tax unfair or unjust?" requires one to look at the underlying principles of taxation. Adam Smith, often referred to as the "Father of Economics", propounded four maxims of taxation in his famous work, the Wealth of Nations (Taxpayer, 1954). One of the maxims advanced by Smith (Taxpayer, 1954) was that tax should be fair, or as far as possible equitable. In Smith's view in order for taxation to be justified (just) it had to be fair not only in respect of the burden to placed on one taxpayer as against the other, but in the weight of the burden – i.e. by not being excessive given the circumstances. Kaufmann explains (Taxpayer, 1954) that taxation must be imposed in accordance with the rules of distributive justice by which he meant that in order for taxation to be fair it must take into account the general benefit which taxpayers receive from Government as well as certain special benefits which only some receive. In particular Kauffman explains that the taxation must take into account not only the taxable capacity of the country as a whole, but those of each separate class or family, "*it must take into account the taxable capacity as a whole as well as the taxable capacity of the parts*" (Taxpayer, 1954:15).

The notion of 'taxable capacity' which is fundamental to a fair and equitable tax system is also known as taxation according to ability or faculty (Taxpayer, 1954). Essentially this system taxes in a progressive manner based on the theory of marginal value and the limitation of human wants (Taxpayer, 1954).

Based on the principles underlying modern taxation, namely fairness and equity, which is achieved through distributive justice and taxation according to ability or faculty, there clearly is a problem when a class of taxpayer consistently pays less than they should. This strikes at the very heart of the foundation of the system of taxation and simply is unfair. The United Kingdom publication, Sunday Times, recently published an article in conjunction with Grant Thornton, a firm of Chartered Accountants, in which the abuse of Britain's tax laws by a set of billionaires was

highlighted (Tax Research UK, 2005:1). The United Kingdom is the world's second most important tax haven in the world (Braithwaite, 2005). According to Grant Thornton, fifty-four of the world's foremost billionaire's living in the United Kingdom paid income tax of just £14.7 million on their £126 billion combined fortunes, and only a mere handful paid capital gains tax. Further, at least thirty-two of the individual billionaires or family groupings were calculated as having not paid any personal taxes on their accumulated fortunes, apart from VAT and council taxes. The total estimated tax paid by these fabulously wealthy people amounted to a mere 0.14% of their combined income. Despite the dubious quality of the figures calculated the article highlights the gross inequality in the system of taxation in the United Kingdom which allows the very richest of its citizens to escape the liability to tax on their personal fortunes.

Some proponents of tax avoidance, usually the very wealthy, and their tax advisors argue that but for tax avoidance, these extremely wealthy individuals or families would leave the United Kingdom having a major impact on the attractiveness of London to work in (amongst many other reasons put forward) and would accordingly damage the city's reputation as a major financial centre (Tax Research UK, 2005). Despite the attractiveness of this claim, and many others, the Tax Research Institute maintains that these claims are contrived in that capital flight is simply another form of tax avoidance albeit one that is of a far worse kind. In a way then corporate tax avoidance in its current form in the United Kingdom (and for many other countries) is a type of 'better the devil you know than the one you don't'.

There are many other reasons why proponents of avoidance may be wrong (Tax Research UK, 2005) in their claims that tax avoiders contribute in other ways to the fiscus. Continuing with the example of the fifty-four billionaires in London, there is evidence to show that such large concentrations of wealth are contributing to the fantastic rise of property prices in London and the South East of London where the average property price is now well beyond the reach of even many professional people. Disparities in wealth have a serious impact on perceptions of well-being

amongst the population and create the impression that paying tax is an option they can choose to make (Tax Research UK, 2005:2). Paul Kaihla (2000), a specialist Canadian tax advisor, claims that these days people are not only screaming at the tax authorities, but at their own accountants too. According to Paul, the average client, when listening to idle chatter at cocktail parties about the tax coups some investors have made, begin to ask the question, "*why am I paying so much tax? I'd better tell my accountant that he's not being aggressive enough*" (Kaihla, 2000:33).

Indeed, it seems as if many celebrities have been making headlines lately for reasons other than the style of their latest dress. Recently both Mick Jagger and Bono have been taken to task over their tax affairs (New Statesmen, 2006). In the 1970's the Rolling Stones moved their business dealings out of the United Kingdom into the Netherlands. Such a move allowed Mick Jagger today to pay only 1.6 percent tax on earnings of £81 million. Bono took much more of a pounding from the press as a result of his campaigning for the poor. He recently moved his tax affairs from Ireland (a tax haven itself) to the Netherlands, prompting some observers to sarcastically comment that, "*perhaps Bono should mount a new campaign: Make Taxation History*" (New Statesmen, 2006:7).

The simple answer that paying less tax is unfair should, however, be viewed in a narrow sense. In reality the tax law and administrative systems of most countries are not just and equitable. Indeed many tax authorities use the tax system as a political tool for social engineering. In the run up to an election popular tax promises may be made with little or no thought for the consequences. In some countries such as the United States, powerful lobby groups exist which in many ways hold the prospective or incumbent administration in check restricting them from effecting the necessary tax reform badly needed. In the United States the House Ways and Means Committee Chairperson Mr. William M. Thomas recently gave tax avoiders a green light (Thorndike, 2002). Mr Thomas (2002:1) explained his position as follows:

> I'm less inclined to say "you can't do it", than I am to treat it as a symptom, examine the underlying disease...and it's the tax code and its failure to be even minimally

> useful to these folk...and deal with the fact that the U.S. is out of synch with the rest of the world.

According to Thorndike (2002:1) if tax avoidance is a "symptom" of an "underlying disease" then one can hardly blame the "stricken" patients. In keeping with the medical imagery Thorndike suggests somewhat tongue-in-cheek that, "*if an ailing company decamps to Bermuda, we should presumably treat it like a trip to the spa...a tax-advantaged treat to a corporate Baden-Baden.*"

A real cause of concern highlighted by both KPMG and SAICA in the response to the Discussion Paper issued by SARS, was the fact that South African taxpayers (who no doubt are similar in their actions to taxpayers from other countries) often enter into avoidance transactions to make up for shortcomings in the Income Tax Act or for perceived inequities in the Act. For example, there is no group relief in South Africa amongst groups of companies. Also, taxpayers are given very little and in some cases no tax allowances for commercial property[2]. This should be reassessed having regard to the fact that such property is used in the carrying on of a business producing income. The grant of an allowance having regard to the commercial reality would reduce the need for taxpayers to enter into schemes such as the bare dominium schemes (Arendse, 2006). There are countless other examples. In an international context (Olivier et al, 2005), section 9D(2A)(b) provides that where a controlled foreign company ("CFC") produces an assessed loss such assessed loss may not be set off against income received by the South African entity from other trades outside the Republic but has to be carried forward to the immediately succeeding foreign tax year to be set off against future income of the CFC. The effect of this rule is that, as far as income is concerned, there is (effectively) group taxation but not as far as assessed losses are concerned.

Very often, in order to counteract these perceived inequities, taxpayers will structure their transactions in order to bring about, in their eyes, equity (Arendse, 2006). This

[2] At the time of submitting this thesis the Revenue Laws Amendment Bill, 2007 had been released for comment. In terms of the Bill a new section 13*quin* commercial building allowance is proposed.

can also be referred to tax symmetry. In South Africa there are many instances where the treatment of a receipt in the hands of a recipient is not dependent on the expenditure or outlay by the other taxpayer. For example, the expenditure for the purchase of a residential building is not deductible, being expenditure of a capital nature, whilst the receipt by the developer is taxable as income. Accordingly, some transactions are engineered to take advantage of this lack of symmetry.

Tax avoidance, when viewed in light of known inconsistencies and inequities in the Act seems to garner a certain acceptance (Divaris, 2006). Aggressive avoidance on the other hand is seen in a less acceptable light. Perhaps it may be summarised that when paying less tax is as a result of tax avoidance which counters known inconsistencies and inequities in the Act it is to a certain extent fair in that it brings about a just result for the taxpayer. Such inconsistencies and inequities are there for everyone to exploit and by and large an overall consistent and fair result may be achieved. Where tax avoidance brings about a wholly inequitable result, such as in the case of the fifty-four billionaires referred to where the outcome is not a simple result of exploiting inconsistencies and inequities in the said Act, but rather a case of aggressive and abusive avoidance based on stretching the provisions of the law to their utmost so that many would simply not have the appetite for the risk, one may say that an unjust result has been brought about both for the taxpayer and his fellow countrymen.

Whether paying less tax is immoral is a completely different discussion to that of whether paying less tax is unfair. Tax is law and as is often taught across the universities to first year law students - justice is not a measure of the law, but an ideal of the law. An unjust law is nevertheless the law. To give an example, the apartheid laws of South Africa were immoral. Those who chose to ignore the apartheid laws were labelled criminals despite their actions being highly moral. Morality, as defined above, is "*concerned with character or disposition, or with the distinction between right and wrong.*" The courts, when propounding on the acceptability of tax avoidance such as Lord Tomlin's famous dictum in IRC v. Duke of Westminster, are

concerned with the acceptability of tax avoidance in terms of the law. Many authors, with great respect, confuse this distinction and perceive that as the judiciary in their respective country (those men charged with upholding justice) have given their stamp of approval to tax avoidance, this must surely mean that tax avoidance is both legal and morally right. In reality, the decisions on avoidance passed by the judiciary of many countries cannot be viewed in isolation. The judiciary themselves pay taxation and accordingly one must allow for some measure of bias. For example the decisions outlined above in IRC v. Duke of Westminster and in Helvering v. Gregory must be considered in light of the general sentiment expressed by the people of their respective countries at the time that they were made. At that time (circa. late 1930s) the highest marginal rates of tax in Britain and the United States were in excess of ninety percent. Over the period from 1960 to 2000 the United States federal income tax system underwent large changes (Saez, 2003). From 1950 to the early 1960s the statutory top marginal income tax rate was ninety-one percent. Following the Kennedy tax cuts of the 1960s the rate was reduced to seventy percent. During the Reagan administration the top rate was again reduced to fifty percent. In 2003, following various reductions and increases the rate is at thirty-five percent (Saez, 2003). A similar process of reform was undertaken in the United Kingdom and to some extent in South Africa.

It is little cause for surprise that the judiciary in both the United States and the United Kingdom have gradually changed their outlook on tax avoidance. In South Africa, the courts too initially looked favourably on avoidance. Like their American and British counterparts, however, the South African courts have also gradually changed their favourable outlook to one of increasing hostility.

It is difficult to come to a conclusion on whether tax avoidance is immoral. Even among tax practitioners there is no unanimity on the morality or otherwise of tax avoidance. The view most commonly held, however, amongst tax practitioners is that tax avoidance is not immoral at all. The reason being, it is surmised, is because tax practitioners are often far more aware than others how unfair, complex and ridiculous tax rules often are, and they see avoidance in that context (Wikipedia Online, 2006).

Perhaps the morality or otherwise of tax avoidance should be viewed in light of the particular facts of an avoidance arrangement. In an Insider Business Club weekly discussion meeting Damian Wilde, editor-in-chief of AccountancyAge tackled Mike Warburton of HMRC on how one might determine whether an avoidance transaction was overly aggressive. Mike responded by saying that a good test would be to imagine how you would feel a few years later standing in the High Court explaining your actions. If you would feel uncomfortable or embarrassed explaining your actions to the Judge then most likely you should not have entered into the arrangement (Wilde, 2006). Perhaps this 'conscience test' as described by Mike Warburton could similarly be used as a type of litmus test for the morality or otherwise of a tax avoidance scheme.

