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**The South African GAAR: Striking a balance between permissible and impermissible tax avoidance**

By

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## SUMMARY

In the topic of tax avoidance, there are two types of tax avoidance namely permissible and impermissible tax avoidance. Permissible tax avoidance is recognised throughout the world and more so it is recognised as a right. That is, a taxpayer has the right to choose to pay the least tax where the Income Tax Act permits. There other type of tax avoidance – impermissible tax avoidance – is completely prohibited. In fact, the South African General Anti-Avoidance (GAAR) primarily aims to combat impermissible tax avoidance although it has not been judicially considered. The application of the GAAR face a clash of interests of two parties namely the taxpayer’s right to legally pay the least amount of tax and the government’s need to protect the revenue base from impermissible tax avoidance. The question thereof is does the GAAR strike a balance between these two competing interests by drawing a line between permissible and impermissible tax avoidance. The GAAR attempts to limit the right of taxpayers to avoid tax but the complexity of the tainted elements hinders it to effectively inform taxpayers on what is permissible and what is not permissible.

## LIST OF ACRONYMS AND ABBREVIATIONS

A	Appellate Division
Act	Income Tax Act 58 of 1962
AC	Appeal Cases
All ER	All England Law Reports
ATC	Australian Tax Cases
ATO	Australian Tax Office
ATR	Australian Tax Report
CIR	Commissioner of Inland Revenue (South Africa)
CIR	Commissioner of Inland Revenue (UK)
CITA	Canadian Income Tax Act
CRA	Canadian Revenue Agency
CSARS	Commissioner: South African Revenue Service
CTC	Canadian Tax Cases
Ct Cl	Connecticut Circuit
Cth	Commonwealth
EY	Ernst & Young
FA	Finance Act 2013
FCA	Federal Court of Australia
FCA	Federal Court of Appeal (Canada)
FCR	Federal Court Reports
FCT	Federal Commissioner of Taxation
Fed Cir	US Court of Appeals for the Federal Circuit
F. Supp 2d	Federal Supplement
F. 2d	Federal Reporter, US Court of Appeals for the Second Circuit
F. 3d	Federal Reporter, US Court of Appeals for the Third Circuit
GAAR	General Anti-Avoidance Rule
GAAR	General Anti-Abuse Rule (UK)
HMRC	Her Majesty's Revenue and Customs
HL	House of Lords
ITAA	Income Tax Assessment Act 1936
IRC	Internal Revenue Commissioner

IRS	Internal Revenue Service
OECD	Organisation for Economic Development and Cooperation
PWC	Price Waterhouse Coopers
SAAR	Specific Anti-Avoidance Rule
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service
SATC	South African Tax Cases
SCA	Supreme Court of Appeal
SCC	Supreme Court of Canada
SIR	Secretary of Inland Revenue
STC	Simon's Tax Cases
TAA	Tax Administration Act
TC	Tax Cases (UK)
TCC	Tax Court of Canada
UK	United Kingdom
UKHL	United Kingdom House of Lords
US	United States of America
WLR	Weekly Law Reports
VAT	Value Added Tax
ZASCA	South Africa: Supreme Court of Appeal

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### 1. BACKGROUND

The focus of this discussion is on tax avoidance.<sup>1</sup> Tax avoidance entails the legal arrangement<sup>2</sup> of a taxpayer's tax affairs resulting in him or her paying little or no income tax.<sup>3</sup> There are two types of tax avoidance: namely permissible tax avoidance and impermissible tax avoidance.

Impermissible tax avoidance is described as the 'artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed

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<sup>1</sup> In South Africa tax avoidance is often used interchangeably with "tax planning". In Garg, R & Mukerjee, K (2012) 'Removing the Fences: Looking Through GAAR' <http://www.pwc.com/in/en/assets/pdfs/publications-2012.pwc-white-paper-ongaar.pdf> (Accessed on 2 March 2015) 10 the OECD defines "tax planning" as '[an] arrangement of a person's business and/ or private affairs in order to minimise tax liability'. See South African Revenue Services (2005) 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act' <http://www.sars.gov.za> (Accessed 2 March 2015) (SARS Discussion Paper) 4 where "tax planning" is defined as 'the organisation of a taxpayer's affairs (or the structuring of transactions) so that they give rise to the minimum tax liability within the law without resort to [...] impermissible tax avoidance'.

<sup>2</sup> Section 80L of the Income Tax Act of 58 of 1962 (the Act).

<sup>3</sup> Van Schalkwyk, L 'Chapter 25: Tax Avoidance' in Stiglingh, M (eds) *Silke: South African Income Tax* (2014) 811. See Croome, B (eds) *Tax Law: An introduction* (2013) 487-488. These authors also distinguish tax avoidance from tax evasion. Tax evasion is described as an illegal activity where a taxpayer deliberately fails to pay tax. Tax evasion is prohibited by the Tax Administration Act (TAA) and Section 235 of the TAA specifically provide for the consequences thereof. According to Broomberg, E 'Evasion vs avoidance' (2012) 26 *Tax Planning* 104 the words "evasion" and "avoidance" cannot be used interchangeably because the consequences that flow from each instance are different as *per* the Act.

to manipulate or exploit perceived “loopholes” in the laws in order to achieve results that conflict with or defeat the intention of Parliament’.<sup>4</sup> Permissible tax avoidance is described as a permitted reduction of a taxpayer’s tax liabilities in terms of the letter and spirit of the tax law.<sup>5</sup> Permissible tax avoidance is recognised in case law across the whole world.<sup>6</sup>

A case that is often referred to and which recognised permissible tax avoidance is the *Duke of Westminster v IRC* case.<sup>7</sup> This case is famous across the world for the remarks made by Lord Tomlin that: ‘[e]very man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it would otherwise be’.<sup>8</sup> The *Duke of Westminster* case is still relevant even today, particularly in South Africa. Since South Africa is a democratic country; the government plays an important role in ensuring that its people receive economic and social well-being.<sup>9</sup> The taxpayer has the right to minimise their tax liability to their advantage within the bounds of the law.<sup>10</sup> However the government also has an obligation to protect the tax base from impermissible tax avoidance.<sup>11</sup> Therefore the right of taxpayers must be balanced against other rights and obligations.<sup>12</sup>

There has been local judicial acknowledgement of the taxpayer’s entitlement to avoid tax in a manner that is permissible since the enactment of the Section 103(1) of the Act (the old GAAR). In *CSARS v NWK*<sup>13</sup> the SCA had to deal with issue of whether the Commissioner was correct in disallowing the deduction from NWK’s income of portion of the interest expenditure that had been claimed on the ground that the transactions that NWK had entered into with a subsidiary of FNB Bank were

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<sup>4</sup> SARS Discussion Paper (note 1 above) 4.

<sup>5</sup> Kujinga, B ‘Analysis of Misuse and Abuse in terms of the South African General Anti-Avoidance Rule: Lessons from Canada’ (2012) 45 *Comparative and International Law Journal of Southern Africa* 43.

<sup>6</sup> Croome (note 3 above) 488. See Van Schalkwyk (note 3 above) 811; *Levene v IRC* (1928) AC 217; *Meyerowitz v CIR* 1963 (3) SA 863 (A) and *Hicklin v SIR* 1980 (1) SA 481 (A).

<sup>7</sup> *Duke of Westminster v IRC* (1953) AC 520.

<sup>8</sup> As above.

<sup>9</sup> SARS Discussion Paper (note 1 above) 15.

<sup>10</sup> As above. See Cilliers, C ‘The Proposed Section80A(c)(ii) of the Income Tax Act: Should it be enacted?’ (2006) 55 *The Taxpayer* 185.

<sup>11</sup> Kujinga (note 5 above) 43.

<sup>12</sup> SARS Discussion Paper (note 1 above) 15 and Kujinga (note 5 above) 43.

<sup>13</sup> *CSARS v NWK Limited* (27/10) [2010] ZASCA 168.



simulated.<sup>14</sup> In giving her judgement, Lewis JA said that: ‘it is trite that a taxpayer may organise his financial affairs in such a way as to pay the least tax permissible’.<sup>15</sup>

While permissible tax avoidance should not be faulted, impermissible tax avoidance is a serious threat to the integrity of any tax system because of its harmful effects.<sup>16</sup>

The harms caused by impermissible tax avoidance include:

[S]hort-term revenue loss, growing disrespect for the tax system and the law, increasingly complex tax legislation, the uneconomic allocation of resources, an unfair shifting of the tax burden, and weakening of the ability of Parliament and National Treasury to set and implement economic policy.<sup>17</sup>

As quoted above impermissible tax avoidance encourages the disrespect for the tax system and the law amongst taxpayers.<sup>18</sup> This practice impacts on the equity and fairness of the tax system.<sup>19</sup> Impermissible tax avoidance causes an increase in more complex tax legislation.

Generally, the main role of a General Anti-Avoidance Rule (GAAR) is to prevent impermissible tax avoidance arrangements and allow permissible tax avoidance.<sup>20</sup> A GAAR is intended to protect the tax base from impermissible tax avoidance and to draw a clear line between permissible and impermissible tax avoidance. Therefore a GAAR must strike a balance between the right to avoid tax and the need to protect the tax base from impermissible tax avoidance.<sup>21</sup>

The balance referred to above is achieved by defining and isolating impermissible tax avoidance. Factors that are used to identify impermissible tax avoidance are

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<sup>14</sup> Broomberg (note 3 above) 103. See CSARS v NWK 33.

<sup>15</sup> As cited in De Koker, A & Williams, R *Silke on South African Income Tax* (2014) 19.1.

<sup>16</sup> In Garg & Mukerjee (note 1 above) at 8 the author points out that such tax avoidance undermines the achievements of the public financial objectives of collecting revenues in an efficient, equitable and effective manner.

<sup>17</sup> SARS Discussion Paper (note 1 above) 1 & 9.

<sup>18</sup> SARS Discussion Paper (note 1 above) 10.

<sup>19</sup> SARS Discussion Paper (note 1 above) 13.

<sup>20</sup> Kujinga (note 5 above) 43.

<sup>21</sup> In Kujinga (note 5 above) 43 the author points out that it is this “balance” that makes the application of a GAAR effective.

found in many anti-avoidance rules in the world.<sup>22</sup> Countries such as Canada<sup>23</sup>, the UK<sup>24</sup>, the US<sup>25</sup>, India<sup>26</sup> and Australia<sup>27</sup> have a system to curb impermissible tax avoidance that is either couched in legislation (GAARs) or in judicially developed doctrines.<sup>28</sup> GAARs in different countries rely on different concepts to distinguish between impermissible and permissible tax avoidance.<sup>29</sup>

In South Africa, the Act requires an avoidance arrangement with the sole or main purpose of obtaining a tax benefit with any of the tainted elements, namely, abnormality, absence of a commercial substance or the misuse or abuse of any provision of the Act to exist before the GAAR can be applied.<sup>30</sup> The incorporation of all these elements makes the GAAR too complex and wide, and ultimately creates an uncertain GAAR.

Sections 80A to 80L of the Act<sup>31</sup> form part of the South African GAAR. These provisions apply only to arrangements entered into on or after 2 November 2006.<sup>32</sup> This dissertation will discuss the South African GAAR in order to determine whether it strikes the requisite balance between curbing impermissible tax avoidance and allowing permissible tax avoidance.

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<sup>22</sup> This includes concepts such as the misuse or abuse test and economic substance; and the objective primary purpose of the arrangements that avoid tax.

<sup>23</sup> In Canada Section 245 of the Canadian Income Tax Act RSC 1985 C 1 (5<sup>th</sup> Supp) to curb impermissible tax avoidance. See Kujinga (note 5 above) 43.

<sup>24</sup> See *IRC v Westminster* [1936] AC 1, *W T Ramsay Ltd v IRC* [1982] AC 300, *Furniss v Dawson* [1984] AC 474, *IRC v McGuckian* [1997] 1 WLR 991 and *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6. Also see Burt, K 'The approach in *WT Ramsay Ltd v IRC*: Elucidation long overdue' (2004) 121 *South African Law Journal* 745 and Tiley, J 'Part One: The United Kingdom: 9.3 Anti-Avoidance Doctrines and Rules' in Ault, H & Arnold, B *Comparative Income Taxation: A Structural Analysis* 3<sup>rd</sup> ed (2010) 167-169.

<sup>25</sup> As cited in Kujinga (note 5 above) 43 the US has taken a more cautious approach by applying the economic substance doctrine, the step transaction doctrine, and the business purpose doctrine. It was also noted that these doctrines were followed after the decision by Judge Learned Hand in *Gregory v Helvering* 69F 2d 809. See Repetti, J 'Part One: The United States: 9.3 Anti-Avoidance' in Ault & Arnold (note 24 above) 192.

<sup>26</sup> See *Vodafone International Holdings B.V v Union of India & Anr.* Civil Appeal No.733 of 2012.

<sup>27</sup> See Cassidy, J 'The Holy Grail: The Search for the Optimal GAAR' (2009) 126 *South African Law Journal* 742-746.

<sup>28</sup> Garg & Mukerjee (note 1 above) 3.

<sup>29</sup> Kujinga (note 5 above) 43.

<sup>30</sup> In Croome (note 3 above) at 492 the author summarised the tests as follows: the business purpose test; the commercial substance test; the abnormal rights and obligations test; and the misuse or abuse test.

<sup>31</sup> Croome (note 3 above) at 490; Steenkamp, L 'Combating impermissible tax avoidance through efficient administrative approaches: what SARS can learn from its Canadian counterpart' (2012) 45 *Comparative and International Law of Southern Africa* 227 and Kujinga (note 5 above) 42.

<sup>32</sup> Broomberg, E 'Tax avoidance' (2007) 21 *Tax Planning* 112.

