A COMPARATIVE ANALYSIS OF THE EFFICACY OF THE GENERAL ANTI-AVOIDANCE RULE AS A MEASURE AGAINST IMPERMISSIBLE INCOME TAX AVOIDANCE IN SOUTH AFRICA

By

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THESIS

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FACULTY OF LAW

At the

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PRETORIA

NOVEMBER 2013

Supervisor: Prof RCD Franzsen
DECLARATION

I, Benjamin Tanyadwa Kujinga, hereby declare that the research in this thesis and the conclusions and recommendations contained herein are the result of my own individual and independent work. Where I have used the ideas and words of others I have appropriately acknowledged the source of the ideas or words.

Signed: BT Kujinga.

Date: 11 February 2014
ACKNOWLEDGEMENTS

Firstly, I would like to thank God for giving me the qualities that I needed to start and complete this study.

Secondly, I would like to thank my supervisor, Prof Riël Franzsen, under whose leadership I have developed immensely as a legal researcher and academic. His influence has surely left an indelible mark on me as a researcher and academic.

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Lastly, I would like to acknowledge the support I received from my family and friends, who I will not mention by name because there are so many. Your support was both calming and uplifting. Without you this would have been harder, much harder.
SUMMARY

Impermissible tax avoidance has many adverse effects such as, *inter alia*, revenue loss, the complication of the tax laws, and the erosion of equity in taxation. It clearly needs to be curbed if the integrity of tax systems worldwide is to be preserved. Curbing impermissible tax avoidance is one of the basic functions of legislative measures such as general anti avoidance rules (GAARs) and specific anti-avoidance rules (SAARs). Other non-legislative mechanisms such as the judicial doctrines against impermissible tax avoidance and the common law doctrine of substance over form can also be used to curb impermissible tax avoidance. Of these anti-avoidance mechanisms, GAARs and judicial doctrines are the most important weapons against impermissible tax avoidance.

South Africa is one of the vast majority of countries in the world that rely on a GAAR to curb impermissible tax avoidance. The basic problem that arises with the curbing of impermissible tax avoidance is the fact that there is no universally accepted or accurate definition of it. This problem is compounded by the fact that it is well established that taxpayers have the right to avoid tax, and in curbing impermissible tax avoidance, this right must not be adversely affected. When combined, these two factors mean that a GAAR is drafted without certainty on the precise contours of impermissible tax avoidance while it is at the same time expected to honour permissible tax avoidance.

This research analyses the efficacy of the current South African GAAR in sections 80A – L of the *Income Tax Act* 58 of 1962 (the Act) as the main weapon against impermissible tax avoidance in South Africa. In this analysis, extensive reference is made to historic GAARs in South Africa such as section 90 of the *Income Tax Act* 31 of 1941, and section 103(1) of the Act. A large part of this study extensively analyses the GAARs in Canada and Australia and the judicial doctrines in the US and the UK.

The analysis of the South African GAAR in this study demonstrates that this GAAR’s efficacy against impermissible tax avoidance, and in informing taxpayers of the limits of the right to avoid tax is limited. To support this contention, it is argued that this GAAR is too broad, which inevitably creates much uncertainty. It is also argued that this GAAR contains problematic provisions, such as the abnormality, commercial substance, misuse or abuse, and the abnormality for *bona fide* business purposes provisions. These provisions are not adequately defined, or explained in the GAAR. The combined effect of these two anomalies
is increased uncertainty, which this research shows is detrimental to the efficacy of the GAAR.

The uncertainty of the South African GAAR is amplified by the fact that most of its provisions have not been judicially considered yet. This thesis seeks to contribute to the reduction of the uncertainty of the South African GAAR by identifying key lessons from the interpretation of similar provisions or approaches in the jurisdictions identified above that can be learned. It is argued that if these lessons are incorporated into the GAAR, or are used to guide the creation of a future GAAR in South Africa, the uncertainty that has always blighted South African GAARs may be reduced, which will lead to a more effective GAAR.
<p>| A   | Appellate Division                          |
| AC  | Appeal Cases                               |
| AD  | Appellate Division of the High Court       |
| All ER | All England Law Reports                     |
| ATC | Australian Tax Cases                       |
| ATO | Australian Tax Office                      |
| ATR | Australian Tax Reports                     |
| BCSC | Supreme Court of British Columbia         |
| BTA | US Board of Tax Appeals                    |
| Buch | Buchanan’s Reports                         |
| CC  | Constitutional Court (South Africa)        |
| Ch  | Chancery Division                          |
| CIR | Commissioner of Inland Revenue (South Africa) |
| CIR | Commissioners of Inland Revenue (UK)       |
| CIT | Commonwealth Law Review                    |
| COT | Commissioner of Taxation                   |
| Co. Rep | Coke’s King’s Bench Reports                |
| CPD | Cape Provincial Division                   |
| CRA | Canada Revenue Agency                      |
| CRR | Canadian Rights Reporter                   |
| CSARS | Commissioner: South African Revenue Service |
| CTC | Canadian Tax Cases                         |
| Ct CI | Connecticut Circuit                        |
| Cth | Commonwealth                               |
| D &amp; CLD | Commercial Law Digest                      |
| D. Conn | District of Connecticut                    |
| DC Cir | District of Columbia Circuit               |
| D. Md | District of Maryland                       |
| DTC | Dominion Tax Cases                         |
| EC  | Eastern Cape High Court                    |
| EWCA Civ | England and Wales Court of Appeal (Civil Division) |
| FA  | Finance Act 2013                            |
| FCA | Federal Court of Australia                 |
| FCA | Federal Court of Appeal (Canada)           |
| FCAFC | Federal Court of Australia Full Court      |
| FACV | Final Court of Appeal (Hong Kong)          |
| FCR | Federal Court Reports                      |
| FCT | Federal Commissioner of Taxation           |
| FCTD | Federal Court: Trial Division              |
| 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 Appeal for the Third Circuit |
| GAAR | General Anti-Avoidance Rule                |</p>
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<tr>
<th>Acronym</th>
<th>Full Form</th>
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<td>Her Majesty’s Revenue and Customs</td>
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<td>Income Tax Assessment Act of 1936</td>
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<td>9th Cir</td>
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TABLE OF CONTENTS

DECLARATION ......................................................................................................................... i
ACKNOWLEDGEMENTS ......................................................................................................... ii
SUMMARY .............................................................................................................................. iii
LIST OF ACRONYMS AND ABBREVIATIONS ................................................................... v

CHAPTER 1: INTRODUCTION

1. BACKGROUND .................................................................................................................... 2
2. RATIONALE OF THE STUDY ............................................................................................ 4
3. SCOPE AND LIMITATIONS OF THE STUDY ................................................................. 5
   3.1 Scope....................................................................................................................................5
   3.2 Limitations ............................................................................................................................ 6
4. METHODOLOGIES .............................................................................................................. 7
5. RESEARCH QUESTIONS .................................................................................................... 7
6. STRUCTURE ......................................................................................................................... 7

CHAPTER 2: TAX AVOIDANCE AND THE RIGHT TO AVOID TAX

1. INTRODUCTION ................................................................................................................ 10
2. TAX ...................................................................................................................................... 10
   2.1 Types of Taxes .................................................................................................................... 12
3. TAX AVOIDANCE.............................................................................................................. 13
   3.1 Tax Avoidance and Tax Evasion ........................................................................................ 15
4. PERMISSIBLE TAX AVOIDANCE ................................................................................... 16
   4.1 The Right to Engage in Permissible Tax Avoidance ......................................................... 17
   4.2 Questions on the Existence of the Right to Engage in Permissible Tax Avoidance........... 18
   4.3 Judicial Recognition of the Right to Avoid Tax ............................................................... 22
   4.4 Judicial Criticism of Tax Avoidance .................................................................................. 23
   4.5 The Right to Utilise Business Methods with the Least Tax Implications ......................... 24
5. IMPERMISSIBLE TAX AVOIDANCE .............................................................................. 29
   5.1 Features of Impermissible Tax Avoidance Transactions .................................................. 31
   5.1.1 Absence of Business Purpose .......................................................................................... 31
   5.1.2 Abnormality ..................................................................................................................... 32
   5.1.3 Misuse or Abuse of the Tax Laws ................................................................................... 32
5.1.4 Participation of Tax Indifferent or Accommodating Parties ............................................ 33
5.1.5 Unnecessary Steps and Complexity ................................................................................. 33
5.1.6 Other Features of Impermissible Tax Avoidance Schemes ............................................. 34
5.2 Analysis of the Indicators of Impermissible Tax Avoidance .............................................. 35
5.3 The Goals of Impermissible Tax Avoidance ........................................................................ 36
5.4 Other Methods through which Impermissible Tax Avoidance is done .............................. 39
5. CONCLUSION ..................................................................................................................... 39

CHAPTER 3: ANTI-AVOIDANCE RULES IN SOUTH AFRICA

1. INTRODUCTION ................................................................................................................ 42
2. SIMULATION AND THE COMMON LAW SUBSTANCE OVER FORM RULE .......... 42
3. SPECIFIC ANTI-AVOIDANCE RULES ............................................................................ 49
4. GENERAL ANTI-AVOIDANCE RULES ........................................................................... 49
4.1 Characteristics ..................................................................................................................... 51
4.2 The Inherent Uncertainty of a GAAR ................................................................................. 53
5. REGULATION OF TAX PRACTITIONERS ..................................................................... 55
6. REPORTABLE ARRANGEMENTS ................................................................................... 57
7. NON-LEGAL MEASURES AGAINST IMPERMISSIBLE TAX AVOIDANCE .......... 59
8. CONCLUSION ..................................................................................................................... 61

CHAPTER 4: THE HISTORICAL BACKGROUND TO THE SOUTH AFRICAN
GENERAL ANTI-AVOIDANCE RULE

1. INTRODUCTION ................................................................................................................ 63
2. SECTION 90 ......................................................................................................................... 63
2.1 Analysis of Section 90 ........................................................................................................ 64
2.1.1 CIR v King: The First Major GAAR case ................................................................... 64
2.1.2 Schreiner JA’s Contribution to the South African GAAR ........................................... 67
2.2.1 Transaction, Operation or Scheme ................................................................................ 69
2.2.2 Interpretation of Tax Avoidance, Postponement or Reduction Effect ............................ 70
2.2.3 COT v Ferera: Possible Misunderstanding of the Significance of the King case ......... 70
3. SECTION 103(1 .................................................................................................................. 73
3.1 Section 103(1) Prior to the 1996 amendments ................................................................. 74
3.2 Transaction, Operation or Scheme Entered into or Carried Out ..................................... 75
3.3 Tax Avoidance or Postponement Effect ................................................................. 76
3.4 Normality of Manners Employed or Creation of Abnormal Rights and Obligations ..... 76
  3.4.1 SIR v Geustyn, Forsyth and Joubert .............................................................. 77
  3.4.2 Hicklin v SIR ............................................................................................... 78
  3.4.3 CIR v Louw ............................................................................................... 81
  3.4.4 ITC 1496 .................................................................................................... 84
  3.4.5 ITC 1582 .................................................................................................... 85
  3.4.6 ITC 1635 .................................................................................................... 86
  3.4.7 Efficiency of Abnormality as an Indicator of Impermissible Tax Avoidance ........ 86
3.5 Sole or Main Purpose to Avoid Tax ...................................................................... 87
3.6 Problems with Section 103(1) and the 1996 Amendments .................................... 92
3.7 The Significance of the 1996 Amendments ......................................................... 94
3.8 CIR v Conhage and the Demise of Section 103(1) ............................................. 96
4. CONCLUSION ..................................................................................................... 99

CHAPTER 5: THE SOUTH AFRICAN GENERAL ANTI-AVOIDANCE RULE

1. INTRODUCTION .................................................................................................. 103
2. THE GAAR: SECTION 80A – 80L ............................................................. 104
  2.1 Section 80A .................................................................................................. 104
  2.1.1 Arrangement ............................................................................................ 106
  2.1.2 Tax Benefit ............................................................................................. 109
  2.1.3 Purpose .................................................................................................... 110
  2.2 The Tainted Elements in the Context of Business ............................................ 111
    2.2.1 Normality for Business Purpose ............................................................ 111
    2.2.2 Commercial Substance ........................................................................ 112
    2.2.2.1 Section 80D: Round Trip Financing .................................................. 113
    2.2.2.2 Section 80E(1): Accommodating or Tax – Indifferent Parties ......... 114
    2.2.2.3 Section 80C(2)(b)(iii): Offsetting and Cancelling Elements .......... 115
    2.2.3 The Creation of Abnormal Rights or Obligations .................................... 116
    2.2.4 Misuse or Abuse ..................................................................................... 116
      2.2.4.1 Statutory Interpretation in South Africa ............................................ 117
      2.2.4.2 Traditional Approach – Literalism ................................................... 117
      2.2.4.3 Literalism in Tax Statutes and Tax Avoidance ............................... 120
3.3 Tax Benefit ........................................................................................................................ 180
3.4 Avoidance Transaction ..................................................................................................... 181
3.5 Series of Transactions ....................................................................................................... 182
3.6 Tax Purpose Test ............................................................................................................... 183
3.6.1 Tax Purpose of a Series of Transactions ........................................................................ 184
3.7 Misuse or Abuse ............................................................................................................... 185
4. ANALYSIS OF SECTION 245 .......................................................................................... 188
4.1 Judicial Views on the GAAR ............................................................................................ 188
4.2 Problems with Applying the Misuse or Abuse Concept ................................................... 192
4.3 Problems with the Isolation of a Single Transaction in a Series ....................................... 198
4.4 Copthorne Holdings Ltd v The Queen: Further GAAR Analysis from the Canadian Supreme Court ........................................................................................................................ 199
4.5 Section 245 and the Taxpayer’s Right to Avoid Tax ......................................................... 202
5. CONCLUSION ................................................................................................................... 204

CHAPTER 8: THE JUDICIAL DOCTRINES TO COUNTER IMPERSSIBLE TAX AVOIDANCE IN THE US

1. INTRODUCTION .............................................................................................................. 208
2. BACKGROUND TO THE JUDICIAL ANTI-AVOIDANCE DOCTRINES ................... 208
2.1 The Role of the Judiciary .............................................................................................. 208
2.2 Substance over Form as the Primary Consideration ......................................................... 210
3. THE ECONOMIC SUBSTANCE DOCTRINE ................................................................ 212
3.1 The Economic Substance Doctrine in Selected Cases ...................................................... 215
3.1.1 Gregory v Helvering ...................................................................................................... 215
3.1.2 Knetsch v United States ............................................................................................ 217
3.1.3 Frank Lyon Co v United States ................................................................................ 218
3.1.4 Rice’s Toyota World Inc v Commissioner ................................................................ 218
3.1.5 Falsetti v Commissioner .......................................................................................... 219
3.1.6 ASA Investering Partnership v Commissioner of Inland Revenue ......................... 219
3.1.7 Yosha v Commissioner of Internal Revenue ............................................................ 220
3.1.8 Long Term Capital Holdings v United States .......................................................... 222
3.1.9 Black and Decker Corporation v United States ......................................................... 223
3.1.10 Coltec Industries Inc v United States ....................................................................... 224
3.1.11 TIFD III – E Inc v United States ............................................................................. 225

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5.1.2 Self Cancelling or Offsetting Transactions

5.2 The Purposive Interpretation of Statutes

6. THE INTRODUCTION OF A GAAR IN THE UK

6.1 Consultations on the Need for a GAAR in the UK

6.1.1 Conclusion on Whether the UK Needs a GAAR

6.1.2 The Principles Underlying a GAAR in the UK

6.1.2.1 The Overarching Principle

6.1.2.2 Distinguishing between Permissible and Impermissible Tax Avoidance

6.1.2.3 Reducing Uncertainty

6.1.2.4 The Exclusion of Transactions with no Intent to Avoid Tax

6.1.2.5 The Counteraction of Impermissible Tax Avoidance

6.2 The Illustrative GAAR

6.2.1 Exclusions from the Application of the GAAR

6.2.2 Definition of Abnormal Arrangements

6.3 The Government’s Response

6.4 The UK General Anti-Abuse Rule

6.5 Analysis of the UK GAAR

6.5.1 The Steps Leading to the Introduction of the GAAR

6.5.2 The GAAR

6.5.2.1 Tax Arrangement

6.5.2.2 Abuse

7. CONCLUSION

CHAPTER 10: CONCLUSIONS AND RECOMMENDATIONS

1. CONCLUSIONS

1.1 The Efficacy of the South African GAAR

1.1.1 The Problem with the GAAR as a Whole: Uncertainty

1.1.2 The Problems with Individual Components of the GAAR

2. RECOMMENDATIONS

2.1 Amending the Uncertain or Problematic Concepts in the GAAR

2.1.1 Arrangement: Sections 80L, 80H and 80G

2.1.2 Normality for a Bona Fide Business Purpose: Section 80A(a)(i)

2.1.3 Creation of Abnormal Rights or Obligations: Section 80A(c)(i)
2.1.4 Commercial Substance: Section 80C(1) .................................................................305
2.1.4.1 Legal Substance v Legal Form: Section 80C(2)(a) ..............................................306
2.1.4.2 Self-Cancelling Elements: Section 80C(2)(b)(iii) ..............................................307
2.2 Future GAARs in South Africa ..............................................................................307
2.2.1 Basing the GAAR on the UK GAAR Approach ...............................................308

TABLES

Table 1: Countries with GAARs and Countries with Judicial Doctrines ......................3
Table 2: South Africa’s Historical GAAR Timeline .....................................................97
Table 3: Australia’s GAAR Timeline ........................................................................168
Table 4: The Economic Substance Doctrine’s Development Timeline ......................241
Table 5: The UK Anti-Avoidance Timeline ................................................................287
Table 6: Country Comparison of Impermissible Tax Avoidance Indicators ..............290

BIBLIOGRAPHY ..................................................................................................308
CHAPTER 1

INTRODUCTION

TABLE OF CONTENTS

1. BACKGROUND ....................................................................................................................................2
2. RATIONALE OF THE STUDY ........................................................................................................4
3. SCOPE AND LIMITATIONS OF THE STUDY ..............................................................................5
   3.1 Scope.......................................................................................................................................5
   3.2 Limitations ................................................................................................................................6
4. METHODOLOGIES .........................................................................................................................7
5. RESEARCH QUESTIONS ..................................................................................................................7
6. STRUCTURE .....................................................................................................................................7
1. BACKGROUND

Impermissible tax avoidance has been described as a threat to the integrity of tax systems worldwide.¹ Its harmful effects have been identified as, *inter alia*, revenue loss, inequality, the complication of tax legislation, the creation of impunity for the tax laws, discouraging taxpayer compliance and a limitation of the government’s ability to implement economic policies through taxation.² Impermissible tax avoidance has also attracted hostile statements from governments and revenue authorities, such as the statement by the South African Revenue Service (SARS) that impermissible tax avoidance shows a “complete and reckless disregard for tax morality and South African tax law”³ and robs “not only the *fiscus* of tax revenue but all South Africans”.⁴ This statement further noted that SARS would engage with the parties involved in such activities, in certain instances, in order to understand their “commitment to poverty alleviation and the overall development of South Africa, and details of how the particular structuring of the transaction supports this”.⁵ These statements and the harmful effects of impermissible tax avoidance indicate that it is behaviour that needs to be curbed effectively.

General anti-avoidance rules (GAARs) are one of the legislative measures that exist to curb impermissible tax avoidance in many countries. However, certain countries rely on non-legislative measures such as judicial doctrines, instead of GAARs, to curb impermissible tax avoidance. The following table illustrates this:

---

⁵ Meyerowitz et al (2007) 37. Former US president, FD Roosevelt once made a similarly hostile statement quoted in Barker (2009) 232 that “[a]ll [methods of avoidance] are alike in that they are definitely contrary to the spirit of the law. All are alike in that they represent a determined effort on the part of those who use them to dodge the payment of taxes which Congress based on ability to pay. All are alike in that failure to pay results in shifting the tax load to the shoulders of those less able to pay”.

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South Africa is one of the many countries that rely on a GAAR to curb impermissible tax avoidance. The current GAAR in sections 80A – L, inclusive, of the Income Tax Act\(^\text{11}\) (the Act) is the third generation GAAR.

The battle against impermissible tax avoidance in South Africa and many other countries is complicated by the fact that many taxpayers will act to limit the taxes they pay.\(^\text{12}\) In seeking to

\(^{6}\) Ferreira “Form versus Substance: A Comparison of Brazil’s Tax System to the Tax System of the United States of America” (2004) 35 2 The University of Miami Inter American Law Review 311 312 notes that the Brazilian GAAR is based on the US judicial doctrine of substance over form.

\(^{7}\) Hong Kong is part of the People’s Republic of China but it is administered as a special administrative region (SAR).

\(^{8}\) India is in the process of introducing a GAAR in its tax legislation. See generally www.deloitte.com/assets/Dcom-India/Local-Assets/Documents/Taxdocuments/GAAR - India and International Perspective.pdf (accessed on 10/10/2012)

\(^{9}\) The Netherlands relies on both a GAAR and a judicial doctrine to curb impermissible tax avoidance. See generally Pickup “In Relation to General Anti-Avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect Their Tax Revenues” in Freedman (ed) Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management (2008) 9 27.

\(^{10}\) The UK recently introduced a GAAR in its tax legislation. The judicial anti-avoidance rules still apply to transactions that were entered into before the GAAR was introduced. The UK system will be discussed in detail in Chapter 9.

\(^{11}\) 58 of 1962.

\(^{12}\) Eustice “Abusive Corporate Shelters: Old “Brine” in New Bottles” (2002) 55 Tax Law Review 135 136 states that “taxpayers do not like taxes. Despite the Biblical admonition to render to Caesar the things which be Caesar’s, the expected renderers have been ever reluctant to do so”.

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### Table 1: Countries with GAARs and Countries with Judicial Doctrines

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<th>COUNTRY</th>
<th>GAAR</th>
<th>JUDICIAL DOCTRINES</th>
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avoid taxes many taxpayers have consistently searched for “imaginative and at times unimaginable ways to reduce their tax expenditures”. This behaviour is obviously frustrating for the government and SARS. However, it is well established that taxpayers have a right to manage their financial affairs so as to attract the least possible amount of tax. One of the earliest cases that dealt with tax avoidance stated that a taxpayer has a legal right to avoid taxes. In one of the many cases confirming this right, Ayrshire Pullman Motor Services and Ritchie v Commissioner it was stated as follows:

A taxpayer is not under the smallest obligation, moral or other, so to arrange his legal relations to his business as to enable the Inland Revenue to put the largest shovel into his stores. The Inland Revenue is not slow, and quite rightly, to take every advantage which is open to it under the taxing statutes for the purposes of depleting the taxpayer’s pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by Revenue.

The existence of the right to avoid tax and the fact that many taxpayers will attempt to avoid taxes means that there is tension between these taxpayers and the government which needs to curb impermissible tax avoidance and its harmful effects. The need to curb impermissible tax avoidance effectively and the existence of a right to avoid tax means that an efficient GAAR should be capable of performing two basic roles, namely, curbing impermissible tax avoidance and informing taxpayers of the limits of their right to avoid tax. This research will analyse the South African GAAR to determine its efficacy in terms of the above.

2. RATIONALE OF THE STUDY

The topic of tax avoidance appears extensively in South African and international literature. However, currently there is no literature that comprehensively and academically analyses the South African GAAR and its history and compares it with the GAARs in countries such as Australia, Canada and the UK and the judicial doctrines in countries such as the US and the UK. This study will contribute to this sparse literature by extensively analysing the South African GAAR, and comparing its provisions with similar provisions in the Australian, Canadian and UK GAARs as well as the judicial doctrines in the US and the UK. This research is aimed at

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13 Eustice (2002) 140. The desire by companies and individual taxpayers to reduce taxes is described here as “powerful” and a “fact of life”.
14 The courts have persistently recognized the right to avoid tax. Gunn “Tax Avoidance” (1978) 76 5 Michigan Law Review 733 735 states that the principle that a taxpayer can act to avoid taxes has been so frequently enunciated that it would be an accurate statement if the times it has been stated was a measure of accuracy. This right will be discussed in more detail in Chapter 2
15 United States v Isham 84 US (17 Wall.) (1873) 496 506.
16 (1929) 14 TC 754 763-764.
determining whether the South African GAAR is up to the task of curbing impermissible tax avoidance whilst simultaneously creating certainty regarding the limits of permissible tax avoidance. This research will also examine whether there are any lessons that can be learned from these other jurisdictions that could improve the scope and efficacy of the South African GAAR.

3. SCOPE AND LIMITATIONS OF THE STUDY

3.1 Scope

This research consists of a comprehensive critical analysis of the South African GAAR and a historic review of its predecessors, namely section 90 of the Income Tax Act and section 103(1) of the Act. Thereafter, a critical legal comparative analysis of the Australian and Canadian GAARs and the US and UK judicial doctrines will be undertaken. These four countries have been selected for the reasons indicated below.

In Australia the GAAR appears in Part IVA of the Income Tax Assessment Act. It was introduced in 1981. Part IVA was preceded by section 260 of the same Act. The historical experience of section 260 will be analysed in order to determine whether or not lessons for South Africa can be drawn from it. Part IVA and the judicial decisions in relation to it will also be analysed in order to draw possible lessons for the South African GAAR.

Canada introduced a GAAR in 1988. The analysis of the Canadian GAAR is critical for this research because it contains the misuse or abuse concept which is also present in the South African GAAR. This research will analyse the Canadian judicial decisions in respect of this concept. In this regard, important judicial decisions in cases such as Canada Trustco Mortgage Company v Canada will be discussed in order to determine whether or not there are any possible lessons that can be learned when dealing with the misuse or abuse concept in the South African GAAR.

18 31 of 1941.
19 1936.
20 Section 80A(c)(ii) of the Act.
21 2005 SCC 54.
The judicial doctrines in the US were developed following Judge Learned Hand’s landmark decision in *Gregory v Helvering.* These doctrines are based on the overarching “substance over form doctrine”, which in essence contains the following sub-doctrines:

(i) the business purpose doctrine;
(ii) the economic substance doctrine;
(iii) the step transactions doctrine; and
(iv) the sham transactions doctrine.

The US has vast case law on tax avoidance and the doctrines mentioned above. The significance of studying the US system is to examine the interpretation and efficacy of the economic substance doctrine, which is similar to the South African GAAR element of commercial substance in section 80C of the Act. The purposive interpretation approach in the US will also be analysed to compare with the South African approach in terms of section 80A(c)(ii) of the Act.

The UK courts created the *Ramsay* approach, which was initiated in the case *WT Ramsay Ltd v IRC, Eilbeck (Inspector of Taxes) v Rawling* to curb impermissible tax avoidance. The popular *IRC v Duke of Westminster* case, which is generally seen as the encapsulation of a taxpayer’s right to avoid taxes, was decided by the House of Lords in the UK. The importance of studying the UK’s *Ramsay* approach is to determine the potential efficacy of certain principles in the current South African GAAR that are borrowed from this approach such as commercial substance in section 80C of the Act. The recently introduced GAAR in the UK will also be discussed at length to identify possible lessons that may be relevant in the South African context.

### 3.2 Limitations

Firstly, this study will be limited to income tax avoidance. Secondly, although references to other jurisdictions such as France and Germany are made during the discussion of the abuse of law doctrine in Chapter 4, the comparative review is generally limited to the jurisdictions identified and justified above. Finally, the study will not deal extensively with non-legal aspects of tax avoidance such as tax psychology, tax morale, and compliance behaviour.

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22 293 US 465 (1935).
23 [1981] 1 All ER 865.
24 1936 AC 1.
4. METHODOLOGIES

The methodology adopted for this qualitative research consists of a critical and comparative legal analytic review of the relevant legislation, case law, and literature. A legal historical review of the South African, Australian, and Canadian GAARs as well as the judicial doctrines in the US and the UK will also be carried out.

5. RESEARCH QUESTIONS

This research will respond to the following questions:

1. What is tax avoidance as opposed to tax evasion, and how does it relate to the right to legally avoid tax?
2. What is permissible as opposed to impermissible tax avoidance?
3. What measures are in place in South Africa to curb impermissible tax avoidance?
4. What is a GAAR and how does it relate to the other options to curb impermissible tax avoidance?
5. What are the background, scope, strengths and weaknesses of the current South African GAAR?
6. Is the South African GAAR an effective measure to counter impermissible tax avoidance and to inform taxpayers of the limits of permissible tax avoidance?
7. What lessons, if any, can be learned from jurisdictions such as Australia, Canada, the UK and the US to enhance the efficacy of the South African GAAR?

6. STRUCTURE

To respond adequately to the above questions this research is structured as follows:

1. Chapter 2 contains definitions and a detailed analysis of important concepts such as tax avoidance and tax evasion. The right to avoid tax is also discussed in this chapter. Distinguishing between permissible and impermissible tax avoidance is both very important and immensely problematic and accordingly, these key concepts are discussed in detail in this chapter.
2. Chapter 3 contains a discussion of direct anti-avoidance measures in South Africa such as specific anti-avoidance rules, the common law rule known as the substance over form rule, indirect anti-avoidance measures such as the regulation of tax practitioners, and the
requirement to report certain arrangements to the Commissioner. A background discussion of GAARs will also be done in this chapter.

3. Chapter 4 contains a historical analysis and discussion of South Africa’s first two GAARs, namely section 90 of the 1941 Act and section 103(1) of the Act.

4. Chapter 5 contains a discussion of the South African GAAR. This discussion is aimed at determining this GAAR’s potential efficacy. In this regard this chapter will focus on the indicators of impermissible tax avoidance relied on in this GAAR to identify and curtail impermissible tax avoidance. Potential strengths and weaknesses of this GAAR, if any, will be identified.

5. Chapters 6 and 7 contain a discussion of the scope and historic development of the Australian and Canadian GAARs.

6. Chapters 8 and 9 contain a discussion of the judicial doctrines used to curtail impermissible tax avoidance in the US and the UK. Chapter 9 also contains a discussion of the recently introduced GAAR in the UK.

7. Chapter 10 concludes this research by providing final conclusions regarding the efficacy and efficiency of the South African GAAR. These final conclusions are informed by the detailed review of this GAAR and the comparative review of the general anti-avoidance measures applicable in Australia, Canada, the US and the UK. Chapter 10 also contains recommendations for legislative changes that should be made to the South African GAAR to enhance its efficacy.
CHAPTER 2

TAX AVOIDANCE AND THE RIGHT TO AVOID TAX

TABLE OF CONTENTS

1. INTRODUCTION ................................................................................................................ 10
2. TAX ...................................................................................................................................... 10
2.1 Types of Taxes .................................................................................................................... 12
3. TAX AVOIDANCE .............................................................................................................. 13
3.1 Tax Avoidance and Tax Evasion ........................................................................................ 15
4. PERMISSIBLE TAX AVOIDANCE ................................................................................... 16
4.1 The Right to Engage in Permissible Tax Avoidance .......................................................... 17
4.2 Questions on the Existence of the Right to Engage in Permissible Tax Avoidance......... 18
4.3 Judicial Recognition of the Right to Avoid Tax ................................................................. 22
4.4 Judicial Criticism of Tax Avoidance .................................................................................. 23
4.5 The Right to Utilise Business Methods with the Least Tax Implications......................... 24
5. IMPERMISSIBLE TAX AVOIDANCE .............................................................................. 29
5.1 Features of Impermissible Tax Avoidance Transactions .................................................... 31
5.1.1 Absence of Business Purpose ........................................................................................ 31
5.1.2 Abnormality ..................................................................................................................... 32
5.1.3 Misuse or Abuse of the Tax Laws ................................................................................... 32
5.1.4 Participation of Tax Indifferent or Accommodating Parties ........................................ 33
5.1.5 Unnecessary Steps and Complexity ................................................................................. 33
5.1.6 Other Features of Impermissible Tax Avoidance Schemes ............................................. 34
5.2 Analysis of the Indicators of Impermissible Tax Avoidance.............................................. 35
5.3 The Goals of Impermissible Tax Avoidance ...................................................................... 36
5.4 Other Methods through which Impermissible Tax Avoidance is done ............................ 39
5. CONCLUSION ..................................................................................................................... 39
1. INTRODUCTION

Tax avoidance is a concept that polarises opinion between many taxpayers (and those that are conscious of taxpayers’ rights) on the one hand, and the revenue authorities (and those who believe that the tax avoiders act immorally) on the other. Thus, much of the literature on tax avoidance is often influenced by the writer’s personal views on this contentious topic.\(^1\) Bias and subjectivity in the analysis of tax avoidance can lead to a misunderstanding of this complex subject.

This chapter will discuss the concept of tax avoidance, and in the process key concepts such as permissible and impermissible tax avoidance will be extensively analysed. In this regard, concepts commonly used to identify impermissible tax avoidance, such as abnormality, business purpose, and misuse and abuse will be discussed to consider whether or not they sufficiently reflect the behaviour that revenue authorities seek to curtail. The overarching aim of this chapter is to initiate the investigation towards the efficacy of the GAAR in South Africa by investigating whether or not the factors that are commonly used to identify impermissible tax avoidance sufficiently distinguish between permissible and impermissible tax avoidance.

2. TAX

To obtain a general understanding of tax avoidance one first has to understand the concept of “tax” as the dictionary definitions vary. Tax has been defined as “money that must be paid to the state, charged as a proportion of income and profits or added to the cost of some goods and services”.\(^2\) Discipline specific dictionaries also provide varying definitions of tax. Law


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and Owen define tax as a “levy on individual or corporate bodies by central or local government in order to finance the expenditure of that government and also as a means of implementing its fiscal policy”. Legal dictionaries also define tax differently: according to Black’s Law Dictionary tax is “a monetary charge imposed by the government on persons, entities, or property to yield public revenue”. In A Dictionary of Law tax is defined as a compulsory contribution to the state’s funds” that “is levied either directly on a taxpayer...or indirectly through tax on purchases of goods and services”.

Legal scholars have weighed in with definitions of tax. Morse and Williams define tax as “a compulsory levy imposed by government for public purposes”. According to Thuronyi, “[i]n economic terms, any imposition of costs on individuals or firms by the government can be considered a tax”. Thuronyi also states that “[t]ax might be defined as a required payment to government”. Lymer and Oats define tax as “a compulsory levy, imposed by government or other tax raising body on income, expenditure or capital assets, for which the taxpayer receives nothing specific in return”. In the case Attorney General of Trinidad and Tobago v Ramesh Dipraj Kumar Mootoo it was stated that tax entails a burden or a charge that the legislature imposes on persons or property in order to fund public expenditure.

Some economists define tax as “transfers of resources from persons or economic units to government and are compulsory”. Tax is compulsory in the sense that taxpayers cannot opt out of paying it; this compulsory nature of tax is noted by other public finance economists such as Musgrave and Musgrave, Bird and Tsiopoulos, and Jones and Rhoades-Catanach. There is no correlation between the tax paid and the goods and services provided

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6 Principles of Tax Law (2000) 3 state that the question “what is a tax” is a difficult one to answer and that the definition given above is not exhaustive.
8 Thuronyi (2003) 45 notes that certain regulatory requirements which effectively have the same economic consequences as tax must be excluded from this economic definition.
9 Thuronyi (2003) 45 states that certain required payments to the government such as civil or criminal fines must be excluded from this definition.
12 Black, Calitz and Steenekamp (Black et al) Public Economics (2011) 163.
by the government in return;\textsuperscript{16} this can be illustrated by the fact that a government can collect tax from one group for the benefit of another.\textsuperscript{17}

The various definitions noted above establish that tax has certain inherent characteristics that include the following:

1. it is compulsorily levied on individuals and companies;\textsuperscript{18}
2. it is one of the means by which a government raises revenue;\textsuperscript{19}
3. it is used to fund public expenditure;\textsuperscript{20} and
4. there is no specific \textit{quid pro quo} for the tax paid.

A government’s power to tax has been described as an “inherent power of sovereignty”.\textsuperscript{21} The US Supreme Court has noted that “[t]he power of taxation operates on all persons and property belonging to the body politic [and] has its foundations in society itself”.\textsuperscript{22}

2.1 Types of Taxes

Taxes can be classified as direct or indirect taxes.\textsuperscript{23} Direct taxes are taxes imposed on individuals and companies, while indirect taxes are imposed on commodities. Income tax is an example of a direct tax. The distinction between direct and indirect taxes is based on incidence or on where the tax burden lies. In this regard, direct taxes are relatively difficult to shift, and are levied on the taxpayers intended to bear the tax burden. By contrast, indirect

\textsuperscript{16} As Thuronyi (2003) 46 notes, “taxes should not include payments to the government for which the taxpayer receives something in return”. Thuronyi, however, further explains this characteristic: he states that “[t]here is a continuum ranging from pure taxes where the taxpayer receives nothing, to a fee for services corresponds to what was paid”. Thuronyi states that fees that correspond to the services that are received in return can be property transfer taxes that are paid in order to register property ownership.

\textsuperscript{17} Black \textit{et al} (2011) 163.

\textsuperscript{18} According to Morse and Williams (2000) 4, Smith \textit{An Inquiry into the Nature and Causes of the Wealth of Nations The Wealth of Nations} (2003 reprint) 1032 and Black \textit{et al} (2008) 115 tax is one of the major sources of government revenue. This means that it must be compulsory because a government cannot reasonably rely on voluntary contributions.

\textsuperscript{19} Morse and Williams (2000) 4 note that the raising of revenue is one of the major reasons behind the imposition of tax. Barker (2006 – 2007) 2 notes that revenue collection and the power to tax may easily be the most significant of all the powers a government possesses because many other government duties need tax revenue to be exercised effectively. In this regard Tiley \textit{Revenue Law} (2008) 101 notes that from a government perspective “tax avoidance is a problem because it nibles away at the edges of the tax base so reducing government revenue and, in extreme cases, making government policy implementers look foolish”.


\textsuperscript{23} Thuronyi (2003) 54. Black \textit{et al} (2011) 163 note that in South Africa, tax can be divided into classes such as income and profit tax, employees’ tax, property tax, goods and services tax and international transactions tax.
taxes are levied on goods and services and can be shifted to another taxpayer. Indirect taxes such as value added tax (VAT), excise duty, and fuel levies can often be shifted to another person or entity. Consumers of the goods and services that are indirectly taxed bear the tax burden.\textsuperscript{24}

\section*{3. TAX AVOIDANCE}

Although one of the characteristics of a tax is that it is compulsory, this does not mean that it cannot be avoided; the laws that make tax compulsory are the same laws that can be used to avoid it. Tax avoidance is a complex concept that is difficult to define as evidenced by the absence of a general consensus on its precise meaning. For instance, a number of Committee reports in different countries have defined it differently. In 1975, the Asprey Committee in Australia defined tax avoidance as a legal act that results in income splitting between persons and lowers a taxpayer’s taxable income.\textsuperscript{25} In 1955 the Radcliffe Committee in the UK defined tax avoidance as an act in which a taxpayer arranges his financial affairs in order to pay less tax than he would pay without the arrangement.\textsuperscript{26}

In 1966, the Carter Commission in Canada, defined tax avoidance as “every attempt by legal means to reduce tax liability which would otherwise be incurred by taking advantage of some provision or lack of provision in the law”.\textsuperscript{27} This definition acknowledges the legality of tax avoidance. The Carter Commission further states that arrangements entered into to avoid tax amount to an abuse of law.\textsuperscript{28} In terms of this definition, tax avoidance exists where taxpayers interpret provisions of a taxing Act in a manner that confers tax benefits on them but that is inconsistent with the purpose of the provisions of the Act. Defining tax avoidance as an abuse

\textsuperscript{24} Black \textit{et al} (2011) 166. Other classifications of tax noted by Black \textit{et al} (2011) at 164 – 165 entail general or selective taxes and specific and \textit{ad valorem} taxes. General or broad based taxes are taxes on the entire tax base without any exemptions. An example is value added tax (VAT). Income tax on all income sources with no exception can also be referred to as a general tax. Selective or narrow base taxes are taxes on selected products and do not apply to the tax base as a whole. Taxes can also be classified into specific and \textit{ad valorem} taxes. Specific tax is a fixed amount on a unit of a product. \textit{Ad valorem} tax is a rate levied on the value of a commodity.


\textsuperscript{26} The Royal Commission on the Taxation of Profits and Income (1955) par 1024. This definition is similar to the one offered by the Asprey Committee in the sense that it contains a reference to an arrangement which has the effect of tax reduction. The Radcliffe Committee does not however mention legality and this may present problems because its definition may extend to tax evasion because a taxpayer may arrange his affairs to pay less tax by concealing income completely or by understating it, which qualifies as tax evasion.


\textsuperscript{28} Carter Commission Report 538.
of the tax laws means that the purpose of the laws has to be ascertained over and above ascertaining the complex black letter provisions themselves.29

The discrepancies in the definition of tax avoidance can also be found in the definitions coined by various authors. Tax avoidance has been defined as behaviour by the taxpayer that is intended to reduce tax liability, but is legally ineffective because the taxpayer is not entitled to the tax benefits sought, even though it does not amount to a criminal offence.30 Thuronyi31 concedes that the precise “contours” of tax avoidance are disputable, meaning that there is no universally acknowledged definition for tax avoidance. Wheatcroft’s32 “short” description of tax avoidance is that it is “the art of dodging tax without actually breaking the law”. Tax avoidance has also been defined as “legal but unsuccessful tax planning”,33 as “arranging one’s affairs within the rules so as to pay the smallest bill possible”34 and as “formulating stratagems which are lawful unless expressly proscribed by the Act”.35

These diverse definitions show that tax avoidance is an act that results in income liable for taxation being reduced. The definitions noted above show that tax avoidance is viewed by some as effective in securing the tax benefits sought. Some view tax avoidance as “legal but unsuccessful” or legally ineffective, since it does not actually secure the tax benefits sought.36 These apparently conflicting views on tax avoidance can be reconciled on the basis that tax avoidance is a continuum that stretches from permissible tax avoidance to impermissible tax avoidance. Permissible tax avoidance is effective in securing the tax benefits sought, while impermissible tax avoidance is ineffective. The line between permissible and impermissible tax avoidance that clarifies the stage at which a permissible transaction becomes impermissible is unclear.

32 Wheatcroft (1955) 209.
33 Barker “The Ideology of Tax Avoidance” (2009) 40 Loyola University Chicago Law Journal 229 242. At 230 Barker concedes that tax avoidance is a term without a definite meaning because it is a label used to describe tax ‘abusive situations.’ He notes that it is something a good tax attorney can identify when he encounters it without being able to define it precisely.
34 Morse and Williams (2000) 9.
36 Larking IBFD (International Bureau of Fiscal Documentation) International Tax Glossary (2005) 29 notes that tax avoidance can refer to “acceptable” behaviour or more often to “unacceptable” or “illegitimate” behaviour that does not qualify as evasion. This shows that tax avoidance is a term used differently by different authors.
3.1 Tax Avoidance and Tax Evasion

Tax avoidance can and must be distinguished from tax evasion. Both result in revenue loss for the *fiscus* which means that they have a similar effect with regards to revenue loss. However, the two concepts are fundamentally different. Tax evasion is the illegal failure to pay tax, in the sense that it is contrary to the law and makes the evader liable to punitive measures such as fines or imprisonment.\(^{37}\) Legality is the most basic distinction between tax evasion and tax avoidance. Tax evasion is not limited to fraudulent or intentional acts, even though these constitute the most blatant forms of tax evasion;\(^{38}\) this is because tax can be evaded in two ways. The first is a wilful and conscious action to violate the tax laws and the taxpayer fraudulently escapes legal obligations. In the second instance, a taxpayer recklessly or negligently fails to honour his tax obligations but does not deliberately conceal any income or information.\(^{39}\) A taxpayer can evade tax by, outright failure to submit a tax return, by submitting an inaccurate tax return that omits required information, by excessively claiming deductions he or she is not entitled to, and by falsely or fraudulently claiming tax rebates or exemptions.

Tax avoidance on the other hand is not inherently illegal and involves arranging one’s financial affairs in a manner that will reduce the tax payable.\(^{40}\) Wheatcroft succinctly explains the distinction on the basis of legality as follows:

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\(^{37}\) The Taxation Review Committee Full Report 1975 (Asprey Committee Report) par 11.1 defines tax evasion as “an act in contravention of the law whereby a person who derives a taxable income either pays no tax or pays less tax than he would otherwise be bound to pay”. In South Africa section 235 of the Tax Administration Act 28 of 2011 provides for certain punitive interventions against tax evaders that entail imprisonment or a fine. These punitive measures can be said to be one of the reasons why tax evaders are apprehensive of having their activities exposed as noted by Sandmo “Three Decades of Tax Evasion: A Perspective on the Literature” (2003) 4, paper presented at the Skatteforum or Research Forum on Taxation, Rosendal, Norway quoted in Kirchler The Economic Psychology of Tax Behaviour (2007) 22. According to Potas “Thinking About Tax Avoidance” (1993) The Australian Institute of Criminology: Trends and Issues in Crime and Criminal Justice 1 2, traditional criminological wisdom, crime may be found where money is made or is expected to be made. When applied to taxation this theory means that where there is a duty to pay taxes there will always be individuals who will take criminal steps to avoid this duty.

\(^{38}\) Webley “Tax Compliance by Business” in Sjogern and Skogh (eds) New Perspectives on Economic Crime (2004) 95 – 126 seems to limit evasion behaviour to the deliberate or intentional non-payment of tax. This view can also be seen in Elffers, Weigel and Hessing “The Consequences of Different Strategies for Measuring Tax Evasion Behaviour (1987) 8 3 Journal of Economic Psychology 311 where tax evasion is referred to as synonymous with “tax cheating” and as a deliberate failure to pay tax owed and in Gardner (ed) (1999) where tax evasion is defined as “the wilful attempt to defeat or circumvent the tax law in order to illegally reduce one’s tax liability”.

\(^{39}\) Olivier and Honiball International Tax a South African Perspective (2008) 381.

\(^{40}\) Lymer and Oats (2009-2010) 40.
Avoidance is legal; evasion illegal. The man with a new Swiss watch in his pocket who says to Customs “I have nothing to declare” is evading tax and should clearly be distinguished from the man who keeps within the law and does not use fraud or concealment.\textsuperscript{41}

Wheatcroft’s assertion above shows that tax evasion essentially involves fraudulent conduct, but it has been noted that a taxpayer can evade tax by acting recklessly or negligently.

4. PERMISSIBLE TAX AVOIDANCE

Permissible tax avoidance is one of the forms of tax avoidance. It can be defined as the act of taking legally permissible steps to limit one’s tax liability. Terms such as tax planning or tax mitigation can be said to be synonymous with permissible tax avoidance. Permissible tax avoidance can exist in different forms. One form exists where a taxpayer studies and comprehends the tax laws and makes minor adjustments to his or her financial affairs to avoid tax. An example of this form can be found in Lord Templeman’s statement in \textit{Craven (Inspector of Taxes) v White},\textsuperscript{42} where it was decided that if the law states that a company in the Isle of Man is immune from taxation and a taxpayer transfers assets to an Isle of Man company, that taxpayer will enjoy the tax immunity because Parliament intends that immunity to be enjoyed, unless a provision to the contrary is present.

It is recognised that the nature of the contract giving rise to revenue may have a decisive impact on the taxability of the revenue generated.\textsuperscript{43} This means that parties are often able to avoid tax by ensuring that their transactions do not give rise to taxable revenue. For instance, revenue received by virtue of a lease agreement is taxable because of paragraph (g) of the definition of gross income in section 1 of the Act. In \textit{Vacu-Lug (Pvt) Ltd v COT}\textsuperscript{44} the taxpayer acquired exclusive rights to utilise a patent process for lugging tyres. The patent still had 14 years to run when the taxpayer acquired it. The taxpayer entered into a contract with a company and granted the company exhaustive rights, including the right to utilise the process for a twenty year period. In return the taxpayer was paid a sum of £5000. This sum was held to be taxable as income because it constituted a rental receipt in the taxpayer’s hands. If the


\textsuperscript{42} [1988] 3 All ER 495 508.


\textsuperscript{44} 1963 (2) SA 694 (SR).
taxpayer had sold the rights to the company it would have received a capital amount that was not subject to tax, and the taxpayer could have permissibly avoided tax without being worse off commercially by simply selling the rights.\footnote{45 Kruger and Scholtz (2003) 24. At 61 these authors note that “tax consequences seem to depend entirely upon the way in which the draftsman formulates the consideration”. Many other cases show that permissible tax avoidance can exist by making minor adjustments to one’s affairs. In a South African context the following certain cases can be used to substantiate this statement. In \textit{ITC 652} (1948) 15 SATC 373 the taxpayer could have avoided tax by concluding a sale and not the lease that the court believed was in existence. In \textit{ITC 429} (1939) 10 SATC 355 the taxpayer avoided tax because the receipt in question was a lump sum payment which was held to be a capital gain. Taxpayers can make minor adjustments to their affairs by reference to the definition of gross income in section 1 of the Act. \textit{CIR v Butcher Brothers Pty Ltd} 1945 AD 301 is authority for the proposition that the paragraphs to this definition serve to convert what may be capital income to gross income. This means that taxpayers may need to ensure that their receipts or accruals are not provided for as gross income. For instance annuities are taxable as income and cases such as \textit{ITC 768} (1953) 19 SATC 211, \textit{SIR v Watermeyer} 1965 (4) SA 431 (A) and \textit{SIR v Struben Minerals (Pty) Ltd} 1966 (4) SA 585 (A) explain the meaning of an annuity. In \textit{ITC 712} (1950) 17 SATC 337 the taxpayer failed to avoid receiving annuities when he received a monthly payment of R100 for life as consideration for his selling his business and was consequently taxed on his annuities. A similar scenario can be found in \textit{ITC 115} (1928) 4 SATC 66. In \textit{KBI v Hogan} 1993 (4) SA 150 (A) a taxpayer’s monetary compensation for accident injuries was taxed because it was received in monthly payments which qualified as annuities and not one lump sum which could have been treated as a capital sum. In these cases, it would have been permissible tax avoidance if the taxpayers had made minor adjustments to their affairs to receive an amount that is not subject to tax. It is probably this form of permissible tax avoidance that, in a UK context, prompted Lord Summer in \textit{Levene v Inland Revenue Commissioners} 1928 AC 271 277 to state that taxpayers who plan their affairs in such a way that their receipts or accruals are outside the ambit of the taxing Act do not incur penalties or moral blame.}

Another form of permissible tax avoidance involves in-depth knowledge of the tax laws and taking more substantial steps to avoid tax. Taxpayers who take substantial steps to avoid tax often test the boundary between permissible and impermissible tax avoidance.

4.1 The Right to Engage in Permissible Tax Avoidance

Taxpayers have a right to avoid tax.\footnote{46 Weisbach “Ten Truths about Tax Shelters” (2001 – 2002) \textit{Tax Law Review} 215 222 criticises permissible tax avoidance as wasteful. Weisbach notes that “tax planning, all tax planning...produces nothing of value. Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. No new medicines are found, computer chips designed or homeless housed through tax planning. At a minimum, defenders of tax planning must justify why we should care about a non-productive activity”. Schler “Ten More Truths about Corporate Tax Shelters” (2001 -2002) \textit{Tax Law Review} 325 responds to Weisbach and at 385 states that “tax planning is not all bad”. Schler states that certain tax incentives such as deductions on qualifying research and development exist because the legislature believes that they encourage socially beneficial activities. If taxpayers cease to take advantage of tax incentives that exist to encourage certain economic behaviour it would mean that certain fiscal and economic policies might become impossible to implement through taxation. As Squires J stated in \textit{R Ltd and K Ltd v COT} (1983) 45 SATC 148 167 the provisions of the Act make it evident that the legislature intends that some revenue received or accruing to a taxpayer will not attract tax or will be subject to a reduction in tax. He also noted that some incentives in the Act are used to further fiscal or economic policy. Where a taxpayer arranges his or her affairs to take advantage of these incentives it will be an operation or scheme aimed at reducing tax but would not be impermissible because it is what the Act intends.} The right to avoid taxes is in line with individual liberty in taxation, which allows one to arrange his or her financial affairs so as to avoid tax. The idea of individual liberty in taxation has been criticised. Barker notes that this idea is...
supported by the freedom of the individual from state intervention, freedom of property, and freedom to contract. Barker also notes that the hidden goal of the proponents of the freedom to avoid tax is the placement of the tax burden on other taxpayers. Nevertheless, it is debatable that a person who takes steps to limit his or her tax liability intends to make others pay more. Permissible tax avoidance is generally aimed at limiting individual tax payments, and one cannot be precluded from permissibly avoiding tax merely because others in similar circumstances are not doing the same.

4.2 Questions on the Existence of the Right to Engage in Permissible Tax Avoidance

Weisbach disputes the existence of a right to avoid tax, stating that the right “is a truism of the tax law” and that when trying to curtail impermissible tax shelters (avoidance) it must not be assumed that the right exists. He states that:

> [v]iewing something as a right usually means that there is something profound or inviolate about it. But if the so called right is based merely on language in the statute, nothing stops Congress from changing the language. …If the right were based on a source more profound than a mere statute, modifying it might be more troublesome. We would not want to limit fundamental rights or values. But the right cannot be found in any such source. For example, there is no right to engage in tax planning in the constitution or any other foundational documents of our society. And the right to alter behaviour to minimise taxes is not a basic principle of moral philosophy. Tax planning does not, for example, rank with the freedom of thought, speech, association, religion, or other principles supported by moral philosophers. To summarize, no moral or philosophical basis for the right to tax plan has yet to be articulated. There is no constitutional right. There is not even an explicit statutory right. There is in short, no basis for a right to tax plan other than statements made up out of thin air by a few judges using questionable theories of statutory interpretation.

Weisbach further notes that the legislature’s ability to limit or expand the right to avoid tax by “the stroke of a pen” proves that the right is not “profound or inviolable”, which is one of the characteristics of a right.

Weisbach’s criticism of the right to avoid tax can be countered. Regarding his contention that the right to avoid tax is based on judicial statements, Weisbach may have been referring to the *IRC v Duke of Westminster* case. This case has been blamed for creating a situation

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51 19 TC 490.
where taxpayers could avoid tax by merely conforming with the literal provisions of the tax legislation.\textsuperscript{52} It is indeed true that an environment that favours a literal interpretation of the tax legislation allows tax avoidance to flourish.\textsuperscript{53} It can be stated, nonetheless, that the right to avoid tax has been judicially acknowledged for a very long time and in different jurisdictions. As will be seen later in this chapter, Canadian, American, British, South African, and Australian courts have consistently acknowledged this right; it is therefore difficult to say that these courts, at different times, all misunderstood or misunderstand statutory interpretation. For instance, while the House of Lords in the \textit{Duke of Westminster} case may have promoted literalism with its approach in the case, the US Supreme Court in \textit{Gregory v Helvering}\textsuperscript{54} adopted a purposive approach, but still recognised the right to avoid tax. It can also be stated that in permissible tax avoidance taxpayers often comply with the letter \textit{and} purpose of the applicable tax legislation. As stated above, permissible tax avoidance can help achieve economic policies advanced through tax incentives. In this regard it is, with respect, inaccurate to state that statutory interpretation sustains tax avoidance in a negative way.

Regarding the second point, that the right to avoid tax is not constitutionally guaranteed and is not even expressly provided for in tax legislation one can argue otherwise, albeit from a South African context. Taxation amounts to a deprivation of property. Taxpayers in South Africa have a constitutional right to property in terms of section 25 of the Constitution. In terms of this section, taxpayers may not be deprived of property except in terms of a law of general application. This section also provides that the law may not allow any arbitrary deprivation of property. Property is not limited to land in terms of section 25(4)(b).\textsuperscript{55} In \textit{First National Bank of South Africa Ltd t/a Wesbank v CSARS and Another}\textsuperscript{56} it was stated that “deprived” extends to situations where the right to property is interfered with and not only where property is taken away and that to fully realise the protection of the rights of individuals, property rights of companies and other juristic persons had to be afforded constitutional protection.

\textsuperscript{52}The legacy of the \textit{Duke of Westminster} case will be discussed in Chapter 9.
\textsuperscript{53}In the regard, see generally Arnold B.J. “Reflections on the Relationship between Statutory Interpretation and Tax Avoidance” in Erlichman H (ed) \textit{Tax Avoidance in Canada: The General Anti Avoidance Rule} (2002).
\textsuperscript{54}69 F.2d 809.
\textsuperscript{55}The word property in the constitution has been interpreted to mean physical property, property rights and any relationship or interest with an exchange value – Currie and De Waal \textit{Bill of Rights Handbook} (2005) 537.
\textsuperscript{56}2002 (4) SA 768 CC pars 45, 57 and 58.
A person’s income is “property” and it can be said that the payment of tax, which is involuntary, amounts to a deprivation of property. In this regard the provisions of section 36 of the Constitution are relevant. Section 36(1) provides for the limitation of the rights in the Constitution except as provided for in section 36(1). It is patently clear that income taxation is necessary to enable the government to fund its operations and the provision of public services and is authorised in terms of the Act which is a law of general application. There are no other less restrictive measures that can be taken by government to finance its activities apart from taxation of income; this means that the infringement of property rights by taxation is constitutionally justified.

However, it does not necessarily follow that the right to avoid tax is not constitutional; a taxpayer can use legal means to enforce their Constitutional right to property. It would be unconstitutional and contrary to section 25 of the Constitution for any law to arbitrarily state that taxpayers may not use legal mechanisms available to them to limit the taxes that they pay. This is probably one of the reasons why a GAAR may not simply state that it is prohibited for taxpayers to avoid tax in any manner.

Apart from the constitutional backing of the right to avoid tax, and the tax concessions that expressly encourage tax to be avoided in different scenarios, it can be stated that this right exists by implication in tax legislation that does not compel a taxpayer only to transact in a

58 Croome (2010) 8 notes that many taxpayers erroneously believe that constitutionally enshrined rights may not be violated. It is important to note that with regard to most constitutional rights the question is whether the violation or infringement is justifiable in terms of the constitution, not whether there has been an infringement. Certain rights namely human dignity and right to life are however not to be infringed under whatever circumstances.
59 Per Conradie J in the court a quo in First National Bank of South Africa Ltd v/a Wesbank v CSARS and Another 2001 (3) All SA 310 328G-H and Ackerman in the Constitutional Court par 27.
60 This could have been possible in the pre-1994 dispensation when South Africa was a parliamentary state in which the Parliament ruled supreme. Section 34 (3) of the Republic of South Africa Constitution Act 110 of 1983 barred courts from analysing or pronouncing on the validity of any Act of parliament. This constitution did not contain any Bill of Rights and this enabled parliament to introduce any legislation it pleased. Legislation could only be nullified if it was enacted in a manner inconsistent with the procedures set by parliament or in terms of the constitution. On 22 June 1994 the then Minister of Finance DL Keys announced a Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa headed by Prof M.M. Katz and known as the Katz Commission in his 1994 Budget Speech. This Commission noted in its Interim Report that “the tax system is subject to the Constitution and must conform to the society’s commitment to the Rule of Law”. This means that Parliament cannot arbitrarily provide for the erosion of the taxpayer’s right to avoid tax under the current constitutional dispensation. For a discussion of the impact of the Constitution on the tax legislation see generally Croome (2010).
manner that will attract tax.⁶¹ In addition, the fact that GAARs and SAARs apply only if certain conditions are present means that taxpayers have the freedom to transact in a manner that does not attract these rules. It can therefore be argued that the right to avoid tax would still exist even if it were not constitutionally guaranteed.

Regarding the third point on the morality of tax avoidance, it must be noted that the conviction that tax avoidance is morally reprehensible is held by many.⁶² Moral arguments against tax avoidance have also been criticised.⁶³ These arguments can be further criticised on the grounds that morals are subjective and uncertain and that it would be undesirable to require taxpayers to consider the morality of their actions apart from their legality, when seeking to avoid tax. The courts have weighed in with arguments against the use of morals in tax avoidance cases. In Craven v White, Lord Oliver stated as follows:

I am at one with those of your Lordships who find the complicated and stylised antics of the tax avoidance industry both unedifying and unattractive but I entirely dissent from the proposition that, because there is present in each of the three appeals before this house the element of a desire to mitigate or postpone the taxpayer’s tax burdens, this fact alone demands from your Lordships a predisposition to expand the scope of the doctrine of Ramsay and of Dawson beyond its rational basis in order to strike down a transaction which would not otherwise realistically fall within it.⁶⁴

Lord Oliver noted that the fact that there is a plan to avoid tax should not detract from the application of the law, without fear or favour, despite the fact that one may find such practice

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⁶¹ In Dadoo Ltd and Others v Krugersdorp Municipal Council 1920 AD 530 548 and Van Heerden v Pienaar 1987 (1) SA 96 (A) 107E-F it was stated that parties are entitled to arrange their affairs in a manner that enables them to remain outside the provisions of a particular legislative provision.

⁶² McDonald JP in COT v Ferera 1976 (2) SA 653 (SR) 656E-G noted that “I endorse the opinion expressed that the avoidance of tax is an evil. Not only does it mean that a taxpayer escapes the obligation of making his proper contribution to the fiscal, but the effect must necessarily be to cast an additional burden on taxpayers, who, imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice and set up the necessary tax avoidance machinery, fail to do so. Moreover the nefarious practice of tax avoidance arms opponents of our capitalistic society with potent arguments that it is only the rich, the astute and the ingenious who prosper in it and that good citizens will always fare badly”. In Glen Anil Development Corporation Limited v SIR 1975 (4) SA 715 (A) 728H and 37 SATC 319 334 Botha JA described tax avoidance as “mischief”.

⁶³ Vorster “Tax Avoidance, Morality and the Devil’s Sermon on Sin” South African Institute of Tax Practitioners Annual Conference: Tax Administration in an African Context (2009) 75 and Freedman “Defining Taxpayer Responsibility: In Support of a General Anti Avoidance Principle” (2004) British Tax Review 332 337. Dismissing the morality argument against tax avoidance, Freedman notes that the “law does not extend to a moral not embodied in legislation or case law. Calls on morality, where the law proves inadequate to achieve what government intends, are unreasonable, unfair and incomprehensible since taxpayers are entitled to be able to rely on the law as it is written. If this does not accord with the intention of parliament, it is for parliament to make its intention clearer”. It can also be argued that morals, like opinions, are inconsistent and it is unthinkable that a tax avoidance scheme could be struck down by merely referring to its immorality.

⁶⁴ 527.
both “unedifying and unattractive”. Similar sentiments were expressed in *Vestey’s (Lord) Executors and Another v Inland Revenue Commissioners* where it was stated:

Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. This is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved.  

It can therefore be concluded that despite the criticisms of the right to avoid tax this right exists.

4.3 Judicial Recognition of the Right to Avoid Tax

The existence of a right to avoid tax has been acknowledged by courts in a number of countries, and one of the most recognisable cases in this regard is *IRC v Duke of Westminster* where Lord Atkin stated as follows:

> For it has to be recognised that the subject, whether poor and humble, or wealthy and noble, has the right to dispose of his capital and income as to attract the least amount of tax. The only function of a court of law is to determine the legal result of his disposition so far as they affect tax.

In the same case, Lord Tomlin acknowledged that a taxpayer has a right to plan his or her affairs within the law so as to avoid taxation and noted 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 otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax.

In this statement Lord Tomlin appears to be alluding to the fact that tax avoidance, no matter how objectionable it may be to other parties, is not illegal merely because of that perception.

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65 [1949] 1 All ER 1108 1120.
66 511. One of the earliest cases to recognise the right to avoid tax is according to Gunn “Tax Avoidance” (1978) 76 5 Michigan Law Review 733 735, *United States v Isham* 84 US (17 Wall) 496 506 (1873) where the Supreme Court stated that a taxpayer has “a legal right” to avoid taxes on twenty dollar cheques by issuing two ten dollar cheques to his creditors.
67 520.
In *IRC v Fisher’s Executors*, it was noted:

[M]y Lords, the highest authorities have always recognized that the subject is entitled so to arrange his affairs as not to attract tax imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms or any omissions that he can find in his favour in taxing Acts. In so doing he neither comes under liability nor incurs blame. 68

In South African law the *Duke of Westminster* principle was quoted with approval in a number of cases. 69 In *CIR v Estate Kohler and Others*, 70 Centlivres CJ in a dissenting judgment stated that “[i]t is true that the device adopted was designed in order to escape death duties, but it has long been a well-recognised principle of law that a person may so order his affairs to escape taxation”.

In the American case *Gregory v Helvering*, 71 described as one of the most cited tax cases ever, 72 Judge Learned Hand stated that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid them, by means which the law permits cannot be doubted”. Further affirmation of the taxpayer’s right to avoid tax in the US can be found in the case *Commissioner v Newman* where Judge Learned Hand stated:

> Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands, taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant. 73

Judge Learned Hand’s forceful statement can be said to be an attack on the use of morals in tax avoidance cases.

### 4.4 Judicial Criticism of Tax Avoidance

The right to avoid tax has also been criticised by the courts. In *Lord Howard de Walden v CIR*, Lord Greene noted that:

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69 See *CIR v King* 1947 2 SA 196 (AD), *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* 1941 AD 369, *CIR v George Forest Timber Company Ltd* 1924 AD 516, *CIR v Wolf* 1928 AD 177 and *Gratus v CIR* 1933 WLD 100.
70 (1953) 18 SATC 354 361.
71 810.
73 159 F.2d (2d Cir 1947) 848 850 - 851.
[f]or years the battle of manoeuvre has been waged between the legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle the legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present appellant has not been the least successful. It would not shock us in the least to find that the legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.  

In *Latilla v IRC*, Viscount Simons stated that:

> [t]here is of course no doubt that they are within their legal rights, but that is no reason why their efforts or those of the professional gentleman who assist them in the matter should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship.

Lord Denning in *Re Weston's Settlements* stated that “the avoidance of tax may be lawful but it is not yet a virtue”. It can be noted that the opinions presented here do not directly deny the existence of a right to avoid tax. Lord Denning and Viscount Simons both criticise tax avoidance but acknowledge its legitimacy as a right.

4.5 The Right to Utilise Business Methods with the Least Tax Implications

The right to avoid tax means that where the same commercial result can be achieved by two or more methods, the taxpayer has a right to choose the method with the least tax implications. This right is recognised in the UK and was described by Lord Keith of Kinkel in *Craven v White* who stated that:

> [i]t remains true in general that the taxpayer, where he is in a position to carry through a transaction in two alternative ways, one of which will result in liability to tax and the other of which will not, is at liberty to choose the latter and do so effectively in the absence of any specific tax avoidance provision.

In *IRC v Wesleyan Assurance Society*, Lord Tomlin stated that:

> [i]f one of these methods is adopted, tax will be payable. If the other method is adopted tax will not be payable...The net result, from the financial point of view, is precisely the same in each case, but one method of achieving it attracts tax and the other does not. There have been cases in the past where what

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74 1942 1 KB 389 397.
75 1943 AC 377 (HL) 381.
77 500.
has been called the substance of the transaction has been thought to enable the court to construe a
document in such a way as to attract tax that particular doctrine of substance as distinct from form was,
I hope, finally exploded by the decision of the House of Lords in *Duke of Westminster v Inland
Revenue Commissioner*.

In *IRC v Brebner*, Lord Upjohn stated:

> My lords, I would conclude my judgment by saying that when the question of carrying out a genuine
> commercial transaction as this was is considered, the fact that there are two ways of carrying it out –
one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be
> quite wrong as a necessary consequence to draw the inference that by adopting the latter course one of
> the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses
> is going to carry out commercial transactions except on the footing of paying the smallest amount of
tax involved. The question whether in fact one of the main objectives was to avoid tax is one for the
> Special Commissioners to decide on a consideration of all the relevant evidence before them and the
> proper inferences to be drawn from that evidence.

This right is recognised in many other jurisdictions. In South African law, this right is
recognised and was acknowledged in *Hicklin v SIR* where Trollip JA stated:

> It is true, of course, that shareholders could have repaid their loans by declaring Reklame’s reserves
> and assets as dividends, thereby incurring the ensuing tax liability. But they were not obliged to do that.
> They were perfectly entitled to try to avoid such liability by adopting some other legitimate course.

*CIR v Conhage (Formerly Tycoon)* illustrates how this right can be exercised. In this case
the taxpayer required capital to expand their business and a certain financier was available.
The two parties became aware of the tax benefits to be obtained if the deal was structured as a
sale and leaseback transaction and decided to transact that method instead of concluding a
loan agreement. A dispute with the Commissioner arose when the taxpayer sought to deduct

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78 (1948) 1 AER 555 (HL) 557.
79 [1967] 1 All ER 779 784.
80 For instance, in Australia the case *Federal Commissioner of Taxation v Westraders* [1980] HCA 24 61 this
right was affirmed. Weisbach (2001-2002) 221 states that the view of Judge Holmes in the case *Bullen v State
of Wisconsin* 240 US 625 (1916) 630 that “when the law draws a line, a case is on one side of it or the other,
and if on the safe side is none the worse legally that a party has availed himself to the full of what the law
permits” informs the affirmation of this right by the courts. Cases such as *Commissioner v Brown* 380 US
563 579-380, *Gregory v Helvering* and *CIR v National Carbide Corp* 167 Fed (2d) 304 (1948) 306 signal the
recognition of this right in the US.
81 1980 (1) SA 481 (A) 494F – G.
82 1999 (4) SA 1149 (SCA).
the rentals paid in terms of the leaseback as expenditure incurred in the production of income.\textsuperscript{83} The Commissioner argued as follows:

1. The taxpayer did not actually sell and leaseback its equipment but had, in substance, borrowed the purchase price of the equipment from the financier.
2. There was no intention to enter into a sale and leaseback agreement from both parties. The real reason behind the agreement was merely to reduce the taxpayer’s tax liability.
3. If the deal was structured as a straightforward loan the same tax advantages would not have been obtained.
4. The deductions should therefore be disallowed.

The taxpayer contended that the main purpose in concluding the deal was to obtain capital. The taxpayer further contended that the fact that tax was reduced in the process did not mean that it was the main purpose in the deal. Hefer JA, in dismissing the Commissioner’s argument, stated:

\begin{quote}
Within the bounds of any avoidance provisions in the relevant legislation a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax.\textsuperscript{84}
\end{quote}

Another case that illustrates how this right can be exercised is the Canadian case of \textit{Shell Canada Products Ltd v Her Majesty The Queen}.\textsuperscript{85} In 1988 Shell required about US$100 million for general purposes. To acquire these funds at the most favourable after tax cost Shell entered into debenture agreements with three foreign lenders and borrowed NZ$150 million at 15.4\% interest per annum. The deal required Shell to make ten bi-annual interest payments of NZ$11.55 million before paying the principal debt in 1993. Shell entered into a forward exchange contract with a foreign bank where it used the NZ$150 million to purchase US$100 million. This deal allowed Shell to exchange a certain amount of US dollars for NZ$11.55 on each day it made the bi-annual payment to the lenders and to exchange another specified amount of US dollars on the day the principal debt would be paid to the lenders. Shell reported a capital gain of US$21 million from the forward exchange deal.

\textsuperscript{83} In terms of s 11 (a) read with s 23 (g) of the Act.
\textsuperscript{84} 1155G.
\textsuperscript{85} [1999] 3 SCR 622.
When computing its income for tax purposes Shell relied on section 20(1)(c) of the Canadian Income Tax Act\(^{86}\) (CITA) which allowed a taxpayer to deduct from income interest payments on borrowed money that is used for the purpose of earning income from a business. This provision had four elements namely:

i. the amount must be paid in the year or payable in the year it is sought to be deducted;

ii. the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;

iii. the borrowed money must be used for the purpose of earning non exempt income from a business or property; and

iv. the amount must be reasonable, as assessed by reference to the first three requirements.

In spite of Shell’s reasoning, the Minister of National Revenue reassessed Shell contending that it was only permitted to deduct interest at the rate it would have paid if it had borrowed US dollars, which was 9.1% per annum, relying on section 67 of the Act that disallowed unreasonable deductions. The court held that Shell did qualify for the deduction it sought because it met all the requirements set there. The 15.4% interest payment was deemed to be reasonable since it was market related and was incurred to produce the required income.

The Minister of National Revenue also relied on section 245(1) of the CITA that outlawed deductions of disbursements or expenses that were made in a transaction or operation that would, if allowed, unduly or artificially reduce income.\(^{87}\) The Minister claimed that allowing Shell to deduct interest at 15.4% would unduly reduce its income. In deciding whether the Minister had correctly invoked section 245(1), the court referred to the decisions of the Canadian Federal Court of Appeal namely \textit{Canada v Fording Coal Ltd}\(^{88}\) and \textit{Canada v Central Supply Company}\(^{89}\) that analysed the requirements for the proper construction of section 245, which were as follows:

i. whether the deduction is contrary to the object and spirit of a provision in the Act;

\(^{86}\) RSC 1985, C. 1 (5\(^{th}\) Supp).
\(^{87}\) Paragraph 52. It is also stated here that this provision was replaced by the current section 245, the Canadian GAAR, which came into effect on September 13 1988.
\(^{88}\) [1996] 1 FC 518.
\(^{89}\) [1997] 3 FC 674.
ii. whether the deduction is based on a transaction which is not in accordance with normal business practice; and

iii. whether there is a *bona fide* business purpose for the transaction.\(^{90}\)

Regarding the first requirement, the court held that the deduction of interest paid to foreign lenders at 15.4% per annum was not contrary to the object and spirit of section 20(1)(c)(i). In terms of the second requirement, the court stated that the deductions were based on normal business practice, and court agreed with the trial judge’s opinion that “the fact that business transactions may be regarded as convoluted does not, of course, mean that they are abnormal”. The court also agreed with another trial judge’s finding that “[i]n choosing to borrow the funds in New Zealand dollars rather than US dollars the respondent took into account the tax impact of the transaction, and this is a common business concern”.\(^{91}\)

With regard to the third requirement, the *bona fide* business purpose of the transaction, the court held that there was a business purpose behind the debenture agreements, which led to the interest that was sought to be deducted despite the fact that Shell had structured its transactions in a way that showed consideration of the after-tax cost. The court summed up as follows:

> However this court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the court’s role to prevent taxpayers from relying on the sophisticated structure of their transaction, arranged in such a way that the particular provisions are met on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way …unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.\(^{92}\)

The principle that a taxpayer has a right to avoid tax and may, in the exercise of that right, choose business methods that attract the least amount of taxation is thus well founded. However, this right is limited by GAARs and SAARs which will apply if conditions warranting their application are present in a tax avoidance transaction.

\(^{90}\)Paragraphs 53 – 54.

\(^{91}\)Paragraph 58.

\(^{92}\)Paragraph 59.
5. IMPERMISSIBLE TAX AVOIDANCE

Impermissible tax avoidance is the one form of tax avoidance that is the target of anti-avoidance rules and must be struck down in the courts if successfully challenged, and therefore not result in the avoidance of tax. Nevertheless, since there is no broad consensus on the exact scope of tax avoidance, it follows that there is no broad consensus on the precise contours of impermissible tax avoidance.

Various definitions for impermissible tax avoidance have been proposed. The South African Revenue Service (SARS) has defined impermissible tax avoidance as artificial or contrived arrangements that have negligible or no bearing on the economic position of the taxpayer and are designed to abuse the tax laws contrary to the intention of Parliament. According to the Ralph Report, impermissible tax avoidance exists where there is a “misuse or abuse of the law…often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by parliament but also includes the manipulation of the law and a focus on form and legal effect rather than substance”. According to Lord Templeman in *CIR v Challenge Corporation* impermissible tax avoidance exists where a taxpayer seeks to obtain a tax benefit by deducting expenses without incurring the expenditure or loss that would make him qualify for the deduction. Permissible tax avoidance was in this case held to be the opposite, where a taxpayer claims a deduction after incurring the expenditure that qualifies him for that deduction.

Impermissible tax avoidance has also been said to be an artificial scheme without any other commercial justification apart from the avoidance of tax. In *Matrix – Securities Ltd v Inland Revenue Commissioners*, a case which involved a scheme with the deception of circular,

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93 This is also referred to as an “impermissible avoidance arrangement” in terms of the section 80A (GAAR) in the Act. According to Evans (2008), the term tax avoidance is subject to different labels. In Australia the Australian Tax Office (ATO) refers to it as “aggressive tax planning”, while in South Africa the term “impermissible or abusive tax avoidance” is used. In New Zealand and the UK the term “unacceptable tax avoidance” is used while in the US the term “tax abusive shelters” is used.


97 In *CIR v Willoughby* [1997] 4 All ER 65 73 a view clarifying the stance in the *Challenge Corporation* case was presented. It was stated that the “hallmark of tax mitigation…is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation and genuinely suffers the economic consequences that parliament intended to be suffered by those taking advantage of the option.

98 [1994] 1 All ER 769 780.
self-cancelling payments with corresponding receipts, Lord Templeman stated that “[e]very tax avoidance scheme involves a trick and pretence. It is the task of the Revenue to unravel the trick and the duty of the court to ignore the pretence”. In Craven (Inspector of Taxes) v White Lord Templeman described impermissible tax avoidance, stating:

My Lords, an artificial tax avoidance scheme is carried out by an individual taxpayer to avoid (or reduce or postpone) payment of the tax exigible in respect of a taxable transaction by means of one or more tax avoidance transactions which serve no business purpose apart from the avoidance of the tax on the taxable transaction...an artificial tax avoidance scheme does not alter the incidence of tax. 99

Lord Templeman noted that one of the elements of impermissible tax avoidance is a lack of business purpose. As will be seen below, this is one of the widely recognised features of impermissible tax avoidance schemes.

In the US, the Department of Treasury defines the so-called corporate tax shelters, a term used to refer to impermissible tax avoidance schemes used by companies to create losses that in turn offset taxable income as “any entity, plan or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction”.100 A “tax avoidance transaction” is in turn defined as any transaction where the profits to be made are non-existent or negligible while the tax benefits to be made are significant. This definition is connected with the economic substance doctrine which will be discussed in detail in Chapter 8. An alternative definition of tax shelters is given as a transaction that involves an “improper” elimination or minimisation of tax on economic income.101 The term improper is not defined.

99 503. Lord Templeman referred to a string of decisions in the UK House of Lords that may help to illustrate the features of an abusive tax avoidance scheme. These are Black Nominees Ltd v Nicol (Inspector of Taxes) [1975] STC 375 where the taxpayer actress unsuccessfully tried to avoid taxes on her future earnings because her schemes lacked business purpose; Floor v Davis (Inspector of Taxes) [1978] 2 All ER 1079; WT Ramsay Ltd v IRC, Eilbeck (Inspector of Taxes) v Rawling [1981] 1 All ER 865 where a taxpayer failed to avoid capital gains tax because the transaction created an allowable loss matched by a tax exempt gain and lacked business purpose; IRC v Burmah Oil Co Ltd 1982 STC 30 where the taxpayer failed to avoid tax by means of an artificial scheme to convert a bad debt into a deductible loan and Furniss (Inspector of Taxes) v Dawson [1984] 1 All ER 530 where a tax avoidance scheme was struck down because the transaction attracting tax was not binding and was artificially concluded by a taxpayer without the powers to do so.


101 US Revenue Proposalsa (1999) par 364. In the US Department of Treasury, General Explanation of the Administration’s Fiscal Year 2001 Revenue Proposals (2000) the endeavour to define tax shelters was abandoned. The definition noted above was now taken as a codification of the economic substance doctrine and the proposed test in the Revenue Proposals (2000) par 622 was designed to target “any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the taxpayer from the transaction is insignificant relative to
5.1 Features of Impermissible Tax Avoidance Transactions

The discussion above shows that impermissible tax avoidance is subject to a variety of definitions. The definitions referred to above show that impermissible tax avoidance transactions have the following characteristics in common:

1. they are artificial and contrived;
2. they abuse the tax laws to obtain the tax benefit(s);
3. the absence of business purpose and the presence of tax purpose are cited as the sole or dominant purpose; and
4. there is little or no pre-tax profit while the after-tax profit is high, illustrating the absence of economic or commercial substance.