In a recent symposium held by KPMG, London and attended by representatives from academia, multinationals and officials from Treasury and HMRC, it was suggested that debating tax avoidance on the level of morality rather than legality may run the risk of encouraging avoidance amongst those who disagree with the way taxes are spent (Hawkes, 2006). In South Africa, where the overwhelming majority have poor access to education and medical care, this could be a cause for concern. "*If you claim that tax avoidance is unpatriotic and immoral, this is presumably based on the use to which the money would [otherwise] be put.*" (Rick Raubenheimer, director of Megaplex in a direct response to Pravin Gordhan's claim that tax avoidance is unpatriotic and immoral) (Raubenheimer, 2006). Even those taxpayers who have the best education and access to private healthcare may have cause to disagree with the way in which their taxes are spent as currently in South African there are serious concerns over the high rate of violent crime, the high rate of corruption and the poor investment into infrastructure such as roads. In the UK case of Cheney v Conn (1968) All ER 779, an individual objected to paying tax that, in part, would be used to procure nuclear arms in unlawful contravention, he contended, of the Geneva Convention. His claim was dismissed, the Judge ruling that "*What the [taxation] statute itself enacts cannot be unlawful, because what the statute says and provides is itself the law, and the highest form of law that is known in this country.*"

Rick Raubenheimer's remark, while suited to determining the morality or otherwise of tax avoidance, perhaps provides more insight into whether tax avoidance is unpatriotic. A "patriot' is defined as "*one who defends or is zealous for his country's freedom or rights*", or more simply as "*one who loves his country and is prepared to defend its interests.*" (Soanes, 2002:648). South Africa has a substantial development agenda (SARS, 2004) with large amounts of money targeted at the development of infrastructure such as transport and housing. Simply put, tax avoidance, to the extent that it undermines the government's ability to deliver is unpatriotic. This is, however, a very simple view of the debate. For example, a country's right to tax income on a residence basis of taxation stems from a connection or nexus between the taxpayer and the country (Olivier et al, 2005). As the taxpayer enjoys the freedom and protection of the country within which he resides a nexus exists between the taxpayer and the country. The right of a country to tax, however, isn't reduced proportionately based on the level of crime in a country which one is subjected to or the level of protection which a country can afford its citizens. Such measures are absolute not progressive which means that citizens may perceive that a country is failing in its obligations despite their commitment to paying their taxes in full. This may prompt taxpayers to reduce their tax burden through avoidance or evasion without any qualms. Rather cynically taxpayers may love their country depending on how much their country 'loves' them. Put another way, tax productivity – how much a taxpayer receives for each Rand of tax spend – may be a factor in determining the patriotism or otherwise of taxpayers, or as Rick Raubenheimer puts it, whether tax avoidance may be viewed as unpatriotic depends on the use to which the money would otherwise be put.

3.8 Attitude of the courts to tax avoidance

The following extracts from various cases seek to indicate the change in attitude by the various courts:

> No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or his property as to enable the Inland Revenue to

> put the largest possible shovel into his stores. Lord Clyde in Ayrshire Pullman Motor Services and Ritchie v. IRC (1929) 14 TC 75

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. Lord Tomlin, in the UK House of Lords case, IRC v. Duke of Westminster (1936) 19 TC 490, [1936] AC 1

> It is trite law that his Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure if, having considered the lines drawn by the Legislature for the imposition of taxes, they make it their business to walk outside of them. Viscount Sumner in Levene v. IRC 1928 AC 217

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Helvering v. Gregory, 69 F.2d 809, 13 A.F.T.R. 806 (2d Cir. 1934), aff'd. 293 U.S. 465 (1935)

Contrast the above four cases with the following:

> That principle cannot be used as a shield behind which a taxpayer can shelter when he has entered into an abnormal transaction in order to avoid his tax liability. Judge Tebbut in ITC 1606 1995 (58) SATC 328

> In common with my predecessors I regard tax avoidance schemes of the kind invented and implemented in the present case as no better than attempts to cheat the Revenue. Lord Templeman in IRC v Fitzwilliam (1993) 67 TC (at 756)

Politicians and Revenue Administrators will generally express disapproval of avoidance and categorise it as immoral:

> Promoting improper avoidance to the detriment of the tax base of a developing country with a huge development challenge is unpatriotic and immoral. (The Commissioner for the SARS on STC in the Business Report. March 2006.)

> The difference between tax avoidance and tax evasion is the thickness of a prison wall. (Denis Healy, former UK Chancellor of the Exchequer. (Wikipedia Online)

Regardless of the views of contemporary judges, Revenue administrators and politicians, taxpayers still tend to approve of avoidance regardless of its morality or lack thereof.

> Now of course I am minimising my tax...and if anybody in this country doesn't minimise their tax, they want their heads read (Crikey, 2005:1).
>
> While tax avoidance cannot be celebrated, no-one has the moral standing to say that a business has acted wrongly if it acts within the law to reduce its tax burden. (Richard Baron, head of taxation at the Institute of Directors) (Accountancy, 2006:107).

3.9 Remedies against tax avoidance available to the Commissioner: the specific anti-avoidance sections

In the "contest" between the Revenue services and the taxpayer intent on avoiding tax, Revenue has a powerful armory of weapons, some targeting specific types of schemes or transactions, as well as a general anti-avoidance measure.

Some of the more important specific anti-avoidance sections in the Act are the following:

- The definition of "connected person" in section 1 of the Act and provisions in numerous sections restrict allowances that can be claimed in respect of transactions between connected persons

- Sub-sections 7(3) to 7(10) of section 7prevent the taxpayer from divesting himself of income while retaining some control over the assets from which the income is derived.

- Section 8E which aims to prevent the lending of money in return for non-taxable dividends instead of interest, which is fully taxable, deems certain types of dividend income to be interest and therefore taxable in full.

- Section 23A was introduced to counter "leverage" leasing schemes.

- Section 23D prevents the deduction of excessive allowances claimed on assets acquired from connected persons or lessees who have claimed allowances on these same assets.

- Section 23G places restrictions on sale and leaseback arrangements which make use of the fact that one of the parties is not subject to tax.

- Section 24F curtails the very valuable tax advantages of film schemes.

- Section 24H limits the deductions that may be claimed by limited partners to the amounts for which they are at "risk" thus preventing the use of limited partnerships in order to secure excessive tax advantages.

- Section 24J changes the normal rules relating to the accrual and incurral of interest on certain financial instruments and was introduced to combat the use of such instruments or their use in connection with tax avoidance schemes such as those involving racing syndicates, plantation farming, intellectual property, etc.

- Section 24K deals with the taxation of agreements whereby interest accrues or is incurred on notional capital amounts, to regulate the timing of such accruals and incurrals.

- Section 24L provides for the amounts incurred and accrued in respect of option contracts, in order to regulate the time of incurral and accrual.

This list of the so-called "sniper sections" in the Act is by no means exhaustive, and new "sniper sections" are continuously being added to the Act in the aim of closing any loopholes that may be exploited by the taxpaying public.

3.9.1 Reportable arrangements

The reportable arrangements legislation was previously contained in section 76A of the Act. Following the enactment of the new anti-avoidance provisions (sections 80A to 80L) section 76A was withdrawn and replaced by substantially rewritten provisions housed in Part IIB, chapter III of the Act. The new reportable arrangements legislation is now covered by sections 80M to 80T.

Essentially, the reportable arrangements legislation contains product disclosure and promoter penalty provisions. The legislation is designed to identify exploitation schemes before they have an adverse impact on the fiscus. Emil Brincker of Edward Nathan Sonnenbergs (2006:1) likens the legislation to an "early warning system". He explains that the section is valuable to the SARS as it generally takes the Commissioner three to four years to identify abusive transactions and then many more years to counter them. In countering these transactions, SARS is "closing the gate where the horse has already bolted" (Brinckner, 2006:1).

In their response to the Discussion Paper, SAICA criticise SARS's approach in seeking amendment both to the reportable arrangement provisions and the general anti-avoidance provisions. Instead SAICA recommended that the SARS should first revisit the reportable arrangement provisions before seeking to amend the general anti-avoidance provisions. SAICA stated that in the UK and elsewhere the revenue authorities are achieving success with their equivalent reportable arrangement legislation (Arendse, 2005). In the UK reportable arrangement legislation, termed the Tax Avoidance Disclosure Rules, were introduced by sections 306 to 319 of the Finance Act 2004. By the United Kingdom autumn of 2005 informal statistics released by HMRC indicated approximately 500 to 600 direct tax disclosures and approximately 750 indirect tax exposures (Bond, 2006). These disclosures led to a number of legislated specific anti-avoidance measures (Bond, 2006), a clear indication of the effectiveness of the Tax Avoidance Disclosure Rules.

When first promulgated, section 76A was expected to give rise to a flood of reported arrangements. Under the old legislation, however, the SARS only received fifty-five reported arrangements of which fifty-three were deemed to be vanilla-type arrangements – i.e. standard everyday arrangements with little or no adverse impact to the fiscus (Brinckner, 2006). Brincker (2006) explains that the failure of the legislation is twofold. Failure arises partly because taxpayers are not entering into the types of arrangements envisaged by the SARS and partly because the relevant provisions were not wide enough.

Previously, the reportable arrangement legislation in section 76A provided for the reporting of a transaction if the transaction incorporated a fee-variation clause. A fee-variation clause is one where the fees or interest incurred by one party under the arrangement will depend on the tax treatment of the arrangement. Should the tax treatment differ from that anticipated (i.e. should SARS or the courts set the transaction aside) then the fee would be altered. Section 76A also provided for another category of reportable arrangement, namely preference shares and convertible debt instruments that have a period of less than five years to redemption or conversion to equity. According to Brincker (2006) it was these transactions which were caught by the reportable arrangement provisions and which were deemed to be the plain vanilla type transactions. The withdrawn provisions of section 76A have been reproduced in Annexure D.

In terms of the recently enacted reportable arrangements legislation, now covered by sections 80M to 80T, the extent of reportable arrangements has been substantially increased. The most significant changes are the requirement that all arrangements which display any of the characteristics or characteristics which are substantially similar to those outlined in the new anti-avoidance legislation as lacking commercial substance must be reported, and the introduction of a penalty of up to R1 million for both promoters and participants should they fail to report a reportable arrangement.

Section 80C(2)(b) of the new anti-avoidance legislation deems the inclusion or presence of certain attributes to be indicative of a lack of commercial substance. These attributes are the inclusion or presence of round trip financing, an accommodating or tax indifferent party and elements that have the effect of offsetting or cancelling each other without a substantial change in the economic position in any one or more of the parties. Consequently, should an arrangement include any of the above characteristics or characteristics which are substantially similar to the above then the arrangement will be required to be reported.

In terms of the new reportable arrangements legislation a transaction would also have to be reported if:

- It is disclosed as a loan or financial liability for the purposes of generally accepted accounting practice, but not for purposes of the Income Tax Act;
- It does not result in a reasonable pre-tax profit for any participant;
- If the pre-tax profit is less than the value of the tax benefit, if these amounts are discounted to present value at the first year of assessment; and
- They include preference share transactions and convertible debenture arrangements where redemption or conversion will take place within less than ten years.

Expressly excluded from the reportable arrangement provisions by way of section 80N are vanilla loans, advances or debt agreements, lease agreements, transactions undertaken through a regulated exchange and transactions in participatory interests in a regulated scheme. However, these exclusions only apply if the transaction is undertaken on a stand-alone basis or would have qualified as a stand-alone transaction were it not for a connected arrangement entered into purely for the provision of security and where no tax benefit is obtained by virtue of that security arrangement. The new reportable arrangements legislation has been reproduced in Annexure B.

3.9.2 Substance over form

In South Africa, the GAAR is not the only means which the Commissioner has to attack arrangements. Where transactions are concluded that are not what they purport to be the SARS may treat such transactions as a sham and may tax the parties as if the transactions had not been concluded at all (Arendse, 2006). Based on the common law principles of substance over form, the SARS may set aside transactions where the taxpayer disguises a transaction to give it the appearance of something which it is not intended it to be.