## 2. MOTIVATION

In order for the GAAR to achieve its deterrent purpose, it might be safe to draft it widely.<sup>33</sup> However drafting a GAAR that is too widely ‘creates uncertainty with regard to the amount of tax payable by taxpayers and the area within which they will be regarded as trespassers’.<sup>34</sup>

This dissertation is important because it will analyse whether the South African GAAR draws a clear line between permissible and impermissible tax avoidance.<sup>35</sup> It is crucial that a GAAR draws this line because an unclear GAAR will discourage taxpayers from permissible tax avoidance. After the analysis has been considered, this dissertation will conclude on whether the South African GAAR has the characteristics of an optimum GAAR and whether there should be any changes to the GAAR that will reduce any uncertainty.

## 3. SCOPE AND LIMITATIONS

The discussion in the dissertation is limited to the GAAR in context of the income tax. Therefore there will be no discussion of the GAAR from a Value-Added Tax Act<sup>36</sup>, Customs and Excise Duty Act<sup>37</sup> perspective, and/or any other statute dealing with any other type of tax except the income tax. The comparative focus will be on foreign nations with a direct influence on the South African GAAR.<sup>38</sup> In this regard the following jurisdictions will be discussed: Canada, Australia, the UK, the US and India. Discussions of other jurisdictions aim to expose the fundamental differences between the respective countries’ GAARs with the South African GAAR. They also aims to point out the lessons (if any) that South Africa could learn from other GAARs in order to make it more certain and effective at its functions.

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<sup>33</sup> SA Tax Guide ‘Section 80A(c)(ii) of the Income Tax Act and the scope of part IIA’ (undated) <http://www.sataxguide.wordpress.com/section-80-a-c-ii-of-the-income-tax-act-and-the-scope-of-part-ii-a> (Accessed 2 March 2015).

<sup>34</sup> As above. See SARS Discussion Paper (note 1 above) 6-7.

<sup>35</sup> As illustrated above, it is important that a tax system is able to balance the rights of the taxpayer and the obligation of the Government to collect revenues in an efficient, equitable and effective manner.

<sup>36</sup> Act 89 of 1991.

<sup>37</sup> Act 91 of 1964.

<sup>38</sup> The GAARs of the following countries, *inter alia*, will not be discussed: Spain, Hungary, Austria, Portugal, France, Germany, Japan, The Netherlands, Sweden, New Zealand, and Switzerland.

There will not be an extensive discussion of tax evasion in the dissertation. The dissertation will consist of a brief discussion of the history of the GAAR. This history will not go as far back as 1941 when the first GAAR was in place, but will focus on Section 103(1) of the Act. Any interpretation of the current South African GAAR, that is Sections 80A to 80L of the Act, will not be based on South African case law as it has not been tested yet in the South African courts.

#### **4. RESEARCH QUESTIONS**

The problem statement of this study is: In incorporating the various tainted elements in the South African GAAR, the GAAR becomes too complex, wide and reduces its ability to perform its primary function of curbing impermissible tax avoidance. The dissertation will analyse the GAAR in South Africa by considering the following questions:

- a) What is tax avoidance?
- b) What is the role of a GAAR?
- c) Does the South African GAAR perform its primary function of curbing impermissible tax avoidance?
- d) Does the South African GAAR inform taxpayers of their limitation to their rights to engage in impermissible tax avoidance?
- e) How does the South African GAAR compare to foreign GAARs?
- f) Is there anything that can be done to improve the efficacy of the GAAR?

#### **5. METHODOLOGY AND APPROACH**

A qualitative research method will be used in order to answer the research questions posed. In addition comparative analysis approach that compares the South African GAAR with the GAARs in specific foreign nations which have the similar concepts to those used in South Africa will be adopted.

The specific foreign nations that will be discussed are Canada, Australia, the UK and the US and briefly India. India is important for this study because it unsuccessfully

attempted to introduce a GAAR similar to that of South Africa. There is an interest in India because of reasons behind the rejection of the GAAR.

Canada will be discussed because the Canadian GAAR curbs impermissible tax avoidance by employing the misuse or abuse provision. Canadian case law will be looked at in order to analyse any potential issues that may arise where the misuse or abuse provision would be applied in South Africa. Australian GAAR will be discussed where it relevant to the South African GAAR that is, its usage of the three elements namely a scheme, tax benefit and an objective conclusion that the primary purpose of the scheme was to obtain the tax benefit.<sup>39</sup> These elements are also used in South Africa.

The UK has for long relied on the so-called *Ramsay* doctrine, which entails treating circular and self-cancelling transactions as one single transaction for tax purposes.<sup>40</sup> This doctrine will be analysed in relation to the commercial substance provision in South Africa. In the US, the courts have created various common law doctrines to curtail taxpayers' avoidance activities.<sup>41</sup> These include: the economic substance doctrine, the step transaction doctrine and the business purpose doctrine.<sup>42</sup> These doctrines will be studied for the purposes of comparison with certain aspects of the commercial substance indicator in South Africa. This comparative analysis will explore the lessons which South Africa can learn from the studied foreign nations.

## 6. CHAPTER OUTLINE

The dissertation will consists of the following chapters in this order:

Chapter 1: Introduction

Chapter 2: The current General Anti-Avoidance Rule and its background

Chapter 3: Comparative analysis with other GAARs

Chapter 4: Comparative analysis with judicial anti-avoidance rules

Chapter 5: Conclusion

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<sup>39</sup> Vann, R 'Part One: Australia: 9.3 Tax Avoidance and Anti-Avoidance legislation' in Ault, H & Arnold (note 24 above) 22.

<sup>40</sup> Tiley (note 24 above) 168.

<sup>41</sup> Repetti, J (note 25 above) 191.

<sup>42</sup> Kujinga (note 5 above) 43.

## CHAPTER 2

### THE CURRENT GENERAL ANTI-AVOIDANCE RULE (GAAR) AND BACKGROUND

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#### 1. INTRODUCTION

South Africa has a long history with general anti-avoidance rules (GAARs). South Africa's first GAAR was enacted in 1941 in Section 90 of the old Income Tax Act<sup>1</sup> and that Section was later replaced by Section 103(1) of the Income Tax Act<sup>2</sup>. Section 103(1) was later replaced by Sections 80A to 80L of the Act which is the current GAAR.

This chapter consists of a brief historical background of Section 103(1) of the Act. This discussion is aimed at exposing the weakness that the former GAAR had which subsequently led to the enactment of the current GAAR. This chapter also highlights the structure of the current GAAR and the elements that should be contained in a transaction for it to be subject to the GAAR. With this, the aim is to analyse whether

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<sup>1</sup> Act 31 of 1941.

<sup>2</sup> Act 58 of 1962 (the Act).

the current GAAR clearly distinguishes between permissible and impermissible tax avoidance transaction.

## 2. HISTORICAL BACKGROUND

Before the current GAAR, the GAAR was enacted in Section 103(1) of the Act.<sup>3</sup> Section 103(1) of the Act had four requirements namely:

- a) a transaction, operation or scheme;
- b) a tax avoidance effect;
- c) abnormality or the creation of abnormal rights or obligations; and
- d) a sole or main purpose to avoid or reduce liability for tax.<sup>4</sup>

The sole or main purpose of the taxpayer was a subjective test and the abnormality requirement was an objective test. For Section 103(1) of the Act to be applied the subjective and the objective elements had to be present. This meant that a taxpayer could enter into any transaction despite the abnormality of the transaction as long as the taxpayer did not have a subjective sole or main purpose to avoid tax.<sup>5</sup> Conversely the taxpayer could also enter into any transaction with the subjective sole or main purpose of tax avoidance provided that the transaction was not objectively abnormal as prescribed by Section 103(1).<sup>6</sup> A sole or main purpose to avoid tax was presumed in terms of Section 103(4), placing the burden to prove a purpose other than tax avoidance on the taxpayer.<sup>7</sup>

Section 103(1) of the Act was repealed by Section 36(1)(a) of the Revenue Laws Amendment Act<sup>8</sup> although it was amended several times before 1996. The Katz Commission recommended that Section 103(1) be amended. It identified a tough

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<sup>3</sup> Schalkwyk, L & Geldenhuys, B 'Section 80A(c)(ii) of the Income Tax Act and the Interpretation of Tax Statutes in South Africa' (2009) 17 *Meditari Accountancy Research* 167.

<sup>4</sup> Section 103(1) of the Act.

<sup>5</sup> See Williams, R 'The 1996 Amendments to the General Anti-Tax Avoidance Section of the Income Tax Act' (1997) 114 *South Africa Law Journal* 675.

<sup>6</sup> As above.

<sup>7</sup> See *SIR v Guestyn, Forsyth & Joubert* 1971 (3) SA 567 as cited in De Koker, A & Williams, R *Silke on South African Income Tax* (2014) 19.4 and *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 as cited in Loof, G *Critical Analysis of the Requirements of the South African General Anti-Avoidance Rule* (unpublished thesis, University of Cape Town, 2013) 14.

<sup>8</sup> Act 20 of 2006.

challenge in the application of the “normality test” found in Section 103(1) alluding that it was ambiguous.<sup>9</sup> The Commission recommended that where a transaction occurs in the context of business, a business purpose test should replace the normality test.<sup>10</sup> Before the new GAAR, SARS described Section 103 as an inconsistent and ineffective deterrent to abusive avoidance schemes and other impermissible tax avoidance.<sup>11</sup> It was described as such because the application of Section 103 appeared to be too narrow and often placed the Commissioner in a difficult position in having to prove the “purpose” requirement in court.<sup>12</sup>

After analysing the requirements in Section 103(1) it can be seen that the sole or main purpose requirement posed some difficulties because it required the courts to establish the taxpayer’s intentions by looking into the mind of the taxpayer. In addition the courts would have to, based on the evidence before it, decide whether the required purpose was present when the transaction in question was entered. A decision based on the taxpayer’s subjective state of mind cannot always be reliable and credible.

The Commissioner encountered such difficulties in *CIR v Conhage*.<sup>13</sup> In this case, the taxpayer entered into two sets of agreements with Firstcorp Merchant Bank whereby each set comprised a sale and a lease-back of some of its manufacturing plant and equipment.<sup>14</sup> *Conhage* sought to deduct the rentals paid in terms of the leasebacks as expenditure in the production of income as per the general deductions formula under Section 11(a) of the Act.<sup>15</sup> The Commissioner refused to allow the deduction and relied on Section 103 alleging that the agreements were not what they purported to be.<sup>16</sup>

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<sup>9</sup> South African Revenue Services (2005) ‘Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act’ <http://www.sars.gov.za> (SARS Discussion Paper) 40. See Katz Commission Report into Tax – National Treasury ‘Tax Avoidance – Chapter 11’ (Undated) <http://www.treasury.gov.za/publications/other/katz/3.pdf> (Accessed 24 August 2015).

<sup>10</sup> As above.

<sup>11</sup> SARS Discussion Paper (note 9 above) 1 & 41.

<sup>12</sup> The “purpose” requirement referred to is in Subsection 103(1)(c) of the Act. The “purpose” requirement can only be met if obtaining a tax benefit was the taxpayer’s sole or main purpose of a transaction.

<sup>13</sup> *CIR v Conhage (Pty) Ltd* 1999 (4) SA 1149 (SCA); 61 SATC 391.

<sup>14</sup> De Koker, A & Williams, R *Silke on South African Income Tax* (2014) 19.28.

<sup>15</sup> As above.

<sup>16</sup> As above.



The SCA, found the case in case in favour of the taxpayer in regard to the application of Section 103. Hefer JA held that the court *a quo* was correct in its decision that the Commissioner had not established the abnormality of the sale and lease-back agreement as required by Section 103 and the taxpayer had established the absence of the requirement of purpose in Section 103.<sup>17</sup>

Mazansky pointed out that the Commissioner faced difficulties in the application of Section 103 because it applied the section in the wrong circumstances.<sup>18</sup> The author used *Conhage* case as an example and described the case as the “final nail in the coffin” which rendered Section 103 as “toothless” or rather weak.<sup>19</sup> Liptak also described Section 103 as weak and said it was one of the reasons that caused the increase of abusive tax avoidance.<sup>20</sup>

To remedy this problem, Section 103(1) was replaced and the new GAAR goes a bit further than the Section 103(1) in seeking to combat tax avoidance. The legislature expanded the scope of the GAAR with new provisions, some of which borrowed concepts from foreign legislation. Two of the major changes and that were borrowed from foreign legislation include the commercial substance and misuse and abuse provision.<sup>21</sup> The following paragraphs highlight the major changes in greater detail.

### 3. THE CURRENT GENERAL ANTI-AVOIDANCE RULE

It was held in the *Duke of Westminster* that the taxpayer is free to structure or arrange his or her tax affairs in a tax-efficient way. In other words, taxpayers have a choice to pay the least amount of tax as permitted by legislation. However this right cannot be exercised anyhow, there needs to be limits, since impermissible tax avoidance is outlawed by the GAAR. The GAAR seeks to distinguish between

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<sup>17</sup> As above.

<sup>18</sup> Mazansky, E ‘Some Observations on the New General Anti-Avoidance Rule (GAAR)’ (1 February 2006) <http://www.thesait.org.za/news/96886/Some-Observations-On-The-New-General-Anti-Avoidance-Rule-GAAR.htm> (Accessed 23 March 2015).

<sup>19</sup> As above.

<sup>20</sup> Liptak, E ‘Chapter 3: Battling with Boundaries: The South African GAAR Experience’ in Freedman, J *Beyond Boundaries Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 23 - 24.

<sup>21</sup> Liptak (note 20 above) 26.

permissible and impermissible tax arrangements. For the Commissioner to invoke the GAAR there must be an impermissible tax avoidance arrangement.<sup>22</sup>

Section 80A of the Act stipulates the requirements for ‘impermissible tax avoidance’ to exist and applies to any arrangement or any steps in an arrangement entered into on or after 2 November 2006. It reads as follows:

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

- a) in the context of business-
  - i) it was entered into or carried out by means or in a manner which would not normally be employed for *bona fide* purpose, 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).