These characteristics show that impermissible tax avoidance can exist in different forms and various cases and transactions illustrate different aspects of impermissible tax avoidance. There is no limit to what forms impermissible tax avoidance transactions can take but it can be argued that many of these transactions would still have one or more of the characteristics noted above. The fact that certain indicators or features of impermissible tax avoidance are generally acknowledged does not mean that there is a universal consensus on the precise definition of impermissible tax avoidance. The following paragraphs will discuss some of the commonly acknowledged features of impermissible tax avoidance transactions.

5.1.1 Absence of Business Purpose

The absence of a business purpose or business justification behind a tax avoidance scheme is one of the commonly known indicators of impermissible tax avoidance. In transactions without a business purpose the taxpayer appears to make a considerable investment which on deeper analysis turns out to be non-existent. Typically the taxpayer will be protected from virtually all the economic hazards concomitant with the transaction and there is no prospect of a substantial pre-tax profit. The transaction is entered into to take advantage of its tax benefits only; in other words, without the significant tax benefits the transaction will not be concluded because it would result in a loss. The case *Moodie v Inland Revenue Commissioners and Another and Related Appeal*\(^{102}\) where the only expense paid by the

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\(^{102}\) 1993 (2) All ER 49.
taxpayer was the fee paid for the implementation of the scheme can help to illuminate this indicator. Lord Templeman struck the scheme down referring to Lord Brightman’s decision in *Furniss v Dawson*\(^{103}\) that (i) there was no commercial justification behind the scheme in that it was not implemented to achieve any business objective and (ii) there was no expectation of profit from the scheme itself.\(^{104}\)

### 5.1.2 Abnormality

Abnormality is recognised in South Africa as an indicator of impermissible tax avoidance. A number of cases from this jurisdiction illustrate how this indicator is used to isolate impermissible tax avoidance. In *Meyerowitz v CIR*\(^{105}\) the taxpayer arranged his affairs in such a way that revenue that would normally accrue to him ended up in his children’s hands. The sole or main purpose of this scheme was to avoid tax. Beyers JA,\(^{106}\) in striking down the scheme and describing it as abnormal, referred to *CIR v King*\(^{107}\) where Schreiner JA stated that in the normal and natural course of events an owner of an income generating asset receives income from this asset and a labourer receives income from his labour. Where this order is destroyed and there is a sole or main purpose to avoid tax then tax is avoided impermissibly. This indicator will be discussed in greater detail in Chapter 4.

### 5.1.3 Misuse or Abuse of the Tax Laws

Another commonly accepted feature of impermissible tax avoidance is the misuse or abuse of tax legislation. Tax avoidance in general involves a deep understanding of the black letter of the tax laws, and using the same laws to obtain tax benefits; this raises the question whether this use is consistent with what parliament intended. If the use is compliant with the text and purpose of the provision, it constitutes permissible tax avoidance. If it only complies with the

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\(^{103}\) 539.

\(^{104}\) The lack of business purpose is at the heart of many tax avoidance cases. Another example is *Winn–Dixie Stores, Inc and Subsidiaries v Commissioner of Internal Revenue* 254 F.3d 1313 (11th Cir 2001). In this case the appellant entered into an insurance transaction, the sole purpose of which was to generate billions of dollars in interest deductions for the appellant, despite the fact that the transaction would result in a pre-tax loss. The appellant eased out of the transaction when the favourable tax laws applying to the transaction were changed. The appellant contended that the transaction had business purpose but the Tax Court rejected this contention and held that the transaction was a sham and that the appellant was not entitled to the deductions claimed. On appeal it was held that the transaction had no business purpose. The court found that: (i) the appellant was aware of the fact that the transaction was not profitable; (ii) the appellant’s withdrew from the transaction only when the changes to the tax laws led to the erosion of the tax benefits; (iii) the transaction did not result any benefit for anyone apart from the appellant; and (iv) the transaction was not linked to any of the appellant’s business needs.

\(^{105}\) 1963 (3) SA 863 (A).

\(^{106}\) 872F-G.

\(^{107}\) 1947 (2) SA 196 (A) 216.
textual meaning or literal terms of the law it will amount to a misuse or abuse of the law and constitute impermissible tax avoidance. The misuse or abuse indicator will be discussed in more detail in Chapters 5 and 7. The purposive interpretation of statutes will be discussed in more detail along with the misuse or abuse indicator in these chapters and in Chapters 7, 8, and 9.

5.1.4 Participation of Tax-Indifferent or Accommodating Parties

The presence of parties that can either generate neutralising income receipts with deductions, or make use of assessed losses in transactions, has been identified as indicative of impermissible tax avoidance. These parties, which may include foreign persons, trusts and pension funds, are known as tax-indifferent or accommodating parties. The operation of schemes where these parties are present is described as follows:

The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years...involve inter-conned transactions between artificial persons, limited companies, without minds of their own but directed by a single master – mind.

The presence of multiple parties in a transaction that should ideally involve fewer parties can raise suspicion. In some of these multi party transactions one of the parties will be tax-indifferent or accommodating. In *Erf 3183/1 Ladysmith and Another v CIR* it was stated that:

Affiliated companies are of course at liberty to structure their mutual relationships in whatever legal way their directors may prefer, but when for no apparent commercial reason, a third party is interposed in what might equally well have been an arrangement between affiliates, it is not unnatural to seek the motive elsewhere.

Such motive may easily be to take advantage of a certain company’s assessed losses or favourable tax position.

5.1.5 Unnecessary Steps and Complexity

Transactions that have complex and multiple steps are widely seen as indicative of impermissible tax avoidance. These complex and multiple steps may, on closer analysis, be

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109 Per Lord Diplock in *IRC v Burmah Oil Company Ltd* 1982 SK 30 (HL) 32.
110 1996 (3) SA 942 (A) 942 948G-H. In this case one of the parties involved in a set of simulated agreements was a pension fund.
111 This is specifically outlawed by section 103(2) of the Act.
shown to be unnecessary in normal business, and are probably necessitated by the need to fulfil certain formalities to obtain tax benefits; they may also be motivated by the need to shield the impermissible avoidance arrangement from detection.\textsuperscript{112}

5.1.6 Other Features of Impermissible Tax Avoidance Schemes

SARS\textsuperscript{113} has identified more features of abusive tax avoidance as:

- “The inconsistent treatment of income for tax and accounting purposes”. This exists where companies put emphasis on structuring transactions that qualify for deduction without the financial accounting expense, or obtaining revenue for financial accounting purposes without incurring tax liability.
- “Exorbitant transaction costs”. Creators of tax-saving schemes typically receive a considerable percentage of the tax saved as fees for creating the scheme.
- “The use of innovative financial instruments”. Innovative financial instruments can replicate the risks and returns associated with the more traditional financial instruments, such as equity shares or debt. However, they are not always taxed in the same way despite being economically equivalent, because their novelty might mean that they are not legislated for in the taxing Acts.
- “Tax haven arrangements”. This is where taxpayers take advantage of jurisdictions with significantly lower tax rates to avoid higher taxes in their respective jurisdictions.\textsuperscript{114}

\textsuperscript{112} Millet “Artificial Tax Avoidance: The English and American Approach 1986 British Tax Review 327 334 describes the unnecessary complexity and multiple steps as something that would prompt a reasonable person to exclaim, “don’t be silly!”

\textsuperscript{113} SARS Discussion Paper 23-27. Commenting on the hallmarks of impermissible tax avoidance identified in the SARS Discussion Paper, Evans (2008) states that “it is not to suggest that the existence of these characteristics, either alone or in combination, must necessarily point to the existence of tax avoidance activity. That conclusion can only be drawn after a careful consideration of all the facts. But it is to suggest that, prima facie, the existence of these features, alone or in combination, may indicate avoidance activity”.

\textsuperscript{114} In the UK, the Anti Avoidance Group of Her Majesty’s Revenue and Customs has developed a description of the “signposts” of impermissible tax avoidance that generally accords with the SARS Discussion Paper. These are; (i) transactions or arrangements which have negligible or no economic substance; (ii) transactions or arrangements which have little or no prospect of before tax profit and whose business sense lies on the expected tax benefit ; (iii) transactions or arrangements whose legal form is inconsistent with its legal substance; (iv) transactions or arrangements whose sole or main purpose is to be found in obtaining tax benefits and little or nothing else; (v) transactions or arrangements involving redundant, contrived and artificial steps; (vi) transactions or arrangements where the profit or losses incurred in the UK is not commensurate with the economic activity relating to the transaction undertaken in the UK – http://www.hmrc.gov.uk/avoidance/aag-risk-assessing.htm (accessed on 11/11/2009).
5.2 Analysis of the Indicators of Impermissible Tax Avoidance

The features or indicators of impermissible tax avoidance that were discussed above can be criticised on the basis that they are not always indicative of impermissible tax avoidance. Regarding the absence of business purpose, it can be argued that it does not follow that every transaction without business purpose is impermissible. For example, it can be argued that a taxpayer fulfilling a statutory purpose in tax concessions may do so simply because of the tax benefits to be obtained and without any business purpose. In such an instance the business purpose indicator, if applied strictly and in isolation would, result in it overriding statutory purpose.

Regarding abnormality, it can be stated that this indicator may be relative in the sense that what is abnormal to one, may be normal to another. It may also be difficult to determine when an innovative transaction becomes abnormal. For instance, is abnormality established when a taxpayer departs from normal practise in relation to a particular transaction? In some of the previously discussed transactions in this chapter, such as the Shell Canada and CIR v Conhage transactions, taxpayers managed to avoid tax successfully by deviating from normal ways of obtaining finance, and by choosing tax effective methods of doing business. This illustrates that it can be difficult to establish abnormality, because there is uncertainty on the normal way of structuring any transaction.

Regarding the misuse or abuse indicator, it can be stated that this indicator can also be relative and difficult to establish. This is because a provision’s purpose can be uncertain. Moreover, the misuse or abuse indicator may itself be subject to abuse by revenue authorities that may use it to challenge or strike down transactions that avoid tax in a manner that is not favoured by the revenue authorities. In other words, purpose can be used with the benefit of hindsight to argue that a certain tax avoidance transaction was not intended when the provisions were drafted.

Regarding the presence of unnecessary steps and complexity it can be noted that while many impermissible tax avoidance transactions involve complex multiple steps, it is impossible to determine with any certainty the degree of complexity or the number of steps required, to

make the transaction impermissible. Apart from this, it does not automatically follow that any tax avoidance transaction that is complex and involves a number of steps is impermissible. It can therefore be concluded that the known indicators of impermissible tax avoidance can be controvertible even though they may be helpful in identifying impermissible tax avoidance in many cases.

5.3 The Goals of Impermissible Tax Avoidance

In South Africa, SARS has identified the four main goals of impermissible tax avoidance as follows:116

i. the deferral of tax liability;
ii. changing the character of taxable items;
iii. outright elimination of tax liability; and
iv. putting income in the hands of a taxpayer subject to a lower tax rate.

According to the SARS Discussion Paper, these goals are meant to be indicative of impermissible tax avoidance. An analysis of these goals shows that it is impossible to avoid tax in any manner without doing it in one of the manners indicated above. This means that the factors identified in the SARS Discussion Paper, such as characterising impermissible tax avoidance, can also occur in permissible tax avoidance. For instance, the deferral of income is a recognised permissible tax avoidance method, and it is linked to the timing of receipts or accruals.117 The factor of time is important in determining tax liability because tax is only levied on amounts received or accrued in a particular year or period of assessment and deferring income is not always indicative of a goal to abuse the tax system. There are instances where the receipt or accrual of income is deferred to a future year of assessment, by contractual terms that suspend the realisation of income.118 In other instances it may be permissible tax avoidance to defer the receipt or accrual of amounts especially where such

116 SARS Discussion Paper 16.
118 An amount accrues to a taxpayer when he becomes unconditionally entitled to it – Lategan v CIR 1926 CPD 203. In this regard see generally CIR v People’s Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A) and Mooi v SIR 1972 (1) SA 675 (A).
amounts are for all intents and purposes meant to benefit other parties. This was illustrated in *CIR v Witwatersrand Association of Racing Clubs*. 119

Regarding the other goals, it is well established that a taxpayer may change the character of his or her receipts or accruals by, for instance, altering the status of an asset from revenue to capital. 120 Whether a taxpayer who changes the character of an item to capital is involved in impermissible tax avoidance is not always indicative of impermissible tax avoidance, and is a finding that the courts must make. 121 The third goal consists in the outright elimination of tax liability, which has been described as “the tax avoider’s nirvana”. 122 Again, this is not always indicative of impermissible tax avoidance since tax avoidance in general frequently involves the elimination of tax liability. 123

The fourth goal entails the placement of income into the hands of a taxpayer who is subject to a lower tax rate. 124 As with the other goals discussed, this goal does not always indicate impermissible tax avoidance; this is because permissible tax avoidance can be achieved by placing income in the hands of a taxpayer subject to lower or zero tax rates. In tax avoidance, incidence is recognised as the first factor in determining tax liability; it refers to the taxpayer who will bear tax on certain income, and is said to be easy to vary because it is possible to decide whether the taxpayer should be an individual, an existing company, a company to be

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119 1960 (3) SA 291 (A). Cases such as *Hiddingh v CIR* 1941 AD 111 and *Rishworth v SIR* 1964 (4) SA 493 (A) are authority for the proposition that a taxpayer can antecedently divest income before it is received or accrued. Also see *Williams Income Tax in South Africa Cases and Materials* (2005) 136.

120 Stiglingh (ed), Koekemoer, Van Schalkwyk, Wilcocks and De Swardt *SILKE: South African Income Tax* (2012) 32 note that “[a] taxpayer may change his initial or original intention with regard to the use of an asset. For example, an original intention to use an asset as an investment may change to an intention to use it in the carrying out of a scheme of profit making. Conversely, an original intention to acquire an asset for the purpose of resale at a profit may be changed to one to hold it as an investment”. Cases that illustrate this change of intention entail *CIR v Lydenburg Platinum* 1929 AD 137 and *CIR v Richmond Estates* 1956 (1) SA 602 (A).

121 *Natal Estates Ltd v CIR* 1975 (4) SA 177 (A) is one of the cases where the tests used to determine whether a receipt or accrual is capital or revenue in nature, are identified. In this case the court explained the difference between realising a capital asset and selling an asset in the course of business or in a profit-making scheme. On page 220 the court noted that where a capital asset is sold and the amount realised is sought to be taxed as income, regard must be given as to whether or not the taxpayer has “crossed the Rubicon” and changed to business and profit making. This is done with reference to the particular facts of each case. The opposite is true in that the “Rubicon” can be crossed from holding an asset as revenue to capital. This means that the courts have sufficient and independent tests that can be used to determine whether a taxpayer has received a capital sun or revenue. One cannot assert that merely converting the character of items to capital is strong evidence of impermissible tax avoidance.


123 Kruger and Scholtz (2003) 2 note that the elimination of tax liability by the neutralisation of factors that give rise to tax liability is one of the fundamental rules of tax planning.

124 There are provisions in the Act aimed at curtailing this practice in certain cases. For instance, in terms of section 7(3) of the Act the income of a minor child is deemed to have been received by the parent of that child if that child has received it or if it accrues to the child after a donation, settlement, or other disposition made by the child’s parent.
formed, a trust, or a partnership.\textsuperscript{125} Taxpayers avoiding tax legitimately, have the liberty to place potential income in the hands of an individual or entity that will pay the least tax. For instance, where property is to be purchased the decision whether an individual or a company should purchase the property may well be affected by the likelihood of selling the property at a later stage. A company may have more difficulty in proving that it is realising a capital asset than an individual because of “the ‘business tendency’ of a company”.\textsuperscript{126} An asset in the hands of a company may easily be treated as a business or revenue asset, resulting in it being taxed as income.

It can also be noted that the antithesis of this factor is that a taxpayer is not required to place income in the hands of an entity subject to a higher rate of tax either. In this regard the case \textit{African Life Investment Corporation (Pty) Ltd v SIR}\textsuperscript{127} is in point. In this case a certain insurance company operated under the favourable tax system available to long term insurers. One aspect of this system was to exempt completely from tax all the share-dealing profits made by long term insurance companies. The African Life Group’s board of directors decided to consolidate the share portfolios of its subsidiaries under one new company, which was formed for this particular purpose. Apparently the reason behind this drive was to ensure administrative convenience. There was no tax avoidance purpose. This new company was not a long-term insurer, so it could not claim any tax-exemption for the share-dealing profits it made; it was therefore taxed on these profits. Clearly, tax was payable because income had been shifted from a company with full exemption from tax on certain income, to a company which could not qualify for the exemption on the same income. This case illustrates the point that a taxpayer is not required to place income in the hands of an individual or entity subject to tax. In this case, if the income had remained in the company that qualified for the exemption, there would have been no question about impermissible tax avoidance.

\textsuperscript{125} Kruger and Scholtz (2003) 3.
\textsuperscript{126} Kruger and Scholtz (2003) 9.
\textsuperscript{127} 1969 (4) SA 259 (A).
5.4 Other Methods through which Impermissible Tax Avoidance is done

Other significant methods identified are the manipulation of discrepancies and discontinuities in the tax system and tax arbitrage, which is defined as an attempt to exploit inconsistencies and discontinuities to obtain tax advantages.

6. CONCLUSION

This chapter dealt with the complex concept of tax avoidance. While it is relatively easy to distinguish between tax avoidance and tax evasion, the precise contours of tax avoidance are uncertain. In an attempt to simplify the concept of tax avoidance, tax avoidance has been described as a continuum entailing permissible and impermissible tax avoidance. The division between the two forms of tax avoidance is based on the indicators of impermissible tax avoidance. These indicators are, *inter alia*, the absence of business purpose, abnormal transactions, and the misuse or abuse of tax legislation. It has been stated that these indicators are deciphered from past and known impermissible tax avoidance transactions. While these factors have consistently characterised impermissible tax avoidance transactions, it is likely that future impermissible tax avoidance transactions might involve indicators that are not known presently.

The indicators of impermissible tax avoidance that were discussed in this chapter are controvertible, and do not always isolate impermissible tax avoidance accurately. This, and the fact that the goals of tax avoidance that are identified by SARS in its *Discussion Paper*, such as the outright elimination of taxable income and the conversion of income to a non-taxable form also exist in permissible tax avoidance, shows that the distinction between permissible and impermissible tax avoidance is frequently uncertain. The general discussion of tax avoidance in this chapter thus initiated and provided a background for the analysis of the efficacy of the South African GAAR by showing that this GAAR targets a dynamic, enigmatic and uncertain concept. It has also been shown that whatever form a GAAR takes, it

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128 The *SARS Discussion Paper* is not the only source of a description of the ways in which impermissible tax avoidance is done. Evans (2008) quotes Lord Walker of Gestingthorpe who identified seven ways to achieve impermissible tax avoidance. These are (i) using a relief; (ii) finding a gap; (iii) exploiting a relief; (iv) anti-avoidance karate, which refers to a taxpayer’s manipulation of anti-tax avoidance provisions; (v) unnatural assets or transactions; (vi) preordained transactions and shady offshore operations. However, these factors do not point conclusively to the existence of impermissible tax avoidance. For instance, “using a relief” does not necessarily constitute impermissible tax avoidance because certain tax reliefs are meant to benefit taxpayers in certain circumstances.

129 *SARS Discussion Paper* 16. An example is given here of the different treatment of dividends and interest for tax purposes inviting taxpayers to engage in transactions which effectively convert dividend income to interest income.
must create sufficient certainty to allow taxpayers to know the extent to which they can exercise their legitimate right to avoid tax.
CHAPTER 3

ANTI-AVOIDANCE RULES IN SOUTH AFRICA

TABLE OF CONTENTS

1. INTRODUCTION ................................................................................................................ 42
2. SIMULATION AND THE COMMON LAW SUBSTANCE OVER FORM RULE ............. 42
3. SPECIFIC ANTI-AVOIDANCE RULES ............................................................................ 49
4. GENERAL ANTI-AVOIDANCE RULES ........................................................................... 49
   4.1 Characteristics ............................................................................................................... 51
   4.2 The Inherent Uncertainty of a GAAR ....................................................................... 53
5. REGULATION OF TAX PRACTITIONERS .................................................................... 55
6. REPORTABLE ARRANGEMENTS ................................................................................... 57
7. NON-LEGAL MEASURES AGAINST IMPERMISSIBLE TAX AVOIDANCE .......... 59
8. CONCLUSION ..................................................................................................................... 61
1. INTRODUCTION

Tax avoidance is subject to regulation and legal provisions exist to regulate the extent to which taxpayers can exercise their right to avoid tax, in spite of the difficulty involved in distinguishing between permissible and impermissible tax avoidance.¹ This chapter will discuss the anti-avoidance rules that are in place to curtail impermissible tax avoidance in South Africa. These mechanisms entail legislative measures such as SAARs, a GAAR, the regulation of tax practitioners, and the imposition of a duty to report certain arrangements to the Commissioner. The common law doctrine of substance over form will also be analysed, as it is also relied on to curb impermissible tax avoidance in South Africa.

The overall aim of the discussion in this chapter is to review the various anti-avoidance measures. In so doing, the status and importance of the GAAR within the system of anti-avoidance rules in South Africa can be established. A preliminary review of how the GAAR deals with the uncertainty surrounding the distinction between permissible and impermissible tax avoidance is presented.

2. SIMULATION AND THE COMMON LAW SUBSTANCE OVER FORM RULE

One of the indicators of impermissible tax avoidance that was deliberately omitted in Chapter 2 to allow for its discussion in this chapter is simulation. Simulation exists where there is a purported transaction which in reality is initiated without the intention to give effect to it or some of its terms, and the parties to the transaction have, in fact, an ascertainable and real agreement they intend to give effect to, despite what they purport to agree on.² In South African law, the situation where parties disguise their true intentions with simulated acts was aptly described as follows by Innes JA in Zandberg v Van Zyl:

Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give; or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to


express but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect what the transaction really is: not what in form it purports to be. The maxim then applies \textit{plus valet quod agitur quam quod simulate concipitur}. But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that the contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.\footnote{1910 AD 302 309.}

The \textit{plus valet quod agitur quam quod simulate concipitur} principle which, in South Africa, is also known as the substance over form principle is a common law principle that applies to all transactions including tax transactions.\footnote{A distinction must be drawn between the substance over form rule, as it is known in South Africa, and as it is known in other jurisdictions such as the US and the UK. In South Africa, the rule refers to simulation as described above, while in the US and the UK, as discussed in Chapter 8 and 9 below, refers to anti-avoidance doctrines.} This principle also encompasses the \textit{fraudem legis} principle as held in cases such as \textit{Dadoo v Krugersdorp Municipality}\footnote{1920 AD 530. In this case a group of individuals prohibited from ownership of land in a certain area created a company to own the land. The question in the case was whether corporate ownership of land was in substance ownership by the shareholders. Wessels J in the court \textit{a quo} held that the transaction was in \textit{fraudem legis}, reasoning that it was impossible to do indirectly that which cannot be done directly. Innes CJ on appeal however did not agree and he held that the \textit{fraus legis} rule was merely a part of the substance over form doctrine.} and \textit{Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd.}\footnote{1941 AD 369. Other cases illustrating the substance over form doctrine and its connection with the \textit{fraudem legis} rule include \textit{Boots Co Ltd v Somerset West Municipality} 1990 (1) SA 585 (A), \textit{CIR v Collins} 1923 AD 347, \textit{CIR v Saner} 1927 TPD 162, \textit{Du Plessis v Joubert} 1968 (1) SA 585 (A) and \textit{Kilburn v Estate Kilburn} 1931 AD 501. Olivier and Honiball \textit{International Tax a South African Perspective} (2008) 386 note that the mere fact that a transaction is aimed at avoiding the boundaries of a legal provision or the operation of law does not mean that it is simulated. Authority for this proposition can be found in \textit{Fox v Muller} 1930 OPD 180, \textit{Colonial Banking and Trust Co Ltd v Hill’s Trustee} 1927 AD 488 and \textit{Western Credit Bank v Van der Merwe} 1970 (3) SA 461 (C). Olivier and Honiball note further that \textit{fraudem legis} means that the parties to an agreement do not reflect their real intentions in that transaction, which is effectively a disguise. The term should therefore not mislead one into believing that it is aimed at curbing circumventions of the operation of the law.} When applied in tax transactions the substance over form principle empowers the court to ignore the simulated transaction that appears to legitimise a taxpayer’s claims for a tax benefit and give effect to the real

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transaction. For the purposes of illustrating this principle in the context of taxation, reference will only be made to three major and relatively recent cases.

One of these cases is *ERF 3183/1 Ladysmith (Pty) Ltd v CIR*. In this case the Pioneer Group (PG) of companies wanted to build a furniture factory in Ladysmith in a tax efficient manner. It purchased Erf 3183/1 Ladysmith (Pty) Ltd which owned land in the area. The appellant then entered into a lease agreement with a certain pension fund that was a non-taxable entity. This lease provided that the fund was entitled but not obliged to erect improvements (the furniture factory) on the land. At the expiration of the lease, the land would revert to the appellants, who were not required to compensate the fund for any improvements made. The fund subleased the same property to Pioneer. The sublease obliged the fund to erect a factory on the land in line with certain plans and in return, Pioneer had an obligation to pay the rentals to the fund and to compensate the fund for constructing the property.

The tax position of this scheme was centred on section 11(g) of the Income Tax Act \(^9\) (the Act) which states that if a lessee is obliged to effect improvements on leased premises, the lessee qualifies for a deduction equal to the costs incurred in effecting the improvements. In terms of paragraph (h) of the definition of gross income in section 1 of the Act, a lessor must include the value of improvements made to his or her property in terms of a lease by a lessee in his or her gross income. These provisions only apply if the lessee has a legal obligation to effect improvements, and the lessor has a legal right to have improvements on his or her property. In the present case the appellant, on the face of the lease with the fund, had no legal right to have improvements made on the leased premises. Consequently, the appellant would not incur any tax liability because paragraph (h) would not apply. Pioneer would qualify for a deduction of the value of the improvements it effected on the leased property because it had an obligation to effect the improvements. The fund, which had a legal right to have the improvements, would not need to worry about the tax implications since it was a non-taxable entity.

The court however set the lease agreements aside and held that in terms of the real agreement between the parties the appellant actually had a right to have the improvements effected to the leased premises. Hefer JA noted that there was “a real likelihood that there was an unexpressed agreement or tacit understanding between the appellants”, and that the evidence

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\(^8\) 1996 (3) SA 942 (A).

\(^9\) 58 of 1962.
did not eliminate a real likelihood that the agreements in writing did not have any impact on
the real intention of the parties.\textsuperscript{10} The decision in \textit{Erf Ladysmith} is authority for the contention
that it is insufficient to prove that a taxpayer arranged his or her affairs to avoid the
provisions of the taxing act when seeking to establish that the transaction was simulated.\textsuperscript{11}

The same conclusion was reached in \textit{Relier (Pty) Ltd v CIR}.\textsuperscript{12} In this case Harms JA noted
that, when taken at face value, the tax avoidance effect of the transaction in question had to
be respected, but since the transaction contained some unusual and unreal components, the
court found that there was an underlying agreement the parties intended to give effect to.

In \textit{ITC 1833}\textsuperscript{13} Boruchowitz J stated that a taxpayer cannot avoid tax by arranging his or her
affairs “through or with the aid of simulated transactions”. The court in this case found that
the transaction was effected as stated and intended, not simulated. The Commissioner
appealed to the Supreme Court of Appeal which ruled on the transaction in \textit{CSARS v NWK
Limited}.\textsuperscript{14}

In this case, the taxpayer, a public company which had previously operated as a cooperative
society in the maize trading business, had claimed deductions for interest payments in terms
of a loan for a five-year period from 1999 to 2003. The loan amounted to R96\,415\,776 and
had been facilitated by Slab Trading Co (Pty) Ltd, a First National Bank (FNB) subsidiary.
The deductions were allowed, but in 2003 the Commissioner issued new assessments that
denied the deductions. In addition, the Commissioner imposed additional tax and interest in
terms of sections 76 and 89quat of the Act. It was argued on behalf of the Commissioner that
the loan which gave rise to the interest deductions was not a genuine contract since it was
part of a series of transactions between the taxpayer and FNB, and had the aim of reducing
tax liability. It was also argued that the loan agreement had to be seen in the light of the series
of transactions that showed that the taxpayer had actually only borrowed a sum of R50
million, and the purported amount of R96 million was meant to secure higher interest
deductions.

\textsuperscript{10} \textsuperscript{956C}.

2 \textit{TSAR} 378. In \textit{Michau v Maize Board} 2003 (6) SA 459 (SCA) the court held that it is a long established
principle that parties may arrange their affairs to stay outside the ambit of a particular statute. It was further
stated that it is insufficient that the provisions would not have been avoided had the parties to a transaction in a
different manner and that what is prohibited is to disguise the real transaction.

\textsuperscript{12} (1997) 60 \textit{SATC} 1 (SCA) 7.

\textsuperscript{13} (2008) 70 \textit{SATC} 238 248.

\textsuperscript{14} (27/10) [2010] ZASCA 168 (1 December 2010).
Lewis JA recognised that the taxpayer was entitled to arrange its financial affairs in a manner that would result in tax savings; she cautioned, however, that a simulated transaction would make the exercise impermissible. She noted that:

[i]t is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax effective. But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not, especially if that has the purpose of tax evasion, or the avoidance of a peremptory rule of law.\(^\text{15}\)

The court needed to find that the transaction was simulated before applying the substance over form rule and ignoring the transaction. As Innes JA in *Zandberg* noted, this is done by ascertaining whether the parties to the contract actually gave effect to its terms, and if they did not, finding out what the real agreement was and giving effect to it. The Supreme Court deviated from this, and Lewis JA noted:

In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.\(^\text{16}\)

The taxpayer was thus found liable to pay the taxes payable after the Commissioner’s reassessment because the whole transaction was aimed at obtaining a tax benefit; that the taxpayer’s transaction was given effect to was held to be insufficient to exclude the application of the substance over form rule.

Certain issues can, with respect, be raised about the decision. The first and obvious issue is that the court departed from the traditional test for simulation, stating that it was not enough and an analysis of the commercial sense of the transaction must be made. In stating this, the court basically said that to determine whether the parties to a transaction intended to give

\(^\text{15}\) Par 42.  
\(^\text{16}\) Par 55. Lewis JA reaffirmed this view in par 86 where she noted that “[a]s I have said, the appropriate question to be asked, in order to determine whether the loan and other transactions were simulated, is whether there was a real and sensible commercial purpose in the transaction other than the opportunity to claim deductions of interest from income tax on a capital amount greater than R50m. None is to be found. What NWK really wished to achieve was a tax advantage”.  

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effect to the terms of their transaction(s) and did not have a hidden but ascertainable agreement, one must look at whether the transaction has commercial sense, not simply whether the terms were actually given effect to.\textsuperscript{17} It is submitted that the court erred in applying this test. As noted earlier, the substance over form rule is applied universally to all transactions. Requiring the commercial substance and purpose tests to be made may be beneficial in tax cases, but may complicate the application of the rule in other matters.

The second issue stems from the first, and is that there may be questions whether the court created a broader anti-avoidance rule. In its pre NWK form, the substance over form rule in tax cases effectively served as a specific anti-avoidance rule; this means that it could only be applied in specific tax avoidance instances, namely those where the parties actually disguised their transactions with facades, but had underlying agreements which were ascertainable and given effect. Post-NWK, the rule now seems to serve as a broad anti-avoidance rule because it requires the commercial sense and purpose of a transaction to be tested, and not just the simulation.

The third issue is that the decision could potentially lead to a situation where the substance over form rule could be preferred by the Commissioner over the GAAR itself in seeking to strike down tax avoidance transactions seen as impermissible.\textsuperscript{18} Lewis JA made it clear that the fact that taxpayers actually gave effect to the terms of their transactions does not mean that there was no simulation, because a tax avoidance purpose and a lack of commercial sense were sufficient. However, the court’s interpretation of the substance over form rule does not clearly show the extent to which taxpayers can go in planning their affairs to reduce the tax payable. It is unclear how much commercial substance is enough. Purpose is not decisive either, because taxpayers who avoid taxes legitimately, do so on purpose.\textsuperscript{19}

\textsuperscript{17} Some commentators view the NWK case as an improvement of the substance over form doctrine, in spite of its unconventional approach to simulated transactions. According to Legwaila “Mordenising the ‘Substance over Form’ Doctrine” (2012) 24 1 SA Mercantile Law Journal 115 121, the NWK case modernised the substance over form doctrine. He states that “[p]rior to NWK, the application of the substance over form doctrine focused on the form that the taxpayers projected the transaction to be vis-à-vis the substance that was the real object of the transaction. If the parties intended to carry out what was agreed, the transaction could not be flawed. After NWK, the focus falls on the transaction, regardless of what the taxpayers intend to do. This case changes the view of the form that the taxpayers present the transaction to be as well as the substance that it is.” It is however submitted that the court, in introducing unconventional principles to this doctrine may have over-stretched the doctrine as argued above, that commercial purpose should not be relevant when determining whether a transaction is simulated or not. Rather, the court must limit its analysis to whether the parties have given effect to their intention.

\textsuperscript{18} See generally, Vorster “NWK and Purpose as a Test for Simulation” 60 The Taxpayer 61.

\textsuperscript{19} In Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd 395 Watermeyer JA noted that “I wish to draw particular attention to the words “a real intention, definitely ascertainable, which differs from
The decision in NWK can be said to be the antithesis of the decision in CIR v Conhage (Pty) Ltd (Formerly Tycon (Pty) Ltd). In this case it was stated that taxpayers are entitled to arrange their affairs in a manner that avoids tax liability within the confines of anti-avoidance rules. It was stated that the success of this avoidance activity depends on the court examining the transaction in question and finding that it is not simulated. The court found that the series of transactions in question had two purposes, namely the acquisition of finance, and to obtain that finance in a tax effective manner. The court held that there was nothing wrong with entering into a transaction to obtain finance in a tax effective manner and that the evidence showed that the parties had genuinely intended to give effect to the transaction.

The gist of the transaction in NWK is clear from the facts discussed earlier. The taxpayer needed finance for business purposes and obtained it, but through a series of transactions managed to secure higher interest deductions than would have been deductible on the actual loan amount secured. The Tax Court found the transaction to be effective and not simulated. It is submitted that the Supreme Court of Appeal should have restricted itself to the traditional simulation test, and ruled that the transaction was not simulated. This does not mean that the transaction had avoided tax permissibly; it means that the substance over form rule was not applicable in the case, because there was no simulation.

the simulated intention”, because they indicate clearly what the learned Judge meant by a “disguised” transaction. A transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interpreted by the Courts according to its tenor, and then the only question is whether, so interpreted, it falls within or without the prohibition or tax”. This supports the idea that the court erred in basing its finding of simulation on the tax purpose of the transaction.

20 1999 (4) SA 1149 (SCA).
21 1155H.
22 1156 – 1159 for the court’s determination of the true intention of the parties.
23 Approaches identical to the substance over form rule in South Africa exist in jurisdictions such as Australia and Canada. In both countries the decision in Snook v London and Westriding Investments [1967] 1 All ER 518 528 is authority for the proposition that sham transactions will be ignored and effect will be given to the real agreement. For Australian authority on sham transactions see generally Jacques v Federal Commissioner of Taxation (1924) 34 CLR 328, Bell v Federal Commissioner of Taxation (1953) 87 CLR 548 and Pagone Tax Avoidance in Australia (2010) 4. For Canadian authority see generally MNR v Cameron 72 DTC 6325 (SCC) Spur Oil Ltd v R [1980] CTC 170, Stubart Investments Ltd v The Queen [1984] CTC 294. And Krishna The Fundamentals of Canadian Income Tax (2002) 853.
3. SPECIFIC ANTI-AVOIDANCE RULES

SAARs are anti-avoidance rules that regulate or prohibit tax avoidance in specific situations or transactions.\(^{24}\) There are a number of sections in the Act that operate as SAARs.\(^{25}\) It is beyond the scope of this thesis to discuss these sections in detail.

4. GENERAL ANTI-AVOIDANCE RULES

The anti-avoidance mechanisms discussed above have a limited scope because they apply to specific transactions. The substance over form rule only applies to transactions that are simulated, and SAARs only apply to specific transactions that are within the ambit of the relevant rule. A possible limitation of SAARs as a measure against impermissible tax avoidance, is that the number of transactions that can be created by taxpayers in response to individual provisions of the Act is unknown, and drafting SAARs for each tax provision is basically impossible. This means that SAARs, or the substance over form rule alone, may never curb impermissible tax avoidance effectively.

The limitations of these anti-avoidance mechanisms are offset by the presence of a GAAR which, as its name implies, is a rule of more general application. In *ITC 1558*\(^{26}\) it was contended that *generalia specilibus non derogant*, which, when translated, means that a general provision cannot supersede a specific provision and apply where the specific provision does not apply. The taxpayer sought to rely on this principle to exclude the application of the GAAR to the transaction in question, on the basis that the applicable SAAR could not be applied to deny the tax benefits obtained. However, the court dismissed the taxpayer’s contentions and held that the GAAR could apply in such situations. Moreover, in terms of section 80I of the Act the Commissioner has the power to apply the GAAR in the alternative; it therefore follows that the Commissioner can apply the GAAR in tandem with a SAAR, or the substance over form rule, as alternative remedies.

Broadly defined, a GAAR is a rule in tax legislation that is enacted to strike down impermissible tax avoidance transactions. It is created by parliament to protect the provisions of the Act from abuse and to prevent taxpayers from circumventing tax liability by

\(^{25}\) For instance, section 8C(5) and (6) deals with situations where a taxpayer attempts to transfer profits from the exercise of a share option to another person. Section 8E and 8F deal with cases where a taxpayer attempts to present a loan as a share or vice versa. Section 7 treats income received by a spouse, minor or trust as received by or accrued to the person disposing of that income in a number of circumstances described by its subsections.
\(^{26}\) (1992) 55 SATC 231.
impermissible means. The role of a GAAR was summarised by Richardson P in the New Zealand Court of Appeal as follows:

[A GAAR] is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature通过 GAAR has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn. Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than an existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice...The function of [the GAAR] is to protect the liability for the income tax established under the other provisions of the legislation.

This statement shows that a GAAR should only target artificial transactions and transactions that can be said to fall within the impermissible tax avoidance realm. This is an essential requirement of a GAAR because it allows taxpayers to exercise their right to avoid tax as discussed in Chapter 2, whilst simultaneously prohibiting impermissible tax avoidance. Krishna notes that:

[t]ax avoidance falls into two categories: ...tax mitigation and abusive avoidance. In the former case, transactions achieve the desired result of tax minimisation and therefore, are effective. In the latter cases, abusive transactions may be ignored for tax purposes and do not achieve the desired goal of tax minimisation. What is not always clear, however, is the line between the two. When does lawful tax

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27 Judicial anti-avoidance rules that exist in jurisdictions such as the US, the UK, Russia and India show that courts can also create anti-avoidance rules that perform a general anti-avoidance function. Cooper “Conflicts, Challenges and Choices – The Rule of Law and Anti Avoidance Rules” in Cooper (ed) Tax Avoidance and the Rule of Law (1997) 13 13 asks; “[w] hose responsibility is it to control tax avoidance and how is the task to be divided between the legislature, administration and judiciary in a constitutional democracy framed in the tradition of western liberal democracies?” According to Arnold “The Canadian General Anti-Avoidance Rule” in Cooper (ed) Tax Avoidance and The Rule of Law (1997) 226 the development of a statutory GAAR is more acceptable to those who believe that the making of tax laws is the legislature’s exclusive responsibility because the statutory rule will then be subjected to all of the standard safeguards of the legislative process which include the consultative process. Arnold notes further that the limits of a statutory rule can be created with more accuracy than the limits of a judicial GAAR. This is done by explanatory notes and administrative guidelines that help to limit uncertainty. Freedman “GAAR: Challenging Assumptions” (27 September 2010) Tax Journal 12 12 notes that one of the objections to a GAAR in the UK is that the courts have developed doctrines that work in the place of a GAAR. She however notes that the doctrines have not developed in a linear fashion and do not present a clear and predictable position that at least makes it worthwhile to consider introducing a GAAR in the UK.

28 *CIR v BNZ Investments* 2002 1 NZLR 450.
mitigation cross over and become abusive tax avoidance? What if a general anti-avoidance rule conflicts with a specific permissive rule?  

The questions asked by Krishna are important and should be answered by reference to the provisions of a GAAR. It is one of the fundamental roles of a GAAR to draw a line between permissible and impermissible tax avoidance that provides certainty on what is permissible and what is impermissible.

4.1 Characteristics

As will be seen in the following chapters, GAARs differ from country to country, but they have three common characteristics. Firstly, a GAAR requires a transaction, operation, arrangement, or scheme to exist. Secondly, this transaction, operation, arrangement, must result in a tax benefit, which is an obvious requirement because there can be no avoidance of tax without the presence of a tax benefit. Thirdly, a GAAR requires the relevant taxpayer to have a sole or main purpose to avoid tax. GAARs in different countries then base their identification of impermissible tax avoidance on various indicators after providing for these basic features.

Apart from the main elements described above, it has been stated that there are two main approaches to a GAAR. One approach focuses on the acceptability of a transaction in the context of obtaining a tax benefit while the other approach focuses on the taxpayer’s purpose. According to Arnold, determining a taxpayer’s purpose provides a reasonable basis for isolating impermissible tax avoidance. Arnold notes that where the primary purpose of a transaction is to avoid tax, determined objectively, it can be said that impermissible tax avoidance exists. Conversely, where the primary purpose of a transaction is the achievement of commercial objectives, it can be concluded that tax has been avoided permissibly.

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30 Cooper “International Experience with General Anti-Avoidance Rules (2001) 54 1 SMU Law Review 83 111 notes that the requirement of purpose is crucial to limit the scope of a GAAR. If it is absent, the GAAR could apply to transactions that have no tax avoidance purpose.
31 Orow “Part IVA: Seriously Flawed in Principle (1998) 1 Journal of Australian Taxation 57 available at http://www.austlii.edu.au/au/journals/JATax/1998/6.html states that there is no uniform manner in which GAARs can be designed because their individual design may very well be a response to perceived or real risks peculiar to a particular country or jurisdiction. He also notes that jurisprudential differences between different tax systems may explain the existence of different GAARs. One could perhaps look at a country such as the US and reasonably predict that if a GAAR were to be enacted there it would be based on the existing judicial anti avoidance rules already in place there.
33 Arnold (1997) 228.
The purpose approach may be difficult where there is a dual purpose, but this problem can be countered by providing for a sole or dominant purpose to avoid tax before a GAAR can be applied. Nevertheless, a dominant or even sole purpose to avoid tax is not always indicative of impermissible tax avoidance. Arnold notes that the purpose test only provides a “reasonable” basis, not a conclusive one; this is because some transactions with a dominant purpose to avoid tax may be authorised by tax legislation. A taxpayer taking advantage of a tax concession in the legislation does so for the sole or dominant purpose of obtaining a tax benefit. Without the tax concession in the legislation, the taxpayer will not seek to obtain the tax benefit.

It has been stated that an ideal GAAR should target impermissible tax avoidance without discouraging permissible tax avoidance, yet the three essential features of a GAAR referred to above do not distinguish between permissible and impermissible tax avoidance. As will be seen in the GAARs to be analysed, legislation widely defines the concepts transaction, operation, arrangement, or scheme to include virtually any conduct that leads to a tax benefit. The same conduct would also result in permissible tax avoidance and the same applies to tax benefit which exists in both permissible and impermissible tax avoidance. Regarding purpose to avoid tax, it can be said that purpose is universal and taxpayers who avoid tax permissibly or impermissibly do so on purpose.

Since the three elements constituting the basis for a GAAR do not isolate impermissible tax avoidance, it can be argued that the role of these elements is to establish that tax has been avoided purposely through a taxpayer’s actions. GAARs go beyond the basic elements and make use of one or more of the indicators of impermissible tax avoidance. Some of these indicators were discussed in Chapter 2 and they entail, inter alia, abnormality and misuse or abuse of the tax legislation. The function of these indicators is to limit the application of the GAAR to impermissible tax avoidance transactions, and to inform taxpayers of the extent to which they can exercise their right to avoid tax. In applying the GAAR, the question is therefore not whether tax has been purposely avoided, but whether this has been done in a manner that indicates impermissible tax avoidance.

Arnold (1997) 228.

Orow argues that “the notion of tax benefit is particularly problematic because tax Acts contain a range of choices that taxpayers are able to make which have different tax consequences. Where taxpayers merely make a choice between alternatives that the Act itself lays open to them, can it be said that there is a tax benefit”.

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4.2 The Inherent Uncertainty of a GAAR

The previous chapter showed that the characteristics and indicators of impermissible tax avoidance are controvertible and can be difficult to establish. This is partly due to the fact that there is no consensus on the precise constituents of impermissible tax avoidance. It therefore follows that a GAAR is drafted without precision on what constitutes impermissible tax avoidance. Cooper notes:

What can and ought to be the focus of anti-avoidance rules? And more importantly...can text be drafted which can still be called a rule, but for which there is no clear target, and, what is worse, not even agreement on what the target should be? How can the drafter prepare a weapon against something that in the opinion of some cannot be adequately defined and certainly cannot be defined ex ante?\(^{36}\)

Cooper further notes that “[d]eciding what are the distinguishing features that go to make up tax avoidance is an enormously difficult task, even before one even attempts the task of expressing that idea in writing in a law”.\(^{37}\) It is therefore clear that in determining the efficacy of the South African GAAR, one must note that GAARs generally have an inherent uncertainty that is based on the fact that impermissible tax avoidance has proved thus far to be incapable of precise definition. This inherent uncertainty partly explains why “[n]o country has yet succeeded or is likely to succeed, in framing its tax laws in such a way that it is clear how tax liability will be calculated on any conceivable set of facts”.\(^{38}\)

This inherent uncertainty is compounded by the general weakness of tax legislation regarding tax avoidance. It is accepted that tax legislation “will never” predict the infinite options taxpayers can take when responding to it and seeking to obtain tax benefits.\(^{39}\) This is a problem a GAAR has to deal with if it is to be effective in protecting the integrity of the tax base. Taxpayers are capable of creating infinite tax avoidance plans that the Commissioner may find unacceptable but which his main weapon, the GAAR, may not have contemplated at

\(^{36}\) Cooper (1997) 26. Cooper notes further that at least two concepts, namely tax evasion and behaviour modification, are certain because tax evasion can be distinguished by its fraudulent nature. Regarding behaviour modification, which is exemplified by quitting smoking to avoid the tax on cigarettes, Cooper states that it is not impermissible at all. He however concedes that “in between benign behaviour adjustments and deliberate misrepresentation is the battleground of a fierce war”.

\(^{37}\) Cooper (1997) 27.


\(^{39}\) Cooper (1997) 18. Wheatcroft in Cooper (1997) 13 also subscribes to this view noting that “even the most accurate draftsman of a law will not be able to find precise language to convey his meaning and the wisest legislator cannot foresee every possible set of circumstances that may arise”.

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This problem may not be countered by enacting a GAAR that targets all tax avoidance because “[a]ny anti-avoidance rule must distinguish between acceptable and unacceptable tax avoidance transactions”, and permissible tax avoidance must be allowed.41 The absence of a precise understanding of tax avoidance and certain indicators of impermissible tax avoidance raises questions about the relevance or efficacy of a GAAR.42 In this regard, Cooper notes:

Since a GAAR is enacted as one strategic element in solving tax avoidance, how important is that problem? Is it sufficiently important to justify the other fallout from the means employed to solve the problem? If governments choose to enact GAARs in the face of vocal opposition, what alternatives are open to government to achieve the goals sought but using less contentious tools?43

Cooper’s statement calls for more certainty in GAARs to make them more relevant and effective. This can be contrasted with the view that since the line between permissible and impermissible tax avoidance has thus far proved basically impossible to draw, the focus should be elsewhere rather than on drawing this line or deleting GAARs and drafting new ones. In this regard, Freedman notes:

It is considered whether the time has come to go beyond the concerns about line drawing. A precise boundary is clearly impossible and even undesirable, given that such boundary would be an instant target for tax ‘planning’ activity. Could it be that what matters now is not whether the boundary lines are clear but how we deal with the inevitable lack of clarity?44

Freedman advocates for more focus on how to deal with the uncertainty surrounding permissible and impermissible tax avoidance. Apart from Cooper, the views of certain commentators show that uncertainty is a much bigger problem and that ignoring it would not solve the problems it creates.

40 Put differently, drafters of a GAAR cannot envisage the avoidance schemes likely to be carried out in future. On the other hand, the taxpayers who conceive such schemes know exactly what the GAAR entails and work directly against it.


42 It has also led to certain suggestions on how to curb impermissible tax avoidance. Rice “Judicial Techniques Combating Tax Avoidance” (1952 — 1953) 51 Michigan Law Review — 1021 1031 notes that “[s]till another general approach has been (perhaps facetiously) suggested the view that the solution to the problem here will be found in the exercise of common sense. However much this consummation is to be desired, revenue agents and taxpayers notoriously disagree on what tax consequences should arise from a transaction, each claiming the support of that general assortment of information, logic, experience and intuition described as common sense”. The existence of a single, effective and ascertainable standard in the form of a GAAR is therefore imperative to regulate tax avoidance in general.

43 Cooper (1997) 19.

According to Adam Smith:

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experiment of all nations, is not near so great as a very small degree of uncertainty.\(^{45}\)

Kirchler also subscribes to the view that uncertainty causes problems and states that:

\[\text{uncertainty in the tax law makes it difficult for both taxpayers to follow the law and tax authorities to decide unequivocally what is illegal and what is at the fringe of tax law. In the area of “tax avoision” it is relevant that taxpayers comply with the spirit of the law. Financial engineering is just a newer modality of a long tradition of multinational corporations who have the capacity to escape liability, and also of individuals who have the money to pay for artful advice. Thus, the complexity and ambiguity of tax law lends itself to exploitation without actual violation of the law. It goes without saying that the self-employed and owners of small business, without strong financial backing, cannot purchase advice to contrive such clever schemes and risk being condemned for aggressive non-compliance. In the meantime, it is the rich offenders who are avoiding and getting away with it, inflicting greatest losses on the community.}\(^{46}\)

It is therefore submitted that while absolute certainty may be impossible to create, it is imperative that a GAAR create reasonable certainty regarding the impermissible tax avoidance transactions it targets and the extent to which taxpayers can exercise their right to avoid tax.

5. REGULATION OF TAX PRACTITIONERS

Anti-avoidance measures such as GAARs and SAARs and the substance over form rule can be defined as direct measures against impermissible tax avoidance, because they target identified or identifiable behaviour and are used to challenge the tax effects of such behaviour

directly. Nonetheless, the control of impermissible tax avoidance is not limited to these direct measures.

The regulation of tax practitioners is an indirect measure aimed at curbing impermissible tax avoidance. Since tax avoidance, in general, often requires an in-depth knowledge and understanding of the tax laws, taxpayers often rely on the advice of tax practitioners when seeking to avoid tax. This means that tax practitioners play a critical role in the avoidance of tax, and that impermissible tax avoidance can be curtailed in part by regulating tax practitioners and making it unlawful for them to create impermissible transactions for their clients.

In the South African context, the purpose of the Regulation of Tax Practitioners Bill (the Bill) is to regulate the tax practitioners’ profession by ensuring that tax practitioners are adequately qualified and experienced, follow ethical standards, and are held responsible for their conduct when acting as tax practitioners. Tax practitioners will be required to comply with the provisions of any Act administered by the Commissioner, and with the code of professional conduct determined by the Independent Regulatory Board for Tax Practitioners (the Board) when carrying out their duties. This essentially means that it will be unlawful for tax practitioners to advise their clients to avoid tax in a manner that is contrary to the anti-avoidance rules the Act.

When the Bill is passed into law, section 105A of the Act will be changed. This section currently deals with the reporting of professional conduct and it provides for the removal of professionals, such as lawyers and accountants, from the roll of their respective controlling bodies such as the Law Society of South Africa (LSSA), the South African Institute of Chartered Accountants (SAICA), the South African Institute of Professional Accountants (SAIPA) and the South African Institute of Taxpayers (SAIT), where they are found to have deliberately or negligently aided a client to unduly avoid or defer any obligation imposed by the Act. Section 105A will be expanded to apply to tax practitioners and will define misconduct in respect of tax practitioners as:

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48 2008.

49 Clause 2 of the Regulation of Tax Practitioners Bill. Clause 23 of this Bill requires tax practitioners to be registered as tax practitioners.
a. Failure to exercise due diligence in the preparation or in assisting to prepare any return, affidavit, or document on matters relating to the administration of any Act administered by the Commissioner.

b. Unreasonably delaying the finalisation of any matter that is before the Commissioner.

c. Gross negligence in any work performed as a registered tax practitioner.

d. Deliberately providing false or misleading information on matters affecting the application of any Act administered by the Commissioner.

e. Directly or indirectly attempting to influence any employee of the Commissioner, on any case related to any Act administered by the Commissioner, by use of force in threats, duress, coercion, or by offering gifts, favours, or any special inducements.

f. Gross incompetence, deliberate or reckless falsehood in providing information on any matter relating to an Act administered by the Commissioner.

Where misconduct in terms of any of the above is present the Commissioner may lodge a complaint with the Board that has the power to deregister a tax practitioner.

6. REPORTABLE ARRANGEMENTS

Another indirect measure aimed at curbing impermissible tax avoidance that is contained in the Tax Administration Act\(^\text{50}\) (the TAA) in the Act is the requirement to report certain arrangements.\(^\text{51}\) This reporting mechanism is related to the regulation of tax practitioners because the burden of reporting the arrangement partly lies with the promoter of the arrangement, who may be a tax practitioner in terms of section 37 of the TAA.\(^\text{52}\) In terms of section 35(1) of the TAA, an arrangement is reportable if it is listed as such in section 35(2), or if it will result in a tax benefit being obtained by any participant in the arrangement. This section further defines the following arrangements as reportable:

\(\text{28 of 2011.}\)

\(\text{The current provisions on reportable arrangements were preceded by section 80M – T of the Act, that was itself preceded by section 76A of the Act which was aimed at giving the Commissioner an advance warning of potentially tax-driven transactions. Mitchell "Reportable Arrangements (2007) 21 Tax Planning 39 however notes that the transactions reported under section 76A were disappointingly few since taxpayers raised technical arguments on why they did not report their transactions. The new reporting provisions were thus aimed at improving compliance in reporting transactions and to continue to provide the Commissioner with an advance warning of potentially tax-driven transactions.}\)

\(\text{A promoter is defined in section 34 as any person who has the central responsibility to organise, design, sell finance, or manage the reportable arrangement.}\)
1. Arrangements that contain provisions where interest calculations as defined in section 24J of the Act, finance costs, fees, or other charges is totally or partly contingent on the expected tax implications of that arrangement.  

2. Arrangements that have elements similar, or significantly similar, to an arrangement that lacks commercial substance, as defined in subsection 80C(2)(b) of the Act.  

3. Arrangements that are, or will be, reported by any one of the participants as resulting in financial liability for Generally Accepted Accounting Practice (GAAP) purposes but not for the purposes of the Act.  

4. Arrangements that do not result in any profit before tax for any participant.  

5. Arrangements that result in profit before tax that is lesser than the tax benefit to be obtained, or that is expected to be obtained for any participant.  

A reportable arrangement must be disclosed within 45 business days of receipt, or accrual of the first amount due to any participant, or within 45 business days of any expenditure that is actually expended, or incurred by any participant in terms of the arrangement. The details that must be submitted are described in section 38 as follows:  

1. a description of the steps and key components of the arrangement;  
2. details of the tax benefit(s) expected, whether in the form of, *inter alia*, deductions and deferred income;  
3. the names, identification numbers, and registered addresses of the participants of the arrangement;  
4. a list of all the agreements constituting the arrangement; and  
5. the financial models reflecting the expected tax implications of the arrangement.  

Certain arrangements are not subject to these reporting requirements. In terms of section 36(1) certain loans, advances, debts, and leases, *inter alia*, are not reportable. An arrangement that does not stand alone and is directly or indirectly connected to other arrangements is not excluded. The same applies to an arrangement that was entered into with the main purpose  

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53 Section 35(1)(a).  
54 Section 35(1)(b).  
55 Section 35(1)(c).  
56 Section 35(1)(d).  
57 Section 35(1)(e).  
58 Section 37(4).  
59 Section 36(2).
to obtain a tax benefit, or in a manner that either enhances or will enhance a tax benefit. The Minister of Finance has the power to exclude arrangements by public notice if he is satisfied that the arrangement will not result in the participants obtaining undue tax benefits.

The reportable arrangements are arrangements that may in certain instances constitute impermissible tax avoidance transactions. Transactions that lack commercial substance and those that have little or no pre-tax profit, are among those required to be reported. The reporting requirement thus provides SARS with an opportunity to analyse novel tax avoidance schemes before the tax benefits are claimed, obtained, or challenged in court. The requirement that taxpayers submit detailed particulars of every reportable arrangement makes it possible for SARS to analyse new tax avoidance trends, and enables it to be more informed when contributing to the formulation of new anti-avoidance rules.

7. NON-LEGAL MEASURES AGAINST IMPERMISSIBLE TAX AVOIDANCE

It has been argued that measures seeking to curb impermissible tax avoidance should not be limited to the legal provisions discussed above because impermissible tax avoidance is a systemic problem. It has also been argued that legal measures against impermissible tax avoidance alone, may be incapable of curbing it effectively. In this regard, McBarnet notes that:

[in]forcers cannot enforce laws unless they are violated. What regulation studies have underplayed is the extent to which the regulated do not violate but merely avoid the law. Responses to law are not just a matter of breaking it (crime) and obeying it (compliance) it is also possible to use legal techniques to achieve non-compliance with the intent of the law without technically violating its content. The law is not broken but it is, nonetheless, entirely ineffective in achieving its aims. Despite the legislature, despite the enforcers, law becomes merely symbolic.

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60 Section 36(3).
61 Section 36(4).
62 The requirement to report potentially impermissible tax avoidance schemes can be found in other jurisdictions. See Lymer and Oats Taxation Policy and Practice (2009/1010) 405.
63 Broomberg “Tax Avoidance Then and Now” (2007) 21 Tax Planning 112 113 notes that it is critically erroneous to assume that impermissible tax avoidance is caused by the marketers of impermissible schemes. He notes further that where impermissible tax avoidance is prevalent there is a systemic problem that requires attention and that changing the tax laws in such circumstances is unlikely to solve the problem. Orow “Structured Finance and the Operation of the General Anti-Avoidance Rule” [2004] British Tax Review 410 415 notes that tax avoidance is largely manifested in the circumvention of legal provisions imposing tax and in the creation of new rules to avert that circumvention. However, as Broomberg notes, it does not follow that impermissible tax avoidance is solely a legal problem that can be solved effectively by use of legal means.
These contentions should be noted, and it can be argued that non-legal measures that address the root causes of impermissible tax avoidance such as the general dislike of tax, the perception that public finances are wasted, and the perception that tax is unfair or confiscatory play an important role in curbing impermissible tax avoidance. A tax system with a holistic approach to curbing impermissible tax avoidance is likely to have more success in curbing impermissible tax avoidance than one that only focuses on legal measures. However, an in-depth discussion of the role of non-legal measures that can help to curb impermissible tax avoidance is beyond the scope of this research.

65 Emslie, Davis, Hutton and Olivier Income Tax Cases and Materials (2001) 1 note that tax is an “everyday reality of life”. Trixier, as quoted in Barker (2009) 236, states that “[t]he attempt to avoid paying taxes is a reaction against the constraints imposed by any tax. It is universal and an inevitable consequence of the very existence of taxes. Tax and evasion are as inseparable as a man and his shadow. Payment of taxes symbolises submission it provokes a feeling of powerlessness by creating a direct bufferless relationship between, defenceless individual and the state Moloch. It is experienced as a restriction on a person’s freedom and interference with his fundamental aspirations for power and prestige. It strikes at the very core of the taxpayer’s being, provoking an affectionate and wholly irrational reaction similar to a child’s reactions to parental domination”. Kruger and Schultz (2003) 1 describe the attitude to tax by stating that “[a] modern Midas might complain that everything he touches turns into tax”. And that “[m]ost people, at the best of times, dislike paying tax”. Freedman “Defining Taxpayer Responsibility: In Support of a General Anti Avoidance Principle” (2004) British Tax Review 332 334 states that taxpayers have “a lack of desire” to pay tax. According to Barker “The Three Faces Of Equality: Constitutional Requirements in Taxation” (2006 – 2007) Case Western Reserve Law Review 1 3 it is man’s “acquisitive nature” that upsets the fair allocation of the tax burden. In Pollock v Farmers Loan and Trust Company 157 US 429 156, where the constitutionality of the federal income tax system was challenged, it was stated that impermissible tax avoidance is motivated by “the inherent selfishness of man”. Lymer and Oats (2009/2010) 1 note that “few people would say they like to pay taxes”. Balestrino and Galmarini “Imperfect Tax Compliance and the Optimal Provision of Public Goods” (2003) 55 1 Bulletin of Economic Research 37 51 state that “[i]n the real world, people often do their best to evade or avoid taxes, and most governments fight a constant battle against these activities”. Kirchler (2007) 21 qualifies this submission and argues that it is erroneous and an exaggeration to assume that the majority of taxpayers engage in tax evasion and avoidance.

66 Evans “Taxpayer Compliance in Developing Countries: Challenges and Constraints” in National Tax Conference 2009 Tax Administration in an African Context (2009) 38 43. Evans notes at 59 that “tax morale is built where taxpayers feel that they are getting a fair deal from the exchange relationship with the state”.

67 Williams and Louw (2001) 1 succinctly state that “to levy a tax is to confiscate the taxpayer’s money. The imposition of tax thus infringes a fundamental liberty and it is not surprising that taxes generate controversy”. Lymer and Oats (2009/2010) 3 highlight the fact that taxes have historically been a “sensitive issue between rulers or governments and their subjects or citizens” by noting that civil disturbances and wars have resulted from tax disputes. These authors note at 4 that during the times of Julius Caesar (c 100 – 44BC) Roman citizens were not subject to tax and the revenue required to sustain the Roman Empire and its war efforts was obtained from citizens of territories occupied by the Romans. Only taxes on the sale of goods and other indirect taxes were levied on Roman citizens. Direct taxes were seen as “humiliating and undignified” due to the requirement to disclose personal details such as income levels. Also see Spitz Tax Magic: Winning Tax Structures At Home And Abroad (2007) 6.

68 Kirchler (2007) 5 notes that in a number of Organisation of Economic Cooperation and Development (OECD) countries, entities shift their income to environments with less tax rates. Kirchler also notes that businesses move to the “underground economy” if taxes are increased and emerge when they decrease. This shows that high tax rates can also motivate businesses to avoid tax. Yet another motivation for tax avoidance and non-compliance is couched in the taxpayer(s) belief that the revenue authority is collecting taxes fairly. Also see generally Bentley “Taxpayer’s Rights: An International Perspective” (1998) Revenue Law Journal 43.
8. CONCLUSION

This chapter discussed direct anti-avoidance measures such as the substance over form rule, SAARs, GAARs, and indirect measures such as the regulation of tax practitioners and the requirement to report certain transactions. The need for a holistic approach to curbing impermissible tax avoidance was also highlighted. From this discussion it is evident that various direct and indirect anti-avoidance measures play an important role in curbing impermissible tax avoidance. A review of these anti-avoidance measures leads to the conclusion that the GAAR, as a direct anti-avoidance measure that applies to all impermissible tax avoidance transactions, is the main weapon against impermissible tax avoidance in South Africa.

The harmful effects of impermissible tax avoidance alluded to in Chapter 1 amplify the need for an effective GAAR. As discussed in Chapter 2, taxpayers have a right to avoid tax. To exercise this right effectively, taxpayers need certainty regarding the extent to which they can exercise this right. The discussion in this chapter shows that GAARs have inherent uncertainty emanating mainly from the absence of a precise definition of key terms such as tax, tax avoidance, and impermissible tax avoidance as seen in Chapter 2. The effect and extent of this uncertainty in the South African, Australian and Canadian GAARs will be discussed in the next four chapters.
CHAPTER 4
THE HISTORICAL BACKGROUND TO THE SOUTH AFRICAN GENERAL ANTI-AVOIDANCE RULE

TABLE OF CONTENTS

1. INTRODUCTION ................................................................................................................ 63
2. SECTION 90 ......................................................................................................................... 63
2.1 Analysis of Section 90 ........................................................................................................ 64
2.1.1 CIR v King: The First Major GAAR case ........................................................................ 64
2.1.2 Schreiner JA’s Contribution to the South African GAAR ............................................. 67
2.2.1 Transaction, Operation or Scheme ................................................................................... 69
2.2.2 Interpretation of Tax Avoidance, Postponement or Reduction Effect ......................... 70
2.2.3 COT v Ferera: Possible Misunderstanding of the Significance of the King case .......... 70
3. SECTION 103(1) .................................................................................................................. 73
3.1 Section 103(1) Prior to the 1996 amendments ................................................................. 74
3.2 Transaction, Operation or Scheme Entered into or Carried Out .................................... 75
3.3 Tax Avoidance or Postponement Effect ............................................................................. 76
3.4 Normality of Manners Employed or Creation of Abnormal Rights and Obligations ...... 76
3.4.1 SIR v Geustyn, Forsyth and Joubert ........................................................................... 77
3.4.2 Hicklin v SIR ................................................................................................................. 78
3.4.3 CIR v Louw ................................................................................................................... 81
3.4.4 ITC 1496 ....................................................................................................................... 84
3.4.5 ITC 1582 ....................................................................................................................... 85
3.4.6 ITC 1635 ....................................................................................................................... 86
3.4.7 Efficiency of Abnormality as an Indicator of Impermissible Tax Avoidance ............... 86
3.5 Sole or Main Purpose to Avoid Tax ................................................................................... 87
3.6 Problems with Section 103(1) and the 1996 Amendments ............................................. 92
3.7 The Significance of the 1996 Amendments ....................................................................... 94
3.8 CIR v Conhage and the Demise of Section 103(1) ......................................................... 96
4. CONCLUSION ..................................................................................................................... 99
1. INTRODUCTION

South Africa has a long history with GAARs. The first GAAR was section 90 of the Income Tax Act\(^1\) (1941 Act) and section 90 of the same Act as amended, and the second GAAR was section 103(1) of the Income Tax Act.\(^2\) These two GAARs form the historical background to the third and current GAAR in section 80A – L of the Act. This chapter will discuss and analyse these two historical GAARs.

The discussion of these GAARs is critical because their legacy in their text and judicial interpretation provides vital lessons regarding the efficiency of a GAAR in the South African context. Moreover, section 103(1) is still applicable to transactions entered into or carried out before 2 November 2006 when it was repealed. In discussing the historical background, this chapter will analyse whether there were any problems with these GAARs that may have hindered their efficacy.

2. SECTION 90

As stated in \textit{CIR v King},\(^3\) section 90 was introduced in 1941 after the \textit{Hiddingh v CIR}\(^4\) case. The \textit{Hiddingh} case was centred on the interpretation of “accrual” in the definition of gross income. The court noted that where a taxpayer diverts income from himself before it has accrued, then that income could not be said to have accrued to him in terms of the definition of gross income. It was felt that without a GAAR, the interpretation approach taken in \textit{Hiddingh} could result in some erosion of the tax base. Section 90 of the 1941 Act provided as follows:

\begin{quote}
Whenever the Commissioner is satisfied that any transaction or operation has been entered into or carried out for the purpose of avoiding liability for payment of any tax imposed by this Act, or reducing the amount of any such tax, any liability for any such tax, and the amount thereof, may be determined, and the payment of the tax chargeable may be required and enforced, as if the transaction or operation had not been entered into or carried out....
\end{quote}

Thus, this GAAR required the presence of a “transaction or operation” that had the “purpose” and effect of avoiding tax. The Commissioner could, in this instance, levy tax by disregarding the transaction and its effects. This section further provided that the decision of the

\(^{1}\) 31 of 1941.
\(^{2}\) 58 of 1962.
\(^{3}\) 1947 (2) SA 196 AD 212.
\(^{4}\) 1941 AD 111.
Commissioner was subject to objection and appeal. It also provided that where it could be proved that the transaction or operation would result in tax avoidance or reduction, a rebuttable presumption that there was a purpose to avoid or reduce tax applied; the burden of rebutting this presumption lay with the taxpayer.

2.1 Analysis of Section 90

An immediately noticeable feature of section 90 is its wide scope, which originated from the fact that this GAAR did not have an indicator of impermissible tax avoidance that could draw the line between permissible and impermissible tax avoidance. As noted in Chapter 3, the basic statutory structure of a GAAR entails a transaction, operation or scheme, a tax benefit, and a sole or main purpose to avoid tax. Section 90 did not go further than this basic statutory structure. This meant that section 90 could be used to attack any transaction that had a tax avoidance purpose, and these transactions include permissible tax avoidance transactions. Apart from the fact that there was no indicator of impermissible tax avoidance, it can be stated that the purpose requirement was also not adequately defined because no reference was made to the degree of purpose. As it was, the purpose provision could have entailed anything from a minor or insignificant purpose, to a main or sole purpose. The absence of an indicator of impermissible tax avoidance and the flawed purpose requirement meant that section 90 was potentially contradictory to other sections of the 1941 Act that conferred tax benefits. It also meant that, literally interpreted, section 90 was too broad and could apply to permissible tax avoidance transactions.

2.1.1 CIR v King: The First Major GAAR Case

Section 90 was judicially considered in the King case in 1947. It appears that some taxpayers were not deterred by the breadth and uncertainty of section 90 because the transaction in King was initiated in 1942, one year after the enactment of section 90. The Appellate Division of the Supreme Court (Appellate Division) in this case devoted much time in its judgment in interpreting section 90, and noted that “avoiding liability” applies to a case where a man specifically orders his affairs so as to escape tax liability which he must pay on income that is his, or that is the product of his capital, or both. The court interpreted “reducing the amount” to mean reducing tax from what it must be in a year of assessment. It is on the basis of these interpretations that the court found the transaction in question not liable to tax. The court
reasoned that the transaction did not have a tax avoidance or reduction effect because tax had not been reduced from what it would have been in the year of assessment.⁵

The court interpreted the term “purpose”, and held that it referred to a dominant purpose, not a mere incidental purpose.⁶ As can be seen from the GAAR itself, purpose was not qualified, but the court noted that the legislature’s intent was not to disregard transactions with an incidental purpose to avoid or reduce tax. The Appellate Division referred to the judgment of the Cape Provincial Division (CPD) on the matter. In this judgment Jones JP stated as follows:

I deem it necessary to express my view for the guidance of the Special Court upon the meaning to be applied to the words “for the purpose.” In my view “for the purpose” means the main purpose. In its judgment the Special Court indicated that it would have little difficulty in “holding affirmatively that a purpose of avoiding tax had been proved”, because “once, however, even a collateral purpose of diminishing tax is admitted it must be that the section comes into operation.” This does not seem to be the correct view. The use of the definite article “the” leads me to think that the Legislature meant the main purpose... The Legislature did not in my opinion mean when it used the words “for the purpose” that if any one of the purposes was to avoid tax the section comes into operation. If it did it would have said so. A person may have several good and sufficient reasons for and objects in view in disposing of an asset, and incidental thereto but not the main purpose thereof may be the satisfaction that he will no longer pay tax on the income for which he is not in need. In my opinion, when the Legislature used the words “for the purpose” it must be taken to have meant the main inducement which brought about the transaction.⁷

This statement shows that the courts, cognisant of the right to avoid tax, may interpret a broad GAAR restrictively to protect this right in a GAAR. The view of Fagan J in the CPD, as quoted by the Appellate Division, is relevant in this regard; he stated as follows:

I do not read the words “for the purpose” (in the Afrikaans; met die oogmerk), with the definite article, as meaning that the section must come into operation once even a collateral purpose of diminishing tax is admitted. To me they suggest the dominant purpose; they certainly do not suggest to me a merely subsidiary purpose incidentally effected in the carrying out of the main purpose...Nor can I imagine that the legislature intended the section to be applied where a man had other reasons that induced him to enter into a transaction, but was very pleased, and even influenced in his decision, by the knowledge that, while it diminished his income it would incidentally also reduce his income tax.⁸

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⁵ 214.
⁶ 196.
⁷ 198-199.
⁸ 198 - 199.
Fagan J concluded by noting that a taxpayer discharges the onus placed on him by section 90 if he shows that he had another purpose when entering into the transaction, and that this other purpose was the dominant purpose for entering into the transaction. Fagan’s statement may be interpreted to mean that a taxpayer who had a business purpose when entering into a transaction could not be discouraged from entering into the transaction by fear of having it disregarded by section 90, merely because the transaction also resulted in the avoidance of tax. In addition, even where a taxpayer in such a situation had a purpose to take advantage of the favourable tax effect of the transaction, this transaction could not be impugned if the dominant purpose behind it was the achievement of business objectives.

The Appellate Division came to a similar conclusion. The court extensively exposed the absurdity of the literal meaning of the GAAR, and noted that a workable meaning for section 90 had to be found. Watermeyer CJ noted:

In a wide sense also the amount of a man’s income tax can be reduced from what it was in previous years if he earns less income than in previous years, but here again it is absurd to suppose that the legislature intended to impose a penalty upon a man who enters into a transaction which reduces the amount of his income from what it was in the previous years merely because his purpose was to reduce the amount of his income and consequently of his tax. These two types of cases may be uncommon but there are other ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to less than it was in the past, or of freeing himself from taxation on some part of his future income.9

The reasoning behind this statement is that there are numerous ways in which tax can be avoided, and reference to purpose alone does not assist in isolating impermissible tax avoidance. The Commissioner’s counsel conceded that the wide scope of section 90 could result in absurdity, and, it was contended, that this absurdity could be limited by exercise of the discretion given to the Commissioner to apply or not to apply section 90. It can be argued that this submission only compounded the problems of section 90 because it suggested that the Commissioner had the power and expertise to only invoke the GAAR in cases where impermissible tax avoidance was perceived to be present. In other words, this submission suggested that since the GAAR did not clearly distinguish between permissible and impermissible tax avoidance, it was up to the Commissioner to distinguish between the two by limiting his invocation of the GAAR to cases where impermissible tax avoidance had occurred. This principle was, with respect, flawed on the following grounds:

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9 208.
1. The Commissioner could not necessarily clearly distinguish between permissible and impermissible tax avoidance.

2. It would create great uncertainty and possible abuse of powers if the Commissioner had the power to determine what amounted to an impermissible avoidance of tax.

3. The Commissioner did not have the power to determine what will be taxed. Watermeyer CJ noted that “the tax is imposed by Parliament, not by the Commissioner; and if a transaction is covered by the terms of the section its provisions come into operation; if it is not then its provisions cannot be applied”.  

Regarding the use of the word “may” in the GAAR, Watermeyer CJ noted:

> It could surely not have been the intention of the Legislature that the Commissioner should be given the discretion, when he has been satisfied that the transaction falls within sec. 90, in one case to say “I will use my powers under the section” and yet in respect of another possibly identical transaction he should be able to say “I will not use these powers.”

The court therefore found it necessary to dismiss the contention that the word “may” conferred upon the Commissioner the discretion to invoke the GAAR.

### 2.1.2 Schreiner JA’s Contribution to the South African GAAR

The significance of the King case can also be found in Schreiner JA’s judgment in the case. He stated that the basic concern when dealing with section 90 was to avoid either giving it a meaning that would result in consequences that were not intended by the legislature, or a meaning that would give it no meaning at all. He noted that interpreting section 90 as nullifying all transactions done with an intention to avoid tax was not, for the reasons provided by Watermeyer CJ, justified. He noted that the section was intended to be used where the Commissioner was aggrieved by a transaction designed to ensure that one or more of its participants would avoid tax. This, he noted, could not be established where a taxpayer had ensured that a certain amount would not accrue to him, even where the Commissioner was certain that the amount would have accrued but for the taxpayer’s action.

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10 209.
11 210.
12 215-216.
13 215-216.
14 216. In this regard, Schreiner JA noted that “[t]he section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer’s affairs which will result in him getting less income”.

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In probably one of the most significant statements on the GAAR in South Africa, Schreiner JA noted that the Commissioner could be aggrieved enough to justifiably invoke section 90 where a transaction created “abnormal or unnatural situations” that resulted in tax avoidance “to the detriment of the fiscus”. To illustrate this submission, Schreiner JA stated as follows:

Now normally and naturally the owner of an income-producing asset receives income and the labourer receives the reward for his labour. Any departure from this order of things, if done with the object of prejudicing the fiscus, is the subject of legitimate objection by the Commissioner, which is met by the machinery of the section. This was not the case on the present facts as the taxpayers had disposed of the shares, i.e. they were no longer in the position of one to whom the income would normally or naturally accrue.

With this statement Schreiner JA substantially contributed to the development of the GAAR in South Africa, as he showed that section 90 was too broad and required an indicator of impermissible tax avoidance. According to Schreiner JA, an indicator of impermissible tax avoidance would be “abnormal or unnatural” transactions. Consequently, section 90 needed to be limited to these transactions. It can be argued that the move towards a GAAR with an indicator or indicators of impermissible tax avoidance was initiated in the King decision, and particularly by Schreiner JA’s statements in this regard.

2.2 The Amendment of Section 90

In 1959, twelve years after the Appellate Division’s decision in King, section 90 was comprehensively amended in an attempt to address certain aspects of the King case, especially the criticism levelled by Schreiner JA. After the amendment, it read as follows:

Where any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) has been entered into or carried out, which has the effect of avoiding or postponing liability for any tax, duty or levy on income (including any such tax, duty or levy imposed by a previous Act), or of reducing the amount thereof, and which in the opinion of the Commissioner, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –

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15 216.
16 216.
17 For more detail on section 90 see generally ITC 581 (1944) 14 SATC 581, ITC 642 (1947) 15 SATC 238 and Silke Tax Avoidance and Tax Reduction Within The Framework of the SA Income Tax Legislation, with Special Reference to the Effect on the Fiscus and to Current Anomalies and Inequities (1958) 11.
18 This amendment was done through section 17 of the Income Tax Act 78 of 1959.
The amendments turned section 90 into a GAAR with a narrower scope. It then identified impermissible tax avoidance as an abnormal transaction, operation, or scheme (to be collectively referred to as transaction) with a sole or one of the main purposes to avoid tax.

2.2.1 Transaction, Operation, or Scheme

One of the first cases to deal with section 90 as amended was *Meyerowitz v CIR*, four years after the amendment. In this case, the court held that the taxpayer’s acts that resulted in the diversion of income to a certain trust meant that the trust would receive income that the taxpayer had worked for. This was held to be abnormal in line with Schreiner JA’s remarks in the *King* case.