Essentially two principles need to be addressed when considering substance versus form. They are the Label principle and the Simulations/Sham principle. The Label principle states that a court must not simply have regard to what the parties to a transaction have called their agreement, but instead must look at the rights and obligations of an agreement to see what type of agreement exists. For example, if X and Y enter into an agreement that they call a "lease", but the rights and obligations show that the agreement is, in reality, a sale then the court must ignore the label and give effect to the true meaning of the agreement (Honiball, 2005).

Should the parties to an agreement deliberately disguise their transactions they will be acting *in fraudem legis*. This is the case when a contract is signed as a mere formality whilst the actual intention was that the contract would not have the effect as detailed (Broomberg, 1998). When an agreement is deliberately disguised the court will, upon hearing the facts, attempt to determine the true nature of the agreement. It is said the court will disregard the form of the agreement and determine in substance what the parties intended (Broomberg, 1998).

In their response to the Discussion Paper, SAICA highlighted the common law doctrine of substance over form and raised the question whether it was even necessary to revise the general anti-avoidance provisions in light of doctrine (Arendse, 2006:2).

> Where taxpayers have concluded transactions that are not what they purport to be, SARS does not require section 103 to set such transaction aside...where a taxpayer

> seeks to rely on non-disclosure and disguises the transactions to give them the appearance of something that they are not...

The SARS (2006a) did not, however, directly address this question in their Interim Response or in the Revised Proposals other than to say that a robust GAAR is a pre-requisite to a healthy tax system.

3.10 The General anti-avoidance section: sections 80A – 80L

3.10.1 What is a GAAR?

In the Revised Proposals (2006b) the SARS set out the proposed new general anti-avoidance rule (*hereinafter*, "GAAR"). The proposed legislation was included in the Taxation Laws Amendment Bill, No. 33 of 2006 and was promulgated in the Second Revenue Laws Amendment Act, No. 20 of 2006. The effective date of the new legislation, which coincided with the withdrawal of the old GAAR, was 1 November 2006.

The very essence of tax planning is captured by famous dictum of Lord Tomlin in IRC v Duke of Westminster (at p.520) "*every man is entitled to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be.*" A GAAR operates in tension with this notion and imposes limits on the extent to which a taxpayer may arrange his affairs (SARS, 2005a). As a consequence, a GAAR is not a revenue-raising provision, but instead is intended to protect the tax base established by Parliament (SARS, 2005a). In a sense a GAAR represents an all-encompassing provision aimed at curbing the loss of revenue to the fiscus when even the best designed tax legislation fails to cover every possible circumstance that may arise (SARS, 2005a). A GAAR normally involves several basic components required to achieve the intended purpose. Typically these would include the concept of a 'tax benefit'; the notion of 'avoidance'; the taxpayer's subjective mind-set or purpose; the ambit of that purpose in terms of whether it requires tax avoidance to have been the dominant ("main") purpose or only one amongst a number of material purposes; or the degree of shifting of the burden of proof on to the taxpayer (KPMG, 2006:8).

In their Call for Comment (2005a:1) the SARS states that the old general anti-avoidance provisions, set out in the now withdrawn section 103(1) of the Act, proved to be an "ineffective deterrent to the increasingly complex and sophisticated tax 'products' that are being marketed by banks, 'boutique' structured finance firms, multinational accounting firms and law firms". Many practitioners, however, believe that SARS has taken a narrow view of the past general anti-avoidance legislation and has not applied the provisions to any great extent (Arendse, 2006).

3.10.2 The changing provisions of South Africa's general anti avoidance rule

South Africa received its first GAAR in the form of section 90 of the Income Tax Act, No. 31 of 1941. The GAAR was inserted following the decision in Hiddingh v Commissioner of Inland Revenue 1941 AD 111 (*hereinafter*, "Hiddingh"). The fact that it was inserted into the Act immediately following the decision in Hiddingh prompted Watermeyer C.J. to speculate in Commissioner for Inland Revenue v. H. B. King and A. H. King 1947 (2) SA 196 AD (*hereinafter*, "CIR v King") that the section was introduced to curb a taxpayer from avoiding liability to tax by means of assignments of income such as took place in Hiddingh (The Taxpayer, 1959:127).

Section 103(1) was the result of a process of continued refinement to the provisions of the original section 90 as amended as a result of the decisions held in various cases before the courts as well as various commissions of enquiry into the Income Tax Act. By 1959 the provisions of the section had evolved to the point where they were substantially similar to those in effect immediately prior to the deletion of the section, apart from an amendment effected in 1996 which qualified the test of abnormality to the extent that commercial acceptance of an avoidance practice would not defeat the operation of the section (Kolitz, 1999b).

Upon first appearance section 90 read as follows:

> Transactions or operations designed to avoid liability for or reduce amount of tax
>
> 90. Whenever the Commissioner is satisfied that any transaction or operation has been entered into or carried out for the purpose of avoiding liability for the payment of any tax imposed by this Act, or reducing the amount of any such tax, and the amount thereof, may be determined, and the payment of the tax chargeable may be required and enforced, as if the transaction or operation had not been entered into or carried out: Provided that any decision of the Commissioner under this section shall be subject to objection and appeal, and in any proceedings relating thereto, whenever it is proved that the transaction or operation in question would result in the avoidance of liability for the payment of any such tax, or in the reduction of the amount thereof, it shall be presumed, unless the contrary is proved, that the transaction or operation was entered into or carried out for the purpose of avoiding such liability or of reducing such amount.

Section 103(1), following its gradual refinement, read as follows:

> Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.
>
> (1) Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) –
> (a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
> (b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –
> (i) was entered into or carried out –
> (aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and
> (bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
> (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and
> (c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit, the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as the in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.

Section 103(1) differed from the old section 90 in the following respects:

- *including a transaction, operation or scheme involving the alienation of property*

  A transaction involving the alienation of property was expressly included. This amendment, like many of the other amendments to section 90 arose following the outcome of the Second and Final Report of the Committee of Enquiry into the Income Tax Act (U.G. No. 63, 1952:105). In CIR v King Watermeyer C.J. stated as an *obiter dictum*, which was later confirmed by Tindall J.A., Greenberg, J.A., Davis A.J.A and Schreiner J.A. (although in a separate judgement) (The Taxpayer, 1959) that the alienation of an income-producing asset was immune against the application of section 90. Accordingly it is surmised that the Legislator expressly included a transaction involving the alienation of property following the outcome of CIR v King (The Taxpayer, 1959).

- *has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act*

  Not only were avoidance arrangements which resulted in the reduction of an income tax liability expressly included, but also transactions which had the effect of postponing liability for any tax, duty or levy on income. This amendment, included in the substituted section 90 by way of clause 17 of the Income Tax Act 1959, was not included within the proposals of the Second and Final Report of the Committee of Enquiry into the Income Tax Act. Neither was this amendment specifically mentioned in the explanatory Memorandum which accompanied the Income Tax Bill, 1959 (The Taxpayer, 1959).

- *was entered into or carried out in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit*

  Following the amendments to section 90 in 1959 the general anti-avoidance rule remained substantially unchanged until it was amended in 1996. To counter tax avoidance schemes which had been entered into so frequently that they were now commonplace (and thus difficult to attack in the light that the means or manner in

which they were employed or the rights and obligations entered into were rendered normal through widespread use), a business purpose test was introduced (Kolitz, 1999b). It had been known for some time previously that the abnormality requirement in the section was somewhat lacking. In the Report of the Margo Commission in 1987 it was recommended that the abnormality requirement be amended to counter schemes which had become commonplace (Kolitz,1999b). It was only in 1996, however, following the recommendations of the Katz Commission of Enquiry that the business purpose test was introduced at a time when avoidance was perceived to be high, with concerns at the extent of the loss to the fiscus (Kolitz, 1999b).

- *was entered into or carried out in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question, or has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question;*

  Except for the words 'between persons dealing at arm's length', this amendment was suggested in the proposals of the Second and Final Report of the Committee of Enquiry into the Income Tax Act (The Taxpayer, 1959:131). The Report made reference to a comment made by Schreiner J.A. in CIR v King in which he stated that the section in its original provisions was designed to curb avoidance where the Commissioner believed the taxpayer had entered into an abnormal or unnatural situation to the detriment of the fiscus (The Taxpayer, 1959:131).

- *solely or mainly for the purposes of*

In CIR v King Watermeyer C.J. stated, as an *obiter dictum*, that the word 'purpose' included in the then section 90 referred to the sole or dominant purpose and not an incidental purpose only. The Second and Final Report of the Committee of Enquiry into the Income Tax Act (The Taxpayer, 1959:132) recommended that this principle be included in the amended section.

The SARS and National Treasury have increasingly been of the opinion that section 103(1) was no longer able to effectively combat complex and sophisticated schemes which they refer to as *impermissible* and *abusive* avoidance schemes (SARS, 2005b). Accordingly, in November 2005 a Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act was released by the SARS and National Treasury calling for comment on the contents therein. Comments were received from a number of significant stakeholders by 28 February 2006 and an Interim Response to the Discussion Paper on Tax Avoidance and Section 103 of the Income Tax, based on the comments received, was issued by the SARS and National Treasury in March 2006.

Following the Interim Response the SARS issued the Revised Proposals on Tax Avoidance and Section 103 of the Income Tax Act on 13 October 2006, which proposals were included in the Revenue Laws Amendment Bill (No. 33 of 2006). In terms of the Revised Proposals section 103(1) was withdrawn and a new Part IIA inserted into the Act. In their Revised Proposals the SARS notes that many commentators, in response to the Discussion Paper, suggested that the new GAAR be redrafted in a multiple section format. By using shorter sentences and simpler language commentators felt that clarity would be achieved which would otherwise be lost using overly verbose provisions (SARS, 2006b).

As a result the draft provisions were included in the Revenue Laws Amendment Bill (No. 33 of 2006). The new GAAR comprises twelve sections, 80A to 80L. The following is a brief summary of the provisions (reproduced from the Revised Proposals and now enacted in terms of the Revenue Laws Amendment Act, No. 20 of 2006):

Section 80A — **Impermissible avoidance arranagements**. This section provides the basic test for determining whether or not an avoidance arrangement is impermissible. In particular, the section would apply 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". The tainted elements would carry over the current "abnormality" and "non-arms length rights and obligations" provisions and would introduce two new elements that would target avoidance arrangements that lack commercial substance or would frustrate the purpose of any provision(s) of the Act. The section would replace the provisions of section 103(1).

Section 80B **Tax consequences of impermissible avoidance**. This section sets forth the remedies the Commissioner may apply in order to determine the tax consequences to any party of any impermissible avoidance arrangement. It would replace the remedy provisions currently found in section 103(1).

Section 80C **Lack of commercial substance**. This is a new section. It sets forth a basic description of avoidance arrangements that lack commercial substance, as well as a non-exclusive list of characteristics that are indicative of such avoidance arrangements.

Section 80D **Round trip financing**. This provision sets forth a basic description of 'round trip financing'.

Section 80E **Accommodating and tax indifferent parties**. This section provides a basic description of 'accommodating and tax-indifferent parties'. It would replace the definition of 'tax-indifferent party' in section 103(7) of the original proposals.

Section 80F **Treatment of connected persons and accommodating parties**. This section would give the Commissioner the authority to treat parties that are either connected persons in relation to each other or accommodating or tax-indifferent parties in certain ways for purposes of applying proposed

section 80C or determining whether or not a tax benefit exists.

Section 80G — **Presumption of purpose**. This section sets forth a revised presumption that would arise in respect of the purpose of an avoidance arrangement and clarifies and confirms that the purpose of a step in or part of an avoidance arrangement may differ from a purpose attributable to the avoidance arrangement as a whole. It would replace the presumption in respect of purpose currently found in section 103(4).