In the quest to curb impermissible tax avoidance Section 80A lays down four basic requirements that must be established before impermissible tax avoidance can exist. The requirements are summarised as follows:

- a) an arrangement;
- b) a tax benefit, which makes the arrangement an avoidance arrangement;
- c) the sole or main purpose of the arrangement must be to obtain a tax benefit;  
and
- d) any one of tainted elements must be present in the avoidance arrangement.

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<sup>22</sup> Croome, B (eds) *Tax Law: An introduction* (2013) 812.

Broadly, the tainted elements are abnormality regarding means and manner; the creation of abnormal rights or obligations; lack of commercial substance and misuse or abuse of the provisions of the Act.<sup>23</sup> A discussion of the elements of the GAAR will now follow.

### 3.1 Arrangement

The first requirement is to establish whether the transaction in question is an arrangement. In terms of Section 80L of the Act an arrangement is defined as:

any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property.

The definition is significant because it helps both the Commissioner and the taxpayer to identify precisely the transaction, operation or scheme, or to which step or parts of a scheme the Commissioner would apply the GAAR.<sup>24</sup> However before looking at whether the arrangement's sole or main purpose was to obtain a tax benefit, the Commissioner needs to prove that the arrangement in question was an avoidance arrangement in terms of Section 80L of the Act. The definition of an arrangement must be read together with Section 80H of the Act, which is the provision that deals with the application to steps in or parts of an arrangement.

Section 80H states that "the Commissioner may apply the provisions of this part to steps in or parts of an arrangement". When reading Section 80H and Section 80B(1)(a) of the Act - which grants the Commissioner the powers to *inter alia* re-characterise any step in or part of the impermissible avoidance arrangement<sup>25</sup> - it is clear that the Commissioner can separate transactions by looking at a part of an arrangement in isolation.<sup>26</sup>

The main purpose of this is to bar taxpayers from inserting impermissible tax avoidance transactions into commercial schemes for the purposes of effectively laundering these transactions. While this provision allows the Commissioner to isolate a potentially impermissible tax avoidance transaction in a composite

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<sup>23</sup> Croome (note 22 above) 490 & 492.

<sup>24</sup> Broomberg, B 'Then and Now – II' (2007) 21 *Tax Planning* 131.

<sup>25</sup> Section 80B(1) of the Act.

<sup>26</sup> Broomberg (note 24 above) 131.

arrangement, the provision could be problematic. This is because as a mere part of an arrangement that was not intended to stand alone but stand as part of a composite arrangement can be attacked without considering the whole arrangement. In this regard, an isolated transaction in a composite arrangement should not be said to be sufficient to constitute an avoidance arrangement where it is clear that the transaction loses its character as a result of the isolation.

Broomberg opines that the legislature intended to destroy the principle in *Conhage* that when a transaction, operation or scheme was entered into for an overriding non-tax reason, the Commissioner could not apply Section 103(1) to any single, isolated part of the transaction, operation or scheme.<sup>27</sup> While the legislature may have achieved that objective, it is submitted that singling out a transaction, operation or scheme from composite arrangement for GAAR purposes where it is clear that the isolated transaction loses its commercial or non-tax character could amount to an unfair limitation of the taxpayer's right to avoid tax.

### **3.2 Tax benefit**

Where it has been established that the transaction, operation or scheme in question constitutes an arrangement in terms of Section 80L; it then follows that such an arrangement should result in a tax benefit. Tax benefit is described as “any avoidance, postponement or reduction of any liability for tax”.<sup>28</sup> In essence, to determine whether there was a tax benefit there need to be an identification of the income that might have accrued to the taxpayer.<sup>29</sup>

### **3.3 Sole or main purpose**

The reference to the “sole or main purpose” made in the opening words of Section 80A is not new to the GAAR. This phrase was used in Section 103(1) in the same context; it basically helps the Commissioner identify the intention of the particular arrangement in question. It requires an objective test in this regard. The question is: ‘would a person viewing the arrangement reasonably conclude that a tax benefit was

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<sup>27</sup> Broomberg (note 24 above) 133. See Legwaila, T “Modernising the ‘Substance Over Form’ Doctrine: Commissioner for the South African Revenue Service NWK Ltd” (2012) 24 *SA Mercantile Law Journal* 125.

<sup>28</sup> Section 1 of the Act.

<sup>29</sup> De Koker & Williams (note 7 above) 19.37. See *Smith v CIR* 26 SATC 1; *CIR v Louw* 45 SATC 113 and *ITC 1625* 59 SATC 383.

likely main effect of the arrangement’?<sup>30</sup> If the answer is in the affirmative then the taxpayer’s sole or main purpose was to obtain a tax benefit. There is a presumption of purpose in terms of Section 80G(1) of the Act, which effectively places the onus of proving a non-tax purpose on the taxpayer.

### **3.4 Tainted elements**

This part of the discussion focuses on some of the profound and significant changes made in the new GAAR. Section 80A of the Act provides three categories of avoidance arrangements namely avoidance arrangements that were entered into in the context of business, in a context other than business and in any context. For each category Section 80A prescribes tainted elements that need to be present for the arrangement in question to be an impermissible avoidance arrangement. However some of the tainted elements appear more than once.

After it has been established that the transaction is an arrangement with the sole or main purpose to obtain a tax benefit, any of the following tainted elements should be contained in that arrangement for it to constitute an impermissible avoidance arrangement:

- a) abnormality (abnormality of manner and means test and abnormal rights and obligations test);
- b) lack of commercial substance; and
- c) a misuse or abuse of the provisions of the Act.

Some of these tainted elements were borrowed from foreign legislation and judicial anti-avoidance doctrines.

#### **3.4.1 Abnormality**

There are two abnormality tests in the GAAR that are used to determine an impermissible avoidance arrangement.<sup>31</sup> The first abnormality test is found where an avoidance arrangement in question was entered into, either in the context of business and in a context other than business. This test provides that an avoidance arrangement will be impermissible if it was entered into or carried in a manner that is

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<sup>30</sup> As above.

<sup>31</sup> Croome (note 22 above) 498.

not normally used for *bona fide* business purposes other than obtaining a tax benefit.<sup>32</sup> This test is new in the GAAR as it was recommended by the Katz Commission and it is referred to as the business purpose test.

However the reference to *bona fide* “business purposes” other than a tax benefit is new; the Act does not define what constitute a *bona fide* “business purpose”. The phrase “business purpose” could be compared with the business purpose test employed in the US which entails that the taxpayer’s transaction is scrutinised to determine whether it was driven by commercial considerations rather than the prospective tax benefit.<sup>33</sup> However unlike Section 80A(a) of the Act, the business purpose test in the US does not entail a comparison between the taxpayer’s transaction and the way in which that type of transaction would normally be carried out.<sup>34</sup> For purposes of certainty of the application of the GAAR, it is clear that the drafters of this provision need to provide guidance on what is meant by “business purpose”.

The second abnormality test is found where an avoidance arrangement entered into creates rights or obligations that would not be created between parties dealing at an arm’s length.<sup>35</sup> This test is not new to the current GAAR therefore there is case law on transactions that create right and obligations that are abnormal. The *Louw* case is a good example, where the Appellate Division found the granting of interest free loans in lieu of a salary to the directors of a company to be abnormal.<sup>36</sup> In essence this test requires the comparison between the manner in which the transaction was entered into with the manner in which it would normally be entered into.

The second abnormality test, which is also referred to as the abnormal rights and obligations test, determines whether the avoidance arrangement entered into in any context has created abnormal rights and obligations that would be created between parties dealing at arm’s length. In order to comprehend this test, one needs to establish the meaning of “parties dealing at arm’s length” which is not expressed in the Act.

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<sup>32</sup> Section 80A(a)(ii) & (b) of the Act.

<sup>33</sup> See *Gregory v Helvering* [1935] 293 US 465.

<sup>34</sup> As above.

<sup>35</sup> Section 80A(c)(i) of the Act.

<sup>36</sup> Croome (note 22 above) 498. See *CIR v Louw* 138.

In *Hicklin v SIR*<sup>37</sup> the Appellate Division briefly held that when parties are dealing at an arm's length each party in the agreement is independent of the other and each party will strive to get the utmost possible advantage out of the transaction. However this interpretation of parties dealing at arm's length will not apply in every transaction, it is left in the hands of the courts to interpret what the relationship of the parties in each transaction. Relying on the interpretation of the courts limits the effectiveness of the GAAR.

### 3.4.2 Lack of commercial substance

Lack of commercial substance appears in Section 80A(a)(ii) of the Act. An absence of commercial substance is one of the tainted elements that could render an avoidance arrangement, in the context of business, to be impermissible under Section 80A. Section 80C(1) of the Act defines lack of commercial substance and Section 80C(2) provides a non-exhaustive list of the characteristics of an avoidance arrangement that are indicative of a lack of commercial substance. In terms of Section 80C(1) an avoidance arrangement lacks commercial substance:

[I]f it would result in a significant tax benefit for a party [...] 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.

Therefore for the avoidance arrangement to be lack commercial substance, it needs to confer a significant tax benefit without necessarily having a significant effect on the taxpayer's business risks or net cash flows. This element is new to the South African GAAR and as such there is no case law interpreting it. It is however similar to the US common law economic substance doctrine. This doctrine requires a transaction to have economic substance that is separate from the economic benefit obtained.<sup>38</sup>

The Act does not define or provide any guidance on what is meant by the phrases "significant tax benefit" and "significant effect".<sup>39</sup> To ensure the efficiency of the GAAR, these concepts need to be defined and not left to the courts to interpret. It

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<sup>37</sup> *Hicklin v SIR* 1980 (1) SA 481 (A) as cited in De Koker & Williams (note 7 above) 19.39.1.

<sup>38</sup> Garg, R & Mukerjee, K (2012) 'Removing the Fences: Looking Through GAAR' <http://www.pwc.com/in/en/assets/pdfs/publications-2012.pwc-white-paper-ongaar.pdf> 50 (Accessed 2 March 2015).

<sup>39</sup> De Koker & Williams (note 7 above) 19.39.1.

therefore requires the legislature to provide guidelines quantifying a “significant tax benefit” and a criterion that will determine a “significant effect”.

An avoidance arrangement that lacks commercial substance can also be identified by looking at any one of these characteristics provided for in Section 80C(2). This section reads as follows<sup>40</sup>:

[C]haracteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to –

- a) the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
- b) the inclusion or presence of –
  - (i) round trip financing, as described in s 80D; or
  - (ii) an accommodation or tax-indifferent party as described in s 80E; or
  - (iii) elements that have the effect of offsetting or cancelling each other.

Where any of the abovementioned characteristics are present in the avoidance arrangement in question the Commissioner can invoke Section 80B of the Act as the avoidance arrangement will be regarded as an impermissible tax avoidance. The Act does not define the meaning of “legal substance” under Section 80C(2)(a) and “offsetting or cancelling” elements under Section 80C(2)(iii). Significantly, Section 80C(2)(a) derives from the common-law doctrine of substance over form which entails that the law has regard to the substance, rather than the form, of things.<sup>41</sup> Furthermore there are traces of “offsetting or cancelling” elements in the UK precedent associated with the “fiscal nullity” doctrine in *WT Ramsay Ltd v IRC*.<sup>42</sup> The “fiscal nullity” doctrine is also known as the *Ramsay* doctrine.

As is evident from the discussion of the commercial substance indicator above, it is clear that there is a lot of uncertainty. This uncertainty stems from the fact that this indicator is complex as it derives from elements of the economic substance doctrine in the US and the fiscal nullity doctrine in the UK. Given that the absence of

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<sup>40</sup> Sections 80C(2)(a) – (b) of the Act.

<sup>41</sup> Cassidy, J ‘Tainted Elements or Nugatory Directive? The Role of the General Anti-Avoidance Provisions (“GAAR”) In Fiscal Interpretation’ (2012) 23 *Stellenbosch Law Review* 340.

<sup>42</sup> *WT Ramsay Ltd v IRC* [1982] AC 300 as cited in De Koker & Williams (note 7 above) 19.39.1. See *Furniss v Dawson* [1984] AC 474 (HL).



commercial substance is an important criterion in drawing the line between impermissible and permissible tax avoidance, there is a need for guidelines from the legislature.

### 3.4.3 Misuse or abuse test

The new GAAR introduced a new concept of “misuse or abuse” which is provided for in Section 80A(c)(ii) of the Act.<sup>43</sup> The Act does not define this concept.<sup>44</sup> The question then is when will the courts reach a conclusion that a taxpayer has misused or abused the provisions of the Act? What is the criterion or the test to determine misuse or abuse of the provisions?

While the GAAR does not explain what is meant by misuse or abuse, it is clear that an avoidance arrangement that complies with the letter of the tax law, but does not comply with its purpose, amounts to a misuse or abuse of the tax law. This means that when determining whether there has been a misuse or abuse of the law, the courts will refer to the specific provisions relied on to obtain the tax benefit, and determine whether the purpose of these provisions has been complied with. The misuse or abuse indicator is therefore couched in statutory interpretation.<sup>45</sup>

There are theories that have been recently accepted namely the “purposive” and “contextual purpose” theory which form part of the modern approach to interpreting legislation.<sup>46</sup> The contextual purpose requires the interpretation of a provision by looking at it in context. The purposive theory attempts to attribute the meaning to a statutory provision in the light of the purpose it aims to achieve.<sup>47</sup> The misuse or abuse provision requires that the provision be interpreted using the purposive

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<sup>43</sup> According to SARS Discussion Paper (note 9 above) 16 the purpose of the insertion of the misuse or abuse provision was to reinforce the modern approach to the interpretation of tax statutes. See Kujinga, B ‘Analysis of Misuse and Abuse in terms of the South African General Anti-Avoidance Rule: Lessons from Canada’ (2012) 45 *Comparative and International Law Journal of Southern Africa* 46.

<sup>44</sup> In Cilliers, C ‘Thou Shalt Not Peep at thy Neighbour’s Wife: Section 80A(c)(ii) of the Income Tax Act and the Abuse of Rights’ (2008) *The Taxpayer* at 87 the author suggests that the “misuse” and “abuse” mean the same thing and they are in fact synonyms.