Tax can be avoided by means of transactions, operations, or schemes, hence the requirement in section 90 that there must be a transaction, operation, or scheme entered into or carried out. The question arises whether a series or combination of transactions with a common aim was covered. This question was answered in *Meyerowitz* where it was noted that the word “scheme” encompasses a series or combination of transactions if these transactions are united towards a tax avoidance purpose. Beyers JA noted that “once they are pressed into the service of the scheme they become part and parcel of it”. This shows that “transaction, operation or scheme” was not limited to a single event, but extended to multiple events with a common purpose to avoid, reduce, or postpone tax. It was also noted in this case that where the first

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19 1963 (3) SA 863 (A).
20 872H.
21 872H.
22 872H.
part(s) of a series of transactions did not have a tax avoidance purpose when they were implemented, the taxpayer in question could not rely on this fact if the subsequent parts of the transaction had a tax avoidance purpose.\textsuperscript{23}

### 2.2.2 Interpretation of Tax Avoidance, Postponement, or Reduction Effect

The Commissioner needed to show that the effect of the transaction was tax avoidance, postponement, or reduction. In \textit{Smith v CIR},\textsuperscript{24} the meaning of avoiding liability was said to be getting out of the way of, escaping, or preventing expected tax liability. Postponing liability for any tax is mainly achieved by postponing the receipt or accrual of income. This is a well-established tax avoidance tool where income, and thus tax payment, is deferred to a future date. Taxpayers stand to gain tax benefits if tax rates subsequently decrease before the year of deferral, or if the rules change to exclude such income from taxation altogether. If neither happens, the time value of money ensures a guaranteed tax benefit. The effect of this subset of section 90 was to ensure that taxpayers could not benefit from such deferral if other subsets of the GAAR were present.\textsuperscript{25}

### 2.2.3 \textit{COT v Ferera}: Possible Misunderstanding of the Significance of the \textit{King} case

The decision in \textit{COT v Ferera}\textsuperscript{26} was on section 91 of the Rhodesian Income Tax Act.\textsuperscript{27} This section was identical to section 90 as amended. It is an important decision in that it confirms the importance of the decision in \textit{King}, and the subsequent amendments to section 90.

In this case, MacDonald JP first expressed opinions on tax avoidance and the measures taken to limit it.\textsuperscript{28} He noted that the language in the GAAR was obviously intended to provide the

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\textsuperscript{23} 872H. At 873A The court referred to Crossland (Inspector of Taxes) v Hawkins [1961] (2) All ER 812 where it was stated that if the transactions in a series have “sufficient unity” about them then it is no defence to state that the transactions at the end were not finalised when the ones at the beginning were implemented.

\textsuperscript{24} 1964 (1) SA 324 (A) 333E.

\textsuperscript{25} In \textit{Smith} the court noted the importance of the \textit{King} case on the development of the South African GAAR. At 332H Steyn CJ noted that “the effect of these limitations is to eliminate most of the absurdities and unsatisfactory results mentioned by Watermeyer, C.J., in his judgment, if indeed not all of them”. Also see Steyn CJ’s statement at 333A-D.

\textsuperscript{26} 1976 (2) SA 653 (RAD).

\textsuperscript{27} 5 of 1967.

\textsuperscript{28} In expressing these opinions MacDonald JP at 655G disregarded the historic English cases on the right to avoid tax by stating that they “are open to the construction that the avoidance of income tax should properly be regarded as a respectable contest between the \textit{fiscus} and the taxpayer concerned”. He also noted that these cases give rise to the belief that tax avoidance should not attract “moral censure” and “should not be regarded as an evil”. The effect of the \textit{dicta} in these cases, he notes, was to encourage taxpayers to avoid tax by astute and ingenious means. In MacDonald JP’s view this was something that was sought to be corrected by the GAAR.
Commissioner with extensive powers to prevent tax avoidance, reduction, or postponement.\(^\text{29}\) He also noted that the GAAR had to be interpreted in a manner that would allow the Commissioner to use his powers against tax avoidance. The construction of the GAAR thus had to be broad in order to enable it to effectively counter the avoidance of tax. And, since tax avoidance was, in MacDonald JP’s opinion, an “evil” and a “mischief”, the principles laid down in *Heydon’s Case*\(^\text{30}\) on interpretation were applicable. These provide “for the sure and true interpretation of all statutes in general” and entail the following:

1. the establishment of the position of the common law before the Act;
2. the identification of the mischief and defect for which the common law did not make provision for;
3. the identification of the remedy that Parliament has resolved to curtail the mischief; and
4. the identification of the reason behind the remedy.

McDonald JP stated that the judiciary is under obligation to interpret the law in such a way as to “suppress the mischief”, and “to suppress subtle inventions and evasions for the continuance of the mischief...and to add force and life to the cure and remedy according to the intent of the Act”.\(^\text{31}\)

According to MacDonald JP, the interpretation rules meant that in interpreting the remedial provisions in section 91 the court had to give effect to the legislature’s intention to suppress the mischief of tax avoidance. The court could not reasonably interpret the provision in a manner that would deprive it of its efficacy. This intention could be seen in the provisions of the section itself.\(^\text{32}\) The section applied to any transaction, operation, or scheme, which to MacDonald JP meant that there were few activities that could not be caught by the section. The fact that the Commissioner merely had to have an opinion that the transaction, operation or scheme was abnormal meant that the legislature intended to “cast the net in such a way as to block every possible avenue of escape”.\(^\text{33}\) Furthermore, the onus on the taxpayer to

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\(^{29}\) 655F.
\(^{30}\) (1584) 3 Co. Rep 7a. quoted in *COT v Ferera* 656H.
\(^{31}\) 657H.
\(^{32}\) 657 H - 658.
\(^{33}\) 658B.
disprove purpose meant that the legislature meant to make the section broad. Macdonald JP opined that the legislature had made it extremely difficult for the taxpayer to avoid tax.

MacDonald JP referred to Schreiner JA’s *ratio*, but it is submitted that he did not fully appreciate the thrust of the *ratio*, and the value of the *King* case in general. Schreiner JA argued that the section required an element of abnormality in the transaction to apply. The *King* case is authority for the proposition that the section had to be limited, because not all instances of avoidance are impermissible and should be struck down by the GAAR. However, MacDonald JP seemed to be of the view that the section as influenced by the *King* case was broad, with a view to curbing an “evil” and a “mischief”. He did not appreciate that the “evil” and “mischief” was limited to impermissible tax avoidance as evidenced by the abnormality requirement and a sole or main purpose to avoid tax. The section was meant to be limited to impermissible transactions, not to tax avoidance in general.

Further evidence of Macdonald JP’s failure to appreciate the focus of the GAAR can be seen in his statement that it was absurd to suggest that the legislature, in dealing with tax avoidance, set certain requirements that had to co-exist before the GAAR could be applied. In this regard he noted as follows:

> It would be absurd to suggest that the legislature, in attacking this evil, could possibly have intended to leave unscathed taxpayers who frankly admit that the transaction, operation or scheme had as its sole or main purpose the avoidance, postponement or reduction of tax. The only consequence of such a frank admission is that it is unnecessary in the light of it for the Commissioner to base his decision to interfere upon circumstantial evidence. This is a conclusion which arises by necessary implication from the terms of the section as a whole. Clearly it was not the intention of the Legislature to reward frankness with exemption from the powers conferred by the section. It is equally absurd to suggest that the Legislature could possibly have intended, as has sometimes been suggested, that taxpayers would not be subject to those powers if the means or the manner employed to avoid, postpone or reduce tax was a means or manner normally employed for this purpose. Paras (a) and (b) of the section use the word “normally” in the context of transactions, operations or schemes which are supposedly or professedly business or trading transactions, operations or schemes and not in the context of transactions, operations or schemes which are admittedly not concerned with trade or business but simply with the avoidance, postponement or reduction of tax.

Macdonald JP supported this statement by noting that if section 91 was to be interpreted as meaning that taxpayer had immunity from the GAAR upon admitting a tax avoidance

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34 658B.
35 658H-659B.
purpose, or upon showing that the transaction was normal, then the section would effectively be nullified. It is submitted that MacDonald JP erred in this reasoning, because a taxpayer who, for instance, admits that tax avoidance was the sole or main purpose, or one of the main purposes of the transaction, would be immune from the GAAR because it required a number of factors to co-exist. An admission that tax avoidance is the sole or main purpose of the transaction did not, and does not make a transaction impermissible, because in permissible tax avoidance taxpayers often have a sole or main purpose to avoid tax. Purpose was just one of the requirements that needed to be established.

The effect of the decision in Ferera was a total reversal of the reasoning in King. It also amounted to a potential reversal of the jurisprudential gains made in making the GAAR focus on elements of impermissible tax avoidance and limiting it to transactions with those elements. The approach taken in Ferera possibly explains why the Ferera decision was not referred to with approval in any subsequent South African GAAR cases.

The Ferera case is also an illustration of what a court must avoid when interpreting a GAAR with limitations. After the amendment of section 90 in South Africa the intention of the legislature was to make the GAAR more effective by eliminating the absurd results it could give rise to, while at the same time focusing on abnormal transactions. The intention was thus to curtail impermissible tax avoidance, without infringing on the right to avoid tax.

In Ferera, the purposive approach of the court to interpreting the GAAR is commendable, as it allows the court to go beyond the literal terms of the legislation and apply its purpose. However, this approach is ineffective if the court does not accurately identify the purpose behind the legislation. In Ferera the purpose of the GAAR in question was to disallow tax benefits from abnormal transactions that had a sole or main purpose to avoid tax. This purpose was not identified, and the court misidentified the purpose as curtailing tax avoidance without exception. This approach could result in the erosion of the taxpayer’s right to avoid tax.

3. SECTION 103(1)

When the new Income Tax Act 58 of 1962 (the Act) was enacted, replacing the 1941 Act in its totality, section 90 was replaced by section 103(1). The new GAAR in section 103(1) was not entirely new, as it retained the wording of section 90 (as amended). Given that section

36 659B-C: © University of Pretoria
103(1) was amended in 1996, the analysis of this section in this research will be divided into two parts namely section 103(1) prior to the 1996 amendments, and section 103(1) after the enactment of the 1996 amendments.

3.1 Section 103(1) Prior to the 1996 amendments

Before the 1996 amendments, the GAAR provided that the Commissioner had to be satisfied that:

1. a transaction, operation or scheme that included the alienation of property was initiated or effected;
2. the transaction, operation or scheme had a tax avoidance effect resulting from the postponement or reduction of liability for any tax imposed by the Act;
3. and considering the circumstances under which the transaction, operation or scheme was initiated or effected;
   a. such circumstances included the carrying out of a transaction in a manner not normally employed in carrying out the transaction operation or scheme in question; or
   b. or has resulted in the creation of rights and obligations not normally created between persons dealing at arm’s length under such transaction, operation, or scheme; and
4. was entered into with the sole or main purpose of avoiding, postponing or reducing liability for the payment of any tax imposed by the Act.

Once the above was proved to exist in a transaction, operation, or scheme (to be referred to collectively as transaction), the Commissioner could disregard the transaction and levy tax as imposed by the Act, or act in such a manner he deemed appropriate to prevent the diminution, postponement, or reduction of such tax liability. Section 103(4) provided that the Commissioner’s decision to apply the GAAR was subject to objection and appeal.

All the case law on section 103(1) was based on the section before it was amended in 1996. In *SIR v Geustyn, Forsyth and Joubert*, the first major case on section 103(1), the court noted that the requisites that had to co-exist before the GAAR could be applied were:

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37 1971 (3) SA 567 (A) 571E-H. Silke “The Operation of s 103” (1999) 13 *Tax Planning* 53 55 notes that the four requirements of the GAAR are set conjunctively which means that they must co-exist, and that the absence of one requirement in a transaction precludes the application of the GAAR. An illustration of the
1. A transaction, operation, or scheme, including the alienation of property was entered into or carried out.

2. The transaction, operation, or scheme must have the effect of avoiding, postponing, or reducing any tax.

3. The Commissioner must be satisfied that the transaction, operation, or scheme was carried out or entered into by abnormal means, taking into account the nature of the transaction. Alternatively, the Commissioner could also alternatively seek to prove that the transaction created rights and obligations not normally created between parties dealing at arm’s length in the transaction, operation or scheme.

4. The Commissioner must also be satisfied that the transaction had the sole or had as one of its main purposes the avoidance, postponement, or reduction of any tax liability.

Where a transaction was found to have a tax avoidance effect, section 103(4) stipulated that a rebuttable presumption that the transaction had a tax avoidance purpose, existed. The effect of the onus provision in the GAAR was to place the onus of proving the above requirements on the Commissioner. According to Meyerowitz, the onus provision in section 82 of the Act did not apply to section 103(1) because this section had its own onus provision, and that this provision would have been superfluous if section 82 applied.

3.2 Transaction, Operation, or Scheme Entered into or Carried Out

The transaction had to be “entered into or carried out”; the Commissioner’s powers could not be extended to mere thoughts, ideas, or plans the taxpayer had in mind to avoid taxes, and the Commissioner’s interest would only be aroused when the plans were put into action. This conjunctive nature of the requirements of the GAAR can be found in CSARS v Knuth: CSARS v Industrial Holdings (Pty) Ltd 2000 (1) SA 1088 (EC) 1103A-B where it was stated that “[t]herefore if the scheme is not abnormal in the sense envisaged, s103 cannot apply even if such scheme has the effect of tax avoidance and this was the taxpayer’s main purpose...Similarly, if tax avoidance is not the sole or main purpose of the taxpayer, s 103 cannot be applied even if the scheme has the effect of tax avoidance and is abnormal as one of the essential requirements (viz tax avoidance being the sole or main purpose of the transaction) is absent”.

38 Brincker “The Purpose Requirement of the General Anti-Avoidance Provision in South African Fiscal Law” (2001) 1 TSAR 158 160 notes that the onus to rebut a tax avoidance purpose was “formidable” and not discharged lightly and that a taxpayer’s ipse dixit may be insufficient where there is no convincing evidence. Brincker provides an example of the case Erf 3183/1 Ladysmith v CIR 1996 (3) SA 942 (A) where the taxpayer failed to discharge the onus to prove that the real intention between the parties in the transaction was honoured and not simulated.


40 This provision states that the onus of proving the non-taxability of an amount lies with the taxpayer.


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was confirmed by Trollip JA in *Ovenstone v SIR*\(^{42}\) when he noted that the Commissioner could get involved when the plans became a practical issue. It was also noted that “entered into” did not mean mere formulation, but required implementation. In *Ovenstone v SIR*, it was held that the mere absence of a sole or main purpose to avoid tax when the transaction was formulated was not decisive, since it may have been the effect of the transaction when the transaction was implemented, and may have been the taxpayer’s purpose when the transaction was carried out.\(^{43}\)

**3.3 Tax Avoidance or Postponement Effect**

The transaction had to have a tax avoidance or postponement effect. In *Hicklin v SIR*,\(^ {44}\) it was stated that “tax liability” is in relation to the taxpayer concerned and that it does not refer to accrued or existing liability since such liability could not be avoided. Liability was held to refer to anticipated liability.\(^ {45}\) In *ITC 1625*,\(^ {46}\) it was stated that courts apply a “but for” test. It was stated that in the majority of the reported cases the taxpayer “started from a position in which, if he had done nothing, income in a taxable form would have accrued to him” and that the effect of the transaction was to enable the taxpayer to “get out of the way of, or escape, or prevent the anticipated liability for tax on that income”.\(^ {47}\)

**3.4 Normality of Manners Employed or Creation of Abnormal Rights and Obligations**

The abnormality element is the factor that was used to draw the line between permissible and impermissible tax avoidance. In terms of section 103(1), abnormality could be established by reference to two alternative and objective tests. These were:

\(^{42}\) 1980 (2) SA 721 (A) 732A-B. In this case the taxpayer needed to prove that the avoidance of tax was not his sole or even main purpose when implementing his scheme. The taxpayer argued that, by showing that the transaction in question was for the saving of estate duty when it was entered into between 1966 and 1968, the onus of proving this had been discharged.

\(^{43}\) 731H-732A. In this case, the effect and purpose of the transaction was not to avoid tax because there was no anticipated liability when the transaction was formulated. The transaction was withheld and not set in motion until 1969. The taxpayer was however immediately encouraged to implement the transaction in March 1969, when it was announced that the exemption from income tax of dividends received from companies in South West Africa was to be repealed. The taxpayer was thus encouraged to act by the substantial tax that would arise due to the new developments. Without the announcement of the removal of the exemption, the taxpayer would not have acted. The court found that the inference that could be drawn from the facts and evidence is that, whereas the appellant’s sole purpose in originally formulating the scheme was the saving of estate duty, he had the additional purpose of avoiding the anticipated liability for tax on the dividends when he carried out the scheme with haste in 1969.

\(^{44}\) 1980 (1) SA 481 (A) 492D.

\(^{45}\) 492G.

\(^{46}\) (1996) 59 SATC 383.

\(^{47}\) 396.
1. the normality of the way in which the scheme was entered into or implemented; and
2. the normality of the rights and obligations created, whether they can reasonably be expected to be created in an arm’s length transaction.

The Act did not define what it meant by abnormality or normality in establishing the manner in which the scheme was entered into, or in relation to the rights and obligations created. In a number of cases discussed below, the courts endeavoured to define abnormality. These cases illustrate the effectiveness of abnormality as an indicator of impermissible tax avoidance, and thus help in examining the efficacy of section 103(1). It can be stated that by failing to define what amounted to a normal, and thus permissible avoidance of tax, section 103(1) placed significant reliance on judicial interpretation. The structure of the normality provision effectively meant that the legislature provided the courts with a broad indicator, with substantial prerogative to determine the transactions that fitted into the broad indicator, and those that did not. It follows that, to a certain extent, the GAAR relied on the courts to identify impermissible tax avoidance transactions; this not only created uncertainty, it also provided the scope for inconsistent interpretations that could undermine the value of abnormality as an indicator of impermissible tax avoidance.

3.4.1 SIR v Geustyn, Forsyth, and Joubert

In this case Geustyn, Forsyth, and Joubert were partners in an engineering practice that expanded quickly, and in 1966 it employed 60 people of whom 17 were engineers. The three partners decided to form a company that would take over the business of the partnership. The company was incorporated in 1966, and it took over the assets and liabilities of the partnership it replaced. The company also paid the partnership a sum of R240 000 as goodwill, and the former partners were each paid a salary of R10 000. The partners became the directors of the company and were issued with equal shares in the company. The R240 000 goodwill was credited to the new directors’ loan accounts. There was no service agreement between the company and the former partners.

The arrangement was disputed by the Commissioner on the grounds that it was an impermissible tax avoidance scheme.48 To succeed in this challenge the Commissioner had to

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48 Williams Income Tax in South Africa Cases and Materials (2009) 642 notes that this case is the first case to deal with the question whether incorporating professional practices could be challenged in terms of the GAAR. The then Companies Act 46 of 1926 was amended in 1968 and section 53(b) was enacted. This section provided for a new company type designed specifically to eliminate the objections to professionals operating in a company. These companies had substantial income tax advantages which meant that there were
prove, in conjunction with the other elements required in the GAAR, that the arrangement was abnormal. Regarding this particular issue Ogilvie-Thompson CJ noted that:

1. The transfer of an existing partnership business to a company was not abnormal because such a transaction could be regarded as common in the business world.\textsuperscript{49}

2. While it may at first appear to be extraordinary that professionals in a partnership would convert their practice to an unlimited company, in the case at hand, certain facts could render the conversion normal. These facts included that the South African Association of Consulting Engineers, of which the three former partners were members, had sanctioned its members to form unlimited companies. More than half of the members of the association had already switched to incorporated companies, and more than half of professionals not in the association had also switched to unlimited companies. It was also noted that the switch was not peculiar to South African engineers, since consulting engineers in countries such as England, Canada, France, Switzerland and Japan practised in company form.\textsuperscript{50}

3. The partners had considered the advantages of incorporation over a partnership. The partnership was obviously disadvantageous because it could be dissolved at instances like death and resignation. The advantages of incorporation entailed the possibility of participating with other consortiums of engineers in large projects, and the elimination of the necessity to limit the number of partners to the legal limit of 20.\textsuperscript{51}

The court noted that these factors meant that the arrangement was a normal way of conducting the business that the taxpayer company was involved in. Abnormality regarding the manner in which the conversion was done could thus not be established, and the court decided in the taxpayer’s favour. The court did not express an opinion regarding the application of the arm’s length principle.

3.4.2 Hicklin v SIR

In the \textit{Hicklin v SIR} case, Hicklin and others held positions as directors in the company known as Reklame Bestuur (Edms) Bpk (Reklame). The taxpayer and his colleagues also held shares in this company. By March 1967, Reklame had accumulated undistributed profits

\textsuperscript{49} 573G.

\textsuperscript{50} 573H – 574B.

\textsuperscript{51} 574A.
totalling R97 000. This profit was subject to a statutory exemption from tax and was thus not subject to undistributed profits tax. Distribution of this profit would have resulted in taxation for Hicklin and the shareholders, so there was no plan to distribute the profits.

A third party known as Ryan Nigel Corporation (Ryan Nigel), which dealt with companies with undistributed profits for the purposes of dividend-stripping, became involved with the taxpayer and his fellow shareholders. An agreement with this company was reached where the members of Reklame sold their shares to the dividend-stripping company Ryan Nigel. The effect of this agreement was that the control of Reklame passed on to Ryan Nigel, which subsequently distributed the profits. The Special Court found that the taxpayer had been party to a dividend-stripping scheme that justified the application of the GAAR.

On appeal, the court had to determine, inter alia, whether abnormality could be established in relation to the transaction in question, namely the agreement with Ryan Nigel. The court noted that when determining abnormality, the GAAR required an inquiry into whether the transaction was conducted at arm’s length. It was stated that parties that deal at arm’s length operate independently from each other, and try as much as possible to obtain individual advantages from the transaction. The court opined that an arm’s length transaction generally includes parties that have normal rights and obligations. The court also stated that when determining abnormality due regard must be paid to the circumstances surrounding the transaction, since the GAAR expressly required that the circumstances must be considered. The court explained that circumstances may have an effect in that what may be deemed to be normal in one case, may be abnormal in the same case with different circumstances. It was concluded that the problem of abnormality was a factual one that could be resolved by taking cognisance of the relevant norms and standards, or the evidence provided by experts, or other evidence given by the parties.

The court then applied the tests it had established on abnormality to the facts of the transaction. The court first applied abnormality in terms of the arm’s length nature of the transaction. Regarding the agreement with Ryan Nigel, the court held that the parties to this agreement dealt at arm’s length because they were not associated, and had no interest in each other. It was found that Ryan Nigel had no influence over the taxpayer and his fellow

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52. 495A – D.
53. 495A – D.
54. 495A – D.
shareholders. Ryan Nigel had drafted the agreement and offered it on an “accept-it-or-reject-it basis” which meant that the taxpayer was not coerced into the agreement.55

The court then determined abnormality in terms of the rights and obligations created in the transaction. It was found that the shareholders in the agreement had an obligation to divest themselves of their control and shares in Reklame. In return, Reklame had to compensate the shareholders by paying the purchase price of the shares. It was held that these obligations on the shareholders and Ryan Nigel were normally associated with contracts of sale of that nature.56 An aspect of the agreement was the undertaking by the shareholders to clear the assets and liabilities of Reklame and the loans to shareholders, but to leave the issued share capital and undistributed reserves intact. The court held that there was nothing abnormal about this undertaking because Ryan Nigel had insisted on such an undertaking because of the nature of its business, and the reasons it had of taking over Reklame.57 The court also accepted the evidence of an attorney experienced in the drafting of agreements for taking over shares in private companies; the attorney stated that the agreement in question was normal and contained rights and obligations ordinarily expected in a similar agreement.58

As part of the agreement, a discount of 10% of Reklame’s distributable profits was to accrue to Ryan Nigel. The Secretary contended that for shareholders to be obliged to pay a third party (Ryan Nigel) to take shares from them was abnormal. It was stated for the Secretary that this obligation was not what a seller of shares would normally undertake. The court noted that it was not an abnormal obligation if the circumstances prevailing at the time, and the fact that it was an arm’s length agreement, were considered. The Secretary’s contention was therefore rejected, and the court held that the 10% discount was a reasonable consideration the shareholders had to pay to be rid of “the stubborn, “untidy”, dormant Reklame, their loan indebtedness to it, and their anticipated tax liability, and for RN to receive a reward for fulfilling its part of the bargain”.59

The Hicklin case contains useful judicial interpretation and guidance of the meaning of the term “arm’s length”. Trollip JA stated that an arm’s length transaction is one where independent parties act for their own individual benefit, and seek to obtain the best for themselves from the transaction. Questions have been raised on whether or not this analysis

55 495H.
56 495H – 496A.
57 496A.
58 496B-C.
59 496E.
can be relied on in all instances. It has been argued that the test advanced by Trollip JA was adequate for the facts in the Hicklin case, since it involved independent parties who had no existing relationship. Where two or more parties have an existing relationship, it might be erroneous to determine only one transaction between them, and analyse the rights and obligations flowing from that transaction. Emslie states that a party in transaction A may forego some advantages for himself knowing well that in transaction B he will be able to obtain a greater advantage. Emslie concludes that the whole relationship between the parties must be analysed, and the court must probe whether each party in the bigger scheme is independent and seeking to obtain maximum benefits. It is submitted that Emslie’s contentions are valid and that the test established in Hicklin needs to be taken in the context of the transaction in question in the case.

Potential weaknesses of the Hicklin normality test are that it can either be avoided by taxpayers, or is insufficient to indicate and curtail impermissible tax avoidance. According to Trollip JA in Hicklin, a transaction is abnormal if the parties to it do not act to obtain the best advantage for themselves. It can be said that it is true that normal transactions entail parties dealing at arm’s length and seeking to obtain the most value for themselves from the transaction. However, it does not follow that in all impermissible tax avoidance transactions, one or more of the parties necessarily neglects to act to obtain the best possible advantage for himself. Parties to an impermissible tax avoidance transaction may act to obtain the best advantage for themselves individually, and where this is done normality for the purposes of applying the GAAR may be impossible to establish. The test established by Trollip JA can be circumvented in this manner, by taxpayers ensuring that the transaction represents efforts by each party to obtain the best advantage for themselves individually.

3.4.3 CIR v Louw

In CIR v Louw, the taxpayer was a registered civil engineer practising in partnership with others. The partnership was incorporated in 1966 by entering into an agreement whereby the assets of the practice would be sold to a company with unlimited liability. The taxpayer and

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62 In ITC 1636 normality was not established because the court was satisfied that the transactions in question were concluded at arm’s length with each party seeking to obtain maximum benefits for itself. The court noted that since sale and leaseback transactions were part of normal commercial practice, the transaction was normal in that regard.
63 1983 (3) SA 551 (A).
his partners held the shares of the company for an amount that was equal to the excess of the
assets over liabilities of the practice. The business expanded and more shareholders and
directors joined the company, and the company was subsequently converted into a section
53(b) company in 1974 following the enactment of the former Companies Act.\footnote{64}

In 1971 and 1972 the loan accounts of the directors were in debit because they received loans
from the company. These loans continued and by the end of the 1976 year of assessment the
taxpayer’s loan account was in debit to the extent of R266 702. The loans to all the directors
amounted to R1 253 867. Before the company was incorporated, the net profit of the practice
was the partners’ income. After incorporation, the profit belonged to the company that
remunerated the directors for their services. This arrangement meant that the amount received
by the taxpayer was significantly less than the amount he had received as a partner prior to
the incorporation.

The Commissioner invoked section 103(1) and issued an assessment of the taxpayer that was
founded on his share of the company’s income as a percentage of his share in the company.
From the court’s decision it appears that the court analysed two transactions, namely the
incorporation of the practice and the granting of the loans to the directors. The court found
that the incorporation of the practice did not justify an invocation of the GAAR.\footnote{65}

The court analysed the loans to the directors and noted that the payment of the loans
constituted a scheme.\footnote{66} It was argued that if the loan amounts had been advanced to the
taxpayer and his fellow directors as additional salaries, tax would have been payable.
However, the amounts were paid as loans and as such did not attract tax in the taxpayer’s
hands. The court stated that in order to establish tax avoidance it had to determine whether
the amounts received as loans would have been received as salaries or in other taxable form.\footnote{67}

In this determination the court relied on the facts of the transaction. Corbett JA noted that the
following facts were important:

1. The amounts received by the respondent as salary and dividend in the relevant tax
   years were relatively small in comparison to the amounts he received under the
   partnership.

\footnotetext[64]{61 of 1973.}
\footnotetext[65]{571A – 577H.}
\footnotetext[66]{578E.}
\footnotetext[67]{579C.}
2. The taxpayer’s evidence made it clear that the amount he received as salary and dividend was enough to cater for his ordinary living costs, and that the portion of his income that he would have used for investment or savings was given to him as a loan by the company.

3. The company made substantial profits after tax in the relevant years of assessment. The substantial amounts paid to the taxpayer as loans amounted to the cash reserves that were surplus to the company’s requirements.\(^\text{68}\)

4. The company had a healthy financial position as evidenced by the reserves it maintained after loans to directors.

5. The taxpayer and his fellow directors were not required to furnish any security for the loans.

6. The company did not attach any conditions restricting the use of the loans. Some recipients had used their loans to purchase houses.

7. The taxpayer and his co-directors were not called on to repay any portion of their loan accounts. The court found this to indicate that the directors knew that the loans were effectively their remuneration and that there was virtually no possibility of them being required to repay the loans.\(^\text{69}\)

After analysing these and other facts, Corbett JA stated that there was a strong probability that the taxpayer would have received similar or substantially similar amounts as salary or dividends if they had not been received as loans. Corbett JA also noted that “it seems very unlikely that respondent and his co-directors would have been content to receive as reward for their labours moneys which were only sufficient to meet living expenses, with no residue for, *inter alia*, investment and to leave large surplus cash reserves, which in fact represented the fruits of their labours, lying in the coffers of the company”.\(^\text{70}\) The court thus found that the payment of loans to the directors was a means of avoiding tax since the directors would have received similar amounts in taxable form, but for the receipt of the loans. It was stated that a determination of the exact amount that would have been received in a taxable format was unnecessary.\(^\text{71}\)

Regarding abnormality, Corbett JA noted that when seen in the light of the amounts received by the directors as salary and dividend, the loans were abnormal as to the means and manner

\(^{68}\) 579F.  
\(^{69}\) 580A.  
\(^{70}\) 580A.  
\(^{71}\) 581B.
adopted in granting them, and as to the rights and obligations created in relation to the loans.\footnote{582A.} In this regard it is important to note that the taxpayer was, for instance, not required to furnish any security for the loans he received; this was an indication of the abnormality of the loan. Furthermore, given that the evidence suggested that the taxpayer would have, on a balance of probabilities, received the money he received as a loan in a taxable form, it can be said that it is abnormal for a person to receive the fruits of his labour in the form of a loan and not as a salary. If the loan is to be considered as a true loan, the abnormality of a situation where a taxpayer works and receives as reward money he has to pay back with interest is patent. The court accordingly held that the transaction constituted impermissible tax avoidance. This decision shows that the abnormality indicator in section 103(1) was not inherently deficient and could be used to isolate and strike down certain impermissible tax avoidance transactions that exhibited abnormal characteristics.

### 3.4.4 ITC 1496

In \textit{ITC 1496},\footnote{(1990) 53 SATC 229.} the Commissioner was successful in applying section 103(1) to an abnormal and consequently impermissible tax avoidance transaction. In this case Melamet J stated that the transaction in question contained a number of abnormal elements. The partnerships in the transaction were structured in such a way that the parties involved were disguised as partners, when in actual fact they were investors. The main partnership in the transaction was made up of four separate sub-partnerships into which the individual partners had been divided. The partners or contributors to the transaction were divided and allocated to sub-partnerships without their knowledge. This division and allocation was done to avoid section 30(1) of the Companies Act, which limited the number of persons in a partnership to twenty. The court found this activity to be inconsistent with the normal formulation of a partnership.\footnote{250 – 252.}

In a statement that further illustrated the abnormality of the transaction in this case, Melamet J stated that:

\begin{quote}
It is highly unlikely that parties who are total strangers would be willing to enter into business as partners in timber farming with joint and several liability. It is all the more so that this would be done without seeing the area, having a meeting with the manager of G and without meeting or corresponding
\end{quote}
with each other .... The whole artificial structure relating to the partnerships was necessitated by the need to camouflage investors as partners.\footnote{Kolitz “Tax Avoidance III; Normal or Abnormal” (2000) 14 Tax Planning 12 13 notes that when the transaction in \textit{ITC 1496} was implemented in 1988 many taxpayers based their transactions on limited \textit{en commandite} partnerships that involved more than 20 taxpayers. Each taxpayer would claim deductions based on their share of the deductions. Kolitz also notes that in \textit{ITC 1496} the transaction was struck down despite the fact that it was commonly used which could make the application of abnormality difficult. This shows that section 103(1) could be successfully invoked used in clearly impermissible transactions.}

Other elements of the transaction that were found to be indicative of its abnormal nature were:

1. a lease that was based on an absurd rental of R10 a year;
2. a management fee that was levied, but which contained costs that were not related to the establishment and maintenance of a plantation such as a fee paid to a chartered accountants’ firm;
3. the manner in which the transaction was timed and effected;
4. the payment of interest in advance; and
5. the advance payment of expenses relating to the establishment and maintenance of the plantation on the first day of the transaction.\footnote{(1994) 57 SATC 27.}

The court found that the evident underlying reason for the transaction in question was investment and not farming, and that the transaction as a whole was abnormal and artificial.\footnote{250.}

\textbf{3.4.5 ITC 1582}

In \textit{ITC 1582},\footnote{251 – 252.} the Commissioner applied section 103(1) to a transaction that involved the granting of purchase discounts and the price alteration of products sold to companies that were wholly owned subsidiaries of one holding company. The court found that the manufacturing company in the group delivered goods to other companies within the group without a purchase agreement in place. In terms of the transaction, the purchase price was to be determined at the end of the year based on the size of the tax benefit to be obtained after the transaction. The court also found that the companies in the group had sold goods that had not yet been acquired, and whose purchase price was unknown. In the light of the above, the court held that the transactions had been concluded in an abnormal manner, and had created rights and obligations that would not normally be created by persons dealing in transactions of the same kind. Streicher J accordingly held that the transactions were abnormal since
persons dealing at arm’s length would require clarity on the price to be paid for goods, and would not allow the price to be determined by the size of the tax benefits to be obtained by the other party to the transaction.

3.4.6 *ITC 1635*

In *ITC 1635*, the Commissioner applied section 103(1) to disallow deductions for travel expenditure. The taxpayer’s employer conducted a scheme whereby all employees would choose either to take an annual service bonus in the month of the employee’s birthday, or to receive the amount of the bonus in the form of a monthly travel allowance. The Commissioner contended that the scheme was abnormal in that it was carried out in a manner that would not normally be followed in the granting of travel allowances, and had created rights and obligations that would not normally be created between an employer and employees. The Commissioner further contended that the fact that the taxpayer had the option of receiving either the bonus or the travel allowance was indicative of abnormality.

However, the court decided in the taxpayer’s favour and held that the taxpayer had incurred travelling expenses in producing his income and that there was no abnormality on the taxpayer’s part or in the scheme. The court also found that the taxpayer had not been deceptive in any manner and that there was no irregularity in the taxpayer’s acceptance of the allowance. This case showed that the abnormality provision could be inapplicable where taxpayers utilised novel tax effective methods in their operations. The Commissioner’s contention that the scheme was abnormal in the sense that it was carried out in a manner that was not normally followed in the granting of travel allowances was rejected. It can be argued that the case *ITC 1635* showed that the abnormality indicator in section 103(1) did not necessarily bar taxpayers from adopting new methods of conducting business.

3.4.7 Efficiency of Abnormality as an Indicator of Impermissible Tax Avoidance

The origin of the normality indicator can be found in Schreiner JA’s separate and concurring judgment in the *King* case. It has been shown that when stating that section 90 was aimed at abnormal transactions, Schreiner JA was interpreting section 90 in a manner that would prevent it from producing absurd results. As stated earlier, his statement certainly contributed to the development of the GAAR jurisprudence in South Africa. However, it can be argued

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80 266.
that he did not intend that his submission form the basis of a GAAR’s isolation of impermissible tax avoidance in future transactions. In other words, in creating the abnormality provision, the legislature based its formulation of the provision meant to isolate impermissible tax avoidance on a judgment made in one case, and not on a broader analysis of impermissible tax avoidance. It is submitted that this is one of the main reasons why the abnormality indicator was not extensively defined in section 103(1).

The cases discussed above show the use of the abnormality provision in transactions that were challenged by the Commissioner. In cases such as *Louw*, *ITC 1496*, and *ITC 1582* the abnormality provision was effective in isolating impermissible tax avoidance in transactions that can be said to have been clearly contrived and abnormal. In other cases such as *Hicklin*, *SIR v Geustyn, Forsyth and Joubert*, and *ITC 1635*, section 103(1) could not be applied because the transactions in question were held to be normal. A question that can be raised about this indicator is whether or not it was only effective in blatantly abnormal and impermissible transactions. To be more effective the abnormality provision needed to be capable of application to less obvious transactions. In this regard, the fact that the Act did not define “abnormal” is relevant. Without this definition it was difficult to determine when a transaction became abnormal, and only transactions that were obviously abnormal were detected.

### 3.5 Sole or Main Purpose to Avoid Tax

Section 103(1) showed evidence of the legislature responding to the *King* case by requiring a “sole or main” purpose to avoid tax before the section could be invoked. The qualification of purpose to require a “sole” or “main” purpose meant that the presence of a tax purpose would not in itself lead to a transaction a section 103(1). In *ITC 983*, Watermeyer J stated that “for the section to operate the avoidance of tax must at least have been the principal purpose of the taxpayer”. In *ITC 1307* it was stated that:

> [i]n a case such as the present, where at most two purposes have been suggested, ... if one purpose preponderates over the other it cannot be said that the other is a main purpose. The taxpayer himself made it clear that income tax was not a totally irrelevant factor: he knew that the scheme would involve a saving on income tax. On his evidence, however, such a saving was not a purpose of the scheme at all: it was at most a no doubt welcome by-product.

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82 (1979) 42 SATC 147 153.
This means that the principal purpose had to be determined by weighing the different purposes of the scheme.

Once a transaction was seen to have a tax avoidance, reduction, or postponement effect a sole or main purpose to avoid tax was presumed, and the onus was on the taxpayer to disprove this in terms of section 103(4). The fact that a taxpayer had an opportunity to rebut the presumption of a tax avoidance purpose meant that the presence of a tax avoidance effect did not necessarily imply a tax avoidance purpose.

To establish a sole or main purpose to avoid tax a subjective determination into the subjective mind of the taxpayer was required. In *SIR v Geustyn, Forsyth and Joubert*, it was stated that the inquiry is whether the avoidance, postponement, or reduction of tax was the sole or one of the main or dominant purposes of the disposal of the practice to a company. It was also stated that the determination of the intention or purpose behind a transaction involves a factual inquiry. The importance of making this a factual inquiry was that the taxpayer’s statements of purpose in court were not necessarily decisive. It was stated that reliance would also be placed on other evidence. The court found that due to the advantages the partners had considered of converting the partnership into a company, it could not be said that there was a sole or main purpose of avoiding tax; these advantages had nothing to do with tax.

In *SIR v Gallagher*, it was stated that the test for purpose is a subjective test because the GAAR drew a clear distinction between the “effect” of the scheme and the “purpose” of the scheme. The effect of the scheme could be established by reference to independent objective factors, such as the tax benefits obtained. However, the purpose required an investigation of the thinking and evidence of the progenitor of the scheme as to why the scheme was entered into. This approach represents a subjective approach. It was however noted that the court is not obliged to accept what the taxpayer says. Colman J’s statement in the court *a quo* was referred to, where he stated as follows:

> But on the other hand, the sworn testimony of a witness, given with the appearance of truthfulness and candour, is not lightly to be discarded unless some reason appears for disbelieving the witness. What he says may be discarded if there is credible evidence to the contrary, or if there are such weighty

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83 *ITC 1636* 334.
84 576G.
85 576H.
86 1978 (2) SA 463 (A).
87 471D-E.
88 471E.
probabilities against what he has deposed to that the court does not feel justified in accepting his
evidence. A witness may be found to have been wilfully untruthful, or he may be found to have been
mistaken or confused.\textsuperscript{89}

The court thus noted that it could avail itself of the benefits provided by considering the
objective factors surrounding the case. An example of an instance where the court referred to
the objective matters surrounding the facts of the transaction can be found in the \textit{Hicklin} case,
where the court noted that the sole or one of the main purposes of the agreement the taxpayer
had with Ryan Nigel, as referred to above, was to be determined by reference to the purpose
the shareholders had in mind when the agreement was concluded. The court however found
that there was little doubt that the avoidance of tax was one of the main purposes of the
transaction, because “the only reason why the shareholders themselves had not hitherto
liquidated, dissolved, or deregistered Reklame was that that would have landed them in
liability for substantial tax on its distributable profits”.\textsuperscript{90}

The importance of the \textit{Gallagher} case lies in the manner in which it exposed a weakness in
section 103(1). The respondent in the case admitted that the requirements for the application
of the GAAR had all been met in relation to the transaction in question. However, it was
contended that the purpose of the transaction could not be reconciled with the purpose
requirement in the GAAR, because there was no purpose to avoid income tax levied by the
provisions of the Act. The Commissioner’s appeal was therefore dismissed because the
purpose of the scheme was basically based on the fact that the taxpayer “would not have
implemented the scheme if he had thought that there would be no saving of estate duty on his
death”\textsuperscript{91}. There was no purpose to avoid income tax as imposed by the Act. At the time of the
\textit{Gallagher} case section 103(1) required a purpose to avoid “the payment of any tax, duty or
levy imposed by this Act”. Since estate duty was not imposed in terms of the Act, section
103(1) could not be applied to the transaction. After the \textit{Gallagher} case the GAAR was

\textsuperscript{89}472H.
\textsuperscript{90}493E. The court in determining purpose also held that there was a purpose to rid the shareholders in Reklame
of the “untidy, dormant” Reklame. The court, however, found that since the taxpayer in the case was a
chartered accountant and one of the advisors to the agreement with Ryan Nigel was an auditor, “[i]n all those
circumstances the inference is irresistible that one of the main purposes they probably had in mind when
entering into the RN agreement was the avoidance of tax”. An illustration of one of the differences between
section 90 and section 103(1) can be found in the statement that “[i]t does not necessarily follow that, because
a transaction, operation or scheme was aimed at and had the effect of avoiding an anticipated liability for tax,
it is hit by the provisions of s 103 (1). For they are inapplicable if that transaction, etc falls within the limits of
normality of means, manner, rights and obligations prescribed by s 103 (1) (i) and (ii)”. In contrast, section 90
required only a tax avoidance purpose to apply.

\textsuperscript{91}472A.
amended to apply to the avoidance of tax imposed by the Act or any law administered by the Commissioner.\textsuperscript{92}

Section 103(1) could not be applied if a sole or main purpose to avoid tax was not established. Conversely, the mere presence of a tax purpose did not mean that section 103(1) would automatically apply. In \textit{CSARS v Knuth: CSARS v Industrial Holdings (Pty) Ltd},\textsuperscript{93} counsel for the Commissioner argued that the transaction had resulted in tax benefits for the taxpayer, and that by inference the sole or main purpose of the transaction was to obtain these tax benefits. It was further argued that the transaction was effectively a scheme of profit-making.\textsuperscript{94} The court however rejected this submission and Leach J stated that:

\begin{quote}
[n]o obligation rests upon a taxpayer to pay greater tax than is legally due under the Act and a taxpayer is not debarred from entering in a bona fide transaction which, when carried out, has the effect of avoiding or reducing liability for tax, provided his actions in doing so do not offend a provision in the law designed to prevent the avoidance or reduction of tax.\textsuperscript{95}
\end{quote}

This shows that a tax avoidance purpose alone was insufficient and was relevant only as far as the transaction avoided tax in a manner that was inconsistent with the confines set by section 103(1), which in turn had provisions that functioned conjunctively.

In instances where a business transaction could be completed in two or more different ways and the taxpayer chose the tax efficient one, a question could arise whether a sole or main purpose to avoid tax existed in relation to the selected transaction. Taxpayers seeking to disprove tax purpose in such transactions could do so by arguing that the purpose of the transaction was couched in business. In cases where the business purpose of the transaction

\textsuperscript{92} Williams (2009) 632.
\textsuperscript{93} (1999) 62 SATC 65, 2000 (1) SA 1088 (EC) 1103.
\textsuperscript{94} Williams “Is a Bona Fide Transaction that Falls Outside the Anti-Avoidance Provisions of the Income Tax Act Rendered Taxable Merely Because its Main Purpose was to Obtain a Tax Benefit?” (2001) 118 \textit{South African Law Journal} 237 238 notes that this argument was novel and without authority. He notes that its premise was that a transaction is a profit-making scheme and consequently taxable if the taxpayer carried it out with a sole or main purpose of obtaining a tax benefit. The contention for the Commissioner in fixating on purpose apparently ignored the conjunctive nature of the requirements of section 103(1). Williams further states that if this argument was accepted, it would mean that a transaction that is not taxable because it does not satisfy all the requirements of section 103(1) would be taxable merely because it constitutes a scheme of profit-making aimed at securing a tax benefit. Williams concludes that the consequence of such a proposition is that “the common-law concept of scheme of profit making would then be a more far reaching anti-avoidance provision than s 103(1)”.\textsuperscript{95}
\textsuperscript{95} 74. The same principle was stated in \textit{KBI v Botha} 2000 (1) SA 908 (O) where the court qualified the right to avoid tax with the statement that this right can only be exercised to the extent that it does not violate the anti-avoidance provisions and is not simulated.
was clear, it is generally accepted that the purpose provision in section 103(1) could not be established.\textsuperscript{96}

Nevertheless, the decision in \textit{ITC 1606}\textsuperscript{97} qualified the permissibility of tax avoidance transactions with a business purpose. In this case Tebutt J stated that in a series of preordained transactions the purpose of avoiding tax had overtaken the basic business purpose of the transaction. The manner in which the transaction was carried out probably convinced the court that the sole or main purpose was to avoid tax.\textsuperscript{98} The impact of the decision is that the tax purposes of a transaction may be so dominant that they can override the commercial basis of the transaction and become the main purpose of the transaction. It was however not clear how dominant the tax purpose needed to be to become the main purpose of a transaction. It was thus not clear to what extent a taxpayer could structure a transaction couched in business to be tax effective without crossing to a tax purpose, and thus satisfying the purpose requirement in the GAAR.

In \textit{ITC 1636} the same question confronted the courts, and it was held that the Commissioner had to fail because the taxpayer had succeeded in proving that tax avoidance was not the sole or main purpose of the transaction. In this case two purposes were advanced, namely the raising of finance for expansion, and the raising of finance in a tax effective manner. The dominant purpose between these two purposes was found to be the raising of finance. The court noted that it was acceptable business and common sense to enter into genuine commercial transactions in a tax effective manner. The decision in \textit{ITC 1636} was upheld on appeal in \textit{CIR v Conhage (Formerly Tycon)},\textsuperscript{99} which remains authority for the proposition that in South African tax law, a taxpayer may pursue commercial objectives in a tax effective manner. In this regard Brincker notes that:

\begin{quote}
[\textit{a}]lthough a taxpayer has a choice with reference to the manner in which he is to implement a transaction, it should always be tested against the anti-avoidance provisions and the question whether the parties in fact intended to give effect to the terms of the agreement. In the context of s 103(4) it
\end{quote}

\begin{footnotes}
\item[96] Clegg “A Spotless Decision; Section 103” (1999) 13 \textit{Tax Planning} 7. At 8 Clegg provides an example where a taxpayer needs a motor vehicle for business purposes. Mindful of the tax efficiency of an instalment sale agreement over a finance lease, he may choose the former method of acquisition over the latter without satisfying the purpose requirement of the GAAR.
\item[97] (1995) 58 SATC 328.
\item[98] Brincker (2001) 159 notes that the traditional knowledge was that the purpose requirement could not be met if the taxpayer could prove that there were genuine business reasons behind a transaction. However, he notes that this approach was weak because the manner in which a transaction is carried out may reflect a tax avoidance purpose.
\item[99] 1999 (4) SA 1149 (SCA).
\end{footnotes}
implies that, faced with a legitimate transaction, it is to be expected that a prudent businessman, faced with alternative options, would choose, as he is legally entitled to do, the one which entails a lesser tax liability. The exercise of that choice alone does not as a matter of probability justify the inference that his main purpose is tax avoidance. If the tax benefits flowing from a transaction are thus a compelling reason why a taxpayer has recourse to a particular vehicle to achieve his commercial purpose, that in itself will not result in the sole or main purpose being that of tax avoidance. However it presupposes that there is in fact a commercial purpose which preponderates over the tax purpose, and the manner of implementation of the transaction should not give rise to an inference that the tax purpose was dominant.\(^{100}\)

The fact that a taxpayer may choose a tax effective method of conducting business does not however mean that section 103(1) automatically sanctioned the aggressive and possibly impermissible pursuit of tax benefits in commercial transactions. As shown in *ITC 1606*, it is possible for taxpayers to avoid tax impermissibly by abusing the commercial nature of their transactions, and aggressively seeking tax benefits in these transactions. By being silent on the issue, and not defining the extent to which taxpayers could seek to obtain tax benefits in commercial transactions, section 103(1) paved the way for inconsistent judicial decisions and provided scope for taxpayers to aggressively seek tax benefits in commercial transactions and claim commercial purpose in these transactions.\(^{101}\)

### 3.6 Problems with Section 103(1) and the 1996 Amendments

Some problems with section 103(1) were discussed above. These problems meant that impermissible tax avoidance continued to flourish in spite of section 103(1).\(^{102}\) SARS viewed the abnormality requirement in section 103(1) as weak because it was thought that taxpayers could argue that a particular tax avoidance structure was not abnormal since it was an ordinary business measure.\(^{103}\) The Margo Commission\(^ {104}\) and the Katz Commission\(^ {105}\) both

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100 Brinker (2001) 162.
101 The approach in Australia, to be discussed in detail in Chapter 6, is to objectively determine the dominant purpose of the transaction. According to Morphet “Australia v South Africa at Tax Legislation” (2005) 19 *Tax Planning* 129-129, “commercial rationality will now be secondary to the rapacious grasp of the taxing authority” if South Africa adopted a similar test.
103 Williams and Louw *Income Tax and Capital Gains Tax in South Africa: Law and Practice* (2001) 799. Kolitz “Tax Avoidance II; The Changing Provisions of s 103(1)” (1999) 13 *Tax Planning* 128 128 notes that the use of tax avoidance schemes became commonplace and the success in the application of section 103(1) to curb these schemes was limited because the schemes contained elements that were commonly used. This meant that taxpayers could argue that the schemes were normal.
indicated that the danger with the abnormality requirement was that a particular scheme could be so widely used that it could become normal and accepted in business. The Margo Commission also stated that:

[t]he nature of anti-avoidance provisions must obviously be sufficiently flexible to be effective while being not so vague as to undermine or impair proper planning of the taxpayer’s affairs. Measured against these criteria the existing s 103(1) is, in the Commission’s view, defective and, in many cases, ineffective from the Commissioner’s point of view.\(^\text{106}\)

These views meant that changes to section 103(1) needed to be made. The Katz Commission recommended amendments that would ensure that the widespread commercial use of a scheme, or elements thereof, would not make that scheme immune from section 103(1). These amendments were incorporated into section 103(1) by section 29 of the Revenue Laws Amendment Act.\(^\text{107}\) The amendment to the normality provision of section 103(1) thus read as follows (with the changes in italics):

a. Having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –
   i. Was entered into or carried out
      aa. in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and
      bb. in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provision of item (aa) by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
   ii. Has created rights or obligations which would not normally be created between persons dealing at arm’s length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question.

The amendments to the normality requirement applied to a transaction, operation, or scheme in the context of business. They were introduced to enable the Commissioner to overcome the difficulty with applying section 103(1) to a transaction that was so widely used that it had become commercially acceptable and normal.\(^\text{108}\) The amendments introduced a business

\(^{105}\) Third Interim report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa par 11.2.2.
\(^{106}\) Par 27.15.
\(^{107}\) 36 of 1996.
purpose test in the GAAR. “Business” was not defined in the Act, but this could not cause any problem because the plain meaning of the term is clear and could be referred to when necessary. “Trade”, a term that could have been used in place of business, is defined in section 1 of the Act as including every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use or grant of permission to use any patent design or copyright or similar property. It has been argued that since trade is a more familiar term, it should have been used. However, as stated above, the term “business” did not have a real likelihood of causing any interpretation problems because its plain meaning is obvious. It can also be stated that the amendment in introducing “bona fide business purposes” sought consistency in targeting transactions “in the context of business”, as opposed to transactions in the context of trade.

The amendment focused on the manner in which the transactions was carried out and not on the transaction itself. The manner was required to be consistent with what would be expected in a transaction entered into for bona fide business purposes. Section 103(1) could be invoked where the transaction was entered into in a manner that was inconsistent with what would be employed for bona fide business purposes. Business purpose was not defined but one can note that the section essentially required the following:

a. The utilisation of normal means.

b. Real, not contrived, or artificial business purpose. The term bona fide served to exclude transactions with contrived or artificial ‘business purpose’ meant to disguise the weak or non-existent business purpose of the transaction.

c. The business purpose of the transaction to outweigh the tax purpose of the transaction.

3.7 The Significance of the 1996 Amendments

To measure the significance of the 1996 amendments, one must determine whether they made it possible for the Commissioner to successfully challenge abnormal transactions that had gained acceptance due to widespread commercial use. One must also determine whether the amendments created certainty on the types of transactions that would be targeted. In this regard it must be noted that the amendments were not judicially considered before section

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103(1) was replaced. The phrases that required judicial interpretation were “in the context of business” and “for bona fide business purposes”. It can be seen that the amendment made it harder for a taxpayer to claim that the transaction is widely used and accepted and therefore normal because that could not prove that the transaction was normal for *bona fide* business purposes. In this regard, on paper the amendment, improved the efficacy of section 103(1) in curbing impermissible tax avoidance.

When analysing the effect the amendment had on creating certainty on permissible and impermissible tax avoidance transactions it is important to consider one of the weaknesses of the abnormality provision raised earlier. Before the amendment, the abnormality requirement was not defined in the Act, which meant that potentially undue reliance was placed on the courts to determine its application in the cases before them. After the amendment, the provision was still not defined. The amendment only required a determination to be made on whether the transaction was normal for *bona fide* business purposes. It therefore fell short of providing guidance on what was normal or abnormal. This means that reliance was still placed on the courts to determine what was normal for business purposes. As before, this reliance was undesirable as it could have led to inconsistent judicial interpretation of the abnormality indicator in transactions before the courts.

It has been noted that section 103(1) based the distinction between permissible and impermissible tax avoidance on the abnormality of the transaction. This distinction was inadequate, and to improve the efficacy of section 103(1) in performing its functions the legislature needed to identify more certain and unambiguous indicators of impermissible tax avoidance, and not limit its efforts to amending the abnormality indicator. In this regard, one can refer to the fact that section 103(1) was replaced before the amendments were adjudicated on, a development some thought meant that the legislature was not satisfied with its effect on the strength of section 103(1) as a whole.¹¹¹

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¹¹¹Clegg “Dropped Before Playing; Proposed Amendments to s 103” (2005) 19 *Tax Planning* 53. Clegg at 55 refers to the statements in the 2005 *Budget Review* that stated that section 103(1) would be revised because “it was based on antiquated notions of legal form and intent and that had been worsened by formalistic judicial interpretations that undermine the legislation’s ultimate goal of curtailing tax avoidance schemes”. Clegg at 54 described this statement as “rank arrogance at best and at worst disrespectful to the courts” for the National Treasury to pronounce that the interpretation method in tax cases is unacceptable where it is not in favour the results of a case. Clegg refers to the proposed revision of section 103(1) as a “throwing in of the towel” considering that there was no decision upon which to base the value of the amendments. Clegg notes that in spite of the proposed revision, the amendments had given section 103(1) “teeth it never had before” and appeared to have altered the thinking of tax planners who had previously been aggressive. For more on the business purpose requirement also see Clegg “Business Purpose Test” (2002) 16 *Tax Planning* 108.
3.8 CIR v Conhage and the Demise of Section 103(1)

Part of the reason why the 1996 amendments to section 103(1) were not judicially considered was because the Supreme Court in 1999 in CIR v Conhage (Formely Tycon) “effectively emasculated the legislation”.\textsuperscript{112} In this case, Hefer JA noted that even though section 103(1) was enacted to enable the Commissioner to effectively deal with tax avoidance schemes, the section only operated in the stipulated circumstances.\textsuperscript{113} It was not a section aimed at curbing tax avoidance in general, and it was stated that “[b]roadly speaking, the section empowers the Commissioner to determine a taxpayer’s liability for income tax and other taxes by disregarding any abnormal transaction which the latter entered into for the purpose of avoiding or postponing his tax liability or reducing the amount thereof”.\textsuperscript{114}

The court noted that, in carrying out the tax saving sale and leaseback transaction in question, the taxpayer had wanted to have capital for the expansion of its business. Finance for this expansion could have been obtained in a straightforward loan, or as a sale and leaseback transaction. A sale and leaseback was more attractive from a tax perspective, and for this reason it was preferred over the straightforward loan. It was contended for the Commissioner that the fact that the sale and leaseback transaction was preferred for its tax benefits was all that mattered and that the sole purpose of the transaction was to reduce the taxpayer’s tax liability. It was also contended that the fact that the taxpayer required capital for expansion did not matter. For the taxpayer it was contended that obtaining capital was the sole purpose of the transaction, and the consequent reduction in tax was not the main purpose.

The court held that the commercial purpose of the transaction was paramount, and that there would not have been any transaction but for the taxpayer’s need for capital. In support of this finding, it was also held that the taxpayer did not approach the financier in order to lessen its tax liability, but rather to obtain capital.\textsuperscript{115} The court found that abnormality had not been established. The decision in this case is authority for the proposition that if an overall scheme had an overriding business purpose, steps in the transaction could not be isolated and deemed to lack a business purpose. The court also reaffirmed the principle that a taxpayer has a right to choose the most tax effective manner of conducting business.


\textsuperscript{113}1159. Hefer JA referred to Watermeyer CJ’s statement in CIR v King at 209 that “if a transaction is covered by the terms of the section its provisions come into operation, if it is not then its provisions cannot be applied”.

\textsuperscript{114}1159.

\textsuperscript{115}1160.
This decision is said to have led to the eventual demise of section 103(1). It is however submitted that where two or more transactions exist to achieve a certain business objective, the GAAR should not be applied to bar the taxpayer from carrying out the transaction that has the least tax implications. Support for this contention can be found in *ITC 1625* where it was stated that:

[a]nother ground upon which the Commissioner’s attempt to invoke s 103 must fail is that the appellant has manifestly established that tax avoidance was not the sole purpose or one of the main purposes of the transaction or scheme. That transaction that is attacked is the acquisition of property by the appellant. The scheme, in a wider sense, was the totality of the steps which were implemented to achieve the taxpayer’s objective. The appellant, as a corporate entity, did not acquire the property in order to avoid tax. It acquired the property in order to have a valuable rent-producing asset which was regarded as a good investment. The method which it chose was obviously a tax-effective method. If a taxpayer has a commercial or family purpose for entering into an agreement which is not itself a tax avoidance purpose and chooses a method to achieve his or her objective which is tax effective; that does not convert the transaction into one for the avoidance, reduction or postponement of tax. I have always understood our courts to have adopted the approach of the House of Lords in *IRC v Brebner* [1967] 1 All ER 779 at 784.

In this regard it has been argued that even though the *CIR v Conhage* transaction led to the replacement of section 103(1), this transaction can still withstand an attack under the current GAAR in sections 80A-L inclusive of the Act.

Another significant aspect of the *CIR v Conhage* case is that it reinforced the idea that a GAAR must create enough certainty on the limits of the right to avoid tax. This will not only inform taxpayers but also SARS in making a decision to either challenge or honour a transaction. The statements referred to above from Liptak and the 2005 Budget Review seem to place the blame for the demise of section 103(1) on judicial interpretation. It is submitted that these statements do not comprehensively identify the causes of the demise of section 103(1). This is because SARS’ role in challenging legitimate transactions is largely ignored or underplayed. According to Mazansky:

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117 398.
118 In *IRC v Brebner* the court noted that if a genuine commercial transaction can be carried out in two or more ways, it is “quite wrong” to infer that a taxpayer who adopts the course that has the least tax consequences has as one of his main objectives, the avoidance of tax.
119 Kolitz “ITC 1636 and GAAR” (2007) 21 Tax Planning 45 states that the transaction in *ITC 1636* and subsequently *Conhage* would not constitute impermissible tax avoidance under section 80A – L of the Act because the purpose requirement is not met, there is no lack of commercial substance, no abnormal rights and obligations and no misuse or abuse of the provisions of the Act.
The need for this [a new GAAR] was identified by SARS in light of the fact that interpretations by the courts on the scope and meaning of s 103(1) has largely diluted its effect (helped, in many instances, by the fact that, in my view, the Commissioner misused the provision by attacking legitimate transactions).

It is submitted that the transaction in CIR v Conhage should not have been challenged because of its commercial purpose. However, it would be amiss to place all the blame on SARS for challenging a legitimate transaction. Part of the blame should fall on the GAAR whose uncertainty meant that the extent of the right to avoid tax was unclear, which in turn misled SARS into challenging a legitimate transaction.

SARS\textsuperscript{121} noted that “[a] GAAR that is only effective against sloppy, ill-advised or ill-conceived schemes is hardly an effective deterrent”. It noted that section 103(1) was ineffectual as a deterrent because:

1. The abnormality requirement had “fundamental weaknesses”, because the tax field is not partitioned between impermissible transactions and transactions that are \textit{bona fide} business transactions. Scheme promoters could still hijack transactions that were initially entered into or carried out for \textit{bona fide} business purposes. In this regard scheme promoters could almost always be able to present a tangible \textit{bona fide} business purpose to any transaction.

2. The purpose test in section 103(1) could only be established in the Commissioner’s favour if it could be proved that tax was the predominant purpose. This presented difficulties for the Commissioner because most transactions were in a business context and had a business purpose that could be inflated to become the predominant purpose.

3. Section 103(1) was uncertain regarding its application to steps within a larger transaction.

4. It was also uncertain whether the Commissioner could seek to apply section 103(1) in the alternative.\textsuperscript{122}

The view that section 103(1) had weaknesses is shared by some commentators. In this regard Williams argued that this section could only apply to a transaction without any \textit{bona fide}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{120}] Mazansky “New GAAR Initial Observations” (2006) 20 Tax Planning 130 130.
\item[\textsuperscript{122}] See generally SARS Discussion Paper 42–44.
\end{itemize}
\end{footnotesize}
business purpose at all or to “highly artificial tax schemes”. Olivier noted that, in amending section 103(1), the legislator was unsuccessful in establishing clarity on certain aspects of the section and instead “created even more problems”. These concerns are summed up by Pickup who noted as follows:

In brief, South Africa has had a GAAR since 1941. However by 2005 it had lost confidence in the then current text, and its ability to successfully litigate GAAR cases. Its key problem was that it was for SARS to prove that a transaction had been entered into in an abnormal manner. Since most schemes utilize techniques that were developed for bona fide business purposes, and have at least some purported business purpose, how was abnormality to be demonstrated? In addition, if a particular scheme is being widely used, can what is being done be described as abnormal? A second major concern was that the purpose test...was a subjective, not an objective, test. These and other technical difficulties were compounded by SARS being outgunned on the expert evidence needed for litigation, since most experts in South Africa were already committed to the taxpayer’s cause.

4. CONCLUSION

This chapter shows that South Africa has had a long and informative history with a GAAR. The history discussed in this chapter is summarised in the following table:

Table 2: South Africa’s Historical GAAR Timeline

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1941</td>
<td><em>Hiddingh</em> case leads to the introduction of section 90.</td>
</tr>
<tr>
<td>1942</td>
<td>Transaction in <em>CIR v King</em> initiated.</td>
</tr>
<tr>
<td>1944</td>
<td><em>ITC 581</em> case, one of the first on section 90, is decided and results in a victory for the Commissioner.</td>
</tr>
<tr>
<td>1947</td>
<td>Appellate Division passes judgment in the taxpayer’s favour in <em>CIR v King</em>. <em>ITC 642</em> case, decided after <em>CIR v King</em> results in a loss for the Commissioner.</td>
</tr>
<tr>
<td>1959</td>
<td>Section 90 amended to incorporate the judgment of Schreiner JA in <em>King</em>.</td>
</tr>
<tr>
<td>1962</td>
<td>The Act replaces the 1941 Act and section 103(1) is introduced.</td>
</tr>
<tr>
<td>1963</td>
<td>Judgement is passed in <em>Meyerowitz</em> and <em>Smith</em>, cases based on section 90 as amended. Judgment is passed in <em>ITC 983</em>, one of the first cases on section 103(1).</td>
</tr>
</tbody>
</table>

123 Williams (1997) 682.
<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>Judgment in <em>Geustyn, Forsyth and Joubert</em>, the first major case on section 103(1), is passed and it results in a loss for the Commissioner.</td>
</tr>
<tr>
<td>1976</td>
<td>Judgment in <em>COT v Ferera</em> passed, showing evidence of a misunderstanding of the approach in <em>King</em>.</td>
</tr>
<tr>
<td>1978</td>
<td><em>Gallagher</em> decision passed and it results in a loss for the Commissioner.</td>
</tr>
<tr>
<td>1980</td>
<td><em>Ovenstone</em> and <em>Hicklin</em> decisions passed. <em>Ovenstone</em> results in a victory for the Commissioner while <em>Hicklin</em> results in a victory for the taxpayer</td>
</tr>
<tr>
<td>1983</td>
<td><em>Louw</em> decision passed and it results in a victory for the Commissioner.</td>
</tr>
<tr>
<td>1987</td>
<td>Margo Commission notes certain problems with the abnormality provision in section 103(1) and also notes that this GAAR does not strike a balance between curbing impermissible tax avoidance and allowing permissible tax avoidance.</td>
</tr>
<tr>
<td>1990 - 1995</td>
<td>Period wherein patently abnormal transactions such as those in <em>ITC 1496</em> and <em>ITC 1582</em> and <em>ITC 1606</em> are successfully challenged.</td>
</tr>
<tr>
<td>1995</td>
<td>Katz Commission identifies problems with the abnormality provision that were highlighted eight years earlier by the Margo Commission.</td>
</tr>
<tr>
<td>1996</td>
<td>Amendments taking into account the recommendations of the Margo and Katz Commissions are made to section 103(1).</td>
</tr>
<tr>
<td>1997</td>
<td>Taxpayer victories in <em>ITC 1635</em> and <em>ITC 1636</em>.</td>
</tr>
<tr>
<td>1999</td>
<td>Judgment passed in <em>CIR v Conhage</em>, the case widely believed to have led to the demise of section 103(1) as a potent GAAR against impermissible tax avoidance. Decision in <em>Knuth</em> which resulted in another loss for the Commissioner passed.</td>
</tr>
<tr>
<td>2006</td>
<td>Section 103(1) replaced and section 80A – L introduced.</td>
</tr>
</tbody>
</table>

It can be argued that the first GAAR in section 90, as the first generation GAAR, dealt with the absence of a universal definition of impermissible tax avoidance by targeting all tax avoidance transactions. However, the decision in the *King* case showed that creating a broad GAAR is not the answer to impermissible tax avoidance. Section 90 was amended and later on superseded by section 103(1) of the Act, which was based on the amended section 90.

Regarding section 103(1) it can be stated that this GAAR was an improvement because it sought to distinguish between permissible and impermissible tax avoidance by reference to a transaction’s abnormality. However, section 103(1) had limited efficacy because it had certain fundamental flaws that were discussed in this chapter and also identified by both the Margo and the Katz Commissions. It can be concluded that a combination of factors led to the demise of section 103(1), and all of these factors can be said to have originated from the fact that section 103(1) was based on a weak indicator of impermissible tax avoidance namely, abnormality. This indicator was weak because:
1. it was based on Schreiner JA’s statement in *CIR v King* that was not meant to form the basis of a GAAR, but to make a point;
2. it was not defined in the Act, but relied on judicial interpretation;
3. it was too narrow in limiting impermissible tax avoidance to abnormal transactions; and
4. it created too much uncertainty, because abnormality is relative;

It can also be concluded that the history of the South African GAAR suggests that the inherent uncertainty of GAARs in general was not adequately addressed, as indicated by the uncertainty that was created by the historical GAARs. The uncertainty in section 103(1) culminated in the Commissioner challenging and losing the transactions in major cases such as *SIR v Geustyn, Forsyth and Joubert*, *SIR v Gallagher*, *Hicklin v SIR*, *CSARS v Knuth*, *CIR v Conhage* and *ITC 1635*. The historical South African GAAR experience thus shows that South Africa has had GAARs with limited efficacy in curbing impermissible tax avoidance, and in creating enough certainty to promote permissible tax avoidance.

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126 The Commissioner in turn won challenges in cases such as *CIR v Louw, Ovenstone v SIR, CIR v Ocean Manufacturing, ITC 1496, ITC 1582 and ITC 1606.*
CHAPTER 5

THE SOUTH AFRICAN GENERAL ANTI-AVOIDANCE RULE

TABLE OF CONTENTS

1. INTRODUCTION .............................................................................................................. 103
2. THE GAAR: SECTION 80A – 80L ................................................................................... 104
   2.1 Section 80A ....................................................................................................................... 104
   2.1.1 Arrangement .................................................................................................................. 106
   2.1.2 Tax Benefit ..................................................................................................................... 109
   2.1.3 Purpose ........................................................................................................................... 110
   2.2 The Tainted Elements in the Context of Business ............................................................ 111
      2.2.1 Normality for Business Purpose .................................................................................... 111
      2.2.2 Commercial Substance ................................................................................................ 112
      2.2.2.1 Section 80D: Round Trip Financing ........................................................................... 113
      2.2.2.2 Section 80E(1): Accommodating or Tax – Indifferent Parties ..................................... 114
      2.2.2.3 Section 80C(2)(b)(iii): Offsetting and Cancelling Elements ....................................... 115
      2.2.3 The Creation of Abnormal Rights or Obligations .......................................................... 116
      2.2.4 Misuse or Abuse ............................................................................................................ 116
         2.2.4.1 Statutory Interpretation in South Africa ..................................................................... 117
         2.2.4.2 Traditional Approach – Literalism ............................................................................. 117
         2.2.4.3 Literalism in Tax Statutes and Tax Avoidance ........................................................... 120
         2.2.4.4 The Modern Approach – Purposive Interpretation ..................................................... 121
         2.2.4.5 Purposivism in Tax Legislation .................................................................................. 123
         2.2.4.6 Criticism of Purposivism ............................................................................................ 124
         2.2.4.7 Misuse or Abuse as a European Legal Concept .......................................................... 127
3. ANALYSIS OF THE GAAR .............................................................................................. 129
4. CONCLUSION ................................................................................................................... 134

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1. INTRODUCTION

Section 103(1) was repealed and replaced with the current GAAR which is contained in section 80A – 80L in Part IIA of Chapter III of the Income Tax Act. The GAAR is deemed to apply to transactions entered into on or after 2 November 2006. The *Explanatory Memorandum on the Revenue Laws Amendment Bill* (*Explanatory Memorandum*) that accompanied the introduction of this GAAR showed some dissatisfaction with the record of section 103(1) in the courts. It was stated that:

> [t]he GAAR has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated forms of impermissible tax avoidance that certain advisors and financial institutions are putting forward and some taxpayers are implementing. In addition it has become clear that the GAAR has not kept up with international developments. Finally, uncertainty has arisen with respect to the application of the GAAR in the alternative due to the conflicting court decisions in this regard.

This statement makes it patently clear that section 103(1) was seen as static and outdated, and as a GAAR that taxpayers largely ignored. However, Broomberg argues that the reference to section 103(1) as a deterrent is misleading, because unlike in Australia, a taxpayer whose arrangement has been set aside by section 103(1) is not subject to any penalties. The punishment is the payment of taxes that should have been paid anyway.

This chapter will analyse the provisions of the current GAAR in the light of the aims of this research. The GAAR will thus be analysed in order to establish whether:

1. it will be effective against impermissible tax avoidance;
2. it creates sufficient certainty for taxpayers to understand the limits of their right to avoid tax; and

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1. 58 of 1962. The GAAR was inserted by section 34(1)(a) of the Revenue Laws Amendment Act 20 of 2006.
2. 2006 62.
3. Broomberg “Tax Avoidance Then and Now” (2007) 27 *Tax Planning* 112 112. Broomberg further criticises the statement quoted above by arguing that South Africa cannot be said to be lagging behind international developments because the generally acknowledged leaders in tax legislation, the US and the UK (at the time Broomberg’s article was written, the UK did not have a GAAR), do not have GAARs in their tax legislation. According to Broomberg, the other countries with advanced tax legislation, namely Canada and Australia have GAARs that “are perceived to be less than satisfactory” and “are replete with unanswered questions”. Broomberg also argues that the international developments referred to in the statement can be misleading because no country has yet managed to create an effective GAAR.
3. it addresses the problems that were associated with its two predecessors, namely section 103(1) and section 90 of the Income Tax Act. These problems were highlighted in Chapter 4.

2. THE GAAR: SECTION 80A – 80L

In terms of section 80B of the Act, the Commissioner has the power to reduce, eliminate, or neutralise tax benefits that arise from an impermissible avoidance arrangement. The GAAR provides that an impermissible avoidance arrangement is an arrangement that has a sole or main purpose to avoid tax and that is also characterised by any one of the following:

1. the absence of commercial substance;
2. abnormality for a *bona fide* business purpose;
3. the creation of rights and obligations that would not normally be created in an arm’s length arrangement; and
4. the misuse or abuse of the Act.

This shows that the GAAR bases its distinction between permissible and impermissible tax avoidance on four broad concepts. One of the most noticeable features of the GAAR is its detailed and comprehensive nature when compared to its predecessors. The GAAR retains certain phrases and provisions from section 103(1), which means that some of the judicial interpretation of these provisions will therefore still apply in interpreting the GAAR. However, it does not necessarily follow that the retained concepts will be interpreted in exactly the same way that they were previously interpreted.

2.1 Section 80A

This section contains the basic statutory structure of the GAAR. It states 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 is entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit; or

---

4 31 of 1941.
5 SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule (2010) (SARS Guide) 5. It is stated here that the dominant view of the GAAR is that it is an “overhaul” of section 103(1).
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).

The GAAR thus requires the three basic elements identified in Chapter 3 as formulating the basic structure of a GAAR, and a fourth element that can be any one of the tainted elements. For arrangements executed in the context of business the basic elements and the tainted element(s) are:

1. an arrangement;
2. a tax benefit;
3. a sole or main purpose to obtain a tax benefit; and
4. any one of the tainted elements.

The following are the tainted elements:

1. the utilisation of abnormal means or manners which are not used for a *bona fide* business purpose, other than for obtaining a tax benefit;
2. the absence of commercial substance;
3. the creation of rights and obligations which would not normally be created in an arm’s length arrangement; and
4. the misuse or abuse of the provisions of the Act.

In a context other than business, the tainted elements are:

1. the execution of an arrangement by abnormal means or manners not used for a *bona fide* purpose other than obtaining a tax benefit;
2. the creation of rights and obligations which would not normally be created in an arm’s length arrangement; and
3. the misuse or abuse of the provisions of the Act.

The tainted elements in any other context are:
1. the creation of rights and obligations that would not normally be created in an arm’s length arrangement; and

2. the misuse or abuse of the provisions of the Act.

The tainted elements are decisive in the application of the GAAR to an arrangement. The three basic elements do not draw any line between an impermissible avoidance arrangement and a permissible one. The GAAR thus uses the tainted elements to isolate impermissible tax avoidance transactions and these elements are defined in more detail in other sections constituting the GAAR.

2.1.1 Arrangement

Section 80L defines an arrangement as “any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property”. The definition of an arrangement is broad enough to cover all the arrangements or forms that sophisticated tax avoidance transactions could adopt. Steps in a broader arrangement are also defined as arrangements, which in principle means that the GAAR can apply to a single step in a composite transaction. This prevents taxpayers from abusing the commercial nature of a composite transaction by inserting steps that lead to impermissible tax avoidance. However, it can be argued that isolating a single part of a composite transaction and ascribing a sole or main purpose of tax avoidance to it may place taxpayers at a disadvantage, because this bars the taxpayer from arguing that the part has the commercial purpose of the composite transaction.

Part of the reason behind the isolation of a single step in a composite transaction is to counter decisions that held that section 103(1) did not apply to parts of a transaction, operation, or scheme if the transaction as a whole had a non-tax purpose. The decisions of the courts on whether parts of a transaction could be isolated for GAAR purposes have been inconsistent. In *Hicklin v SIR* a composite transaction was entered into, and the court isolated one part when considering the application of the GAAR. It can be argued that the taxpayer’s right to avoid tax may be violated where a part of a composite transaction with a non-tax purpose is excised and determined. This is because in many permissible tax avoidance transactions there

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6 Section 80H states that “[t]he Commissioner may apply the provisions of this part to steps in or parts of an arrangement”.

7 *CIR v Conhage (Formerly Tycon) (Pty) Ltd* 1999 (4) SA 1149 (SCA).

8 1980 (1) SA 481 (A).
is a single step that is decisive towards securing the tax benefits sought. Isolating this step may therefore be an unfair intrusion into the taxpayer’s rights. However, in the context of the South African GAAR the isolation of a single step is explained as follows:

In this regard, section 80H clarifies that the Commissioner has the discretion to isolate the offending step or part and apply the remedies available to such step or part. Therefore, the effect of tax-driven steps or parts, which have no commercial purpose or which are abnormal or which misuse or abuse a provision of the Income Tax Act and have been inserted into an otherwise seemingly innocent or normal arrangement may now be neutralised, without having regard to the purpose of the composite arrangement.9

This means that the isolation of steps in terms of the GAAR does not violate any right because it is not decisive in the application of the GAAR. The isolated step must still be characterised by one of the tainted elements. Isolation is also necessary to prevent taxpayers from inserting steps with a tax saving effect into commercial transactions. In this regard it can be stated that in the context of the South African GAAR the isolation of a single step in a composite transaction does not necessarily lead to an unfair result for taxpayers because all the conjunctive elements of the GAAR would still need to be established. In other words, the tax saving step of a transaction may be isolated and be alleged to have a sole or main purpose of tax avoidance but this would be insufficient to have the step impugned. The step would still need to satisfy the basic elements of the GAAR, and have at least one of the tainted elements. Where the step contains a tainted element there should be no consideration of unfairness in isolating it, because any tax avoidance achieved through means that fit the tainted criteria is inherently impermissible.10

There are, however, certain instances where isolating a part of a composite transaction would change the character of the isolated part altogether. Broomberg describes this situation as follows:

Unfortunately, the new definition of ‘arrangement’ does not address certain questions that have already arisen in the jurisdictions from which the wording of this new definition was borrowed. Can the

9 SARS Guide 25.
10 The isolation of a part of a composite transaction is thus not as contentious in South Africa as it is in Australia under Part IVA of the Income Tax Assessment Act of 1936 that functions on a fundamentally different basis. In Australia, purpose is central to the application of the GAAR and a dominant purpose, objectively determined, would result in the GAAR being invoked. Isolating one step, which is always the tax saving step, means that a taxpayer cannot rely on the purpose of the composite transaction as a whole to defend the step. Since tax avoidance is usually pursued in a tax avoidance transaction, the taxpayer may be placed at a disadvantage. As stated above, in South Africa purpose is insufficient, which makes the isolation of a single step less contentious. The Australian GAAR and this issue will be discussed in more detail in the next Chapter.
Commissioner apply the provisions of this Part to steps in or parts of an arrangement when the step or part so selected loses commercial substance when considered in isolation?  

This could be prejudicial to taxpayers, and where the character of an isolated part changes, the courts must deem such isolation to be impractical and revert back to analysing the composite transaction as a whole, not just the part. Section 80G(2) states that “[t]he purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole”. This means that a transaction with a commercial or other non-tax purpose cannot be used to disguise a step with a tax avoidance purpose. However, if the character of the step changes by being analysed separately as the GAAR sanctions, there must be provision for the isolated step to be viewed in the light of the composite transaction as a whole.

Agreements and understandings are also included in the definition of arrangement, which means that written or oral agreements suffice. It does not matter whether the transaction is enforceable or not. This is probably directed at transactions where the parties do not appear to have the rights conferred when in actual fact they do. It is therefore not a defence to argue that the transaction is not legally enforceable.