Section 80H — **Application to steps in or parts of an arrangement**. This section clarifies and confirms that the Commissioner may apply the GAAR to steps in or parts of an arrangement.

Section 80I — **Use in the alternative**. This section clarifies and confirms that the Commissioner may apply the GAAR as an alternative basis for raising an assessment.

Section 80J — **Notice**. This section introduces a new notice requirement in connection with any potential application of the GAAR.

Section 80K — **Interest**. This section carries over the provisions of current section 103(6).

Section 80L — **Definitions**. This section sets forth the definitions of certain terms that are used throughout the GAAR.

The detailed provisions of the GAAR are discussed below and have been reproduced in their entirety in Annexure A.

3.10.3 Impermissible tax avoidance arrangements

80A.

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).

3.10.3.1 An avoidance arrangement is an impermissible avoidance arrangement...

'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 CIR v Meyerowitz 1963 (3) SA 863 (A) the court was faced with the argument that if the transactions were not a preconceived plan and that if there was a lack of continuity between the various operations, the section could not be applied. The court held that the word "scheme" had a wide scope and can be applied if, viewed as a whole, the steps taken are so connected with the other that they lead to an avoidance or reduction in tax. This investigation can take place in retrospect, so that even if it can be shown that when the first transaction was initiated there was no plan, if on retrospective examination all the transactions are sufficiently connected, they can be held to constitute a scheme. Thus a preconceived plan is not required for the section to be applicable.

In CIR v King 1947 (4) SATC 184, the court held that the expectation of a dividend attaching to a share when alienated with the share had to be regarded as an alienation

of capital and not of income. The expectation of a dividend attaching to a share could not for this reason be regarded as income. Accordingly, the court held that such an alienation was not a transaction which had the effect of avoiding liability for the payment of tax. As a result of the decision in this case, the Act was amended to include the express provision of the alienation of property.

3.10.3.2 If its sole or main purpose...

If there are mixed purposes, the main purpose must be clearly the predominant purpose (Davis, 1999). This was recently confirmed in CIR v Bobat 67 SATC 47. In this case the taxpayer contended that a scheme entered into was done so for two purposes, namely the avoidance of estate duty and the "tidying" up of the group. The Court found that each of these "purposes" had been of at least equal significance, with the result that neither was the main purpose as required. Consequently section 103(1) did not apply.

In the Discussion Paper (SARS, 2005a) the SARS argue that since most transactions have at the very least a 'colourable' commercial rationale, the Commissioner is placed in the difficult position of having to disprove a taxpayer's *ipse dixit* through circumstantial evidence. For this reason the SARS in the Discussion Paper (2005a:48) proposed that the purpose requirement be changed from a subjective test to one determined objectively by reference to the relevant facts and circumstances. SARS (2005a:56) stated that it is anticipated and intended that it would be very difficult for a taxpayer to rebut the presumption of a tax avoidance 'purpose' where there is a 'tax effect' and the taxpayer has been unable to rebut the proposed presumption of abnormality. Essentially the SARS were seeking to address the cynical observation made by RC Williams (SARS, 2005a:44):

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

In addition to the proposed change from a subjective to an objective test of purpose, the SARS proposed that the 'sole or main' test be changed to 'sole or one of the main purposes' (2005a:43). KPMG (2006:9), in their response to the Discussion Paper stated that the expression "sole or one of the main purposes" is grammatically impossible. The Shorter Oxford English Dictionary defines "main" as meaning "*chief in size or extent; constituting the bulk; the chief part; of pre-eminent importance; principal, chief, leading*". That is, the term "main" is universally accepted to mean more than fifty percent. KPMG (2006:9) stated that by opening the purpose test to 'sole or one of the main purposes' would place at risk those transactions which are commercially expedient, but which have as a secondary purpose an element of tax efficiency. Such secondary purpose would surely be one of the main reasons for entering into a scheme or transaction. Put another way a company would certainly be loathe to enter into a scheme which is not fiscally efficient. KPMG (2006:9) also drew attention to the purpose test used in the New Zealand GAAR which deals with the purpose requirement in the negative by applying the GAAR only where the tax benefit was something other than an incidental benefit. It would seem that this approach would be more grammatically correct and would make more sense. To this end, KPMG (2006:9) suggested that the purpose requirement be amended as follows:

> Has as its sole or one of its main purposes, the obtaining of a tax benefit "**other than that expressly provided for in the Income Tax Act**".

It seems that other commentators had equal misgivings on the proposed changes to the purpose test (SARS, 2006). SARS states in their Revised Proposals (2006c:21) that many of the commentators expressed concern that the proposed 'objective' purpose requirement might preclude the court from considering a taxpayer's *ipse dixit*. This, the SARS states was never their intention, but rather that the taxpayer's *ipse dixit* be evaluated in light of the relevant facts and circumstances. Accordingly, the SARS amended the proposed change to the purpose requirement to its previous form.

3.10.3.3 Was to obtain a tax benefit...

'Avoidance arrangement' means any arrangement that results in a tax benefit. 'tax benefit' includes any avoidance, postponement or reduction of any liability for tax.

This is a fundamental requirement for the application of the section. If the purpose of the scheme is for something other than tax avoidance then that is the end of any attempt to apply the section. Often the purpose will be commercial, but it is immaterial what the purpose is, so long as it's not the avoidance of tax. In such a case the normality or abnormality of the transaction is also immaterial, since the section cannot be applied unless the purpose requirement is met. The test as to purpose is subjective. In SIR v Gallagher 1978 (2) SA 463 (A) the court rejected an objective test and said:

> ...a subjective test takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme...of prime importance in determining the purpose of the scheme would be the evidence of the respondent, the progenitor of the scheme as to why it was carried out.

The *ipse dixit* of the taxpayer will be evaluated within the context of objective factors to arrive at a conclusion of the true purpose SIR v Geustyn, Forsyth and Joubert 1971(3) SA 567(A).

3.10.3.4 In the context of business 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;

As a result of the amendment to section 103(1) of the Act, a transaction, operation or scheme carried out in the context of business will be liable to attack if it is carried out in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit. This is often referred to as the "business purpose test". This test has been incorporated in the new section 80A of the Act.

This test was introduced to assist the Commissioner in applying the provisions of section 103 when a particular type of scheme is common-place and has gained commercial acceptability (Kolitz, 2000b).

The phrases requiring attention are:

- In the context of business and
- For bona fide business purposes.

Jarvis states that there is no definitive definition of "business" but that there have been several cases dealing with the phrase "carrying on business" (Jarvis, 1996). He refers to the ruling of Judge Beadle in Estate G v CIR 1964 (26) SATC 168 where it was said the sensible approach was to look at the activities as a whole and to ask whether they would be regarded as the sort of activities which in commercial life would be regarded as carrying on business. The principle features of the activities which could be examined in order to determine this are: their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, etc. Jarvis believes that the courts, in interpreting "business context" will follow the same approach.

Judge Melamet in ITC 1529 1991 (54) SATC 252 noted that it was not possible to devise a universal test for "business" and, as such, each case had to be decided on its own merits. He did, however, note that the word "business" is included within the word "trade". "Trade" in the Act, is defined as including every profession, trade, business, employment, calling, occupation or venture, including the letting property and the use of or the grant of permission to use any patent, design, trademark, copyright or similar property. In an unreported judgement of the Transvaal Income Tax Special Court heard in 2000, Justice Cloete stated that when examining the words "in the context of business" and whether or not a taxpayer's transaction can be regarded as normal it must be made clear that the transaction must correspond to a hypothetical model of the "normal transaction". This is devised by asking how

businessmen generally (objective yardstick), with a real business rationale, and without being motivated by any possible tax advantage would have structured a corresponding transaction.

In relation to "bona fide" which is also not defined, Jarvis argues that it probably bears the established judicial interpretation of "good faith". The words indicate that the business purpose must be real and not simulated. The words "business purpose" must mean that if there is a commercial purpose for the transaction such as in CIR v Louw 1983 3 SA 551 (A), 45 SATC 113, (the conversion of a partnership to a company) then the section cannot be applied. The business purpose test must be considered objectively. The presence or absence of a business purpose of the taxpayer is also important in establishing whether subjectively speaking, the taxpayer's sole or main purpose was to obtain a tax benefit.

3.10.4 It lacks commercial substance, in whole or in part, taking into account the provisions of section 80C

80C.

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

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

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

(b) the inclusion or presence of –

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

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

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

The Commercial Substance Element or test was introduced to act as an objective commercial "yardstick" (SARS, 2006c:6). Previously the business purpose test may have failed in that an abusive or aggressive tax-motivated transaction may have been entered into so often that it gained an element of normalcy and opening up the abnormality test to the defence that "everyone is doing it" (SARS, 2006c:6).

The new Commercial Substance Element would then apply, regardless of whether a particular practice had gained commercial expediency.

SARS states (2006c:7) that as a guiding rule, a lack of commercial substance would encompass any avoidance arrangement that fails to have a substantial impact upon any party's business or commercial risks, net cash flows or beneficial ownership of any asset involved in the avoidance arrangement, apart from the obvious tax benefit.

Section 80C introduces four characteristics that are indicative of arrangements that lack commercial substance, namely:

- where the legal effect of the arrangement is inconsistent with the legal form (essentially a codification of the common law substance over form rules);
- where the avoidance arrangement includes or involves
    - round-trip financing;
    - an accommodating or tax indifferent party or
    - elements which have the effect of offsetting or cancelling one another without a substantial change in the economic position of the parties.

The terms 'round-trip financing' and 'accommodating or tax indifferent party' are further defined below.

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

This requirement, which only applies outside a normal business context previously applies in all contexts.

3.10.4.2 In any context it has created rights or obligations that would not normally be created between persons dealing at arm's length

The importance of this test should not be underestimated as it will probably be easier for a taxpayer who enters into a tax avoidance scheme to ensure that the transaction is concluded and executed in a manner normally used for business purposes than it would be to hide abnormal rights and obligations (Van Der Linde, 1997:58). The meaning of arm's length was set out by Trollip JA in Hicklin v CIR 1980 (41) SATC 179:

> It connotes that each party is independent of the other, and in so dealing will strive to get the utmost possible advantage out of the transaction for himself.

Of importance here is the change in the wording previously used. Under the old section 103(1), abnormality had to be determined in relation to a transaction, operation or scheme, of the nature of that in question. Trollip JA in Hicklin v CIR 1980 (41) SATC 179 further stated that:

> What may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances.

The new anti-avoidance section requires that one consider the rights and obligations created *in any context*. This new requirement may be a cause for concern, particularly where taxpayers are connected persons. SAICA (2006:14) in their response to the Discussion Paper stated that the exclusion of the need to have regard to the fact of parties being connected persons when determining whether they are dealing at arm's length, has far-reaching consequences. By way of example SAICA raised the issue of interest free loans between members of a group of companies. According to SAICA (2006:14) such arrangements could now be successfully attacked on the basis that the non-charging of interest results in the avoidance of tax and it is deemed to be carried out by means or in a manner not normally employed for *bona fide* business purpose.

3.10.4.3 In any context it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

In the Revised Proposals the SARS highlighted (2006c:15) that it became increasingly obvious during the commentary period that the original section 103(1) and the revised proposals fell short of international best practice in that they did not have a test or requirement based upon the purpose of the underlying tax laws.

Certainty of the meaning of statue law cannot be taken for granted (The Taxpayer, 1957:28). As a consequence a great number of canons of construction have been developed by the courts over the years. Essentially the interpretation of fiscal statutes intends to determine the intention of the Legislator as expressed in the language of the Act. If, therefore, the language used is clear and intended it cannot be departed from (The Taxpayer, 1957:28). The new anti-avoidance provision would depart from the strict literal approach to a more contextual and purposive approach.