<sup>45</sup> Kujinga (note 43 above) 46. See De Ville, J *Constitution and Statutory Interpretation* (2000) 51 & 52 and Devenish, G *Interpretation of Statutes* (1992) 25 – 50.

<sup>46</sup> Van Schalkwyk & Geldenhuys (note 3 above) 170 the authors make references to case law which decided in favour of the modern approach of statutory interpretation including *De Beers Marine (Pty) Ltd v CSARS* [2012] 3 All SA 181 (A), *Standard General Insurance Company Ltd v CCE* [2004] 2 All SA 376 (SCA), *CSARS v Airworld CC & Another* [2008] 2 All SA 593 (SCA) and *Metropolitan Life Ltd v CSARS* [2008] 70 SATC 162.

<sup>47</sup> As above.

interpretation approach.<sup>48</sup> The purposive interpretation approach looks beyond the literal meaning of the words according to its grammatical analysis; and requires the interpreter to engage with the purpose which lies behind the provision of the Act.<sup>49</sup>

These theories intertwine and are therefore intellectually and jurisprudentially more sound and advanced.<sup>50</sup> The modern approach of interpretation particularly the purposive interpretation of statutes is in line with the standards of the Constitution<sup>51</sup> as prescribed in Sections 39(1) and (2) of the Constitution.<sup>52</sup> Accordingly in order to ascertain the purpose of the provision, wider contextual considerations may be invoked, even where there are ambiguities.<sup>53</sup>

The concept of misuse or abuse was adopted from the Canadian GAAR in Sections 245(4)(a) – (b) of the Canadian Income Tax Act (CITA).<sup>54</sup> Section 245(4) of the CITA is similar in wording to Section 80A(c)(ii) of the Act and - unlike in South Africa – the Supreme Court of Canada had an opportunity to interpret Section 245 in *Canadian Trustco Mortgage Co v Canada*.<sup>55</sup>

The Supreme Court pointed out the Section 245(4) of the CITA is a twofold inquiry that firstly requires a contextual and purposive method of interpretation in order to find a meaning that harmonises the wording, object, spirit and purpose of the provisions of the CITA.<sup>56</sup> Secondly it requires an examination of the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit and purpose of the provision in question.<sup>57</sup>

South African courts may follow this approach in determining the application of the “misuse or abuse” indicator. The importance of Section 80A(c)(ii) of the Act has been highlighted by some legal scholars who describe this provision as the provision that works to expand the scope of the GAAR to address as many forms of impermissible tax avoidance as possible and protects the Act from being self-defeating. The latter

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<sup>48</sup> Van Schalkwyk & Geldenhuys (note 3 above) 178 and Kujinga (note 43 above) 47.

<sup>49</sup> Devenish (note 45 above) 36.

<sup>50</sup> Devenish (note 45 above) 33.

<sup>51</sup> The Constitution of the Republic of South Africa, 1996.

<sup>52</sup> Kujinga (note 43 above) 46 - 47.

<sup>53</sup> De Koker & Williams (note 7 above) 19.39.1.

<sup>54</sup> Canadian Income Tax Act RSC 1985 C 1 (5<sup>th</sup> Supp).

<sup>55</sup> *Canadian Trustco Mortgage Co v Canada* [2005] 2 SAR 601; 2005 SCC 54.

<sup>56</sup> *Canadian Trustco* 47 & 55.

<sup>57</sup> As above.

function ensures that the GAAR protects the provisions of the taxing Act from being used to avoid tax by taxpayers who only comply with the letter but not the purpose of the tax law.

Nevertheless, there exists great potential for uncertainty within the requirements of the misuse or abuse indicator. This is because determining the purpose of a detailed tax provision is not always straight-forward. Different interpreters can come up with different statutory purpose. The extent to which the words of the provisions can be relied on is unclear, yet for taxpayers, the words are the primary consideration when entering into tax arrangements. In this regard it is submitted that the misuse or abuse indicator does not establish certainty on what is permissible and what is impermissible.

#### **4. CONCLUSION**

This chapter looked at the old GAAR and discussed the problems that led to its replacement. SARS described the old GAAR as inconsistent and ineffective in combating impermissible tax avoidance. The *Conhage* case appeared to have been a nudge to the legislature to change the old GAAR.

The current GAAR includes tainted elements employed to characterise impermissible tax avoidance transactions namely the presence of abnormality, the absence of commercial substance and the misuse or abuse of the provisions of the Act. The inclusion of these tainted elements makes the GAAR more aggressive but uncertain. The purpose of the legislature in creating this wide GAAR may have been to deter taxpayers from testing the limit between permissible and impermissible tax avoidance and to counteract as many instances of tax avoidance as possible. However, the complex detail of the GAAR and its uncertainty may make it hard for the judiciary to identify an impermissible tax avoidance transaction

The judicial problems may stem from the fact that the current GAAR fails to provide definitions or guidelines for the expressions used in the provisions of the Act; leaving the duty of clarifying the meanings to the judiciary. The abnormality test also appears to be over reliant on the court's interpretation on what it regards as normal and depends solely on the nature and circumstances of the transaction. It is undesirable

to leave the courts with too much interpretation to do because interpretations differ from one judge to the other. This could lead to even more uncertainty.

Overall it can be concluded that while the GAAR aims to draw a line between permissible and impermissible tax avoidance, the line between the two still seems blurred because of the complexity and uncertainty of the GAAR, which ultimately fails to properly balance two conflicting interests namely the taxpayers' right to arrange their tax affairs to minimise their tax liability and SARS' obligation to protect the tax base.

## CHAPTER 3

### COMPARATIVE ANALYSIS WITH OTHER GAARS

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#### 1. INTRODUCTION OF THE GAARs

This chapter comprises of a discussion of the current GAARs in Australia, Canada and the UK. The chapter explores the statutory measures used in these three countries to combat impermissible tax avoidance, or abusive tax arrangements in the context of the UK GAAR. Similar to the South African GAAR discussion, only certain concepts of the GAARs in each country are discussed. The discussion will begin with a brief introduction of each country's GAAR. A discussion of concepts such as "arrangement", "purpose" and the tainted elements will follows. This chapter will end with a discussion of the proposed GAAR in India - which appears to be significantly similar to the South African GAAR.

This chapter not only aims to expose the fundamental differences between the three countries' GAARs with the South African GAAR. It also aims to point out the lessons (if any) that South Africa could learn from these GAARs in order to make it more

certain and effective at its functions. Lastly this chapter highlights the reasons that led to the rejection of the proposed Indian GAAR.

### 1.1 The Australia GAAR:

The Australian GAAR can be found in Part IVA as amended in Sections 177A – 177G of the Income Tax Assessment Act<sup>1</sup> (ITAA). The ITAA's primary aim is to counter arrangements that, objectively viewed, are carried out with the sole or dominant purpose of securing a tax advantage for a taxpayer.<sup>2</sup> In 2012 the Australian GAAR was amended, and it now applies to schemes<sup>3</sup> that were entered into on or after 16 November 2012. The amendments were driven by the weakness revealed by case law in the way in which Part IVA determines whether or not a tax advantage has been obtained in connection with an arrangement.<sup>4</sup>

The Australian GAAR has three elements namely<sup>5</sup>:

- a) a scheme as defined in Sections 177A(1) and (3) of the ITAA;
- b) a tax benefit as defined in Section 177C of the ITAA; and
- c) the dominant purpose of the taxpayer or identified taxpayer in entering into that scheme.<sup>6</sup>

In addition the GAAR stipulates in, Section 177D(2)(a) - (h) of the ITAA, eight factors to have regard to when considering the dominant purpose of the taxpayer. In *Peabody v Commissioner of Taxation*<sup>7</sup> it was stated that it requires an objective fact to determine the existence of a scheme and a tax benefit. If all the elements are

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<sup>1</sup> Income Tax Assessment Act 1936 (ITAA).

<sup>2</sup> Australian Government Explanatory Memorandum (13 February 2013) 'Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013' [http://www.comlaw.gov.au/Details/C2013B00015/Explanatory%20memorandum/Text\\_1.2](http://www.comlaw.gov.au/Details/C2013B00015/Explanatory%20memorandum/Text_1.2) (Accessed 12 May 2015) .

<sup>3</sup> Section 177A(1) of the ITAA.

<sup>4</sup> Australian Government Explanatory Memorandum (note 2 above) 1.4. See *Commissioner of Taxation v Hart* [2004] 206 ALR 207 15.

<sup>5</sup> Section 177D(1) of the ITAA.

<sup>6</sup> Garg, R & Mukerjee, K (2012) 'Removing the Fences: Looking Through GAAR' <http://www.pwc.com/in/en/assets/pdfs/publications-2012.pwc-white-paper-ongaar.pdf> 35 (Accessed 2 March 2015).

<sup>7</sup> *Peabody v Commissioner of Taxation* [1994] 123 ALR 451 458 & 459 as cited in Australian Government Explanatory Memorandum (note 2 above) 1.20. See Cashmere, M 'Chapter 2: Australia' in Brown, K (ed) *A Comparative Look at Regulation of Corporate Tax Avoidance* (2012) at 37 & 38.

satisfied the Commissioner may cancel any tax benefit as a result from that transaction in terms of Section 177F of the ITAA.

## 1.2 The Canadian GAAR:

The Canadian GAAR can be found in Part XVI, Section 245 of the Canadian Income Tax Act (CITA).<sup>8</sup> It was enacted in 1987 after the Supreme Court in *Stuart Investments Ltd v The Queen*<sup>9</sup> rejected the adoption of a judicially developed business purpose test where an avoidance transaction was in issue. The business purpose test entails that the transactions which lack a business purpose, other than the avoidance of tax, may be disregarded.<sup>10</sup>

In order to combat tax avoidance, Section 245(2) of the CITA provides that where a taxpayer is involved in an avoidance transaction the tax consequences of that transaction may be determined to disallow any tax benefit arising from the transaction.<sup>11</sup> An avoidance transaction in this context entails any transaction that (directly or indirectly) results in a tax benefit unless the primary *bona fide* purpose is something other than to obtain a tax benefit.<sup>12</sup> In other words to trigger the application of the CITA there are three requirements that need to be met namely<sup>13</sup>:

- a) a tax benefit arising from a transaction;
- b) to determine whether the transaction is an avoidance transaction not arranged mainly for *bona fide* purpose other than to obtain the tax benefit; and
- c) to determine whether the avoidance transaction is abusive.

It is notable that Section 245(2) should be read with Section 245(4) of the CITA. In terms of Section 245(4) where a transaction complies with the requirements of Section 245(2), such a transaction will only be considered an impermissible tax avoidance if the transaction results in the direct or indirect misuse or abuse of the

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<sup>8</sup> Canadian Income Tax Act RSC 1985 C 1 (5<sup>th</sup> Supp).

<sup>9</sup> *Stuart Investments Ltd v The Queen* [1984] CTC 294 (SCC) as cited in Arnold, B 'Chapter 4: The Canadian Experience with a General Anti-Avoidance Rule' in Freedman, J *Beyond Boundaries Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 29.

<sup>10</sup> Arnold, J 'Part One: Canada: 9.3 Anti-Avoidance Doctrines and Rules' in Ault, H & Arnold, J *Comparative Income Taxation: A Structural Analysis* (2010) 41.

<sup>11</sup> Arnold (note 10 above) 42.

<sup>12</sup> Sections 245(3)(a) & (b) of the CITA.

<sup>13</sup> Garg & Mukerjee (note 6 above) 40.

provisions of the CITA read as a whole.<sup>14</sup> Therefore there are three requirements that must be established to allow the application of the Canadian GAAR.<sup>15</sup> These requirements were summed up in the Supreme Court judgment in *Canada Trustco*.<sup>16</sup>

The taxpayer must refute (or challenge) the Minister of National Revenue's factual assumptions by contesting the existence of a tax benefit or by proving that a *bona fide* non-tax purpose primarily drove the transaction.<sup>17</sup>

The Canadian GAAR was first applied in the Tax Court of Canada 10 years after its enactment in 1997 in *McNichol v The Queen*.<sup>18</sup> After 18 years of the enactment of the GAAR, the Supreme Court dealt with the *Canada Trustco* case where the taxpayer was successful and the *Mathew* case where the tax authorities were successful.<sup>19</sup>

### 1.3 The UK GAAR:

A GAAR was introduced for the first time in the UK on 17 July 2013, and it can be found in Part 5 Sections 206 to 215 of the Finance Act.<sup>20</sup> The GAAR applies to any transaction that took place on or after 17 July 2013.<sup>21</sup> The acronym GAAR – in the context of the UK – stands for the general anti-abuse rule; it aims to counteract tax advantages<sup>22</sup> arising from tax arrangements<sup>23</sup> that are abusive.<sup>24</sup> Unlike the SA

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<sup>14</sup> Sections 245(4)(a) & (b) of the CITA.

<sup>15</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SAR 601, 2005 SCC 54 66 and *Mathew v The Queen* [2005] SCC 31.

<sup>16</sup> *Canada Trustco 2*. See EY 'GAAR Rising: Mapping Tax Enforcement's Evolution' (February 2013) [http://www.ey.com/Publication/vwLUAssets/GAA\\_rising/\\$FILE/GAAR\\_rising\\_1%20Feb\\_2013.pdf](http://www.ey.com/Publication/vwLUAssets/GAA_rising/$FILE/GAAR_rising_1%20Feb_2013.pdf) 41 (Accessed 29 June 2015).

<sup>17</sup> As above.

<sup>18</sup> *McNichol v The Queen* [1997] 2 CTC 2088 (TCC) as cited in Arnold, B 'The Long, Slow, Steady Demise of the General Anti-Avoidance Rule' (2004) 52 *Canadian Tax Journal* 488.

<sup>19</sup> Arnold (note 10 above) 42.

<sup>20</sup> The UK Finance Act 2013 (c. 29) (Finance Act). For a detailed background of the UK GAAR see generally Bowler, T 'Chapter 8: Tackling Tax Avoidance in the UK' in Freedman, J *Beyond Boundaries Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 63 & 3.