The extent to which an arrangement is defined and provided for in the GAAR shows the verbose nature of the GAAR. It can be argued that the extent to which a mere arrangement is defined causes unnecessary complexity in the GAAR. This is because if the whole GAAR is to be taken into context, an arrangement must result in a tax benefit. This then means that an arrangement is the action the leads to a tax benefit. Without a tax benefit being obtained, SARS will not bother to look at any arrangement, which means that the tax benefit is really what triggers the determination of the arrangement. It is submitted that the provisions that define an arrangement can be replaced by a provision that defines an arrangement as the action that leads to a tax benefit.

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12 See SARS Guide 14 for examples of such arrangements.
13 Broomberg (2007) 131. Broomberg partly supports this contention stating that “it is difficult to conceive how any question of a tax benefit could arise without there being a transaction. Certainly there do not appear to be any reported cases in which it was even argued that the Commissioner should fail on the ground that there was no transaction, operation or scheme”. However, he notes that the definition of arrangement is important in that it identifies the act which the Commissioner has sought to disregard by invoking the GAAR.
2.1.2 Tax Benefit

For an arrangement to constitute an avoidance arrangement, a tax benefit must be obtained from the arrangement. In terms of section 80L, a tax benefit is defined as “any avoidance, postponement or reduction of any liability for tax”.\(^\text{14}\) In terms of section 80F the Commissioner is empowered to treat parties that are connected as one, and to either disregard tax-indifferent or accommodating parties or treat them the same as other parties. The effect of this section is to ensure that a taxpayer cannot circumvent the application of the GAAR by redirecting tax benefits to another. The burden of proving that a tax benefit has been obtained lies with the Commissioner. However, the presence of a tax benefit should not be difficult to prove since its presence in the avoidance of tax is one of the main instigators of an investigation into the applicability of the GAAR.

Section 80C(1)(1) deals with certain tax benefits that are linked to the general commercial substance test and states that:

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

This section means that a transaction that is challenged on the basis of a lack of commercial substance must have produced a significant tax benefit without having a significant impact on the taxpayer’s business operations, or profit, or income, excluding the commercial or financial impact of the tax benefit. The phrase “but does not have a significant effect” means that the economic or financial value of the avoidance arrangement, when taken in isolation without the tax benefit, must be insignificant. This section targets transactions that do not have any business purpose apart from the business benefits of the tax benefit.

However, the term “significant” is not defined. From the wording of the section it can be stated that “significant” means that when compared with the impact the arrangement has on the taxpayer’s financial position and business the tax benefit is such that it can be said that the taxpayer entered into the transaction for the purpose of obtaining the tax benefit. The SARS Guide states that the word “significant” should be determined by reference to the dictionaries which define the term as meaning something; “extensive enough to merit

\(^{14}\) See generally Smith v CIR 1964 (1) SA 324 (A) for a definition of avoiding liability.
attention”, “meaningful”, “important”, or “noteworthy”. This would mean that the tax benefit must “merit attention” or meaningfully surpass all the other effects of the transaction in terms of impact on the taxpayer’s operations or financial position. It can be argued that the word “significant” is unnecessary because section 80C(1)(1) can work without it. The enquiry should not be whether the tax benefit is significant, it should rather be based on whether the tax benefit(s) when viewed in the light of the non-tax impact of the transaction on the business or financial affairs of the taxpayer, gives rise to an inference that the transaction was entered into for the tax benefits.

2.1.3 Purpose

Section 80A starts by stating that “an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit”. It is therefore crucial to determine an arrangement’s purpose to determine whether it is an impermissible avoidance arrangement. A sole or main purpose to obtain a tax benefit is rebuttably presumed in terms section 80G(1), which states as follows:

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

In terms of section 80A it is the purpose of the avoidance arrangement, not of the taxpayer in question which will be determined. This means that the determination of purpose is objective and not subjective, because the facts surrounding the avoidance arrangement will be considered. When trying to rebut the presumption of purpose, the taxpayer is directed by section 80G(1) to refer to the “relevant facts and circumstances”. The taxpayer’s individual and subjective submissions will thus be considered only if they are corroborated by the facts and the circumstances. In line with the GAAR’s position regarding steps in a composite transaction, the purpose of a single step in a composite transaction can be different from the purpose of the composite transaction. The objective determination of purpose in the GAAR can be said to be an improvement on section 103(1) because this determination may be

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15 SARS Guide 18.
16 This approach is thus different from the one under section 103(1) described in CIR v Gallagher 1978 (2) SA 463 (A) 471 where it was stated that “if the subjective approach be adopted (as it must) then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of the respondent, the progenitor of the scheme, as to why it was carried out”.
17 Section 80G(2).
helpful in regulating the extent to which taxpayers in commercial arrangements can seek tax benefits; which was something that section 103(1) did not do properly. If a commercial arrangement is surrounded by facts and circumstances that show that its main purpose was to obtain a tax benefit, the court will ascribe a tax purpose to it in spite of its commercial aspects.

“Sole or main” is not defined, but it is submitted that there is no need for these terms to be defined. An arrangement will have a sole or main purpose to obtain a tax benefit if obtaining the tax benefit is the only or major purpose. Main purpose does not necessarily mean more than half of the purpose, a lesser measure can qualify as the main purpose if it is more dominant than the others.18

2.2 The Tainted Elements in the Context of Business

An avoidance arrangement is not impermissible and not subject to the GAAR unless it is characterised by any one of the tainted elements identified earlier and discussed below. The Commissioner must prove that an avoidance arrangement contains one of the tainted elements. Sections 80C to 80E contain guidelines and definitions (which are not exhaustive) that the Commissioner can rely on to prove the elements.

2.2.1 Normality for Business Purpose

In terms of section 80A(a)(i) an avoidance arrangement is impermissible where it was entered into or carried out in a manner that would not normally be employed for bona fide business purposes, apart from obtaining a tax benefit. This provision was retained from section 103(1), and the analysis done on it in the previous Chapter will not be repeated here. The reference to the first tainted element in a business context as a business purpose test in the section should not be confused with the business purpose doctrine in the US, and the question is not whether the transaction has a commercial or business purpose.19 Rather, this tainted element looks at the means employed in the arrangement. The enquiry here is whether or not the transaction was entered into or carried out in a manner that would be normally carried out for bona fide business purposes, other than to obtain a tax benefit. If the answer is in the negative, then the arrangement is an impermissible avoidance arrangement. As was noted in the previous chapter, “normal” is not defined, which means reliance is placed on the courts to determine

18 Also see SBI v Lourens Erasmus (Edms) Bpk 1966 (4) SA 434 (A).
19 This doctrine will be discussed extensively in Chapter 8.
what is normal for *bona fide* business purposes. This can lead to inconsistent judicial
decisions and standards that can limit the efficacy of the GAAR. It is submitted that regarding
abnormality in a business context, the legislature failed to rectify the problems in section 103(1) by providing sufficient guidance on what this indicator means.

Section 80A(a)(i) seems to acknowledge that in business a tax purpose is a business purpose
since tax affects profits and is considered when making decisions to conduct certain business.
By excluding tax purposes from *bona fide* business purpose, this element effectively
precludes a taxpayer from arguing that the manner adopted in the arrangement is normal
considering the tax benefits to be obtained. The exclusion of tax purpose prevents the GAAR
from defeating itself, by barring taxpayers from arguing that tax benefits amount to business
purpose in defence against a GAAR that seeks to deny the very same tax benefits.

### 2.2.2 Commercial Substance

The second alternative tainted element in a business context, is the lack of commercial
substance. It is contained in section 80C(1) and (2) of the Act. This element is a novelty in
South African GAAR jurisprudence. Section 80C(1) has been referred to already regarding
its impact on the tax benefits obtained. To be safe from section 80C(1), an arrangement must
show that its commercial or economic benefits are larger than the tax benefits of an
arrangement, and that it would have existed without the tax benefit. Thus, a transaction lacks
economic substance if it would result in a significant tax benefit for a party, whilst at the
same time having no significant impact on the business or net cash flows of that party
excluding the impact the tax benefit has. The commercial substance test is strikingly similar
to the economic substance doctrine used to disregard impermissible tax avoidance in the
US.\(^{20}\) It remains to be seen how the courts will determine the meaning of the term
“significant” in relation to the establishment of commercial substance. Does it mean that an
arrangement cannot be said to lack commercial substance if its tax benefit is not significant?
It is submitted that regarding commercial substance (not tax benefit as before), the provision
should have excluded the term “significant”, because it is unnecessary. It is enough if the test
simply states that the arrangement confers tax benefits that are greater than any other business
or financial effects on the taxpayer.

\(^{20}\) This doctrine is discussed extensively in Chapter 8.
Section 80C(2) contains indicators of a lack of commercial substance that are not exhaustive. These indicators are identified as follows:

[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 section 80D; or

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

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

The SARS Guide\(^{21}\) states that a transaction will generally lack economic substance if there is a “disproportionate relationship between the actual expenditure or loss incurred by a party and the value of the tax benefit that would have been obtained by that party but for the provisions of the GAAR; or a loss claimed for tax purposes that significantly exceeds any measurable reduction in that party’s net worth”. It does not refer to the significance of the tax benefit.

2.2.2.1 Section 80D: Round Trip Financing

The presence of round trip financing can indicate an arrangement’s lack of commercial substance. Round trip financing exists where funds are transferred between the parties in an avoidance arrangement, and the effect of the transfer results in the obtaining of a direct or indirect tax benefit and in significant reduction, or outright elimination, of any business risk incurred by any party involved in the avoidance arrangement. The SARS Guide\(^{22}\) notes that round trip financing is a broad concept that is similar to “circular cash flows” in the US, and “round trip financing” in Australia. These concepts entail arrangements with circular financial transfers that in actual fact pose no financial risk to the participants in the arrangement. Lord Wilberforce in *WT Ramsay v Inland Revenue Commissioners* described round trip financing as follows:

Although sums of money, sometimes considerable, are supposed to be involved in individual transactions, the taxpayer does not have to put his hand in his pocket...The money is provided by means

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\(^{21}\) SARS Guide 26. It is noted here that when interpreting net cash flows SARS will refer to the Generally Accepted Accounting Principles (GAAP) in International Accounting Standard 7.6 that defines cash flows as inflows and outflows of cash or its equivalents.

\(^{22}\) SARS Guide 29.
of a loan from a finance house which is firmly secured by a charge on any asset the taxpayer may appear to have, and which is automatically repaid at the end of the operation.\textsuperscript{23}

This statement shows that round trip financing essentially involves the deceptive use of funds in a circular fashion between parties to an avoidance arrangement. Typically, parties do not use their own funds, so there is no real risk of loss.

\textbf{2.2.2.2 Section 80E(1): Accommodating or Tax – Indifferent Parties}

In terms of section 80E(1), a person who is party to an avoidance arrangement is an accommodating or tax-indifferent party if:

\begin{itemize}
  \item[a)] any amount derived by the party in connection with the avoidance arrangement is either
    \begin{itemize}
      \item[i)] not subject to normal tax; or
      \item[ii)] significantly offset either by an expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and
    \end{itemize}
  \item[b)] either –
    \begin{itemize}
      \item[i)] as a direct or indirect result of the participation of that party an amount that would have
        \begin{itemize}
          \item[aa)] been included in the gross income (including the recoupment of any amount) or receipts or accruals of a capital nature of another party would be included in the gross income or receipts or accruals of a capital nature of that party; or
          \item[bb)] constituted a non-deductible expenditure or loss in the hands of another party would be treated as a deductible expenditure by that other party; or
          \item[cc)] constituted revenue in the hands of another party would be treated as capital by that other party; or
          \item[dd)] given rise to taxable income to another party would either not be included in gross income or be exempt from normal tax; or
        \end{itemize}
      \item[ii)] the participation of that party directly or indirectly involves a prepayment by another party.
    \end{itemize}
\end{itemize}

In terms of section 80E(2) a person may qualify as an accommodating or tax indifferent party, even if he is connected to the other party in an avoidance arrangement beforehand. It is thus not a defence to argue that the parties have always been commercially connected and were not brought together by the avoidance arrangement in question.

Section 80E(3) provides for the exclusion of certain parties that would otherwise be said to be accommodating or tax-indifferent. A party that is subject to a comparable foreign income tax is not accommodating or tax-indifferent if the funds derived by this party are subject to income tax in another jurisdiction of at least two thirds of the normal tax that would have

\textsuperscript{23} [1982] AC 300 322.
been levied in terms of the Act. The party will accordingly not be accommodating or tax-
indifferent because the foreign tax that is comparable to the normal tax levied in South Africa
will neutralise the tax benefits.

Further exclusion is extended to parties that are engaged in active trading activities. To
qualify for this exclusion a party must continue to engage directly in substantial and active
trading activities linked to the avoidance arrangement for a period not less than 18 months. If
the party is located outside South Africa, and the party to the avoidance arrangement is a
controlled foreign company, this exclusion is subject to the fact that the activities must be
attributable to a place of business, site, agricultural land, vessel, vehicle, rolling stock, or
aircraft that would constitute a foreign business establishment as defined in section 9D(1) of
the Act. Parties that perform a transitory role in the avoidance arrangement cannot qualify for
this exclusion.\(^{24}\)

2.2.2.3 Section 80C(2)(b)(iii): Offsetting and Cancelling Elements

The last listed indicator of a lack of commercial substance is the presence of elements that
effectively offset or neutralise other aspects of the avoidance arrangement. This provision is
primarily targeted at avoidance arrangements that involve complex financial derivatives that
create a gain in one leg of the arrangement, and a loss in the other to neutralise the tax
implications. There is nothing wrong with obtaining tax relief from losses or expenditure
incurred but the GAAR will be applied to transactions that create losses or expenditure for
the purposes of neutralising gains made earlier. The provision does not specify whether the
neutralising effect of certain parts of the arrangements should be deliberate. However, it is
clear that there must be an intention to create losses and gains that neutralise each other to
obtain a tax benefit. The provision was inspired by a UK precedent in \(WT\ Ramsay Ltd v IRC,
Eilbeck (Inspector of Taxes) v Rawling\)^{25} where the fiscal nullity doctrine was established. In
terms of this doctrine, a transaction in which the gains subject to tax are artificially
neutralised is a fiscal nullity and thus amounts to impermissible tax avoidance.\(^{26}\)

\(^{24}\) SARS Guide 33.
\(^{25}\) [1981] 1 All ER 865.
\(^{26}\) This doctrine will be discussed in greater detail in Chapter 9.
2.2.3 The Creation of Abnormal Rights or Obligations

This is the third tainted element in the context of a business and it also applies in any context other than business. In terms of section 80A(c)(i), an avoidance arrangement is abnormal if “it has created rights or obligations that would not normally be created between persons dealing at arm’s length”. The abnormality test is identical to the one under section 103(1) because the facts and circumstances surrounding the arrangement will be analysed when the normality of the arrangement is being established. The test here is whether or not the rights or obligations created in the avoidance arrangement conform to the rights or obligations that would have been created in a fictional normal transaction. This means the decision in Hicklin v SIR is still authoritative regarding the test for abnormality.

Section 80A(b) provides for another abnormality test in a context other than business. In terms of this sub-section, an avoidance arrangement is impermissible if it is carried out in a way that would not be carried out for bona fide purposes other than obtaining a tax benefit. This provision is related to the one that outlaws transactions that are abnormal for bona fide business purposes, but is intended to apply to family transactions and other non-business transactions.

2.2.4 Misuse or Abuse

The fourth indicator that applies in a business context, and in any context, is misuse or abuse. In terms of section 80A(c)(ii), any avoidance arrangement that would result in a direct or indirect misuse or abuse of the provisions of the Act, including the GAAR, itself constitutes an impermissible avoidance arrangement. The concept of misuse or abuse works to deny tax benefits that are obtained in a manner that conforms to the letter of the law, but not with the purpose of the Act. It is based on a view of impermissible tax avoidance as an abuse of the provisions it uses to obtain tax benefits. In a GAAR context, this concept is new in South Africa because it was absent in both section 90 and section 103(1).

27 Explanatory Memorandum 63.
28 1980 (1) SA 481 (A) 495.
29 Cilliers “Thou Shalt not Peep at thy Neighbour’s Wife: Section 80A (c) (ii) of the Income Tax Act and the Abuse of Rights” (2008) 57 Taxpayer 85 87 states that misuse and abuse mean the same thing and that when analysing this section the presumption that every word in a provision must be given an independent meaning does not apply. He notes that “[i]n using both the word ‘misuse’ and the word ‘abuse’ the legislature merely acted ex abundant cautela”. The use of the two words can be said to be further evidence of the verbose nature of the GAAR.
2.2.4.1 Statutory Interpretation in South Africa

To analyse the misuse or abuse provision in the GAAR, a detailed discussion of statutory interpretation in South Africa is required. Statutory interpretation is critical because:

[t]he fact that a certain subject is dealt with by legislation does not mean that there is now clarity regarding that subject… Language can be ambiguous; it can be vague or it can be used too generally. To complicate matters further, the grammatical meaning of a word may differ from its legal meaning. As a result of all the above mentioned problems, certain rules have been formulated in order to facilitate the task of the interpreter to promote legal certainty.

In South Africa, the interpretation of statutes is governed by two broad approaches, namely the modern approach and the traditional approach. The traditional approach is characterised by intentionalism and literalism, while the modern approach is characterised by purposivism and contextualism. In the traditional approach, literalism is where the true meaning of a statutory provision is construed with reference to nothing but its wording. The words of the provision are paramount, regardless of the absurdity that may result. Intentionalism states that the meaning of a provision must be determined in accordance with the intention behind it, and therefore the intention of the legislature in enacting the provision in question is paramount. In the modern approach, purposivism requires that the purpose sought to be achieved by a provision must be determined. Contextualism is where the meaning of a provision is analysed in the context within which it appears.

2.2.4.2 Traditional Approach – Literalism

The basic rule for the interpretation of statutes is that where the plain wording of a provision is clear and unambiguous, it must be applied as it is. The interpreter must concentrate on the

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30 Statutory interpretation is an important aspect in determining the meaning of legislation in general. Kellaway *Principles of Legal Interpretation: Statutes, Contracts and Wills* (1995) 3 notes that the meaning of laws has been a source of contention for lawyers for a long time, and that to this day legal interpretation and the meaning of the words used in statutes causes debates in courts. In the context of tax legislation, statutory interpretation has been said by Goldswain “The Purposive Approach to the Interpretation of Fiscal Legislation – The Winds of Change” (2008) 16 2 Meditari Accountancy Research 107 107 to be “the cornerstone on which the revenue authorities can assess and collect taxes and correspondingly, the foundation on which a taxpayer’s rights are built”.

31 Van Heerden and Crosby *Interpretation of Statutes* (1996) I. These authors at 5 define statutory interpretation as “the rules, principles, methods and techniques available to the interpreter” that enable the interpreter “to understand and apply the legislation”.


33 This approach and the basic rule of interpretation were introduced in South Africa in *De Villiers v Cape Division Council* 1875 Buch 50. In *Principal Immigration Officer v Hawabu* 1936 AD 26 it was stated that
literal meaning of the provision in question. In its purest form, literalism requires the meaning of a provision to be deciphered from the *ipsissima verba* in which it is found, with no consideration of the unjust or absurd consequences that may arise.\(^{34}\) An exception to this rule exists where applying the general rule would lead to an absurdity so obvious that it cannot be said to have been contemplated when enacting the provision.\(^{35}\) When this absurdity arises, the intention of the legislature must be determined. However, it has to be understood that “it is dangerous to speculate on the intention of the legislature... and the court should be cautious about departing from the literal meaning of the words of a statute...Moreover it is not the function of the court to supplement a statutory provision...”\(^{36}\) Botha notes that the literal approach was common in legal systems where English law had influence and that certain factors led to the acceptance of literalism in England.\(^{37}\) These factors entail:

1. The separation of powers and the supremacy of parliament led to the acceptance of the notion that the will of parliament was manifest in the words of the legislation, and that the role of the courts was confined to the interpretation and application of the legislature’s will.
2. Legal positivism and the positivist notion that a state’s decree is law. In this regard the function of the court is confined to interpreting the law as it is decreed, not as it should be decreed.
3. Legislation in England was believed to be precisely drafted to create legal certainty and to cater for a plethora of possible future cases. According to Botha, the maxim that “the legislature has prescribed everything it wishes to prescribe is derived from this approach”\(^{38}\).

The literal approach is therefore based on the notion that the words in the provisions in question are predominant, and that the intention behind the words is synonymous with the

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\(^{34}\) Du Plessis *Re-Interpretation of Statutes* (2002) 93. One of the justifications for strict literalism is the need to stop judges from making law through statutory interpretation. This was observed by Van den Heever JA in *Sachs v Donges* NO 1950 (2) SA 265 (AD) 312, where he stated that “[j]udges while purporting to expound and apply the law sometimes make law in the process”. Also see, generally, Cockram *Interpretation of Statutes* (1975) 1 – 14.

\(^{35}\) *Venter v Rex* 1907 TS 910. A classic example of literalism leading to absurd consequences and requiring a wider ascertainment of legislative intent can be found in the case *Geldenhuys v CIR* 1974 (3) SA 256 (C) where “received by” in the definition of gross income in section 1 of the Act was interpreted as meaning received by the taxpayer on his own behalf and for his own benefit. If this phrase were given a literal grammatical meaning it would have absurd consequences, such as loans being received for tax purposes.

\(^{36}\) *Summit Industrial Corporation v Jade Transporters* 1987 (2) SA 583 (A) 596 597.


\(^{38}\) Botha (2012) 92.
literal, plain, and grammatical meaning of the words.\textsuperscript{39} This was reflected in \textit{Engels v Allied Chemical Manufacturers (Pty) Ltd.},\textsuperscript{40} where the court noted that “[t]he rules of construction of Acts of Parliament...clearly state that they must be construed according to the intention of the legislature expressed in the Acts themselves. One consequence of this rule is that a statute may not be extended to meet a case for which provision has clearly and undoubtedly not been made”.

The literal approach has certain limitations, as is evidenced by the fact that it is subject to modification if it leads to absurd consequences. This appears to be an admission that seeking only the ordinary, plain, and grammatical meaning of words in a provision may lead to absurd results. Other criticisms that can be levelled against literalism entail:

1. The elevation of words and their literal meaning to legislative intent blocks reference to other internal and external factors that can aid statutory interpretation. The fact that a contextual meaning will only be sought where the textual meaning is absurd or ambiguous, means that the interpreter is denied the benefit of other valuable aids to interpretation.
2. The literal approach in equating legislative intent to the plain meaning of the words in the legislation renders legislative intent dependant on the clarity of the words used in the legislation.
3. Literalism does not take cognisance of the fact that very few words and texts are clear and unambiguous. Du Plessis notes that no matter how clear it is, language is not infallible, and the meaning that can be deciphered from the act as a whole may be more desirable than the meaning deciphered from the words of a single provision.\textsuperscript{41} Botha notes that “[t]he mere fact that a discipline such as interpretation of statutes exists would by implication suggest that legislation is seldom clear and unambiguous”.\textsuperscript{42}

\textsuperscript{39} Also see Van Heerden and Crosby (1996) 9 – 17.
\textsuperscript{40}1993 (4) SA 45 (Nm) 53. In cases such as \textit{Union Government v Mack} 1917 AD 731 and \textit{Farrar’s Estate v CIR} 1926 TPD 501 the courts noted that to determine the intention of the legislature the plain meaning of the words in the provision in question had to be found. An inference that can be drawn from these cases is that where the legislature had a certain intention it would automatically be reflected in the plain meaning of the words of the legislation.
\textsuperscript{41} Du Plessis (2002) 93.
\textsuperscript{42} Botha (2012) 94. Also see Van Heerden and Crosby (1996) 16 -17.
These limitations necessitate a mode of statutory interpretation based on the modern approach.43

2.2.4.3 Literalism in Tax Statutes and Tax Avoidance

Despite its deficiencies, the literal approach was used in interpreting tax legislation.44 In this approach to tax legislation, the courts indicated that a person could only be taxed if “he comes within the letter of the law… however great the hardship may appear to the judicial mind to be” and that in interpreting tax legislation one should “simply adhere to the words of the statute”.45 In South Africa, the literal approach to interpreting tax legislation followed the same literal style. In CIR v Delfos, Wessels CJ stated as follows:

I do not think we are justified in rejecting the plain meaning of the words “received by or accrued to” merely on that account. We have no right whatsoever to strain the language of the statute in favour of the taxpayer merely because in hypothetical cases double taxation may occur. The principle of interpretation laid down by Lord Cairns in Partington v Attorney General 21 LT 370 375 and accepted by this court in George Forest Timber Co is a sound principle.46

As in other legislation, literalism restricts the meaning of tax legislation to the plain meaning of the words used. The question follows whether an approach as restrictive as literalism is the correct way of interpreting tax legislation in particular. Some of the justification for literalism is that legislation is detailed and caters for future developments, and that literalism creates legal certainty. However, literalism can allow taxpayers to avoid tax impermissibly by

43 Devenish Interpretation of Statutes (1992) 26 notes that literalism has persisted in South African law and while it has been given some quietude, it still exists in the guise of intentionalism. Cases that illustrate the persistence of the literal approach include Public Carriers Association v Toll Road Concessionaries (Pty) Ltd 1990 (1) SA 925 (A) 934 where Sandberger JA noted that even though the legislature’s intention was the primary interpretation rule, “it must be accepted that the literal interpretation rule is firmly entrenched in our law and I do not seek to challenge it”. In Swanepoel v Johannesburg City Council 1994 (3) SA 789 (A) 794 the court noted that the rules of statutory interpretation assist in determining the true intention of the legislature and “[w]here this intention is proclaimed in clear terms either expressly or by necessary implication the assistance of these rules need not be sought”.

44 Emslie, Davis, Hutton, and Olivier Income Tax Cases And Materials (2001) 16 note that “the literal meaning approach to the interpretation of statutes is, however, at best a convenient fiction; it is naïve to believe that statutes can be interpreted literally”.

45 Partington v Attorney General 21 LJ 370 375. The same sentiments were expressed in Cape Brandy Syndicate v IRC (1921) 1 KB 64 71 where Rowlatt J noted that “[i]n a taxing Act one has to look merely at what is clearly said. There is no room for any intention. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used”.

46 1933 AD 242. A number of South African cases followed the literal style of interpretation in Cape Brandy Syndicate v IRC and Partington v Attorney General. These cases entail the following; CIR v George Forest Timber 1924 AD 177 185; CIR v Wolf 1928 AD 177 184 – 185; New Era Consolidated Ltd v CIR 1951 (3) SA 211 (T) 215; McNeil v CIR 1958 (3) SA 375 (D&CLD) 377; Emary v CIR 1960 (4) 641 (D & CLD) 643 and CIR v Frankel 1949 (3) SA 733 (A) 738.
creating artificial methods that ensure that their transactions fall outside or inside the literal scope of the legislation. A mode of interpretation that only gives cognisance to the plain meaning of the words in legislation would consequently create opportunities for impermissible tax avoidance.

2.2.4.4 The Modern Approach – Purposive Interpretation

The purposive interpretation method is not a direct opposite of literalism, it is a much deeper analysis of the legislation in question in order to ascertain its meaning. In terms of the purposive approach, the purpose or object of the legislation is the central issue in interpreting the legislation. The context in which the legislation exists, which entails the social and political policy factors, are useful in ascertaining the purpose behind the legislation. In purposive interpretation, the context in which the legislation operates is to be determined from the start, and is not to be limited to instances where the literal meaning of the legislation is absurd or ambiguous. In purposive statutory interpretation, a balance between the ordinary grammatical meaning of a provision and its contextual meaning is struck.

In *Jaga v Dönges NO and Another*, Schreiner JA explained the purposive interpretation process and stated that the interpreter can put a provision’s context into consideration together with its text. Schreiner JA also stated that the context of a provision is important whether or not the provision’s grammatical meaning is clear or unambiguous, and in some

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47 It does not necessarily follow that literalism amounts to the outright promotion of impermissible tax avoidance. Goldswain (2008) 109 notes that the fact that equity and fairness do not have any role in literalism means that literalism generally favours the *fiscus*. Goldswain also notes that the court decisions in which literalism was the preferred approach produced varying results for taxpayers and the *fiscus*. For instance the taxpayer benefited in *CIR v Lunnon* 1924 AD 94 where a payment that was directly linked to the services rendered by the taxpayer, was held not to be taxable because it was voluntary. Williams *Income Tax in South Africa Cases and Materials* (2005) 149 notes that the decision was wrong because the court failed to recognise that a payment for services rendered is inherently income in nature. The Commissioner benefited from a literal approach in *Ochberg v CIR* 1931 AD 215; 5 SATC 93. In this case a taxpayer was remunerated by means of additional shares in a company he already fully owned. This meant that his economic position did not change at all despite the additional shares. The court, however, held that the shares had to be valued objectively and the taxpayer was taxed on the value. In a minority judgment, Stratford JA at 118 stated that the Income Tax Act contained nothing “which compels us to designate as income something which every principle of reason and common sense tells us is nothing of the sort”. Wessels JA stated that the purpose of the Act was to tax income and not capital. If it was to be assumed that the taxpayer had earned nothing else apart from the shares, which in his hands were basically worthless, taxing him would result in him having to use his own capital to discharge the tax obligation imposed, which was against the purpose of the Act. These cases show that literalism does not always favour the taxpayer and disadvantage the *fiscus*.

48 Botha (2012) 98.

49 According to Botha (2012) 98, statutory interpretation is incomplete if there is no such balance. Botha also notes that this balance ensures that the intricacies of language and the internal and external aids to interpretation are considered in finding a holistic meaning of the legislation.

50 1950 (4) SA 653 (A)
circumstances such context is more important than the text of the provision.\textsuperscript{51} Once the text and context has been ascertained, the court has a duty to apply the provision as interpreted whether or not the court as interpreter has a different opinion regarding the intention of the legislature. Botha states that the approach in \textit{Jaga v Dönges} was one of the first steps towards purposive interpretation.\textsuperscript{52}

It is therefore clear that in purposivism the role of the court is more flexible and active, and not as mechanical as it is in literalism. The law-making discretion of the court is more prominent in purposivism because of the processes involved. Botha\textsuperscript{53} notes that this discretion is qualified by the requirement that the adjustment of the textual meaning is only admissible where the scope and purpose of the legislation is certain, and actually in agreement with such adjustment. This means that the court’s law-making through textual adjustment is “merely a logical extension of the powers of the court during the interpretation and application of the relevant legislation in each practical instance” and does not amount to an encroachment into the legislature’s powers.\textsuperscript{54}

The 1996 Constitution also supports the modern approach to the interpretation of all legislation, including tax legislation. In terms of sections 1, 2, and 8 the Constitution is superior to all South African law. Sections 39(1) and (2) of the Constitution state as follows:

39. Interpretation of Bill of Rights.

(1) When interpreting the Bill of Rights, a court, tribunal or forum –

(a) must promote the values that underlie an open and democratic society based on human dignity, equality and freedom;

(b) must consider international law; and

(c) may consider foreign law.

(2) When interpreting any legislation and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.

By directing the interpretation of all legislation to follow constitutional standards, section 39(2) effectively requires legislation to be interpreted with reference to the modern approach,

\textsuperscript{51} University of Cape Town v Cape Bar Council 1986 (4) SA 903 (A).

\textsuperscript{52} Botha (2012) 99.

\textsuperscript{53} Botha (2012) 99.

\textsuperscript{54} Botha (2012) 99. Kellaway (1995) 13 notes that in statutory interpretation, advancing the meaning of a provision amounts to stating the law whether a purposive (extended) meaning or a literal (restricted) meaning is advanced. It is stated that this process is not equivalent to law making but giving meaning to it and that in ascertaining meaning the courts have reiterated that “judges are to state the law not make it” as expressed in the term \textit{judices est jus dicere non facere}.
even though it does not expressly prescribe this approach.\textsuperscript{55} This is because prior to the interpretation of a statutory provision, section 39(2) compels the interpreter to “promote the spirit, purport and objects of the Bill of Rights”. In so doing, the interpreter effectively considers external issues before ascertaining the text of the provision. The Constitution is at the top of the factors that have to be considered before legislation is interpreted. In \textit{Matiso v Commanding Officer, Port Elizabeth Prison}\textsuperscript{56} it was stated that the discovery of the intention of the legislature does not apply in a system where the Constitution is supreme, because “the Constitution is sovereign and not the legislature”. Therefore, the central principle of statutory interpretation is to give effect to the legislature’s intention in light of the Bill of Rights in the Constitution. This principle is applicable to all legislation.\textsuperscript{57} In \textit{Glen Anil Development Corporation v SIR},\textsuperscript{58} it was stated that “there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation”. This means that tax statutes are required to be interpreted purposively and contextually.

\subsection{2.2.4.5 Purposivism in Tax Legislation}

One of the first cases to advance purposivism in tax legislation was \textit{Glen Anil Development Corporation Ltd v SIR}. Similarly, Nicholas AJA in \textit{CIR v Ocean Manufacturing Ltd}\textsuperscript{59} noted that “s 103(2) should be construed in such a way as to advance the remedy provided by the section and suppress the mischief against which it is directed. The Commissioner’s powers should not be restricted unnecessarily”. In these two cases, the court relied on another aid in establishing statutory purpose – the mischief rule, which was laid down in \textit{Heydon’s Case}\textsuperscript{60}

\begin{itemize}
\item \textsuperscript{55} Van Schalkwyk and Geldenhuys (2009) 178 and Botha (2012) 99-105. In \textit{Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism} 2004 (4) SA 490 (CC) pars 72, 80 and 90 Ngcobo J noted that the starting point in statutory interpretation is the Constitution and the legislation must be interpreted purposively in order to advance Constitutional values and to promote the spirit, object and purport of the Constitution. He also stated that “the emerging trend in statutory construction is to have regard to the context in which words occur, even where the words to be construed are clear and unambiguous”.
\item \textsuperscript{56} 1994 (4) SA 592 (SE) 597.
\item \textsuperscript{57} A rule in the interpretation of tax legislation that seems to be congruent with the values in the Constitution as submitted by Goldswain (2008) 116 is the \textit{contra fiscum} rule. This rule is part of the broader concept that a legislative provision that affects the rights of an individual must be interpreted in a manner that favours the individual if it is ambiguous because the intention of the legislature is to preserve individual rights as much as possible. In \textit{Hulett and Sons Ltd v Resident Magistrate, Lower Tugela} 1912 AD 760 764 Innes CJ noted that “[t]he question is not free from doubt; but in a taxing statute the proper course is, in cases of doubtful construction, to give the benefit of the doubt to the person sought to be charged”. The \textit{contra fiscum} rule was applied in \textit{Israelsohn v CIR} 1952 (3) SA 529 (A) 540; \textit{IRC v Ross and Coulter and Others (Bladnoch Distillery Co Ltd)} [1948] 1 All ER 616 625 and \textit{Shell’s Annandale Farm (Pty) Ltd v CIR} 62 SATC 97.
\item \textsuperscript{58} 1975 4 SA 715 (A) 727.
\item \textsuperscript{59} 1990 (3) SA 610 (A) 617.
\item \textsuperscript{60} (1584) 3 Co Rep 7a (76 ER 637). See par 3.2.3 in Chapter 4 for the specific elements of the mischief rule.
\end{itemize}
by Lord Coke. The mischief rule as applied in tax cases favours a purposive interpretation of the tax legislation in question, and its use in tax avoidance cases signalled a shift to purposivism.

Purposivism was also advanced in other cases that made use of other extrinsic aids to statutory interpretation. In *CIR v Nemojim (Pty) Ltd* Corbett JA noted:

> It has been said that “there is no equity about a tax”. While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the *fiscus*. And it may be fairly inferred that such a result is in conformity with the intention of the legislature.\(^{61}\)

Apart from these historical cases illustrating purposivism in tax legislation, a series of recent cases also shows that the modern approach to the interpretation of tax statutes in particular is already well established. These are *DeBeers Marine (Pty) Ltd v CSARS*,\(^{62}\) *Standard General Insurance Company Ltd v CCE*,\(^{63}\) *CSARS v Airworld and Another*\(^{64}\) and *Metropolitan Life Ltd v CSARS*.\(^{65}\)

### 2.2.4.6 Criticism of Purposivism

The purposive interpretation of statutes is favoured on the premise that it requires a wider analysis than literalism. This is believed to be helpful in finding the purpose behind the legislation. It can however be argued that the mere fact that purposivism is more comprehensive than literalism does not mean that it finds the purpose of the legislation all the time. This is because while it is true that statutory interpretation “requires more than merely reading the provisions”,\(^{66}\) the interpretation of statutes remains, in essence, “the juridical understanding of legislation”.\(^{67}\) In *Corocraft Ltd v Pan American Airways Inc* it was stated that in statutory interpretation;

> [J]udges do not act as computers into which are fed the statutes and the rules for the construction of statutes and from which issue forth the mathematically correct answer. The interpretation of statutes is a craft as much as a science and the judges, as craftsmen, select and apply the appropriate rules as to

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\(^{61}\) 1983 (4) SA 935 (A) 958.
\(^{62}\) 2002 (3) All SA 181 (A).
\(^{63}\) 2004 (2) All SA 376 (SCA).
\(^{64}\) 2008 (2) All SA 593 (SCA).
\(^{65}\) 70 SATC 162.
\(^{66}\) Botha (2012) 5.
\(^{67}\) Botha (2012) 4.
the tools of their trade. They are not legislators, but finishers, refiners and polishers of legislation which comes to them in a state requiring varying degrees of further processing. 68

This means that the courts in interpreting legislation and ‘finishing’, ‘refining’ or ‘polishing’ it may end up with a meaning not exactly intended by the legislature, whatever mode of interpretation is used. Botha 69 notes that the law is not necessarily neutral, objective, or value-free. Interpreters have a pre-conceived notion of what the legislation entails, and such pre-understanding is the effect of each interpreter’s history, background, experience, and prejudices, which means that interpretation essentially entails value judgment. This shows that what is statutory purpose to one, may not necessarily be statutory purpose to another. The end result is that purposivism does not necessarily lead to unanimity on the purpose of a particular provision. 70

The wide analysis required in purposivism requires reference to be made to internal and external pointers of purpose which may not be available or analysed by the average citizen. In Pepper v Hart, Oliver LJ of Aymerton noted as follows:

A statute is after all, the final and complete intimation to the citizen of a particular rule of law which he is enjoined, sometimes under penalty, to obey and by which he is both expected and entitled to regulate his conduct. We must therefore, I believe, be very cautious in opening the door to reception of material not readily or ordinarily accessible to the citizen whose rights and duties are to be affected by the words in which the legislature has elected to express its will. But experience shows that language...and particularly language adopted or concurred in under the pressure of a tight parliamentary timetable...is not always a reliable vehicle for the complete or accurate translation of legislative intention; and I have been persuaded...that the circumstances of this case demonstrate that there is both the room and necessity for a limited relaxation of the previously well settled rule which excludes reference to parliamentary history as an aid to statutory construction. 71

70 This submission can be substantiated by referring to COT v Ferera 1976 (2) SA 653 (RAD) and CIR v King 1947 (2) SA 196 (A) discussed in Chapter 4. Macdonald JP in COT v Ferera described tax avoidance as an evil, which probably indicated his pre-understanding of tax avoidance. This pre-understanding could have contributed to his interpretation of the GAAR as a wide remedy against tax avoidance. This can be contrasted with the approach in CIR v King where the court had a pre-understanding that not all instances of tax avoidance were impermissible. This probably contributed to the court in King stating that the purpose of the GAAR was to curtail impermissible tax avoidance, and not all incidents of tax avoidance. Nevertheless, it can also be argued that literalism does not also always lead to unanimity on the meaning of tax legislation. This was illustrated by Schreiner JA in Savage v Commissioner 1951 (4) SA 400 (AD) 410 who stated that “what seems clear meaning to one man may not seem clear to another… The “literal” meaning is not something revealed to judges by a sort of authentic dictionary; it is only what individual judges think is the literal meaning”.
71 [1993] 1 All ER 42 52.
It can therefore be argued that purposivism potentially renders plain statutory provisions complex and beyond the comprehension of citizens who are supposed to comply with them. In tax legislation, it means that more reliance is placed on experts whose fees are exorbitant, which in turn, makes them unavailable to ordinary taxpayers.

Another concern that can be raised about purposivism is the extent to which it may be used to extend statutory provisions. It is acknowledged that circumstances that necessitate legislation do not necessarily correspond with future circumstances where that legislation may be invoked. For instance, it has been stated that GAARS are designed on past characteristics of impermissible tax avoidance. If a transaction that has no such characteristics but is perceived to be impermissible were challenged, how would a purposive interpretation of the GAAR stretch the GAAR to curtail a novel tax avoidance transaction? Lord Denning in *Seaford Court Estates v Asher* stated that in such instances the question is “[i]f the makers of the Act had themselves come across this ruck in the texture of it, how would they have straightened it out?” This means that it will be determined whether the legislature would have outlawed such type of transaction when it created the GAAR. This however creates uncertainty and can lead to statutory provisions, especially those proscribing certain acts such as the GAAR, being overstretched in order to strike a particular transaction down.

The SARS noted that the reason behind the introduction of the “misuse or abuse” provision was to reinforce the modern approach to the interpretation of tax statutes. The misuse or abuse provision could however be superfluous, since the Constitution already requires a purposive construction of statutes and the courts have accepted purposivism in the interpretation of statutes. However, it can be noted that, in introducing the misuse or abuse provision, the legislature sought to reinforce purposivism in the interpretation of tax statutes and to negate the possibility of literalism being used again, in spite of the Constitution and the recent judicial trend favouring purposivism.

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72 This is despite the fact that it is crucial for the ordinary citizen to be able to accurately interpret legislation. In *The Charlotta* (1814) 1 Dods & Adm 387 392 Sir Walter Scott stated that “it is not competent to them [ordinary citizens] to aver in a Court of Justice that they have mistaken the law, it is a plea which no Court of Justice is at liberty to receive”.

73 (1949) 2 KB 481 499.


75 This is illustrated by Clegg “Use it or Abuse it” (2007) 21 *Tax Planning* 36 37 who notes “[i]s the section a mere judicious reminder to the judiciary that in applying the law that they must not forget to look for absurdity, ambiguity and purpose (as they already should, in any event?)”.

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2.2.4.7 Misuse or Abuse as a European Legal Concept

The *Explanatory Memorandum* states that the misuse or abuse concept was borrowed from Canada and from certain European jurisdictions. This means that the concept is intended to incorporate the abuse of law doctrine as used in certain European jurisdictions.\(^76\)

One of the jurisdictions that use the abuse of law doctrine to curb impermissible tax avoidance is Germany, where the abuse of law, or abuse of rights, is known as *Rechtsmissbrauch*.\(^77\) *Rechtsmissbrauch* is embodied in paragraphs 226 and 242 of the *Civil Code* or the *Burgerliches Gesetzbuch*.\(^78\) In terms of paragraph 226, “[t]he exercise of a right is not permitted if its only purpose consists in causing damage to another”. It has been noted that the test established by this paragraph is narrow because the exercise of a right is not proscribed where it has another purpose in addition to causing harm.\(^79\) In tax matters, a taxpayer can circumvent paragraph 226 if the transaction in question is not only purposed to avoid tax, but has other non-tax purpose. This paragraph can only apply to transactions with a sole purpose of tax avoidance and can be circumvented easily in this regard. However, it has been noted that this paragraph is rarely used, which means that its shortcomings are not commonly exposed.\(^80\)

In terms of paragraph 242, rights must be exercised in good faith. This paragraph states that “[a]n obligor has a duty to perform according to the requirements of good faith, taking customary practice into consideration”. This paragraph appears in a part of the *Civil Code* that deals with the law of obligations, which means that it only applies to cases where a

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\(^76\) For a discussion of the abuse of law doctrine in France, known as *abus de droit* see Ault and Arnold *Comparative Income Taxation A Structural Analysis* (2010) 61. Prebble and Prebble “Comparing the GAAR of Income Tax Law with the Civil Law Doctrine of Abuse of Law” (2008) 62 4 *Bulletin for International Tax* 151 158 note that in France the terms *abus de droit* is used when referring to abuse of private rights or to the avoidance of law. An avoidance of the law, they note, is more accurately represented by the term “*fraude a la loi*”. Ault and Arnold state at 61 that two major doctrines have been used in France to combat impermissible tax avoidance. The first doctrine, the *abus de droit*, allows the revenue authorities to reconstruct a transaction that simulates another transaction, or for tax purposes to disregard any transaction that has no business purpose and exists only for tax reasons. The second doctrine identified by Ault and Arnold is the “abnormal management decision” or the *acte anormal de gestion*. In terms of this doctrine, the consequences of a management decision can be disregarded where it causes fictitious expenditure or losses, blocks any income for the business, and does not serve the interests of the business. Where income is blocked, it is taxed as if it was received, and the fictitious expenses will not be allowed as deductions. In article L664 of the French *Code of Tax Procedure* or the *Livre de Procedure Fiscale* the tax administration is empowered to set aside artificial or fictitious transactions that have a sole or main purpose of avoiding tax.


contract or other legal obligation exists. The paragraph has been interpreted to be broad, and together with paragraph 226, constitute the *Rechtsmissbrauch*, which is described as the “fundamental legal principle underlying Germany’s legal system”. It applies to the German civil law in its entirety including tax law. In tax avoidance, it can be stated that a taxpayer has a duty to comply with the tax laws or to avoid tax in a manner that is consistent with good faith and in determining good faith, “customary practice” will be considered.

If *Rechtsmissbrauch* as presented above is considered in determining the application of the GAAR in South Africa, the courts will be required to determine whether the taxpayer has exercised his or her right with the sole purpose of avoiding tax (paragraph 226) and whether the taxpayer has exercised good faith in avoiding tax (paragraph 242). Paragraph 226 is however in conflict with the GAAR because the GAAR requires a sole or main purpose to avoid tax, not just a sole purpose. In determining paragraph 242, South African courts may struggle to determine what constitutes good or bad faith in the exercise of the right to avoid tax. This could lead to inconsistent judicial interpretations and great uncertainty, since good or bad faith will have to be decided on a case by case basis.

Under German tax law, sections 42(1) and (2) of the *Federal Code of Tax Procedure* or the *Abgabenordnung* constitute the *Rechtsmissbrauch*. These sections state as follows:

1. It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. Where the element of an individual tax law’s provision to prevent circumventions of tax has been fulfilled, the legal consequences shall be determined pursuant to the provision. Where this is not the case, the tax claim shall in the event of an abuse within the meaning of subsection (2) below arise in the same manner as it arises through the use of legal options appropriate to the economic transactions concerned.

2. An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate action, leads to tax advantages unintended by law for the taxpayer or a third party. This shall not apply where the taxpayer provides evidence of non-tax reasons for the selected option which are relevant when viewed from an overall perspective.

Section 42 thus outlaws the tax saving effects of a transaction that entails a *Rechtsmissbrauch*. In terms of section 42(2) a *Rechtsmissbrauch* exists where a taxpayer selects an “inappropriate legal option” that leads to “unintended” “tax advantages” which an

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“appropriate action” does not provide. This defines Rechtsmissbrauch as obtaining of tax benefits that are not intended. To determine whether the tax benefits are intended, it is clear that the purpose behind the provisions used to obtain tax benefits must be determined, and this entails a purposive construction of the provisions of the Abgabenordnung. In this regard, it is submitted that reference to the Rechtsmissbrauch as defined in the Abgabenordnung does not add anything new to the South African GAAR, which calls for purposivism in conjunction with the South African Constitution and recent interpretation trends.

3. ANALYSIS OF THE GAAR

There is currently no reported case on the GAAR.\textsuperscript{84} This does not greatly affect the analysis of the GAAR in this research. In analysing the GAAR it is necessary to analyse whether the problems noted in the previous Chapter and highlighted in the introduction of this Chapter were addressed. In this process, the overall aims of the research to examine the efficacy of the GAAR will be addressed.

The starting point in analysing the GAAR involves examining its foundation. Liptak states as follows:

There has been some academic debate over the proper basis for a GAAR – should it be ‘business purpose’, legislative intent (determined using a purposive construction) or the ‘artificial and contrived’, nature of arrangements? These bases are often presented as mutually exclusive options. The amendments to the SA GAAR sought to recognize that impermissible tax avoidance takes many forms and that each of these tests plays a role depending upon the circumstances.\textsuperscript{85}

\textsuperscript{84} This is not unusual. As will be seen later in this research, the introduction of a GAAR was followed by a period of over ten years before it was used to attempt to strike down transactions in Canadian and Australian courts. Pickup “In Relation to General Anti-Avoidance Provisions: A Comprehensive Study of the Legal frameworks Used by Different Countries to Protect Their Tax Revenues” in Freedman (ed) Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management (2008) 9 17 notes that in the case of Australia there was a deliberate policy to refrain from litigation on the GAAR to avoid the risk of dissipating its deterrent effect. In South Africa, the reasons for the delay in having the GAAR judicially considered are not as clear. It can be said that since there are relatively fewer GAAR cases in South Africa than there are in countries such as Australia and Canada; the current delay can be understood in this light. It can also be said that this delay could mean that the GAAR is serving its deterrent role effectively and that taxpayers are not attempting transactions that could provoke its invocation. One can argue that this delay is because the GAAR is effective in establishing certainty and drawing clear lines between permissible and impermissible tax avoidance and because of this there are virtually no cases to litigate. The latter scenario is, however, unlikely because it cannot be said with any certainty that the South African GAAR has now struck a balance that has proved to be elusive worldwide.

This statement shows that the GAAR is founded on an amalgamation of the major indicators of impermissible tax avoidance such as business purpose, misuse or abuse, and artificiality. This explains the wide scope of the GAAR, which is immediately noticeable especially in comparison to its predecessors. The approach in drafting this broad GAAR was justified by the need to provide for the diverse forms of impermissible tax avoidance. In this regard, Liptak states:

Do we really know ‘impermissible tax avoidance’ when we see it? Particularly in South Africa, the answer seems to be ‘no’. Not only was there disagreement between SARS and practitioners, but there was widespread disagreement among practitioners themselves.86

From these statements it can also be understood that another reason why the broad and flexible GAAR was preferred is that impermissible tax avoidance has proved to be impossible to define with precision.

It is important now to analyse the form that the GAAR has taken. One of the most obvious aspects of the GAAR is its breadth as shown by the presence of four indicators of impermissible tax avoidance. It was noted that one of the weaknesses of section 103(1) was its reliance on a narrow and undefined indicator of impermissible tax avoidance, namely abnormality. The GAAR, which is now wider in scope due to the addition of new indicators of impermissible tax avoidance, namely misuse or abuse, and a lack of commercial substance, goes beyond its predecessor by enabling a more comprehensive attack on impermissible tax avoidance, which is multi-faceted. In this regard the wide scope of the GAAR can be said to be an improvement on the narrow section 103(1).

The GAAR is not just broad; it is also flexible in the sense its indicators of impermissible tax avoidance are not exhaustively defined. The flexibility of the GAAR could make it effective against dynamic impermissible tax avoidance arrangements in future. This flexibility, when combined with the breadth of the GAAR, means that taxpayers are generally not clear on what transaction(s) would justify a GAAR attack. One probable effect of this status quo is that many taxpayers will be compelled to utilise tax avoiding transactions that are most likely to be able to withstand a GAAR attack. This uncertainty probably causes many taxpayers to refrain from using aggressive transactions that could be impermissible, or that could test the boundary between permissible and impermissible tax avoidance. The end result is that the

GAAR, in creating uncertainty, is to some extent effectively discouraging impermissible tax avoidance. On the uncertainty of the GAAR, Liptak notes as follows:

A final word about uncertainty: uncertainty is a reality. The question is whether a stronger GAAR (and a more purposive approach to statutory construction) will increase or decrease that uncertainty for the majority of taxpayers who do not seek to push the envelope.  

This statement can be interpreted as showing that there was some reliance placed on uncertainty as a deterrent in the GAAR. Because certainty in an area of tax law where clear boundaries are elusive is virtually impossible to create, it can be said that the drafters of the GAAR may well have sought to use the uncertainty as an advantage, rather than seeking to limit it. This was reinforced by the stated belief that the majority of taxpayers do not use avoidance arrangements that test the boundaries set in the GAAR.

However, this research has shown that uncertainty played a central role in the demise of section 90 and section 103(1). Regarding the current GAAR, it can be said that the same uncertainty that can act as a deterrent, can in equal measure be harmful to SARS because the nature of tax avoidance is such that there will always be taxpayers who are not deterred by the GAAR. Some of these taxpayers will enter into arrangements that might provoke the

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87 Liptak (2008) 27.
88 SARS notes in its Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962) (2005) 46 that “[c]ertainty and predictability are undeniably important in the tax arena”. SARS at 46 is also of the view that uncertainty is a part of the GAAR that can be used to enhance its efficacy. It is stated here that “there is a growing recognition that a GAAR cannot be overly precise if it is to be effective” and that any “uncertainty created by a stronger GAAR would leave the overwhelming majority of ordinary taxpayers and ordinary business transactions unaffected”. These views are consistent with those of Liptak.

89 This could be seen as further proof of the difficulty in defining impermissible tax avoidance with precision. This difficulty may have prompted the drafters rather to use the uncertainty as opposed to countering it. Cillers (2008) 108 states that “it must be accepted that a GAAR will, by its very nature, be somewhat open-ended. Given that the very purpose of a GAAR is to cater for circumstances that are difficult to foresee, those responsible for drafting it cannot be blamed for using general words with flexible, situation-dependent meanings. One might therefore provisionally admit that the wording of any GAAR will to some degree be uncertain, in the sense that it may be even more difficult than in the case of other statutory provisions to predict exactly how the courts will apply it in a given situation”. The courts have also supported the contention that legislation that has to deal with unseen future conduct will be uncertain. In Boyce Motor Lines, Inc v United States (1952) 342 US 337 339 it was stated that “[f]ew words possess the precision of mathematical symbols, most statutes must deal with untold and unforeseen variations in factual situations, and the practical necessities of discharging the business of government inevitably limit the specificity with which legislators can spell out prohibitions”. The same reasoning can be found in R v Nova Scotia Pharmaceutical Society 10 CRR (2d) 34 56 where it was stated that “[l]anguage is not the exact same tool some may think it is. It cannot be argued that an enactment can and must provide enough guidance to predict the legal consequences of any given course of conduct in advance. All it can do is enunciate some boundaries, which create an area of risk”. This can be contrasted with views that uncertain laws violate due process. In Conally v General Construction Co (1926) 269 US 385 391 it was stated that “[a] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law”. In the context of tax law it can be stated that it is impossible for a GAAR to be absolutely clear. A measure of uncertainty is bound to be present because there is no known universal definition of impermissible tax avoidance.
Commissioner into invoking the GAAR. This is where the uncertainty is likely to prove to be harmful to SARS by misleading the Commissioner into challenging transactions that should not be challenged, with adverse consequences, as seen after the *CIR v Conhage* case. It is accordingly submitted that the argument that the uncertainty of the South African GAAR serves as a deterrent to taxpayers can be countered by the contention that the uncertainty will also affect SARS and misdirect it into challenging transactions it should not challenge.

It is true that the current GAAR is more focused when compared directly with the broad section 90. However, it can be argued that the GAAR is similar to section 90 in that it requires extensive judicial interpretation before its provisions can be understood better. Provisions dealing with transactions within a composite transaction, purpose, *bona fide* business purpose, abnormality, a lack of commercial substance, and misuse or abuse can be said to be in need of further clarification either judicially or legislatively; this is because many of them are borrowed from overseas jurisdictions. The objective determination of purpose required by the GAAR is largely derived from Australia, and the isolation of steps in a composite arrangement is derived from Australia and Canada. The commercial substance test in the GAAR is similar to the economic substance doctrine in the US. Economic substance is identified as the single most important doctrine against impermissible tax avoidance in the United States. Arrangements can be disregarded for tax purposes by referring to the doctrine and nothing else. Misuse or abuse forms the basis of the GAAR in Canada. Certain aspects of the commercial substance indicator, for instance, arrangements that have neutralising and cancelling elements, are derived from the fiscal nullity doctrine in the UK in the *WT Ramsay* case. A number of European countries rely on the abuse of law doctrine to curb impermissible tax avoidance. The South African GAAR combines all these concepts in one GAAR and the result is a flexible, complex, and uncertain GAAR.

Broomberg notes that the complexity of the GAAR is such that “much litigation will ensue before any degree of certainty is achieved in interpreting these new provisions”. For instance, when establishing commercial substance, how much will the courts rely on the extensive case law in the US on the economic substance doctrine? How long is it going to take before the courts apply a consistent misuse or abuse determination? How much certainty will the abuse of rights or law as applied in countries such as Germany and France create for

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90 For a discussion of the lessons to be learned from the Canadian experience with the misuse or abuse provision see generally Kujinga “The Misuse or Abuse Analysis in terms of the South African General Anti-Avoidance Rule – Lessons from Canada” (2012) 45 1 *Comparative and International Law Journal of Southern Africa* .

taxpayers and SARS? These are questions that will have to be addressed. As Cilliers notes, importing concepts from abroad into the GAAR “leaves one with the uncomfortable feeling that the drafters are perhaps too easily tempted to borrow terminology from foreign legal systems, with unpredictable and potentially dangerous consequences”.

The risk of the courts adopting the approach in CIR King where the court interpreted section 90 with the right to avoid tax in mind eventuating in the interpretation of the GAAR, is great in such circumstances. The same can be said about the risk of having inconsistent judicial interpretations. It is submitted that the uncertainty of the GAAR, which requires extensive judicial interpretation to reduce its uncertainty, may in the end lead to its demise. In this regard, one can argue that the deliberate use of uncertainty as a deterrent may yield undesired results in the long term.

Another noticeable feature of the GAAR is the manner in which it uses the misuse or abuse concept. In the Final Draft Report of the Joint Committee on Finance on the Third Interim Report of the Katz Commission of Inquiry into Taxation it was stated that section 103(1) should be amended by, inter alia, inserting the following provision:

> Provided that the provisions of this section shall not apply where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse or abuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole.

It can be seen that the misuse or abuse provision was recommended as a defence against the application of section 103(1), which is consistent with the manner in which this concept is used in Canada. The misuse or abuse provision in section 245(4) of the Canadian Income Tax Act (CITA) works as a limitation of the Canadian GAAR. This means that the Canadian GAAR will not apply if the avoidance arrangement does not amount to a misuse or abuse of the provisions on the CITA. Broomberg notes that the use of the misuse or abuse concept in Canada is very important because:

1. In the first place, a general anti-avoidance rule empowers the Commissioner to override the specific and unambiguous provisions of an Income Tax Act as laid down by an elected parliament. This is an undesirable state of affairs to say the least.

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92 Cilliers (2008) 107. Cilliers at 108 dismisses the misuse or abuse provision “section 80A (c) (ii) is either a dead letter (because it does not seem to add anything material to the common law) or it is impermissibly nebulous and uncertain”.


94 RSC 1985, C. 1 (5th Supp).
2. In addition, it creates an atmosphere of uncertainty that may act as a disincentive to economic activity in the country.

3. Finally, if the anti-avoidance legislation is too broad it starts to hit at transactions that the legislature could never have intended to attack. This, in turn, tends to provoke the courts into placing an unduly restrictive interpretation on the legislation.  

The misuse or abuse concept as a defence against the application of the GAAR was however not added to section 103(1) of the Act. In the current GAAR, it operates as one of the indicators of impermissible tax avoidance, not as a limitation as it is in Canada, or as it was recommended to be by the Katz Commission. This means that transactions achieving legislative purpose can be struck down by the GAAR. Broomberg notes that “the new GAAR is now in an even more vulnerable condition. One can therefore anticipate a hostile judicial reaction and this could prove costly to the fiscus”. It can be stated that the manner in which the misuse or abuse concept is used in South Africa further indicates a desire to widen the ambit of the GAAR.

4. CONCLUSION

In analysing the South African GAAR in the context of the aims of this thesis, this chapter examined whether the GAAR dealt with the issues that led to the demise of its predecessors. This chapter shows that some of the major issues from section 103(1), identified in the previous chapter and in the introduction of this chapter, were dealt with when the GAAR was drafted and enacted. In this regard issues such as the following were addressed:

1. the objective determination of purpose which can help in regulating the extent to which taxpayers can seek to obtain tax benefits in commercial arrangements;
2. the isolation of steps within a composite arrangement and ascribing purpose to those steps;
3. the expansion of the scope of the GAAR from one controversial and limited indicator (abnormality) to a number of indicators;
4. the introduction of flexible indicators that can be used against future complex and dynamic impermissible tax avoidance arrangements; and,

Broomberg “Then and Now – IV” (2008) 22 Tax Planning 31 31. Broomberg argues that the problems with a GAAR that has no limitations is that it could be used to attack arrangements that parliament intended, meaning that certain government economic policies are subject to the Commissioner’s approval. This scenario is possible because if the Commissioner has challenged arrangements that should not have been challenged before he may not be trusted to honour arrangements that can be disregarded by the GAAR but that comply with legislative purpose.

5. the introduction of indicators whose scope is open and whose uncertainty can serve as a deterrent against impermissible and potentially impermissible tax avoidance arrangements.

It has been seen that some key aspects of the GAAR were adopted from countries such as Australia, Canada, the US, the UK and certain European jurisdictions that use the abuse of law principle such as France and Germany. This has helped to address some of the issues that adversely affected section 103(1). However, this has also led to the enactment of a GAAR that combines a number of concepts that can operate individually against impermissible tax avoidance into one broad and uncertain rule. The overall result is a GAAR whose uncertainty is duplicitous in the sense that it can be a deterrent against impermissible tax avoidance, but can also discourage genuine commercial transactions, negatively affect SARS, invite judicial activism in favour of the right to avoid tax, and lead to inconsistent judicial interpretation. In this regard it can be said that the issue of uncertainty was not accorded the attention it requires, especially considering the approach of the court in *CIR v King* where the court went to great lengths to limit the uncertainty of section 90. Further evidence of this contention can be seen where abnormality was retained, as it was in section 103(1). It was not defined in section 103(1), and is still not adequately defined now.

Since it has been shown that uncertainty is virtually impossible to eliminate completely by drawing a clear line between permissible and impermissible tax avoidance, the question is whether the uncertainty in the GAAR can be limited or not. One method of limiting the current uncertainty in the GAAR is to analyse the manner in which the courts in the countries from which certain concepts were borrowed have interpreted these concepts, and deriving important lessons from this interpretation.
CHAPTER 6

THE AUSTRALIAN GENERAL ANTI-AVOIDANCE RULE

TABLE OF CONTENTS

1. INTRODUCTION .............................................................................................................. 137
2. HISTORICAL ORIGINS: SECTION 260 ........................................................................... 137
2.1 The Doctrines Created in Response to Section 260 .................................................... 138
2.2 Section 260’s Late Revival ......................................................................................... 144
2.3 Analysis of section 260 ............................................................................................... 145
3. THE CURRENT AUSTRALIAN GAAR: PART IVA ...................................................... 146
3.1 Background .................................................................................................................. 146
3.2 Requirements .............................................................................................................. 147
3.2.1 Scheme .................................................................................................................. 149
3.2.2 Tax Benefit ............................................................................................................ 155
3.2.2.1 Section 177C(1)(a) Excluding Amounts: Federal Commissioner of Taxation v Spotless Services Ltd ................................................................................................................................. 156
3.2.2.2 Exception for Tax Benefits Expressly Provided for: Choice Doctrine Legislated .... 156
3.2.3 Purpose ................................................................................................................... 158
3.2.3.1 The Impact of Section 177D on Commercial Transactions; Federal Commissioner of Taxation v Spotless Services Ltd and Other Cases ................................................................. 159
4. ANALYSIS OF PART IVA ............................................................................................ 165
5. CONCLUSION ............................................................................................................... 170
1. INTRODUCTION

Australia has an extensive history with a GAAR that dates from the historical section 260 of the Income Tax Assessment Act of 1936 (the ITAA) and its predecessors, to the current GAAR contained in Part IVA of the ITAA. Throughout this history, significant judicial pronouncements on these GAARs were made by the courts. This chapter will discuss section 260 as the historical background to Part IVA in Australia, before discussing Part IVA itself.

The discussion of section 260 will focus on how the courts responded to this GAAR. Lessons on the efficacy of a GAAR will be gleaned from the manner in which the courts reacted to section 260. When discussing section 260’s successor, Part IVA, this chapter will focus on the scope and judicial interpretation of Part IVA. The analysis of Part IVA in this chapter will focus on its efficacy against impermissible tax avoidance and in creating sufficient certainty to inform taxpayers of the limits of their right to avoid tax. Lessons on the efficacy of a GAAR will also be gleaned from the discussion of the Australian experience with Part IVA.

2. HISTORICAL ORIGINS: SECTION 260

Australia has had a GAAR for over a century. Section 260 of the ITAA can be said to have been one of the first GAARs, because this section was preceded by a similarly worded GAAR in section 53 of the Commonwealth Income Tax Act (Cth).\(^1\) This section was itself preceded by similar sections in the Commonwealth Land Tax Assessment Act (Cth)\(^2\) and the Income Tax Act (Vic)\(^3\) and the Land and Income Tax Act (NSW).\(^4\)

Section 260 basically disregarded any agreement, arrangement, or contract that had the effect of directly or indirectly:

a. altering the incidence of any income tax;
b. relieving any person from liability to pay any income tax or to make any return;
c. defeating, evading or avoiding any duty or liability imposed on any person by this Act; or
d. preventing the operation of this Act in any respect.

As can be seen, this was a wide rule that did not draw a discernible line between permissible and impermissible tax avoidance. This is because all it required was a tax avoidance effect in

\(^{1}\) 1915.
\(^{2}\) 1910.
\(^{3}\) 1895.
order to render a transaction void against the Commissioner. In *DFC of T v Purcell* the court stated, in relation to the similarly worded section 53 of the 1915 Act, that the section would cover virtually every tax avoidance transaction if interpreted literally. It had to be toned down from its literal terms. Knox CJ noted as follows:

>[I]n my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognised as valid, would enable the taxpayer to avoid payment of income tax on what is in truth *his* income. It does not extend to the case of a *bona fide* disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person. The section is intended to protect the revenue against any attempted evasions of the liability to income tax imposed by the Act...and the *bona fide* gift or sale by a taxpayer of assets producing income is therefore in no sense an attempt to evade his liability to income tax.  

This statement criticised the potential breadth of section 53 if applied literally. Nevertheless, the flaws identified by the court were not corrected because section 53 was replicated in section 260. This may have prompted the court in *FCT v Newton* to describe section 260 as a “difficult provision” that was “inherited” and that required an overhaul by “someone who will take the trouble to analyse his ideas and define his intentions with precision before putting pen to paper”. It was also noted that the section’s vagueness meant that it could apply to transactions that the legislature did not envisage when drafting it.

### 2.1 The Doctrines Created in Response to Section 260

The breadth of section 260 elicited an emphatic judicial response that culminated in the creation of judicial doctrines aimed at giving it a proper meaning and limiting its scope. These doctrines were known as the predication test, the choice doctrine, and the antecedent transactions doctrine. Their theory and impact on section 260 is discussed below.

The predication test was propounded by the Privy Council in *Newton v FCT*. Their Lordships in this case held that:

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5 1921 29 CLR 464.

6 466. Mannix *Tax Avoidance 1981: The New Law* (1981) 3 opines that the judgment must have sown the seeds of section 260’s inefficiency against the tax avoidance schemes of the 1970s and 1980s and its eventual collapse. Grbich “Section 260 Re-examined: Posing Critical Questions about Tax Avoidance” (1975-1976) *University of New South Wales Law Journal* 211 214 stated that “it is universally accepted that section 260 cannot be applied literally to all transactions which have the effect of diminishing tax. But in reading down the literal words of the provision it is very easy to go too far and to undermine its objectives”. This shows that a GAAR whose scope needs to be limited may end up being ineffective against impermissible tax avoidance.

7 (1956) 96 CLR 577 596.

8 646.

9 (1958) 98 CLR 1.
In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealings, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section. Thus, no one, by looking at a transfer of shares *cum* dividend, can predicate that the transfer was made to avoid tax. Nor can anyone, by seeing a private company turned into a non-private company, predicate that it was done to avoid Div 7 tax.\(^{10}\)

In this statement the court reasoned that section 260 was not concerned with a tax avoidance objective, but with the manner in which this objective was met. It was also reasoned that for a transaction to be struck down in terms of the section, one had to be able to predicate by analysing the manner in which a tax avoidance transaction was implemented that the transaction was implemented in such a manner to avoid tax. This was the essence of the predication test. It involved an enquiry into whether, objectively determined, a transaction could be said to be a tax avoidance transaction. If such predication could not be made, and the transaction could be explained as an “ordinary business or family dealing, without necessarily being labelled as a means to avoid tax”, then the arrangement could not be struck down by the section.\(^{11}\) This last statement shows that the test based its distinction between permissible and impermissible tax avoidance on an objective determination of the facts of a transaction. It is submitted that this interpretation was not immediately obvious, even from a close scrutiny of section 260.

The predication test was thus a judicial attempt to limit the ambit of section 260.\(^{12}\) The predication test, in stating that arrangements that could be explained by reference to ordinary business dealings could not be caught by section 260, shows that the court was prepared to honour a taxpayer’s right to use business methods that attract the least amount of tax, even in the context of an expansive GAAR. The predication test did not leave room for the taxpayer’s subjective reasons, even if they were to obtain a tax benefit.\(^{13}\) This means that it was

\(^{10}\) 8-9.
\(^{11}\) See 8-10, for a description of the predication test.
\(^{12}\) Grbich (1975 – 1976) 216 states that the predication test was a wrong way to interpret section 260. He noted that “most transactions will combine taxation and non-taxation objectives in varying degrees. No sensible business man enters any transaction today without a firm eye on the tax consequences. Nor can he be expected not to. Section 260 is simply not directed at tax diminution as such and, *a fortiori*, not at the objective to bring about that diminution. The test attempts to prevent the avoiding or defeating of the provisions of the Act. The test is whether the steps used are imprinted with the badge of an artificial scheme to circumvent these provisions”.
\(^{13}\) Pagone (2010) 28.
acknowledged that a subjective tax avoidance purpose is common to both permissible and impermissible tax avoidance, and is therefore indecisive.

The predication test was applied in *Peate v Federal Commissioner of Taxation*, where Kitto J noted that:

> [t]he arrangement in the present case, considered objectively as is thus required, may well seem to be characterised by several purposes and effects, some of them unconnected with taxation, including the protection of individual members of the group against liability for negligence; the making of superannuation provision for employees, including doctors employed to assist the group; the better organisation of the group’s activities and particularly its methods of accounting; and the making of provisions for the doctor’s families. But the question remains, whether the overt acts that were done under the plan are fairly explicable without an inference being drawn that tax avoidance is a purpose of the arrangement as a whole.14

It is clear from Kitto J’s statement that the family dealing and commercial objectives were insufficient to stop the application of section 260. Kitto J noted that the same family benefits from the transaction could have been obtained through different means. It was found to be to the taxpayer’s disadvantage that the family dealings were sought through a transaction that had a tax avoidance effect.15 Section 260 was also applied to the transaction in *Hancock v Federal Commissioner of Taxation*16 where the court applied the predication test and found that the tax purpose dominated the other purposes of the transaction. These two decisions attest to the fact that the predication test strengthened section 260 by nullifying the absurdity of its literal meaning and using it to target transactions with an objectively determined dominant tax purpose.

The second doctrine that was created by the courts in response to the breadth of section 260 was the choice doctrine. As discussed below, the choice doctrine meant that section 260 could not be applied to transactions where taxpayers took advantage of tax incentives provided for in the ITAA. The basic foundation of the choice doctrine was therefore that where taxpayers opted for a fiscally attractive choice provided for in tax legislation, and obtained tax benefits in the process, section 260 could not be applied to deny these tax benefits.

14 (1964) 111 CLR 443 469.
15 469.
16 (1961) 108 CLR 258, where the High Court applied section 260 to an avoidance arrangement even though the subjective purpose of the transaction entailed family dealings.
W.P. Keighery Pty Ltd v Federal Commissioner of Taxation\(^{17}\) is the case credited with introduction of the choice doctrine. In this case the court upheld a transaction whereby a company’s controllers reorganised the company to a public company for the purposes of enabling the company to avoid taxes on its undistributed profits. The court stated that:

> [t]he very purpose or policy of [the provision relied on to obtain tax benefits] is to present the choice to a company between incurring the liability it provides and taking measures to enlarge the number capable of controlling its affairs. To choose the latter course cannot be to defeat, evade or avoid a liability imposed on any person.\(^{18}\)

The court declined to apply section 260 because it found that the section could not apply to a transaction chosen by a taxpayer for its tax benefits if the transaction was contemplated in the ITAA.

The choice doctrine was applied in other cases, three of which had a significant effect on section 260. Two of these three cases involved Barwick CJ. In the first case, Mullens v Federal Commissioner of Taxation,\(^{19}\) the taxpayer entered into a transaction to take advantage of the provisions that allowed taxpayers to deduct expenditure incurred in prospecting or mining activities aimed at petroleum discovery, or on the assets needed in these activities. It was clear that the taxpayer entered into the transaction to exploit the deduction available. It was also clear that the activities which gave rise to the deduction were not connected with the taxpayer’s ordinary business. Barwick CJ noted as follows:

> If the transaction, being effective and not in breach of the Act, reduced the amount of tax which the taxpayer otherwise would pay, it did not alter in any relevant sense the incidence of tax. An intention to enter into such a transaction so as to obtain the statutory benefit would not relevantly be an intention to alter the incidence of tax. The Court has made it quite plain in several decisions that a taxpayer is entitled to create a situation to which the Act attaches taxation advantages for the taxpayer. Equally, the taxpayer may cast a transaction into which he intends to enter into a form which is financially advantageous to him under the Act.\(^{20}\)

Barwick CJ noted that a taxpayer is “entitled to create” a transaction that would allow him to obtain certain tax benefits allowed by the ITAA. It is submitted that this statement substantially widened the scope of the choice doctrine, because Barwick CJ allowed taxpayers to “create” the conditions that are required to exist before a tax incentive is

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\(^{17}\) (1957) 100 CLR 66. This decision came before the *Newton* case introduced the predication test. The choice doctrine thus existed before the predication test.

\(^{18}\) 93–94.

\(^{19}\) (1976) 135 CLR 290.

\(^{20}\) 298.
exploited. In this case, the approach of the court weakened section 260. Evidence of this destabilisation is illustrated by the fact that the *Keighery* transaction was less elaborate than the *Mullens* transaction where the taxpayer made use of a transitory transaction that was not related to the taxpayer’s usual business to qualify for a tax benefits.

In the second case, *Slutzkin v Federal Commissioner of Taxation*,21 the choice doctrine was again applied to honour a tax avoidance transaction. Barwick CJ reaffirmed the basic premise of this doctrine and stated that “the choice of the form of transaction by which a taxpayer obtains the benefit of his assets is a matter for him: he is quite entitled to choose that form of transaction which will not subject him to tax, or subject him only to less tax than some other form of transaction might do”.22 Stephen J concurred with this reasoning and stated that the taxpayer had merely refrained “from taking a course which, had it been taken, would then, for the first time, have brought into existence a situation whose features would have subjected the appellants to liability to pay tax”.23

The choice doctrine’s onslaught on section 260 reached its zenith in *Cridland v Federal Commissioner of Taxation*.24 In this case, certain taxpayers entered into a transaction that involved unit trusts that operated primary production businesses. This transaction enabled the taxpayers to benefit from the averaging provisions that applied to primary producers. These provisions offered tax benefits by allowing income tax to be deferred at the beginning of the business. Mason J held that section 260 was not applicable, and stated as follows:

> The decision in *Mullen’s* case and the passages from the judgment to which I have referred show that the principle which underlies the *Keighery* case is not as narrow as the primary judge supposed it to be. It is not confined to cases in which the Act offers two alternative bases of taxation; it proceeds on the footing that the taxpayer is entitled to create a situation by entry into a transaction which will attract tax consequences for which the Act makes specific provision and that the validity of the transaction is not affected by s 260 merely because the tax consequences which it attracts are advantageous to the taxpayer and he enters into the transaction deliberately with a view to gaining that advantage.25

Mason J reaffirmed the fact that the freedom to “create” the conditions required to qualify for tax benefits offered in the act was part of the choice doctrine. Mason J further noted as follows:

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21 (1977) 140 CLR 314.
22 319.
23 322.
24 (1977) 140 CLR 330.
25 339.
The transaction into which the appellant entered in the present case by acquiring income units in the trust funds in question were not, I should have thought, transactions ordinarily entered into by university students. Nor could they be accounted as ordinary family dealings. They were explicable only by reference to a desire to attract the averaging provisions of the statute and the taxation advantage which they conferred. But these considerations cannot, in light of the recent authorities, prevail over the circumstance that the appellant had entered into transactions to which the specific provisions of the Act apply, thereby producing the legal consequences which they express.  

This statement shows that the court was cognisant of the fact that the transaction in question was not aligned to the taxpayer’s business. However, the court did not attach much weight to this fact, and instead chose to honour the taxpayer’s efforts to create the conditions needed to comply with the provisions conferring the tax benefits. It must be noted that the choice doctrine was sound in so far as it excluded section 260 from transactions in which taxpayers obtained tax benefits that were intended by the legislature. It was also sound in so far as it deemed the taxpayer’s purpose irrelevant where tax was avoided in compliance with statutory purpose. Nevertheless, the expansion of this doctrine by Barwick CJ and Mason J in Mullens and Cridland, respectively, led to the honouring of created (impermissible) transactions and section 260’s demise as a GAAR.

The third and final doctrine introduced by the courts in response to the breadth of section 260 was the antecedent transactions doctrine. This doctrine was introduced by Barwick CJ in the Mullens case to prevent section 260 from being interpreted “out of existence”. In terms of this doctrine, section 260 would apply to a transaction that was initially subject to tax, but was subsequently altered by the taxpayer to avoid tax. This doctrine was described by Waincymer as the “changing tax horses in midstream” doctrine. It applied to transactions where the taxpayers did not consider the tax implications of the transactions they entered into. This meant that the doctrine and section 260 could not apply to transactions whose tax implications were well considered before the transaction was initiated. Waincymer criticised this doctrine and noted:

It only imposes a penalty on those foolish enough not to think about tax issues before embarking upon their transactions. From a tax policy point of view, the antecedent transaction doctrine would deny horizontal equity among different taxpayers embarking upon the same transaction. If taxpayers had the foresight to think about the tax issues before embarking upon transactions and took action accordingly,
they would not be taxed. The person who became aware of the structure of the first person’s transactions and tried to copy it mid-stream would be caught.  

Waincymer’s criticism regarding the doctrine’s equity is valid. Nevertheless, it can be argued that the doctrine was, to an extent, a reflection of the reality in tax avoidance cases. Taxpayers who consider the tax implications of their transactions before initiating them are likely to avoid tax implications. Conversely, taxpayers who do not consider the tax implications of their transactions, or who only attempt tax effective methods after the transaction has already been entered into, are likely to sustain adverse tax consequences.

2.2 Section 260’s Late Revival

Section 260 experienced a revival after the Cridland case. In Federal Commissioner of Taxation v Student’s World (Aust) Pty Ltd, Mason J noted that a provision (section 260) that was introduced as a broad attack on tax avoidance should be interpreted broadly as the legislature intended, and not limited to achieve certainty. This can be seen as a clear attack on the previous attempts by the courts to limit the scope of section 260. Other cases that signified the revival of section 260 were Greghorn Investments Pty Ltd and Others v Federal Commissioner of Taxation, and the joint case of Federal Commissioner of Taxation v Gulland, Watson v Federal Commissioner of Taxation and Pincus v Federal Commissioner of Taxation. Waincymer notes that even though these decisions went against the precedent set in the earlier cases that limited the application of section 260, it would be wrong to state that the same cases established a consistent principle to be followed. He notes that:

[i]t is simply not possible to reconcile, with any logical consistency, the decisions in Newton, Peate, Keighery, Slutzkin and Mullens, to name just a few. These cases display a shift from a discussion of the proper interpretation of the provision to a philosophical dissertation upon a taxpayer’s rights.