In the Revised Proposals (2006c:15-16) SARS states:

> Throughout the world, tax laws have...increased in both length and complexity in order to cope with this rapidly changing environment. At times, the traditional "literal" approach to the interpretation of tax statutes has exacerbated this problem. As a result, there has been a broad movement towards the so-called "modern" approach to interpretation which requires a "contextual and purposive approach...". The proposed Element is intended to reinforce this emerging trend in South Africa.

Chris Cilliers (The Taxpayer, 2006:55) argues vehemently against an inclusion of the proposed Element in its current form. Cilliers states that the law reports are replete with instances where the courts have shunned a strict literal approach in order to give weight to contextual and purposive factors. By way of example in Stellenbosch Farmers' Winery Limited v Distillers Corporation (SA) Limited and Another, 1962 (1) SA 458 (A) at 476 it was stated:

> ...it is the duty of the Court to read the section of the Act which requires interpretation sensibly, i.e. with due regard, on the one hand, to the meaning or meanings which permitted grammatical usage assigns to the words used in the section in question and, *on the other hand, to the contextual scene, which involves consideration of the language of the rest of the statute as well as the matter of the statute, its apparent scope and purpose, and within limits, its background.* [Emphasis added]

Cilliers (The Taxpayer, 2006:55) states that there are two main ways in which the proposed contextual or purposive Element may be approached. Firstly, he argues the provision could be regarded as a codification of the common law substance over form rules which would essentially render the provision as, what he terms, a 'dead letter', a provision without any substantive effect. Alternatively he claims the provision could be seen to be extending the ambit of the common law which he argues in certain circumstances must be presumed. Should the latter of the two approaches prevail, Cilliers states that it would make the proposed Element 'one of the most draconian provisions imaginable' (The Taxpayer, 2006:55):

> Yet to reiterate what I have already said, under the second approach to section 80A(c)(ii) one would be obliged to go further still, to seek a supposed 'purpose' behind whatever fiscal provision falls to be interpreted, but one which - per definition – a court has already found (or would find) does not inhere in the provision. This is not interpretation; on the contrary it smacks of 'divination'. Such an approach would be completely unacceptable for a variety of reasons. One important reason is that it would undermine the rule of law, which is one of the foundational values of our Constitution.

SAICA (2006:15) also expressed reservations over the inclusion of the new purposive interpretation Element:

> With the purposive interpretation of fiscal statute there is a concern that the new general anti-avoidance rule will shift the power to tax from Parliament to SARS. It is the view of this author that the number of discretions conferred upon the Commissioner: SARS should be as few as possible. By introducing a GAAR, particularly one which requires the purposive interpretation of legislation, SARS will be empowered with greater taxing authority and may seek to tax transactions in any way it sees fit.

The Canadian general anti-avoidance rule[3] (section 245 of the Canadian Income Tax Act ["the CITA"]) incorporates a similar purposive Element or test, the provisions of which came under scrutiny by the Supreme Court of Canada in the recently decided

[3] The application of section 245 of the CITA involves three steps (SARS, 2005a:30). The first step requires that there is a tax benefit, the second step requires that one determine whether the transaction is an avoidance transaction as contemplated under section 245(3) and the third step requires that one determine whether the avoidance transaction is an abusive transaction. In terms of section 245 of the CITA an abusive transaction is one that would result directly or indirectly in a misuse of the provisions of the CITA or an abuse having regard to the provisions of the CITA other than section 245, read as a whole (SARS, 2005a:31).

cases of The Queen v. Canada Trustco Mortgage Co. 2005 SCC 54 and Matthew v. The Queen 2005 SCC 55.

In both cases the Supreme Court stated that abusive avoidance is present where it can reasonably be concluded that allowing a tax benefit would be inconsistent with the object, spirit or purpose of the provisions relied upon by the taxpayer (Smith et al, 2006:40). The Court did not, however, provide guidance on how the object, spirit or purpose should be determined, except to state that one should have regard to "*the scheme of the act, the relevant provisions and permissible extrinsic aids*" (Smith et al, 2006:40). The court also emphasised that the role of the GAAR was not to introduce uncertainty into tax planning, neither was it for the courts to determine the overriding policy of the act. The court also made it clear that the burden of proof of abusive avoidance rests with the Minister.

It remains to be seen how the South African courts will apply the purposive Element or test and it may take years and numerous court decisions before the full impact of the new provisions can be assessed.

3.10.5 Tax consequences of impermissible tax avoidance

80B.

(1) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by -
  (a) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
  (b) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;
  (c) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
  (d) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
  (e) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
  (f) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

(2) Subject to the time limits imposed by section 79, 79A(2)*(a)* and 81(2)*(b)*, the Commissioner must make compensating adjustments that he or she is satisfied are

necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

The above remedy provisions contain both specific remedies (section 80B(1) (a) to (f)) as well as a final general remedy in the event that the specific remedies are not sufficient to neutralise the effect of a particular avoidance arrangement (SARS, 2006c:22). Most notable is that the Commissioner may make adjustments to the tax consequences of any taxpayer party to an impermissible avoidance arrangement (SARS, 2006c:22).

SARS (SARS, 2006c:22) also notes that in certain circumstances the old remedy provisions of section 103 resulted in an inappropriate adjustment. With the all encompassing general remedy provision contained in section 80B(2) the new legislation aims to mitigate any unfair adjustments (SARS, 2006c:22).

3.10.6 Round trip financing

80D.

(1) Round trip financing includes any avoidance arrangement in which -
  (a) funds are transferred between or among the parties (round tripped amounts); and
  (b) the transfer of the funds would -
    (i) result, directly or indirectly, in a tax benefit but for the provisions of this Part; and
    (ii) significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement.

(2) This section applies to any round tripped amounts without regard to -
  (a) whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;
  (b) the timing or sequence in which round tripped amounts are transferred or received; or
  (c) the means by or manner in which round tripped amounts are transferred or received.

(3) For the purposes of this section, the term 'funds' includes any cash, cash equivalents or any right or obligation to receive or pay the same.

In the Revised Proposals (2006c:12) the SARS notes that circular flows of cash are 'well-recognised and well-understood' components of many impermissible avoidance arrangements. Many commentators expressed concern that a simple loan arrangement may fall foul of the round tripping provisions (KPMG, 2006:16, and Arendse, 2006:16). In a simple loan agreement a company may raise finance upon which the interest payments are normally deductible. It could be held then that the transfer of

loan capital from lender to borrower, coupled with the tax benefit in the form of an interest deduction and the subsequent repayment of the loan could fall foul of the round tripping provisions.

The SARS, however, stated (2006c) that the commentators' concerns in these circumstances were displaced. In a typical *bona fide* financing transaction, SARS notes, the proceeds from a loan are invested in the borrower's business and repaid from revenues earned as opposed to simply being re-routed to the lender through one or more accommodating or tax indifferent parties. The provisions SARS notes are analogous to the concept of "round robin financing" used in Australia and "circular cash flows" in the United States (SARS, 2006c:13).

One problem that may also arise is the definition of "cash equivalents", to which the section applies. This would seem to broaden the ambit of the section even further.

3.10.7 Accommodating or tax-indifferent parties

80E.

(1) A party to an avoidance arrangement is an accommodating or tax-indifferent party if -

(a) any amount derived by the party in connection with the avoidance arrangement is either—

(i) not subject to normal tax; or

(ii) significantly offset 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;

(bb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party;

(cc) constituted revenue in the hands of another party would be treated as capital by that other party; or

(dd) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or

(ii) the participation of that party directly or indirectly involves a prepayment by any other party.

(2) A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party.

(3) The provisions of this section do not apply if either -

(a) the amounts derived by the party in question are cumulatively subject to income tax by one or more spheres of government of countries other than the Republic that are subject to tax in another country which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or

(b) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months: Provided these activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment as defined in section 9D(1) if it were located outside the Republic and the party in question were a controlled foreign company.

(4) For the purposes of subsection (3)(a), the amount of tax imposed by another country must be determined after taking into account any applicable agreements for the prevention of double taxation and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

The SARS notes that accommodating or tax indifferent parties are typically used in impermissible avoidance arrangements to, *inter alia*, shift items of gross income from one party to another, to convert the character of amounts from revenue to capital, non-deductible to deductible, or taxable to exempt, or to absorb a prepayment or accelerated payment of expenditure (SARS, 2006c:13).

Certain 'safe harbours' have been included however, in order to limit the application of the provisions. Firstly, the provisions do not apply to a party if the amounts received by that party are subject to tax in another country, provided that the tax in question is equal to at least two-thirds of the normal tax which would have been payable if those amounts had been subject to tax in the Republic (SARS, 2006c:14).

Secondly, the provisions do not apply to a party if that party continues to engage in substantive active trading activities in connection with the avoidance arrangement. These activities must be conducted for a period of at least 18 months and must be attributable to a business establishment (now foreign business establishment), as defined in section 9D(1) (SARS, 2006c:14). Clearly it is the SARS intention to attack those parties which act as a conduit with no substantive trading activities.

3.10.8 Treatment of connected persons and accommodating or tax-indifferent parties

80F.

For the purposes of applying section 80C or determining whether or not a tax benefit exists for purposes of this Part, 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 order to determine whether a tax benefit has arisen for purposes of applying section 80C or section 80E(1)(b), the Commissioner is entitled in terms of section 80F to treat certain persons who are connected persons as the same person. In addition, the Commissioner may also disregard any accommodating or tax-indifferent parties. Set out below is an example extracted from the Revised Proposals setting out the mechanics of section 80F:

> Company X is a holding company. It owns a subsidiary, Company Y, that owns assets that have substantially appreciated and significant taxable income. Company X forms a new subsidiary, Company Z. Company Z then borrows from Bank A ostensibly in order to purchase the assets of Company Y in a section 45 intragroup transaction. Company Y then invests the proceeds of the sale in preference shares issued by a Bank A subsidiary that has a large assessed loss for tax but not financial accounting purposes. The terms of the loan and the preference shares are substantially similar.
>
> In this example, the arrangement would result in a tax benefit in the form of an interest expense deduction, despite the fact that the proceeds are invested in preference shares yielding exempt dividends. Company Y is a tax-indifferent party because the amounts it derives from the avoidance arrangement are not subject to tax and it results in the conversion of a non-deductible expense into one that would be deductible but for the provisions of the new GAAR. In addition, the circular flow of funds from Bank A through Companies Y and Z and back to the Bank A subsidiary constitutes round trip financing, while the substantially similar terms of the loan and preference shares constitute an offsetting element within the arrangement.
>
> Furthermore, for purposes of applying section 80C, the Commissioner may deem Companies Y and Z, who are connected persons in relation to each other, to be a single party. That being the case, the avoidance arrangement would not have a substantial effect upon their business or commercial risks, net cash flow or beneficial ownership of the assets involved in the avoidance arrangement. Accordingly, the avoidance arrangement lacks commercial substance on multiple grounds and constitutes an impermissible avoidance arrangement within the meaning of section 80A.

3.10.9 Presumption of purpose

80G.

(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.

Section 80G creates a rebuttable presumption of purpose. Of particular importance is the fact that the new GAAR confirms that a step in or part of an arrangement may have a purpose different from the overall purpose of the arrangement. Further, although the new GAAR does not require an objective test for the determination of purpose, section 80G(1) requires that the subjective purpose or *ipse dixit* of the taxpayer be considered 'in light of the relevant facts and circumstances' which essentially requires that the courts consider the veracity of the taxpayer's claims in light of objective factors.

3.10.10 Application to steps in or parts of an arrangement

80H.

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

In the Discussion Paper (SARS, 2005a:44) the SARS state that in terms of the old legislation housed under the now withdrawn section 103, taxpayers would argue that following the outcome of the decision in the case CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391, an overall commercial purpose would be sufficient to defend each and every step in the scheme from challenge.