<sup>21</sup> PWC 'UK Enacts General Anti-Abuse Rule and Confirms Tax Rate Reductions' (17 July 2013) [http://www.pwc.com/en\\_US/us/tax-services-multinationals/newsalert/assests/pwc-uk-finance-act-2013-enacted.pdf](http://www.pwc.com/en_US/us/tax-services-multinationals/newsalert/assests/pwc-uk-finance-act-2013-enacted.pdf) 1 (Accessed 15 May 2015).

<sup>22</sup> Section 208 of the Finance Act. See Eden, S 'Chapter 16: United Kingdom' in Brown, K (ed) *A Comparative Look at Regulation of Corporate Tax Avoidance* (2012) 321.

<sup>23</sup> Section 207(1) of the Finance Act defines "tax arrangements".

<sup>24</sup> Section 207(2) of the Finance Act defines tax arrangements that are "abusive". See Tiley, J 'Chapter 9: The Avoidance Problem: Some UK Reflections' in Freedman, J *Beyond Boundaries Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 71.



GAAR which aims to combat impermissible tax avoidance, the UK GAAR specifically targets “abusive” tax arrangements.

In terms of Section 207(2) of the Finance Act, a tax arrangement is considered “abusive” where the entering into or the carrying out of such an arrangement cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions. Furthermore, Section 207(2) has a list of circumstances that need to be taken into consideration in determining whether arrangements are abusive. Those circumstances include<sup>25</sup>:

- (a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions,
- (b) whether the means of achieving those results involves one or more contrived or abnormal steps, and
- (c) whether the arrangement are intended to exploit any shortcomings in those provisions.

Abuse of the tax arrangement is the core issue which drives the UK GAAR. In order to invoke the GAAR the following three questions should be answered in the affirmative in relation to a taxpayer’s tax affairs<sup>26</sup>:

- a) Is there an arrangement which give rise to a tax advantage?
- b) Is the tax advantage the sole or main purpose of entering into or carrying out the arrangement?
- c) Is the tax arrangement “abusive” in terms of Section 207(2) of the Finance Act?

## **2. ARRANGEMENT**

What is referred to as an “arrangement” in the SA GAAR is referred to as a scheme in the Australian GAAR. In terms of Section 177A(1) of the ITAA a scheme is defined as follows:

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<sup>25</sup> Sections 207(2)(a) – (c) of the Finance Act.

<sup>26</sup> MacKenzie, S ‘UK GAAR and Double Reasonableness’ (30 March 2014) <http://www.blears.com/ournews/uk-gaar-and-double-reasonableness/> (Accessed 20 July 2015).

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings and;
- (b) any scheme, plan, proposal, action, course of action or course of conduct.

It is evident that the definition of a scheme is wide as it encompasses any scheme including a part of a scheme. However the courts<sup>27</sup> have endeavoured to limit what may be regarded as a “scheme”.<sup>28</sup> The first case to deal with this issue was *Peabody v FCT*<sup>29</sup> which was followed by the *Hart v FCT*<sup>30</sup> case.

The question that was raised in *Peabody* was; does Section 177D of the ITAA suggest that a part of a scheme can be covered by Part IVA? In other words can a transaction be taken out or isolated from a broader transaction? This question was answered in the Federal Court and High Court in *Peabody* where the court made substantive comments on the meaning of this notion. The court referred to this style of looking at a transaction as the “sub-scheme” approach. The full Court of the Federal Court rejected the notion of sub-scheme approach arguing that it was not sufficient that ‘an element of the scheme had a tax advantage’.<sup>31</sup>

The High Court dismissed the argument that Part IVA applies to a part of a scheme. It contended that to be a scheme, as opposed to a sub-scheme, the circumstances must be capable of “standing on their own without being ‘robbed of all practical meaning’”.<sup>32</sup> Furthermore, the court held that Part IVA does not provide for a scheme to include part of a scheme and it is impossible to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself.<sup>33</sup>

In *Hart* the court emphasised that the tax benefit need to be identified first, and the identified tax benefit must relate to a scheme. In other words the scheme cannot be identified in isolation; it must be identified by reference to sufficient facts to enable

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<sup>27</sup> See *Hart v FCT* [2004] 55 ATR 712 as cited in Cashmere (note 7 above) 39.

<sup>28</sup> Cashmere (note 7 above) 38.

<sup>29</sup> *Peabody v FCT* [1992] 92 ATC 4585 which was subsequently followed by *Peabody v FCT* [1993] 93 ATC 4104 and *Peabody v FCT* [1994] 94 ATC 4663 as cited in Cassidy, J ‘Peabody v FCT and Part IVA’ (1995) 5 *Revenue Law Journal* 200.

<sup>30</sup> *Hart v FCT* 2002 50 ATR 369.

<sup>31</sup> *Peabody* 4111 as cited in Cassidy (note 29 above) 207.

<sup>32</sup> *Peabody* 4670. See Cassidy, J ‘Part IVA – A Toothless Tiger?’ (2001) 11 *Revenue Law Journal* 6. See Cashmere (note 7 above) 38.

<sup>33</sup> *Peabody* 4670.

the appropriate connection to be made between the schemes itself and the tax benefit because the two are inter-related.<sup>34</sup>

On appeal the court rejected the approach followed in *Peabody* concluding that a sub-scheme is a scheme.<sup>35</sup> Accordingly the Commissioner can isolate a part of a scheme from a broader scheme for purposes of Part IVA. This decision was criticised for not taking into account the effect of isolating a sub-scheme on commercial transactions.<sup>36</sup>

In Canada Section 245(1) of the CITA defines a “transaction” as an arrangement or event. In addition an “avoidance transaction” is defined in Section 245(3) as any transaction that results, directly or indirectly, in a tax benefit, by itself or as part of a series of transactions, unless the transaction was for a *bona fide* purpose other than to obtain a tax benefit.<sup>37</sup> It is clear that a part of a transaction or a series of transactions can be isolated and be considered an avoidance transaction despite the fact that it is not a full transaction but merely a part of a transaction. If a transaction is found to be an avoidance transaction, the tax implications thereof are determined to deny the tax benefit resulting from that transaction or a series of transactions.<sup>38</sup>

In terms of Section 248(10) of the CITA, a “series of transactions” includes any related transactions or events completed in contemplation of the series. To clarify the idea of a “series of transaction”, the Federal Court of Appeal in *OSFC Holdings Ltd v Canada*<sup>39</sup> adopted the guidelines laid down in *Furniss*<sup>40</sup>, a case that explains the interconnectedness of transactions in a series.

In the UK, Section 207(3) of the Finance Act stipulates that: ‘where the tax arrangements form part of any other arrangements regard must also be had to those other arrangements’. In other words this provision suggests that should an

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<sup>34</sup> Cashmere (note 7 above) 40. See D’Ascenzo, M ‘Part IVA: Post-Hart’ (2004) 7 *Journal of Australian Taxation* 368. This was submitted by the court in *FCT v Hart* 43 that the definition of a scheme encompasses not only a series of steps which together can be said to constitute a “scheme” or a “plan” but also (by its reference to “action” in the singular) the taking of but one step.

<sup>35</sup> See *FCT v Hart* 2004 55 ATR 725 – 726.

<sup>36</sup> See generally Kujinga, B *A Comparative Analysis of the Efficacy of the General Anti-Avoidance Rule as a Measure Against Impermissible Income Tax Avoidance in South Africa* (LLD thesis, University of Pretoria, 2013) 153 – 154.

<sup>37</sup> See *Canada Trustco* 22.

<sup>38</sup> Section 245(2) of the CITA.

<sup>39</sup> *OSFC Holdings Ltd v Canada (C.A)* [2001] FCA 260, [2002] 2 F.C 288.

<sup>40</sup> *OSFC Holdings* 19 and *Canada Trustco* 25 & 26.

arrangement be found to be a tax arrangement in terms of Section 207(1), every arrangement within that tax arrangement must be taken into account in determining whether the tax arrangement is abusive.

The UK GAAR varies from other GAARs with regards to analysing an arrangement by requiring the Her Majesty's Revenue and Customs (HMRC) and the courts to not rush to isolate any part of the tax arrangement in question before examining the tax arrangement in question as whole.

## **TAINTED ELEMENTS**

### **2.1 Sole or Dominant Purpose, Objectively Determined: Australia**

The GAARs discussed in this research all have different indicators of impermissible tax avoidance, or tainted elements as they are known in South Africa. The Australian GAAR provides for the dominant purpose of the taxpayer to be ascertained by objectively applying the following eight factors<sup>41</sup>:

- a) the manner in which the scheme was entered into or carried out;
- b) the form and substance of the scheme;
- c) the time the scheme was entered into;
- d) the length at which it was carried out;
- e) the results it would achieve;
- f) the financial position of the any persons involved in the scheme;
- g) any other consequence for the relevant taxpayer or persons involved; and
- h) the nature of any connection between the taxpayer and persons involved.

For Part IVA of the ITAA to apply these eight factors must be considered in order to determine whether the taxpayer had the sole or dominant purpose to obtain a tax benefit. In *Peabody Hill J* held that the Commissioner must have regard to every single factor when determining the dominant purpose underlying the scheme.<sup>42</sup>

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<sup>41</sup> Sections 177D(2)(a) – (h) of the ITAA.

<sup>42</sup> Cassidy, J 'Are Tax Schemes Legitimate Commercial Transactions? Commissioner of Taxation v Spotless Services Ltd and Commissioner of Taxation Spotless Finance Ltd' [1996] HCRev 7; (2006) 2 High Court Review 3.

In *FCT v Spotless*<sup>43</sup> it was held that a purpose will be dominant purpose where it is the “ruling, prevailing or most influential purpose”.<sup>44</sup> The consideration of the eight factors requires a comparison between the scheme in question and an alternative suggestion.<sup>45</sup> This is one of the unique elements of the Australian GAAR because these factors cannot be found in the South African, Canadian and UK GAAR. In order to objectively ascertain whether the scheme in question had a dominant purpose to obtain the tax benefit obtained or to be obtained, the Commissioner has to take into consideration these eight factors.

In *Spotless* the court considered the impact of commercial transactions with tax avoidance effects as the case dealt with a short term investment vehicle. The taxpayers claimed the interest on the investment was exempt from Australian tax in terms of Section 23(q) of the ITAA. The Commissioner argued that the interest should be assessed under Part IVA. The court *a quo* decided in favour of the taxpayers on the basis that the source of the interest was an Australian source, the Cook Islands, and Part IVA did not apply.<sup>46</sup>

The Commissioner appealed this decision, the court agreed that the first two elements under Part IVA were met that is, there was a scheme and the taxpayers had obtained a tax benefit. However the appeal court disagreed with regards to the dominant purpose underlying the scheme.<sup>47</sup> According to Beaumont J, Section 177D was satisfied as its dominant purpose was to obtain a tax advantage by combining an offshore nominal tax rule with the operation of Section 23(q) of the ITAA.<sup>48</sup> While Cooper J found that the dominant purpose was to “obtain the maximum return on the money invested after the payment of all applicable costs, including tax” and not to get a tax benefit.<sup>49</sup> Therefore an arrangement with a commercial character does not necessarily indicate the attainment of a tax benefit. The appeal was dismissed and the court found that Part IVA does not apply.

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<sup>43</sup> *FCT v Spotless Services Ltd* [1995] 95 ATC 4775.

<sup>44</sup> As above.

<sup>45</sup> D’Ascenzo (note 34 above) 364.

<sup>46</sup> Cassidy (note 42 above). See generally the court of first instance decision *Spotless Services Ltd v FCT* [1993] 93 ATC 4397.

<sup>47</sup> As above.

<sup>48</sup> *FCT v Spotless* 4797.

<sup>49</sup> See *FCT v Spotless* 4812 and Cassidy (note 42 above).

Nevertheless it appears that courts apply Part IVA to transactions with both a commercial and tax benefit.

In both *Eastern Nitrogen v Commissioner of Taxation*<sup>50</sup> and *Federal Commissioner of Taxation v Metal Manufacturers*<sup>51</sup> it was stated that when analysing a commercial transaction, Section 177D does not necessarily require the taxpayer to operate a scheme to obtain a tax benefit. Rather there need to be something more than the attainment of a tax benefit, and that something more is to obtain a substantial amount of money in the most tax effective way possible.

From this analysis it is clear that the sole or dominant purpose is a controversial indicator because the courts have created uncertainty with regards to the application of Section 177D as it reached different conclusions in more than one occasion. According to Cashmere the eight factors are merely matters to be taken into account in determining whether the scheme in question lean more in favour of finding a tax-driven purpose or not.<sup>52</sup> Since the scheme is identified with reference to the facts, the dominant purpose of the taxpayer needs to be determined against the facts of the situation as a whole.<sup>53</sup>

Cashmere suggests that the commercial purpose of the taxpayer must be taken into account in weighing the eight factors.<sup>54</sup> He points out that if a dominant purpose is to be determined then it is important to consider all of the purposes including the commercial purpose.<sup>55</sup> Furthermore he submits that if the commercial purpose is not considered then it is impossible to determine which purpose was dominant in so far as the taxpayer was concerned.<sup>56</sup>

## 2.2 Misuse or Abuse: Canada

The Canadian GAAR is founded on the concept of misuse or abuse of the tax law as an indicator of impermissible tax avoidance. The misuse or abuse provision applies

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<sup>50</sup> *Eastern Nitrogen v Commissioner of Taxation* [2001] 46 ATR 474 & 494.

<sup>51</sup> *Federal v Metal Manufacturers* [2001] FCA 365.

<sup>52</sup> Cashmere (note 7 above) 41.

<sup>53</sup> Cashmere (note 7 above) 42.

<sup>54</sup> As above.

<sup>55</sup> As above.