This contention can be countered on the grounds that the discussion in the cases mentioned was provoked by the section itself. Section 260 left too much room for judicial analysis by merely stating that all tax avoidance transactions must be disregarded. Section 260 indirectly required the courts to furnish criteria with which to differentiate between the transactions that could be disregarded and those that could be honoured. The “philosophical dissertation” must

29 496.
30 (1978) 8 ATR 356.

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therefore not be dismissed summarily because it provided some critical lessons regarding taxpayers’ rights in relation to a GAAR, even though the courts in some of the cases went too far in asserting these rights. As will be seen later in this chapter, the “philosophical dissertation” that Waincymer dismisses as illogical, influenced the foundation of Part IVA that replaced section 260.

2.3 Analysis of section 260

While the choice doctrine that was advanced by the court in the Mullens, Slutskin, and Cridland cases contributed to the demise of section 260, it can be argued that this demise can be traced back to the section itself. This is because the nature and uncertainty of section 260 invited extensive judicial interpretation that went unchecked and led to the creation of doctrines either explaining section 260 (predication test and antecedent transactions doctrine), or limiting it to protect the right to avoid tax (choice doctrine). The courts that were tasked with adjudicating on section 260 spent much time considering whether these doctrines applied or not, and did not limit their focus to the section itself.\footnote{Lehmann “The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism” (1982 – 1983) Monash Law Review 115 132 notes that this section was a “notorious provision” which, in spite of its seemingly clear language, “presented courts with a number of difficulties”. The first difficulty identified is the generality of the section and its potential to strike down “innocent transactions”. This shows that uncertainty can exist in clear provisions which have a wide ambit.} This further illustrates the magnitude of the problems section 260 created for itself.

It is highly probable that the uncertainty created by section 260 was intentional and was aimed at deterring taxpayers from entering into impermissible tax avoidance transactions. This means that the scope of section 260 directly counteracted the idea that tax legislation must be certain. Regarding section 260, Lehman criticised the idea that tax laws, including a GAAR, must be certain as a “jurisprudential error”.\footnote{Lehman (1982 – 1983) 115.} Lehmann also stated that the view that tax laws must be certain did not take cognisance of the fact that in reality tax law concepts “cannot be defined with unambiguous clarity”.\footnote{Lehman (1982 – 1983) 115.} In Federal Commissioner of Taxation v Hancock, Dixon CJ made a statement that supported this view and stated as follows:

> The resource of ingenious minds to avoid revenue laws has always proved inexhaustible and for that reason it is neither possible nor safe to say in advance what must be found, after a scheme is struck down under s 260, before a consequential assessment can be justified.\footnote{1961 AITR 328 333.}
It can therefore be stated that the uncertainty surrounding the definition of impermissible tax avoidance, the impossibility of predicting the characteristics of future impermissible tax avoidance transactions, and the need to create a deterrent GAAR led to the deliberate creation of a wide section 260.

However, the deterrent value of the uncertainty of section 260 never really strengthened this section because some court decisions at the time showed that there was no widespread judicial acceptance of the deterrent value of section 260’s uncertainty. Barwick CJ in Federal Commissioner of Taxation v Westraders Pty Ltd\(^{38}\) stated that “[i]t is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax”. When analysed in conjunction with the cases discussed above that introduced doctrines limiting section 260, this case shows that the main judicial response to section 260 was predominantly one that sought to give it a restricted meaning as opposed to one that upheld its breadth and deterrent value. It can therefore be concluded that the legislature’s vision for section 260 was largely not adopted by the courts that restrictively interpreted this section for a sustained period of time. The judiciary’s refusal to maintain the breadth and uncertainty of section 260, save for some cases just before it was repealed, proved terminal for section 260. The experience with section 260 thus supports the contention that a broad and uncertain GAAR is likely to invite restrictive judicial interpretation which, if sustained, will ultimately lead to the demise of the GAAR. It also supports the contention that it is insufficient to create a GAAR that is wide enough to create uncertainty that is intended as a deterrent if the courts do not accept this breadth by interpreting the GAAR broadly.

3. THE CURRENT AUSTRALIAN GAAR: PART IVA

3.1 Background

The problems with section 260 led to the introduction of section 177A – G, which makes up Part IVA.\(^{39}\) At the time when this GAAR was introduced it was acknowledged that tax

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\(^{38}\) 1980 54 ALJR 461.

\(^{39}\) Part IVA was added into the ITAA by the *Income Tax Laws Amendment Act* (No 2) of 1981. This amendment removed section 260 by providing that it would not apply to schemes or transactions entered into after 27 May 1981. In *Commissioner of Taxation v AXA Asia Pacific Holdings Ltd* [2010] FCAFC 134 par 124 it was stated that when dealing with Part IVA every single provision is crucial and no single provision is more important than the other provisions. The court stated that no provision should be analysed separately or be interpreted in isolation.
avoidance is difficult to define, and John Howard, then Treasurer, in his Second Reading Speech in the House of Representatives, stated as follows:

We are acutely aware that ‘tax avoidance’ means different things to different people. Reasonable men and women are bound to differ on this crucial question and on the subsidiary matter of the appropriate tests for determining what behaviour a general anti avoidance rule ought to proscribe.  

This acknowledgement illustrates the importance of understanding tax avoidance before a GAAR is drafted. In an apparent departure from the section 260 approach, it was stated that Part IVA would target impermissible tax avoidance transactions that have certain characteristics, and not affect permissible tax avoidance transactions. In this regard Howard stated that:

[t]he proposed provisions...seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs. Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage. That description could be expected to cover the types of tax avoidance that, again using the language of social and political debate, are blatant, artificial or contributed, and which are indeed intended to be covered by this Bill. But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti avoidance measures...

The following paragraphs will discuss the scope of Part IVA and analyse whether it strikes the balance between permissible and impermissible tax avoidance, creates certainty, and is effective against impermissible tax avoidance.

3.2 Requirements

In terms of Part IVA, the Australian GAAR has three basic elements. These are:

1. a scheme; and
2. a tax benefit; and

42Scheme is defined widely in section 177A for the purposes of Part IVA. In terms of section 177A(1)(a) scheme refers to any understanding, arrangement, agreement, promise, or undertaking. A scheme also exists whether it is established by express terms or by implication. A scheme can be enforceable, unenforceable, or intended to be enforceable by operation of law. Section 177A(1)(b) further defines a scheme as including any plan, proposal, action, course of action or course of conduct.
3. a tax purpose, objectively determined. Section 177D(2) lists the following eight factors which may be used when objectively assessing a scheme’s purpose and these are as follows:

a) the manner in which the scheme was entered into or carried out;
b) the form and substance of the scheme;
c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
d) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
e) any change in the financial position of any relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
g) any other consequence for the relevant taxpayer, or for any person referred to in paragraph (f), of the scheme having been entered into or carried out;
h) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to paragraph (f).

If any of these eight elements are present, a sole or dominant purpose to obtain a tax benefit on the part of a taxpayer, or any connected person who enters into the scheme or part of it, will be inferred. In short, three requirements must be met before Part IVA can be invoked successfully. These are, a scheme entered after 27 May 1981, a tax benefit in connection with the scheme, and an objective conclusion that there was a sole or dominant purpose of entering into the scheme. Once this is done, the legislation empowers the Commissioner to cancel the tax benefit.

Before the elements of Part IVA are discussed in detail it is important to note the impact of section 260 on Part IVA. The amount of criticism levelled at section 260 would suggest that it had no impact after it was replaced, but this is not the case because the predication test that was formulated in response to it played a central role in the creation of Part IVA. The Explanatory Memorandum, Income Tax Laws Amendment Bill (No2) 1981 (Cth) states as follows:

Part IVA may be seen as effectuating in general anti-avoidance provisions in the income tax law a position akin to that which appears to emerge from the decision of the Privy Council in Newton v Federal Commissioner of Taxation (1958) 98 CLR 1. The essence of the views expressed in that case

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43 Section 177C defines tax benefit and in terms of subsections (a) – (bb) the exclusion of amounts from a taxpayer’s assessable income in certain circumstances, the granting of a deduction in certain circumstances, certain capital losses and a foreign income tax offsets qualify as tax benefits.

was that a tax avoidance situation by section 260 exists only if it can be predicated from looking at an arrangement that it was implemented in that particular way so as to avoid tax.\footnote{9553.}

As was noted in Chapter 3, the presence of a scheme and a tax benefit does not necessarily point to the presence of impermissible tax avoidance, therefore it can be observed that Part IVA bases its distinction of permissible and impermissible tax avoidance on a test that is similar to the predication test advanced in \textit{Newton v FCT}. The eight provisions referred to above are the objective factors which the court must consider when determining whether the scheme can be impugned as impermissible tax avoidance. The constituents of Part IVA will now be discussed in greater detail.

\textbf{3.2.1 Scheme}

Scheme is defined in section 177A. Section 177A(3) broadens the definition of a scheme to include any unilateral scheme, plan, proposal, action, course of action, or course of conduct.\footnote{46} Section 177A(5) also broadens the scope of a scheme or part of a scheme entered into or carried out for a particular purpose by providing for the inclusion of any scheme or part of a scheme entered into or carried out for two or more.

The scheme must be identified, and as the first requirement, it serves as the point of departure from which tax benefits arise.\footnote{47} Once a scheme is identified, all tax benefits arising from it become easier to identify, and this is the functional value of scheme in Part IVA. This was illustrated in \textit{Macquarie Finance Ltd v Federal Commissioner of Taxation} where Hill J stated that:

\begin{quote}
[p]art IVA requires identification of the scheme as an important ingredient in the operation of the Part, if only because, as Gleeson J points out, before a scheme can be one to which the provisions of the Part apply it must be possible to identify a tax benefit which has been obtained by the taxpayer in connection with the scheme. That is, the tax benefit which the Commissioner is authorized to cancel.
\end{quote}

\footnote{9553.}{The schemes identified in the major cases involving Part IVA show the necessity to have a broad definition of scheme because of the diverse ways in which taxpayers structure their schemes. In \textit{Federal Commissioner of Taxation v Spotless Services Limited} (1996) 186 CLR 404 the scheme was identified as the means by which the taxpayer invested money to obtain a tax benefit. In \textit{Federal Commissioner of Taxation v Consolidated Press Holdings Limited} (2001) 207 CLR 235 the scheme was a component of a bigger plan to effect a takeover. In \textit{Federal Commissioner of Taxation v Hart} (2004) 217 CLR 216 the scheme was the loan agreement which split the loan into two parts.}

\footnote{46}{Commissioner of Taxation v Ashwick (Qld) No 27 Pty Ltd [2011] FCAFC 49 par 134. In this case a series of transactions was held to constitute a scheme}

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The conclusion as to dominant purpose must be made by reference to the particular scheme and the tax benefit must be related to the scheme.\(^{48}\)

As noted in Chapter 3 above, scheme is one of the elements of a GAAR that do not draw the line between permissible and impermissible tax avoidance. This point is reinforced by the fact that as long as a scheme qualifies as one in terms of the broad definition provided in section 177A, it suffices for Part IVA purposes. Apart from complying with the definition, the scheme does not need to have any special qualities. The interpretation by Hill J justifies the absence of extra qualities for a scheme, because a scheme is necessary for all the other elements of Part IVA to apply. Identifying the correct scheme is therefore crucial, but failure to do so will not necessarily render the entire Part IVA useless. This was stated in Federal Commissioner of Taxation v Peabody,\(^{49}\) the first case to deal with Part IVA, thirteen years after its introduction, where the court held:

> The erroneous identification by the Commissioner of a scheme as being one to which Pt IVA applies or a misconception on his part as to the connexion of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by s 177F(1) only if in the event the tax benefit which the Commissioner purports to cancel is not a tax benefit within the meaning of Pt IVA. That is unlikely to be the case if the error goes to the mere detail of a scheme relied upon by the Commissioner.\(^{50}\)

This case involved a complex arrangement to publicly float a private business in the most tax-efficient manner. The Commissioner invoked Part IVA and added a certain amount to Peabody’s assessable income for the year, claiming that this amount would have been realised had Peabody entered into a more straightforward purchase and sale transaction. The Commissioner argued that, \textit{inter alia}, the complex scheme which involved the conversion of shares into worthless shares, had resulted in a tax benefit for Peabody. The court of first instance upheld this argument and stated that the conversion was, in fact, a scheme. On appeal, the High Court reversed the decision and held that the Commissioner had identified a scheme that was part of a series of steps in a larger transaction which had a commercial purpose. It was stated that “[t]he question in every case must be whether a tax benefit which the Commissioner has purported to cancel is in fact a tax benefit obtained in connection with

\(^{48}\) (2004) 57 ATR 115 137. In AXA Asia Pacific Holdings Ltd par 148 it was found that there was no tax benefit that could be connected to the scheme in question. As a result, a conclusion under Part IVA could not be reached. This shows the importance of establishing a causal nexus between a scheme and a tax benefit.

\(^{49}\) (1994) 181 CLR 359.

\(^{50}\) 382 per Mason CJ, Brennan JJ, Deane JJ, Dawson JJ, Toohey JJ, Gaudron JJ and McHugh JJ.
a Pt IVA scheme and so susceptible to cancellation at the discretion of the Commissioner".51 This shows that there must be a connection between the scheme and the tax benefit.

A significant part of the Peabody decision is the manner in which the court defined a scheme within a scheme, or the tax avoiding part of a series of transactions. The High Court stated that a scheme within a scheme will not qualify as a scheme for Part IVA purposes if it cannot stand independently without losing its practical meaning.52 The court, in rejecting the sub-scheme approach relied on IRC v Brebner where Lord Pierce stated that:

[i]t would be unrealistic and not in accordance with the subsection to suppose that [the taxpayer’s] object has to be ascertained at each step in the arrangements. ...The subsection would be robbed of all practical meaning if one had to isolate one part of the carrying out of the arrangement, namely, the actual resolutions which resulted in the tax advantage, and divorce it from the object of the whole arrangement.53

The court accepted that the Commissioner may identify alternative schemes, including steps in a broader scheme. However, it stressed that such scheme must be capable of being taken from the main scheme and standing on its own without being rendered senseless. The court rejected the Commissioner’s contention that section 177D and section 177A provided for the isolation of a scheme in a broader scheme. It was stated that while these sections refer to ‘parts of a scheme’, they were aimed at specific matters and were not related to the crucial question of whether or not the main purpose for entering into a scheme was to obtain a tax benefit.54

The isolation of a single part of a larger scheme and ascribing a purpose to it for the purposes of applying Part IVA proved controversial in the very first major Part IVA case. In the Full Federal Court it was held that the fact that an element of the broad scheme had a tax advantage did not mean that it was a scheme. The court explained this by stating that the

51 382.
52 Cassidy “Peabody v FCT and Part IVA” (1995) Revenue Law Journal 197 200, submits that this interpretation of scheme significantly limits the scope of s 177A(1) because it excludes any identified transaction if it is part of a broader scheme. Cassidy notes that the test is whether the alleged scheme would have been entered into without the broader scheme. If not, it is merely a scheme within a broader scheme and can thus not be recognised as a scheme for Part IVA purposes.
53 [1967] 2 AC 18 27.
54 385. Section 177D states that Part IVA will only apply if “it would be concluded that the person or one of the persons who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit”. Cassidy (1995) 207 states that this particular provision merely serves to state that a person participating in a part of a scheme may have a dominant purpose of obtaining a tax benefit. It does not have any impact on establishing whether the scheme as whole had a dominant purpose to obtain a tax benefit.
The Commissioner could not isolate one step in a course of action and treat it as a scheme and that a taxpayer’s sole or dominant purpose must be determined by reference to the scheme as a whole. The court found that the facts indicated that the taxpayer’s dominant purpose was the public floating of a company, and this was held to be a commercial transaction.55

The court’s approach was founded on the premise that allowing the Commissioner to isolate sub-schemes to prove that a scheme exists, regardless of whether such scheme can operate independently of the main scheme or not, would result in all tax avoidance transactions being struck down. This is because all transactions that avoid tax include certain steps that are decisive in avoiding tax. As Krever notes:

Perhaps the most important question to be determined is what constitutes the scheme. Taxpayers rarely act solely for tax reasons. Most often, taxpayers act to realize a profit through investment, business or some other arrangement. Naturally they seek to realize that profit in the most tax-advantaged way possible, but almost always, if the transaction or scheme is taken to be the overall arrangement entered into by a taxpayer, it will have a bona fide commercial objective, namely, to derive a profit. Identification of the correct transaction is thus the first threshold that must be crossed before the general anti avoidance provision can be applied. Is it the entire transaction or just the tax effective element in the larger transaction?56

The Peabody approach to sub-schemes thus took into account the taxpayer’s right to avoid tax.

The controversy surrounding the isolation of a sub-scheme for Part IVA purposes did not end with the Peabody case; it was to be dealt with further in Hart v Federal Commissioner of Taxation57 In this case, the taxpayer entered into a ‘split loan’ with a bank, whereby the funds were split into two parts, one for the acquisition of the taxpayer’s primary residence and the other for refinancing a property to be used for gaining (assessable) rental income. The loan agreement required the taxpayer to repay the part of the loan connected to the acquisition of the primary residence. The part of the loan that was connected to the property for rental income was unaffected and the interest was allowed to accrue, which interest was then capitalised and compounded. The taxpayer claimed a deduction for the accrued interest expense on the basis that the interest accrued was an expense incurred in the financing of

55 FCT v Peabody (1993) 93 ATC 4104 4111.
57 2002 50 ATR 369.
rental property, including the interest on interest component that arose due to the capitalisation of that compound interest.

In the Full Federal Court the Commissioner put forward two alternative descriptions of the scheme the taxpayer had entered into. The first broad scheme constituted the entire loan deal. The second narrow description was the division of the loan account into two, and the requirement that the taxpayer pay the primary residence account first. The Full Federal Court rejected the Commissioner’s approach and stated that the scheme had to include the borrowing of the money and the refinancing of the two properties. The Full Federal Court decided in the taxpayer’s favour. The decision in Peabody was referred to, and the court held that any sub-scheme must be capable of standing alone without becoming absurd. In the end, the court held that the scheme identified by the Commissioner could not stand alone.58

On appeal, in Federal Commissioner of Taxation v Hart,59 the decision of the Full Federal Court was unanimously overturned, and the test in Peabody was questioned. Gummow JJ and Hayne JJ stated:

The reference to circumstances being “robbed of all practical meaning” appears to have been understood in the Full Court in the present matters as a criterion which must be applied in deciding whether there is a scheme to which Part IVA applies. That is not right. First, it is far from clear what legal test is intended by saying that a scheme must “stand on its own feet”. It is not clear how the metaphor is to be translated into legal principle. Secondly, as the Full Court pointed out in the present matters, the words “robbed of all practical meaning”, which were adopted in Peabody, were taken from IRC v Brebner. There they were used in a very different context and with a clearly intended meaning....thirdly, and most importantly, there is no basis to be found in the words used in Part IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or other coherence...60

The court’s approach to a sub-scheme was clearly different from the Peabody approach which was rejected. The Hart approach did not take cognisance of the effect of isolating a sub-scheme on commercial transactions.61 This probably explains why it was criticised.62 The court also noted as follows:

58 380.
59 2004 55 ATR 712.
60 725 – 726.
61 Krever (1997) 128 notes that “business exists to maximise profits and failure to take taxes into account and to structure transactions so as to obtain the highest after tax rate of return would arguably amount to negligence on the part of business managers. If commercial transactions are broken down into separate elements, more often than not it will be possible to identify one particular aspect of the transaction that is tax motivated. But
Thirdly, and most importantly, there is no basis to be found in the words used in Pt IVA for the introduction of some criterion additional to those identified in the Act itself. There is no reference to a scheme having some commercial or other coherence. Far from the Part requiring reference only to the purpose of those who carry out all of whatever is identified as the scheme, s 177D (b) specifically refers to it being concluded “that the person, or one of the persons, who entered into or carried out...any part of the scheme” did so for the purpose of enabling the relevant taxpayer (alone or with others) to obtain a tax benefit in connection with the scheme...  

It can be stated that the inconsistent judicial interpretation of sub-scheme has its origins in the question whether the legislature, in section 177D(b) intended Part IVA to apply to transactions with multiple steps where the overall purpose is not the avoidance of tax. This is in spite of the fact that when literally interpreted, this section states that a sub-scheme can qualify as a scheme for Part IVA purposes.

The controversy and uncertainty on sub-schemes continued in Ashwick (Qld) N 127 Ltd v Commissioner of Taxation. In this case, the scheme was identified as the steps taken to provide revenue in a group of companies. This case is authority for the proposition that steps do not comply with the definition of a scheme if they are not part of a coherent course of conduct. This definition appears to require a scheme to be part of a coherent course of conduct, something that is clearly not provided for in the broad definition of scheme. It is submitted that the court in this case sought to advance the Peabody definition of scheme because if a scheme cannot stand on its own, then it is not coherent.

In Star City Pty Ltd v Commissioner of Taxation scheme was described by Gordon J as excluding a “series of disjointed or unconnected steps” because the identification of a scheme is a factual inquiry where evidence is analysed and “abstracting bits from what actually happened” is not part of the inquiry. This in line with the approach in Peabody. However, this approach was rejected on appeal in Federal Commissioner of Taxation v Star City Ltd. The
inconsistency shows that there is uncertainty on what constitutes a scheme in the context of composite transactions.

In providing that a sub-scheme can stand as a scheme, the legislature sought to ensure that taxpayers do not use commercial transactions to launder impermissible tax avoidance transactions. The sub-scheme approach has however caused controversy and inconsistent judicial interpretation because it allows the Commissioner to isolate the tax avoiding part of a composite transaction, and effectively bars a taxpayer from using the purpose of the composite transaction as a defence. It is submitted that the sub-scheme provision should be interpreted in line with the approach in the *Peabody* case, to allow a balance between the taxpayer’s rights and the legislature’s concerns.

### 3.2.2 Tax Benefit

Linking the scheme to a tax benefit is a necessary step for Part IVA purposes and this is done to determine whether the taxpayer has either obtained a tax benefit, or stands to obtain one, but for the Commissioner’s invocation of Part IVA. The following qualify as tax benefits in terms section 177C of the ITAA:

- a. the exclusion of an amount from a taxpayer’s taxable income where that amount should have been included, or would reasonably be expected to have been included, but for the operation of the scheme;
- b. a deduction which would not have been allowed, or would not reasonably be expected to have been allowed, had the scheme not been entered into;
- c. a capital loss incurred by the taxpayer if the whole or part of the capital loss would not have been incurred, or may reasonably be expected not to have been incurred, but for the scheme being carried out; and
- d. a foreign tax credit allowed to the taxpayer if the entire or part thereof would not have been allowed, or may reasonably be expected not to have been allowed to the taxpayer.

Section 177F confers on the Commissioner the power to cancel the entire or part of the tax benefit, and this power only arises when the tax benefit has already been obtained or is due to be obtained, but for the exercise of powers conferred by section 177F.
3.2.2.1 Section 177C(1)(a) Excluding Amounts: *Federal Commissioner of Taxation v Spotless Services Ltd*

One of the tax benefits provided for in section 177C(1) exists where a taxpayer declares less revenue then he would have declared, or would reasonably be expected to have declared, but for the tax avoidance scheme. The case *Federal Commissioner of Taxation v Spotless Services Ltd* 67 provides an example of this type of tax benefit. The taxpayers in this case invested $40 million in the Cook Islands. They relied on section 23(q) (since deleted) of the ITAA to contend that the interest they had earned on the investment was not taxable in Australia because it was subject to withholding tax in the Cook Islands since it was sourced there. The investment scheme allowed the taxpayers to earn a better return after deducting withholding tax from the Cook Islands than would have been possible if the investment had been made in Australia and subjected to the Australian income tax laws. The taxpayers further contended that if the Cook Islands investments had not been entered into, there would have been no interest and no tax benefit. The High Court however disagreed, stating that the provision operated more broadly and found that the reasonable expectation was that the taxpayers would have invested the funds in Australia and the amount derived from the investment would have been included in the taxpayers’ taxable income. The court found that the taxpayers had obtained a tax benefit by excluding income subject to tax from their taxable income. In other words, the tax benefit was not the amount obtained by the taxpayer in the Cook Islands, but the amount that had not been derived in Australia. Regarding the reasonable expectation requirement, the court stated that “it is sufficient that at least the amount in question might reasonably have been included in the assessable income had the scheme not been entered into or carried out”. 68

3.2.2.2 Exception for Tax BenefitsExpressly Provided for: Choice Doctrine Legislated

In terms of section 177C(2) a tax benefit does not include tax benefits obtained by the exclusion of income if this exclusion is attributable to, *inter alia*, the exercise of an option expressly provided for by the Act. Section 177C(2)(ii) qualifies this provision and states that it shall not apply where the taxpayer creates the circumstances or conditions necessary to enable compliance with the provisions relied on to obtain the tax benefit. The same provision extends to all the other tax benefits identified in section 177C.

67 1996 34 ATR 183.
68 193.
The provisions of section 177C(2) should be understood in the light of the choice doctrine, as discussed in the some of the cases decided under section 260. The *Explanatory Memorandum* introducing Part IVA identified the choice doctrine as one of the doctrines limiting the application of Part IVA.\(^{69}\) According to Pagone “[i]t may be supposed that s 177C(2) was not intended to incorporate into Part IVA the choice principle that the legislator had thought had made it necessary to replace s 260”.\(^{70}\) However, it is difficult to reconcile the provision with anything in Australian tax law other than the choice doctrine. In drafting Part IVA the legislature probably sought to eliminate with some of the weaknesses of section 260 by providing for the choice doctrine as a defence against the application of the GAAR.

As has been noted, the problem with the choice doctrine was the manner in which the judicial decisions on it subsequently allowed the creation of the conditions necessary to obtain the tax benefit sought. However, Part IVA’s version of the choice doctrine is not as broad. Thus, section 177C(2) will not protect any tax benefit obtained if the taxpayer creates the conditions necessary to qualify for the tax benefit expressly provided for. The rationale behind this exclusion is that if a taxpayer is not within the group envisaged by the legislature when providing for a certain tax benefit, then that taxpayer cannot be allowed to create a scheme that puts him within that group.

Another limitation of the choice doctrine as provided for in section 177C(2) is that the tax benefit must be expressly provided for. In the case *Case W58* the Administrative Appeals Tribunal stated as follows:

> It is the escape hatch to Pt IVA. The lynchpin of s 177C (2) is undoubtedly the words “expressly provided”. The clear intention of those words and the structure of the ITAA is that it is not sufficient that the ITAA merely recognise that there are certain legal relationships which might produce an effect on the income of a taxpayer, but rather the ITAA must itself expressly give a choice which has the result, when taken advantage of, of producing a tax benefit.\(^{71}\)

This means that while the Act may recognise that there are many methods through which business can be conducted, this does not mean that they are expressly provided for in order to qualify for the protection conferred by section 177C(2).

\(^{69}\) 9552.  
\(^{70}\) Pagone (2010) 64.  
\(^{71}\) (1989) 29 ATR 3777 3793.
3.2.3 Purpose

Part IVA requires a dominant purpose to obtain a tax benefit to exist before it can apply. Dominant purpose is the “lynchpin” of Part IVA. The eight factors contained in section 177D guide the determination of a particular scheme’s dominant purpose. These factors were influenced by the predication test discussed earlier in this chapter. It is these factors that ultimately determine whether Part IVA should be applied. In the *Explanatory Memorandum* it was noted that:

[i]n brief, section 177D makes Part IVA applicable as a matter of law to a scheme if a taxpayer has obtained a tax benefit under and, on the basis of an objective view of features of the scheme and its surrounding circumstances, it would be concluded that the scheme was, in tax terms, a “blatant” one, that is, it was entered into by a person for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

This is further evidence of the fact that Part IVA has strong connections to the judicial interpretations of section 260. It can be noted that the identification of impermissible tax avoidance in Part IVA is the presence of a dominant purpose to obtain a tax benefit. In *Spotless Services Ltd* it was stated that the dominant purpose is the “ruling, prevailing or most influential purpose”.

Section 177D(b) lists eight criteria that can be used to determine the purpose behind a transaction and these eight factors can be divided into three categories. The first three factors deal with the manner in which the scheme was operated. Factors four to seven deal with the consequences of the scheme without the application of Part IVA. The eighth factor deals with the nature of the connection between the taxpayer and his or her connections. After identifying the factors relevant to conclude that the main purpose of a scheme was to obtain a tax benefit, section 177D does not explain how the conclusion will be arrived at from these factors.

The eight criteria ensure that the taxpayer’s subjective intention for carrying out a scheme is irrelevant because they enable an objective conclusion to be drawn as to the taxpayer’s dominant purpose. As the court noted in *Hart*:

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73 9562.
74 192. In *British American Tobacco Australia Services Limited v Commissioner of Taxation* [2010] FCAFC 13 par 46 it was stated that where a hypothetical alternative scheme that is subject to higher tax can be identified it does not follow that a conclusion will be drawn that the dominant purpose was to avoid tax.
75 Pagone (2010) 72.
In these matters, it is, of course, true that the money was borrowed to finance and refinance the two properties. Of course the loan was structured in the way it was in order to achieve the most desirable taxation result. But those are statements about why the respondents acted as they did or about why the lender (or its agent) structured the loan in the way it was. They are not statements which provide an answer to the question posed by s 177D (b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matter; it does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or part of it.76

The objective purpose of the scheme means that the dominant purpose need not be that of the taxpayer, but can be that of someone else such as a professional tax adviser who conceived or operated the scheme. This means that section 177D ensures that Part IVA does not depend on the fact that the taxpayer had a dominant purpose to obtain a tax benefit. Thus, section 177D basically does not ask for an inquiry into whether a taxpayer actually operated a scheme to obtain a tax benefit. The inquiry is rather whether, after taking into consideration the relevant factors contained in section 177D(b), an objective conclusion can be drawn that the scheme had a dominant purpose to obtain the tax benefit obtained or to be obtained. The existence of the eight factors does not mean that the Commissioner must “tick off” each against a scheme, because a dominant purpose may be ascertained from the facts.77

3.2.3.1 The Impact of Section 177D on Commercial Transactions; Federal Commissioner of Taxation v Spotless Services Ltd and Other Cases

The scope of Part IVA is such that it can potentially affect commercial transactions with tax avoidance effects. In the case Federal Commissioner of Taxation v Spotless Services Ltd this was illustrated and the court unanimously applied Part IVA to strike down an investment that offered good after-tax returns in the Cook Islands. The taxpayer’s argument that the purpose behind the scheme was to secure the investment of a large sum was rejected by the court, who stated that the required purpose lay in the particular means the taxpayer adopted to obtain the commercial advantage. The court held that the presence of a rational commercial decision was irrelevant to the question whether a taxpayer had operated a scheme with a dominant purpose to obtain a tax benefit.78 In stating this, the court made it clear that section 177D

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76 243 per Gummow JJ and Hayne JJ. Also see Commissioner of Taxation v Mochkin [2003] FCAFC 15 par 44 where it was stated that the inquiry under section 177D (b) is whether a reasonable person would conclude that the dominant purpose of a transaction is tax avoidance.
77 FCT v CPH Property Pty Ltd 1999 42 ATR 575 601.
78 184.
required a close inspection of the particular method utilised to obtain the tax benefit.\textsuperscript{79} An examination of the scheme in this case reveals that it had a commercial basis. The taxpayer invested a huge sum and got a considerable return. This means that it was not the lack of a commercial purpose that led to an adverse conclusion for the taxpayer. The inquiry turned on the particular method the taxpayer relied on to obtain the tax benefit. Since the particular method was complex and involved a series of planned steps the court opined that the method could largely be explained by reference to the tax benefits obtained.

This decision demonstrates that Part IVA can be used to strike down ordinary commercial schemes if the scheme is “elaborate” and has “attendant circumstances” that “lead inevitably to the conclusion that the scheme was not merely tax-driven but that its purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme”.\textsuperscript{80} The reasoning behind the decision was that the most influential, prevailing, or ruling purpose of the transaction was to obtain a tax benefit.\textsuperscript{81}

Certain commentators criticised the court’s approach in this case. Dabner\textsuperscript{82} notes that the \textit{Spotless} decision may have delighted the Australian Taxation Office (ATO), but it raised concerns that the decision was too comprehensive and could lead to a judicial or even legislative reaction to the breadth of Part IVA. Nevertheless, the decision in \textit{Spotless} was backed by Michael Carmody, then Commissioner of Taxes in 1997, who noted as follows:

> The particular significance of the \textit{Spotless} decision is that the High Court has confirmed that “a person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where the dominant purpose is consistent with the pursuit of a commercial gain in the course of carrying on a business.” Had \textit{Spotless} been lost a gaping hole would have appeared in the protection offered by Part IVA. In doing that the High Court has also confirmed that the application of Part IVA is not to be determined according to whether you bring...
arrangements under a particular commercial, business or other categorisation. Rather the application of Part IVA is to be determined by an analysis of the factors set down in section 177D. This requires consideration of such issues as the manner in which the scheme was entered into, the form and substance of the arrangements. And in this regard the degree of contrivance, artificiality and elaborateness of the transaction will be relevant.\(^{83}\)

It can be stated that the decision in this case regulated the manner in which taxpayers can pursue tax benefits in commercial transactions. The court did this by emphasising that if the tax-avoiding elements of a transaction can reasonably be interpreted as indicating a dominant purpose to avoid tax, then Part IVA will apply in spite of the presence of any commercial purpose in the transaction.\(^{84}\)

A number of cases decided after the *Spotless Services Ltd* case shows that the courts continued to apply Part IVA to transactions with commercial purpose that was eclipsed by tax purpose. One of these cases is *Spotlight Services Pty Ltd v FCT*\(^{85}\) where the court applied Part IVA to disallow a substantial deduction for contributions made to an employee benefit trust created to facilitate the payment of employee bonuses. The existence of a commercial purpose did not influence the court, which stated that the dominant purpose was to obtain tax benefits. This dominant purpose was demonstrated by the fact that the trust was established at the end of the taxpayer’s year of assessment and was financed by a circular loan-back transaction.

In *Consolidated Press Holdings Ltd* the court expressed similar views in relation to a scheme the taxpayer used when taking part in a takeover bid of a UK company. The commercial character of the overall scheme was beyond question in the case. The taxpayer contended that the purpose requirement in section 177D needed a determination of the purpose of the structure as a whole, but the court was unmoved and chose to focus on the particular means that led to the tax benefit being obtained. It was stated that:

\[
\text{[t]he fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a}
\]


\(^{84}\) See also *FCT v Lenzo* 2008 71 ATR 511 where the court stated that the structuring of the scheme could only be justified by reference to the tax consequences, not just the commercial reasons.

\(^{85}\) 2004 55 ATR 745.
s177D purpose. Nor is there any inconsistency involved, as was submitted, in looking to the wider transaction in order to understand and explain the scheme, and the eight matters listed in s 177D.

In Cumins v Federal Commissioner of Taxation, the court noted that the timing of the scheme meant the scheme had a dominant purpose to obtain a tax benefit that eclipsed the family objectives it sought to achieve. Part IVA was applied to a scheme where a capital loss was generated by a taxpayer who, as trustee of two family trusts transferred listed shares from one to another. The court stated that the scheme could not be described as ordinary, because the shares were mortgaged to a bank and the taxpayer had not obtained the bank’s consent. Crucially, the scheme was entered into just a day after the first family trust had made a capital gain of $790 000.

The cases discussed so far in this paragraph may give rise to an inference that Part IVA can be used to strike down tax-avoiding commercial schemes. Pagone refutes this, and argues that:

[perm]ermissible structuring to secure tax advantages and permissible motivation to achieve a favourable tax outcome may be seen where what secures the tax benefit also secures other outcomes. In such cases what secures the tax benefit will not be explicable only by the taxation consequences for the taxpayers.

This means that section 177D is not inherently against all commercial transactions with a tax avoidance effect. An example of a commercial transaction which survived a Part IVA challenge can be found in Eastern Nitrogen Ltd v Commissioner of Taxation. This case involved a sale and leaseback scheme. The finance proposal presented to the taxpayer had a lower after-tax cost than other borrowing methods. The Commissioner sought to apply Part IVA to this scheme and to disallow the deduction sought for rentals paid by the taxpayer. The court rejected the Commissioner’s contentions and stated as follows:

Due and proper management of the business required assessment to be made of the net cost of finance after taking into account the extent to which any outgoings associated with that cost were allowable deductions from assessable income. In the circumstances of this case, to say that the appellant was attracted by a proposal that provided finance at a lower after-tax cost than other means of obtaining funds for the business would not, without more, support an objective conclusion that the appellant obtained finance for the dominant purpose of obtaining the tax benefit constituted by the deductibility.

86 264 per Gleeson CJ, Gaudron JJ, Gummow JJ, Hayne JJ and Callinan JJ.
87 2007 66 ATR 57.
from assessable income the outgoings incurred in connection with the obtaining of that finance. To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business has obtained that finance at a net cost after taking into account the provisions of the Act, that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be greater than the deductible outgoings that would have been incurred under another method of obtaining finance.90

The court held that the fact that a taxpayer had obtained finance in the most tax-effective way did not necessarily establish a dominant purpose to obtain a tax benefit. Rather, the dominant purpose in this case was found to be as follows:

[B]alancing the various factors above, it cannot be said that the ruling, prevailing or most influential purpose of the appellant was to obtain a tax benefit. I think that a reasonable person would form the view that although that factor was important, the ruling prevailing or most influential purpose was to obtain a very large financial facility on the best terms reasonably available.91

The decision in this case is similar to the decision in *FCT v Metal Manufacturers Ltd*,92 where the court stated that even though one of the purposes of the scheme was to obtain a tax benefit, the dominant purpose was to obtain a huge amount of finance in the most tax-effective way. In another case, *Commissioner of Taxation v BHP Billiton Finance Ltd*,93 the court honoured the commercial nature of the scheme over its tax purpose. The court held that where a taxpayer opts for an obvious commercial option, “it is difficult to envisage that any of the matters to which one is mandated to have regard to in s 177D(b) viewed alone, together or in the aggregate, would point to a conclusion that the sole or dominant purpose of Finance or any other party which entered into or carried out the identified scheme was to obtain for Finance the relevant allowable deduction”.94

An analysis of decisions, such as *Eastern Nitrogen* and *Metal Manufacturers* (decided in favour of the taxpayer) and *Hart* and *Spotless Services Ltd* (decided against the taxpayer) indicates the uncertainty created by Part IVA. This is because the schemes in these cases all had commercial and tax considerations, but the decisions were different as already seen. Pagone explains this difference as follows:

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90 478.
91 494.
94 Paragraph 70.
The reasons for the judgement in *Hart* are instructive to an understanding of how crucial is the particular means adopted to a commercial end in determining whether the conclusion required by Part IVA is to be reached. The clear implication from *Spotless* and *Hart* is that the tax benefits obtained in each case could have been secured by other means without the application of Part IVA, but that what made it applicable was the way in which the taxpayers in each case obtained the tax benefits. It is difficult to see how Part IVA could have applied in *Spotless* if the taxpayer had simply sent funds for investment offshore without the added complexities to ensure that it would not be exposed to a foreign risk. In *Hart* it is difficult to see how Part IVA could apply if the taxpayers had taken out two separate loans and simply elected to repay the loan which did not attract tax deductibility on the interest charges before or faster than the other loan.95

This passage succinctly explains the application of Part IVA. It can be reconciled with the following statement from *British American Tobacco Australia Services*:

However, a transaction may take such a form that there is a particular scheme in respect of which a conclusion of the kind described in s 177D is required, even though the particular scheme also advances a wider commercial objective…According to *Hart* the central question then becomes, would it be concluded, having regard to the 8 matters listed in s 177D(b), that a person who entered into or carried out the … scheme, or any part of [the] scheme, did so for the dominant purpose of enabling the [appellant] to obtain a tax benefit in connection with the scheme?96

In this case, the taxpayer contended that the dominant, ruling, or prevailing purpose of the scheme was to effect a successful merger. However, the court noted that the court *a quo* had rejected this contention and held that the same commercial and legal result could have been achieved in a manner that did not show a dominant purpose to avoid tax.97 The court stated that after a consideration of the eight factors in section 177D of the ITAA, the dominant purpose of the scheme was to obtain a tax benefit. Of the eight factors, the court highlighted section 177D(2)(c) and noted that the timing of the scheme was crucial to its tax consequences.98

One can however argue that the commercial purpose in *Eastern Nitrogen* or *Metal Manufacturers* could also have been achieved by other methods. It can also be argued further

96 Paragraph 47.
97 Paragraph 51.
98 Paragraph 54. Further evidence of the uncertain application of Part IVA to taxavoiding commercial transactions can be seen in *Commissioner of Taxation v Citigroup Pty Ltd* [2011] FCAFC 61 par 45 where it was stated that in a section 177D inquiry a broader understanding of the commercial and financial environment in which the taxpayer operated was subordinate to the narrow question of what the taxpayer would obtain from the scheme. However, in *Mochkin* at par 48, the court stated that a taxpayer may enter into a scheme for the dominant purpose of avoiding tax, even though the dominant purpose may be couched in the pursuit of commercial objectives.
that another court could have applied Part IVA to these cases. The cases discussed in this paragraph, where Part IVA was applied, show that the courts will apply Part IVA to a transaction that is structured to avoid tax even though it also has commercial purposes. These cases do not indicate the extent to which tax structuring must go before it turns the dominant purpose of a transaction from commercial to tax avoidance. This means that there is some uncertainty regarding the extent to which a taxpayer can obtain tax benefits in an otherwise commercial scheme.

4. ANALYSIS OF PART IVA

In analysing Part IVA it must be determined whether this GAAR is effective against impermissible tax avoidance, and whether it honours the taxpayers’ right to avoid tax. In *Mochkin* the court noted as follows:

> [T]his court has recognised that Pt IVA must be applied having regard to the reality that the tax laws affect the shape of nearly every transaction. Accordingly, the form of the transaction may be tax driven, yet the scheme giving rise to the transaction may be one to which Pt IVA does not apply…drawing the line between commercial transactions that are and are not caught by Pt IVA is a matter of degree having regard to the 8 factors specified in s 177D(b).  

Krever subscribes to this view and notes:

> [T]he application of the general anti-avoidance principles must be reconciled with the long standing doctrine that the taxpayers cannot be penalised for choosing a tax effective option when it is available.  

Regarding the right to avoid tax, Part IVA is fundamentally different from its predecessor section 260 in the sense that it targets transactions with a dominant purpose to avoid tax, not all tax avoidance transactions. In cases such as *Peabody, Eastern Nitrogen, Metal Manufacturers, BHP Billiton Finance Ltd* and *Mochkin* the courts demonstrated that Part IVA allows taxpayers to exercise their right to avoid tax as long as their schemes do not show a sole or dominant purpose to avoid tax.

The case that best reflects the efficacy of Part IVA against impermissible tax avoidance and its position on the right to avoid tax is the *Spotless Services Ltd* case. In this case the court’s approach to the right to avoid tax was mixed, even though its dominant position honoured

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99 Paragraph 49.
100 Krever (1997) 124.
this right.\textsuperscript{101} In response to the reference to the Duke of Westminster principle\textsuperscript{102} by the taxpayer’s representative, the court stated that “[p]art IVA is to be construed and applied according to its terms, not under the influence of muffled echoes of old arguments concerning other legislation”.\textsuperscript{103} The court dismissed the Duke of Westminster principle, but it simultaneously showed an appreciation of the elements of the right to avoid tax by stating that a taxpayer is allowed to achieve commercial objectives in a tax-effective manner.\textsuperscript{104}

On the right to utilise tax-effective methods in commercial transactions; McHugh J’s concurring and brief judgment in this case noted that the conclusion that a person operated a scheme for the dominant purpose of obtaining a tax benefit would “seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayer”.\textsuperscript{105} According to McHugh J, a “very special set of facts” led to the application of Part IVA to the Spotless Services Ltd case.\textsuperscript{106} These facts related to the elaborate nature of the scheme.\textsuperscript{107}

On impermissible tax avoidance, the court stated that schemes with commercial purpose can still amount to impermissible tax avoidance if they have a dominant purpose to avoid tax. According to Krever,\textsuperscript{108} the following characteristics of the scheme in question convinced the court that it was impermissible in terms of Part IVA:

\begin{itemize}
\item According to Krever (1997) 122 the judgment belatedly recognised the legislature’s attempt to do away with the Duke of Westminster doctrine that had haunted Australia’s tax jurisprudence. He, however, notes that the decision may have undermined certainty and consistency in the tax laws by expanding the scope of Part IVA. The decision has been described by Passant “Spotless: Removing the Stain of Tax Avoidance in Australia (1997) 2 British Tax Review 131 as an “outstanding victory for the Revenue”.
\item The principle is based on the IRC v Duke of Westminster 19 TC 490 case where Lord Tomlin famously pronounced the right to avoid tax. In Australian terms it is arguably unnecessary to refer to the taxpayer’s right to avoid tax as the Duke of Westminster principle because the Duke of Westminster case was preceded by Jacques v Federal Commissioner of Tax (1924) 34 CLR 28 which basically pre-empted the famous statements of Lord Tomlin, but noted that while a taxpayer has an inalienable right to avoid tax it still depends on legislation whether the taxpayer has successfully exercised that right.
\item D’Ascenzo, in his capacity as Second Commissioner in a speech titled “Part IVA and the Common Sense of a Reasonable Person” delivered at the Queensland Taxation Institute on 17 May 2002 available at http://www.ato.gov.au/corporate/content.asp?doc=/content/22809.htm (accessed on 21.10.2010) stated that “Spotless explains that the way things are done can stamp an arrangement that has a commercial outcome as having been done that way for tax purposes. This is an internationally accepted approach”.
\item Krever (1997) 123.
\end{itemize}
i. The scheme was complex, well-conceived, and was marketed on the strength of its ability to create tax benefits.\footnote{Another case where a marketed tax avoidance scheme was struck down is \textit{Howland – Rose v Commissioner of Taxation} 2002 FCA 246. Conti J noted in this case that the decision by each taxpayer involved in the scheme “was not made in the context of existing business operations which they were respectively conducting; as in the case of \textit{Metal Manufacturers}, so that it was not the situation here of the principals merely adopting a particular course of action capable of being influenced by revenue considerations, nor the case of applicants adopting one of two alternative courses of action, being the one that produces a tax benefit”\footnote{John Howard, as quoted in Kobetsky \textit{et al} (2006) 642. See Harris “Australia’s General Anti Avoidance Rule: Part IVA Has Teeth but Some Are Missing” (1994) 2 \textit{British Tax Review} 124 134. Murphy “Part IVA From Here To...” (2000) 3 \textit{Journal of Australian Taxation} 198 at \url{http://www.austlii.edu.au/au/journals/JATax/2000/13.html} (accessed on 21/10/2010) for a discussion of the transactions that Part IVA is intended to target. Orow “Part IVA: Seriously Flawed in Principle” Cooper (ed) \textit{Tax Avoidance and The Rule of Law} (1997) 223 228 notes that the term is ambiguous because it can mean both “unnatural” and “fictitious”, which in itself can mean “sham”, and overall does not add any value to a GAAR. Arnold notes further that in Canada, and most countries, artificiality is not inherently offensive because many artificial or unnatural transactions are specifically permitted by statute or administrative concession.}}

ii. The taxpayer did not have a number of investment options, from which one could say the chosen one was the most tax efficient.

iii. The tax saving was a crucial element of the transaction, without it the taxpayer would not have entered into the scheme. Krever further states that the same conclusion in \textit{Spotless} could have been reached if the court, instead of looking at the investment in the Cook Islands as the scheme, had looked at the investment as a whole and seen that it was only commercially justified because of the tax benefit.

The decision in \textit{Spotless Services Ltd} thus showed that Part IVA can apply to commercial transactions with a dominant purpose to avoid tax and not just “blatant artificial, and contributed”.\footnote{This can be said to be a positive because it means that Part IVA is not limited to the obvious cases of impermissible tax avoidance. According to Evans:}

> After Peabody, the High Court has subsequently heard three cases (Spotless, Consolidated Press Holdings and Hart) relating to the application of Part IVA. In addition there have been many cases on Part IVA heard in the lower Federal and Full Federal Courts. The Commissioner has enjoyed success in most of these Part IVA cases. In particular, outright High Court victory in Spotless and in Hart, and...
partial success in Consolidated Press Holdings, has provided the Commissioner with a weapon of mass destruction that is not only perceived to be a potential threat, but which actually is a powerful threat. Evans further notes that “[p]art IVA is seen as effective and plans to strengthen it have been left on the shelf”.

Regarding certainty, it has been stated above that there is uncertainty on the stage at which a transaction crosses over to a dominant tax avoidance purpose. In *Spotless Services Ltd* the court noted that the elaborate nature of the transaction was decisive in reflecting a dominant tax avoidance purpose for Part IVA purposes. This decision however created uncertainty because it did not describe how elaborate a transaction must be before it possesses the dominant purpose required by Part IVA. In this regard, Dabner notes that “what is elaborate for one person may not be for another”. In court this means that what one court may find to be too elaborate could be found to be acceptable by another court. Evans also notes that “[t]he abundance of jurisprudence relating to Part IVA has not provided any greater certainty of outcomes as to when, or why, Part IVA will apply in particular circumstances”.

This uncertainty led to criticism of Part IVA. Orow notes that “[i]f Pt IVA is considered to be directed at transactions which can truly be described as tax avoidance, being transactions which result in a tax benefit contrary to the purpose and policy of the Act, then its presence in the Act cannot be justified”. To support this contention he argues that:

> it is necessary to read down Part IVA in order to provide for the intended operation of the ordinary and charging provisions of the Act. It is submitted that the interpretation of Pt IVA by the High Court in *Spotless* cannot stand because it leaves the provision with an undefined broad operation that is not conducive for certainty and consistency. *Spotless* is as it were “as good as it gets” and it is predicted that the ordinary operation of the legal system and the doctrine of precedent would ultimately prove to be a major force that militates against such breadth, leading to the gradual reduction in its scope. It is

---


112 Orow (1998) notes that in coming to a conclusion on dominant purpose under section 177D two issues are raised namely the threshold of dominance and the characterisation of the purpose. Describing dominant purpose in terms of section 177D, Orow notes that it “create[s] a major difficulty in determining the stage at which the relevant tax purpose passes the requisite threshold of dominance because that threshold is a matter of impression and degree and hence there will be significant differences in opinion as to what constitutes a dominant purpose. Further, there is greater difficulty in determining the relevant purpose to be considered so as to ascertain whether it passes the threshold of dominance”. Thus, “dominant purpose conclusions can arguably be made in many ordinary tax planning arrangements”.

113 Dabner (2000).


neither inconceivable nor should it be surprising that Pt IVA may suffer the same fate as that of its predecessor s 260.

Orow’s criticism of Part IVA continues and he suggests that the uncertainty created by this GAAR is such that it will lead to restrictive judicial interpretation to protect the right to avoid tax. He notes in this respect that:

[i]n circumstances where a general standard or provision fails to prescribe a clear and coherent rule, courts would, in discharging their function, seek to gradually define its requirements and parameters with a view to developing a rule or principle that provides for certainty and predictability in future determinations. This is an inevitable and unavoidable aspect of common law systems where greater emphasis is placed upon the certainty and predictability of law. In this regard, in the Australian context, there is a degree of tension between the ordinary operation of the judicial process and the need for generality in terms and principle in the design and drafting of general anti-avoidance provisions in order to deal with unforeseeable tax avoidance. That characteristic arguably explains the complete emasculation of former s 260. It was enacted in extremely broad terms that, if given literal effect, could not have been intended. High Court decisions gradually defined the scope of the provision in manners that produced certainty but deprived it of any significant practical operation.

Dabner\(^\text{116}\) criticises Part IVA in a similar fashion and argues that the breadth of Part IVA and its disregard for the commercial character of transactions as exposed by the court in Spotless Services Ltd makes it unworkable.

It is submitted that the uncertainty of Part IVA has to be viewed in the context of the consistent absence of a precise definition of impermissible tax avoidance. As stated in Chapter 3, a GAAR has an inherent measure of uncertainty due to this fact. The critical question should therefore be whether Part IVA’s uncertainty is limited, or unlimited, as was the case with section 260. It is argued that the uncertainty created by Part IVA is limited to a certain degree because the courts, taxpayers, the ATO, and government can be expected to understand the stage at which a reasonable adjudicator can begin to state that the dominant purpose of a transaction has metamorphosed to tax avoidance in some cases. In other words, reasonable efforts to secure tax benefits in a transaction can be said to be identifiable some of the times, even though in some cases, identifying these efforts can be relative. The inherent uncertainty is thus limited, but exists to ensure that the GAAR retains its broad and deterrent nature.

\(^{116}\)Dabner (2000).
It can also be argued that the fears expressed by Orow and Dabner can be contrasted with the decisions made in cases such as *Eastern Nitrogen*, *Metal Manufacturers*, *Mochkin*, and *BHP Billiton Finance Ltd*, where the courts honoured commercial transactions with a tax avoidance effect. It should also be noted that Part IVA, in section 177C(2), provides that transactions with a dominant purpose to avoid tax will not be impugned if these transactions amount to an exercise of choices expressly provided for in the ITAA. This provision functions as a defence against the application of Part IVA, and means that Part IVA cannot apply to transactions expressly encouraged by the ITAA.

5. CONCLUSION

The following timeline summarises the Australian experience with a GAAR that was discussed in this chapter:

**Table 3: Australia’s GAAR Timeline**

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1921</td>
<td>The decision in <em>DFC v Purcell</em> criticising the uncertainty and width of section 53 (section 260’s predecessor) is passed.</td>
</tr>
<tr>
<td>1936</td>
<td>The ITAA is enacted and the literally wide section 260 comes into force.</td>
</tr>
<tr>
<td>1956</td>
<td>Era of doctrines seeking to clarify the application of the wide section 260 starts with <em>FCT v Newton</em>.</td>
</tr>
<tr>
<td>1957</td>
<td>The choice doctrine is created in <em>Keighery</em>.</td>
</tr>
<tr>
<td>1958</td>
<td>The predication test is created in <em>Newton v FCT</em>.</td>
</tr>
<tr>
<td>1961 – 1964</td>
<td>The predication test is used to apply section 260 in <em>Peate</em> and <em>Hancock</em>.</td>
</tr>
<tr>
<td>1976 – 1977</td>
<td>The choice doctrine’s adverse effects on section 260 intensifies in cases such as <em>Mullens</em>, <em>Slutzkin</em> and <em>Cridland</em>. Barwick CJ is involved in <em>Mullens</em> and <em>Slutzkin</em> where the freedom to exercise tax saving choices is extended to the freedom to create the conditions necessary to exercise tax-saving choices. <em>Cridland</em> decision in 1977 is the zenith of judicial emasculation of section 260.</td>
</tr>
<tr>
<td>1978 – 1984</td>
<td>Section 260 experiences a revival in cases such as <em>FCT v Student’s World Pty Ltd</em>, <em>Greghorn Investments Pty Ltd and Others v FCT</em>, <em>FCT v Gulland</em>, <em>Watson v FCT</em> and <em>Pincus v FCT</em>.</td>
</tr>
<tr>
<td>1981</td>
<td>Part IVA is enacted to replace section 260, and develops the predication test as an indicator of impermissible tax avoidance.</td>
</tr>
<tr>
<td>1994</td>
<td>Judgment passed in <em>Peabody</em>, the first Part IVA case. The court rules that a scheme within a scheme cannot be isolated if it cannot stand alone away from the larger scheme. The result is a taxpayer victory.</td>
</tr>
<tr>
<td>1996</td>
<td><em>Spotless Services Ltd</em> decision in favour of the Commissioner handed down. Fears raised on Part IVA’s potential to adversely affect commercial transactions with tax benefits.</td>
</tr>
</tbody>
</table>
2001  *Consolidated Press Holdings* decision in favour of the Commissioner handed down. Approach taken is similar to the *Spotless Services Ltd* approach. However, fears for Part IVA’s effect commercial transactions with tax benefits are eased when two sale and leaseback transactions are honoured by the court in *Eastern Nitrogen* and *Metal Manufacturers*.

2002  *Hart v FCT* reaffirms the *Peabody* approach of prohibiting the isolation of sub-schemes if such sub-schemes cannot stand independently.

2004  *FCT v Hart* rejects the *Peabody* approach to sub-schemes, and the court states that a sub-scheme can be isolated for Part IVA purposes in any context.

2007  The court rules in *Star City Pty Ltd v COT* that a sub-scheme may not be isolated and favours the *Peabody* approach.

2009  *FCT v Star City Pty Ltd* rules against the court a quo and states that the *FCT v Hart* approach to sub-schemes is the correct one. The decision in *Ashwick* however favours the *Peabody* approach.

As discussed earlier, and indicated in the timeline above, Australia has had two contrasting GAARs. Section 260 was one of the first GAARs, and its broad nature meant that it could apply to all forms of tax avoidance if literally interpreted. In an effort to limit its scope, the courts interpreted it restrictively in cases such as *Newton, Keighery, Slutzkin, Mullens*, and *Cridland*. This restrictive interpretation gradually worsened, and this resulted in the demise of this GAAR. The experience with section 260 is critical in any GAAR study because it reinforces the idea that the courts seek to interpret broad and uncertain GAARs restrictively in order to strike a balance between curbing impermissible tax avoidance, and respecting the right to avoid tax.

Part IVA replaced section 260 and is currently in force. It basically defines impermissible tax avoidance schemes as those that are structured in such a way that it can reasonably be concluded that tax avoidance is the dominant purpose of the transaction. This approach has narrowed the GAAR’s focus. Part IVA has created controversy and uncertainty regarding the extent to which commercial schemes can seek tax benefits without metamorphosing into a scheme with a dominant purpose to avoid tax. However, it must be noted that this GAAR has been successfully invoked in a number of major cases, such as *Spotless Services Ltd, Hart* and *Consolidated Press Holdings*. This success has led to Evans stating that Part IVA is an effective weapon against impermissible tax avoidance in spite of the uncertainty it creates.\(^{117}\)

The success and challenges of Part IVA give rise to certain crucial lessons on a GAAR and these are as follows:

\(^{117}\) See generally Evans (2007).
1. A GAAR does not need to be an amalgamation of a number of indicators of impermissible tax avoidance, since it can be relatively effective if it is based on one broad but sufficiently explained indicator.

2. An indicator of impermissible tax avoidance can be defined or explained in a GAAR to reduce uncertainty. This is the case with Part IVA which has eight factors that may be used to determine dominant purpose. This would not necessarily turn a GAAR into a specific anti-avoidance rule as long as the definition or explanation is not exhaustive.

3. Isolating a scheme from a larger composite scheme for GAAR purposes can cause inconsistent judicial response as was witnessed in the Peabody and Hart cases. This can cause uncertainty.
CHAPTER 7
THE CANADIAN GENERAL ANTI-AVOIDANCE RULE

TABLE OF CONTENTS

1. INTRODUCTION .............................................................................................................. 174
2. BACKGROUND TO A GAAR IN CANADA ................................................................. 174
3. THE CANADIAN GAAR ............................................................................................... 178
   3.1 Section 245(2) ....................................................................................................... 178
   3.2 Recharacterisation of Avoidance Transactions ..................................................... 179
   3.3 Tax Benefit ............................................................................................................. 180
   3.4 Avoidance Transaction ......................................................................................... 181
   3.5 Series of Transactions ........................................................................................... 182
   3.6 Tax Purpose Test .................................................................................................. 183
   3.6.1 Tax Purpose of a Series of Transactions .......................................................... 184
   3.7 Misuse or Abuse .................................................................................................... 185
4. ANALYSIS OF SECTION 245 ...................................................................................... 188
   4.1 Judicial Views on the GAAR ............................................................................... 188
   4.2 Problems with Applying the Misuse or Abuse Concept ........................................ 192
   4.3 Problems with the Isolation of a Single Transaction in a Series ............................ 198
   4.4 Copthorne Holdings Ltd v The Queen: Further GAAR Analysis from the Canadian Supreme Court ...................................................................................... 199
   4.5 Section 245 and the Taxpayer’s Right to Avoid Tax ............................................. 202
5. CONCLUSION ............................................................................................................... 204
1. INTRODUCTION

Canada relies on a GAAR to curb impermissible tax avoidance. Unlike South Africa and Australia, Canada does not have a long history with a GAAR. The current GAAR in section 245 of the Canadian Income Tax Act (CITA)\(^1\) was introduced in 1988 and is the first and only GAAR in Canada. Nevertheless, despite the fact that the GAAR has not been part of the Canadian tax system for a long time, this country has considerable experience with a GAAR. There are valuable lessons on the interpretation of certain GAAR provisions that can be derived from this relatively short history.

The Canadian GAAR is founded on misuse or abuse as an indicator of impermissible tax avoidance, which in itself indicates the importance of discussing the Canadian GAAR experience because this study enables an analysis of the efficacy of the purposive interpretation of tax statutes in curbing impermissible tax avoidance, by reference to actual court cases on the indicator. The discussion of the Canadian GAAR will also focus on whether the misuse or abuse concept creates sufficient certainty to inform the revenue authority of the transactions that should be challenged, and inform taxpayers of the limits of permissible tax avoidance.

2. BACKGROUND TO A GAAR IN CANADA

Before the GAAR was introduced in Canada, there was a system of specific anti-avoidance rules aimed at curtailing impermissible tax avoidance.\(^2\) These specific rules were ineffectual, which prompted the Canadian Department of Finance, in its testimony before the House Committee on Finance and Economic Affairs, to state that, “we no sooner get the stuff out and the ink gets dry than there is a way to beat the rules”.\(^3\) The need for a broad and more effective rule was clear. It can be said that the Canadian GAAR was partly motivated by the failure of the specific anti-avoidance rules that were in place.\(^4\)

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\(^1\) RSC 1985 c 1 (5th Supp).
\(^4\) Krishna (2002) 860. Krishna notes that the specific anti-avoidance rules were problematic because they were reactionary, complex and insufficient to counter the intellectual energy behind the sophisticated schemes of the day. In explaining the reactionary nature of the specific anti-avoidance rules, Krishna notes that these rules targeted “specific transactions close to the barn door only after the horses have [sic] bolted”.

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The other reason why the GAAR was introduced in Canada is the decision in *Stubart Investments Ltd v The Queen*. In this case the court analysed the business purpose test as applied in the US and the UK, and concluded that it did not apply in Canada. It was stated that “a transaction cannot be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose”. The court rejected the suggestion that the transaction in question was a sham and rejected the business purpose test on the basis that it was a violation of the right to avoid tax. The court stated that:

> [t]he transaction was effectual and not a sham because it created the legal relations between the parties which the parties intended to create. The business purpose test is a distinct test from that of sham but is inapplicable because of its incompatibility with the long standing principle that a person might order his affairs so as to attract the least tax liability – a principle too deeply entrenched in Canadian law to be rejected in the absence of clear statutory authority. No such authority was advanced here.

The court reaffirmed the status of the taxpayer’s right in Canadian tax law as follows:

What then is the law in Canada as regards the right of the taxpayer to organise his affairs so as to reduce his tax liability without breaching any express term in the statute? Historically the judicial response is found in Bradford (Borough of) v Pickles [1895] A.C. 587 where it was stated

> If it was a lawful act, however ill the motive might be, he had a right to do it. If it was an unlawful act, however good his motive might be, he would have no right to do it.[Lord Halsbury L.C. 594]

> No use of property, which would be legal if due to a proper motive, can become illegal because it is prompted by a motive which is improper or even malicious [Lord Watson 598].

The court also referred to the *IRC v Duke of Westminster* case and noted that it represented the rights of taxpayers in Canadian tax law. Regarding a GAAR the court acknowledged that the presence of such a rule may have a bearing on the traditional right of the taxpayer to avoid tax. It noted:

> The presence of a provision of general application to control avoidance schemes looms large in the judicial approach to the taxpayer’s right to adjust his sails to the winds of taxation unless he thereby navigates into legislatively forbidden waters. The legislature has provided the standards of

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5 1984 1 SCR 536.
6 Per Beetz, Estey and McIntyre JJ 536-537.
7 537.
8 598.
9 1936 AC 1.
unacceptable avoidance procedures and there being no other limit imposed by the Act, the court found itself under no duty, nor indeed possessed of any authority, to legislate new limits.\textsuperscript{10}

The court went on to state that where legislation provides for certain tax concessions, a taxpayer who takes advantage of these concessions should not have his or her transaction impugned if the transaction is consistent with the purpose of the provisions. The court also stated that such transactions should not be impugned on the grounds that the taxpayer purposely sought to take advantage of the tax benefits available. The court referred to \textit{Produits LDG Products Inc v The Queen} where it was stated that:

\begin{quote}
[t]here is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible.\textsuperscript{11}
\end{quote}

Further authority for the court’s reasoning was found in \textit{The Queen v Alberta and Southern Gas Co} where it was stated that:

\begin{quote}
[a] transaction that clearly falls within the object and spirit of [a given transaction of the Act] cannot be said to unduly or artificially reduce income merely because the taxpayer was influenced in deciding to enter into it by tax considerations.\textsuperscript{12}
\end{quote}

The business purpose test was ultimately rejected on the grounds that it was not in line with the purpose of the tax legislation. Wilson J stated:

\begin{quote}
I therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose. A strict business purpose test in certain circumstances will run counter to the apparent legislative intent which, in the modern taxing statutes, may have a dual aspect. Income tax legislation, such as the Federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus the statute is a mix of fiscal and economic policy. The economic policy of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no bona fide business purpose. Thus, by imposing a positive requirement that there be such a bona fide business purpose, a taxpayer might be barred from undertaking the very activity Parliament wishes to encourage. At minimum, a business purpose
\end{quote}

\textsuperscript{10} 557.
\textsuperscript{11} 76 DTC 6344 6349.
\textsuperscript{12} 1978 1 FC 454 462 – 463.
requirement might inhibit the taxpayer from undertaking the specified activity which Parliament has invited in order to attain economic and perhaps social policy goals.\textsuperscript{13}

The rejection of the business purpose test in this case accelerated the enactment of the GAAR in 1988.\textsuperscript{14} Krishna notes that tax professionals applauded and “hailed” the \textit{Stubart} case as “striking a blow for the rights of taxpayers”.\textsuperscript{15} He notes that some advisers construed \textit{Stubart} as authority for the proposition that any transaction with a sole purpose to obtain tax benefits constituted permissible tax avoidance. Consequently, taxpayers entered into transactions that were justifiable only by reference to their tax implications. Krishna also notes as follows:

> It soon became clear that \textit{Stubart}, which rejected the business purpose test as a \textit{sine qua non} of legitimate tax planning, created a breach in the fiscal system that needed immediate repair if the integrity of the Canadian tax system was to be preserved. There was a desperate need for legislative action.\textsuperscript{16}

It is submitted that the decision in \textit{Stubart} had completely negative connotations for curbing impermissible tax avoidance at the time. The court favoured a purposive approach in this case and this should be interpreted as a positive. The fact that the GAAR later mandated a purposive approach shows that the response to the \textit{Stubart} case was not entirely about reversing every aspect of the decision in this case.\textsuperscript{17} The \textit{Canada Trustco} case is one of the most significant cases in current tax law.

\begin{thebibliography}{99}

\bibitem{575} 575.

\bibitem{Canada Trustco Mortgage Company v Canada 2005 SCC 54; [2005] 2 SCR 601 par 14.}\textsuperscript{14} The Canada Trustco case has been described by Sandler “The Minister’s Burden under GAAR” (2006) 54 1 \textit{Canadian Tax Journal} 3 and Trombitas “The GAAR and the Ten Commandments – Eternal Tax Dilemma No More/ Case Comment on \textit{Canada Trustco Mortgage Co v R}” (2007) 11 4 \textit{New Zealand Journal of Taxation Law and Policy} 407 as one of the most significant cases in current tax law. For more discussion of the \textit{Stubart} case see \textit{Duha Printers (Western) Ltd v Canada} 96 DTC 6323 (FCA).

\bibitem{Krishna (1990) 1.}\textsuperscript{15} Krishna (1990) 1.

\bibitem{Krishna (1990) 1.}\textsuperscript{16} Krishna (1990) 1.

\bibitem{Arnold “The Canadian General Anti-Avoidance Rule” in Cooper (ed) \textit{Tax Avoidance and The Rule of Law} (1997) 223 223 describes the decision in \textit{Stubart} as flawed, but notes that the court rightly recognised the relationship between statutory interpretation and the control of tax avoidance. The court in \textit{Stubart} specifically rejected the strict literal approach in favour of the so called “modern approach”. The approach in \textit{Stubart} can be contrasted with the approach in \textit{Friesen v The Queen} 1995 95 DTC 5551 where it was held that the purposive approach is restricted to instances where the provision in question is not clear.\textsuperscript{17}

\end{thebibliography}
3. THE CANADIAN GAAR

The GAAR was created to curb impermissible tax avoidance without affecting permissible
tax avoidance.18 Its provisions are discussed below.

3.1 Section 245(2)

Section 245(2) of the CITA states as follows:

Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances, in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction. (own emphasis in italics) 19

The italicised terms are the key terms of the section. “Tax benefit” refers to a reduction, avoidance, or deferral of tax or other amount due in terms of the CITA. It includes a reduction, avoidance, or deferral that would, but for the operation of a tax treaty, be due in terms of the CITA. “Tax benefit” also includes an increase in a tax refund applicable under the CITA due to the operation of a tax treaty.20 “Tax consequences” refer to the amount of income, taxable income, earned in Canada or not, or other amounts payable by, or payable as a refund to a person in terms of the CITA, or any amount that is relevant to the computation of that amount. “Transaction” refers to any arrangement or event.21 An “avoidance transaction” refers to any transaction that would directly or indirectly result in a tax benefit, but for the GAAR. A transaction is not an avoidance transaction if it may reasonably be considered to have been carried out for other bona fide purposes, and not to obtain a tax

18 Duff “The Supreme Court of Canada and the General Anti Avoidance Rule” in Duff and Erlichman Tax Avoidance in Canada Trustco and Mathew (2007) 1 1 notes that the GAAR is designed to draw a distinction between permissible and impermissible tax avoidance.
19 At first glance, this provision appears to be a wide reference to all tax avoidance transactions. However, it is clear that the term “avoidance transaction” limits the section to avoidance transactions that are defined in the GAAR. The term “but for” means that the GAAR can only be applied if there is no other provision in CITA to deny the tax benefit, as stated in Rousseau-Houle v The Queen 2001 DTC 250 par 24. In Canada v Imperial Oil Ltd [2004] FCA 36 par 30 – 31 it was stated that “[t]he purpose of GAAR is to prevent abusive tax avoidance to which more specific anti-avoidance rules do not apply. Thus if a taxpayer does not satisfy the statutory requirements of a provision on which the taxpayer relies, the Minister need not resort to GAAR. Similarly, GAAR is not needed if a more specific anti-avoidance rule applies. In other words, GAAR is the anti-avoidance provision of last resort. It purports to provide a framework to distinguish between legitimate tax minimization and abusive tax avoidance”.
20 Arnold (1997) 231 notes that the definition of tax benefit is broadened to ensure that the GAAR will not only apply to transactions that avoid tax but to other transactions that result in any form of tax advantage including the deferral of tax. He notes further that the definition of tax benefit assumes that there is a real amount of tax a taxpayer should have paid. This amount is used to determine the extent of the reduction, deferral or avoidance of tax effected by the taxpayer.
21 CITA section 245(1).
A transaction that is part of a series of transactions that result directly or indirectly in a tax benefit, but for the GAAR, will also be deemed to be an avoidance transaction. If that transaction can be explained by reference to other *bona fide* purposes, it cannot be characterised as an avoidance transaction.

In terms of section 245(4), section 245(2) referred to above will only apply to a transaction if it may reasonably be considered that the transaction would result, directly or indirectly, in a misuse or abuse of the CITA, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other relevant Act when computing tax, or any amount due or refundable to a person in terms of the CITA. It can thus be summarised that three conditions must be satisfied before section 245 can be applied. These are:

1. an avoidance transaction;
2. a tax benefit that arises from the avoidance transaction; and
3. the avoidance transaction must be abusive. This requirement is satisfied if the avoidance transaction results directly or indirectly in the misuse of the CITA or any other provisions of the documents referred to above.

The burden lies on the taxpayer to refute (i) and (ii). The Minister must prove that the avoidance transaction is abusive and amounts to a misuse of the provisions of the CITA read as a whole. Where the abusive nature of the transaction is unclear the taxpayer, will get the benefit of the doubt.

### 3.2 Recharacterisation of Avoidance Transactions

Section 245(2) empowers the Minister to recharacterise the tax consequences of an avoidance transaction by disregarding them. Tax consequences will be redetermined “as is reasonable in the circumstances”. In terms of section 245(5) recharacterisation that is reasonable in the circumstances entails, but is not limited to:

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22 Arnold (1997) 231 notes that the non-tax purpose test is the essence of the definition of the avoidance transaction. The non-tax purpose test, he notes, is actually an expanded form of the business purpose test. The legislature did not specifically use the term “business purpose” because it was concerned that the courts would narrowly interpret it by excluding family and investment transactions because, for Canadian tax purposes, the term business has a very established meaning. “reasonably considered” requires an objective test with reference to what the taxpayer did and the legal, commercial and tax consequences of his actions as opposed to subjective motive and intentions.

23 CITA section 245(3).

24 *Canada Trustco* par 17.
a. disallowing any deduction, exemption, or exclusion made in calculating income, taxable income or taxable income derived in Canada or tax payable;
b. any deduction, exemption or exclusion, income, or loss will be allocated to any person;
c. the nature of any payment or other amount will be recharacterised; and
d. the tax effects that would result from the application of the CITA provisions will be ignored.

Section 245(5) clearly states that it does not limit section 245(2) in the sense that the Minister can still recharacterise transactions as is reasonable in the circumstances without sticking to the provisions of section 245(5). Krishna notes that what is reasonable is a question of fact.25 This is because the Canada Revenue Agency (CRA) and the Minister need to keep abreast of the ever-changing transactions and tax avoidance methods taxpayers come up with. The term “reasonable in the circumstances” allows the Minister some flexibility in recharacterising avoidance transactions that are abusive. It is important to note that recharacterisation only happens after the transaction has been found to be an avoidance transaction. The Minister is not empowered to recharacterise a transaction to determine whether it is an avoidance transaction or not.

3.3 Tax Benefit

This is the first step when determining whether the GAAR applies to a scheme or not. A tax benefit must arise from a particular transaction or series of transactions, otherwise there would not be any question about tax being avoided. As seen in section 245(1) above, a tax benefit is widely defined and is not limited to avoidance or reduction of tax. It also extends to the deferral of tax, the deduction of expenses or losses, the exclusion of income, and obtaining a tax relief.26

There are four main principles that are used when determining whether a tax benefit has been obtained. The first, and probably the most obvious one is the factual determination.27 In this approach the courts make a finding based on the available information and if this information points to the existence of a tax benefit, a tax benefit will be adjudged to exist. The second principle is that the extent of the tax benefit is immaterial; the value of the tax benefit could

27 Canada Trustco par 19.
be anything, from several dollars to millions. However, in most cases where the GAAR is invoked, the tax benefit will be substantial because of the costs of the litigation.\textsuperscript{28} In the \textit{Canada Trustco} case, the taxpayer had purchased and leased trailers to generate over $80 million in deductions over two years. In \textit{Mathew v Canada},\textsuperscript{29} the taxpayer stood to obtain a tax benefit of $10 million through losses that were to be deducted from other income. These cases demonstrate the tax benefits taxpayers stand to obtain in some instances.

The third principle is that where the reduction of taxable income is not in issue, a tax benefit can be determined by reference to an alternative arrangement that the taxpayer could have carried out. This principle was explained in \textit{Canada Trustco} as follows:

For example, characterisation of an amount as an annuity rather than as a wage, or as a capital gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements.\textsuperscript{30}

This alternative must not be the most taxed one, as the court stated in \textit{Univar Canada Ltd v R}.\textsuperscript{31} It is rather the alternative transaction the taxpayer may actually have entered into. In \textit{Univar}, the court found that it is possible for the taxpayer to have entered into an alternative transaction, even if that transaction amounts to nothing. Lastly, the transaction giving rise to a tax benefit cannot be recharacterised when determining the existence of a tax benefit.\textsuperscript{32} Section 245(3) does not require that the person who obtains the tax benefit is the one who initiated the transaction.\textsuperscript{33}

\textbf{3.4 Avoidance Transaction}

Once a tax benefit is identified, the next step is to determine whether the transaction or series of transactions that gave rise to it is an avoidance transaction in terms of section 245(3). In terms of this section, an avoidance transaction is a transaction that results in a tax benefit either by itself, or as part of a series of transactions “unless the transaction may reasonably be considered to have been undertaken or arranged primarily for \textit{bona fide} purposes other than to obtain a tax benefit”. This provision works to target transactions that may reasonably be considered to have been undertaken for tax purposes. For a transaction to pass the test posed

\begin{itemize}
\item \textsuperscript{28} Hogg \textit{et al} (2010) 678.
\item \textsuperscript{29} [2005] 2 S.C.R. 643, 2005 SCC 55.
\item \textsuperscript{30} \textit{Canada Trustco} par 20.
\item \textsuperscript{31} 2005 DTC 1478.
\item \textsuperscript{32} \textit{Canadian Pacific Ltd v R} 2002 CTC 197.
\item \textsuperscript{33} In \textit{OSFC Holdings Ltd v Canada} 99 DTC 1044 (TCC) 1054 it was stated that the “recipient of the tax benefit need not be the same person who enters into, or orchestrates, the transaction or series of transactions”.
\end{itemize}
by this provision, it must have a *bona fide* non-tax purpose as its primary purpose.\(^{34}\) *Bona fide* means that the non-tax purpose must be real and not contrived to create a non-tax purpose impression.

### 3.5 Series of Transactions

Many impermissible tax avoidance arrangements involve complex transactions that involve a series of transactions. Such transactions can be said to be unnecessarily complex with the complexity often used to launder or conceal the impermissible nature of the transaction.\(^{35}\) The inclusion of a series aspect in the GAAR is therefore critical, even though it still does not mean that a transaction involving a series of transactions is impermissible tax avoidance.\(^{36}\) Section 245(3)(b) deals with transactions in a series of transactions. It provides that an avoidance transaction can be a transaction that is part of a series that results in a tax benefit, unless the transaction may reasonably be deemed to have a *bona fide* non-tax purpose. In terms of this section, a single step within a series of transactions qualifies as a transaction for GAAR purposes if it does not have a *bona fide* non-tax purpose.

Sections 245(2) and 245(3) do not provide guidance on the meaning of “series of transactions”, despite the importance of the concept. Inevitably, questions on the connection between the transactions in a series will be raised.\(^{37}\) In terms of the common law, a link is

\(^{34}\) The fact that a transaction results in a significant tax benefit does not mean that it does not have a *bona fide* non-tax purpose. In *Husky Oil v Canada* 99 DTC 308 (TCC) the taxpayer made a loss claim of about $26,568,045 (Canadian dollars) which arose from an oil and gas exploration the taxpayer had with an arm’s length party in a company based in Bermuda. Significant losses in the transaction were repatriated to Canada, and the transaction was deemed to be abusive by the Canadian tax authorities, who opined that the transaction was contrived to keep the income offshore. The Minister contended that the parties had no intention to make any profit, and that there was no partnership because the purported partnership was a sham. The Minister sought to apply the GAAR. The court held at 324 that the primary and *bona fide* purpose behind the partnership, which was found to be legal, was commercial for all the parties involved. The court also noted at 320 that the partnership was “the only feasible legal route by which to proceed”. Van der Hout “Development of the GAAR in the Case Law” in Erlichman (ed) *Tax Avoidance in Canada: The General Anti Avoidance Rule* (2002) 117 notes that “this case demonstrated that the Crown must bear in mind the real circumstances underlying a transaction rather than focusing all of its attention on the tax results obtained when considering whether or not to apply the GAAR”.