In order to ensure the effectiveness of the new anti-avoidance provisions the SARS saw it as necessary to clarify and confirm that the GAAR may be applied to a step in or parts of an arrangement (SARS, 2006c:21).

3.10.11 Use in the alternative

80I.

The Commissioner may apply the provisions of this Part in the alternative for or in addition to any other basis for raising an assessment.

Section 103(1) previously contained the requirement that the Commissioner may only apply the section to the extent that he was satisfied that the provisions of the section were fulfilled ("*Commissioner's satisfaction*"). Accordingly, many commentators expressed the concern that with the deletion of the phrase "*Commissioner's satisfaction*" the new provisions may automatically apply, particularly in light of the originally proposed presumption of abnormality (SARS, 2006c:18). Many commentators were also concerned that the SARS would apply the new anti-avoidance provisions in the alternative as a "catch-all" (SARS, 2006c:18).

The outcome of the dialogue between the SARS and taxpayers resulted in the withdrawal of the proposed presumption of abnormality with the result that the new provisions cannot be applied automatically. In addition the revised proposals (now promulgated) introduced a new requirement that requires the Commissioner to issue a written notice setting forth the reasons why the Commissioner believes the GAAR to be applicable.

3.11 Conclusion

It is patently clear that the concept, "tax avoidance" is far too complex to reduce to a single, comprehensive definition. In reality the concept is multi-faceted and includes such terms as "abusive avoidance", "aggressive avoidance" and "impermissible avoidance". Even the definitions provided by Lord Templeman in CIR v Challenge Corporation Ltd (1987) AC155 and the Ralph Review of Business Taxation (2005a) are by no means comprehensive and should, it is submitted, be read in conjunction with the overwhelming volume of literature on the subject.

Whilst most authoritative authors, tax practitioners and taxpayers share the same view on the legality of tax avoidance, many differ on the various forms that tax avoidance may take and on the acceptability of each form thereof. Of all stakeholders the SARS

is most vehemently opposed to tax avoidance in any form. As such, it is essential that taxpayers educate themselves on the essence of tax avoidance and the various forms it takes from the simple to the complex and from the least objectionable to the most objectionable so that they will be able to make informed decisions on the underlying risks of transactions undertaken.

Public sentiment on taxpayers entering into tax avoidance arrangements has changed from one of begrudging admiration at the ingenuity of schemes adopted to outright hostility. Revenue departments, non-governmental organisations (such as the Tax Justice Network), etc. have fuelled the fires of public outrage by sensationalising stories where investors have achieved a tax coup. Left unsaid, but certainly implied is that law-abiding taxpayers are left to carry the tax bill of these "errant" taxpayers.

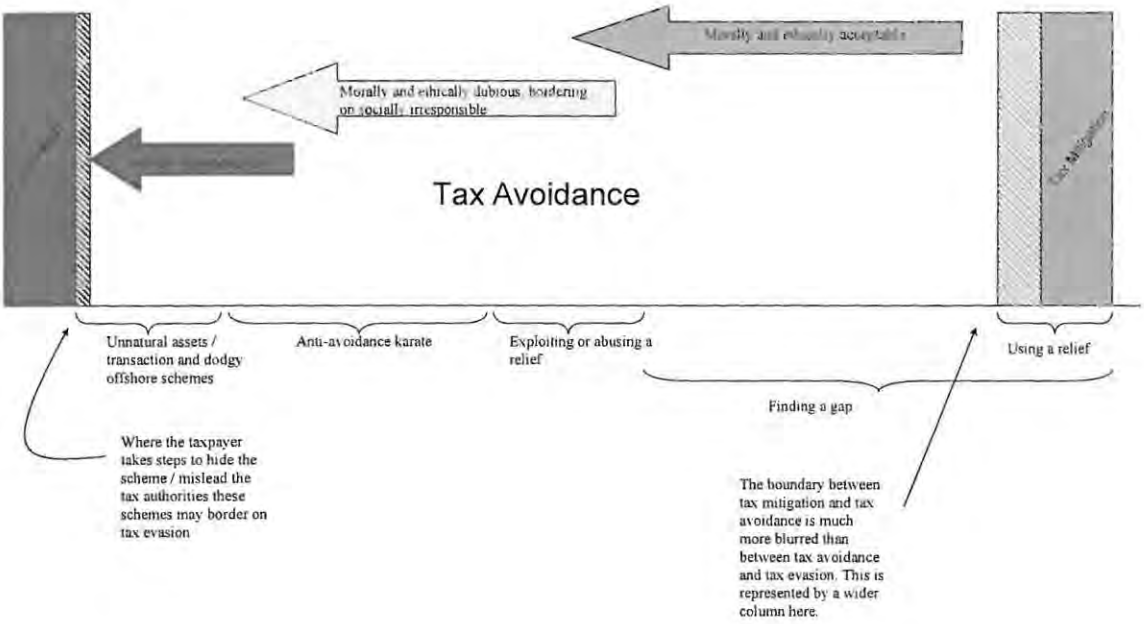
As a result of the inherent risks associated with tax avoidance, taxpayers are becoming increasingly more averse to tax avoidance arrangements. Certainly tax "products" prepared by accounting firms are being adopted far less enthusiastically than they were in the past. KPMG (Loughlin et al, 2007:4) speaks of a "creeping conservatism" which is pervading the boards of many companies.

It seems that taxpayers are aware that tax avoidance carries attendant risks, but owing to the complexity of the concept of tax avoidance (and the complexity of the schemes themselves) they are not able to appropriately guage the level and extent of the risks involved. This "creeping conservatism" is compounded by the use of terms such as "impermissible" avoidance by the SARS which entrenches the idea that tax avoidance is to be shunned.

Even partially tax-literate taxpayers, though they may understand the concept of tax avoidance in a legal sense, may not fully appreciate the blurred boundary between tax avoidance and extreme forms of aggressive or abusive tax avoidance. Further, they are even less likely to identify the blurred boundary between what may be termed socia'ly responsible and irresponsible tax avoidance.

Set out below is a diagram of the different types of tax avoidance from the least aggressive to the most abusive and from the least objectionable to the most objectionable. This diagram has been designed by the writer of this thesis.

Diagrammatic representation of the distinction between tax evasion, tax avoidance and tax planning emphasising the different types of tax avoidance from least aggressive to the most abusive and from the least objectionable to most objectionable.



The above diagram serves, it is submitted, as a simple indication of the types of tax avoidance which exist and their possible relationship with moral and ethical norms and the concept of social responsibility. Undoubtedly the tax authorities would have a very different understanding of what is legally, morally, ethically and socially acceptable. In reality, however, the distinction is far more complicated and any attempt to reduce it into a diagram such as the one above would be met with fierce resistance from both tax practitioners and revenue officials.

Nevertheless, it is submitted that the above diagram may be used to educate taxpayers on the following within the concept of tax avoidance, namely: that tax avoidance is legal; that different forms of tax avoidance exist, some forms being more aggressive than others; that aggressive forms of tax avoidance carry reputational risks; and that in

certain circumstances aggressive tax avoidance schemes may border on tax evasion. This, it is envisaged, may prompt taxpayers to ask the right questions when faced with an external or in-house tax avoidance arrangement rather than simply blindly accepting or rejecting the arrangement.

In the past tax planning, it is submitted, may simply have referred to the need to take the impact of tax into consideration when entering into any contract or undertaking and transaction, to ensure that the tax consequences are minimised. Tax planning at the present time would also require the consideration of whether or not a particular transaction, operation or scheme, or part thereof, is an "impermissible tax arrangement". In the next chapter the concept of tax planning is discussed in detail.

4 Chapter 4: Tax Planning

4.1 Introduction

Tax planning has its origin in the concept that a taxpayer is not "*under the smallest obligation, moral or other, so to arrange his legal relations to his business or his property as to enable the Inland Revenue to put the largest possible shovel into his stores.*" (Lord Clyde in Ayrshire Pullman Motor Services and Ritchie v. IRC (1929) 14 TC 75)

In South Africa there is no recognised distinction between the concepts 'tax planning' and 'tax avoidance'. Some writers do not distinguish between the two terms whereas others regard tax avoidance as aggressive or abusive tax planning which "*stretches the law to its limits*" (Kruger, 1996:21). Some authors state, rather cynically, that if the outcome of the arrangement is broadly acceptable to Revenue then it is tax planning, but if not, it is tax avoidance.

As tax avoidance can be an emotive term many tax practitioners are now using the term 'tax planning' when describing a scheme or arrangement or when selling a tax "product". Tax practitioners also prefer not to use the terms "scheme" or "tax product" as these appear to have negative connotations with taxpayers and Revenue officials. Indeed, the Compact Oxford Dictionary (Soanes, 2002:801) defines the word, "scheme" as, *inter alia*, "*a secret or underhand plan; a plot*". When selling a "scheme" or "tax product" tax practitioners now use terms such as "tax compliance arrangement" or "tax planning arrangement". Accordingly, it is important that taxpayers have an understanding of the distinction so that they can appropriately identify the type of arrangement and the attendant risks, if any.

The concept, "tax planning", is discussed in this chapter from various perspectives in an attempt to address the research question – the distinction between tax evasion, tax avoidance and tax planning.

Set out below is the meaning of 'tax planning' as it is understood by the SARS together with various comments made by authoritative writers on the distinction.

4.2 The meaning of 'tax planning' as it is understood by the SARS

In their Discussion Paper (2005a:4) the SARS use the definition of tax planning set out by Lord Templeman in the English case CIR v Challenge Corporation [1987] AC 155:

> Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. [The general anti-avoidance rule] does not apply to tax mitigation because the taxpayer's advantage is not derived from an arrangement but from the reduction of income which he accepts or the expenditure which he incurs.

The SARS understanding of tax planning is the situation where a taxpayer takes advantage of an expressly provided and intended fiscal benefit. In CIR v Willoughby [1997] 4 All ER 65 at p.73 the notion of tax planning was defined as follows:

> ...hallmark of tax mitigation...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.

SAICA, however, argue (2006) that there are many instances of tax avoidance which are codified either in terms of the Act or in case law which SARS are aware of and which they simply ignore. For example interest incurred on loans utilised to purchase assets as opposed to shares (equity), which pay (non-deductible) dividends, is allowed as a deduction. SAICA further argues (2006) that taxpayers structure their transactions because of perceived anomalies in the legislation such as the example above.

Presumably one could assume that the SARS are aware of those instances in which tax avoidance is codified in the Act or in case law, and against which no action has been taken, and one can therefore treat them as an expressly provided and intended fiscal benefit. After all, the SARS has it within its power to lobby National Treasury to change the legislation when it deems necessary. Where the SARS are unaware of an anomaly, which was not expressly provided for and where any benefit was not intended by the legislator, one may presumably rely on the fact that the SARS will

treat any tax saving as tax avoidance. The intention of the legislature is usually encapsulated in the Explanatory Memoranda which accompany the Revenue Law Amendment Bills.

Having said the above, the exploitation of a 'loophole', as opposed to an expressly provided incentive, as part of a tax planning exercise is dangerous as it is more likely than not to be corrected at some time. Pencharz (1979) states that it is a misconception that tax planning consists of finding a loophole and exploiting it vigorously to save enormous amounts of tax. In support of his contention, he quotes the words of an American lawyer, Harvey Dale, who said:

> A loophole in tax which is too readily and obviously usable becomes not a loophole, but a noose. It will be closed and the taxpayer may be unable to extricate himself.

4.3 Conclusion

Tax planning – if one looks at the "reverse side" of sections 80A – 80L – would imply that any transaction, operation, scheme, agreement or arrangement:

- entered into or carried out in a manner employed for *bona fide* purposes, other that purely to obtain a tax benefit;
- which creates rights and obligations normally created between persons dealing at arm's length (looked at from an objective perspective);
- the substance and legal form of which do not differ;
- which has commercial substance and does not depend solely upon round trip financing, the use of tax indifferent or accommodating parties or offsetting elements to provide benefits, without having a significant effect on business risks or before-tax net cash flows;

will not fall foul of sections 80A – 80L.