<sup>56</sup> See Cashmere, M 'Towards an Appropriate Interpretative Approach to Australia's General Tax Avoidance Rule – Part IVA' (2006) 35 AT Rev 231 240.

to a transaction only if it would result directly or indirectly in a misuse of the provisions or would result directly or indirectly in an abuse having regard to those provisions.<sup>57</sup> The word “misuse” refers to the misuse of the provisions of the Act, Income Tax Regulations, Income Tax Application Rules, a tax treaty, or any other relevant legislation; and the word “abuse” refers to an abuse having regard to any of these provisions (other than Section 245 of the Act) read as a whole.<sup>58</sup>

In *OSFC Holdings* the Federal Court of Appeal held that Section 245(4) mandates two different inquiries.<sup>59</sup> Firstly to consider whether there was a misuse of a provision of the Act that were relied upon to achieve the tax benefit and secondly, whether there was an abuse of any policy of the Act read as a whole.<sup>60</sup> However the court in *Canada Trustco* disagreed with that argument and held that misuse or abuse are synonyms.<sup>61</sup> The court further stated that Parliament specifically that it could not have intended two different inquiries which raises a difficult question of how one can abuse the Act as a whole without misusing any of its provisions.<sup>62</sup> It was concluded that Section 245(4) requires a single inquiry that is unified to the textual, contextual and purposive interpretation of the specific provisions of the CITA.<sup>63</sup>

It was highlighted in the *Canada Trustco* that the abusive element is central. As a result the Canadian GAAR can only apply to deny a tax benefit when the abusive nature of the transaction is clear.<sup>64</sup> However Section 245(4) does not provide for the steps to be taken when determining whether or not a transaction is abusive. The *OSFC Holdings* and *Canada Trustco* cases have shed some light as to the determination of whether or not a transaction is abusive.

The courts have adopted a two-stage test to determine if a transaction is abusive. Firstly the relevant provisions of the Act should be identified and secondly, the facts must be analysed the facts to determine whether the avoidance transaction constitute a misuse or abuse having regard to the identified provisions.<sup>65</sup> However it

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<sup>57</sup> Sections 245(4)(a) & (b) of the CITA.

<sup>58</sup> Section 245(4) of the CITA. See EY (note 16 above) 39.

<sup>59</sup> *OSFC Holdings* 61.

<sup>60</sup> As cited in *Canada Trustco* 38.

<sup>61</sup> *Canada Trustco* 39.

<sup>62</sup> *Canada Trustco* 39.

<sup>63</sup> *Canada Trustco* 43.

<sup>64</sup> *Canada Trustco* 36 & 50.

<sup>65</sup> *OSFC Holdings* 67 and *Canada Trustco* 47. See Arnold (note 18 above) 497.



is required that the identified relevant provision should be clear and unambiguous. This requirement appeared to be burdensome and unfavourable to the tax authority in both these cases.<sup>66</sup> The test involves a mixed question of law and fact; the court has characterised this approach as a purposive interpretation of the CITA.

However it has been pointed out that a statutory purpose is not easily established and where it is established it is not always consistent or unanimous. Different people can interpret purpose differently. As a result the courts have faced difficulties in establishing a statutory purpose. It is thus argued that the misuse or abuse provision does not clearly distinguish between legitimate tax planning and abusive tax avoidance.

### 2.3 Double Reasonableness Test: UK

As mentioned earlier, in terms of the UK GAAR, an arrangement will be considered abusive if it cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions by having regard of all circumstances including the following circumstances listed in this provision.<sup>67</sup>

- a) the comparison of the substantive results of the arrangements with the principles on which the relevant tax provisions are based, and with the policy objectives of those provisions;
- b) the determination of whether the means of achieving the results involves one or more contrived or abnormal steps; and
- c) the determination of whether the arrangements are intended to exploit any shortcomings in the relevant provisions.

When considering the double reasonableness test the court is required to consider the range of reasonable views that could be held in relation to the arrangements.<sup>68</sup> If the court holds the review, after considering all the circumstances, which the tax

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<sup>66</sup> Kujinga, B 'Factors That Limit The Efficacy of General Anti-Avoidance Rules in Income Tax Legislation: Lessons From South Africa, Australia and Canada' (2004) 47 *Comparative and International Law Journal of South Africa* 447.

<sup>67</sup> HMRC GAAR Guidance (Undated) [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/39927012\\_HMRC\\_GAAR\\_Guidance\\_Parts\\_A-C\\_with\\_effect\\_from\\_30\\_January\\_2015\\_AD\\_V6.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/39927012_HMRC_GAAR_Guidance_Parts_A-C_with_effect_from_30_January_2015_AD_V6.pdf) 18 (Accessed 20 July 2015).

<sup>68</sup> HMRC GAAR Guidance (note 67 above) 24.



arrangement could reasonably be regarded as a reasonable course of action then such an arrangement would not be regarded as abusive.<sup>69</sup> In this case the taxpayer would be given the benefit of the doubt that the tax arrangement he/she entered into or carried out is not abusive and such a taxpayer was merely exercising his/her choice to pay the least amount of tax.

It is important to note that even where the court does not hold the view that the tax arrangement as a reasonable course of action; the court's view will not inevitably lead to conclusion that the arrangement is not abusive.<sup>70</sup> According to Section 211(1) of the Finance Act the burden of proving of that the tax arrangement was abusive rests on the HMRC.

The concept of a reasonable course of action in relation to the relevant tax provisions referred to in Section 207(2) of the Finance Act focuses on the taxpayer's choice of course of action with respect to the tax legislation that are engaged by that course of action in order to achieve the tax advantage.<sup>71</sup> The test to this part of the provision recognises that some parts of the tax legislation provide a clear tax relief or acknowledge the attainment of certain results for certain courses of action.<sup>72</sup> Therefore reasonable steps taken to achieve those results will be a reasonable course of action in terms of the relevant tax legislation.

From the above analysis it can be argued that the double reasonableness test is rather subjective because accordingly what may appear to be reasonable course of action to one person may not appear to be a reasonable course of action to another. This test appears to be wide in the sense that it does not operate merely by establishing what is a reasonable course of action but it establishes whether there are reasonably held views that the arrangement in question was a reasonable course of action.<sup>73</sup> It will be to see how this test is interpreted by the courts in practice but early indications are that the test will be difficult to apply.

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<sup>69</sup> As above.

<sup>70</sup> As above.

<sup>71</sup> HMRC GAAR Guidance (note 67 above) 19.

<sup>72</sup> HMRC GAAR Guidance (note 67 above) 20.

<sup>73</sup> Ashurst 'General Anti-Abuse Rule (GAAR) (Tax Newsletter, June 2013)' (Undated) [http://www.ahurst.com/publication-item.aspx?id\\_Content=9246](http://www.ahurst.com/publication-item.aspx?id_Content=9246) (Accessed 28 August 2015).

### 3. THE INDIAN ATTEMPT AT INTRODUCING A GAAR

In 2012 the Indian government introduced the Finance Act containing GAAR provisions.<sup>74</sup> The Finance Act contained proposals to amend the Income Tax Act especially with respect to the GAAR provisions.

Sections 95 to 99 of the Finance Act provides for the GAAR provisions. Significantly similar to the South African GAAR, the Indian GAAR provisions apply to an arrangement, which is defined as an impermissible avoidance arrangement, if its main purpose is to obtain a tax benefit and it contains any one of the following tainted elements:

- a) not at arm's length;
- b) results in misuse or abuse of the provisions;
- c) lacks commercial substance; or
- d) was entered into in a manner not normally employed for *bona fide* purposes.<sup>75</sup>

The consequences thereof are listed in Section 98 of the Finance Act which gives the tax authorities wide powers to *inter alia* disregard or re-characterise impermissible avoidance arrangements.<sup>76</sup>

The GAAR provisions have been heavily criticised as having a wide and uncertain application. The provisions have also been criticised as being overriding in nature by extending to the tax treaties to which India is a signatory.<sup>77</sup> Some criticism has been that the GAAR provisions have ambiguities and clarify and therefore amendments are required.<sup>78</sup> The Institute of Cost Accountants of India (the Institute)<sup>79</sup> has recommended *inter alia* that the GAAR's scope of operation should be limited to

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<sup>74</sup> The Institute of Cost Accountants of India 'Exposure Draft on Framework of Indian GAAR' (Undated) [http://www.icmai.in/upload/Institute/Comments\\_Invited?GAAR\\_White\\_Paper.pdf](http://www.icmai.in/upload/Institute/Comments_Invited?GAAR_White_Paper.pdf) 3 (Accessed 5 May 2015). See PWC 'Indian Budget Proposal Retains Indirect Transfer Tax Rules But defers GAAR Until 2015' (28 February 2013) *Asia Pacific Tax Newsletter* 1.

<sup>75</sup> See Section 96 of the Finance Act; the Institute of Cost Accountants of India (note 74 above) 9 and Sayta, P 'How Will Business In India Change With GAAR?' (September 2014) <http://www.ey.com/IN/en/Services/Tax/EY-how-will-doing-busniess-in-india-change-with-gaar-pranav-sayta> (Accessed 4 May 2015).

<sup>76</sup> As above.

<sup>77</sup> The Institute of Cost Accountants of India (note 74 above) 21.

<sup>78</sup> The Institute of Cost Accountants of India (note 74 above) 23.

<sup>79</sup> According to The Institute of Cost Accountants of India <http://icmai.in/icmai/aboutus/history.php> (Accessed 27 July 2015) this institute is a recognised statutory professional organisation governed under the Cost and Works Accountants Act.

transactions which objectively, have tax avoidance as a sole or main purpose and that; the GAAR should exclude transactions that are consistent with the intention of legislature after looking at the legislation as a whole.<sup>80</sup>

The Institute has also recommended that the GAAR should have a provision that enables the Central Government to exclude transactions that, in a legal sense, attract the GAAR but are actually genuine transactions.<sup>81</sup>

It is of great interest that India delayed the implementation of its GAAR which is very similar to that of South Africa. Although no law is precisely perfect at the beginning, it has to be improved at every stage. The heavy criticism of the Indian GAAR, which has crossed over to downright rejection, further illustrates the point made in chapter 2 above; that the South African GAAR is too uncertain to perform its functions properly.

#### **4. CONCLUSION**

This chapter looked at the current GAARs in Australia, Canada and UK. The focus of this chapter was on how the three countries' GAARs define an "arrangement" in the context of a tax avoidance transaction. This chapter also looked at how the GAARs of the countries studied isolated impermissible tax avoidance.

The countries discussed in this chapter appear to have a different approach in defining an "arrangement". The definition of "arrangement" seems to be wide in the Canadian and Australian GAARs. However, the UK GAAR provides for a narrower approach in this regard by obligating the HMRC to look at the whole arrangement when establishing an abusive tax arrangement. It is submitted that the UK approach to arrangements is the correct one as it is more balanced and allows the isolation of a part of an arrangement only when the whole arrangement has been considered.

South Africa can learn from this because not only does it give a taxpayer a fair judgment of his or her tax avoidance arrangement, it also lessens the uncertainties brought by a wide definition. Lessons could be drawn from the UK with regards to analysing the tax arrangement as a whole as opposed to isolating or targeting a particular part of the tax arrangement, without considering the tax arrangement as a

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<sup>80</sup> The Institute of Cost Accountants of India (note 74 above) 24.

<sup>81</sup> As above.

whole. As it stands currently, in South Africa, the Commissioner can examine any part of the arrangement and this could potentially destroy the commercial nature of the tax arrangement.

Regarding the indicators of impermissible tax avoidance, the Australian GAAR have a unique provision that provides for factors that are employed to determine whether a taxpayer had the sole or dominant purpose to obtain a tax benefit. For Part IVA of the ITAA to apply there must be a scheme, tax benefit and such a scheme must have been entered with the sole or main purpose to achieve a tax benefit. However it can be argued that these requirements are insufficient to isolate impermissible tax avoidance because the point when tax purpose trumps non-tax purpose, or vice versa, for GAAR purposes, is unknown and uncertain especially after cases such as *Spotless*, *Eastern Nitrogen* and *Metal Manufacturers*.

In Canada the misuse or abuse test as an indicator has given the Canadian courts difficulties especially with regards to the statutory purpose as it has been proved that it is not easily established. The interpretation of purpose have posed a challenge in the past as different courts interpreted it differently consequently causing inconsistency. The conclusion that can be drawn is that the misuse or abuse provision does not clearly distinguish between permissible and impermissible tax avoidance.

The double reasonableness test employed by the UK to attack abusive tax arrangements appears to be controversial to a certain extent. Its focus is mainly on the subjective views held the court. In comparison to other indicators, it appears to be a less stringent and wide indicator as it establishes whether there are reasonably held views that the arrangement in question was a reasonable course of action. It is still an untested indicator therefore firm conclusions about it cannot be drawn yet.

This chapter also dealt with the proposed new GAAR in India. This new GAAR is very similar to the South African GAAR. As discussed above, it should be alarming to South Africa that certain India stakeholders rejected this GAAR on the basis of uncertainty. The rejection has also been centred on criticism that the definition of “arrangement” needs to be revisited and that the tainted elements are too wide.

In summary, from the discussion in this chapter, it is evident that a clear line between permissible and impermissible is difficult to draw. Some of the aspects of the South African GAAR that were adopted from other jurisdictions have proven to be controversial in these jurisdictions. For instance, this chapter shows that:

- a) objective dominant purpose has caused uncertainty in Australia;
- b) the misuse or abuse indicator has caused uncertainty in Canada; and
- c) the isolation of a part of an arrangement has caused controversy in Australia.

All this shows that it is almost inevitable that when drafting legislation of this nature, where there are conflicting interests between the taxpayer's rights and the rights of the government, there will be a lack of clarity. It also reinforces the conclusion made in chapter 2 above that the South African GAAR is too wide and uncertain. Like Freedman pointed out, the challenge is not drawing a clear line between the types of tax avoidance but it is to learn to work around the uncertainties.<sup>82</sup> It is submitted that South Africa is not isolated in having an uncertain GAAR but lessons from other jurisdictions on aspects of the GAAR need to be heeded in order to reduce uncertainty.