\(^{35}\) An example of a complex multi-step transaction can be found in *Fredette v The Queen* [2001] 3 CTC 2468. In this case the taxpayer obtained a tax benefit by deferring tax on rental income for two years in a series of transactions but claimed interest deductions in the same period. The court held at par 67-68 that deferring income while at the same time claiming interest deductions was acceptable to a certain extent, but “interposing a second, third or fourth partnership to defer the taxation of income for two, three or four years is quite another matter”.

\(^{36}\) Arnold “The Long, Slow, Steady Demise of the General Anti-Avoidance Rule” (2004) 52 2 *Canadian Tax Journal* 488 489 notes that the series part of the avoidance transaction is one of the critical components of a GAAR that determines its success.

established where a transaction is pre-ordained and pre-planned. In *Craven v White* it was stated that a series of transactions is preordained if the transactions are “pre-ordained” to produce a certain result with “no practical likelihood that the pre-planned events would not take place in the order ordained”. This line of reasoning was adopted in *OSFC Holdings Ltd v The Queen*, where the Federal Court of Appeal found that a series of transactions must be preordained to produce a particular final result. For a series of transactions to exist, there must be a prior understanding that a transaction will comprise certain steps that will all be put in place to complete the transaction.

The CITA provides a definition of “series of transactions” in section 248(10), which states that a series of transactions includes any related transactions or events completed with the series in mind. This means that the step must not be independent and must be related to the bigger transaction and must achieve the objectives of the series. It does not need to be preordained; it may not have been contemplated at the beginning, but if it is related to the series, and was completed with the series in mind, then it suffices as a step in the series to be treated in terms of the GAAR.

### 3.6 Tax Purpose Test

After determining that the transaction or series of transactions carried out by a taxpayer has obtained a tax benefit, the next question is whether the primary purpose was to obtain that tax benefit. In terms of section 245(3) a transaction which can reasonably be considered to have a primary purpose to achieve a certain bona fide objective is not an avoidance transaction. The use of the term “reasonable” in this section suggests that the inquiry is an objective one, and the reasonable person’s interpretation of the facts of the transaction is important. The use of the word “primarily” in this section means that a comparative evaluation is required where a transaction has both bona fide non-tax purposes and tax avoidance purposes.

38 1989 AC 398 UKHL 514. This concept was also explained in two other cases namely, *IRC v Bowater Property Developments* [1989] AC 398, *Bayliss v Gregory* 1988 STC 476 (House of Lords), where it was stated that it is not necessary for a contractual obligation to take the next step in a series to exist, but there must be no likelihood that the next steps will not be taken.

39 2001 4 CTC 82.

40 Hogg *et al* (2010) 682. In *OSFC Holdings Ltd* the court stated that the tax purpose test is objective. It was stated at 1054 that the subjective evidence of the taxpayer would not be given as much weight as the documentary and objective evidence.

41 *Canada Trustco* par 28. It was stated here that the word “primarily” justifies “an objective assessment of the relative importance of the driving forces of the transaction”. The court in this case (pars 27 – 35) considered the non-tax purpose test and came up with three main findings. These can be summarised as follows:

i. Determining the primary purpose of a transaction is a factual inquiry.
According to Hogg et al., certain factors have been considered useful in this objective inquiry. These are:

i. Comparing the tax avoided and the commercial or non-tax benefits of the transaction.

ii. The lifespan of the arrangements in the transaction.
   If the arrangements have a short lifespan, or are transitory, this may indicate a tax purpose.

iii. The dominance of a tax purpose over other non-tax purposes.
   Where the evidence clearly shows that the transaction was tax driven, the courts will have no difficulty in finding that tax avoidance was the primary purpose.

iv. The election of one particular transaction over another.
   Where a taxpayer chooses one transaction over another to achieve the same purpose, a tax purpose may be established. However, it does not automatically follow in this instance that a tax purpose for GAAR purposes exists. Hogg et al note in this respect that where “there is a legitimate business or non-tax objective for undertaking a transaction and there are alternative methods of achieving that objective, the use of a most tax-efficient method does not necessarily make the transaction an avoidance transaction”.

3.6.1 Tax Purpose of a Series of Transactions

In cases where a series of transactions is under consideration the question may arise as to whether it is the purpose of the whole transaction, or of one step in the series, that is relevant. This question was answered in Canada Trustco where it was held that “[i]f at least one transaction in a series of transactions is an “avoidance transaction”, then the tax benefit that

ii. It is irrelevant to establish that a similar non-tax objective could have been achieved but with higher taxes.

iii. A primary purpose to avoid tax may be established but will be irrelevant if the tax is avoided in a manner that is consistent with statutory purpose.

43 Water’s Edge Village Estates (Phase II) Ltd v R 2002 4 CTC 1. Where the tax benefit is bigger than the non-tax purpose to be pursued, it may be concluded that the transaction was carried out for tax purposes. This criterion is not conclusive because it raises the question whether a taxpayer wishing to pursue a non tax purpose must necessarily choose an option whose tax benefits are lower than what he stands to gain in his non tax driven transaction. Tax benefits may incidentally be higher in many instances.
44 Hogg et al (2010) 684. Also see generally Evans v R 2005 DTC 1792 where Bowman CJTC found that the primary purpose of a series of surplus stripping arrangements was to put certain funds into the hands of the taxpayer and the method that was used to achieve that was the most tax-effective.
45 Canada Trustco par 34. The isolation of one step in a series of transactions is similar to the approach in terms of the South African and Australian GAARs, as seen in Chapters 5 and 6.
results from the series may be denied under the GAAR. This is apparent from the wording of s 245(3). Conversely, if each transaction in a series was carried out primarily for bona fide non-tax purposes, the GAAR cannot be applied to deny the tax benefit”. This shows that a single transaction in a series of transactions can be isolated and its purpose can taint the whole series.

3.7 Misuse or Abuse

The determination of the abusive nature of the avoidance arrangement under section 245(4) is the last stage of the inquiry. This stage provides for immunity from the GAAR. Section 245(4) provides that the GAAR will “not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole”. Section 245(4) plays a central role in the GAAR, because it is the provision that distinguishes between permissible and impermissible tax avoidance. As such, the abusive nature of the transaction must be clear before the GAAR can be applied. This is

46 In Canadian Pacific Ltd v Canada 2000 DTC 2428 (TCC), a weak currency borrowing transaction, similar to the one in Shell Canada Ltd v Canada [1999] 3 SCR 622 discussed in Chapter 2, was challenged. In this case, the court stated that a step in a composite transaction cannot be isolated for the purposes of the GAAR, in spite of the provisions of sections 245(3)(b). The approach that was used by the Minister in this case to derive primary purpose from each step in the series of transactions was dismissed by the court that stated at 2430 that “[n]o transaction forming part of the series can be viewed as having been arranged for a purpose which differs from the overall purpose of the series”. On appeal, in Canada v Canadian Pacific Ltd 99 DTC 5132 (FCA), the court at par 25 and 26 stated that “[t]he implication of the Crown’s argument, if accepted, would have consequences which Parliament did not intend. If this argument was correct, the Crown could allege that the tax planning component of any transaction amounted to an event or arrangement constituting a “separate transaction”. Because it was undertaken for purely tax purposes, the “separate transaction” would be an avoidance transaction. In other words, any action taken to obtain a tax benefit would be an avoidance transaction and there would never be an occasion to determine the primary purpose of a transaction. The Crown’s argument would make use of the word “primarily” in subsection 245(3) redundant. The words of the Act require consideration of a transaction in its entirety and it is not open to the Crown artificially to split off various aspects of it in order to create an avoidance transaction”. Arnold (2004) 495 notes that the reasoning in this case is not reconcilable with the requirements of section 245(3)(b), which clearly states that the purpose behind each transaction in a series must be determined individually. Arnold also notes at 493 that the purpose behind the series definition and provision is to stop taxpayers from inserting a transaction without a bona fide non-tax purpose into one with a commercial or other bona fide non-tax purpose, and this purpose is not served if the Minister is barred from isolating such transaction.

47 Krishna (2002) 870 describes this limitation as “the single most significant”. Hogg et al (2010) 685 support this view and state that the misuse or abuse analysis is the “key and most difficult issue in the application of the GAAR”.

48 Canada Trustco par 50. In RMM Canadian Enterprises Inc v Canada 97 DTC 302 (TCC) 302 it was stated that the GAAR is a provision of last resort and is “heavy artillery”. This point was made in Jabs Construction Limited v Canada 99 DTC 729 (TCC) par 111 where Bowman J stated that “[t]his transaction is the last one that would have occurred to me as subject to attack under section 245. Section 245 is an extreme sanction. It should not be used routinely every time the minister gets upset just because a taxpayer structures a transaction in a tax effective way, or does not structure it in a manner that maximises the tax”. These cases reinforce the notion that the GAAR will only be applied where the abusive nature of the transaction is beyond doubt. This does not imply that taxpayers can exercise their right to avoid tax with impunity. In McNichol v Canada 97
an important safeguard that, apart from protecting taxpayer’s rights, helps to limit the application of the GAAR to transactions that are clearly abusive.

Reference to the two words “misuse” and “abuse” can be said to be superfluous because the Supreme Court in *Canada Trustco* found the term “abuse” broad enough to encompass “misuse”. To establish misuse or abuse under section 245(4), a purposive analysis is required. The court in *Canada Trustco* identified two steps in determining whether a transaction is abusive of the provisions of the CITA. The first step involves a contextual, textual, and purposive interpretation of the provisions that the taxpayer relies on to obtain the tax benefit. This is clearly a question of law. The second step involves a determination of whether the facts of the transaction fit in the purposive analysis of the relevant provisions. If not, an abuse of the provisions has occurred, and the GAAR can be used to strike the transaction down. The second step is a factual inquiry. It was noted in this case that:

> [s]ection 245 (4) imposes a two part inquiry. First, the courts must conduct a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act. Second, the court must examine the factual context of the case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance.

Since the GAAR warrants a purposive interpretation of the CITA, it can be said that an avoidance transaction is abusive if it defeats or frustrates the purpose of the statutory

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DTC 111 (TCC) 120 it was stated that tax avoidance transactions will not be successful if they are abusive, which means that the GAAR still regulates tax avoidance even though the court stated in *RMM Canadian Enterprises Inc* that it is a provision of last resort.

49 Paragraph 39. This can be contrasted with the decision in *OSFC Holdings v The Queen* 2001 4 CTC 82 where the court separated these two, and stated that they required different analysis. It was noted in this case that where there is no misuse, the court must determine whether the transaction is an abuse of the provisions of the Act read as a whole.

50 This section does not state the criteria that the tax authorities or the courts must apply when determining whether a transaction or series of transactions amounts to a misuse or abuse of the provisions of the CITA.

51 Paragraph 44. Sandler “The Minister’s Burden under GAAR” (2006) 54 1 *Canadian Tax Journal* 3 3 notes that the court did little to explain the operation of section 245. He refers to the two stage inquiry to establish misuse or abuse as confusingly described as the “overall inquiry”, entails a “mixed question of fact and law”. Nevertheless, it is submitted that the two stage inquiry in *Canada Trustco* is clear enough to establish certainty regarding the determination of the abusive nature of a transaction.
provisions.\textsuperscript{52} This does not necessarily extend to the policy underlying the provisions. This is because the policy is difficult for both the taxpayer and the revenue authorities to ascertain. In \textit{Canada Trustco} the court stated:

\begin{quote}
\textit{[T]}o search for an overarching policy that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs. Although Parliament’s general purpose in enacting the GAAR was to preserve legitimate tax minimization schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law. These three latter purposes would be frustrated if the Minister and/or the courts overrode the provisions of the \textit{Income Tax Act} without any basis in a textual, contextual and purposive interpretation of those provisions.\textsuperscript{53}
\end{quote}

The purposive inquiry required by section 245(4) means that a transaction that amounts to an abuse of the provisions of the CIT\textit{A} will be disregarded even if it complies with a literal interpretation of the provisions. This means that section 245(4) allows the GAAR to stop the CIT\textit{A} from self destruction, which is possible if a literal interpretation method is followed. It must be noted that the literal meaning of the provision in question is important in the inquiry. It was stated in \textit{Canada Trustco}\textsuperscript{54} that the CIT\textit{A} must be interpreted in a manner that allows consistency, predictability and fairness to enable taxpayers to manage their affairs “intelligently”. Consequently, where the words of a provision are clear and unambiguous, their ordinary meaning will play a more dominant role in interpretation.\textsuperscript{55}

The court in \textit{Canada Trustco} stated that a transaction’s lack of economic substance does not necessarily mean that it is abusive. It was stated that “s. 245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident”.\textsuperscript{56} The court further stated that “[t]he central inquiry is focussed on whether the transaction was consistent with the purpose of the provisions of the \textit{Income Tax Act} that are relied upon by the taxpayer, when those provisions are properly interpreted in light of their context”. According to the decision in \textit{Canada Trustco}, economic substance has

\begin{thebibliography}{9}
\bibitem{52} Hogg \textit{et al} (2010) 687.
\bibitem{53} Paragraph 42. It is noted in par 50 that the GAAR was intended to prevent abusive tax avoidance and to preserve the taxpayer’s right to tax planning, without sacrificing fairness and certainty.
\bibitem{54} Paragraph 12.
\bibitem{55} Paragraph 10. In explaining the need for certainty, consistency, and fairness in interpretation the court referred to Hogg and Magee \textit{Principles of Canadian Income Tax Law 2\textsuperscript{nd} ed} (1997) 476 where it is stated that “[i]t would introduce intolerable uncertainty into the ITA if clear language in a detailed provision of the Act were to be qualified by unexpected exceptions derived from a court’s view of the object and purpose of the provision”.
\bibitem{56} Paragraph 57.
\end{thebibliography}
limited importance and “any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance”. Nevertheless, economic substance seems to have played an important role in Mathew, where the court stated that “[t]he abusive nature of the transactions is confirmed by the vacuity and artificiality” that characterised the transaction. It can therefore be stated that economic substance will only be a factor in the application of the GAAR if it is relevant in establishing the abusiveness of a particular transaction.

4. ANALYSIS OF SECTION 245

4.1 Judicial Views on the GAAR

Certain judicial comments in certain cases can be said to reflect that some judges view the GAAR in the following light:

1. as a provision so powerful that it must be applied cautiously;
2. as a provision that does not draw a clear line between permissible and impermissible tax avoidance; and
3. as a provision that unduly threatens the taxpayer’s right to avoid tax.

This is in spite of the fact that the basic scope of the GAAR is fundamentally different from the literally broad GAARs that attracted hefty judicial criticism, such as section 90 of the South African Income Tax Act (discussed in Chapter 4), and section 260 of the Australian Income Tax Assessment Act (discussed in Chapter 6). These judicial views are summed up by Arnold who states that:

> [o]ccasionally judges cannot resist the temptation to make general comments, often uncomplimentary, about the tax legislation they are called on to interpret. For example, they have complained about the

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57 Paragraph 58.
58 Paragraph 62.
59 Some early cases on the GAAR certainly made more use of commercial substance in determining the abusive nature of a transaction. In Michelin Tires (Canada) Ltd v MNR (1995) 3 GTC 4040 (CITT), the first GAAR case, it was stated that the absence of a bona fide non-tax purpose was indicative of an abuse of the CITA for GAAR purposes. This decision was upheld on appeal in Michelin North America (Canada) Inc v Canada 2000 GTC 4070 (FCTD), where it was stated that the fact that the transaction was justifiable only by reference to the tax benefits it conferred, meant that it was abusive. In RMM Canadian Enterprises Inc 313 it was stated that “[a] form of transaction that is otherwise devoid of any commercial objective and that has as its real purpose the extraction of corporate surplus and the avoidance of the ordinary consequences of such a distribution, is an abuse of the Act as a whole”. In Lyse Nadeau v Canada 99 DTC 324 (TCC), the court stated that the absence of a bona fide non-tax purpose confirmed the abusive nature of the transaction in question.
60 Of 1941.
61 Of 1936.
prolix, turgid, impenetrable statutory drafting that characterizes the legislation. They have also made
general comments about the GAAR. These comments provide insights into the judge’s attitudes about
the GAAR that could influence their decisions in GAAR cases. In my view, these comments reflect
misconceptions about the GAAR that might prejudice its application by the courts.  

The view that a GAAR is a harsh measure, to be used only as a measure of last resort, was
expressed in a number of cases. In *Jabs Construction*,63 the court noted that the GAAR is an
“extreme sanction” that should not be used when the minister gets “upset” by a tax avoidance
transaction. In *Hill v The Queen*64 the GAAR was described as an “ultimate weapon” which,
in the transaction in question, was however ineffective. In *Canada Trustco Mortgage Company v The Queen*65 the GAAR was described a “tax legislation to be applied with utmost caution”.

The perception that the GAAR is too powerful to be utilised all the time is described in
*Geransky v The Queen* where Bowman ACJ noted as follows:

The Income Tax Act is a statute that is remarkable for its specificity and replete with anti- avoidance
provisions designed to counteract specific perceived abuses. Where a taxpayer applies those provisions
and manages to avoid the pitfalls the minister cannot say “because you have avoided the shoals and
traps of the Act and have not carried out your commercial transaction in a manner that maximises your
tax, I will use GAAR to fill in any gaps not covered by the multitude of specific anti-avoidance
provisions. That is not what GAAR is all about.  

*In Fredette*, more comments about the GAAR were made and it was stated that:

[w]hen it passed section 245 of the Act, parliament’s aim was to put a stop to schemes put in place to
create an undue tax benefit for taxpayers. Parliament’s intent was not, however, to enable the Minister
to force taxpayers to structure their transactions so as to give rise to the greatest possible tax liability. In
his explanatory notes on the new section 245 accompanying the bill to amend the Act, the Minister of
Finance acknowledged that a taxpayer is entitled to arrange his affairs so as to pay the least tax
possible. Section 245 is a powerful tool for discouraging and preventing flagrant abuses of the Act. It
cannot serve as a tool for the Minister to force taxpayers to structure their transactions in the manner
most favourable to the tax authorities.  

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63 Paragraph 48.
64 [2003] 4 CTC 2548 par 68.
67 Paragraph 76.
Arnold notes that the adverse comments are only attributable to a few judges and must therefore be taken with caution. He also notes that some judges view their role in GAAR cases as a fundamental one where they have to act to limit its application. Arnold believes that the statements from the cases referred to in this paragraph show a misunderstanding of the GAAR and notes that the GAAR should be understood in terms of the following:

1. It was enacted after Parliament saw no other option to curtail abusive tax avoidance when the court rejected the business purpose test in *Stubart*.

2. The GAAR is a provision of last resort that is not the extreme sanction it is considered to be. This is because the application of the GAAR does not lead to anything more than the payment of tax that, reasonably determined in the circumstances, would have been due but for the abusive avoidance transaction. There are no penalties for engaging in abusive tax avoidance which means that the only downside is the payment of tax that would have been paid anyway.

3. Despite what the courts have said, the Minister has applied the GAAR responsibly. This is because all the instances that could need the GAAR to be applied have to first go through the GAAR Committee.

Arnold’s submissions referred to in the points above on the GAAR are correct. It can nevertheless be argued that the courts in question did not acknowledge these points because the GAAR limits the right to avoid tax. The fact that the GAAR was introduced because there was no other general anti-avoidance option after the *Stubart* case rejected the business purpose doctrine, or that the GAAR is not a punitive measure, can be argued to be insufficient to sway the courts’ views that the GAAR must create certainty regarding its target, and must not unduly limit the right to avoid tax. The fact that the judicial views on the GAAR have been somewhat sustained and also been aired in the Canadian Supreme Court reinforces this argument. In *Canada Trustco*, the court stated that the GAAR is uncertain and

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68 These comments must also be seen in the light of the fact that the courts have refused to strike the GAAR down for vagueness. In *Longley v Canada* 99 DTC 5549 (BCSC). Quijano J rejected the contention that the GAAR is void because of its vagueness, and stated at 5562 that “[i]t is clear that although the courts have interpreted the GAAR as being of very limited application, they have not had difficulty in understanding and interpreting the GAAR within the context in which it has been an issue. I cannot, therefore, find that the GAAR is void for vagueness”. Also see *Gregory v Canada* 2000 DTC 2027 (TCC) in the Tax Court and 2000 DTC 6561 (FCA) for another rejection of the contention that the GAAR is void for vagueness.

69 Arnold (2004) 491. Arnold states at 492 that “I am curious as to why some judges see their role with respect to the GAAR as serving as a check or restraint on the authority of Parliament and the tax authorities to control abusive tax avoidance”.

does not clarify the boundary between permissible and impermissible tax avoidance. It was stated that:

[the GAAR draws a line between legitimate tax minimisation and abusive tax avoidance. The line is far from bright. The GAAR’s purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act. But precisely what constitutes abusive tax avoidance is the subject of debate. Hence these appeals.]

The view that the GAAR can unduly limit the right to avoid tax was expressed in Binnie J’s dissenting judgment in *Lipson v Canada*. Binnie J noted as follows:

How healthy is the Duke of Westminster? There is cause for concern. Although this court in *Canada Trustco Mortgage Co v Canada* affirmed the continuing viability of the principle that taxpayers are entitled to arrange their affairs to minimise the amount of tax payable (a principle enshrined in *Commissioners of Inland Revenue v Duke of Westminster* [1936] A.C. 1 (H.L.) the traditional approach is now tempered by the application of the general anti-avoidance rule ("GAAR"). The question in these appeals, as it was in *Canada Trustco*, is where the appropriate balance is to be struck.

Binnie J also noted that in limiting the application of the GAAR, care must be taken to ensure that the GAAR is not emasculated. He noted in this regard that:

[the GAAR is a weapon that, unless contained by the jurisprudence, could have a widespread, serious and unpredictable effect on legitimate tax planning. At the same time, of course, the GAAR must be given a meaningful role. That role is circumscribed by the requirement in s 245(4) of the Income Tax Act R.S.C. 1985 C.1 (5th Supp) that the transaction not only be shown to be “avoidance transaction[s]” i.e. transactions structured primarily to obtain a tax benefit, but in addition that the Minister demonstrate that the tax benefit results from a misuse/abuse of the provisions of the Act relied upon to produce it.]

As Arnold notes, the courts have not always expressed negative views on the GAAR. For instance, the majority decision in *Lipson* shows that the court had a different view of the GAAR from what has been referred to above. It was noted that the fact that a purposive approach to statutory interpretation is not a faultless way of curbing impermissible tax avoidance does not mean that the GAAR unduly limits the right to avoid tax. It was stated that:

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71 Paragraph 16.
72 2009 SCC 1.
73 Paragraph 54.
74 Paragraph 55.
[t]o the extent that it may not always be obvious whether the purpose of a provision is frustrated by an avoidance transaction, the GAAR may introduce a degree of uncertainty into tax planning, but such uncertainty is inherent in all situations in which the law must be applied to unique facts. The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed, in the context of the ITA, to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved. A desire to avoid uncertainty cannot justify ignoring a provision of the ITA that is clearly intended to apply to transactions that would otherwise be valid on their face.\textsuperscript{75}

However, in spite of the majority’s approach in \textit{Lipson}, it can be stated that there has been a sustained negative judicial view on the GAAR in Canada.

\textbf{4.2 Problems with Applying the Misuse or Abuse Concept}

The misuse or abuse concept is central to the application and efficacy of the GAAR. However, in spite of its importance, it has been misapplied in some cases. The origin of the problems with applying the concept can be traced to the Federal Court of Appeal’s decision in \textit{OSFC Holdings Ltd} where Rothstein J stated as follows:

\begin{quote}
It is also necessary to bear in mind the context in which the misuse and abuse analysis is conducted. The avoidance transaction has complied with the letter of the applicable provisions of the Act. Nonetheless, the tax benefit will be denied if there has been a misuse or abuse. This is not an exercise of trying to divine Parliament’s attention by using a purposive analysis where the words used in a statute are ambiguous. Rather, it is an invoking of a policy to override the words Parliament has used. I think, therefore, that to deny a tax benefit where there has been strict compliance with the Act, on the grounds that the avoidance transaction constitutes a misuse or abuse, requires that the relevant policy be clear and unambiguous. The court will proceed cautiously in carrying out the unusual duty imposed upon it under subsection 245(4). The court must be confident that although the words used by Parliament allow the avoidance transaction, the policy relevant provisions of the Act as a whole is sufficiently clear that the court may safely conclude that the use made of the provision or provisions by the taxpayer constituted a misuse or abuse.\textsuperscript{76}
\end{quote}

The court made use of the word “policy” that needed to be “clear and unambiguous”. Rothstein J noted that policy meant a reference to the spirit, object, and purpose of the provisions of the Act.\textsuperscript{77} It is submitted that the reference to a “clear and unambiguous” policy was misleading, as it imposed a requirement to refer to such policy before a transaction could be found to be abusive. It was also misleading in the sense that the term policy could easily be interpreted as meaning something other than the CITA’s spirit, object, and purpose. The

\textsuperscript{75} Paragraph 52.
\textsuperscript{76} 2001 4 CTC 82 par 67.
\textsuperscript{77} Paragraph 66.
approach advanced in this case made it extremely difficult for the Minister to prove misuse or abuse because in actual fact there was no “clear and unambiguous” policy document that accompanied the CITA.\textsuperscript{78}

Rothstein J stated that the approach of the court referred to above would not make the misuse or abuse concept difficult to establish. He stated as follows:

\begin{quote}
In answer to the argument that such an approach will make the GAAR difficult to apply, I would say that where the policy is clear, it will not be difficult to apply. Where the policy is ambiguous, it should be difficult to apply. This is because subsection 245(4) cannot be viewed as an abdication by Parliament of its role as lawmaker in favour of the subjective judgment of the Court or particular judges. In enacting subsection 245(4), Parliament has placed the duty on the Court to ascertain Parliament’s policy, as the basis for denying a tax benefit from a transaction that otherwise would meet the requirements of the statute. Where Parliament has not been clear and unambiguous as to its intended policy, the Court cannot make a finding of misuse or abuse, and compliance with the statute must govern.\textsuperscript{79}
\end{quote}

According to Rothstein J, the Minister had to either provide clear evidence of a “clear and unambiguous” policy, or accept that a transaction was not abusive. The correct approach would have been to require the Minister to prove that the transaction used a provision or provisions in a manner not intended by the legislator. In spite of Rothstein J’s assurances to the contrary, the determination of a “clear and unambiguous” policy in analysing whether a transaction was a misuse or abuse proved to be unduly bothersome to the Minister in subsequent cases discussed below.

In \textit{Hill v The Queen} the misuse or abuse analysis adopted in \textit{OSFC Holdings Ltd} was decisive in swaying the decision of the court in the taxpayer’s favour. The transaction in this case involved the conversion of accrued interest to principal in a circular fashion. The Minister conceded that the issue was whether the transaction was abusive or not. In this regard the Minister needed to comply with the ruling in \textit{OSFC Holdings Ltd} by establishing a “clear and unambiguous” policy behind the abused provisions. In response, the taxpayer admitted that the transaction was engaged to ensure that the interest accruing and payable would be simple interest and not compound interest. The taxpayer contended that the transaction had not been

\textsuperscript{78} Arnold (2004) 499 notes that the court erred in setting up an opposition between the words and policy of the CITA. He argues that the GAAR is the same as any words used in the Act thus it would have been fairer for the court in \textit{OSFC Holdings Ltd} to interpret the misuse and abuse concept as entailing the use of some words used by Parliament to override other words used by parliament, instead of using policy to override the words parliament has used.

\textsuperscript{79} Paragraph 70.
proved to be abusive by arguing that, in line with the *OSFC Holdings Ltd* decision, the Minister had failed to establish any “clear or unambiguous” policy. Miller J stated:

I now find myself at GAAR’s doorstep in a case that enticingly beckons me to open the door and apply the GAAR provisions in favour of the Respondent. Yet when those provisions are applied in the manner as set forth by Justice Rothstein in the *OSFC* case, the result is by no means inevitable. Indeed while I am led to the inexorable conclusion that the transactions are avoidance transactions within the meaning of subsection 245(3) of the Act, they are saved from the application of subsection 245(2) by the grace of subsection 245(4) as they are not avoidance transactions which result in a misuse of the provisions of the Act or an abuse of the Act read as a whole.\(^\text{80}\)

This statement shows that the court found the transaction to warrant the application of the GAAR but for the interpretation of misuse or abuse in *OSFC Holdings Ltd*. The manner in which the court dismissed the Minister’s submissions on policy shows the difficulty associated with establishing a “clear and unambiguous” policy.\(^\text{81}\) Miller J dismissed the policy submissions by stating as follows:

I can glean no identifiable policy from this argument. It is simply a reiteration of what the Act itself says, that is, simple interest can be deducted on a paid or payable basis and compound interest must be paid to be deductible. That is not the underlying policy statement; that is a summary of the legislation. I was not referred by the respondent to any materials that would assist me in understanding why the government permitted the deduction of simple interest on a payable basis and only permits the deduction of compound interest on a paid basis. What is the policy? It is not my role to speculate; it is the respondent’s role to explain to me the clear and unambiguous policy. He has not done so. I am therefore unable to find that there has been a misuse or abuse as contemplated by subsection 245(4) of the Act. Consequently, subsection 245(2) does not apply to the appellant’s avoidance transactions.\(^\text{82}\)

What started as a reference to a “clear and unambiguous” policy, had proceeded to a test that was completely different from the spirit, object, and purpose of the CITA. While Rothstein J stated that policy represented statutory purpose, Miller J went further and the statement referred to above shows that the Minister was now required to produce a document containing tax policy reasons behind statutory provisions. A lot can be said about the manner in which the taxpayer admitted that the transaction was meant to obtain a tax benefit but that the Minister had not identified the relevant policy. The fact that the taxpayer’s defence was based on the Minister’s inability to establish a “clear and unambiguous” policy, and not on

\(^{80}\) Paragraph 59.

\(^{81}\) The Minister stated that the policy of the CITA could be seen in the provisions contended to have been abused.

\(^{82}\) Paragraph 62.
the legitimacy of the transaction could be taken to mean that the taxpayer was confident from the start that the Minister had an extremely onerous, if not impossible, onus to discharge.

Miller J conceded in *Canada Trustco Mortgage Company v The Queen* that the policy approach was difficulty and risky and he noted as follows:

What this analysis highlights is the difficulty and risk in determining tax issues based on policy. Certainly GAAR invites such an approach, and the Federal Court of Appeal has made it clear that the only way to determine if there has been a misuse or abuse is to start with the identification of a clear and unambiguous policy. No clear and unambiguous policy – no application of GAAR. But at what level do we seek policy? And, as previously mentioned, do “policy”, “object and spirit” and “intended use” all mean the same thing? Is there a policy behind each particular provision, a policy behind a scheme involving several provisions, a policy behind the act itself? Is the policy fiscal? Is the policy economic? Is the policy simply a regurgitation of the rules? Does the identification of policy require a deeper delving into the raison d’etre of those rules? How deep do we dig? The success or failure of the application of GAAR left to the Court’s finding of a clear and unambiguous policy inevitably invites uncertainty. That is simply the nature of the GAAR legislation in relying upon such terms as misuse and abuse. As many have stated before, this is tax legislation to be applied with utmost caution as it directs the Court to ascertain the Government’s intention and then rely on that ascertainment to override legislation. This is quite a different kettle of fish from the accepted approach to statutory interpretation where policy might be sought to assist in understanding legislation. Under GAAR policy can displace the legislation.83

In this statement, Miller J blamed the difficulty of establishing policy on the GAAR, stating that a GAAR that relies on the misuse or abuse concept is uncertain in any event. This uncertainty, he noted, arose from the fact that the courts could not be sure of the extent to which they could go when determining policy. In the Federal Court of Appeal84 the decision was upheld. The court noted that the Minister’s attempt to glean policy from the provisions in question was insufficient, and noted that a policy source that clearly and unambiguously showed that the transaction had misused or abused the provisions of the Act had not been identified.85

The policy approach was used in *Canada v Jabin Investments Ltd.*86 In this case, the court rejected the Minister’s reference to the 1966 *Report of The Royal Commission on Taxation* chaired by Kenneth Carter to establish policy. It was noted that the *Report* was not a policy

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84 The Queen v Canada Trustco Mortgage Company 2004 DTC 6119.
85 Paragraph 1-3.
source because the proposals it contained had not been adopted in their entirety. It was stated that “because the policy invoked by the Minister is to override the words that Parliament has used, the policy must be clear and unambiguous if it is to be applied”. 87

In *Canada v Imperial Oil Ltd* 88 the same approach was followed and it was stated that the requirement that the policy must be “clear and unambiguous” is implicit in the language of section 245(4). The policy approach was also used in *Canada v Produits Forestiers Donohue Inc.* 89 The line of the cases that followed the *OSFC Holdings Ltd* interpretation of misuse or abuse when determining misuse or abuse is therefore long. These cases reinforce the notion that if an indicator of impermissible tax avoidance in a GAAR is erroneously interpreted, this can have a serious effect on the GAAR’s efficacy against impermissible tax avoidance.

It is arguable whether the Minister’s losses in cases where the policy approach was used would have been victories if the purposive approach was used. 90 The Supreme Court in *Canada Trustco* did away with the policy approach, and properly installed the purposive approach in determining misuse or abuse. One can note that the transaction in *Canada Trustco* was not abusive after all, because the Supreme Court, using a purposive approach, upheld it just as much as the lower courts using the policy approach had done.

The problems with applying the misuse or abuse concept also relate to the way in which the Supreme Court in *Canada Trustco* interpreted this concept. It has been stated that the court held that a purposive approach is required when determining whether a transaction has misused or abused the provisions of the CITA. However, in its attempt to balance between the taxpayers’ right to avoid tax with the prohibition of abusive transactions, the court gave mixed interpretation guidelines on misuse or abuse. The court stated as follows:

> As a result of the *Duke of Westminster* principle (*CIR v Duke of Westminster* 1936 A.C. 1 (H.L.)) that the taxpayers are entitled to arrange their affairs to minimise the amount of tax payable, Canadian tax legislation received a strict interpretation in an era of more literal statutory interpretation than the present. There is no doubt today that all statutes, including the *Income Tax Act* must be interpreted in a

87 Paragraph 3.
88 Paragraph 39.
89 [2002] FCA 422.
90 See generally Gammie “Barclays and Canada Trustco: Further Comment from a U.K. Perspective” (2005) 53 *4 Canadian Tax Journal* 1047 who notes that where there is no coherent tax policy behind what is intended to be taxed, it is improbable that the legislative definition of the tax base will be clear. As a result, the courts whose function is to interpret tax legislation will be unable to provide consistency where the policymakers have been unable to do so. Gammie at 1051 also argues that a GAAR “will never be a complete solution” to impermissible tax avoidance as long as it requires extensive judicial scrutiny into transactions where there is no coherent policy underlying the provisions in question.
textual, contextual and purposive way. However, the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.91

This statement shows that the court appeared to favour a literal interpretation of the CITA where the provisions relied on to obtain the tax benefits are particular and detailed. In this statement, the court effectively held that a taxpayer who relies on a provision aimed at achieving a particular result, cannot have his or her transaction disregarded by the GAAR if he or she relies on that provision to obtain the prescribed result. According to the court’s reasoning, this is because:

[t]he provisions of the Income Tax Act must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may arrange their affairs intelligently... “It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court’s view of the object and purpose of the provision.92

The court’s analysis of the misuse or abuse was therefore not unequivocally founded on purposive statutory interpretation. One can conclude that the need for purposive interpretation of tax statutes was not entirely satisfied by the misuse or abuse provision in the GAAR.

Another problem with the misuse or abuse concept is the manner in which it has been abused by the Minister in seeking to apply the GAAR to tax avoidance transactions. Kellough notes:

In my experience, Revenue Canada has adopted the object and spirit approach in virtually every transaction it finds objectionable but cannot fit within a specific provision of the Act. There is usually no indication of where the object and spirit of the provision comes from, much less the legal basis for applying such a test.93

In Geransky, Bowman ACJ noted:

Subsection 245(4) excludes from the operation of subsection 245(2) transactions that do not result “directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole”. What is misuse or an abuse is in some instances in the eye of the beholder. The Minister seems to be of the view that any use of a provision is

91 Paragraph 11.
a misuse or an abuse if the provision is not used in a manner that maximises the tax resulting from the transactions. 94

The Minister’s apparent readiness to label a transaction abusive can be attributed to two factors. The first is that misuse or abuse is a decisive factor in the application of the GAAR. Since misuse or abuse is the primary determination, it is only natural that the Minister will allege misuse or abuse in every transaction that is challenged. In this regard, the haste with which the Minister has alleged abuse can be explained by reference to the GAAR itself, which, in using misuse or abuse as the single factor in isolating impermissible tax avoidance, inadvertently encourages the Minister to allege abuse every time a suspicious transaction is encountered. The second factor is that the uncertainty surrounding the purpose of the provisions of the CITA has an effect on the Minister, who is not always certain that a particular transaction is abusive. This reinforces the notion that uncertainty in a GAAR, which may deter taxpayers from testing the boundary between permissible and impermissible tax avoidance, also has an effect on any revenue authority and causes it to challenge transactions which should not be challenged.

4.3 Problems with the Isolation of a Single Transaction in a Series

Section 245(3)(b) basically states that a single step in a series of transactions can be isolated for GAAR purposes. The GAAR can be applied to this single step and this can result in the denial of the tax benefits of the series of transactions. In Canada Trustco the court stated that:

[i]f at least one transaction in a series of transactions is an “avoidance transaction”, then the tax benefit that results from the series may be denied under the GAAR. This is apparent from the wording of s. 245(3). Conversely, if each transaction in a series was carried out primarily for bona fide non-tax purposes, the GAAR cannot be applied to deny a tax benefit. 95

However, a study of some cases decided after Canada Trustco shows that the courts have sometimes refused to isolate steps in a series of transactions for GAAR purposes. 96 One of these cases is Evans v The Queen. 97 In this case Bowman CJ held that there was no avoidance

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94 Paragraph 40.
95 Paragraph 34
96 For a discussion of some issues with the application of the GAAR that remained after the Canada Trustco case see generally, Sandler “The Minister’s Burden under GAAR” in Duff and Erlichman Tax Avoidance in Canada after Canada Trustco and Mathew (2007) 85.
97 [2006] 2 CTC 2009. This problem started with the Canadian Pacific case where it was held that a transaction that is part of a series cannot have a purpose that is different from the purpose of the series. See Arnold
transaction because of the bona fide non-tax primary purpose of the series of transactions. He did not ascribe a purpose to an isolated transaction in the series. The court followed the correct approach in *Desmarais v The Queen* where it ascribed a tax avoidance purpose to a step in a series of transactions that had an overall bona fide non-tax purpose.

The problem reappeared in *Makay v Canada*, where the Federal Court of Appeal overturned a decision of the Tax Court that stated that purpose could not be ascribed to a step in a series. Justice Campbell in the Tax Court actually referred to paragraphs 27 – 35 of the decision in *Canada Trustco*, which deal with section 245(3) of the CITTA, but came to a different conclusion. She reasoned that section 245(3) required a determination of all the individual transactions in the series, but only as part of the larger analysis of determining the purpose of the series as a whole. She concluded that the transactions in the series each had a bona fide non-tax purpose because the purpose of the series as a whole was bona fide. The Federal Court of Appeal however disagreed with the Tax Court’s reasoning and noted that it was inconsistent with the requirements of section 245(3). It was stated that “the conclusion that a series of transactions was undertaken for bona fide non-tax purposes does not preclude a finding that the primary purpose of one or more steps within the series was to obtain a tax benefit”.

4.4 *Copthorne Holdings Ltd v The Queen*: Further GAAR Analysis from the Canadian Supreme Court

The *Copthorne* case is the fourth and most recent GAAR case that the Canadian Supreme Court has dealt with. The Federal Court of Appeal had earlier dismissed the taxpayer’s case. This court had noted that a finding of misuse or abuse in terms of the two-stage approach in *Canada Trustco* could be justified in the following instances:

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98 2006 DTC 2376.

99 Sandler (2007) 95 states that the inconsistencies can be removed if GAAR cases are limited to the misuse or abuse analysis. He notes that the other requirements of the GAAR namely tax benefit and avoidance transactions are “no brainers” and if the Minister cannot establish them then he should not be challenging the case under the GAAR. Arnold (2006) 170 supports this view and notes that from the first GAAR case to *Canada Trustco* there has never been a problem with establishing tax benefit and avoidance arrangement except for the determination of the purpose of steps in a series. Arnold notes that the real contention has been on whether a transaction is abusive or not.

100 2008 FCA 105.

101 Paragraph 19.

102 Paragraph 21.


104 *Copthorne Holdings Ltd v The Queen* 2009 FCA 163.
1. where the taxpayer relies on specific provisions of the CITA for tax consequences that the provisions do not seek;
2. where a transaction defeats the underlying rationale of the provisions relied upon by the taxpayer; and
3. where a transaction avoids the application of anti-avoidance provisions in the CITA in a manner that frustrates the object, spirit, and purpose of those provisions.\textsuperscript{105}

The Supreme Court upheld the Federal Court of Appeal’s decision. The court noted that establishing misuse or abuse was the most difficult part of applying the GAAR.\textsuperscript{106} The court noted that this difficulty emanates from the fact that the GAAR “is a legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provision or provisions relied upon by the taxpayer”.\textsuperscript{107} The court also stated that transactions that are challenged by the Minister are in compliance with the literal terms of the CITA but not necessarily with its spirit, object, and purpose. In applying the GAAR to such cases uncertainty is created, which makes it imperative for the court to remember that the GAAR is a provision of last resort.\textsuperscript{108} The Supreme Court thus reiterated the views in \textit{Canada Trustco} that the GAAR is a provision of last resort and should only be applied when there is no doubt about the abusiveness of the transaction.\textsuperscript{109}

The court noted that it had to be mindful of the implications of its decisions on the “innumerable everyday transactions of taxpayers”.\textsuperscript{110} Regarding the transaction in question, the court noted that its decision on the transaction had far reaching consequences on numerous paid-up capital transactions. As such, the court had to approach its decision cautiously, mindful that Parliament must “be taken to seek consistency, predictability and fairness in tax law”.\textsuperscript{111}

The court then explained the analysis required under the misuse or abuse indicator. It noted that determining the object, spirit, and purpose of the provisions could be done in a manner similar to the traditional purposive analysis where a unified textual, contextual, and purposive

\textsuperscript{105} Paragraph 59 and 61.
\textsuperscript{106} Paragraph 65.
\textsuperscript{107} Paragraph 66.
\textsuperscript{108} Paragraph 66.
\textsuperscript{109} Paragraph 68.
\textsuperscript{110} Paragraph 67.
\textsuperscript{111} Paragraph 67.
approach sufficed.\textsuperscript{112} It was stated that in a GAAR analysis, the aim of the purposive analysis is to find the rationale of the provisions that is absent in the words of the provisions, whether the meaning of the provisions is clear or not. This made it different from a traditional purposive analysis that is aimed at the meaning of the provisions. The court cautioned that because of the need to establish the rationale of tax provisions in a GAAR analysis the temptation to align this rationale with a value judgment and theories on what tax legislation should be must be resisted.\textsuperscript{113}

Regarding the determination the textual meaning of the provisions the court stated that any GAAR case involved a transaction that complied with the literal terms of the provisions. This meant that the analysis could not end with a determination of the text. The court however stated that it does not follow that the literal meaning is insignificant since it could help to illustrate the intention of the provisions.\textsuperscript{114} The court’s position on statutory interpretation can be said to be clearer than its position in Canada Trustco that contained statements that could be interpreted as arguing for literalism in certain cases, even though the decision generally favoured a purposive construction.\textsuperscript{115}

The court in the Copthorne case reaffirmed the purposive analysis under the GAAR. It stated that when determining the contextual meaning of a provision as part of the broader textual, contextual, and purposive analysis, an examination of other sections of the CITA and other permissible external aids is necessary. It was also stated that not every section is relevant when determining a provision’s context, only related provisions that are grouped together or that work together are relevant.\textsuperscript{116} Regarding purpose, the court noted that CITA provisions are aimed at promoting specific activities and purposes.

On the controversial issue of isolating steps in a series of transactions, the court in Copthorne contradicted the Canada Trustco decision. Regarding the purpose of steps and transactions in a series, the court stated that:

\begin{quote}
while an avoidance transaction may operate alone to produce a tax benefit, it may also operate as part of a series of transactions that results in the tax benefit. While the focus must be on the transaction,
\end{quote}

\begin{footnotesize}
\textsuperscript{112} Paragraph 70.
\textsuperscript{113} Paragraph 70.
\textsuperscript{114} Paragraph 88.
\textsuperscript{115} See generally Arnold (2004). In spite of the predominantly purposive approach in Canada Trustco, in Overs v The Queen [2006] CTC 2255 an approach that borders on literalism was followed where the court stated that an avoidance transaction was absent since the taxpayer had complied with the rules set in the provisions in question.
\textsuperscript{116} Paragraph 91.
\end{footnotesize}
where it is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is part and the overall result that is achieved.\(^\text{117}\)

The above statement can be interpreted as meaning that individual transactions in a series must have their purpose determined by reference to the purpose of the series as a whole. The determination of the purpose of individual transactions in a series thus continues to be an unresolved, and increasingly controversial, issue in the application of the GAAR.

### 4.5 Section 245 and the Taxpayer’s Right to Avoid Tax

Canadian tax law recognises the principle that a taxpayer has a right to avoid tax permissibly.\(^\text{118}\) According to Krishna:

> [i]t is a fundamental principle of Canadian tax law that a taxpayer is entitled to arrange his or her affairs to minimise tax. Tax avoidance implies the reduction of tax payable by lawful means. Thus we start with the premise that the avoidance of tax is perfectly legitimate, and indeed even moral. A government should intervene in the economy only if it must deliver essential services at a cost or price that is lower than equivalent private sector comparables....as world economies interlink, cross border transactions increase, and tax rates take an increasing slice of the income, tax planning assumes greater importance.\(^\text{119}\)

Honourable John McKay, Parliamentary Secretary to the Minister of Finance in 2004 noted:

> Everyone in this country is entitled to arrange his or her affairs...or his or her company’s affairs to avoid taxes, to minimise the impact of taxes. That is lesson number one in law school and accounting school. Tax avoidance is an expectation on the part of government and taxpayers are entitled to arrange their affairs accordingly.\(^\text{120}\)

The GAAR’s role is to limit tax avoidance to transactions that avoid tax in a manner that is consistent with the purpose of the provisions of the CITCA.\(^\text{121}\) As noted in *Canada v Imperial*

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\(^\text{117}\) Paragraph 71.

\(^\text{118}\) The presence of a GAAR in Canadian tax law should not suggest otherwise. In *Canada Trustco* par 16, the court noted that the intention behind the enactment of the GAAR was to use it as a provision of last resort in addressing abusive tax avoidance. The intention was not to introduce uncertainty in tax planning.\(^\text{119}\)

\(^\text{120}\) Krishna (2002) 849.

\(^\text{121}\) Quoted in Kearl and Lemons “GAAR in the Tax Court after *Canada Trustco*: A Practitioner’s Guide” (2007) 55 4 *Canadian Tax Journal* 745 747. These authors metaphorically note that the CITCA contains a variety of “shoals and traps” that make tax planning a “challenging test of a practitioner’s navigational skills”. Krishna (2002) 850 and Krishna (1990) 53. Trombitas “The Conceptual Approach to Tax Avoidance in the 21st Century: When the Statute Gives but the GAAR can Take Away” (2009) 15 4 *New Zealand Journal of Taxation Law and Policy* 353 notes that “[a] GAAR has a dual function: It is a deterrent and provides a signpost for the judiciary. Contrary to submissions in many of the cases, the GAAR can never be a dead letter (if technical outcomes are allowed to stand) because of its deterrent effect. Many parties are deterred by the
the “GAAR effectively limits the scope of the principle in *Commissioners of Inland revenue v Duke of Westminster*, [1936] A.C. 1 at 19 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 otherwise would be”. In *Lipson* it was noted:

> It has long been a principle of tax law that taxpayers may order their affairs so as to minimise the amount of tax payable... This remains the case. However the Duke of Westminster has never been absolute and Parliament enacted s 245 of the *ITA*, known as the GAAR to limit the scope of allowable avoidance transactions while maintaining certainty for taxpayers.

The question with the GAAR is, therefore, not whether it limits the right to avoid tax, but whether it does so fairly. It is submitted that subjecting the right to avoid tax to a proviso that this right may not be exercised in transactions that are inconsistent with the purpose of the provisions of the CITA, but not with its purpose, is fair in principle. The problem lies with the uncertainty surrounding the identification of statutory purpose. This uncertainty can be argued to have an adverse effect on the right to avoid tax.

The uncertainty of the misuse or abuse provision in particular has, however, not had an unchecked effect on the right to avoid tax. In *Canada Trustco* it was stated that:

> According to the Explanatory Notes, Parliament recognized the Duke of Westminster principle “that tax planning – arranging one’s affairs so as to attract the least amount of tax – is a legitimate and accepted part of Canadian tax law (p. 464). Despite Parliament’s intention to address abusive tax avoidance by enacting the GAAR, Parliament nonetheless intended to preserve predictability, certainty and fairness in Canadian tax law. Parliament intends taxpayers to take full advantage of the provisions of the *Income Tax Act* that confer tax benefits. Indeed, achieving the various policies that the *Income Tax Act* seeks to promote is dependent on taxpayers doing so.

GAAR, thereby also preventing aggressive transactions from being implemented”. It is difficult to argue against this point on the grounds that there is no knowledge of the percentage of taxpayers who are deterred from entering into transactions that avoid tax by the GAAR because the percentage is irrelevant. It is also true that in spite of its weaknesses, a GAAR does work to a certain extent to deter impermissible tax avoidance schemes that are clearly within its ambit. However, the point has already been made in relation to the Canadian GAAR, and the GAARS discussed in the previous chapters, that uncertainty can equally affect the revenue authority. Uncertainty also invites restrictive judicial interpretation and this can lead to the annihilation of the GAAR’s efficacy against impermissible tax avoidance.

122 Paragraph 32.
123 Paragraph 21.
124 Paragraph 31. Regarding this statement Trombitas (2009) 412 notes that “[t]he Duke of Westminster principle is alive and well” and that there is no rule preventing transactions being structured in a tax effective manner. The real issue on which the analysis must turn is whether the structuring of the transaction is consistent with the statutory purpose. Duff “The Supreme Court of Canada and the GAAR: *Canada Trustco* and Mathew” (2006) 60 1 *Bulletin of International Taxation* 54 62 states that the judgment in this case (*Canada Trustco* par 12) started with the Supreme Court’s general approach to tax avoidance, as in other
This statement shows that the courts do not acknowledge the deterrent effect of the GAAR’s uncertainty. It is also imperative to note that the court in Canada Trustco ruled that the GAAR is a provision of last resort, and can only be applied where the abusive nature of the transaction is clear. As discussed in par 4.1 above, lower courts have also described the GAAR as an extreme measure to be applied at the last resort. The courts’ statements that limit the GAAR mean that any doubt regarding the application of the GAAR is to be resolved in favour of the taxpayer. This implies that the potential uncertainty that surrounds misuse or abuse only has a limited deterrent effect. It also means that the courts have consistently limited the GAAR’s uncertainty in order to protect the right to avoid tax. Furthermore, the burden of proof regarding the abusive nature of a transaction has been held to lie with the Minister.

5. CONCLUSION

The Canadian GAAR relies on the purposive interpretation of statutes to isolate and curb impermissible tax avoidance. The experience with purposive interpretation in Canadian tax avoidance cases shows that determining the purpose of provisions is not a straightforward matter. In OSFC Holdings Ltd the court stated that a transaction misuses or abuses the provisions of the CITA if it is inconsistent with a “clear and unambiguous” policy behind the provisions. The Minister was required to establish a “clear and unambiguous” policy, and to prove that this policy had been violated by a tax avoidance transaction. This proved to be an impossible onus to discharge in a number of cases until the Canada Trustco decision dispensed with the policy approach and installed the purposive interpretation of the provisions of the CITA as a formula for determining whether misuse or abuse had occurred.

However, the court in Canada Trustco did not unequivocally state that the misuse or abuse provision requires a purposive interpretation of tax provisions because it stated that where the provisions are detailed, then more reliance will be placed on the literal meaning of these provisions. The court also stated that certainty, predictability, and fairness should not be

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125 Paragraph 21. Also see Copthorne par 67.
126 Paragraph 50.
128 Canada Trustco par 65.
129 Paragraph 67.
sacrificed when determining purpose. In its most recent decision on the GAAR, the Supreme Court in *Copthorne* interpreted the misuse or abuse provision as requiring purposive interpretation since all transactions comply with the literal terms of the CITA. However, the court reiterated the view that purposive interpretation imposed on the court an “unusual” duty of going behind the literal terms of the statute in order to determine purpose. From this experience, it can be concluded that the misuse or abuse provision in the GAAR does not necessarily lead to the seamless introduction of the purposive interpretation of tax statutes. It can also be concluded that if the purposive interpretation of statutes is required, then it is advisable to qualify the misuse or abuse provision accordingly. This could help to avoid the inconsistencies seen in the discussion of misuse or abuse in this chapter.

The misuse or abuse concept is, in principle, a fair limitation of the right to avoid tax. However, this limitation is unfair to the extent that statutory purpose is not always clear. This is where the Canadian courts have limited the GAAR by stating that, *inter alia*, it will only be applied as a matter of last resort and where the abusive nature of the transaction is beyond doubt. The courts have also consistently passed negative comments on the GAAR. It can be argued that these comments stem from the broad and uncertain nature of the GAAR itself, and the favourable attitude to the right to avoid tax consistently shown by the courts. In this regard, it can be concluded that the deterrent value of the GAAR is limited because the courts have consistently indicated a desire to limit it. It can also be concluded that, in spite of the limited deterrent value of this GAAR, it has proven to be capable of curbing impermissible tax avoidance in the major cases in which it has been invoked. Three of the four Supreme Court cases in which it has been invoked namely *Mathew*, *Lipson* and *Copthorne* have resulted in victory for the Minister.

Another important issue is the isolation of a step in a series of transactions and applying the GAAR to this step to deny the tax benefits of the series. Section 245(3)(b) states that a step in a series of transactions qualifies as a transaction for GAAR purposes. This provision has consistently proved to be problematic in the courts, with some courts refusing to isolate one step in a series for GAAR purposes, and others acknowledging the effect of section 245(3)(b) and isolating a single step in a series for GAAR purposes. Cases such as *Makay*, *Evans*, *Desmarais*, *Canada Trustco*, and *Copthorne* illustrate the problems encountered with the

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130 Paragraph 12.
131 Paragraph 66.
isolation of a single step in a series. It can be concluded that the isolation of a step in a series of transactions is another problematic and unresolved aspect of the GAAR.
CHAPTER 8

THE JUDICIAL DOCTRINES TO COUNTER IMPERMISSIBLE TAX AVOIDANCE IN THE US

TABLE OF CONTENTS

1. INTRODUCTION .............................................................................................................. 208
2. BACKGROUND TO THE JUDICIAL ANTI-AVOIDANCE DOCTRINES ................... 208
   2.1 The Role of the Judiciary ......................................................................................... 208
   2.2 Substance over Form as the Primary Consideration .................................................. 210
3. THE ECONOMIC SUBSTANCE DOCTRINE ................................................................. 212
   3.1 The Economic Substance Doctrine in Selected Cases .............................................. 215
      3.1.1 Gregory v Helvering .......................................................................................... 215
      3.1.2 Knetsch v United States ..................................................................................... 217
      3.1.3 Frank Lyon Co v United States ......................................................................... 218
      3.1.4 Rice’s Toyota World Inc v Commissioner ......................................................... 218
      3.1.5 Falsetti v Commissioner .................................................................................... 219
      3.1.6 ASA Investerings Partnership v Commissioner of Inland Revenue .............. 219
      3.1.7 Yosha v Commissioner of Internal Revenue .................................................... 220
      3.1.8 Long Term Capital Holdings v United States ................................................... 222
      3.1.9 Black and Decker Corporation v United States .................................................. 223
      3.1.10 Coltec Industries Inc v United States ................................................................. 224
      3.1.11 TIFD III – E Inc v United States ...................................................................... 225
      3.1.12 CMA Consolidated Inc v Commissioner .......................................................... 226
      3.1.13 Santa Monic Pictures LLC v Commissioner ..................................................... 227
      3.1.14 ACM Partnership v Commissioner .................................................................. 227
   3.2 The Inconsistent Application of the Economic Substance Doctrine ..................... 229
   3.3 The Codification of the Economic Substance Doctrine ............................................ 230
4. ANALYSIS OF THE ECONOMIC SUBSTANCE DOCTRINE .................................... 231
   4.1 The Economic Substance Doctrine and Statutory Interpretation; Literalism v Purposive Interpretation ........................................................................................................... 231
   4.2 The Economic Substance Doctrine against Impermissible Tax Avoidance .......... 237
   4.3 Uncertainty ............................................................................................................... 240
   4.4 Comparison with a GAAR ....................................................................................... 242
5. CONCLUSION .............................................................................................................. 243

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1. INTRODUCTION

The last four chapters discussed GAARs as weapons against impermissible tax avoidance. As seen in Chapter 1, not every country in the world relies on a GAAR to curb impermissible tax avoidance, and the US is one of these countries. The US relies on judicially created doctrines that are aimed at curbing impermissible tax avoidance, and serve as a general anti-avoidance mechanism. *Gregory v Helvering* is the case that is widely credited with the introduction of these judicial doctrines. The judicial doctrines that were introduced in this case entail the business purpose doctrine, the economic substance doctrine, the sham transactions doctrine, and the step transactions doctrine.

This discussion in this chapter will focus on the creation, scope, development, and application of the economic substance doctrine. Other doctrines indicated above will not be discussed because they have no direct relevance to the theme of this research. In this discussion, the court’s role in the creation of the doctrine will be discussed, as will the manner in which the courts have applied the doctrine in various cases. The discussion in this chapter is aimed at identifying the factors that indicate the lack of economic substance in a transaction, and determining the efficacy of the economic substance doctrine as a weapon against impermissible tax avoidance.

2. BACKGROUND TO THE JUDICIAL ANTI-AVOIDANCE DOCTRINES

2.1 The Role of the Judiciary

In countries with a GAAR, it is the responsibility of the legislature to create anti-avoidance legislation. The courts’ role in these countries is limited to interpreting and determining

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2 293 US 465 (1935).

whether these GAARs are applicable to transactions that are challenged by revenue authorities in court. By contrast, the courts in the US have responded to impermissible tax avoidance by creating and developing judicial anti-avoidance doctrines that function like GAARs. These judicial doctrines are founded on the purposive interpretation of tax legislation.

A study of the *Gregory v Helvering* case shows that, in creating the judicial doctrines, the courts in the US had no inhibitions when scrutinising a transaction that complies with the literal terms of the tax legislation. This approach was adopted in the earliest days of the federal income tax legislation to ascertain whether the transaction had substance, and whether it complied with the spirit and purpose of the provisions it relied on to obtain tax benefits. The Sixteenth Amendment authorising the imposition of tax was ratified by the states in the US in 1916 and, as already noted, in 1935 the Supreme Court handed down a landmark ruling in the case *Gregory v Helvering*. In this case the court acknowledged the taxpayer’s compliance with the literal terms of the legislation, but applied the judicial sham or business purpose doctrine to the transaction in question. The court laid the foundation for the application of the judicial doctrines against impermissible tax avoidance in the US, and crucially showed the courts’ willingness to enforce the legislative purpose to ensure that transactions did not just comply with the text of the provisions. After *Gregory v Helvering*, the courts referred to the judicial doctrines that were created in this case to strike down transactions that promoted form over substance.

The judicial doctrines were developed over time as the courts applied them in different cases. As can be expected with unwritten concepts, there has been some inconsistent use of

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6 MacMahon “Economic Substance, Purposive Activity and Corporate Tax Shelters” (2002) 94 8 *Tax Notes* 1017 1018 notes that the purposive interpretation of tax legislation on which the judicial doctrines are founded is critical to limit the literal interpretation of the Internal Revenue Code of 1986, as amended (the Code), which produces results that are “too good to be true”. For instance, the facts of the *ACM Partnership* case show that in 1989 a representative of Merrill Lynch, MaCauley Taylor approached Colgate with a plan to neutralise part of the capital gains Colgate had received the previous year when it sold its wholly-owned subsidiary The Kendal Company. Prior to this approach, Colgate had considered and rejected a number of proposals for the limitation of tax liability on its 1988 income. The Merrill Lynch proposal entailed the forming of a partnership to generate losses which would offset some of the gains Colgate had made. Colgate’s then Vice President for taxation, Steven Belasco, expressed reservations about the Merrill Lynch proposal, noting that it had significant costs, was not related to Colgate’s non-tax business purposes, and could, as a result, be potentially liable to an attack in terms of the judicial doctrines. His reservations did not stop the transaction, which in turn was disregarded because it lacked economic substance.
terminology in relation to the doctrines. In *Long Term Capital Holdings v United States*, it was noted that the terms used to describe the doctrines could vary from sham, profit motivation, and economic substance, but this did not matter since the evaluation was ultimately based on a transaction’s business purpose and economic substance.

There is the view that the courts are better equipped than the legislature to create and develop anti-avoidance rules that perform a GAAR function. According to MacMahon:

> Congress simply cannot keep pace with the army of hardworking tax maven who are engaged in the never ending design of new tax shelters. Thus the job falls to the IRS and the courts. Without the uncertainty these doctrines create, mastery of the nooks and crannies of the code and regulations would become even more valuable for both tax practitioners and their clients. It is they, the aggressive taxpayers and their advisers, combing the nooks and crannies of the code and regulations for anomalies that they can turn in to either home grown tax shelters or tax shelter products to be marketed to taxpayers by the advisers – who create the uncertainty.9

MacMahon’s submission illustrates the dynamism of judicial doctrines that are constantly developing on a case-by-case basis as opposed to GAARs, which require legislative changes by parliament before they can evolve. A comparative review of GAARs and judicial doctrines will be carried out later in this chapter.

### 2.2 Substance over Form as the Primary Consideration

The judicial doctrines in the US are based on the substance over form doctrine. The basis of this doctrine is that the tax implications of a transaction are to be determined by reference to its substance as opposed to the form that its participants have chosen to follow.10 In

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8 330 F.Supp.2d 122 (D Conn 2004).
9 MacMahon (2002) 1019. Pichhadze and Pichhadze “Economic Substance Doctrine: Time for a Legislative Response” (2007) 48 1 Tax Notes International 61 62 support the theory that the legislature cannot be expected to create a law of general application that can effectively curtail impermissible tax avoidance. They note that “the problem is that a legislature cannot anticipate all types of tax avoidance schemes to expressly provide that they should require economic substance. Therefore tax authorities have preferred that the courts assist them by deciding on a case by case basis when a transaction should require economic substance. The judiciary, which carries out the institutional function of interpreting and applying law, could carry out this function through a purposive interpretation of tax shelters”. Regarding uncertainty, Li “Economic Substance: Drawing the Line Between Legitimate Tax Minimisation and Abusive Tax Avoidance” (2006) 54 1 Canadian Tax Journal 23 41 notes that certainty is a relative concept, and that absolute certainty is impossible to achieve because taxes are levied on real business transactions that are not easy to predict. He notes further that certainty, most importantly, is not the only basic policy objective, and must not be achieved or sought “at any cost”. It can be stated that while absolute certainty may be impossible, a substantial measure of certainty is required, because lack of it will confuse both the taxpayers and the revenue authorities.
**Minnesota Tea Co v United States**\(^\text{11}\) the Supreme Court stated that a result arrived at, at the end of a transaction, is not necessarily rendered different just because a devious method has been utilised.

The principle of substance over form became part of the adjudication of tax avoidance cases at an early stage. The US Supreme Court in *United States v Phellis* in the early 1920s noted:

> We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases we have under varying conditions followed the rule.\(^\text{12}\)

In another case, *Weiss v Stearn*, it was stated that:

> [q]uestions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants...when applying the Sixteenth Amendment and income tax laws enacted we must regard matters of substance and not mere form.\(^\text{13}\)

The early cases referred to above show that the courts were prepared to give effect to a transaction’s substance and not its form. However, the case that entrenched this doctrine and established important tests to indicate the need to give effect to the substance is *Gregory v Helvering*. In this case, the taxpayer’s conveyance of equity was not to reorganise her business, but to effect a transfer of a corporation’s assets to the taxpayer at a minimal rate of taxation. The taxpayer took advantage of the reorganisation provisions but acted without business purpose. The court thus created the business purpose test to deny the tax benefits in the case as an ancillary of the substance over form doctrine.

Substance over form was described in *Weinert’s Estate v Commissioner*\(^\text{14}\) as “the cornerstone of sound taxation”. The basis of the judicial doctrines on the substance over form doctrine is important because it has been observed that taxpayers rely on the form of their transactions when they are challenged by the Internal Revenue Service (IRS).\(^\text{15}\) The IRS’s argument in these challenges is made on the basis that the tax benefits sought to be obtained through a transaction should not be obtained if the form of the transaction does not correspond with its


\(^{12}\) 257 US 156 (1921) 168.

\(^{13}\) 265 US 242 (1924) 242.

\(^{14}\) 294 F.2d 750 (5th Cir 1961) 755.

\(^{15}\) Knight and Knight (1991) 92.
substance. In this instance, a transaction is said to lack substance if it does not have business purpose or economic substance.\textsuperscript{16}

3. THE ECONOMIC SUBSTANCE DOCTRINE

The economic substance doctrine is one of the judicial doctrines used by the courts to strike down impermissible tax avoidance transactions. According to Bankman,\textsuperscript{17} the doctrines are interrelated and no single doctrine operates alone. However, he states that the economic substance doctrine has played a significant role in countering corporate tax shelters, and has been used to strike down transactions that would have led to billions of dollars in tax being avoided.

The economic substance doctrine is part of the US common law. The courts will disregard a business transaction for lacking economic substance if the transaction gives rise to a tax benefit or a tax loss but has no economic value other than the value attributable to the tax loss. In \textit{Frank Lyon Co v United States}\textsuperscript{18} the court stated that to establish economic substance, two questions must be answered. The first question is an objective one; it asks whether the taxpayer has proved that the transaction in question has resulted in a meaningful change in the taxpayer’s economic position, without considering the economic impact of the tax benefits obtained. This question involves the consideration of issues such as the (reasonable) expectations of profit, the risk of loss, and whether or not any taxpayer or entity sustained a loss or realised a profit from the transaction.\textsuperscript{19} Korb, Chief Counsel for the IRS in 2005 stated that actual profit is not necessary. He noted:

Of course even competent investors lose money on some of their investments. Thus a transaction is not required to actually result in a profit in order for the taxpayer’s transaction to have objective economic substance. Generally speaking, however a potential for profit is present when a transaction is carefully

\textsuperscript{16} Canellos (2001) 49 – 50. Canellos notes that “to the tax shelter promoter and its adviser, form is always a friend and substance always an enemy to be expiated. In a tax shelter, form is malleable because it needs to conform only to tax needs and not business objections”. Other cases illustrating the substance over form doctrine include \textit{Higgins v Smith} 308 US 473 (1940) and \textit{Commissioner v Court Holding Co} 324 US 331 (1958) where the court held at 334 that “the incidence of taxation depends upon the substance of a transaction”. The courts have, at times, been inconsistent with the application of the substance over form doctrine. In \textit{Waterman SS Corp v Commissioner} 430 F. 2d 1185 1192 it was stated that “[s]omething more than easy generalisation that the substance rather than the form of a transaction is determinative of its tax effect. \textit{Gregory} (the case describing the factors to be taken into account when examining a transaction’s substance) should not be considered a ‘talisman of magical powers’, since in numerous situations the form by which a transaction is effected does influence or control its tax consequences”.


\textsuperscript{18} 1978 435 US 561. This case is widely recognised as the case that introduced the test shown above.

\textsuperscript{19} VanderWolk “Codification of the Economic Substance Doctrine: If We Can’t Stop It, Let’s Improve It” (2009) 55 7 Tax Notes International 547 549.
conceived and planned in accordance with standards applicable to a particular industry, so that judged by those standards the hypothetical reasonable businessman would participate in the investment.\textsuperscript{20}

The non-tax effect aspect of the enquiry is unclear on the extent of the non-tax effect that is sufficient for a transaction to have economic substance.

The second question is a subjective one. It involves an inquiry into the purpose of the transaction and the question whether the taxpayer entered into the transaction for business purposes apart from obtaining the tax benefit.\textsuperscript{21} This stage of the inquiry demands an investigation of the taxpayer’s circumstances and a determination of his or her declared motives.\textsuperscript{22} In \textit{Compaq Computers Corporation v CIR}\textsuperscript{23} it was stated that “[t]o satisfy the business purpose requirement of the economic substance inquiry, the transaction must be rationally related to a useful non-tax purpose that is plausible in the light of the taxpayer’s conduct and economic situation”.

Business purpose is a significant aspect because it helps to identify real transactions. It has been stated that real transactions have their basis in making profit in the long-or short-term by increasing income and reducing expenses. Connected with this is the fact that financing that is founded on business purpose is aimed at raising capital. This does not exclude tax considerations, which nevertheless do not provide the primary reasons for engaging a particular transaction. Impermissible tax avoidance schemes can be contrasted with this because they are solely or mainly purposed to reduce taxes.\textsuperscript{24}

According to Korb, the following factors are crucial when determining business purpose.

i. whether there was a possibility of profit;
ii. whether the taxpayer had a business reason that is not tax motivated;
iii. whether the taxpayers or the advisors behind the scheme deliberated certain factors, such as market risk;
iv. whether the taxpayer committed financial resources to the transaction in the form of capital;

\textsuperscript{22} \textit{Frank Lyon Co v United States} 583-584. In \textit{Shriver v Commissioner} 899 F. 2d 724 726 it was noted that the proper inquiry is “whether the taxpayer was induced to commit capital for reasons only relating to [business] considerations or whether a non-tax motive, or legitimate profit motive, was involved”.
\textsuperscript{23} 113 TC 214 (1999) 224.
\textsuperscript{24} Canellos (2001) 51.
v. whether the transaction involves other entities, whether these entities carried out their (legitimate) business independently, and whether they continued to do so after the completion of the transaction;

vi. whether the purported steps in the transaction were carried out in a normal way and in a way the participants intended; and

vii. whether the transaction was presented as a tax avoidance scheme whose tax benefits substantially outweigh the taxpayer’s investment in it.  

The second stage of the enquiry is thus the incorporation of the business purpose doctrine into the bigger economic substance analysis. The business purpose enquiry has been argued to be similar in effect to the objective economic substance. It was noted in ASA Investerings Partnership v Commissioner of Inland Revenue that:

[t]here is no real difference between the business purpose and economic substance rules. Both simply state that the Commissioner may look beyond the form of an action to discover its substance. The terminology of one rule may appear in the context of the other because they share the same rationale. Both rules elevate the substance of an action over its form. Although the taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effects to a transaction if its sole purpose is to evade taxation.  

However, it is clear that, while both require a focus on the substance of the transaction, the objective economic substance and subjective business purpose tests require different analysis. 

Regarding the subjective purpose aspect, Bankman notes that it is impossible to know a taxpayer’s subjective intention. This means that when conducting the business purpose aspect of the enquiry, the courts are forced to look at objective factors that will illustrate the taxpayer’s subjective intent. Such factors include those referred to by Korb above, and documents and other objective evidence. Bankman notes that the problem that affects this determination is that the objective factors can easily be manipulated. He states that:

25 Korb (2005) 9. Michaelson “Business Purpose and Tax-Free Reorganisation (1952) 61 Yale Law Journal 14 25 notes that since a taxpayer inevitably provides proof of purpose, he must not be allowed to benefit from the choice to provide or withhold certain incriminating indicators of purpose. These objective criteria are necessary to nullify possibly biased evidence of business purpose from the taxpayer.

26 201 F. 3d 505 (D.C. Cir 2000), par 39 – 40, referring to Zmuda v Commissioner 731 F.2d 1417 1420 (9th Cir 1984) 1421.


29 Bankman (2000) 27. Summers (1961 – 1962) 41 subscribes to this reasoning and goes further to say that the susceptibility of the business purpose doctrine to manipulated findings calls for its abandonment. He notes that “such tests actually stack the cards in favour of the taxpayer rather than against him; the advantages of
[a] primary criticism of the business purpose test is that it leads to the creation of false or misleading documents that evidence non-tax motives. Promoters supply corporations with reams of paper on the ostensible business benefits of a particular shelter; the corporation approves the purchase in meetings whose notes stress such benefits – all for a shelter that in truth is purchased only for its tax benefits.

Combining business purpose with economic substance means that the effect of the taxpayer’s manipulation of business purpose therefore potentially weakens the economic substance doctrine in certain circumstances. This is because the two tests are conjunctive which means that they both have to be satisfied before the economic substance doctrine can be used to nullify a transaction. A taxpayer who manages to create a convincing impression of business purpose may escape the application of the economic substance doctrine.

The business purpose leg of the inquiry requires a comparison between the significance of the taxpayer’s tax avoidance objective and his or her business or non-tax purposes. This leads to the conclusion that an abusive tax shelter or impermissible tax avoidance exists where the business purpose is outweighed by the tax avoidance goals. The extent of the business purpose that is required to protect a transaction is unclear especially where the tax and non-tax purposes equally contribute to the carrying out of a transaction. In this instance it is not clear whether the business purpose or tax avoidance purpose will take precedence over the other.30

3.1 The Economic Substance Doctrine in Selected Cases

The economic substance doctrine has been considered in many cases. These cases illustrate the scope and application of this doctrine. A selection of these cases will be discussed below.

3.1.1 Gregory v Helvering

As has been noted earlier, the case generally credited with laying the foundation for the economic substance doctrine is Gregory v Helvering. In this case the taxpayer was the owner

sweeping definitions and of whatever presumptions may be available to the government will remain more than offset by the fact that the evidence as to motive is almost entirely in the possession of the taxpayer, unless psychology devises a better mental x-ray than has so far been discovered”. The manufacturing of a non-tax purpose to satisfy the business purpose doctrine is not an awesome task. Rice “Judicial Techniques in Combating Tax Avoidance (1953) 51 Michigan Law Review 1021 1044 states that “only the most unimaginative of tax counsel will find it difficult to project innumerable business reasons supporting any device to save taxes”.30 The right to avoid tax is as established as the business purpose doctrine. As Blum “Motive, Intent and Purpose in Federal Income Taxation” (1966-1967) 34 University of Chicago Law Review 485 515 notes, the freedom to minimise tax is expected to be exercised in today’s society and is not condemned which means that it should not easily be overshadowed by business purpose where it constitutes half of the motivation to enter into a particular transaction.
of the entire stock in an entity known as United Mortgage Corporation (UMC) which held 1000 shares in Monitor Securities Corporation (MSC) as part of its assets. The taxpayer, for the sole purpose of effecting a transfer of these shares to herself for resale at a profit while simultaneously limiting her exposure to taxation on the income that would be levied if she obtained dividends, elected to reorganise a company in terms of the legislation at that time. The taxpayer then organised a new entity, Averill Corporation, and three days later UMC transferred the 1000 shares in MSC to Averill. Just three days later, the newly organised Averill Corporation was dissolved and liquidated by distributing all its assets, the 1000 shares in MSC, to the taxpayer. Averill did not conduct any business and from the facts it was clear that it was never intended to conduct any business. The taxpayer then sold the shares immediately for $133 333.33 (USD) and returned a sum of $76 007.88, based on a reduction of $57 325.45, for taxation.

The Commissioner disregarded the whole scheme and stated that the taxpayer would be liable for tax as if UMC had paid her a dividend from the amount gained by the sale of MSC shares. This contention was based on the opinion that the organisation had to be disregarded for lack of substance. The taxpayer, however, responded that the reorganisation of Averill was technically compliant with the legal requirements for a reorganisation. She argued that her motives to escape the payment of tax had no impact on the reorganisation and could not make it unlawful because the statute allowed it. She also contended that her motive to avoid tax was immaterial because she had a legal right to decrease her taxes legally from what they otherwise would be.

The court stated that the question for determination was whether what was done, apart from the tax motive, was what the statute intended. The court held that when the provisions the taxpayer used to obtain a tax benefit provided of a transfer of assets from one entity to another, they essentially meant a transfer made in executing a plan to reorganise a corporate business. This was opposed to a transfer of assets by one entity to another in the execution of an arrangement that did not have any connection with the business of either entity, as was evident from the facts in the case. The court concluded that what actually happened was that the taxpayer conceived and carried out a scheme with no business or corporate purpose. The scheme was a device that put on a reorganisation front to conceal its real character. The sole objective was to achieve a certain objective for the taxpayer, which was to transfer shares to her, and not to reorganise a business or any part of a business. In this regard the Supreme Court stated as follows:
When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made ‘in pursuance of a plan of reorganization’ (section 112(g) of corporate business: and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business but to transfer a parcel of shares to the petitioner. No doubt, a new, valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purposes; it performed, as it was intended from the beginning it should perform, not other function. When that limited function had been exercised, it immediately was put to death. In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.31

The court interpreted the provisions in question purposively and focused on the substance of the transaction. In so doing, the court found that the transaction had no appreciable economic benefits on the taxpayer apart from the impact of the tax benefits (economic substance objective test), and had no business justification either (subjective business purpose test).32

3.1.2 Knetsch v United States33

This case is also one of the major cases that shaped the judicial doctrines against impermissible tax avoidance. In this case Knetsch (K) obtained a loan to buy deferred annuity savings bonds. He then borrowed back, in cash, the discrepancy between his indebtedness and the value of the bonds. There was nothing of substance K could realise in this transaction. The court used this fact to rule that the loans were a “facade” and that the transaction was a sham, which meant that the interest incurred on the loan was not allowed as a deduction.34

31 469.
34 366.
From this decision, it is clear that the courts will recognize a taxpayer’s right to avoid taxes. Nevertheless, the court showed that it will disregard a transaction that is inconsistent with the purpose of the provisions relied on to avoid tax. This case reaffirmed the fact that the economic substance doctrine is founded on the purposive interpretation of legislation. Since the taxpayer did not derive anything of substance from the transaction, the court ruled that that the transaction was a facade or a sham. The court noted that the absence of an independent economic benefit showed that the transaction was deceptive in that it unduly entitled the taxpayer to deductions for which he did not really qualify.

3.1.3 Frank Lyon Co v United States

This case is also one of the major cases in which the judicial doctrines were developed. In this case the court discussed the substance over form doctrine and noted that the analysis under the doctrine would involve a determination of “the objective economic realities of a transaction rather than...the particular form the parties employed.” The court found that the transaction in question was not a sham and investigated the “substance and economic realities of the transaction”. It came to the conclusion that:

We hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax – independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honour the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.

3.1.4 Rice’s Toyota World Inc v Commissioner

This case also contained an analysis of the economic substance doctrine. It was noted that for a transaction to be disregarded for lacking economic substance, “the court must find that the taxpayer was motivated by no business purpose other than obtaining the tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists”. This finding indicates that the court established a two-legged test before the transaction could be disregarded as a sham. Applying these tests, the court found that when the taxpayer entered into the transaction the sole reason was to

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35 573.
36 582.
37 583 – 584.
38 752 F. 2d 89 (4th Cir. 1985).
39 91.
obtain a tax benefit. The court proceeded to the second test and noted that the fact that the transaction had no reasonable possibility of profit and no other economic benefit apart from the revenue saved by the sought tax benefits meant that the second leg of the inquiry had been satisfied. As a result, the transaction was found to lack economic substance.