Within the distinction between tax avoidance and tax planning, it is sufficient to rather cynically conclude, it is submitted, that when the outcome of a transaction is broadly acceptable to the SARS it is tax planning, when not, it may be viewed as tax avoidance or in some circumstances as even tax evasion.

Outside of the distinction, tax planning is a topic within itself and includes aspects such as tax planning best practices and responsible tax management.

5 Chapter 5: Conclusion

Tax avoidance has taken centre stage in many countries. The reasons for this worldwide scrutiny are many and varied. The SARS and other foreign taxation authorities complain of a proliferation of schemes aided by the advent of advanced telecommunications, the growing number and complexity of financial instruments, the growing number of tax havens, highly mobile capital, transfer pricing, etc. Part of the scrutiny, without doubt, is attributed to the growing alarm by tax authorities at the sheer scale of tax avoidance brought about by the perception that "everyone is doing it". Unless checked, it is believed that this growing perception may result in disillusionment and an entrenched culture of avoidance.

As a means of addressing tax avoidance many taxation authorities (including the SARS) have embarked on a programme of utilizing the concept of responsible tax management and compliance as an indicator of corporate social responsibility. The aim is to emphasise the negative impact which tax avoidance can have on the social and development programmes of a country and so tarnish the reputation of those firms which engage in aggressive or abusive avoidance behaviour. In South Africa the SARS has also "muddied the waters" somewhat by altering the historically accepted, although vociferously debated, distinction of "illegal tax evasion, legal and morally acceptable tax planning, and legitimate tax planning". The SARS now refers to "illegal tax evasion, *impermissible* tax avoidance, and legally and morally acceptable tax planning". This mirrors the efforts of taxation authorities in other countries.

Some taxpayers cynically commented that the SARS, through the inclusion of the word "impermissible" in the Discussion Paper, is trying to convince taxpayers that tax avoidance is not permissible, even when parliament and the courts have never legislated against it (SARS, 2006a). The SARS responded in their Interim Response by stating that it recognised the difficulties with terminology and the potential for miscommunication and misunderstanding. To its mind, however, the use of the words "tax evasion, impermissible avoidance and legitimate tax planning" is as clear as

possible within the limitations of language and the decisions of the courts. The SARS quoted from the decision in Smith v CIR 1964 (1) SA 324(A), 26 SATC 1 (p.14):

> In so far as the exaction of tax in such circumstances may be said to be something in the nature of a penalty for entering into or carrying out such a transaction, operation or scheme, it would not be a penalty designed to exceed the amount by which the taxpayer would otherwise have enriched himself by outwitting the fiscus, and the means by which he would have done so may, because of its abnormal features, well be described as not permissible in the contest between the taxpayer and the tax-gatherer.

Of importance in this case, however, is that the court found that the arrangement in question contravened the provisions of the GAAR. Hence it could be said that the arrangement was "not permissible" in terms of the law. To say generally, however, that tax avoidance is impermissible would be stretching the *ratio decidendi* in the above case beyond that intended by the court. A more correct view, it is submitted, is that an avoidance arrangement is only an impermissible avoidance arrangement to the extent that it contravenes the provisions of the GAAR.

Despite this approach by SARS (i.e. the inclusion of the word "impermissible" within the terminology of the distinction), tax avoidance remains perfectly legal. There is a point, however, where an avoidance arrangement could "cross over" to tax evasion which is an illegal and dishonest activity. In a complex scheme this "point" may be confused, misunderstood or overlooked. Consequently, taxpayers should be careful that they are fully informed of the legal risks attached to an avoidance arrangement.

Equally important, but even less easily understood and explored are the potential reputational risks arising from aggressive and abusive avoidance arrangements. In the past these risks have rarely even been touched on by tax practitioners or taxpayers. These risks are, however, very real as the clients of FirstRand Bank have recently learned. At the time of writing this conclusion the FirstRand Bank saga was only just beginning to unfold. Details in the media are sketchy, but it seems that the gist of the scheme saw FirstRand Bank assisting its clients in circumventing certain exchange control provisions. This was done illegally, albeit allegedly with the tacit approval of the Exchange Control Division of the South African Reserve Bank. If true, these

allegations would only serve to further entrench the idea in ordinary salaried taxpayers' minds that the rich pay less tax than their due. Worse still for FirstRand, however, is that many of their clients named in the scandal did not apply for amnesty during the 2004 income tax and exchange control amnesty. Already the SARS have expressed the intention of investigating the FirstRand scheme (which was brought to their attention by Noseweek magazine) as well as their client which participated in the scheme. This could have major ramifications for the bank, particularly as they have been accused of "selling their clients out to the SARS" (Khuzwayo, 2007:1 and Dawes and Sole, 2007).

As a result of the above, attitudes to tax planning (through the collective efforts of revenue authorities worldwide, non-governmental organisations and private concerns such as the Tax Justice Network) have already begun to shift towards the risk-averse end of the spectrum. KPMG (Loughlin, H. Starkey, S. Deverall, L. Kelly, S. and Bonney, S. 2007) reports that their most recent studies indicate that companies are less likely to engage in tax planning activity or an avoidance arrangement that might be construed as aggressive because they do not want to be seen as high risk by the authorities or presented by the press as engaging in unethical tax behaviour. KPMG (Loughlin et al, 2007:4) describe a "creeping conservatism" which is sweeping company boardrooms. What is not clear, however, is whether taxpayers, in becoming more conservative, are simply more fully aware of tax risks and are making informed decisions or whether they are simply responding to external events, such as the worldwide focus by revenue authorities and the media on tax avoidance.

Whatever the reason, it is now critical, in the case of corporate taxpayers, that their policies for tax and its attendant risks need to be as sophisticated, coherent and transparent as its policies in all other areas involving multiple stakeholders, such as suppliers, customers, staff and investors (Erle, 2004:1).

In setting the strategic tax direction and risk appetite of a company, boards need to work in tandem with external stakeholders to find common ground about what is acceptable in this new environment (Erle, 2004:1).

> Companies need to find ways to comply with the legitimate demands of their shareholders, as well as the legislative and regulatory demands of the societies in which they operate. To create and preserve value-creating reputations, they should be responsive to the demands of the public for high ethical and environmental standards. To discharge their duties to their shareholders, they should accept some risks and reject others. (Erle, 2004:15)

How does a company begin to set its tax philosophy and strategic direction or to determine its appetite for risk? A starting point, it is submitted would be a review of the distinction between tax evasion, avoidance and planning with a heightened sensitivity to the unfamiliar ethical, moral and social risks. The goal of this thesis was to clearly define the distinction between tax evasion, tax avoidance and tax planning from a legal interpretive, ethical and historical perspective in order to develop a rudimentary framework for the responsible management of strategic tax decisions, in the light of the new South African general anti-avoidance legislation.

The analysis of the distinction in this work culminated in the diagrammatic representation of the distinction between tax evasion, tax avoidance and tax planning emphasising the different types of tax avoidance from least aggressive to the most abusive and from the least objectionable to most objectionable. It is anticipated that a visual representation of the distinction, however flawed, would result in a far more pragmatic tool to taxpayers than a lengthy document. From a glance taxpayers can determine the following: That tax avoidance is legal; that different forms of tax avoidance exist, some forms being more aggressive than others; that aggressive forms of tax avoidance carry reputational risks; and that in certain circumstances aggressive tax avoidance schemes may border on tax evasion. This, it is envisaged, may prompt taxpayers to ask the right questions when faced with an external or in-house tax avoidance arrangement rather than simply blindly accepting or rejecting the arrangement. By assigning a position to intended transactions, operations or schemes on the diagrammatic spectrum provided in paragraph 3.11 of chapter 3 and assigning

a level of risk to the position (possibly determined by the cost-benefit relationship), more informed decisions can be made before entering into the transaction, operation or scheme.

In South Africa, as elsewhere, tax practitioners and the authorities still tend to speak of the distinction, whatever their interpretation, in absolute terms. This is unhelpful as rather than meeting somewhere near halfway, tax practitioners and authorities are camped on 'islands' of understanding. It does not help either that each 'camp' can find an overwhelming amount of literature to support their view. Unless, it is submitted, tax practitioners acknowledge the pernicious effects of abusive or aggressive avoidance and the part they play and similarly, unless tax authorities acknowledge the acceptability of avoidance in light of how unfair, complex and ridiculous tax rules often are, the outcome may be a much more aggressive, adversarial relationship between the two (AccountancyAge:2006). Such a situation does not create certainty and stability for either party (AccountancyAge:2006).

* * *

6 Annexures

6.1 Annexure A

Part IIA
Impermissible tax avoidance arrangements

80A.
An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and -

d) 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;
e) 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
f) 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).

Tax consequences of impermissible tax avoidance

80B.
(3) The Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by -
   (g) disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
   (h) disregarding any accommodating or tax-indifferent party or treating any accommodating or tax-indifferent party and any other party as one and the same person;
   (i) deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
   (j) reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
   (k) re-characterising any gross income, receipt or accrual of a capital nature or expenditure; or
   (l) treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

(4) Subject to the time limits imposed by section 79, 79A(2)*(a)* and 81(2)*(b)*, the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

Lack of commercial substance

80C.

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

(4) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to -

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

(d) the inclusion or presence of –

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

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

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

Round trip financing

80D.

(4) Round trip financing includes any avoidance arrangement in which -

(c) funds are transferred between or among the parties (round tripped amounts); and

(d) the transfer of the funds would -

(i) result, directly or indirectly, in a tax benefit but for the provisions of this Part; and

(ii) significantly reduce, offset or eliminate any business risk incurred by any party in connection with the avoidance arrangement.

(5) This section applies to any round tripped amounts without regard to -

(d) whether or not the round tripped amounts can be traced to funds transferred to or received by any party in connection with the avoidance arrangement;

(e) the timing or sequence in which round tripped amounts are transferred or received; or

(f) the means by or manner in which round tripped amounts are transferred or received.

(6) For the purposes of this section, the term 'funds' includes any cash, cash equivalents or any right or obligation to receive or pay the same.

Accommodating or tax-indifferent parties

80E.

(5) A party to an avoidance arrangement is an accommodating or tax-indifferent party if -

(c) 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

(d) 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;

(cb) constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party;

(dc) constituted revenue in the hands of another party would be treated as capital by that other party; or

(ed) given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or

(ii) the participation of that party directly or indirectly involves a prepayment by any other party.

(6) A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party.

(7) The provisions of this section do not apply if either -

(c) the amounts derived by the party in question are cumulatively subject to income tax by one or more spheres of government of countries other than the Republic that are subject to tax in another country which is equal to at least two-thirds of the amount of normal tax which would have been payable in connection with those amounts had they been subject to tax under this Act; or

(d) the party in question continues to engage directly in substantive active trading activities in connection with the avoidance arrangement for a period of at least 18 months: Provided these activities must be attributable to a place of business, place, site, agricultural land, vessel, vehicle, rolling stock or aircraft that would constitute a foreign business establishment as defined in section 9D(1) if it were located outside the Republic and the party in question were a controlled foreign company.

(8) For the purposes of subsection (3)(a), the amount of tax imposed by another country must be determined after taking into account any applicable agreements

for the prevention of double taxation and any assessed loss, credit or rebate to which the party in question may be entitled or any other right of recovery to which that party or any connected person in relation to that party may be entitled.

Treatment of connected persons and accommodating or tax-indifferent parties

80F.
For the purposes of applying section 80C or determining whether or not a tax benefit exists for purposes of this Part, the Commissioner may -

(c) treat parties who are connected persons in relation to each other as one and the same person; or
(d) 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.