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<sup>82</sup> Freedman, J 'Chapter 1: Introduction' in Freedman, J *Beyond Boundaries Developing Approaches to Tax Avoidance and Tax Risk Management* (2008) 7.

## CHAPTER 4

### COMPARATIVE ANALYSIS WITH JUDICIAL ANTI-AVOIDANCE RULES

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#### 1. INTRODUCTION

Chapter 3 dealt with a comparative analysis with other GAARs from which aspects of the South African GAAR were adopted. The South African GAAR has also adopted concepts from GAAR alternatives, namely anti-avoidance doctrines in the US and the UK.

Unlike South Africa, the US does not have a formal statute that regulates abusive tax shelters<sup>1</sup> or impermissible tax avoidance. The US courts and tax authorities, the Internal Revenue Service (IRS), rely mainly on judicial anti-avoidance doctrines to combat impermissible tax avoidance.<sup>2</sup> The courts have been influential in shaping the US tax policy, and one case which is significant in this regard is *Gregory v*

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<sup>1</sup> According to Kaye, T 'Chapter 17: United States' in Brown, K *A Comparative Look at Regulation of Corporate Tax Avoidance* (2012) 336 & 337 tax shelter can be permissible and constitute tax avoidance or impermissible and constitute tax evasion however she points out that the line between the two is blurred. As result, the Internal Revenue Service (hereafter the IRS) targets abusive tax shelter transactions.

<sup>2</sup> Garg, R & Mukerjee, K (2012) 'Removing the Fences: Looking Through GAAR' <http://www.pwc.com/in/en/assets/pdfs/publications-2012.pwc-white-paper-ongaar.pdf> 50 (Accessed on 2 March 2015).

*Helvering*<sup>3</sup>. This case is a landmark in articulating one of the critical common law doctrines namely the economic substance doctrine<sup>4</sup>. Over the years the economic substance doctrine, although it was not the only doctrine relied on, has been applied as a judicial anti-avoidance rule that performs the role of a GAAR.

There are five main doctrines that the IRS used to challenge tax shelter transactions and denying the benefits obtained thereof.<sup>5</sup> These doctrines are as follows<sup>6</sup>:

- a) the economic substance doctrine;
- b) sham transaction doctrine;
- c) the business purpose doctrine;
- d) substance over form doctrine and
- e) step transaction doctrine.

For purpose of this discussion the focus will be mainly be on the economic substance doctrine. These doctrines are generally used to prevent tax avoidance practices where the taxpayer follows the literal wording of the Internal Revenue Code but disguise the true economic reality of the transaction.<sup>7</sup> These doctrines overlap in application even though the courts have applied them differently over the years.

To have some form of uniformity, the Health Care and Education Reconciliation Act<sup>8</sup> created Section 7701(o) officially codified the doctrine.<sup>9</sup> The economic substance will be discussed in details in this chapter primarily to indicate its application in the US in

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<sup>3</sup> *Gregory v Helvering* [1935] 293 US 465. Other leading cases articulating the economic substance are *Knetsch v United States* [1960] 364 US 361; *Frank Lyon Co. v United States* [1978] 435 US 561 and *Goldstein v Commissioner* 364 F.2d 734 (2d Cir. 1966).

<sup>4</sup> See Garg & Mukerjee (note 2 above) 50; Section 7701(o)(5)(A) of the Health Care and education Reconciliation Act of 2010, Pub. L. No. 11-152 and Kaye (note 1 above) 345 for a detailed explanation of the economic substance doctrine.

<sup>5</sup> See Kujinga, B 'The Economic Substance Doctrine Against Abusive Tax Shelters in the United States: Lessons For South Africa' (2015) 27 *South Africa Mercantile Law Journal* 222.

<sup>6</sup> See Garg & Mukerjee (note 2 above) 50; Thoronyi, V *Comparative Tax Law* (2003) 164 and EY 'GAAR Rising: Mapping Tax Enforcement's Evolution' (February 2013) [http://www.ey.com/Publication/vwLUAssets/GAA\\_rising/\\$FILE/GAAR\\_rising\\_1%20Feb\\_2013.pdf](http://www.ey.com/Publication/vwLUAssets/GAA_rising/$FILE/GAAR_rising_1%20Feb_2013.pdf) 10 (Accessed 29 June 2015). According to McMahon, M 'Economic Substance, Purposive Activity, and Corporate Tax Shelters' (2002) 94 *Tax Notes* at 1018 the application of these judicial doctrines is a critical element of enforcing the statutory rules and to deter transactions that are economically inefficient.

<sup>7</sup> Kaye (note 1 above) 344.

<sup>8</sup> Act of 2010.

<sup>9</sup> The economic substance doctrine is regarded the most important doctrine; this is an opinion shared by Bankman, J 'The Economic Substance Doctrine' (2000) 74(5) *Southern California Law Review* at 6 as cited in Kujinga (note 5 above) 223.

curbing impermissible tax avoidance and the lessons that, South Africa could learn from it, if any.

This chapter will also discuss the UK judicial approach to impermissible tax avoidance as introduced in *W.T Ramsay v IRC*<sup>10</sup> and expanded in *Furniss v Dawson*<sup>11</sup> and then later improved in *Craven v White*<sup>12</sup>. The purpose of the discussion of the *Ramsay* approach is to determine whether adopting this approach in the South African GAAR is still necessary.

## 2. THE ECONOMIC SUBSTANCE DOCTRINE: USA

The economic substance doctrine is one of the US common law doctrines which hold that a transaction, with a tax benefit or a tax loss, with no economic substance should not be recognised for tax purposes.<sup>13</sup> The economic substance doctrine demands that a transaction which has a result of a tax benefit should have a relevant business purpose. An important aspect of the economic substance is the required business purpose that should be present in a transaction. This aspect is important because a transaction with a business purpose permissible tax avoidance.<sup>14</sup> On the one hand, a real transaction is one which is profit driven by increasing income or reducing expenses.<sup>15</sup> On the other hand, the only objective of an impermissible tax transaction is to reduce taxes.

It is crucial to mention the case that laid the foundation for the economic substance doctrine namely *Gregory v Helvering*. Thuronyi noted that this case had within it the seeds of all the anti-avoidance doctrines namely<sup>16</sup>:

- a) the step transaction doctrine;

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<sup>10</sup> *W.T Ramsay v IRC* [1981] STC 174, [1982] A.C. 300; [1981] 1 All ER 865.

<sup>11</sup> *Furniss v Dawson* [1984] STC 153, [1984] A.C. 474; [1984] 1 All ER 530. See Thuronyi (note 6 above) at 176 and Burt, K 'The Approach In *WT Ramsay Ltd v IRC: Elucidation Long Overdue*' (2004) 121 *South African Law Journal* 745 & 748.

<sup>12</sup> *Craven v (Inspector of Taxes) v White and related appeal Inland Revenue Commissioners v Bowater Property Development Ltd Baylis (Inspector of Taxes) v Gregory* [1988] 3 All ER 495.

<sup>13</sup> Thuronyi (note 6 above) 163.

<sup>14</sup> Kujinga, B *A Comparative Analysis of the Efficacy of the General Anti-Avoidance Rule as a Measure Against Impermissible Income Tax Avoidance in South Africa* (unpublished Phd thesis, University of Pretoria, 2013) 213.

<sup>15</sup> As above.

<sup>16</sup> Thuronyi (note 6 above) 162.



- b) the business purpose doctrine;
- c) the substance over form doctrine; and
- d) the economic substance doctrine.

## 2.1 Cases on the Economic Substance Doctrine

In one of the cases to illustrate the economic substance doctrine, in *ACM Partnership v Commissioner*<sup>17</sup> the court adjudicated on a transaction in which the partnership purchased property and almost immediately after the purchase, sold the property for purposes of generating capital losses for the partnership.<sup>18</sup> By doing so, the losses triggered the application of the ratable basis recovery rule taking advantage of the rules regulating contingent sales.<sup>19</sup> The court looked at the transaction as a whole to establish whether the transaction in question had the relevant economic substance. The Court pointed out that the inquiry of establishing this turns on both the objective economic substance of the transaction and the subjective business motivation behind them.<sup>20</sup>

Both the objective and the subjective aspect of the economic sham inquiry represent related factors which inform the analysis of whether the transaction in question had relevant economic substance to be respected for tax purposes.<sup>21</sup> The court concluded that the objective analysis of the economic consequences of the taxpayer's transaction and subjective analysis of the taxpayer's intended purposes supported the Tax Court's conclusion that the transaction in question did not have sufficient economic substance to be respected for tax purposes.<sup>22</sup>

In *Compaq v Commissioner*<sup>23</sup> the taxpayer took advantage of the American Depository Receipt (ADR) transaction to reduce its tax liability. The transaction involved a purchase of stock priced at \$888 million which was later sold for \$868

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<sup>17</sup> *ACM Partnership v Commissioner* 157 F.3d 231 (3rd Cir. 1998). See Thuronyi (note 6 above) 165.

<sup>18</sup> *ACM Partnership* 231.

<sup>19</sup> As above.

<sup>20</sup> *ACM Partnership* 232.

<sup>21</sup> See Thuronyi (note 6 above) 165 & 166.

<sup>22</sup> *ACM Partnership* 247 & 248. See Thuronyi (note 6 above) 166.

<sup>23</sup> *Compaq Computer Corp. v Commissioner* F.3d 778 (5<sup>th</sup> Cir 2001) as cited in Thuronyi (note 6 above) 166 and Kujinga (note 5 above) 239. See also *IES Industries Inc v United States* F.3d 350 (8<sup>th</sup> Cir 2001) where the application of the economic substance was controversial.

million, resulting in the taxpayer generated a loss of \$19 million.<sup>24</sup> It was not always clear to the courts to what extent the transaction in question impacted on the taxpayer's economic position.<sup>25</sup>

The Tax Court dismissed the taxpayer's case and decided in favour of the Commissioner and held that the ADR transactions in question lacked economic substance.<sup>26</sup> The Appeal Court disagreed and held that the transactions had economic substance and allowed the tax benefit sought by the taxpayers.<sup>27</sup> The court found that the taxpayer was minimising the risk of loss related to the ADR transactions. It also rejected the argument that the taxpayer's main purpose was to obtain tax benefits that were not allowed to be obtained.<sup>28</sup> This is an indication of the court's acknowledgement of the taxpayer's right to permissibly avoid tax.<sup>29</sup>

## 2.2 The Codification of the Economic Substance Doctrine

Over the years, the economic substance remained a judicial construction that was not formally reduced to legislation. For the purposes of uniformity and consistency with respect to the application of the economic substance doctrine in the courts; the doctrine was codified in Section 7701(o) of the Internal Revenue Code of 1986 (which form part of the Health Care and Education Affordability Reconciliation Act of 2010).<sup>30</sup> The provision was enacted to clarify and enhance the application of the economic substance doctrine.<sup>31</sup> Under Section 7701(o)(1), a transaction has the relevant economic substance<sup>32</sup>:

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<sup>24</sup> As above.

<sup>25</sup> Kujinga (note 5 above) 243.

<sup>26</sup> McMahon (note 6 above) 1020.

<sup>27</sup> As above.

<sup>28</sup> See *Frank Lyon Co. v United States* 435 US (1978) 580 & 583 where the Court pointed out that it was inevitable for a business transaction such as the one in question to not be affected by tax laws; the taxpayer is ought to take advantage of the favourable tax consequences.

<sup>29</sup> As argued in Kujinga (note 5 above) 240. However McMahon criticised the application of the economic substance and the business purpose tests by calling them useless because the Court have applied them incorrectly (using a mechanistic approach) both in *Compaq* and *IEC Industries*.

<sup>30</sup> PWC 'The Codified Economic Substance Doctrine: Making Decisions in an Uncertain World' (29 July 2011) <http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml> 1 (Accessed 28 July 2015). See Jellum, L 'Codifying and "Miscodifying" Judicial Anti-Abuse Tax Doctrines' (2014) 33 *Tax Notes* 617.

<sup>31</sup> Kaye (note 1 above) 346.

<sup>32</sup> Section 7701(o)(1) of the Health Care and Education Reconciliation Act.

[T]he transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

This provision requires the use of conjunctive two-prong tests, including both the subjective business purpose prong and the objective economic substance prong, in order to determine whether a transaction will be treated as having economic substance.<sup>33</sup> Under the guidance for the application of the tests, the IRS has stated that it will continue to apply case law related to the common law economic substance doctrine.<sup>34</sup> The first test, the objective economic substance prong, requires the transaction in question to change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position.<sup>35</sup> This means the transaction must have some non-tax effect.<sup>36</sup> In this regard the IRS will apply case law to establish whether (or not) the tax benefits obtained are allowable (or not) satisfying (or not) the economic substance prong of this doctrine.<sup>37</sup>

The second test, the subjective business prong, requires that the taxpayer have a substantial purpose (apart from Federal income effects) for entering into the transaction.<sup>38</sup> In this regard the IRS will use case law to establish whether (or not) the tax benefits of a transaction are allowable (or not) because the transaction has (or lacks) a business or corporate purpose.<sup>39</sup> If a transaction does not satisfy the two tests, Section 6662(b)(6) imposes a 20 percent penalty to any underpayment attributable to any disallowable of tax benefits because the transaction fails to satisfy Section 7701(o)(1).<sup>40</sup> This is a strict liability penalty imposed by congress where anyone violates the doctrine.

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<sup>33</sup> IRS 'Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010' (13 September 2010) <http://www.irs.gov/pub/irs-drop/n-10-62.pdf> 3 (Accessed 11 August 2015). See Kaye (note 1 above) 351 and Jellum (note 30 above) 618 & 619.

<sup>34</sup> IRS (note 33 above) 4.

<sup>35</sup> Section 7701(o)(1)(A) of the Health Care and Education Reconciliation Act.

<sup>36</sup> Jellum (note 30 above) 619.

<sup>37</sup> IRS (note 33 above) at 4.

<sup>38</sup> Section 7701(o)(1)(B) of the Health Care and Education Reconciliation Act.