3.1.5 *Falsetti v Commissioner*\(^{40}\)

The transaction in this case involved a ‘sale’ in terms of which legal title was not passed. It was also found that the transaction was not concluded at arm’s length, the purchase price for the property far exceeded its fair market value at the time, the terms of the agreement were flouted willingly, and the parties to the transaction did not treat the transaction as a transfer of property. The court found that the transaction lacked economic substance and held that “[c]onsidering the totality of the facts and circumstances surrounding the purported sale transactions...[the] petitioners engaged in the expedient of drawing up papers to characterise the transaction in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits”\(^{41}\).

3.1.6 *ASA Investerings Partnership v Commissioner of Inland Revenue*

In this case Allied Signal (AS) manufactured aerospace and automotive products. It decided to dispose of its interest in Union Texas Petroleum Holdings Inc (UTPH) in 1990. UTPH was an oil, gas, and petrochemical company. AS knew it would realise a substantial capital gain ($400 million) from this disposal, and promptly made plans to shelter these gains from taxation. It approached an investment bank, Merrill Lynch, to deliberate a set of transactions the investment bank had developed to create tax losses that would offset the anticipated capital gains. The taxpayer adopted a plan that entailed a set of transactions in partnership with several foreign-based entities. The transactions were moulded to exploit provisions in the Code and other regulations that provided reasonable results where property was disposed by way of an instalment sale and the value of the instalments could not be verified in advance. The taxpayer managed to satisfy the form of these provisions to generate tax losses to the value of several hundred million dollars. The gains that softened these losses were attributed to the foreign entities that were not subject to taxation in the US.

The Commissioner issued a notice effectively attributing a large portion of the capital gain to AS. The Commissioner relied on the following two alternative grounds:

\(^{40}\) 87 TC 332 (1985).
\(^{41}\) 355.
(i) the ASA partnership was not a bona fide partnership; or
(ii) the transaction lacked economic substance.

The court did not decide on the second ground but upheld the attribution of the capital gain and subsequent taxation on the grounds that the partnership that ultimately led to the tax benefits was not bona fide and, consequently, constituted a sham. In finding that the partnership was a sham for tax purposes, the court noted that two of the partners were just agents of one of the participants in the transaction, ABN. These two were found to be thinly capitalised, and the parties generally treated ABN as the real partner.

The partnership complied with the definition of partnership in the US Code, which stated that a partnership includes a syndicate, group, pool, joint venture, or other unincorporated organisation through or by means of which any business, financial operation, or venture is carried. However, literal compliance was insufficient and the court still needed to establish that the partnership was not a sham. To determine this, the court relied on the fundamentals of a partnership laid down in Commissioner v Cuthbert that ruled that a partnership for tax purposes can be established if “considering all the facts ...the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise”. After applying this test, the court concluded that the ASA partners did not possess the required intent to join together in a partnership. Regarding the contention that the transaction had a risk of loss, the court noted that this was present, as every transaction involved some risk, but was de minimis.

3.1.7 Yosha v Commissioner of Internal Revenue

In Yosha v Commissioner of Internal Revenue it was stated that the Gregory decision showed that the starting point in an economic substance case is that a taxpayer has a right to avoid tax. It was stated:

There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes...Many transactions are largely or even entirely motivated by the desire to

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42 Paragraph 30.
43 20 USC section 761.
44 337 US 733 742 (1949).
45 Paragraph 31.
46 1988 USCA 7 787.
obtain a tax advantage. But there is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer such an advantage.⁴⁷

Regarding the definition of economic substance, the court noted:

A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages – may indeed have had no other interest in the deduction.⁴⁸

This description of the doctrine, essentially noting that a transaction that has economic substance must be one that a reasonable person would enter into normally without a tax motive, is in line with the tests that have been seen to be part of the establishment of the doctrine. The element of objectivity is present. The court showed that to establish the first leg of the economic substance doctrine, a taxpayer may argue that the transaction is normal and would be undertaken by any taxpayer in similar circumstances, with or without tax motives. In other words, the transaction would be economically viable if its tax effects are set aside even though the tax effects strongly influence the decision to carry out the transaction.

The Yosha case is another example of the aggression with which taxpayers sometimes seek tax benefits. In this case, brokers from the London Metal Exchange (LME) marketed a scheme to American taxpayers that took advantage of the IRS’s incongruent treatment of granted and purchased options without exposing the taxpayers to the usual uncertainties of trading on the LME. The taxpayers were explicitly and implicitly promised that the brokers would arrange events so that the taxpayers would obtain income loss and no capital gain in the first year. Since the commodity prices were expected to rise in the second year, these losses were promised for this period as well. In return, the taxpayers were required to deposit funds that would act as consideration to the brokers. Further consideration was in the form of any gains made in the transaction. Accidental trading losses were to be absorbed by the brokers.

The transaction was consequently structured in a way that the deposit the investors made was the only money that was passed between the parties. No amounts were paid to the investors and investors were not at any stage required to supplement their initial deposits. The investors did not have any risk in the transaction, and the brokers seized any money that was gained as

⁴⁷ Paragraph 7 – 8.
⁴⁸ Paragraph 13.
profit in an investor’s account. Despite this, the investors did not claim any of the profits made because it was clear from the start that the investors were paying for a tax benefit by paying a deposit. The court found that the accounts gave the investors full discretion but the lack of economic substance was proved by the fact that the investors did not have any prospects for profit or loss in the transaction. They were in the investment solely for the tax losses since this was what the brokers were selling to the investors. 49

3.1.8 Long Term Capital Holdings v United States

This case is important because it contains an in-depth analysis of the application of the economic substance doctrine. The taxpayer argued that when applying the economic substance doctrine, the court (Second Circuit) had traditionally used the disjunctive test. In terms of the disjunctive test, the economic substance doctrine would be applied to deny a tax benefit after establishing only one of the two tests in the doctrine. 50 This would constitute a different approach from the traditional economic substance doctrine where both the objective and subjective legs of the inquiry were required before the doctrine could be applied. The taxpayer also argued that in terms of the objective economic substance test, the only relevant inquiry was whether there had been a meaningful change in the economic position of the taxpayer. 51 The court rejected this contention and stated that a meaningful change in a taxpayer’s economic position was insufficient for the transaction to have economic substance. The court applied a cost benefit analysis to the transaction and found that the taxpayer had no realistic prospect of obtaining a profit from the transaction. The court analysed the expenses the taxpayer had incurred in the transaction and opined that the taxpayer, being aware of these costs and having planned the transaction, could not reasonably have expected to obtain a pre-tax profit. 52

Regarding the subjective test, the court found that the transaction was entirely tax motivated because the transaction was brought to the taxpayer’s attention as a tax product. The complexity of the transaction was also held to be far more than was necessary to achieve the

49 Paragraph 17. The court referred to Mahoney v Commissioner 808 F. 2d 1219 (6th Cir 1987) where a transaction entered into without any profit motive was disregarded for lacking economic substance.
50 171.
51 185.
52 175 – 182. The court noted at 173 that “examining the transaction for economic substance (is) an objective test. This requires that we first analyse the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences”. The cost benefit analysis applied in this case was the objective measure that ultimately led to the ruling against the taxpayer.
The court also dismissed the contention that the disjunctive test applied in the Second Circuit and held that the unitary test, where the economic substance and the subjective business purpose are both relevant to the inquiry, was the standard.\(^54\)

### 3.1.9 *Black and Decker Corporation v United States*\(^55\)

In *Black and Decker Corporation* the District Court applied the disjunctive test in terms of which the tax benefits obtained would be upheld if the taxpayer showed either subjective business purpose or objective economic substance. The court, in applying this test, ruled in favour of the taxpayer and this decision was based on the ruling that if a corporation and its transactions are objectively reasonable, the presence of any tax avoidance motive is irrelevant as long as the transaction is bona fide and is economically sound.\(^56\)

On appeal in the Fourth Circuit,\(^57\) the same disjunctive test was used and the court referred to *Hines v United States* where it was stated:

> The ultimate determination of whether an activity is engaged for profit is to be made...by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer’s mere statement of intent is given less weight than objective facts.\(^58\)

The court in *Black and Decker Corporation* also opined in the same vein, noting that the mere assertion of subjective belief that is contrary to significant objective evidence showing that a loss will be sustained will not by itself establish that a transaction should stand.\(^59\) The taxpayer in this case admitted from the very beginning that it did not have a business purpose in the transaction. However, the court’s application of the disjunctive test led to the ruling that the transaction could stand because it had objective economic substance. This case added to the confusion on whether the tests in the economic substance doctrine were conjunctive or disjunctive.\(^60\)

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\(^{53}\) 186 – 187. The court noted that “the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term’s true motivation, tax avoidance”.

\(^{54}\) 171.


\(^{56}\) 623 – 624.

\(^{57}\) 436 F.3d 431 (4th Cir 2006).

\(^{58}\) 912 F.2d 736 739.

\(^{59}\) 433.

3.1.10 Coltec Industries Inc v United States\textsuperscript{61}

This is an interesting case in that it encapsulates the interaction of tax avoidance, literalism, and the purposive interpretation of statutes. It shows the merit in arguments that tax avoidance thrives in instances where the literal interpretation of statutes is paramount. In this case the court began its judgment by referring to the Supreme Court case of \textit{Atlantic Coast Line v Phillips}\textsuperscript{62} and noted:

Many years ago, the United States Supreme Court in \textit{Atlantic Coast Line v Phillips}...quoting from prior decisions of Justice Holmes and Judge Learned hand, observed: As to the astuteness of taxpayers in ordering their affairs so as to minimise taxes we have said that “the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it” this is so because [there is no] public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions.\textsuperscript{63}

The court concluded that the transaction under scrutiny had business purpose. This decision was partly influenced by the fact that the entity used in the transaction was not dissolved after the transaction and continued to exist.\textsuperscript{64} The court also stated that the economic substance doctrine is a composite of the business purpose doctrine, the substance over form doctrine, and the sham transaction doctrine.\textsuperscript{65} The IRS argued that the economic substance doctrine required a taxpayer to comply with the purpose behind the provisions of the Code. Mere compliance with its literal text was argued to be insufficient. The court however rejected this submission and noted that a careful study of the cases that deal with economic substance showed that the court solved the tax issue first by referring to the Code, and then only utilised the doctrines to support its findings.\textsuperscript{66} The court also held that the common law doctrine would only be applied in instances where the Code was unclear and ambiguous.

The Federal Court,\textsuperscript{67} however, overturned this decision and held that the economic substance doctrine was essentially a judicial attempt to give effect to the purpose of the Code. The court reverted to the traditional basis of the economic substance doctrine and held that regardless of

\textsuperscript{63} 718.
\textsuperscript{64} 743.
\textsuperscript{65} 752
\textsuperscript{66} 753. In this regard the \textit{dicta} in the case \textit{King Enterprises, Inc v United States} 418 F.2d 511 (Ct Cl. 1969) is in point. It was stated in this case at 516 that “in coping with this and related problems, courts have enunciated a variety of doctrines such as step transaction, business purpose and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive realities of a transaction determine its tax consequences”.
\textsuperscript{67} 454 F. 3d 1340 (Fed Cir 2006).
the taxpayer’s literal compliance with the provisions of the Code, the transaction still needed to be scrutinised with reference to the common law economic substance standard.\textsuperscript{68} The court also stated that the approach to the application of the economic substance doctrine was conjunctive, following the requirements set in \textit{Frank Lyon}.

\textbf{3.1.11 \textit{TIFD III – E Inc v United States}\textsuperscript{69}}

In this case the taxpayer argued for the application of the disjunctive test while the IRS argued for a unitary standard where both the objective and subjective legs of the economic substance inquiry are used to consider whether the transaction has any real and practical economic implications apart from tax benefits.\textsuperscript{70} The court noted the confusing trend in the Second Circuit regarding the application of the tests, but stated that in the present case the test to be applied was not decisive because the transaction satisfied both legs of the inquiry. The court stated that it did not have to decide on the standard to adopt, because either way the same conclusion would be made. The court found that the Castle Harbour transaction in issue had business purpose and had separate economic implications not induced by the tax benefits. The transaction was also held to comply with the purposive requirements of the law.\textsuperscript{71}

The fact that one of the participants in the transaction had a guaranteed income and consequently did not bear any risk was held to be meaningless when determining whether the transaction lacked economic substance. This was because this party had contributed significantly to the capital.\textsuperscript{72} In a separate challenge, the economic substance of the partnership at the centre of the transaction was questioned on the grounds that in substance, the Dutch banks involved were not real partners but creditors.\textsuperscript{73} This challenge was dismissed and the court distinguished the \textit{ASA Investerings} case because the parties in that case were found to be completely oblivious to the operation of the partnership because their return was certainly assured. In the present case, the court found that the Dutch banks, whose sincerity was challenged, could have sustained heavy losses or gained more than the investment and had a lot to lose because the return was connected to the flawless running of the aircraft leasing business that was part of the transaction.

\textsuperscript{68} 1451.  
\textsuperscript{69} 342 F.Supp. 2d 94 (D. Conn 2004).  
\textsuperscript{70} 109.  
\textsuperscript{71} 109.  
\textsuperscript{72} 109.  
\textsuperscript{73} 111.
The Second Circuit reversed the decision of the District Court and stated that the District Court had incorrectly given legal effect to the partnership.\textsuperscript{74} The court noted that “the IRS properly refused to accept the partnership’s characterization because the banks did not meaningfully share in the business risks of the partnership venture and their interest was overwhelmingly in the nature of secured debt”.\textsuperscript{75} This reasoning shows that the banks, which were held to be real partners in the District Court, did not in fact have a meaningful role and stake in the success or failure of the partnership. The interest they had in the partnership was secured, and this meant that the banks could not suffer any harm if the partnership performed poorly. Conversely, the banks’ interest could not be enhanced by any profits the partnership could have made. Overall, the court did not dispute the fact that the interest in the partnership had evidence of an ordinary partnership with equal participation. However, the court noted that this could not hide the fact that these indications were deceptive and insignificant in the context of the investment the banks had made.

\textbf{3.1.12 CMA Consolidated Inc v Commissioner\textsuperscript{76}}

This case involved the so-called lease strips where rental income accrued to a party that was tax-indifferent or not subject to tax. This transaction was aimed at enabling another party to claim a substantially disproportionate share of the tax benefits available. The structure of the transaction was such that the interest from the lease strip would generate about $4.2 million (USD) in potential tax deductions. The transaction however cost only $40 000.\textsuperscript{77} In determining whether the transaction lacked economic substance, the court applied the traditional two-legged test but noted that the tests had much in common and should not be taken to apply rigidly and separately. These tests were held to be important when applied to determine whether the transaction lacked economic substance. The court preferred the unitary approach to the economic substance analysis.\textsuperscript{78}

When applying the tests to the facts, the court used the profit test and ruled that the taxpayer did not behave in a manner that was consistent with obtaining a genuine pre-tax profit. The strip lease deals were held to be “mere tax avoidance devices or subterfuges mimicking a leasing transaction”.\textsuperscript{79} The court also noted that according to the facts, the transaction was

\begin{footnotes}
\item[74] 459 F.3d 220 (2d Cir 2006).
\item[75] 227.
\item[76] 89 TCM (CCH) 701 (2005).
\item[77] 703
\item[78] 714.
\item[79] 722.
\end{footnotes}
operated through different entities, many of which were either connected to the taxpayer or controlled by parties that had a history of cooperation with the taxpayer. The court held that this factor was significant in finding that the transaction lacked economic substance.

3.1.13 Santa Monic Pictures LLC v Commissioner

In this case the taxpayer challenged the Commissioner’s decision to disallow losses claimed as deductions, on the basis that the taxpayer had complied with the literal terms of the partnership basis and loss provisions. The court applied the unitary approach to the economic substance doctrine and came to the conclusion that the transaction lacked economic substance. The taxpayer’s argument that formal compliance with the relevant statutory provisions meant that the tax benefits provided in the provision could not be disregarded was rejected by the courts. It was noted that the form of the transaction may have been perfect in terms of a literal interpretation of the law, but the substance did not represent a true contribution of property for partnership interests in return.

3.1.14 ACM Partnership v Commissioner

In the ACM Partnership case, the court extensively described the operation of the economic substance doctrine. The reference to the substance of the transaction was reaffirmed. The court stated that even where “the form of the taxpayer’s activities indisputably satisfies the legal requirements” of the applicable statutory language, the courts must examine “whether the substance of those transactions was consistent with their form” because a transaction that is “devoid of economic substance...simply is not recognised for federal tax purposes”.

In applying the principles of the doctrine, the court stated that the transaction must be viewed as a whole and each step, from the conception of the transaction to its completion, is relevant to the inquiry. The court also stated that when viewing the transaction as a whole, the inquiry will turn on both the objective economic substance of the transaction and the

80 TCM (CCH) 1157 (2005).
81 The fact that a taxpayer could make this contention after such a long time in which the economic substance analysis had been shown essentially to favour a purposive construction of the provisions relied on, and an analysis of the substance of the transaction indicates two possible things. The first is the aggression of taxpayers in constantly testing the resolve of the courts in applying a purposive analysis of the provisions of the Code. The second is that there is uncertainty in the law regarding the application of the economic substance doctrine. Keinan (2006 – 2007) 136 notes that the Coltec decision shows the need for the Supreme Court to “once and for all” decide on the role of common law doctrines where the taxpayer complies with the literal provisions of the law.
82 1217.
83 Paragraph 79, referring to Lerman v Commissioner 939 F. 2d 44 (3d Cir 1991) 45.
84 Weller v Commissioner 1959 USCA 3 207.
subjective commercial motivation driving it. The court analysed the economic substance of transactions that involved the disposal of property. It was stated that the economic substance doctrine could be applied to transactions that involve the disposition of property if such disposition had no net economic effect on the taxpayer’s economic position. The court stated that disposal of property at a loss lacked economic substance if the taxpayer retained the opportunity to reacquire the property at the same price, or if the taxpayer offset the economic effect of the disposal by acquiring assets virtually identical to those relinquished.

Regarding the experience with the economic substance doctrine in the courts, it can be noted that the courts will examine “whether the transaction has any practical economic effects other than the creation of income tax losses” and whether the transactions have any business purpose. The large volume of case law on the economic substance doctrine must not lead one to conclude that this doctrine is invoked all the time. Korb notes that:

the economic substance doctrine is not supposed to be a general anti-abuse rule to be trotted out by the IRS every time it confronts a tax shelter it simply does not like...But still there are some tax shelter cases, even though they are a distinct minority of all the cases we have to deal with, where it may be entirely appropriate for the IRS to use such a judicial doctrine to challenge the transaction

In other words, the economic substance doctrine is only relied on in a limited number of cases because the technical arguments the IRS can raise usually suffice. It must also be noted that the economic substance doctrine is not the only judicial anti-avoidance doctrine. Other ancillary doctrines also exist, namely the sham transactions doctrine, and the step

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85 Commissioner v Court Holdings Co 1945 USSC 57.
86 The court referred to cases illustrating this point namely Lerman, Merryman v Commissioner 1989 USCA 834, Kirchman v Commissioner 1989 USCA 11 and Yoshia v Commissioner 861 F. 2d 494. Although the taxpayers in these cases actually and objectively disposed of their property, the courts examined the dispositions in their broader economic context and refused to recognise them for tax purposes where other aspects of the taxpayer’s transaction offset the consequences of the disposition, resulting in no net change in the taxpayer’s economic position.
87 Jacobson v Commissioner 915 F 2d 832 837 (2d Cir 1990).
90 The term “sham” was used by the Supreme Court in Lilienthal’s Tobacco v United States 97 US 237 247 (1877). In this case a tobacco seller, wanting to avoid a higher tax rate, claimed to have sold tobacco to a broker before the date on which the tax rates were to be increased. However, in reality, the tobacco that had been ‘sold’ remained on the merchant’s premises and within a few days the broker ‘sold’ the tobacco back to the tobacco seller. The transaction was held to be a “perfect sham” at 247 and the Supreme Court stated at 270 that the purported sale was “fictitious”. For more on the sham transactions doctrine see generally Moore “The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance (1989) 41 4 Florida Law Review 659, Helvering v Minnesota Tea Co 296 US 378 (1935) and ASA InvesteringsPartnership v Commissioner of Inland Revenue.
transactions doctrine. These doctrines are based on the two-legged objective economic substance and subjective business purpose tests, and are based on the *Gregory v Helvering* case. An in-depth discussion of these doctrines is unnecessary for the purposes of this study.

### 3.2 The Inconsistent Application of the Economic Substance Doctrine

The cases discussed in paragraph 3.1 above show that the objective and subjective aspects of the economic substance inquiry have been part of the economic substance doctrine for a long time. However, some of the cases discussed in paragraph 3.1 above show that there have been instances where the courts have applied the objective and subjective tests of the doctrine inconsistently. In cases such as *Rice’s Toyota World v Commissioner* and *Black and Decker Corp v United States* the courts seemed to state that proving one leg of the inquiry is sufficient for the application of the economic substance doctrine. These inconsistencies prompted Senator Carl Levin to state that:

> [t]he economic substance doctrine has become a powerful analytical tool used by courts to invalidate abusive tax shelters. At the same time, because there is no statute underlying this doctrine and the courts have developed and applied it differently in different judicial districts, the existing case law has many ambiguities and conflicting interpretations.

The inconsistent application of the two-pronged test is not the only challenge to the integrity of the economic substance doctrine. The doctrine’s constitutionality was questioned on the basis that a court has no right to conduct the economic substance enquiry in cases where the literal meaning of the provisions of the Code in question is clear as it amounts to taking over the legislative powers of Congress. This argument was however dismissed.

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93 *Pichhadze and Pichhadze* (2007) 63 note that there were concerns with the doctrine’s lack of consistency and meaning, which made it difficult to predictably and consistently apply in different cases.

3.3 The Codification of the Economic Substance Doctrine

In an effort to irrefutably install both the objective and the subjective tests of the economic substance doctrine, this doctrine was codified in section 7701(o) of the Code.\footnote{The IRS also published guidelines on how it will apply the codified economic substance doctrine. The document with these guidelines is available online on http://www.irs.gov/pub/irs-drop/n-10-62.pdf and is titled Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010, generally referred to as IRS Notice 2010 – 62.} In terms of section 7701(o)(1), a transaction has economic substance if:

i. The transaction has a meaningful impact on the taxpayer’s business. The impact of federal tax consequences of a transaction are not considered when judging a transaction’s impact.

ii. The taxpayer operating the transaction has a substantial purpose for doing so. As with the first criteria, tax considerations do not amount to substantial purpose.\footnote{IRS Notice 2010 – 62 5. The IRS notes that when applying section 7701(o)(2) it will consider the profit motive of a transaction only if the present value of the reasonably expected pre-tax profit is substantial compared with the actual tax benefits the taxpayer stands to obtain if the transaction is allowed to stand. It notes further that in completing this calculation, it will rely on case law on the matter and other published guidance.}

The IRS states that it will continue to rely on applicable case law that deals with the common law economic substance doctrine when conducting this dual and conjunctive test.\footnote{IRS Notice 2010 – 62 4.}

In terms of section 7701(o)(5)(C), the determination of a transaction’s economic substance will be made as if the doctrine was never codified. This provision was requested by the Tax Section of the New York State Bar Association (NYSBA), which generally objected to the codification of the economic substance doctrine on the grounds that codification would undermine the doctrine. The NYSBA stated that if the codification materialised, a provision stipulating that the codification will neither disturb the doctrine from developing in case law, nor stop the doctrine’s progression in the courts would be required.\footnote{Aprill (2001) 15. VanderWolk (2009) 547 notes that the proposal to codify the economic substance doctrine was subjected to some criticism by authors who contended that the codification would disturb the court and government’s ability to stop impermissible tax avoidance and simultaneously discourage permissible tax avoidance because taxpayers may be fearful that their plans may fall within the operation of the codification. This provision dismisses these fears because it essentially states that the codification will have no effect on the natural progression of the doctrine.} The effect of this provision is that the economic substance determination will be carried out in the same manner as before. The IRS argues that the codification of the economic substance doctrine must not result in the doctrine becoming static, and states that neither it nor the US Treasury inquiry of the economic substance doctrine is not unconstitutional because it enables the court to fulfil its constitutional obligations.
Department intends to issue broad administrative guidelines relating to the transactions, which may or may not invite the application of the economic substance doctrine.\textsuperscript{101}

Section 7701(o)(5)(D) states that a transaction includes a series of transactions. Section 7701(o)(2)(A) mandates the consideration of a transaction’s potential for profit when determining whether the transaction has a meaningful impact on the taxpayer’s business or whether the taxpayer had a substantial purpose when entering into it. The IRS’s statement that the codification of the doctrine should not impede its development by the courts is supported by the fact that the codification incorporates all the essential aspects of the doctrine.

Commentators called for care in drafting the doctrine, as this would eliminate some of the problems associated with GAARs from besetting the codified doctrine. These problems are identified as “judicial nullification” and “overinclusiveness”.\textsuperscript{102} The advantage associated with the codification of the judicial doctrines noted by commentators is that courts naturally give more credence to principles that are clearly articulated in regulations and statutes than they give to principles that are backed by reasoning from the case law.\textsuperscript{103} The inconsistency associated with the application of the doctrine may also be lessened.

4. ANALYSIS OF THE ECONOMIC SUBSTANCE DOCTRINE

4.1 The Economic Substance Doctrine and Statutory Interpretation; Literalism v Purposive Interpretation

One of the overriding principles of the economic substance doctrine is the purposive interpretation of statutes, where mere compliance with the formal terms of the Code will not entitle taxpayers to tax benefits which Congress did not intend.\textsuperscript{104} It can be stated that the main reason why the purposive approach became part of the judicial doctrines is that taxpayers have historically taken advantage of the provisions of the taxing statutes. For instance, the Revenue Act\textsuperscript{105} is said to have contained reorganisation provisions that were

\textsuperscript{101} IRS Notice 2010 – 62 5.
\textsuperscript{102} VanderWolk (2009) 548 and Aprill (2001) 34.
\textsuperscript{103} See generally Bankman (2000).
\textsuperscript{105} Of 1921.
thought to be comprehensive. Taxpayers however soon identified and took advantage of certain drafting deficiencies in this Act. Congress responded to this development in 1924 by deciding that the sparse reorganisation provisions be expanded by specifying the precise nature of the requirements for qualification under the provisions. The Revenue Act was enacted and was referred to as the most detailed and precise statute ever developed. Despite this perception, problems with the detail of the Act surfaced. Taxpayers managed to exploit loopholes in the explicit detail. Congress continued to plug exploited shortcomings by adding more detail to the statute. In 1934 the Revenue Act is said to have reached a peak in “completeness and verbosity”, and taxpayers proceeded by complying with the literal terms of the Act without caring about the assumptions underlying the terms. It was against this background that the Gregory v Helvering case was decided. Bank notes:

In this downward spiral of rules, the Gregory case served as a welcome life preserver. Although many practitioners bitterly complained that the opinion in the case was overreaching and vague, they grudgingly recognized that it might be more effective than legislative and administrative rule making efforts in stopping tax avoidance.

When interpreting tax statutes under the economic substance doctrine, the courts are guided by the principle that:

[t]ax is an intensely practical subject. Tax cases cannot be solved by an abstract, intellectual analysis of the language used in a statute, divorced from practical, commercial considerations. Tax is imposed and exemptions from tax are granted by Congress in respect of commercial or financial transactions. The words of a taxing statute are, therefore, to be taken to refer only to transactions entered into for some commercial or financial purpose, and not to extend to transactions with no commercial or financial purpose, but solely to avoid tax.

107 Of 1924.
109 Bank (2001) 42.
111 Millet “Artificial Tax Avoidance: The English and American Approach” (1986) 6 British Tax Review 327 330. Judge Learned Hand reiterated the principles he set in Gregory v Helvering in Commissioner v Transport Trading and Terminal Corporation 176 Fed 2nd 570 (1949) and stated that “[i]n constructing the words of a tax statute which describe commercial or industrial transaction, we are to understand them to refer to transactions entered upon for commercial or industrial purposes, and not to include transactions entered upon for no other purpose but to escape taxation”. Also see Bankman (2000) 11.
Thus, the courts in applying the doctrine have determined the intention of the legislature, or the purpose behind the provisions that the taxpayer relied on to obtain the tax benefit.\footnote{VanderWolk (2009) 548-549 notes that the Supreme Court in the \textit{Gregory v Helvering} case stated the provisions of a statute must be interpreted consistently with the purpose of the statute. This means that where a transaction has no significance when considered without the tax benefit sought or obtained, it should be struck down because “it was clearly not congress' intention, in enacting any of the provisions of the code, to allow taxpayers to avoid tax provided for in the code by implementing meaningless transactions”.} In \textit{Coltec Industries Inc v United States},\footnote{454 F. 3d (Jan 2007) 7.} the contribution of the economic substance doctrine to the interpretation of the Code was noted and the court reinforced the view that the economic substance doctrine enforces the purpose of the Code, and does not rely on the literal terms of the statute to undermine the purpose of the statute. It has also been stated that purposive interpretation is required because “the smartest drafters of legislation and regulation cannot be expected to anticipate every device”.\footnote{\textit{ASA Investerings Partnership} 513.}

Bankman\footnote{\textit{Bankman} (2000) 11. Bankman adds that it seems clear that a transaction that is within the intent and purpose of the provisions and the code is will not be successfully attacked by the economic substance doctrine, even if the transaction meets the economic substance test.} notes that, in a sense, it seems odd to view the economic substance doctrine as a method of statutory interpretation, because the doctrine is “only loosely connected to more conventional interpretative techniques or approaches”. Bankman notes that this is because the decisions in which the doctrine is applied or invoked involve a separate determination of the purpose of the provisions in question.\footnote{\textit{Bankman} (2000) 11.} The doctrine itself is then discussed without much discussion of the purpose of the provisions and the Code. It can be stated that in targeting transactions that lack economic substance, the doctrine automatically states that a taxpayer may not circumvent the provisions of the Code by engaging in uneconomic behaviour, because the Code is not intended to encourage taxpayers to circumvent its provisions through actions that lack economic substance. By referring to the economic impact of a taxpayer’s actions in avoiding tax, the economic substance doctrine therefore assumes that it is against the purpose of the Code to avoid its provisions in an uneconomic manner. This means that the application of the doctrine is squarely couched in a purposive application of the Code.

The economic substance doctrine applies only when the transaction in question violates the intention or purpose of the provisions it relies on to obtain a tax benefit. In other words, the economic substance doctrine does not seek to defeat the provisions it protects. In this regard Korb notes that the economic substance test:
does not necessarily apply when Congress has spelled out in the statutory language the parameters of the tax consequences of a specific form of transaction. The theory behind this approach is that the economic substance doctrine “is an important judicial device for preventing the misuse of the tax code, but the doctrine cannot be used to pre-empt congressional intent.”

This basis in purposive interpretation of tax provisions shows that one of the ways in which the doctrine distinguishes between permissible and abusive tax avoidance is by focusing on whether or not a particular transaction is consistent with the intent and purpose of the provisions of the Code.

It must be noted that the economic substance doctrine has not seamlessly led to the universal acceptance of purposive interpretation. The debate between literalism and the purposive interpretation of statutes means that there was no universal acceptance of the judicial doctrines, at least before the codification of the economic substance doctrine. Those that argue for a literal interpretation of the Code are informed by the idea that taxpayers must be able to plan their finances and need to be confident that if they comply with the letter of the tax laws, they may not expect arbitrary tax claims to be made by the revenue authorities.

According to Aprill, many have criticised the judicial doctrines as basically invoking alien standards that cannot be justified in the context of a Code which has a set of highly pronounced rules. These critics’ main argument is that the judiciary lacks the authority to base decisions on those standards, and any opinions based on them are illegitimate. The principle against the purposive construction of tax statutes is captured by Judge Sternhagen in 

Gregory v Commissioner,

where he states that “a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration”. This reasoning resonates with Rice’s statement that if the courts extend the literal tax provisions by referring to the unclear boundaries of policy which exists

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117 Korb (2005) 7 quoting Horn v Commissioner 968 F. 2d 1229 1236.
119 Kies “Letter to the Editor: Corporate Tax Shelters: It is Time to Come to Terms with the Data” (2000) 88 Tax Notes 133 supports this reasoning and asks the question; “[i]f we cannot rely on the language of the statutes and regulations, then what are we supposed to rely on?”
120 Aprill (2001) 15. This submission is essentially that where there is a set of rules that define circumstances in which transactions will be taxed, why should there be reference to other broad standards alien to the set of rules?
121 27 BTA 223 225 (1932). The decision was reversed in Gregory v Helvering 69 F. 2d 809 (2d Cir 1934) and this decision was upheld in Gregory v Helvering 293 US 465 (1935).
“only in the hearts and minds of the jurists, we may well be coming uncomfortably close to judicial absolutism”.\textsuperscript{122}

Isenberg also argues against the purposive construction of statutes as advocated by the judicial doctrines and notes that:

\textit{[w]hen we are dealing with statutory terms of art, the form-substance dichotomy is a false one. ‘Substance’ can only be derived from forms created by the statute itself. Here there is form and little else; there is no natural law of reverse triangular mergers.} \textsuperscript{123}

The decision in \textit{Gitlitz v Commissioner} \textsuperscript{124} shows that the courts can sometimes base their decisions on a literal interpretation of the statutes. In this case the court honoured a transaction that produced a tax loss without a corresponding economic loss. The IRS had argued that the taxpayer stood to benefit without suffering any real loss to qualify for deductions, but the court dismissed this argument by stating that there was no need to address the policy concern of a provision whose plain text allowed a taxpayer to receive a benefit. Postlewaite notes that this literalism is an indication of the courts shifting the responsibility to counter abusive tax avoidance to the legislation.\textsuperscript{125}

The contentions for literalism can be countered on the basis that literalism leaves tax statutes open to abuse by taxpayers who only have to comply with the formal requirements of the statutes. While impermissible tax avoidance is notoriously difficult to define precisely, it is generally acknowledged that tax avoidance transactions that abuse tax provisions are impermissible.\textsuperscript{126} Consequently, favouring literalism amounts to condoning the abuse of tax statutes through impermissible tax avoidance.\textsuperscript{127} According to Canellos:

\textsuperscript{122} Rice (1953) 1023.
\textsuperscript{123} Isenberg “Musings on Form and Substance in Taxation” (1982) 49 University of Chicago Law Review 859 879.
\textsuperscript{124} 531 US 206 (2001).
\textsuperscript{125} Postlewaite (2005) 148.
\textsuperscript{126} As seen in earlier chapters, countries such as South Africa and Canada have GAARs that use the misuse or abuse indicator to isolate impermissible tax avoidance. Weisbach “The Failure of Disclosure as an Approach to Tax Shelters” (2001) 54 SMU Law Review 73 79 succinctly sums up the value of a purposive approach to impermissible tax avoidance, noting that “[t]he tax law is best implemented through a combination of rules and standards that can override the rules in situations where strict application of the rules produces perverse results”.
\textsuperscript{127} Predictably, this abuse would be on a wide scale because, once taxpayers succeed with tax avoidance transactions that only comply with the literal terms of the legislation, many more will follow suit. As noted by Rice (1953) 1023 any successful taxpayer in this regard, “as with all successful men, will have his imitators”. 
[m]any shelters are simply based on erroneous or distorted interpretations of law – often ignoring relevant provisions, misreading ambiguities, and almost always ignoring the underlying purpose of the law. Almost all are also at least disingenuous as to the purpose for entering into the transaction. It is the rare shelter that so cleverly exploits a provisions of tax law as to afford proponents a relatively high degree of confidence that a court reviewing the transaction, in the light of its overall terms and motivations, would sustain the unreasonable result.¹²⁸

Furthermore, advocating for a literal interpretation of tax statutes is essentially stating that tax statutes clearly represent the intention of the Congress and that tax statutes are created in a wholesome fashion that renders reference to anything but the text of the statute unnecessary. As Johnson¹²⁹ states:

> it is sometimes assumed by the formalistic school of interpretation that the tax law must be clear and simple and that the taxpayer must benefit, and government must suffer, from any ambiguities or misinterpretation of the law. ... [T]he English language and human understanding never reach the level of perfection that the formalistic school expects.

Rice¹³⁰ also subscribes to this reasoning and argues that it is “trite” that the taxing statutes cannot, without error, specify the conditions that must exist for tax to be levied and identifies the limitations of the prescience of the draftsmen and the language used in the statute as key factors causing the weaknesses of the statutes. In *Gilbert v Commissioner*,¹³¹ the weaknesses of statutory language were stated as follows:

> It is a corollary of the universally accepted canon of interpretation that the literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions they are meant to cover; and their interpretation demands the projection of their expressed purpose upon taxpayers based upon their financial transaction, and it is of course true that the payment of tax is itself a financial transaction. If, however, the taxpayer enter into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the Act to provide an escape from the liabilities it sought to impose.¹³²

The acknowledgement of the weaknesses of statutory language and the fact that impermissible tax avoidance transactions comply with the literal terms of the statute means that the purposive interpretation of statutes is the central approach even though the debate between literalism and purposive interpretation is not settled. However, the US experience

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¹³⁰ Rice (1953) 1022.
¹³² Also see Donohue (1993 – 1994) 182.
with purposive interpretation under the economic substance doctrine shows that taxpayers continue to disregard the judicial doctrines by carrying out transactions that comply with the literal terms of the Code. This means that a purposive approach under the economic substance doctrine does not necessarily deter taxpayers from entering into transactions that only comply with the formal requirements of the Code.

4.2 The Economic Substance Doctrine against Impermissible Tax Avoidance

The (codified) economic substance doctrine is one of the main weapons against impermissible tax avoidance and has been successfully invoked in many cases, including some of the cases discussed in paragraph 3.1 above. Even so, there are certain cases in which taxpayers successfully defended an economic substance attack by the IRS that have raised questions about the efficacy of the economic substance doctrine against impermissible tax avoidance. One of these cases is *Cottage Savings Association v Commissioner.*

Commenting on this case, Weisbach states as follows:

*Cottage Savings* did not involve a real transaction. Absolutely nothing happened except for tax. The economics of the ACM transaction, an admitted shelter, swamp those of *Cottage Savings.* In fact it would be difficult to imagine arranging a transaction so that less actually happens. And there is no point to the deal other than to raid the Treasury. The business purpose was precisely zero, not even one tenth of percent. These transactions were marketed widely. All the factors, except the use of an accommodation party (which was not necessary) are present. Yet the taxpayer won in *Cottage Savings.*

In another case, *IES Industries Inc v United States of America,* the taxpayer successfully defended an attack by the IRS in a transaction the court said had a minimal risk of loss. It was held that the negligible risk of loss was not because the transaction was a sham or lacked economic substance, but was mainly because the taxpayer had taken steps to minimise the risk of loss. This case shows that even though the risk of loss is one of the hallmarks of a transaction with economic substance, it does not necessarily follow that taxpayers are precluded from eliminating risk from their transactions.

In *Compaq Computers Corporation v Commissioner of Inland Revenue* the taxpayer purchased the stock of a corporation in the Netherlands whose dividend had already been

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134 Weisbach (2001) 75.
135 253 F. 3d 350 (8th Cir 2001).
136 2001 USCA 5 507.
declared. The taxpayer resold the stock almost immediately, within an hour of the purchase, to the original seller. The Fifth Circuit noted that the purchase price of the stock was about $888 million (USD), with a net dividend of $19 million. The price at which the stock was sold just an hour later was about $868 million, which was computed by deducting the dividend payable to Compaq from the purchase price. The cost of carrying out the transaction was $1.5 million. All in all the transaction generated a loss, which could be said to have deterred the average taxpayer from the transaction. However, considering the transaction as a whole, Compaq stood to benefit from foreign tax credits; the dividend was taxable in the US and the loss of $19 million resulting from the sale sheltered Compaq’s profits in other unrelated transactions. The Tax Court found that the transaction lacked business purpose and any possibility of profit without taxation.

On appeal, the Fifth Circuit overturned the Tax Court’s decision and noted that even if it were to be assumed that the taxpayer primarily sought to obtain tax benefits that were not otherwise available to counterbalance other income, this fact alone did not invalidate the transaction. The court relied on Frank Lyon where it was stated that ‘the fact that favourable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing these consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction’. The court also referred to the ACM Partnership case where it was stated that “[w]here a transaction objectively affects the taxpayer’s net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.”

The court’s reference to these statements shows that the court believed that the transaction in the Compaq case was a legitimate exercise of the right to avoid tax. It went on to state that ACM Partnership and Frank Lyon were not necessarily directly applicable, because the evidence did not prove that the taxpayer’s sole motivation was to obtain a tax benefit. The court was satisfied that the taxpayer also sought to gain the profit available. The court also found that:

137 580.
138 248.
139 Paragraph 30.
i. The parties in the transaction attempted to minimise the risks usually associated with the transaction.

ii. There were significant risks in the transaction, despite the attempts to minimise them, because the transaction was carried out in an open market, with the usual risks associated with it. Due to this fact the transaction was not subject to the taxpayer’s control or manipulation, and the market value of stock could have changed at any time and actually changed during the course of the transaction. The taxpayer also bore the risk of not receiving the dividend it anticipated.

iii. The court noted that absence of risk that could legitimately be eliminated, because the taxpayer has eliminated it, does not make a transaction a sham.\(^{140}\)

Regarding the operation of the transaction in an open market, the court drew a contrast with the circumstances in *Freytag v Commissioner*\(^ {141}\) where the tax benefits were disallowed because the taxpayer’s investment agent had “absolute authority over the pricing and timing of the transaction at issue, which occurred in a self-contained market of its own making”.

The decisions in *Compaq* and *IES Industries Inc* were criticised, and the economic substance and business purpose tests that was applied in the cases was described as “virtually useless because it has lost the forest for the trees”.\(^ {142}\) This is because the test that was applied in these cases was characterised by a mechanistic approach, as opposed to the purposive activity approach that was applied in the *ACM Partnership* case. According to MacMahon, the purposive approach would have led to a different result since it is “much better suited to the task of sorting the pigs from the hogs than any of the various two part tests applied by the Fifth Circuit in *Compaq* and the Eighth Circuit in *IES*”.\(^ {143}\)

Prebble and Prebble have a deeper concern with the victories of the taxpayer in the *Compaq* and *IES Industries* cases. They note that these decisions are foremost in suggesting a weakening of the judicial doctrines against tax avoidance and state as follows:

> The significance of *Compaq* is that, on its facts, it is one of the most extreme settings of the cases producing taxpayer victories. If there were ever a case which, before the turn of the century, would have been as virtually certain to fall prey to the judicial safeguards, it was *Compaq*. The duration of the transaction was less than 24 hours; it had little or no relevance or connection to the taxpayer’s business;

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\(^{140}\) Paragraph 30.

\(^{141}\) 904 F. 2d 1011 1016 (5th Cir. 1990).

\(^{142}\) MacMahon (2002) 1022.

\(^{143}\) MacMahon (2002) 1022.
the transaction costs were significant; the economic profit was virtually non-existent; and the tax
savings were extraordinary. Most tax practitioners in the 1990s, if confronted with the facts of the case
as a proposed transaction of their client, would have had grave difficulties in endorsing it.
Nevertheless, reflective of a new era of broad judicial latitude and deference to tax transactions,
excessive interpretive literalism and increasing judicial restraint, the transaction and its dramatic tax
savings were upheld.\footnote{Prebble and Prebble (2008) 165. Postlewaite (2005) 146 also describes the Compaq decision in the same light. He notes that it is an exposition of the court’s hesitancy to use judicial doctrines to disregard transactions. He also describes the transaction as a prime target for judicial doctrines if the facts were confronted by the courts in the Gregory v Helvering era.}

It can be argued that the cases discussed above show the negative effect of uncertainty in
relation to the economic substance doctrine. This uncertainty stems from transactions that
have both business and tax purpose and whose justification is both economic and tax
avoidance. The Compaq and IES Industries Inc cases show that where a transaction has these
characteristics, the uncertainty regarding the application of the economic substance doctrine
might affect its efficacy against impermissible tax avoidance. The transaction in Compaq had
many features of an impermissible transaction. However, the fact that it also had certain
economic benefits that were highlighted by the court gave it immunity from the economic
substance doctrine. This case shows that borderline cases can be decided in favour of
taxpayers, which can adversely affect the doctrine’s efficacy against impermissible tax
avoidance.

4.3 Uncertainty

The judicial doctrines have been criticised for lacking the three justifications for rules namely
certainty, predictability, and reliance.\footnote{Aprill (2001) 16.} One of the critics, Gideon,\footnote{Gideon “A Good Tax System: Transparent, Simple and Fair” (1998) 81 Tax Notes 999 1001. Cooper “International Experience with General Anti-Avoidance Rules (2001) 54 1 SMU Law Review 83 93 explains the source of uncertainty in the judicial doctrines. He notes that these doctrines are restated repeatedly over generations and these restatements contain minute differences. The scope of the doctrines is seldom defined, they lack consistency in their application, and because of their nature, they can be created at will.} observes that the
judicial doctrines lack certainty and predictability by failing to draw a clear line between
permissible and impermissible tax avoidance. He further notes that the cases that deal with
the judicial doctrines do not apply the doctrines in a manner that is transparent and
understandable which creates uncertainty on how they will be applied in the next case.

Some commentators however dismiss uncertainty as immaterial. Weisbach\footnote{Weisbach (2001) 81.} contends that:
[a] more serious objection to anti-shelter doctrines is that they would create great uncertainty. But the argument is usually just left at that, as if it were self evident that certainty is a bad thing that should be avoided at all costs. But this is not the case. First, note that even if uncertainty is bad, there is a trade off between the good of a substantive disallowance rule and the bad of uncertainty, and it is not clear that the race should necessarily go to uncertainty. In addition, businesses deal with uncertainty all the time, and it is not clear why tax uncertainty is any worse than uncertainty about, say, the weather or about the standard of due care under a negligence rule.\textsuperscript{148}

Aprill\textsuperscript{149} argues that the debate on tax shelters should be on far broader concepts of taxation, such as vertical and horizontal equity. The question in this debate, Aprill notes, should be the extent to which uncertainty is more important than equity. Eustice argues that the calls for certainty and predictability emanate mostly from tax practitioners who must acknowledge that the current uncertainty is to them a “self inflicted wound”.\textsuperscript{150} Eustice explains this by stating that tax practitioners who structure complex tax avoidance transactions contribute to a litigation boom, which inevitably leads to the inconsistent application of the judicial doctrines by the courts and uncertainty. Eustice states that “[i]f tax promoters and their advisors keep coming up with bright ideas, they no longer should be entitled to the bright lines that facilitate these inspirations”.\textsuperscript{151}

It is submitted that while the uncertainty on the scope and application of the judicial doctrines is impossible to eliminate, it does not follow that efforts should not be taken to limit this uncertainty, and that uncertainty is not as important as the other goals of taxation, such as equity. Chapters 4, 5, 6, and 7 show that uncertainty has an adverse effect on the efficacy of GAARs in countries such as South Africa, Australia, and Canada. The same adverse effects of uncertainty have been experienced in relation to the economic substance doctrine in cases such as \textit{Compaq, IES Industries and Cottage Savings Association} discussed in paragraph 4.3 above. As stated earlier, in these cases the court did not apply the economic substance doctrine because it was not clear that the transactions had neither business purpose nor economic substance. It can also be argued that, while uncertainty can serve as a deterrent, some taxpayers may want to take advantage of its presence and engage in potentially impermissible transactions with the hope that the uncertainty could result in the IRS failing to prove the clear lack of business purpose and economic substance in the transactions. The

\textsuperscript{148} Eustice (2002) 147 subscribes to this reasoning and notes that certainty “may have to yield to a higher necessity – that these highly abusive transactions somehow have to be stopped, or at least seriously impeded, and if menacing ambiguity is the only way to do it then do it we must”.

\textsuperscript{149} Aprill (2001) 35.

\textsuperscript{150} Eustice (2002) 147.

\textsuperscript{151} Eustice (2002) 147.
adverse effects of uncertainty on the efficacy of the economic substance doctrine prove that it is an important factor that must be limited in order to enhance the efficacy of the economic substance doctrine. Tax equity is not necessarily more important, because without effective or reasonably effective judicial doctrines, horizontal and vertical equity will be compromised.

4.4 Comparison with a GAAR

The US approach to impermissible tax avoidance is, in form, different from a GAAR approach. According to Millet,\(^{152}\) “the great advantage of judge made law is that it is based on principle, and unlike statute law cannot be undermined by microscopic examination in search for loopholes”. The codification of the economic substance doctrine does not mean that the economic substance doctrine is now a GAAR because it is still subject to development by the courts.

In substance, judicial doctrines have a number of similarities with the GAARs studied in this thesis. These similarities are explained below:

1. Both judicial doctrines and GAARs serve a general anti-avoidance purpose.
2. The business purpose requirement is similar to the purpose requirement in GAARs. A transaction will pass the business purpose doctrine or the tax purpose test if it has a sole or main business purpose, not a sole or main tax purpose. In the US it is known as the subjective business purpose, but as indicated earlier, objective factors are given more weight when determining whether a transaction has business purpose. Similarly, in South Africa, Canada, and Australia the purpose of a transaction is objectively determined.
3. The economic substance of a transaction is an indicator of impermissible tax avoidance in terms of the South African GAAR, where it is known as commercial substance.
4. The purposive interpretation of statutes required by the economic substance doctrine is similar to that required in terms of the South African, Australian, and Canadian GAARs.
5. The uncertainty that stems from the absence of a clear line between permissible and impermissible tax avoidance has a similar effect on both GAARs and judicial doctrines.

\(^{152}\) Millet (1986) 338.
These similarities demonstrate that, in theory, the economic substance doctrine has a lot in common with GAARs.

A notable difference between the judicial doctrines and GAARs is the requirement to identify a transaction, operation, scheme, or arrangement. Unlike the GAARs studied in this research, the economic substance doctrine does not require the establishment of a transaction, operation, scheme, or arrangement. One can state that the approach in terms of this doctrine is that whenever tax is avoided, permissibly or impermissibly, it is obvious that a transaction to this end already exists, and instead of starting the inquiry by identifying this transaction, the attention is immediately placed on the characteristics of the transaction.

5. CONCLUSION

This chapter discussed the creation, scope, and development of the economic substance doctrine. The following table summarises the important developments in relation to this doctrine that were discussed:

Table 4: The Economic Substance Doctrine’s Development Timeline

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1921 and 1924</td>
<td>The substance over form approach is propounded in <em>United States v Phellis</em> and in <em>Weiss v Stearn</em>.</td>
</tr>
<tr>
<td>1936</td>
<td>Judgment in <em>Gregory v Helvering</em> is passed, and the judicial doctrines against impermissible tax avoidance are introduced. The economic substance doctrine with its two-pronged conjunctive test that investigates a transaction’s objective economic substance and subjective business purpose is also introduced.</td>
</tr>
<tr>
<td>1938</td>
<td>The substance over form approach is reaffirmed in <em>Minnesota Tea Company</em>.</td>
</tr>
<tr>
<td>1960</td>
<td><em>Knetsch</em> decision passed and the judicial doctrines are further established.</td>
</tr>
<tr>
<td>1961</td>
<td>The substance over form approach is reaffirmed in <em>Weinert v Commissioner</em>.</td>
</tr>
<tr>
<td>1978</td>
<td><em>Frank Lyon</em> decision further establishing the judicial doctrines is passed.</td>
</tr>
<tr>
<td>1991</td>
<td>The <em>Cottage Savings Association</em> case results in a victory for the taxpayer, which raises questions in relation to the efficacy of the economic substance doctrine against impermissible tax avoidance.</td>
</tr>
<tr>
<td>1999</td>
<td>The <em>Compaq Computers</em> case is heard in the Tax Court.</td>
</tr>
<tr>
<td>2001</td>
<td><em>Compaq Computers</em> decision on appeal results in a victory for the taxpayer and questions on the efficacy of the economic substance doctrine against impermissible tax avoidance are raised. The <em>IES Industries Inc</em> case also results in a victory for the taxpayer and more fears on the efficacy of the economic substance doctrine’s efficacy are raised.</td>
</tr>
</tbody>
</table>
2001  |  *Gitlitz* judgment favouring literal interpretation of tax statutes when conducting the economic substance inquiry is passed.

2004 - 2006  |  Confusion regarding whether the economic substance doctrine has a conjunctive two-pronged test or a disjunctive test abounds. Decisions in cases favouring a disjunctive test contrary to such as *Black and Decker, TIFD III – Inc* are passed. Decisions maintaining the traditional conjunctive test such as *Long Term Capital Holdings* also passed.

2010  |  The economic substance doctrine with the traditional two-pronged conjunctive test is codified into the Code to end the confusion on whether the economic substance is conjunctive or disjunctive.

This timeline shows that the economic substance doctrine has a relatively long history. Since it was introduced in *Gregory v Helvering*, it has been used as a weapon against and an indicator of impermissible tax avoidance. This long history means that there is an extensive volume of case law developing and describing the scope of the doctrine that is not obvious from a reading of the two-pronged test that is part of it. Some of these cases were discussed in this chapter, and from these cases it can be stated that some of the indicators of the lack of economic substance in a transaction are as follows:

1. The absence of a reasonable possibility of profit and any other economic benefit apart from tax avoidance – *Rice’s Toyota World*.  
2. The transaction is such that no reasonable business person would enter into it if its tax benefits are absent – *Yosha*.  
3. The transaction has no realistic profit prospects after conducting a cost–benefit analysis – *Long Term Capital Holdings*, *TIFD III – E Inc*, and *CMA Consolidated Inc*.  
4. The transaction has no appreciable impact on the taxpayer apart from the impact attributable to the tax benefits – *Gregory v Helvering*.

The economic substance doctrine also incorporates the business purpose doctrine. From the discussion in this chapter, it can be concluded that a transaction lacks business purpose if:

1. it does not have a profit possibility; 
2. it does not have a business justification but is tax motivated;
3. it does not have a plausible non-tax purpose aligned with the taxpayer’s conduct and economic situation;
4. it was presented to the taxpayer as a tax avoidance scheme whose tax benefits significantly overshadow the taxpayer’s investment in the transaction; and
5. it is more complex than necessary – *CMA Consolidated Inc.*

Regarding the efficacy of the economic substance rule, it is notable that the IRS has successfully invoked this doctrine against impermissible tax avoidance transactions in most of the cases discussed in this chapter. However, there are certain cases, in particular *Compaq Computers*, *IES Industries Inc* and *Cottage Savings Association*, that have raised questions about the efficacy of this doctrine. The efficacy of this doctrine is adversely affected by the uncertainty surrounding the application of the doctrine in cases with both tax benefits and economic substance. In such cases, it not always clear when the tax benefits erode the economic substance of a transaction. The economic substance doctrine’s efficacy is also limited by the fact that the purposive interpretation of statutes on which it is based does not always create certainty regarding what is impermissible, and does not always result in unanimity on the meaning of tax legislation. These limitations on the efficacy of the economic substance doctrine mean that the US doctrinal approach to curbing impermissible tax avoidance is not necessarily better than the GAAR approach in terms of efficacy against impermissible tax avoidance. This argument is supported by the fact that both the economic substance doctrine and the GAARs studied in this chapter have common elements as discussed above and are both subject to the same adverse effects of uncertainty.
CHAPTER 9

THE JUDICIAL ANTI-AVOIDANCE RULES AND GENERAL ANTI-AVOIDANCE RULE IN THE UK

TABLE OF CONTENTS

1. INTRODUCTION .............................................................................................................. 248
2. BACKGROUND ................................................................................................................ 248
   2.2 Background to the Duke of Westminster Case............................................................ 250
2.3 Other Principles Created in the Duke of Westminster Case .............................................. 252
3. THE JUDICIAL RESPONSE............................................................................................. 252
   3.1 Floor v Davis The Necessity of a New Approach ............................................................ 253
   3.2 Ramsay and the Adoption of a Judicial Anti-Avoidance Rule ......................................... 254
   3.3 IRC v Burmah Oil Co Ltd and the Affirmation of the Ramsay Approach ....................... 257
   3.4 Furniss (Inspector of Taxes) v Dawson ............................................................................ 258
   3.5 The Limitation of the Ramsay Approach: Craven v White; IRC v Bowater Property
       Developments Ltd and Bayliss v Gregory ........................................................................ 260
       3.5.1 Analysis of the Four Pronged Test ........................................................................... 262
       3.5.1.1 Preordainment of Transactions .............................................................................. 262
       3.5.1.2 Commercial Purpose ............................................................................................ 263
4. RAMSAY APPROACH AND STATUTORY INTERPRETATION .................................. 264
5. ANALYSIS OF THE RAMSAY APPROACH .................................................................... 270
   5.1 Characteristics of the Judicial Approach ........................................................................ 270
   5.1.1 Legal Substance v Legal Form .................................................................................. 271
   5.1.2 Self Cancelling or Offsetting Transactions .................................................................. 271
   5.2 The Purposive Interpretation of Statutes ........................................................................ 273
6. THE INTRODUCTION OF A GAAR IN THE UK .......................................................... 274
   6.1 Consultations on the Need for a GAAR in the UK ........................................................ 274
   6.1.1 Conclusion on Whether the UK Needs a GAAR .......................................................... 275
   6.1.2 The Principles Underlying a GAAR in the UK ............................................................ 276
       6.1.2.1 The Overarching Principle .................................................................................. 276
       6.1.2.2 Distinguishing between Permissible and Impermissible Tax Avoidance .......... 277
       6.1.2.3 Reducing Uncertainty ......................................................................................... 278
       6.1.2.4 The Exclusion of Transactions with no Intent to Avoid Tax .............................. 278

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6.1.2.5 The Counteraction of Impermisssible Tax Avoidance ................................................. 278
6.2 The Illustrative GAAR ........................................................................................................... 279
6.2.1 Exclusions from the Application of the GAAR ............................................................... 280
6.2.2 Definition of Abnormal Arrangements .......................................................................... 280
6.3 The Government’s Response ............................................................................................... 281
6.4 The UK General Anti-Abuse Rule ...................................................................................... 282
6.5 Analysis of the UK GAAR .................................................................................................. 283
6.5.1 The Steps Leading to the Introduction of the GAAR .................................................... 283
6.5.2 The GAAR ...................................................................................................................... 285
6.5.2.1 Tax Arrangement ........................................................................................................ 286
6.5.2.2 Abuse .......................................................................................................................... 287
7. CONCLUSION ...................................................................................................................... 288
1. INTRODUCTION

Until recently, the UK relied on judicial anti-avoidance doctrines to curb impermissible tax avoidance. This chapter will discuss these doctrines in detail. The starting point in the discussion of the judicial approach in this chapter is the literalistic and taxpayer-friendly approach in the \textit{IRC v Duke of Westminster}\textsuperscript{1} case. This chapter will analyse the legacy of this case, and its influence on the formation of the judicial approach to impermissible tax avoidance in the UK. A discussion of the judicial approach in the UK is of great importance in the context of this research because it illuminates certain aspects of the commercial substance indicator. In this regard the UK judicial approach to legal form versus legal substance and transactions with offsetting and self-cancelling elements will be analysed. This will be done by extensively analysing the major cases in which the judiciary disregarded composite transactions that had circular or self-cancelling characteristics. The discussion of the UK’s judicial approach is also important because it presents another opportunity to analyse the purposive interpretation of statutes in a context that is different from the South African, Canadian, and US contexts.

This chapter will also discuss and analyse the recently introduced UK GAAR. This discussion will start with the broad consultations on the introduction of the GAAR and culminate in an analysis of the new GAAR itself.

2. BACKGROUND

The judicial response to impermissible tax avoidance was developed in the UK over a long time span that can be divided into two distinct periods. The initial response focused on the strict interpretation of the words in tax statutes and reference was made only to the legal nature of the avoidance schemes in question, and not the substance. The second response was based on dissatisfaction with the fixation on the legal form of the scheme, and constituted analysing the substance of the scheme. The initial response or the analysis of the legal form of the transaction is also known as the formalistic approach, which allowed taxpayers to structure transactions that were outside the ambit of tax legislation. The second response, in focusing on the substance of the transaction, ignored the legal form of the transaction with the result that the tax-avoiding effect of the transaction could be thwarted.\textsuperscript{2}

\textsuperscript{1}[1936] AC 1 (HL).
2.1 IRC v Duke of Westminster

The formalistic approach that characterised the initial attitude to tax avoidance was followed in the well-known Duke of Westminster case. This case, and the Gregory v Helvering case in the US, is one of the oldest and most important cases in the subject of tax avoidance. The contrasting judicial style in these two cases is outstanding. As noted in the previous chapter, the court in Gregory v Helvering adopted a purposive approach to the interpretation of tax statutes. The Duke of Westminster case shows the early attitude of the UK courts to tax avoidance. The arrangement in this case was that the servants of the taxpayer would receive their payments in terms of a deed of covenant. A tax deduction was available for a person who executed a deed of covenant, which was valid if no consideration was paid by the recipient. The taxpayer in this case had a further arrangement with his employees that for as long as the deed of covenant was in effect, the employees would not claim the wages they were entitled to. This arrangement allowed the taxpayer to claim deductions for the amounts he paid to his servants, where a regular payment of wages would not have conferred the same tax advantages to the taxpayer.

The Commissioner sought to have the transaction disregarded; arguing that the payments were, in actual fact, remuneration for services rendered, and could thus not be allowed for deduction. The transaction was honoured by the House of Lords that held that it was only interested in the legal nature of the arrangement. Lord Tomlin stated:

> It is said that in revenue cases there is a doctrine that the court may ignore the legal position and regard what is called “the substance of the matter”, and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioner apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting “the uncertain and crooked cord of discretion” for the golden and straight metwand of the law. Every man is entitled if he can to order his affairs…the substance seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.\(^4\)

The Commissioner’s contention for the transaction to be impugned was based on the logic that the taxpayer had to be taxed as if he had made ordinary salary payments to his employees. This

\(^3\) 293 US 465 (1935).
\(^4\) 22.
argument was in contravention of the principle that a taxpayer must be taxed on what he has done, as opposed to what he could have done, to achieve the same purpose.\(^5\) The contention was rejected and the taxpayer’s victory in the *Duke of Westminster* case led to the creation of a *Duke of Westminster* principle or doctrine when referring to a taxpayer’s freedom to avoid tax.

The approach of the court in this case can be contrasted with the approach of the US court in *Gregory v Helvering*, where the substance of the transaction was held to be paramount over its form.\(^6\) It has been said that the use of the term “substance” led to the incorrect perception that the case was authority for the proposition that in tax avoidance cases, English law places importance on form and not substance.\(^7\) However, it is clear that the substance of the transaction in the case was not considered. The *Duke of Westminster* case established a principle that authorities can only impose a tax on a taxpayer in accordance with the legal consequences of his or her transactions. The idea that the substance of the transaction must be considered was clearly rejected in the case.\(^8\)

### 2.2 Background to the *Duke of Westminster* Case

It is important to refer to the background of the *Duke of Westminster* case when analysing this case, as it shows that the principles espoused in the case existed before 1936. The tolerance of tax avoidance and negativity to the system of taxation is one of the principles that existed prior to the *Duke of Westminster* case. This negativity was well reviewed by Lord Esher MR in *Grainger and Son v Gough* where it was noted as follows:

> It is no use to tell us that an Income Tax Act is assessing somebody contrary to natural justice; it is a very solemn thing to say, no doubt, but the truth is that all taxes in a certain sense are contrary to natural justice; they are very hard on a great many people, but those who impose taxes care nothing whatever on earth about the justice of the thing with regard to people, or about the injury that it does to people or hurting the

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\(^6\) Likhovskhi “The Duke and the Lady; Helvering v Gregory and the History of Tax Avoidance Adjudication” (2003-2004) 25 *Cardozo Law Review* 953 963 notes that four months after the *Gregory v Helvering* case in the United States, the *Duke of Westminster* case was decided by the House of Lords and that “while Gregory has become a cornerstone of the American substantive, purpose-based, anti-taxpayer approach to tax avoidance, the Duke case has been the cornerstone of a narrow, literal, pro-taxpayer approach which had dominated British and Commonwealth tax-avoidance law until the 1960s”. Robert Stevens *Law and Politics: The House of Lords as a Judicial Body* 1800 – 1976 (1978) 964 (quoted by Likhovskhi) notes that in the 19th Century the House did not treat tax matters differently from other matters. In the early 20th century a formalist and taxpayer-favouring stance on the interpretation of tax statutes characterised tax matters because the British government introduced progressive income taxation. Stevens notes that this stance put the wealthy taxpayers in a position to avoid taxes. The Labour government increased tax rates in the 1930s. Stevens argues that the *Duke of Westminster* case showcases the ideological beliefs of the House of Lords that time, to protect the wealth of the wealthy.

\(^7\) Millet (1986) 333.

feelings of people, they care nothing about that; the imposers of taxes are unpleasant tyrannical monsters – they do not care about the feelings of people, all they want to get at is the amount of the tax...

The view reflected in this case is that taxes are contrary to natural justice. This could have motivated the tolerance to tax avoidance seen in the *Duke of Westminster* case.

The background to the *Duke of Westminster* case also shows that the literalist approach to the interpretation of statutes seen in the *Duke of Westminster* case existed before the case was decided. The literal approach of Lord Cairns in *Partington v AG*\(^9\) was the preferred approach. In *Vickers Sons and Maxim Ltd v Evans*, Lord Loreburn LC noted:

> But still more important, in the present context, is the special constitutional convention which jealously safeguards the exclusive control exercised by Parliament over both the levying and expenditure of the public revenue. It is trite that nothing less than clear, express and unambiguous language is effective to levy a tax.\(^11\)

These sentiments were also expressed in *Cape Brandy Syndicate v IRC*\(^12\) where Rowlatt J reaffirmed the literal approach. The *Duke of Westminster* case thus perpetuated the literalistic approach to the interpretation of statutes. In *Ransom v Higgs*\(^13\) the dangers of this approach were noted, but held to be secondary. It was stated that it may be disagreeable to allow taxpayers to escape taxation, but this could not justify stretching the language of the Act to a taxpayer’s transaction. The stretching of statutory provisions to a taxpayer’s transaction simply because the transaction was disagreeable was held to be akin to the making of “bad law”.\(^14\)

It is clear that the literalist principles have been superseded by the purposive interpretation of tax legislation. However, the sentiments expressed in *Ransom v Higgs* remain true today. The courts, in purposive construction, must guard against stretching statutory provisions to enforce taxation. If a transaction falls completely out of the words and purpose of the Act, the courts should not use statutory purpose unduly to impose tax on the transaction.

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\(^9\) (1894) 3 TC 311 318.
\(^10\) (1869) LR 4 HL 100 122.
\(^12\) 12 TC 358 366.
\(^13\) (1974) 50 TC 1.
\(^14\) 94. Preston “The Interpretation of Taxing statutes: The English Perspective (1990) 7 Akron Tax Journal 43 43 states that since tax legislation is purely a statutory creature a taxpayer’s tax obligations emanate from the words of the statute alone. This was the basis on which literalism existed. In literalism certainty that tax was imposed by the statute was required. As stated in *Tennant v Smith* [1892] AC 150 154 it is impossible in a taxing act “to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes”.

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2.3 Other Principles Created in the *Duke of Westminster* Case

The other principle set in the *Duke of Westminster* case is the idea that a taxpayer has a right to choose business methods that attract the least amount of tax. Accordingly, a transaction will not be taxed because it could have been done in a different manner that would have been subject to more tax. This principle thus means that a taxpayer must be taxed in accordance with what he did, not what he could have done. This principle was explained by Lord Greene MR in *IRC v Wesleyan and General Assurance Society*\(^\text{15}\) as follows:

> In dealing with income tax questions it frequently happens that there are two methods at least of achieving a particular financial result. If one of those methods is adopted, tax will be payable. If the other method is adopted, tax will not be payable. It is sufficient to refer to the common case where property is sold for £1000 and the purchase price is to be paid in ten instalment of £100 each, no tax is payable. If, on the other hand, the property is sold in consideration of an annuity of £100 a year for ten years, tax is payable. The net result, from the financial point of view, precisely the same in each case, but one method of achieving it attracts tax and the other does not.

This principle is still sound today. However, it does not apply to impermissible transactions that can be recharacterised with tax consequently being levied on the basis of what the taxpayer should have done. The *Duke of Westminster* case can therefore be said to have a sound legacy. Prior to the introduction of judicial doctrines in the UK, this legacy was misinterpreted, possibly deliberately, to mean that taxpayers had a wide discretion in seeking to avoid taxes. Lord Tomlin in *Duke of Westminster* did not approve all tax avoidance transactions; he referred to sham transactions and held that these were invalid in-so-far as they sought to avoid taxes.

3. THE JUDICIAL RESPONSE

The (unintended) effect of the *Duke of Westminster* case was an aggressive tax avoidance industry that produced transactions that were not ordinary commercial transactions, but “off the peg” artificial tax avoidance transactions.\(^\text{16}\) These transactions were essentially composite transactions purchased from promoters. The individual transactions in the composite transactions needed to be examined in isolation to be effective in conferring the tax benefits sought. The taxpayers argued that the *Duke of Westminster* case was authority for the proposition that the courts were obliged to recognise the independence of each scheme in the composite transaction, meaning that the fiscal reality of the whole transaction was to be ignored. This was favourable to

\(^{15}\) [1946] 2 All ER 749 751.

\(^{16}\) Olowofoyeku *et al* (2003) 676.
the taxpayers because an analysis of the composite transaction would have shown that the transactions cancelled each other out. No real losses or expenditure was incurred.  

There was therefore a dire need to implement some anti-avoidance rules to curb this practice without infringing on permissible tax avoidance.  

Olowofoyeku et al note:

Parliament feared to tread here (or at least has been tardy in doing so) and so the courts ... rushed in. Their intervention was, and still is, controversial, as it led to the development of what clearly was (until the House of Lord’s recent attempts at denial in Westmoreland Investments Ltd v MacNiven) a general anti-avoidance rule for the UK (albeit one in judicial form), with all the problems that this brings...

In this regard, the conjoined case of WT Ramsay Ltd v IRC; Eilbeck v Rawling is generally considered to be the starting point of the creation of judicial doctrines against impermissible tax avoidance in the UK.

3.1 *Floor v Davis*  

The *Floor v Davis* case was the first step towards the treatment of composite transactions as a whole, rather than as single independent transactions, despite the fact that judicial doctrines in the UK are attributed to the *Ramsay* case. The transactions in *Floor v Davis* involved the disposal of shares between two companies for the purposes of avoiding capital gains tax. The court held that the transactions did not have to be viewed as a single indivisible whole. It was noted that the contention on the Crown’s behalf that the transactions in the scheme should be looked at together was an attempt to revive the argument that substance reigns over form that was rejected in the *Duke of Westminster* case. It was also noted that the contention was an attempt to ignore the legal effect of genuine transactions.

Everleigh J, however, dissented and took the view that the shares in question were disposed for capital gains purposes to company B. The basis of Everleigh J’s decision was that company B had indicated its intention to purchase the shares. The avoidance of capital gains tax was the only

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18 Ashton (1998) 483 quotes Lord Templeman as stating that “[w]hile tax avoidance is not by definition an illegal activity, a tax avoidance industry of the scale that developed in the 1970s had to be destroyed. The origin of the new approach by the courts had to be seen as a reaction to the growth and activities of this industry. An industry of that nature and size had the capacity to make very considerable inroads into government revenues”.

19 676.

20 [1981] 1 All ER 865 HL.

21 (1979) 52 TC 609. The period during which this case was decided saw cases favouring the literal interpretation of statutes such as IRC v Plummer [1979] STC 793 and Vestey v IRC [1980] STC 10.

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reason why there was no direct transfer of shares between company A and company B. In spite of the series of transactions before the transfer to company B, there was no question that the shares would eventually reach company B. The destiny of the shares was therefore known and controlled throughout the scheme. Everleigh J noted:

I see this case as one in which the court is not required to consider each step taken in isolation. It is a question of whether or not the shares were disposed to KDI by the taxpayer. I believe that they were. Furthermore they were in reality at the disposal of the original shareholders until the moment they reached the hand of KDI, although the legal ownership was in FNW.22

Everleigh J further noted that viewing the transaction as a whole was not subject to the decision in the Duke of Westminster case. This dissenting judgment formed the basis of the judicial doctrine created in the Ramsay case.23 It was a direct reaction to the impermissible tax avoidance schemes that were prevalent at the time. In terms of Everleigh J’s approach, impermissible tax avoidance existed in schemes with a verifiable aim and involving multiple steps that appear distinct, but in reality effectively operate together and neutralise each other where necessary to achieve the aim. The overall scheme would not be entered into but for the tax benefits to be obtained.

3.2 Ramsay and the Adoption of a Judicial Anti-Avoidance Rule

The transactions in the conjoined appeals in this case involved taxpayers who realised a certain gain. Specialists then advised the taxpayers that a preconceived plan designed to create a deductible loss was available for a fee, all that was required of the taxpayer was to state the amount of the gain involved that needed to be counterbalanced by a deductible loss, this information would then be factored into the transaction. Lord Wilberforce described the transaction in question as follows:

1. The transaction as well as other transactions before the courts consisted of a number of steps carried out, documents and payments to be made in line with a rapid timetable.
2. The stated intention, or the obvious inference, was that when each transaction was initiated it would proceed through all the steps and would not be stopped before completion. Every transaction would also genuinely be what it purported to be.

22 609.
23 In IRC v Plummer 1979 (3) All ER 775 the approach followed by Everleigh J authorising the analysis of a scheme as a whole not as a series of independent transactions was endorsed by the House of Lords.
3. There was no binding agreement that the transactions would be carried out to completion. It was nevertheless reasonable to assume that the transactions would all be carried out once initiated.

4. The funds involved in the transaction appeared to be substantial, but in reality the taxpayer did not have to use his own funds. The funds were provided as a loan by financiers. This loan was in turn secured by any asset the taxpayer appeared to have and was automatically repaid at the end the transaction.

5. The transactions when treated as a single transaction, as the parties intended them to be, were not designed to produce a profit or a loss; they were effectively self-cancelling. The fees paid to the promoters of the scheme were the only expenses incurred.

6. In each of the cases, there was an admission that the sole purpose behind each scheme was the avoidance of tax. The tax consultant’s letter explicitly stated that “the scheme is a pure tax avoidance scheme and has no commercial justification in so far as there is no prospect of the taxpayer making a profit; indeed he is certain to make a loss representing the cost of undertaking the scheme”.25

Lord Wilberforce noted that due to the elements of the scheme, it would be a “wrong” and “faulty” analysis to “pick out and stop at, the one step in the combination which produced the loss, that being entirely dependent on; and merely reflective of, the gain. The true view, regarding the scheme as a whole, is to find that there was neither gain nor loss, and I so conclude”.26

The taxpayers argued that a general attack on tax avoidance schemes, as advocated by the Commissioner, was an area of exclusive parliamentary competence. The court could not perform a parliamentary function because its role was limited to the strict and correct application of the legislation in question. The taxpayers further contended that if the taxpayer managed to escape the confines of the law, it was for parliament to amend the law, not the court. The gist of the submission by the taxpayer was that it was the role of parliament to lay general anti-tax avoidance rules. This argument was summed up in the submission by Potter QC that:

[a] subject is only to be taxed upon clear words, not upon the “equity” of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are “clear words” is to be ascertained

24 In MacRae v Inland Revenue Commissioner (1961) 34 TC 20 26 the court described the self-cancelling nature of the transactions succinctly noting that the loss was a “mirror image” of the gain.
25 870 and 874.
26 874.
upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may indeed should, be regarded......

Lord Wilberforce noted that, while he respected the principles contained in the argument on behalf of the taxpayer, he did not see them as working to exclude the Commissioner’s contention that the transaction in question was a fiscal nullity. Lord Wilberforce noted that to argue for the nullification of the transaction did “not introduce a new principle” and that:

[while the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to a Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting approach, which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made: legislation cannot be required, or even desirable, to enable the courts to arrive at a conclusion which corresponds with the parties’ own intentions. The capital gains tax was created to operate in the real world, not that of make-belief.]

This statement can be seen as the justification for the introduction of a judicial approach that sought to determine the true nature of the transaction. This approach was justified by the need to protect the tax-base and the tax legislative process from prejudice. Lord Wilberforce alluded to the fact that the courts did not need legislative authority to determine the intentions of the parties in the transaction. In this regard, verifying the true transaction was not a new approach as contended, but a mere investigation of the true nature of the scheme. After referring to the decisions establishing the judicial doctrines in the US, namely *Knetsch v United States* and *Gilbert v Commissioner of Inland Revenue,* Lord Wilberforce noted that the decisions confirmed the belief that “it would be an excess of judicial abstinence to withdraw from the field now before us”. Lord Wilberforce stated that since the courts could not be justified in abstaining from actively determining the reality of the transaction, the circumstances called for their Lordships “to take, with regard to the schemes of the character...described, what may

27 870 – 871.
28 873.
30 (1957) 248 F 2d 399.
31 873.
appear to be a new approach” that called for the treatment of such transactions as “fiscally a
nullity, not producing either a gain or a loss”.32

Lord Wilberforce adopted an approach whereby the transaction was regarded as whole with all
its interconnected transactions. The individual steps in the composite transaction were
preordained and guaranteed to take place one after the other in rapid succession. The House of
Lords noted that even though the steps in the scheme were separate legal transactions, the
transactions could still be viewed as a single transaction by comparing the taxpayer’s position at
the beginning and at the end of the transaction. This analysis was seen to reveal that the
transaction contained transactions that effectively neutralised each other. Lord Wilberforce
stated:

[W]hile obliging the court to accept documents or transactions, found to be genuine, as such, it does not
compel the court to look at a document or a transaction in blinkers, isolated from any context to which it
properly belongs. If it can be seen that a document or transaction was intended to have effect as part of
nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is
nothing in the doctrine to prevent it being so regarded; to do this is not to prefer form to substance, or
substance to form it is the task of the court to ascertain the legal nature of any transaction to which it is
sought to attract a tax, or a tax consequence, and if that emerges from a series, or combination of
transactions, intended to operate as such, it s that series or combination which may be regarded.33

A new approach, first seen in Everleigh J’s dissenting judgment in Floor v Davis, was created.
Since the impermissible tax avoidance transactions of that time were created as a nexus of
transactions appearing to be independent, but which in reality worked together to obtain tax
benefits, a judicial doctrine stating that such transactions could be treated as one and the same
was created.34

3.3 IRC v Burmah Oil Co Ltd35 and the Affirmation of the Ramsay Approach

The Ramsay approach was followed in Burmah Oil. The transaction in this case was made to
create a deductible loss that reduced the capital gains the taxpayer had obtained. Lord Diplock

32 873.
33 871.
34 870. Lord Wilberforce described the neutralising effect of the transactions in the scheme. He noted that “[i]n
each case two assets appear, like particles in a gas chamber with opposite charges, one of which is used to
create the loss, the other of which gives rise to an equivalent gain which prevents the taxpayer from supporting
any real loss, and which gain is intended not to be taxable. Like the particles, these assets have a very short
life. Having served their purpose they cancel each other out and disappear. At the end of the series of
operations, the taxpayer’s financial position is precisely as it was at the beginning, except that he has paid a
fee, and certain expenses, to the promoter of the scheme”.
35 1982 STC 30 (HL).
noted that the effect of the Ramsay case was such that it could not be said that the tax avoidance schemes of the time were immune to unprecedented judicial scrutiny. He noted as follows:

It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay’s case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those steps would have been payable. The difference is in approach. It does not necessitate the over-ruling of any earlier decisions of this House; but it does involve recognising that Lord Tomlin’s oft quoted dictum in IRC v Duke of Westminster: Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be”, tells us little or nothing as to what methods of ordering one’s affairs will be recognised by the courts as effective to lessen the tax that would attach to them if business transactions were conducted in a straight-forward way...\(^{(36)}\)

The court referred to the decision in Ramsay and stated that the issue in Burmah Oil was whether the transaction, when completed, resulted in a loss dealt with by the legislation, and whether the loss was real. It was found that despite the fact that the scheme had real transactions and was not a sham, the losses that resulted from it were unreal. The transaction failed the Ramsay test.\(^{(37)}\)

3.4 Furniss (Inspector of Taxes) v Dawson\(^{(38)}\)

This case further developed the Ramsay approach and presented the House of Lords with an opportunity to clarify the misunderstandings about the scope of the Ramsay approach which had prevailed in the lower courts. Lord Roskill described the court a quo’s refusal to apply the Ramsay approach as an “error” which was due to the reference to the Duke of Westminster case. He noted as follows:

They do not appear to have appreciated the true significance of the passages in the speeches in Ramsay’s case...of Lord Wilberforce and Lord Fraser, and, even more important, of the warnings in Burmah Oil case...given by Lord Diplock and Lord Scarman in the passages to which my noble and learned friend Lord

\(^{(36)}\) 32.