Presumption of purpose

80G.

(3) 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.
(4) 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.

Application to steps in or parts of an arrangement

80H.
The Commissioner may apply the provisions of this Part to steps in or parts of an arrangement.

Use in the alternative

80I.
The Commissioner may apply the provisions of this Part in the alternative for or in addition to any other basis for raising an assessment.

Notice

80J.

(1) The Commissioner must, prior to determining any liability of a party for tax under section 80B, give the party notice that he or she believes that the provisions of this Part may apply in respect of an arrangement and must set out in the notice his or her reasons therefor.

(2) A party who receives notice in terms of subsection (1) may, within 60 days after the date of that notice or such longer period as the Commissioner may allow, submit reasons to the Commissioner why the provisions of this Part should not be applied.

(3) The Commissioner must within 180 days of receipt of the reasons or the expiry of the period contemplated in subsection (2) -
   (a) request additional information in order to determine whether or not this Part applies in respect of an arrangement;
   (b) give notice to the party that the notice in terms of subsection (1) has been withdrawn; or
   (c) determine the liability of that party for tax in terms of this Part.

(4) If at any stage after giving notice to the party in terms of subsection (1), additional information comes to the knowledge of the Commissioner, he or she may revise or modify his or her reasons for applying this Part or, if the notice has been withdrawn, give notice in terms of subsection (1).

Interest

80K.

Where the Commissioner has applied this Part in determining a party's liability for tax, the Commissioner may not exercise his or her discretion in terms of section 89*quat* (3) or (3A) to direct that interest is not payable in respect of that portion of any tax which is attributable to the application of this Part.

Definitions

80L.

For purposes of this Part -

'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;

'avoidance arrangement' means any arrangement that results in a tax benefit;

'impermissible avoidance arrangement' means any avoidance arrangement described in section 80A;

'party' means any -
   (a) person;
   (b) permanent establishment in the Republic of a person who is not a resident;
   (c) permanent establishment outside the Republic of a person who is a resident;
   (d) partnership; or
   (e) joint venture, who participates or takes part in an arrangement;

'tax' includes any tax, levy or duty imposed by this Act or any other law administered by the Commissioner;
'tax benefit' includes any avoidance, postponement or reduction of any liability for tax.''.

6.2 Annexure B

Part IIB

Reportable Arrangements

Reportable arrangements

80M.

(1) An arrangement is a reportable arrangement if it is listed in subsection (2) or if any tax benefit is or will be derived or is assumed to be derived by any participant by virtue of that arrangement and the arrangement -
   (a) contains provisions in terms of which the calculation of 'interest' as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the assumptions relating to the tax treatment of that arrangement (otherwise than by reason of any change in the provisions of this Act or any other law administered by the Commissioner);
   (b) has any of the characteristics or characteristics which are substantially similar to those contemplated in section 80C(2)*(b)*;
   (c) is or will be disclosed by any participant as giving rise to a financial liability for purposes of Generally Accepted Accounting Practice but not for purposes of this Act;
   (d) does not result in a reasonable expectation of a pre-tax profit for any participant; or
   (e) results in a reasonable expectation of a pre-tax profit for any participant that is less than the value of that tax benefit to that participant if both are discounted to a present value at the end of the first year of assessment when that tax benefit is or will be derived or is assumed to be derived on a consistent basis and using a reasonable discount rate for that participant.

(2) The following arrangements are reportable arrangements:
   (a) Any arrangement which would have qualified as a 'hybrid equity instrument' as defined in section 8E, if the prescribed period had been 10 years;
   (b) any arrangement which would have qualified as a 'hybrid debt instrument' as defined in section 8F, if the prescribed period in that section had been 10 years, but does not include any instrument listed on an exchange regulated in terms of the Securities Services Act, 2004 (Act No. 36 of 2004); or
   (c) any arrangement identified by the Minister by notice in the *Gazette* as an arrangement which is likely to result in any undue tax benefit.

(3) This section does not apply to any excluded arrangement contemplated in section 80N.

Excluded arrangements

80N.

(1) An arrangement is an excluded arrangement if it is—
  (a) a loan, advance or debt in terms of which—
    (i) the borrower receives or will receive an amount of cash and agrees to repay at least the same amount of cash to the lender at a determinable future date; or
    (ii) the borrower receives or will receive a fungible asset and agrees to return an asset of the same kind and of the same or equivalent quantity and quality to the lender at a determinable future date;
  (b) a lease;
  (c) a transaction undertaken through an exchange regulated in terms of the Securities Services Act, 2004 (Act No. 36 of 2004); or
  (d) a transaction in participatory interests in a scheme regulated in terms of the Collective Investment Schemes Control Act, 2002 (Act No. 45of 2002).

(2) Subsection (1) applies only to an arrangement that -
  (a) is undertaken on a stand-alone basis and is not directly or indirectly connected to, or directly or indirectly dependent upon, any other arrangement (whether entered into between the same or different parties); or
  (b) would have qualified as having been undertaken on a stand-alone basis as required by paragraph *(a)*, were it not for a connected arrangement that is entered into for the sole purpose of providing security and where no tax benefit is obtained or enhanced by virtue of that security arrangement.

(3) Subsection (1) does not apply to any arrangement that is entered into -
  (a) with the main purpose of obtaining or enhancing a tax benefit; or
  (b) in a specific manner or form that enhances or will enhance a tax benefit.

(4) The Minister may determine an arrangement to be an excluded arrangement by notice in the *Gazette*, if he or she is satisfied that the arrangement is not likely to lead to an undue tax benefit.

Disclosure obligation

80O.

(1) The promoter must disclose such information in respect of a reportable arrangement as is contemplated in section 80P.

(2) If there is no promoter in relation to an arrangement or if the promoter is not a resident, all other participants must disclose the information contemplated in section 80P in respect of the reportable arrangement.

(3) A participant need not disclose the information in respect of a reportable arrangement if that participant obtains a written statement from -
  (a) the promoter that the promoter has disclosed that reportable arrangement as required by this Part; or
  (b) any other participant, if subsection (2) applies, that the other participant has disclosed that reportable arrangement as required by this Part.

(4) The reportable arrangement must be disclosed within 60 days after any amount is received by or accrued to any participant or is paid or actually incurred by any participant in terms of the arrangement.
(5) The Commissioner may grant extension for disclosure for a further 60 days, if reasonable grounds exist for that extension.

Information to be submitted

80P.
The promoter or participant, as the case may be, must submit, in relation to the reportable arrangement, in the form and manner (including electronically) and at such place as may be prescribed by the Commissioner -

(a) a detailed description of all its steps and key features;
(b) a detailed description of the assumed tax benefits for all participants, including but not limited to tax deductions and deferred income;
(c) the names, registration numbers and registered addresses of all participants;
(d) a list of all its agreements; and
(e) any financial model that embodies its projected tax treatment.

Reportable arrangement reference number

80Q.
(1) The Commissioner must, after receipt of the information contemplated in section 80P, issue a reportable arrangement reference number to each participant.
(2) The issuing of a reportable arrangement reference number is for administrative purposes only.

Request for additional information

80R.
(1) The Commissioner may, in relation to any arrangement, require a participant or any other person to furnish such information (whether orally or in writing), documents or things as the Commissioner may require.
(2) The information, documents or things must be submitted to the Commissioner in such form and manner (including electronically) and at such place as may be prescribed by the Commissioner.

Penalties

80S.
(1) Any participant who fails to disclose the information in respect of a reportable arrangement as required by section 80O or section 80R shall be liable to a penalty of R1 million.
(2) The Commissioner may reduce the penalty contemplated in subsection (1), if -

(a) there are extenuating circumstances and the participant remedies the non - disclosure within a reasonable time; or

(b) if the penalty is disproportionate to the assumed tax benefit.

Definitions

80T. For the purposes of this Part -
'arrangement' means any transaction, operation or scheme;
'financial benefit' means any reduction in the cost of finance, including interest, finance charges, costs, fees, and discounts in the redemption amount;
'participant' in relation to a reportable arrangement means—

(a) any promoter; or
(b) any company or trust which directly or indirectly derives or assumes that it derives a tax benefit or financial benefit by virtue of a reportable arrangement;

'pre-tax profit' in relation to an arrangement, means the profit of a participant resulting from that arrangement before deducting any normal tax, which profit must be determined in accordance with Generally Accepted Accounting Practice after taking into account all costs and expenditure incurred by that participant in connection with the arrangement and after deducting any foreign taxes paid or payable by that participant;
'promoter' in relation to a reportable arrangement means any person who is principally responsible for organising, designing, selling, financing or managing that reportable arrangement;
'reportable arrangement' means any arrangement as contemplated in section 80M;
'tax' includes any tax, levy, duty or other liability imposed by this Act or any other Act administered by the Commissioner;
'tax benefit' includes any avoidance, postponement or reduction of any liability for tax.''.

6.3 Annexure C

The old section 103: Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income

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

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

   b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out--

      i) was entered into or carried out--

         aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

         bb) in the case of a transaction, operation or scheme, being a transaction, operation or scheme not falling within provisions of item (aa) by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

      ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

   c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit; and

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

6.4 Annexure D

The old reportable arrangement provisions:

76A.

1) For purposes of this section -
'**arrangement**' means any transaction, operation or scheme;
'**reportable arrangement**' means –

d) any arrangement in terms of which -
   iii) the calculation of interest as defined in section 24J, finance costs, fees or any other charges is wholly or partly dependent on the tax treatment of that arrangement;
   iv) provision is made for the variation of that interest, finance costs, fees or any other charges should the actual tax treatment differ from the anticipated tax treatment (otherwise than by reason of any change in the provisions of the Act) or should the anticipated tax treatment be challenged by the Commissioner; and
   v) the potential amount of the variation contemplated in subparagraph (ii) exceeds R5 million,
   but does not include any arrangement identified by the Minister by notice in the Gazette, which is not likely to lead to any undue tax benefit;

e) any arrangement which has certain characteristics identified by the Minister by notice in the Gazette which are likely to lead to an undue tax benefit;

'**tax benefit**' means any reduction in or postponement of the liability of a person for any tax, duty, levy, charge or other amount in terms of any Act administered by the Commissioner based on the anticipated tax treatment of the arrangement.

2) Every company or trust which derives or will derive any tax benefit in terms of a reportable arrangement must report that arrangement to the Commissioner at such place as the Commissioner may determine within 60 days after the date that any amount is first received by or accrues to any person or is paid or actually incurred by any person in terms of that arrangement: Provided that the Commissioner may extend the period of 60 days by no more than 60 days where he or she is satisfied that reasonable grounds exist for the delay in reporting that arrangement.

3) The company or trust must in so reporting provide to the Commissioner-

a) a description of all the steps and key features of the reportable arrangement;

b) a list of all the parties to that arrangement;

c) copies of all the signed documents relating to that arrangement; and
d) any financial model of that arrangement, including any spreadsheet or computer model of the implementation thereof:

Provided that the company or trust may in so reporting, where another company or trust has reported that arrangement to the Commissioner, provide to the Commissioner only the name and address of that other company or trust and the date on which that arrangement was reported.

4)

a) Where a company or trust fails to report a reportable arrangement as contemplated in subsections (2) and (3), that company or trust shall be deemed to have entered into that arrangement in a manner or by means as contemplated in section 103(1)(b)(i) or to have created rights or obligations as contemplated in section 103(1)(b)(ii).

a) Where a company or trust willfully or recklessly fails to report a reportable arrangement as contemplated in subsections (2) and (3), that company or trust shall also be required to pay, in addition to the tax chargeable in respect of its taxable income, an amount equal to the tax benefits in terms of that arrangement to which that company or trust is entitled. Provided that the Commissioner may remit the additional charge or any part thereof where he or she is satisfied that there were extenuating circumstances.

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