<sup>39</sup> IRS (note 33 above) 4.

<sup>40</sup> Sections 6662(b)(6) & (i) of the Health Care and Education Reconciliation Act. See IRS 'Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties' (Undated) <http://www.irs.gov/irs-drop/n-14-58.pdf> (Accessed 28 July 2015).

It is crucial to note that in terms of Section 7701(o)(5)(C), the determination of whether the economic substance doctrine is relevant to a transaction will be made in the same manner as if Section 7701(o)(1) was not enacted.<sup>41</sup> In other words the IRS will continue to analyse transactions to which the economic substance doctrine is relevant in the same fashion as it did prior to the enactment of Section 7701(o)(1).<sup>42</sup>

### **2.3 The Economic Substance Doctrine as an Indicator of Impermissible Tax Avoidance**

The concept of economic substance is universal and it is generally an important characteristic of abusive schemes. In most cases the taxpayer purports to make a substantial investment, which is usually a disguise, and attempts to employ a particular statutory provision to avoid tax or to pay the least amount of tax payable.<sup>43</sup> Such a scheme usually results in little or no economic substance.<sup>44</sup> Lack of economic substance has become an important universal criterion to counter impermissible tax avoidance although not always certain as seen in *Compaq*.

The economic substance doctrine has been used to strike down impermissible tax avoidance transactions for a long time. However, the economic substance doctrine has not always been clear when applied especially in the borderline cases, cases with features of impermissible and permissible tax avoidance, as a result the US courts have experienced difficulties in the application of the economic substance; this is illustrated in *Compaq*.

In order for a GAAR or a judicial anti-avoidance rule to draw the line between permissible and impermissible tax avoidance, it should not be targeted at commercial transactions. Instead it should follow that transactions that make commercial sense should not be targeted by the GAAR; transactions that lack commercial substance should be targeted by the GAAR.

## **3. RAMSAY DOCTRINE: UK**

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<sup>41</sup> IRS (note 33 above) 5.

<sup>42</sup> As above.

<sup>43</sup> SARS 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act' (2005) <http://www.sars.co.za> 20 (Accessed 2 March 2015).

<sup>44</sup> As above.

The UK is another country that has relied on judicial anti-avoidance doctrines for a long time. The *Ramsay* approach or doctrine was introduced in 1982 after the *Ramsay* case. This case introduced a new approach to challenge tax avoidance schemes or transactions with fiscal nullity.<sup>45</sup> This case involved tax avoidance schemes with self-cancelling transactions.<sup>46</sup> The nature of the scheme in this case was to create out of a neutral situation two assets one of which would decrease in value for the benefit of the other.<sup>47</sup> The decreasing asset would be sold to produce an allowable loss by capital gain which would not be liable to tax.<sup>48</sup> The increasing asset would be sold to produce a gain which would be exempt from tax.<sup>49</sup>

From the facts of the case it is clear that the taxpayer's sole or main purpose for each scheme was to avoid tax, which was not wrong provided the statute relied on permitted such avoidance. In this case it was held that the courts is obliged to ascertain the legal nature of any transaction to which it seeks to attach tax or tax consequences and if the legal nature emerged from a series of transactions which were intended to operate as such therefore the series of transactions should be regarded as opposed to the individual transactions.<sup>50</sup> The statute that the taxpayer relied on for obtaining the tax benefit was applied to this new approach of analysing a series of transactions as a whole rather than as individual transactions.<sup>51</sup>

In essence the *Ramsay* doctrine is a judicially created doctrine that requires the Court to analyse a transaction as an indivisible whole depending on the scheme in question.<sup>52</sup> Subsequent *Ramsay*, the *Furniss* case developed and broadened the *Ramsay* doctrine.<sup>53</sup> It was held in *Furniss* that a pre-ordained series of transactions

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<sup>45</sup> Freedman, J 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 *Law Quarterly Review* 53.

<sup>46</sup> *W.T Ramsay* 321-323; 865-867.

<sup>47</sup> As above.

<sup>48</sup> As above.

<sup>49</sup> As above.

<sup>50</sup> *W.T Ramsay* at 323 & 324; 867. See Freedman (note 45 above) 57.

<sup>51</sup> As above.

<sup>52</sup> Freedman (note 45 above) 57 & 58.

<sup>53</sup> Other cases that followed and applied this doctrine are as follows *IRC v Burmah Oil Co Ltd* [1982] STC 30; *IRC v McGuckian* [1997] 1 WLR 991; and *MacNiven v Westmoreland Investment Ltd* [2001] 1 All ER 865 as all cited in Burt (note 11 above) 745 & 748. See Thuronyi (note 6 above) 176.

are ascertainable by considering the result of the series as a whole as opposed to separating the scheme and considering the each individual transaction separately.<sup>54</sup>

For purposes of tax, such steps should be disregarded when the court is analysing the transactions in question. *Furniss* extended the *Ramsay* doctrine in a sense that: there must firstly be a pre-planned series of transactions or one composite transaction which took place in a particular order and secondly the taxpayer must have inserted steps with no business purpose other than to avoid tax. The court will then disregard the inserted steps and look at the transaction as if the inserted steps did not exist.

In *Craven* Lord Oliver improved and extended the application of the *Ramsay* doctrine to four-pronged tests, as follows<sup>55</sup>:

A linear series of transactions which contained an intermediate tax saving step would be held to be susceptible to tax if, but only if, (a) the series of transactions was, at the time when the intermediate transaction was entered into, preordained in order to produce a given result, (b) that transaction had no other purpose than tax mitigation, (c) there was at that time no practical likelihood that the preplanned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and (d) the preordained events did in fact take place.

The *Ramsay* doctrine was created to assist the courts to give statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply. Therefore it allowed the courts to decide whether the actual transaction answered to the statutory description.<sup>56</sup> Accordingly in terms of the *Ramsay* doctrine a scheme that lacks commercial substance will constitute fiscal

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<sup>54</sup> See *Furniss* 474; 512; Thuronyi (note 6 above) 176 and Burt (note 11 above) 745.

<sup>55</sup> As indicated in *Kujinga* (note 14 above) 261. See *Craven* 496.

<sup>56</sup> This was highlighted in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1 as cited in De Koker, A & Williams, *R Silke on South African Income Tax* (2014) 19.2.

nullity.<sup>57</sup> In other words where commercial substance is not satisfied, according to the particular statutory provision, fiscal results are inevitable.<sup>58</sup>

### 3.1 Lessons for South Africa

It has been argued that the *Ramsay* approach succeeded, although not always, to target impermissible tax avoidance schemes which were common in the UK at the time it was introduced.<sup>59</sup> This perhaps is one of the reasons the UK have moved away from the *Ramsay* approach and have, since 17 July 2013, implemented the GAAR to target tax arrangements that are abusive.

The *Ramsay* approach unveils lessons regarding self-cancelling transactions which South Africa could learn from. Since self-cancelling transactions are not defined in the South African GAAR the court in the *Ramsay* case have dealt with and defined self-cancelling (offsetting) transactions. Self-cancelling transactions are described as transactions that<sup>60</sup>:

- a) are carried out in succession;
- b) have an obvious intention of carrying on without stopping before the last transaction has been completed;
- c) are actually not from the taxpayer; and
- d) produce no profit or loss.

## 4. CONCLUSION

This chapter looked at anti-avoidance doctrines in the US and UK which South Africa has incorporated in its GAAR. The focus of this analysis was to indicate the application of the doctrines in their respective countries and examine whether incorporating these doctrines in the South African GAAR is still necessary.

From the above discussion it can be concluded that judicially created doctrines still play a vital role in combating impermissible tax avoidance schemes and deterring transactions that are economically inefficient. It is evident that abusive tax shelter

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<sup>57</sup> As above.

<sup>58</sup> As above.

<sup>59</sup> Kujinga (note 14 above) 271.

<sup>60</sup> See generally *W.T Ramsay* 870 – 874 and Kujinga (note 14 above) 272.

schemes or arrangements that lack economic substance very often do not have a pre-tax profit.

The US courts experienced difficulty in applying the economic substance doctrine however the uncertainty created by the application of this doctrine should not be viewed as a problem worse than the problem its application is intended to remedy.<sup>61</sup> The South African courts should draw lessons from significant US judgments when establishing the commercial (economic) substance of an avoidance arrangement. In that regard the economic substance could potentially be the most efficient indicator in the South African GAAR.

Since the UK no longer employ the *Ramsay* approach it is suggested that South Africa carve out the approach and retain the economic substance approach. However South African courts may draw on the precedent in the UK, *Ramsay* case, if faced with a self-cancelling transaction.

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<sup>61</sup> McMahon (note 6 above) 1019.



## CHAPTER 5

### CONCLUSIONS AND RECOMMENDATIONS

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#### 1. CONCLUSIONS

Generally tax avoidance is defined as an arrangement of a taxpayer's tax affairs which result in him or her paying less or the least amount of tax payable. It can be permissible tax avoidance and impermissible tax avoidance. Permissible tax avoidance being the legal manner of paying less tax as recognised in statutory provisions of the Income Tax Act (the Act)<sup>243</sup>. Impermissible tax avoidance is when a taxpayer structures his or her tax affairs in a way that is contrary to the provisions of the GAAR in South Africa.

The role of the GAAR is to combat impermissible tax avoidance and to inform taxpayers of the limits of permissible tax avoidance (their rights to avoid tax). Although the South African GAAR has not been tested yet, it attempts to cover as many avenues (tainted elements) as possible in combating impermissible tax avoidance. An avoidance arrangement that is found to have a sole or main purpose to obtain a tax benefit and any one of the four tainted elements will be regarded as an impermissible avoidance arrangement. The tainted elements covered in the GAAR include: the creation of abnormal rights or obligations, an abnormal manner of entering into an avoidance arrangement, misuse or abuse of the provisions in the Act and lack of commercial substance.<sup>244</sup>

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<sup>243</sup> Act 58 of 1962.

<sup>244</sup> See Section 80A of the Act.

The incorporation of all these tainted elements makes the GAAR too complex, wide and reduces its ability to perform its primary function of curbing impermissible tax avoidance. The complexity and width of the GAAR means that GAAR does not adequately inform taxpayers of the limitation of their right to engage in permissible tax avoidance. As it stands the tainted elements overlap and this overlap creates uncertainty.

The legislature has borrowed some of these elements from foreign nations which, from the comparative analysis, appears to be controversial when applied. The Canadian misuse or abuse provision, which South Africa adopted, seems to be uncertain as the provision itself does not provide for the steps to be taken when determining whether or not an avoidance transaction is abusive. As a result the Canadian GAAR does not sufficiently clarify the line between permissible and impermissible tax avoidance. The *Ramsay* doctrine used to be applied in the UK which targeted pre-ordained series of transactions entered into with the purpose of avoiding tax. The UK Courts have long moved on from this approach as it was no longer practical; the “pre-ordained series of transactions” requirement was not workable in all cases as a consequence it was not effective in limiting the taxpayers’ rights to avoid tax.

## **2. RECOMMENDATIONS**

### **2.1 Arrangement**

As it currently stands in the GAAR the Commissioner may separate and target a part of a transaction from an entire scheme of an avoidance arrangement and invoke the GAAR based on that particular transaction. While the UK GAAR requires that an arrangement that is part of an arrangement will only be isolated once the whole arrangement has been considered. It is recommended that South Africa could adopt the UK approach in this regard by narrowly defining an arrangement by obligating the Commissioner to look at the whole arrangement when establishing whether the avoidance arrangement in question constitute an impermissible avoidance arrangement.

## 2.2 Economic Substance

It is not disputed that the tainted elements are an essential part of the GAAR as they are the final requirement that determines whether an avoidance arrangement constitutes an impermissible avoidance arrangement. It is recommended that the GAAR can be efficient and workable by using one tainted element that incorporates all the other tainted elements namely the economic substance provision. The US courts have interpreted the economic substance doctrine to provide that a transaction that does comply with the spirit of the tax laws, i.e. where a taxpayer rely on legislation to avoid tax, does not lack economic substance. The economic substance provision indirectly incorporates the misuse or abuse provision in this regard.

In essence a transaction with commercial substance would have the following characteristics:

- a) the person carrying out or entering into the transaction must have a reasonable expectation of obtaining profit or potential profit;
- b) such a transaction must have a risk of loss;
- c) such a transaction must produce profit or loss;
- d) the person carrying out or entering into the transaction must experience sufficient economic impact of the transaction. This is to prevent the disguise of the true nature of the transaction.

## 2.3 Misuse or Abuse and Abnormality

The misuse or abuse provision in the South African GAAR was formulated to strengthen statutory interpretation, particularly the purposive interpretation. The rationale behind the insertion of that provision was to reinforce the modern approach to the interpretation of tax statutes in order to promote the spirit and object of the Act.<sup>245</sup> Meanwhile the South African Constitution<sup>246</sup> provides in Section 39(2) that

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<sup>245</sup> Van Schalkwyk, L & Geldenhuys, B 'Section 80A(c)(ii) of the Income Tax Act and interpretation of tax statutes in South Africa' (2009) 17 *Meditari Accountancy Research* 167. See Kujinga 'Analysis of misuse or abuse in terms of the South African general anti-avoidance rule: lessons from Canada' (2012) 45 *Comparative and International Law Journal of Southern Africa*.

whenever any legislation is interpreted such legislation must be interpreted to promote the spirit, purport and objects of the Bill of Rights. It is fair to say that the misuse or abuse provision calls for an approach that is already in place therefore it is superfluous and unnecessarily making the GAAR complex.

Moreover a transaction where abnormal rights and obligations are created that in it signifies a transaction that lacks economic substance. In essence the rights and obligations that are created in such a transaction will not make economic sense. The same applies to a transaction entered in a manner which would not normally be employed for *bona fide* business purposes other than obtaining a tax benefit. When these provisions are put next to the economic substance as aids to combat impermissible tax avoidance, they are redundant.

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<sup>246</sup> Act 108 of 1996.

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