\(^{(37)}\) Lord Diplock at 32 described the scheme in Burmah Oil as follows: “The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years, however, involve inter-connected transactions between artificial persons, limited companies without minds of their own but directed by a single master-mind. In Ramsay, the master-mind was the deviser and vendor of the tax-avoidance scheme; in the instant case it was Burmah, the parent company of the wholly owned subsidiary companies between which the pre-ordained series of transactions took place. Burmah was acting in accordance with advice obtained from advisers of the highest integrity who, in reliance on Lord Tomlin’s dictum, did not foresee the difference in approach to tax avoidance schemes involving inter-company transactions that would have been adopted by this House”.

\(^{(38)}\) [1984] 1 All ER 530.
Brightman refers and which I will not repeat. It is perhaps worth recalling the warning given, albeit in another context by Lord Atkin, who himself dissented in the Duke of Westminster case, in United Australia Ltd v Barclays Bank Ltd...: ‘when the ghosts of the past stand in the path of justice, clanking their medieval chains, the proper course for the judge is to pass through them undeterred.’ 1936, a bare half century ago, cannot be described as part of the middle ages but the ghost of the Duke of Westminster and of his transaction, be it noted a single and not a composite transaction, with his gardener and with other members of his staff has haunted the administration of this branch of the law for too long. I confess that I had hoped that the ghost might have found quietude with the decisions in Ramsay and in Burmah. Unhappily it has not. Perhaps the decision of this House in these appeals will now suffice as exorcism.39

Lord Brightman then clarified the application of the Ramsay approach. He noted that in terms of the new approach, there should be no distinction made for fiscal purposes between:

i. a series of transactions that are entered into in accordance with an arrangement that is not binding; and

ii. a similar series of transactions that are entered into in accordance with a binding contractual agreement between the participants.40

According to Lord Brightman this meant that the transaction in Furniss v Dawson was subject to the application of the Ramsay approach. Lord Brightman also noted that there needed to be a two-stage analysis before the principle could be applied. These stages can be defined as follows:

1. There must be a preordained series of transactions that constitute one composite scheme. This scheme may include the obtaining of some commercial objectives or may not have such objectives.

2. There must be steps without commercial or business purpose, apart from the avoidance of tax liability inserted into the scheme.41

Lord Brightman stated that if these are established, the transaction can then be disregarded for fiscal purposes, and the courts can then treat the transaction as one and look at its end result.42

39 533-534. Also see Lord Fraser of Tullybelton’s concurring judgment at 532. Lord Bridge of Harwich at 535 noted that the case was important in that offered the court an opportunity to develop the Ramsay approach. He, however, cautioned against the courts forgetting the basic premise in the Duke of Westminster case. The essence of Lord Bridge’s judgment was that in seeking to curb impermissible tax avoidance, the courts should not introduce an overarching anti-avoidance rule because taxpayers were still entitled to avoid taxes within the reasonable limits set by the courts.

40 542.

41 542.
The scheme in *Furniss v Dawson* was different from the other schemes that had directly led to the formulation of the *Ramsay* principle. This is because it was not sophisticated, and Lord Brightman described it as a straightforward scheme designed to defer tax until such a time as the income had been received. However, it was stated that the mere fact that the court had found that each step in the transaction was genuine did not mean that the court was confined to analysing the steps in isolation. The extension of the *Ramsay* approach to the *Furniss v Dawson* scheme raised concerns regarding the potential scope of the principle. There were musings on whether the scheme would remain limited to circular or linear transactions or transform to a rule of wide application, such as the judicial doctrines in the US. The latter was feared inevitably to lead to uncertainty.

3.5 The Limitation of the *Ramsay* Approach: *Craven v White; IRC v Bowater Property Developments Ltd and Bayliss v Gregory*

The three conjoined appeals in *Craven v White* interpreted the approach in *Furniss v Dawson* and limited the potentially wide scope of the *Ramsay* approach. The transaction in *Craven v White* was designed to defer capital gains tax, resulting from the sale of shares transacted through an Isle of Man company. To defer the capital gains tax, the taxpayer entered into transactions with a controlled company in the Isle of Man in order to acquire the taxpayer’s holdings in return for shares in the company. The Isle of Man company would then sell the holdings to an outside party. The purchase price was paid to the taxpayers. In all three cases, the House of Lords held that the taxpayer had not made a direct disposal to the third party. This decision meant that the *Ramsay* approach could not be applied. Lord Oliver noted that:

> The test whether a series of transactions which contained a tax saving step was nevertheless liable to tax was whether the transactions were preordained, in the sense that, looking at the transactions as a whole, realistically they constituted a single and indivisible whole and were to be treated as such, and was not

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43 Olowofoyeku et al (2003) 679 note that the *Furniss v Dawson* scheme was referred to as the “high water mark” of the application of the *Ramsay* approach because earlier on the approach had been applied to circular or self-cancelling schemes. In *Furniss v Dawson*, there were no such transactions and the two transactions were ‘linear’.


46 [1988] 3 All ER 495.

47 The issue in all three conjoined appeals was as follows: A makes a disposal to B and B disposes the same property to C. The question in *Craven v White* was whether the court was entitled to treat the disposal as merely being one from A to C.
whether the tax saving step was effected for the purpose of avoiding on a contemplated subsequent transaction.48

The Ramsay approach was interpreted and limited. The court noted that the preordainment of a series of transactions exists where the series is planned and carried through as a whole. The court also stated that there must be certainty that the series of transactions would be completed, with no "practical likelihood" that the series would be broken midstream.49 The two-pronged test set by Lord Brightman in Furniss v Dawson was modified in this case by Lord Oliver, who introduced an approach requiring a four-pronged test to be made. The inquiry thus became that:

1. there must be a series of transactions preordained to produce a certain result when an intermediate transaction is entered into;
2. the intermediate transaction must have no other purpose apart from the avoidance of tax.;
3. there must have been no reasonable likelihood that the series of transactions would not take place in the order ordained, meaning that the intermediate transaction had no possibility of having a separate independent life; and
4. the preordained series of transactions must actually happen.50

These limitations established some guidelines and clarity regarding the Ramsay approach as applied in Furniss v Dawson. Lord Templeman, in a dissenting judgement, noted that the four-pronged test would result in a distortion of the decision in Furniss v Dawson and, "if followed, would only revive a surprised tax avoidance industry and cost the general body of taxpayers hundreds of millions of pounds by enabling artificial tax avoidance schemes to alter the incidence of tax".51

It can be argued that the establishment of the four-pronged test was helpful in making the judicial response more certain to the revenue authorities, taxpayers, and the courts.52 In Furniss v Dawson, the court noted the manner in which the Ramsay approach had been ignored by the
lower courts. This failure in the lower courts may be attributed to the fact that there was no certainty regarding the application of the principle. The principle could have continued to exist in *dicta*, without precise guidelines, but it is submitted that the better approach was the one adopted by Lord Oliver and the majority in the House of Lords.

3.5.1 Analysis of the Four Pronged Test

3.5.1.1 Preordainment of Transactions

The statement that the transactions in a scheme must be preordained to take place was common in the cases decided after *Ramsay*. Preordained, as interpreted by Lord Oliver in *Craven v White*, meant that the transactions were not merely “planned or thought out in advance”\(^53\). There had to be certainty and control over the end results of the series of transactions. Certainty did not mean absolute certainty, and a reasonable likelihood that the transactions would be entered into in the manner preordained was sufficient. Lord Oliver also emphasised that it was not the court’s business to reconstruct the transactions of the taxpayer when trying to ascertain whether the transactions were preordained. Instead, when deciding whether there was preordination of transactions, the courts had to base their decisions solely on an analysis of the facts and the circumstances. Lord Oliver noted that preordained means that there must be a practical likelihood that the prearranged transactions would take place.

Lord Keith in *Craven v White* adopted a different approach. He noted that when determining the true legal effect of a series of transactions, it is necessary to ascertain whether the transactions were contractually bound beforehand to take place. Alternatively, the series must have been predestined by a guiding will, which was practically empowered to ensure that all the transactions would be entered into.\(^54\) This approach is different from that of Lord Oliver’s, and shows the propensity of judicial rules to mean different things to different judges. Lord Oliver’s practical likelihood test was based on an analysis of the circumstances surrounding the transactions and determining whether it could reasonably be stated that the transactions would be carried out in a certain manner. Lord Keith’s test was based on the presence of a binding contract or a guiding will. These approaches can be reconciled, because if there is a contractual obligation then there is a practical likelihood that a transaction will be carried out.

\(^{53}\) 528.
\(^{54}\) 500.
Olowofoyeku et al note that the difference in approach did not warrant the selection of one approach over the other. They argue that irrespective of whether the transactions are preordained, the test was threefold namely:

1. there must be a contractual obligation to complete all the transactions in the scheme; or
2. there must be a master-mind or guiding will that ensures that the series of transactions is completed; or
3. the series must be pre-planned and there must be no practical likelihood that the transactions will not be completed in accordance with the plan.\(^{55}\)

### 3.5.1.2 Commercial Purpose

One of the requirements for the application of the Ramsay approach to a transaction was the presence of a tax purpose in the transaction, or the absence of commercial purpose. This requirement was illustrated in Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes).\(^{56}\) In this case, Lord Templeman noted that the taxpayer’s contention was basically a repetition of the statement by Lord Tomlin in the Duke of Westminster case. He noted that the Duke of Westminster case could only be applied in tax mitigation, and not impermissible tax avoidance.\(^{57}\) Tax mitigation was described as a situation “whereby a taxpayer suffers a loss or incurs expenditure in fact as well as in appearance”.\(^{58}\) The absence of a commercial purpose in the transaction was noted, but it was stated that the transaction could not be disregarded in accordance with the Ramsay approach and the precedent set in the cases after Ramsay merely because the transaction was a tax avoidance transaction. Rather, the transaction was disregarded because the taxpayer “had entered into the scheme with fiscal motives as the paramount object”.\(^{59}\) In dismissing the appeal and ruling against the taxpayer, Lord Goff stated that the

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\(^{55}\) Olowofoyeku et al (2003) 686. Lord Templeman in his dissenting judgment at 506 noted that terms like “practical likelihood”, “practical contemplation” and “practically certain” were undefined and indefinable and if any meaning can be ascribed to them, such meaning is not based on the decision in Furniss v Dawson. Lord Templeman also noted that “[t]wo transactions can form part of a scheme even though it is wholly uncertain when the transaction is carried out whether the taxpayer who is responsible for the scheme will succeed in procuring the second transaction to be carried out at all”. Such a scheme would escape the preordainment test as defined by both Lord Oliver and Lord Keith. It can be noted that where the transactions are not preordained to happen in a self-cancelling series, they might indeed be independent and constitute permissible tax avoidance in terms of the Ramsay approach.

\(^{56}\) [1992] 2 All ER 275.

\(^{57}\) 290.

\(^{58}\) 290.

\(^{59}\) 290.
individual transactions were self-cancelling, complex, artificial, and had the sole or main purpose to avoid tax.\textsuperscript{60}

4. **RAMSAY APPROACH AND STATUTORY INTERPRETATION**

The Ramsay approach was also founded on the purposive interpretation of statutes. In \textit{IRC v McGuckian},\textsuperscript{61} Lord Browne-Wilkinson rejected the argument that the Ramsay approach only required the inserted steps to be disregarded if apart from the Ramsay approach they would have been effective in achieving the tax benefits sought.\textsuperscript{62} He noted that the Ramsay approach was introduced and developed as an approach to statutory construction and that in terms of the Ramsay approach, statutory provisions had to be applied to the substance of the transaction as opposed to the form, and without regard to the artificial steps with a sole or main purpose of obtaining tax benefits.

Lord Steyn’s concurring judgment noted the importance of statutory interpretation in tax avoidance cases. He referred to the contention made on behalf of the taxpayer, which was based on the following:

1. The \textit{Duke of Westminster} case is authority for the proposition that the fiscal consequences of a transaction had to be determined by reference to the legal rights and obligations created by the transaction. The substance of the transaction is immaterial to the inquiry.
2. The House had a duty to approach the matter by considering the legal rights and obligations created.
3. The Ramsay approach amounted to an extreme form of statutory interpretation.
4. The decisions of the House of Lords regarding the Ramsay approach should not be extended to the transaction in question.\textsuperscript{63}

Lord Steyn rejected these contentions and noted that it is necessary to distinguish between two questions, namely, whether there was a separate and special rule for the interpretation of tax statutes, and whether there was a special rule preventing the court from investigating the

\textsuperscript{60}297. For more judicial analysis of the composite transactions that were challenged in terms of the Ramsay approach see also; \textit{Moodie v Inland Revenue Commissioners and Another and Related Appeal} [1993] 2 All ER 49, \textit{Fitzwilliam v IRC} [1993] 3 All ER 184, \textit{FA and AB Ltd v Lapton (Inspector of Taxes)} [1971] 3 All ER 948, \textit{Chinn v Collins (Inspector of Taxes)} [1981] 1 All ER 189 and \textit{IRC v Burmah Oil Co Ltd} [1982] STC 30 38-39.

\textsuperscript{61}1997] 3 All ER 817.

\textsuperscript{62}823.

\textsuperscript{63}823.
substance of the transaction.\textsuperscript{64} Regarding the contention on statutory interpretation, Lord Steyn noted that in the 30 years prior to the case, there had been a shift from literal to purposive interpretation of statutes. The effect of the \textit{Duke of Westminster} case was that tax law was subjected to literal interpretation. When other statutes were being interpreted purposively, tax law was “by and large left behind as some island of literal interpretation”, and this needed rectification\textsuperscript{65}

Regarding the second contention, Lord Steyn noted that before the formulation of the \textit{Ramsay} approach, the courts “regarded themselves as compelled to adopt a step by step analysis of such schemes, treating each step as a distinct transaction producing its own tax consequences”.\textsuperscript{66} In combination with a literal approach to the interpretation of statutes, Lord Steyn noted that this led to the proliferation of impermissible tax avoidance transactions, but the \textit{Ramsay} approach brought an “intellectual breakthrough”.\textsuperscript{67} This approach, Lord Steyn continued, mandated a purposive interpretation of tax statutes and showed that the court can analyse the substance of the transaction. Acceding to the contention of the taxpayer’s counsel would therefore be a reinstatement of the approach that led to the proliferation of impermissible tax avoidance transactions prior to \textit{Ramsay}.

Regarding the \textit{Duke of Westminster} case, Lord Steyn stated that the \textit{Ramsay} approach was authority for the proposition that this case did not require the court to adopt a blinkered approach when analysing a transaction. He also stated that the \textit{Duke of Westminster} case was still valid in so far as it acknowledged the liberty of the taxpayer to avoid taxes, but has “ceased to be canonical as to the consequence of a tax avoidance scheme”.\textsuperscript{68} The consequences of a transaction were only to be determined after an application of purpose of the statute to the real transaction.

The purposive interpretation of statutes under the \textit{Ramsay} approach continued in \textit{MacNiven v Westmoreland Investments Ltd}\textsuperscript{69} but the court adopted a different approach from the one taken in \textit{McGuckian}. Lord Nicholls noted that the \textit{Ramsay} approach to verifying the legal nature of a transaction and to the interpretation of statutes should be construed in the context of the particular statutory provisions and the set of facts under consideration in the cases applying the approach. In this regard, Lord Nicholls noted that the \textit{Ramsay} approach could not be taken as

\textsuperscript{64} 824.
\textsuperscript{65} 824.
\textsuperscript{66} 824.
\textsuperscript{67} 824.
\textsuperscript{68} 825.
\textsuperscript{69} [2001] UKHL 6.
establishing a factual pre-requisite that had to exist before the court performed the purposive interpretation of the statute to the facts.\(^7\) This was a departure from the approach taken in McGuckian.

Lord Nicholls noted further that the “Ramsay approach is no more than a useful aid” which did not provide any absolute guidelines because the area of law it dealt with is not one for absolutes.\(^7\)\(^1\) It was noted that the Ramsay approach did not introduce a new legal principle because “[t]he need to consider a document or transaction in its proper context, and the need to adopt a purposive approach when construing taxation legislation, are principles of general application”.\(^7\)\(^2\)

In this case, the Crown argued that, in terms of the Ramsay approach, when a court is required to interpret a provision upon which a taxpayer relies to obtain a tax benefit and:

1. the transaction giving rise to the tax benefit is part of a preordained, circular or self-cancelling transaction; and
2. the transaction, though genuine but was completed for no commercial purpose apart from obtaining the tax benefit;

then there is a rule of construction that the dictates of the transaction in question have not been satisfied, unless there is some indication from the statute that this rule is not to be applied.\(^7\)\(^3\)

This argument ignored the purpose of the provision and merely focused on the characteristics of the transaction. According to this argument, if the transaction lacked business purpose and had a sole or main purpose to avoid tax, then whatever the statute provided, it was automatically a violation of the dictates of the statute. This approach, if accepted, would have widened the Ramsay approach and would curtail any analysis of the ambit of the provisions in question because the courts would be required only to look at the characteristics of a transaction and not the statutory provisions. Lord Hoffman rejected the Crown counsel’s analysis of the Ramsay approach and noted that there is ultimately one principle of construction, “namely to ascertain what Parliament meant by using the language of the statute”.\(^7\)\(^4\) The counsel’s analysis was held

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\(^7\)\(^0\) Paragraph 7.
\(^7\)\(^1\) Paragraph 8.
\(^7\)\(^2\) Paragraph 8.
\(^7\)\(^3\) Paragraph 8.
\(^7\)\(^4\) Paragraph 29.
to be something other than a principle of construction, and it was stated that the courts had no constitutional authority to use it when interpreting tax legislation.\(^{75}\)

The court found that the transaction in question complied with the purpose of the applicable legislation. However, Lord Hoffman’s approach to the purposive interpretation of the legislation was controversial. He noted that “it is first necessary to construe the statutory language and decide that it refers to a concept which Parliament intended to be given a commercial meaning capable of transcending the juristic individuality of its component parts”.\(^{76}\) In his opinion, some statutory terms had to be given a commercial meaning if that was the intention of parliament. Some terms referred to “purely legal concepts which have no broader commercial meaning”.\(^{77}\) Lord Hoffmann stated that the Ramsay approach could not be applied where the statutory terms were based on legal concepts, since it applied to terms to be construed commercially.\(^{78}\)

On the distinction between permissible and impermissible tax avoidance, Lord Hoffman noted that if the statute did not contain words like “avoidance” (impermissible) and “mitigation” (permissible), it was not helpful to introduce them. He explained this statement by noting that a tax avoidance scheme could not be honoured simply because it could be described as mitigation. Similarly, a transaction could not be impugned simply because it could be described as impermissible avoidance.\(^{79}\) He referred to *Norglen Ltd v Reeds Rains Prudential Ltd* where it was stated:

> If the question is whether a given transaction is such as to attract a statutory benefit, such as a grant or assistance like legal aid, or a statutory burden, such as income tax, I do not think that it promotes clarity of thought to use terms like stratagem or device. The question is simply whether, upon its true construction, the statute applies to the transaction. Tax avoidance schemes are perhaps the best example. They either work or they do not...If they do not work, the reason, as my noble and learned friend, Lord Steyn pointed out in *Inland Revenue Commissioners v McGuckian*...is simply that upon the true construction of the statute, the transaction which was designed to avoid the charge to tax actually comes within it. It is not that the statute has a penumbral spirit which strikes down devices or stratagems designed to avoid its terms or exploit its loopholes.\(^{80}\)

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\(^{75}\) Paragraph 29.

\(^{76}\) Paragraph 49.

\(^{77}\) Paragraph 49.


\(^{79}\) Paragraph 62.

\(^{80}\) [1999] 2 AC 1 13-14.
This reasoning was in line with the one in Lord Hope’s speech.\textsuperscript{81} It was not the court’s duty to determine what was, and what was not, permissible by reference to other factors not contained in the statute. Lord Hope and Lord Hoffman noted that preconceived ideas of what constitutes avoidance and mitigation are useless, because exclusive reference must be made to what the statute dictated. Lord Hoffmann held that the payment of a debt in plain terms means an act of discharging that debt. The Crown’s contention regarding the meaning of payment was held by Lord Hoffmann to be “completely elusive”.\textsuperscript{82} The decision of Lord Hoffman, Lord Nicholls, and Lord Hope limited the analysis of the elements of impermissible tax avoidance to statutory purpose.

The \textit{MacNiven} case continued with the purposive interpretation of statutes under the \textit{Ramsay} approach. Lord Hoffmann’s approach to statutory interpretation wherein he stated that provisions could be interpreted differently depending on whether they were intended to carry a commercial or juristic meaning was problematic.\textsuperscript{83} The approach taken by Lord Hoffman can be regarded as evidence of the uncertainty of purposive statutory interpretation as an indicator of impermissible tax avoidance.

\textit{Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)}\textsuperscript{84} is another significant case on the judicial approach to tax avoidance in the UK. The approach in \textit{MacNiven} above, and the general uncertainty surrounding the \textit{Ramsay} approach, may have prompted counsel for Barclays Mercantile to state that he represented the profession in hoping that the House would provide a definitive guide on the \textit{Ramsay} approach and its application. The court noted that:

\begin{quote}
[i]t is no doubt too much to expect that any exposition will remove all difficulties in the application of the principles because it is in the nature of questions of construction that there will be borderline cases about which people will have different views. It should however be possible to achieve some clarity about basic principles.\textsuperscript{85}
\end{quote}

\begin{footnotes}
\item[81] Paragraph 77 where he stated that when adjudicating on tax avoidance matters under the \textit{Ramsay} approach, “[t]he only relevant questions are: (1) the question of law: what is the meaning of the words used by the statute? And (2) the question of fact: does the transaction, stripped of any steps that are artificial and should be ignored, fall within the meaning of these words?”
\item[82] Paragraph 67.
\item[83] Tiley “First Thoughts on \textit{Westmoreland} (2001) 3 \textit{British Tax Review} 153 155 notes that requiring judges to distinguish between terms that require a commercial interpretation and those that require a juristic interpretation, would introduce uncertainty and complexity.
\item[84] [2005] 1 All ER 97.
\item[85] 108.
\end{footnotes}
This statement shows that the court found it onerous to clarify the uncertainties surrounding the *Ramsay* approach. The court could only provide guidelines on basic principles. The court noted that the *Ramsay* case “liberated the construction of revenue statutes from being both literal and blinkered”. The court also reiterated that the *Ramsay* approach essentially required the purposive interpretation of the tax provisions and an enquiry into whether the transaction in question complied with a purposive analysis of the legislation. The court stated that this exercise is not limited to first construing the legislation and then applying it to the facts, as the courts could also analyse the facts first and the legislation second; the central issue remained that of whether the legislation, when purposively construed, applied to the facts of the transaction.

In a departure from some of the principles of the *Ramsay* approach, the court noted that the commercial or business purpose required in the *Burmah Oil* and *Furniss v Dawson* cases was not decisive. The court stated as follows:

> Cases such as these gave rise to a view that, in the application of any taxing statute, transaction or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far. It elides the two steps which are necessary in the application of any statutory provision: first, to decide, on a purposive construction, exactly what transaction will answer to the statutory description and secondly, to decide whether the transaction in question does so.

It is evident that the trend observed in *McGuckian* and *MacNiven* to subordinate all indicators of impermissible tax avoidance to a purposive construction of the statute and applying it to the facts, continued in *Barclays Mercantile*. The court went further and noted that there was a need to avoid “sweeping generalisations regarding transactions undertaken for the purpose of tax avoidance”.

The case *Her Majesty’s Commissioners of Inland Revenue v Scottish Provident Institution* was decided on the same day as *Barclays Mercantile* and the court immediately reversed the trend of subordinating commercial purpose to statutory purpose. The House of Lords took a completely different approach to the one it adopted in *Barclays Mercantile*. The court referred to the

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86 108.
87 109.
88 109.
89 110.
90 110. The court referred to the decision in *MacNiven* and stated that there was a “need to focus carefully upon the particular statutory provision and to identify its requirements before one can decide whether circular payments or elements inserted for the purpose of tax avoidance should be disregarded or treated as irrelevant for the purposes of the statute”.
91 [2004] UKHL 52.

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commercial substance of parts of a transaction, something it had dismissed earlier that day as unnecessary. The court opined that the Ramsay approach would be destroyed if transactions with a commercially irrelevant contingency were not treated as composite transactions. The court noted that if such transactions were honoured for fiscal purposes, there would effectively be a return to “the world of artificial tax schemes, now equipped with anti-Ramsay devices”. The court therefore reinstated concepts of the Ramsay approach that it had marginalised earlier in the day in Barclays Mercantile.

5. ANALYSIS OF THE RAMSAY APPROACH

5.1 Characteristics of the Judicial Approach

From the court decisions on the Ramsay approach, it can be seen that this approach was characterised by the following:

1. The determination of the true nature of the transaction. The courts were required to look at the real transaction and not just the form. The approach targeted artificial, self-cancelling, and circular transactions. These transactions were treated as a whole and not as independent.
2. When determining whether a series of transactions was a composite transaction for fiscal purposes, the court enquired whether there was a practical likelihood at the commencement of the first transaction that all the other transactions in the series would follow.
3. Even though the House of Lords expressed some misgivings about the value of commercial purpose, it is clear, after Scottish Provident and Ensign Tankers, that commercial purpose was important. Thus the Ramsay approach would not apply where a tax-avoiding step in a composite transaction was inserted with a commercial purpose.
4. The Ramsay approach was interpreted as an aid to the construction of tax statutes. The intellectual approach of the Lords in McGuckian, Fitzwilliam, and MacNiven was aimed at analysing the development of the approach through the earlier cases and showing that the matter always turned on whether the transaction complied with the purpose of the statute.

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92 Paragraph 23.
93 This is a factor that can be used to distinguish between the US judicial doctrines and the Ramsay approach, which in its latter years showed that it functioned purely as purposive interpretation of tax statutes. As
As this chapter shows, the characteristics of the Ramsay approach were a direct response to the impermissible tax avoidance schemes that were prevalent at the time the Ramsay decision was handed down. One may argue that this means that the Ramsay approach is, to a certain extent, a purely UK doctrine specifically suited to the impermissible tax avoidance schemes in that jurisdiction. However, the judicial analysis under the Ramsay approach has a wider significance, particularly in the South African context and for understanding the concept of commercial substance. The following paragraphs discuss the lessons that can be learned from the Ramsay approach in this regard.

5.1.1 Legal Substance v Legal Form

In terms of the Ramsay approach, legal substance, as opposed to legal form, is dissimilar to the form versus substance doctrine discussed in Chapter 3. Legal substance and legal form do not involve simulation but entail transactions that are legally separate (legal form) but in effect work in unison to achieve a tax avoidance goal (legal substance). The lesson that can be learned from the UK regarding such transactions is that the legal substance must be considered, and these transactions must be viewed as a whole before their implications are determined. The legal substance over legal form approach means that transactions in a series will not be given individual legal effect if, as a collective, their legal substance is different. This remains true even where the individual transactions in the arrangement are legally sound.

5.1.2 Self-Cancelling or Offsetting Transactions

Self-cancelling or offsetting transactions have been shown to be transactions that operate in a series and neutralise each other for tax purposes. Because these transactions have no purpose other than to neutralise each other, they almost always lack economic or commercial substance. In the Ramsay case Lord Wilberforce described self-cancelling transactions in a manner that clarifies what they entail. He noted that offsetting and cancelling transactions are those that:

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Gammie “Sham and Reality: The Taxation of Composite Transactions (2006) 3 British Tax Review 294 297 notes, “[t]he current proposition, therefore, is that the Ramsay principle has been accorded legitimacy by placing it firmly in the sphere of judicial competence as a principle of statutory construction. It can no longer be advanced, as one imagines Lord Templeman would have preferred, as an overriding judicial anti-avoidance rule. That said, it seems unlikely that any judge who has espoused and applied the Ramsay principle in any of its versions would have claimed to have been doing anything other than giving effect to the Parliamentary intention as expressed in the statutory language that parliament as expressed in the statutory language that Parliament had used. There is no judicial power to tax other than through the interpretation and application of the relevant legislation”.

94 See Chapter 3 par 2.
1. have a number of transactions that are carried out in (quick) succession;
2. have a stated or obvious intention that they will be carried through without stopping before the last transaction has been completed;
3. have funds that appear to be significant but are actually not from the taxpayer; and
4. have transactions that, when treated as a whole, produce no profit or loss.\(^95\)

When dealing with offsetting and self-cancelling transactions, Lord Wilberforce stated that it would be “wrong” to pick and isolate a particular transaction such as the one that results in a loss for tax purposes. This is because such a transaction would be dependent on the other transactions that create a profit, and must not be isolated. According to Lord Wilberforce, the proper analysis is to look at the transactions as a single whole and determine whether the transactions effectively cancel each other out.\(^96\)

Other cases that dealt with the \textit{Ramsay} approach also explained the nature of self-cancelling or neutralising transactions as follows:

1. \textit{Burmah Oil}: Transactions can be self-cancelling or neutralising even though they are real and legally binding. It was stated that the only test was whether the series of transactions as a whole resulted in a real loss.
2. \textit{Furniss v Dawson}: The series of self-cancelling transactions must be preordained to take place in a particular order. The court in this case also stated that a non-binding agreement would suffice. If the transactions had to be contractually bound to take place then taxpayers would have an easy way of avoiding the Ramsay approach by simply not having a binding agreement in place to back their self-cancelling transactions.
3. \textit{Craven v White}: There must be a practical likelihood that an ensuing transaction will take place, and there must be no possibility that a transaction in the series has a separate or independent life.
4. \textit{Fitzwilliam}: It must be intellectually possible to treat the series of transactions as a single composite transaction.

In the course of business, taxpayers may enter into independent transactions that can effectively neutralise each other and lead to tax benefits. The last three points above show that the \textit{Ramsay

\(^{95}\) 870 and 874.
\(^{96}\) 873.
approach did not apply to these transactions because of the absence of the required interconnectedness that was based on the above.

5.2 The Purposive Interpretation of Statutes

The distinction between permissible and impermissible tax avoidance in terms of the Ramsay approach to tax avoidance was based on the purposive construction of the tax provisions in question. The courts were required to look at the transaction without blinkers, and to disregard the artificial or self-cancelling elements before ascertaining the real nature of the transaction. In terms of the Ramsay approach, impermissible transactions were those that, when treated as a single composite, did not comply with the purpose of the tax legislation applicable to the transaction. Conversely, permissible transactions were those that were consistent with statutory purpose. The identification of the composite transaction provided the facts and context within which the court could apply the language, scope, and purpose of the legislation in question and was guided by the presumption that parliament generally does not acknowledge artificial transactions with a sole or main purpose of avoiding the taxes it imposes. This approach ensured that the courts applied the purpose of the legislation to the composite transaction as a whole, and not only to the single tax-avoiding transaction, which, in isolation, could have passed the purposive test.

The experience with the purposive approach to tax provisions in tax avoidance cases in the UK provides further insight into the efficacy of purposive interpretation as an indicator of impermissible tax avoidance. Tiley notes that “the full mantra is that the words must be interpreted purposively and in their context. However this does not produce certainty since it is in the nature of questions of construction that there will be borderline cases about which people will have different views”. The House of Lords also made a similar statement in the Barclays Mercantile case, stating that it would be too much for lawyers to expect the court to make any exposition that would clarify everything in a principle that elicited different views.

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97 Tiley Revenue Law (2008) 128 notes that the effect of the Barclays Mercantile and MacNiven cases was such that the clear and basic question was whether a particular transaction fulfilled the statutory purpose. Tiley notes the fact that the basis is clear does not mean much, because as the Canadian experience with purposive statutory construction has showed, this is not the end as problems can still arise with this approach. The MacNiven case illustrated this and some of the methods used to arrive at statutory purpose were admittedly unusual. The fact that the Revenue lost in the case, also shows that purpose can be elusive to them as well.


99 As noted in Chapters 5, 7, and 8, the purposive interpretation of statutes does not always create certainty regarding impermissible tax avoidance transactions.

100 Tiley (2005) 273.
only prepared to provide clarity on the basic principles of the Ramsay approach. These statements reinforce the view that the purposive interpretation of statutes can result in different views on statutory purpose, and consequently does not always create certainty regarding permissible and impermissible tax avoidance.

The UK’s experience with purposive statutory interpretation in tax avoidance also shows the unpredictable methods that the courts might use when establishing statutory purpose. In this regard, the approach of Lord Hoffman in MacNiven is a case in point. Lord Hoffman stated that the court must determine, from the language of a provision in question, whether parliament intended the provision to have a legal or a commercial meaning. He did not provide a distinction between legal and commercial terms in the statutes, and how they are identified. Lord Hoffman’s approach to establishing statutory purpose complicated the purposive construction of statutes, and is an indication of the potential for courts to utilise unpredictable and possibly unworkable methods of establishing statutory purpose.

6. THE INTRODUCTION OF A GAAR IN THE UK

6.1 Consultations on the Need for a GAAR in the UK

In what can be interpreted as dissatisfaction with the Ramsay approach, the UK government, through Her Majesty’s Treasury, mandated consultations on introducing a GAAR in the UK. An Advisory Committee consisting of academics and practitioners appointed by and under the leadership of Graham Aaronson QC was established in December 2010 to investigate whether the UK required a GAAR. These efforts culminated in the release of a report titled; GAAR Study: A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System (the Report) on 11 November 2011.

102 The unpredictability and complexity of Lord Hoffman’s approach to purposive statutory interpretation can be likened to the approach taken by the Canadian court in OSFC Holdings Ltd v The Queen 2001 4 CTC 82 par 67 which required a clear and unambiguous policy to be established. The impact of the OSFC Holdings Ltd approach is discussed in Chapter 7 par 4.2.
103 See http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm (accessed on 20/06/2012).
104 This Report can be accessed on http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF (accessed on 5/03/2012).
This Report dealt with issues such as the UK’s need for a GAAR, the setting of principles for a GAAR, the introduction of a draft GAAR, and a guidance note on the draft GAAR. The following paragraphs highlight some of the conclusions made in the Report.

6.1.1 Conclusion on Whether the UK Needs a GAAR

The Report concluded that the UK needs a targeted GAAR as opposed to a broad GAAR. A targeted GAAR is one whose focus is limited to impermissible tax avoidance while a broad GAAR is one whose uncertainty creates confusion on what is permissible or impermissible. It was concluded that a broad GAAR would not be desirable because it would unduly limit the ability of individual and corporate taxpayers to carry out permissible tax avoidance or “sensible and responsible tax planning”. The Report, however, noted that a targeted GAAR, which is completely distinguishable from a broad GAAR, is strongly recommended.

The Report noted that the UK anti-avoidance regime, which consists in purposive construction of tax statutes under the Ramsay approach, SAARs, and the rules requiring the disclosure of tax avoidance schemes, has significantly reduced impermissible tax avoidance. It however stated that this approach is inadequate when dealing with sophisticated and potentially impermissible tax avoidance schemes. The Report referred to an example in Mayes v HMRC where a scheme that presented taxpayers with a seven-step process to creating a tax loss that can be used to offset tax liability was not struck down. Proudman J noted in this case that the characteristics of the transaction would instigate an automatic response to disregard it. The court, however, failed to find any purpose in the provisions involved that was sufficient to disregard the transaction. The Court of Appeal reasoned along the same lines and both Thomas LJ and Toulson LJ stated that the scheme required parliament to look at the way the provisions were

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106 Paragraph 1.5.
107 Paragraph 1.8. In par 1.7 it was stated that a targeted GAAR would (i) be capable of deterring and curtailing artificial and contrived transactions; (ii) prevent businesses that carry out impermissible tax avoidance from obtaining an advantage over those that do not; (iii) expand the role of the judges from merely determining the purpose of the statute under the Ramsay approach which inevitably places pressure on judges to stretch the statutory provisions to achieve a desirable result; (iii) lead to a reduction in the system of specific anti-avoidance rules (SAARs) which would in turn make the legislation shorter and simpler; (iv) lead to a limitation of the willingness of Her Majesty’s Revenue and Customs (HMRC) to challenge transactions that are in the outer limits of responsible tax planning.
108 Paragraph 3.7 read with par 3.18.
109 Paragraph 3.20.
111 Paragraph 45.

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drafted since the transaction avoided tax in a manner that could not have been intended even though the transaction was reluctantly honoured.

The Report also noted that while the purposive interpretation system under the *Ramsay* approach the Report was a positive development, it had led to a general view that the courts are in some cases stretching the provisions in question in order to strike down tax avoidance transactions they view as impermissible.\textsuperscript{113} The inadequacy of the *Ramsay* approach in some sophisticated and artificial transactions, the advantages of a targeted GAAR and the negative perception created by the purposive interpretation are factors that led to the conclusion that a targeted GAAR is needed.

6.1.2 The Principles Underlying a GAAR in the UK

The Report concluded that a targeted GAAR needs to be founded on a set of principles. Before discussing the major principles underlying the proposed GAAR, the Report noted that the GAAR would override the logical consequences that flow from tax legislation.\textsuperscript{114} It was noted that this creates both an advantage and a responsibility. The advantage is that the GAAR can make use of concepts that could not have been developed by the courts in under the *Ramsay* approach.\textsuperscript{115} A GAAR in this regard can define exactly what it will target which is something the courts could not do extensively under the *Ramsay* approach.\textsuperscript{116} The responsibility is that being a potentially powerful weapon, the GAAR must be used by HMRC in the public interest. The Report stated that public interest does not extend to using the GAAR to intimidate taxpayers in transactions that it does not apply to.\textsuperscript{117} The principles that the Report identified are discussed below.

6.1.2.1 The Overarching Principle

The Report concluded that a UK GAAR needed to be founded on an overarching principle, which reads as follows:

\textsuperscript{113} Paragraph 3.13. An example of a case where statutory provisions were stretched is given as *HMRC v DCC Holdings* [2010] UKSC 58 par 25 where section 84(1) of the *Finance Act* 1996 is argued to have been stretched in order to avoid absurd consequences.

\textsuperscript{114} Paragraph 5.5.

\textsuperscript{115} Paragraph 5.6.

\textsuperscript{116} Some writers argue that the GAAR will simply legitimise the discretion that judges have been exercising under the *Ramsay* approach. See generally Lethaby “Aaronson’s GAAR” (2012) *British Tax Review* 27. It is argued that, unlike in the US, the UK courts have not gone beyond purposive application of statutes to the substance of the transactions in question. The GAAR will therefore give the UK judges more scope to scrutinise transactions.

\textsuperscript{117} Paragraph 5.7.
[A] GAAR which is appropriate for the UK must be driven by an overarching principle. This is that it should target those highly abusive contrived and artificial schemes which are widely regarded as intolerable, but that it should not affect the large centre ground of responsible tax planning.  

To ensure that the centre ground of responsible tax planning/permissible tax avoidance is safe from the GAAR, it was stated that where there is reasonable doubt about whether the transaction is permissible or not, the case should be resolved in the taxpayer’s favour.

### 6.1.2.2 Distinguishing between Permissible and Impermissible Tax Avoidance

The Report concluded that a UK GAAR needs to be founded on sound principles that distinguish between permissible and impermissible tax avoidance. The Report rejected what it saw as a common GAAR or SAAR approach of targeting of transactions with a sole or main purpose of avoiding tax. It was stated that a UK GAAR should not target transactions with a sole or main purpose to avoid tax because of the tax concessions in the tax legislation. The Report noted that to isolate impermissible tax avoidance, a pragmatic approach is necessary where it is determined whether or not the transaction is abnormal and has abnormal features aimed at obtaining tax benefits.

The Report concluded that the preferable principle to distinguish between permissible and impermissible tax avoidance is one that focuses on what makes permissible tax avoidance permissible, and basing the analysis of abnormal transactions that have been set aside for further analysis on whether they contain elements of permissible tax avoidance. In this regard, the Report noted that the approach of the Hong Kong Court of Final Appeal in *Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue* that “the statutory purpose of section 61A is not to attack arrangements made to secure benefits which are legislatively intended to be available to the taxpayer” is the right one for the UK. The principle that was proposed to distinguish between permissible and impermissible tax avoidance is thus whether the transaction can be said to be a reasonable response to the choices offered by tax legislation to obtain tax benefits.

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118 Paragraph 5.1.
119 Paragraph 5.2.
120 Paragraph 5.13.
121 Paragraph 5.14.
122 Paragraph 5.19
123 FACV No 29 of 2008 par 101
124 Paragraph 5.21.
6.1.2.3 Reducing Uncertainty

The Report identified the reduction of uncertainty as one of the principles underlying a UK GAAR. After an extensive consultation and research process that entailed the analysis of the experience other countries have had with GAARs, the Report acknowledged the inevitable uncertainty that accompanies a GAAR. However, it noted that uncertainty must be limited as much as possible. The Report identified two ways in which uncertainty could be reduced. The first method is to decide a matter that brings doubt as to whether it is impermissible or amounts to a reasonable exercise of statutory choices (permissible) in the taxpayer’s favour. It was proposed that placing the burden of proving that a transaction is not a reasonable exercise of choices on HMRC would achieve this. The second method of addressing uncertainty that the Report described as “effective”, is the setting up of an Advisory Panel that will advise HMRC on the feasibility of challenging certain doubtful transactions.

6.1.2.4 The Exclusion of Transactions with no Intent to Avoid Tax

The Report argued for an exclusion of the very few cases that lead to the avoidance of tax without the intent to do so. It was argued that it is important to allay the fears of small business owners or individuals who enter into transactions such as rendering financial assistance to family members or suppliers without seeking to obtain tax benefits. The burden of proving that the transaction had no intent to obtain tax benefits was proposed to lie with the taxpayer.

6.1.2.5 The Counteraction of Impermissible Tax Avoidance

The Report noted that one of the GAAR’s basic aims is to deter taxpayers from impermissible tax avoidance. Where such deterrence does not work, the GAAR must be capable of counteracting any targeted impermissible tax avoidance transaction. The Report noted that a UK GAAR must have the counteraction of impermissible tax avoidance as one of its principles, and that this counteraction must be reasonable and fair. To achieve fairness in counteraction it was stated that:

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125 Paragraph 5.23.
126 Paragraph 5.25.
127 Paragraph 5.31.
128 Paragraphs 5.32 and 5.33.
129 Paragraphs 5.34 and 5.35.
1. Transactions that are circular and self-cancelling can be nullified and treated as if they did not take place. Where the transaction effects a change in the taxpayer’s economic position, this transaction should be respected.

2. Transactions that have real commercial consequences on top of the impermissible tax avoidance should be counteracted by basing the calculations for the tax due on a hypothetical transaction that achieves the commercial benefits achieved but not the impermissible tax avoidance. The rationale behind this is to limit HMRC’s ability to create the alternative that would lead to the most tax being levied. In this regard, the Report noted that the onus must be placed on HMRC to prove that its proposed alternative is justifiable in the circumstances.  

The principles discussed here reflect one of the underlying themes of the Report, which is the limitation of HMRC’s discretion in GAAR matters, which is believed to contribute to parity between the taxpayer and HMRC.

6.2 The Illustrative GAAR

The Report created an illustrative GAAR incorporating the above principles, which is contained in Appendix 1 of the Report. The central provision of the illustrative GAAR states that:

Section 8 applies to counteract abnormal arrangements which, but for this Part, would achieve an abusive tax result from the application to the arrangements of the provisions of the Acts, and which are contrived to achieve such a result.  

An abusive tax result is defined as an advantageous tax result that is obtained through an arrangement that constitutes neither reasonable tax planning, nor an intention to avoid tax. An abnormal arrangement that obtains an abusive tax result is defined as an arrangement that includes an abnormal feature for the sole purpose or as one of the main purposes of obtaining an abusive tax result. An abusive tax result is achieved by:

1. the avoidance of the provisions of the Acts;
2. the exploitation of provisions of the Acts;

130 Paragraphs 5.36, 5.37 and 5.38.  
131 Section 2 of the illustrative GAAR.  
132 Section 3(1).  
133 Section 3(2).
3. the exploitation of inconsistencies that exist in the application of the provisions of the Acts; and
4. the exploitation of supposed weaknesses in the provisions of the Acts.\textsuperscript{134}

\textbf{6.2.1 Exclusions from the Application of the GAAR}

The illustrative GAAR has certain safeguards that ensure that the GAAR does not apply to certain transactions. Safeguard 1 excludes from the GAAR arrangements that can reasonably be termed reasonable tax planning by stating that they do not lead to an abusive tax result.\textsuperscript{135} Reasonable tax planning is defined as the reasonable exercise of choices provided by the legislation.\textsuperscript{136} Safeguard 2 is aimed at excluding arrangements that do not have an intention to avoid tax. Section 5(1) states that where a taxpayer proves on a balance of probabilities that an arrangement, as a whole or its individual parts, was not designed or carried out with the intention of obtaining an advantageous tax result, then the GAAR cannot be applied to that arrangement. Such arrangements do not produce an abusive tax result. Safeguard 3 places the burden of proving most elements of the GAAR on the HMRC. In this regard, the HMRC has to prove, on a balance of probability, that an arrangement is abnormal, an arrangement results in an abusive tax result and does not amount to reasonable tax planning, and that the counteracting assessment is fair and reasonable.

\textbf{6.2.2 Definition of Abnormal Arrangements}

In line with the conclusion to limit uncertainty in a UK GAAR, abnormality as an indicator of impermissible tax avoidance is explained in the illustrative GAAR. Section 6(1)(a) defines an abnormal arrangement as one which, when viewed objectively, has no significant purpose apart from obtaining an abusive tax result. Section 6(1)(b) offers an alternative definition, and defines an abnormal arrangement as one that has features that would not have been present but for the sole purpose or one of the main purposes of obtaining an abusive tax result. The illustrative GAAR also contains features that may be considered when determining the abnormality of an arrangement.\textsuperscript{137} These are:

\begin{itemize}
\item Section 3(2).
\item Section 4(1).
\item Section 4(1).
\item Section 7(2). It is stated in this section that the features are not exhaustive and the fact that an arrangement has one of the identified features does not automatically lead to the conclusion that it is abnormal.
\end{itemize}
1. arrangements that result in receipts that are substantially less than the real economic gain or profit being considered for tax purposes;

2. arrangements that result in deductions that are substantially greater than the true economic expenditure or loss being considered for tax purposes;

3. arrangements that include elements that are substantially different from market value, or that exist on non-commercial terms;

4. arrangements that are wholly or partly inconsistent with the legal obligations of the parties to that arrangement;

5. arrangements that include a party, an element, or a document that would not have been included, but for the design of the arrangement to obtain an abusive tax result;

6. arrangements that do not have an element, a party, or a document that would have been included, but for the design of the arrangement to obtain an abusive tax result; and

7. arrangements that entail the location of an asset, element, or place of residence of an individual that would not have been so located if the arrangement was not structured to obtain an abusive tax result.\(^\text{138}\)

The identified features of abnormal arrangement are envisaged to assist in identifying abnormal transactions. For instance, it is abnormal to purport to receive income that is less than the economic equivalent of what was actually received with the aim of avoiding tax. Features 5–7 show that certain arrangements will be determined by reference to what a normal arrangement, that is not designed to obtain an abusive tax result, would be like. Thus, an arrangement that has elements or documents that are not normally included in an arrangement of the same kind, but are included because the particular arrangement is designed to obtain an abusive tax result, will be found to be abnormal.

**6.3 The Government’s Response**

The UK government considered the proposals of the advisory committee contained in the Report. On 12 June 2012 it accepted the recommendation of the Report that a GAAR that is targeted at artificial and abusive tax avoidance is needed.\(^\text{139}\) It then published a document titled *A General Anti-Abuse Rule Consultation Document*\(^\text{140}\) (the Document) for consultation on the draft GAAR contained in the Document. This Document states that the government also accepted the

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\(^{138}\) Section 7(3)(a) – (g).

\(^{139}\) See generally http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm (accessed on 20/06/2012).

\(^{140}\) (2012) http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm (accessed on 20/06/2012).
conclusion in the Report that a broad GAAR would not be beneficial for the UK as a place to do business. The government also reaffirmed its desire that the GAAR must establish enough certainty for business and individual taxpayers to know the tax implications of transactions without incurring undue costs. In this regard, the Document states that the proposed GAAR will be aimed at having a narrower ambit than the GAARs in other countries.

6.4 The UK General Anti-Abuse Rule

After the consultation process on the draft GAAR, the UK’s general anti-abuse rule (GAAR) was introduced through the Finance Act 2013 (the FA), which received Royal Assent on 17 July 2013. This GAAR is found in Part 5 of the FA. Section 207 is the main GAAR provision and it provides as follows:

1. Arrangements are “tax arrangements” if, having regard to all circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements.

2. Tax arrangements are “abusive” if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including –
   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 arrangements are intended to exploit any shortcomings in those provisions.

3. Where the tax arrangements form part of any other arrangements regard must also be had to those arrangements.

4. Each of the following is an example of something which might indicate that tax arrangements are abusive –
   a. the arrangements result in an amount of income, profits or gains for tax purposes that is significantly less than the amount for economic purposes,
   b. the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes, and

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141 Paragraph 1.5 and 1.6.
142 Paragraph 2.3. The draft GAAR contained in Annex D of the Document incorporates some of the conclusions of the advisory committee. It targets abusive tax arrangements, and defines what the terms “abusive” and “tax arrangement” mean in section 2.2 and section 2(1), respectively. This draft GAAR was accepted by Aaronson, who noted in the GAAR Study: A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System: Supplementary Report (2012) on par 2.1 that “[w]e are agreed that the consultation draft GAAR embodies all of the main principles which we consider need to be incorporated in, and to form the framework of, a GAAR that would be appropriate for the United Kingdom”. Accessed at http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm (accessed on 20/06/2012).
c. the arrangements result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid,

but in each case only if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted.

5. The fact that tax arrangements accord with established practice, and HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice, is an example of something which might indicate that the arrangements are not abusive.

6. The examples given in subsections (4) and (5) are not exhaustive.

This GAAR applies to abusive tax arrangements, and requires the following to be established before it can be applied:

1. a tax arrangement which, when objectively analysed, is an arrangement with obtaining a tax advantage as the main or one of the main purposes; and
2. The tax arrangement must be abusive in the sense that it cannot be reasonably regarded as a reasonable course of action, having regard to the factors referred to in section 207(2) and (4).

6.5 Analysis of the UK GAAR

The introduction of a GAAR in the UK represents, in UK terms, a paradigm shift in the fight against impermissible tax avoidance from judicial doctrines to a GAAR system. The approach to the UK GAAR and its scope is unique in the way it places some emphasis on what makes permissible tax avoidance permissible and in the way it seeks to depart from a narrow definition of a tax arrangement that is susceptible to a GAAR attack. The UK GAAR analysis below will focus on the process leading up to the GAAR and the GAAR itself.

6.5.1 The Steps Leading to the Introduction of the GAAR

As noted above, the first major step towards the introduction of the GAAR in the UK was the study by Aaronson, which culminated in the Report that presented conclusions on a UK GAAR. These conclusions were arrived at after an in-depth analysis of the GAAR experience in other countries. The missteps made by countries such as South Africa and Australia in their GAAR experiences were noted after this analysis, because the Report concluded that, while a GAAR is
needed in the UK, a broad and uncertain GAAR is not ideal.\textsuperscript{144} This conclusion means that the UK, unlike South Africa and Australia, did not start its GAAR experience with a literally broad and uncertain GAAR.\textsuperscript{145}

The Report noted that a broad and uncertain GAAR would threaten the UK’s status as a business destination and affect permissible tax avoidance. This conclusion was supported by the conclusion that a UK GAAR needs to be founded on principles. It can be argued that the creation of express principles upon which a GAAR is founded is a relatively novel approach to a GAAR. One of the principles created is the reduction of uncertainty that was accompanied by a recommendation to create a GAAR panel to assist HMRC in selecting transactions to be challenged in terms of the GAAR. This principle was also accompanied by a recommendation that all cases that are not clearly impermissible must be decided in favour of the taxpayer.\textsuperscript{146} The attempt to limit uncertainty shows that the UK approach acknowledges the adverse impact of uncertainty on some permissible tax avoidance transactions, and does not subscribe to the use of uncertainty in a GAAR as a deterrent.\textsuperscript{147}

The principle upon which the GAAR would distinguish between permissible and impermissible tax avoidance is probably the most revolutionary and novel. The GAARs and judicial doctrines studied in this research focus on the characteristics of impermissible tax avoidance and seek to define it in different ways. The Report took a completely different approach and states that:

\begin{quote}
[t]he conclusion reached is that to identify the sort of abusive scheme which the GAAR is intended to deter or counteract it is necessary to adopt a more pragmatic and objective initial approach. The starting point
\end{quote}

\textsuperscript{144} The move to a GAAR in the UK should not be taken as direct support for an argument that GAARs are better than judicial doctrines in curbing impermissible tax avoidance. This is because the Ramsay approach in the UK was based on applying the purpose of the statute to the substance of the transaction, and not on creating other indicators of impermissible tax avoidance, as is the judicial approach in the US judicial doctrines. The Report in par 3.20 noted that a GAAR is required because the Ramsay approach was the most that the courts could do since they could not create indicators of impermissible tax avoidance to target sophisticated schemes in the same manner that parliament could by means of a GAAR.

\textsuperscript{145} As discussed earlier, Australia started off with a literally broad GAAR, as seen in section 260 of the Income Tax Assessment Act of 1936 (ITAA), and its predecessors, and South Africa started off with section 90 of the Income Tax Act 31 of 1941.

\textsuperscript{146} In Canada, the court in \textit{Canada Trustco Mortgage Co v Canada} 2005 SCC 54 par 50 interpreted this principle into the Canadian GAAR by stating that the abusive nature of a transaction must be clear before the transaction can be struck down in terms of the Canadian GAAR. In the UK, the government was more proactive in introducing this principle.

\textsuperscript{147} This can be contrasted with the South African approach where there were no clear moves to reduce the uncertainty of the South African GAAR when it was created. Liptak “Battling with Boundaries: The South African GAAR Experience in Freedman (ed) \textit{Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management} (2008) notes that “uncertainty is a reality”, which may explain the apparent lack of effort to limit uncertainty in the South African GAAR. The uncertainty of the South African GAAR is discussed in more detail in Chapter 5 par 3.
should be to see whether the arrangement is abnormal, in the sense of having abnormal features specifically designed to achieve a tax advantageous results. If an arrangement has such an abnormal feature or features then it becomes in effect “short listed” for consideration as a potential target for the GAAR. Conversely, if there is no such feature then it is immediately dismissed from consideration.  

After short-listing an arrangement, the Report states:

I have reached the conclusion that the better approach is to identify what it is that makes the centre ground of responsible tax planning unobjectionable; and to use this as the way to exclude from the shortlist of abnormal transactions those that come within that centre ground.

This is a substantially different approach because it does not base its isolation of impermissible tax avoidance entirely on the characteristics of impermissible tax avoidance, and because the enquiry into the impermissibility of the transaction does not end with the identification of the abnormal features of the transaction. The enquiry proceeds onto whether the transaction with abnormal features can reasonably be said to be “a reasonable response to choices afforded by legislation”. In other words, the ultimate distinction between permissible and impermissible tax avoidance is founded on the characteristics of permissible tax avoidance.

6.5.2 The GAAR

As noted earlier, the government agreed with the broad conclusions arrived at in the Report. Even so, the GAAR is not entirely based on the conclusions in the Report since it contains some material differences that arose from the consultation process.

In line with the conclusions in the Report, the GAAR seeks to strike a balance between curbing impermissible tax avoidance and the right to avoid tax. Regarding the curbing of impermissible tax avoidance, HMRC states that the GAAR’s fundamental approach is that “the levying of tax is the principal mechanism by which the state pays for the services and facilities that it provides for its citizens, and that all taxpayers should pay their fair contribution”. To support this approach, the GAAR is designed to reject “the approach taken by the Courts in a number of old cases to the effect that taxpayers are free to use their

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148 Paragraph 5.15.
149 In South Africa, as seen in Chapter 5 par 2, abnormality is one of the indicators of impermissible tax avoidance and once a tax avoidance transaction is found to be abnormal it will automatically be struck down in terms of the GAAR. This illustrates the difference in approach between South Africa and the UK.
151 Paragraph B2.1.
ingenuity to reduce their tax bills by any lawful means, however contrived those means might be and however far the tax consequences might diverge from the real economic position”.

The GAAR seeks to curb impermissible tax avoidance by:

1. deterring taxpayers from entering into abusive transactions or deterring promoters from promoting abusive transactions; and
2. counteracting abusive transactions where the taxpayer or promoter is not deterred.

The Report concluded that the GAAR should reduce uncertainty. After the acceptance of this principle by the government, it is clear that the deterrent value of the GAAR is not intended to be based on uncertainty, but the threat of counteraction of any abusive transaction.

Regarding the protection of the right to avoid tax, it is clear that this principle is as important as the curbing of impermissible tax avoidance. HMRC notes that “[j]ust as it is essential to understand what the GAAR is targeted at, so it is equally essential to understand what it is not targeted at”. Transactions that the GAAR does not target are those that amount to courses of action that are allowed by legislation. The GAAR also protects the right to avoid tax by providing safeguards that are largely in line with the conclusions in the Report.

6.5.2.1 Tax Arrangement

A tax arrangement must be established before the GAAR can be applied. A tax arrangement is defined in section 207(1) as an arrangement that can reasonably be said to have tax avoidance as its main or as one of its main purposes. The term “reasonably” means that a tax avoidance purpose must be determined objectively. An arrangement is defined in section 214 as including “any agreement, understanding, scheme, transaction or series of transactions (whether or not they are legally enforceable)”.

According to HMRC, arrangements can be viewed broadly or narrowly. A broad view of an arrangement would be similar to the Ramsay approach where a series of arrangements is viewed as a single arrangement if these arrangements are entered into to cancel each other

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152 Paragraph B2.1. The cases that are expressly rejected in this approach are Ayrshire Pullman Motor Services and Ritchie v Commissioner (1929) 14 TC 754, IRC v Duke of Westminster 1936 AC 1 and IRC v Fisher’s Executors [1926] AC 395 (HL). It is submitted that the fundamental principle enshrined in these cases, namely the right of the taxpayer to avoid tax permissibly, is still intact and as has been seen in this research, has been reaffirmed in a number of cases in South Africa, Canada, Australia, and the US.

153 Paragraph B3.1.

154 Paragraph B4.1.
out. A narrow view would allow HMRC to challenge an arrangement within a larger arrangement, which as a whole seeks to launder impermissible tax avoidance with commercial purpose. However, section 207(3) states that “[w]here the tax arrangements form part of any other arrangements regard must also be had to those other arrangements”. This provision means that a narrow assessment of an arrangement must consider the effect of the other arrangements of which the narrow arrangement forms part. If the narrow arrangement cannot reasonably stand alone without losing its character or the purpose of the larger arrangement, then it must not be assessed in isolation.

6.5.2.2 Abuse

The enquiry does not end with the objective determination of the purpose of the arrangement. HMRC notes:

The broad definitions of “arrangements” and “tax arrangements” set a low threshold for initially considering the possible application of the GAAR. A much higher threshold is then set by confining the application of the GAAR to tax arrangements which are “abusive”.

Section 207(2) states that a tax arrangement is abusive if it cannot reasonably be said to be a reasonable course of action in relation to the applicable tax provisions. This double reasonableness test is a safeguard that sets the threshold higher than a single reasonableness test. According to HMRC, this double test:

recognises that there are some arrangements which some people would regard as a reasonable course of action while others would not. The ‘double reasonableness’ test sets a high threshold by asking whether it would be reasonable to hold the view that the arrangement was a reasonable course of action. The arrangement falls to be treated as abusive only if it would not be reasonable to hold such a view.

This test is the most important GAAR test since it is the one upon which the distinction between permissible and impermissible tax avoidance is based. As recommended in the Report, this distinction is largely based on what makes permissible tax avoidance permissible.

155 Paragraph C4.3.
156 This can be taken as evidence of the desire to avoid the problems and judicial controversy caused by isolating a transaction in a composite transaction as experienced in Canada (see Chapter 7 par 4.3) and in Australia (see Chapter 6 par 3.2.1).
157 Paragraph B10.2. This statement shows that this GAAR attempts to set a higher threshold than the one set in Australia in terms of Part IVA of the ITAA in Australia where transactions that can objectively be said to have a tax avoidance purpose are targeted.
158 Paragraph B12.1.
The double reasonableness test is, in terms of section 207(2) applied in relation to, inter alia:

a. Whether the results obtained are consistent with any principles upon which the relevant express or implied provisions are based and the policy objectives of these provisions. This test recognises that certain provisions have a tax relief policy if certain conditions are met. If a taxpayer obtains the tax relief as provided for, this action will reasonably be concluded to be a reasonable course of action and not justify a GAAR attack. This test also recognises that some provisions may present a taxpayer with different courses of action, with different tax consequences. HMRC notes that it is “entirely reasonable” for a taxpayer to consider these tax consequences and choosing a certain course of action.\(^{159}\)

b. “Whether the means of achieving those results involves one or more contrived or abnormal steps”, as stated in section 207(2)(b). The principle under this subsection is that it is not a reasonable course of action to resort to abnormal or contrived steps in order to bring an arrangement within statutory purpose, or to exploit narrow perceived loopholes.\(^ {160}\)

c. Whether the arrangement is aimed at exploiting any weaknesses in the applicable provisions.

Section 207(4) contains a list of indicators of abuse, but section 207(5) states that these indicators only work “if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted”.

7. CONCLUSION

This chapter discussed the judicial response to the legacy of the Duke of Westminster case in the Ramsay cases. This response was at the centre of the fight against impermissible tax avoidance in the UK. It was not a GAAR, but functioned as one.\(^ {161}\) The dissatisfaction with the Ramsay

\(^{159}\) Paragraphs C.5.6.2 and C.5.6.3.

\(^{160}\) Paragraph C5.8.1.

\(^{161}\) The Ramsay approach is basically similar to the Canadian GAAR discussed in Chapter 7. For a discussion of the similarities see generally Freedman “Converging Tracks? Recent Developments in Canadian and U.K Approaches to Tax Avoidance in Duff and Erlichman Tax Avoidance in Canada after Canada Trustco and Mathew (2007) 171. Freedman at 172 notes that the courts in Canada are more conservative in their purposive approach than those in the UK, despite the presence of the GAAR in Canada. This, she notes, reaffirms the belief that a GAAR tends to make courts more protective of taxpayer’s rights.
approach led to the introduction of a GAAR. The table below illustrates the progression of the UK general anti-avoidance mechanisms as discussed in this chapter.

Table 5: The UK Anti-Avoidance Timeline

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1869 - 1935</td>
<td>Pre-Duke of Westminster case, where literalism in the interpretation of tax statutes was the preferred approach in cases such as Partington v AG (1869), Gough (1894), Vickers Sons and Maxim Ltd v Evans (1910).</td>
</tr>
<tr>
<td>1936</td>
<td>The Duke of Westminster decision is handed down and the court appears to favour form over substance.</td>
</tr>
<tr>
<td>1936 - 1979</td>
<td>Post-Duke of Westminster period in which tax avoidance transactions that are fiscal nullities and promote form over substance are rife.</td>
</tr>
<tr>
<td>1979</td>
<td>Floor v Davis decision is handed down and Everleigh J’s dissenting judgment seeks to introduce a new approach that places substance over form.</td>
</tr>
<tr>
<td>1981</td>
<td>The WT Ramsay decision introducing the Ramsay approach is handed down.</td>
</tr>
<tr>
<td>2010</td>
<td>At the government’s request, Aaronson establishes an Advisory Committee to study whether the UK needs a GAAR.</td>
</tr>
<tr>
<td>2011</td>
<td>Aaronson’s Report concluding, inter alia, that the UK needs a targeted, not broad, GAAR is published.</td>
</tr>
<tr>
<td>2012</td>
<td>The UK government accepts the broad recommendations of the Report and releases a Document with a GAAR for public consultation.</td>
</tr>
<tr>
<td>2013</td>
<td>The Finance Bill 2013 receives Royal assent on 17 July 2013 and the UK GAAR is introduced.</td>
</tr>
</tbody>
</table>

The analysis of the Ramsay approach shows the valuable lessons that can be learned when dealing with concepts such as legal substance and legal form, and self-cancelling or neutralising transactions. It also provides a different perspective on the potential limitations that can be encountered in applying the purposive interpretation of statutes.
It is clear from the analysis of the UK GAAR that this GAAR was influenced by the research that was done on the worldwide experience with GAARs. This is shown by the fact that the whole process leading up to the GAAR was aimed at avoiding some of the problems noted in relation to the GAARs in existence worldwide, and reflected in the GAARs studied in this research. The following points on the UK approach to a GAAR can be noted in this regard.

1. The Report concluded that while a GAAR is needed, it must be targeted instead of broad, and efforts must be made to reduce uncertainty. This led to the creation of a GAAR that can be said to be more targeted than the other GAARs studied in this research.

2. The Report also concluded that uncertainty in a GAAR must be reduced. This led to the creation of a GAAR that does not necessarily rely on uncertainty to act as a deterrent.

3. The Report noted that the purposive interpretation of statutes can be insufficient as an indicator of impermissible tax avoidance in some cases, which may lead the court to stretch the statutory provisions in order to strike a transaction down.

4. As recommended by the Report, the GAAR bases its distinction between permissible and impermissible tax avoidance on whether it is reasonable to conclude that the action taken to obtain a tax advantage is a reasonable course of action. This means that this distinction is largely based on the characteristics of permissible tax avoidance, not solely on the characteristics of impermissible tax avoidance, as is the common approach.

5. The GAAR requires an arrangement to be analysed by taking the wider arrangement it is part of into account. This means that a sub-arrangement cannot be isolated for GAAR purposes without considering the composite arrangement. This is different from the approach in South Africa, Canada, and Australia.

6. Overall, as recommended by the Report, the GAAR exhibits concrete efforts to strike a balance between curbing impermissible tax avoidance and allowing permissible tax avoidance.\(^{162}\)

The approach taken to a GAAR in the UK thus represents a fundamentally different approach to the approach taken in the GAARs studied. It remains to be seen how the courts will interpret the UK GAAR. It is argued that lessons can be learned from this approach. The following chapter will, *inter alia*, discuss how these lessons can be learned in the South African context.

\(^{162}\) Freedman “GAAR as a Process and the Process of Discussing the GAAR” (2012) 1 *British Tax Review* 22 23 notes that the reaction to the Report was more positive because of the checks and balances it recommended. Freedman notes that this can be contrasted with the reaction to the GAAR proposal in 1998 which was seen by many as unbalanced.
CHAPTER 10

CONCLUSIONS AND RECOMMENDATIONS

TABLE OF CONTENTS

1. CONCLUSIONS ................................................................................................................. 292

1.1 The Efficacy of the South African GAAR ........................................................................ 293

1.1.1 The Problem with the GAAR as a Whole: Uncertainty ................................................. 294

1.1.2 The Problems with Individual Components of the GAAR ............................................ 297

2. RECOMMENDATIONS .................................................................................................... 302

2.1 Amending the Uncertain or Problematic Concepts in the GAAR ................................ 302

2.1.1 Arrangement: Sections 80L, 80H and 80G ................................................................. 302

2.1.2 Normality for a Bona Fide Business Purpose: Section 80A(a)(i) ................................. 303

2.1.3 Creation of Abnormal Rights or Obligations: Section 80A(c)(i) ................................. 304

2.1.4 Commercial Substance: Section 80C(1) ................................................................. 305

2.1.4.1 Legal Substance v Legal Form: Section 80C(2)(a) .................................................. 306

2.1.4.2 Self-Cancelling Elements: Section 80C(2)(b)(iii) ................................................ 307

2.2 Future GAARs in South Africa ......................................................................................... 307

2.2.1 Basing the GAAR on the UK GAAR Approach .......................................................... 308
1. CONCLUSIONS

This study has shown that the following indicators of impermissible tax avoidance are relied on in South Africa, Australia, Canada, US, and the UK:

1. abnormality for a *bona fide* business purpose;
2. absence of a business purpose;
3. the creation of rights and obligations not normally created in an arm’s length transaction;
4. misuse or abuse of the tax laws;
5. the presence of a tax purpose as a dominant purpose, objectively determined;
6. lack of commercial substance;
7. the use of self-cancelling composite transactions which are separate in form, but in substance are meant to be one transaction;¹ and
8. whether the transactions can reasonably be said to be a reasonable course of action.

The table below links the countries studied in this research to the indicators referred to above:

**Table 6: Country Comparison of Impermissible Tax Avoidance Indicators**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>South Africa</th>
<th>Australia</th>
<th>Canada</th>
<th>USA</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abnormality for a <em>bona fide</em> business purpose.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of commercial or economic substance.</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Creation of abnormal rights and obligations.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Absence of a business purpose.</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Misuse or abuse of the tax laws</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Sole or dominant tax purpose, objectively determined.</td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Self-cancelling composite transactions.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Whether the transaction can reasonably be said to be a reasonable course of action</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

¹ This indicator is part of the *Ramsay* approach discussed in the previous chapter which has been superseded by the GAAR in the UK.
Some indicators are broad enough to incorporate others. For instance, it does not necessarily follow that a transaction without commercial substance will pass the GAAR test in Australia merely because there is no commercial substance indicator in the Australian GAAR. This is because a transaction that lacks commercial substance and is justifiable only by reference to its tax benefits can objectively be said to have a sole or dominant purpose to obtain a tax benefit in terms of the Australian GAAR.

Table 6 above also shows that of the GAARs or judicial doctrines studied in this research, the South African GAAR is, at least on paper, the broadest and most complex.\(^2\) Chapters 4 and 5 of this research discussed the progression of the South African GAAR from section 90\(^3\) which targeted all tax avoidance to section 103(1),\(^4\) which had a single indicator of impermissible tax avoidance, and to the current GAAR,\(^5\) which combines most of the common indicators of impermissible tax avoidance into one rule.

### 1.1 The Efficacy of the South African GAAR

Section 80A of the Act contains the basic structure of the GAAR and 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 business purposes, other than obtaining a tax benefit; or
>   ii. it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;
> b. in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit; or
> c. in any context –
>   i. it has created rights or obligations that would not normally be created between persons dealing at arm’s length; or
>   ii. it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

Based on the discussion in this research, it is concluded that the South African GAAR will have limited efficacy in curbing impermissible tax avoidance and in informing taxpayers of the limits of permissible tax avoidance. This is due to the problems in this GAAR which have been noted in this research. These problems can be divided into two parts, namely problems

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\(^3\) Income Tax Act 31 of 1941 (the 1941 Act).

\(^4\) Income Tax Act 58 of 1962 (the Act).

\(^5\) Sections 80A – 80L of the Act.
with the GAAR as a whole, and problems with the individual components of the GAAR. The identification of these problems is based on the analysis of the GAAR itself and the comparative research done in this thesis. These problems are highlighted below.

1.1.1 The Problem with the GAAR as a Whole: Uncertainty

This study has shown that the problem with the GAAR as a whole is the uncertainty it creates. This uncertainty renders the GAAR incapable of adequately informing taxpayers of the limits of permissible tax avoidance. This research has also shown that uncertainty is an inherent feature of any GAAR, or judicial anti-avoidance rule, due to the fact that there is still no precise definition of impermissible tax avoidance. It does not, however, follow that when drafting a GAAR there should not be efforts to limit uncertainty. In the UK, Aaronson in his Report, namely the *GAAR Study A Study to Consider Whether a General Anti-Avoidance Rule Should be Introduced into the UK Tax System* (the Report), which preceded the introduction of the GAAR, stated that one of the principles underlying the UK GAAR should be the reduction of uncertainty. This Report noted that:

> there is considerable uncertainty in identifying the limit of effective tax avoidance; and no legislative of other framework will ever remove it entirely. However, it is important to reduce the scope of uncertainty as far as possible.

As discussed in Chapter 9, the Report recommended concrete efforts to limit uncertainty in the UK GAAR, such as the establishment of a GAAR panel to provide an independent view on whether a transaction warrants the application of a GAAR. The views expressed in the Report mirror those in the Mirrlees Review that “[p]romoting opacity and unpredictability may seem a clever way to raise revenue in the short run, but transparency and certainty have long been seen as hallmarks of a fair and efficient tax system.”

Before analysing the South African approach, it is important to note that the UK approach to uncertainty is similar to the views of the Margo Commission in South Africa, which stated in 1986 that:

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6 Available at http://www.hm-treasury.gov.uk/d/gaar_final_report_111111.PDF (accessed on 5/03/2012).
7 Paragraphs 5.23 – 5.30.
8 Paragraph 5.25.
9 See par 6.1.2.3.
10 The *Mirrlees Review vol 1: Dimensions of Tax Design* (2010), chaired by Mirrlees J, 1157 available at http://www.ifs.org.uk/mirrleesReview/dimensions (accessed on 13/02/2013). It is stated here with specific reference to Her Majesty’s Revenue and Customs that creating uncertainty regarding the boundary between permissible and impermissible tax avoidance is a short term solution to impermissible tax avoidance.
The nature of anti-avoidance provisions must obviously be sufficiently flexible to be effective while being not so vague as to undermine or impair proper planning of the taxpayer’s affairs. Measured against these criteria the existing s 103(1) is, in the Commission’s view, defective and, in many cases, ineffective from the Commissioner’s point of view.

The current and recent South African experience shows that the views of the Margo Commission were evidently not duly considered, because steps were not taken to reduce the vagueness of section 103(1), or to limit the uncertainty of the current GAAR. If the current UK approach is compared with the approach in terms of the current South African GAAR, a fundamental and curious difference will emerge. The difference in approach is fundamental in that while the UK approach is characterised by the reduction of uncertainty, the South African approach is characterised by the contention that “uncertainty is a reality”, and that the uncertainty created by a stronger GAAR will not affect “the majority of taxpayers who do not push the envelope”.12 The South African approach is also characterised by the contention that “there is a growing recognition that a GAAR cannot be overly precise if it is to be effective”,13 which implies that uncertainty is relied on to act as a deterrent. The difference in approach is curious in that the UK and South African GAARs were introduced in mid-2013 and late-2006 respectively, which is only about 7 years apart. This means that in creating their current GAARs, both countries had an opportunity to analyse the adverse effects of uncertainty on the efficacy of GAARs in general, as seen in a study of the experience with broad and uncertain GAARs in countries such as Australia and South Africa. Yet it is clear that the UK has made conscious efforts to reduce uncertainty and, consequently, its adverse effects, while South Africa has regressed.

Admittedly, the uncertainty that characterises the South African approach to a GAAR is not inherently flawed because uncertainty can and does act as a deterrent. This is due to the fact that some taxpayers may be apprehensive about entering into transactions that test the boundary between permissible and impermissible tax avoidance because of uncertainty about the safety of such transactions from a GAAR attack. Nonetheless, it is submitted that the South African approach to uncertainty is largely problematic because, as this study has shown, uncertainty is duplicitous in the sense that it can also confuse revenue authorities and thereby limit the efficacy of a GAAR. A GAAR’s uncertainty can affect revenue authorities

by making them believe that a particular transaction constitutes impermissible tax avoidance when it is actually permissible, which can dent confidence in the efficacy of a GAAR if the transaction is unsuccessfully challenged.\textsuperscript{14}

Another problem with the South African GAAR is that this research has showed that a GAAR’s uncertainty can lead to restrictive judicial interpretation from courts seeking to protect the right to avoid tax. As seen in this research, the courts play an active role in tax avoidance cases involving a GAAR. In \textit{Pott’s Executors v IRC}\textsuperscript{15} Lord McDermott stated:

> It is true that tax evasion may often place the draftsman in great difficulty, but where the draftsmen attempt the prevention of evasion in a manner which may work great harm to innocent people, a decision against the Revenue which may encourage the substitution of some better language in taxing section need not be a matter of regret.\textsuperscript{16}

In South Africa the then Appellate Division in \textit{CIR v King}\textsuperscript{17} held that the broad section 90, when literally interpreted, would lead to absurd consequences. The court in this case extensively discussed means by which the broad section 90 could be limited. The courts in Australia created doctrines that were deemed to be necessary to limit the broad section 260 of the Income Tax Assessment Act\textsuperscript{18} (ITAA). In Canada, the courts have frequently passed comments to the effect that a GAAR is a provision of last resort.\textsuperscript{19} The cumulative effect of judicial attempts to limit GAARs was the emasculation of GAARs, such as section 260 in Australia and sections 90 and 103(1) in South Africa as effective GAARs. It cannot be stated that the current South African GAAR is as broad as section 90 or section 260 in Australia.

\textsuperscript{14} An example is the challenging of sale and leaseback transactions without success by revenue authorities in the countries studied in this research. Sale and leasebacks were challenged in Australia in \textit{Eastern Nitrogen Ltd v Commissioner of Taxation} (2001) 46 ATR 474 and in \textit{FCT v Metal Manufacturers Ltd} [2001] FCA 365; in Canada in \textit{Canada Tristaco Mortgage Co v The Queen} 2005 SCC 54; in South Africa in \textit{ITC 1636 60 SATC 267} and again in \textit{CIR v Conhage (Formerly Tycon)} 1999 (4) SA 1149 (SCA) and in the UK in \textit{Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)} [2005] 1 All ER 97. The courts in all cases highlighted the commercial nature of the sale and leaseback transactions.

\textsuperscript{15} [1951] 1 All ER 76 88.

\textsuperscript{16} Similar sentiments were expressed in \textit{Atinco Paper and products Ltd v The Queen} 78 DTC 6387 6395 and \textit{Vestey’s (Lord) Executors and Another v Inland Revenue Commissioners} 1949 All ER 1108 1120. Arnold “Reflections on the Relationship between Statutory Interpretation and Tax Avoidance” in Erlichman H (ed) \textit{Tax Avoidance in Canada The General Anti Avoidance Rule} (2002) argues that courts do not act \textit{ultra vires} if they adopt an aggressive stance against impermissible tax avoidance. Olivier and Honiball \textit{International Tax A South African Perspective} (2008) 385 also note that even though it is undisputable that judges act independently when deciding tax cases, it is clear that their individual views are reflected in the judgments. Olivier and Honiball state that a judge who is “pro-government” may be stricter than a judge who is “pro-taxpayer”. These discrepancies can be reduced if the GAAR is clear and no room is left for judges to exercise their individual discretion.

\textsuperscript{17} 1947 (2) SA 196 (A).

\textsuperscript{18} Of 1936. These doctrines entail the predication test, the choice doctrine and the antecedent transactions doctrine discussed in Chapter 6 par 2.1.

\textsuperscript{19} See Chapter 7 par 4.1.
However, the experience with these two historical and broad GAARs is relevant to the current South African GAAR because it is argued that the complexity of this GAAR is such that it will require extensive judicial interpretation to create any certainty on its various indicators and concepts. This extensive judicial interpretation is similar to what was required for section 90 and section 260. Case law on section 103(1) may mitigate the need for extensive judicial interpretation but only to a limited extent because the current GAAR has a number of concepts adopted from other jurisdictions and that were not in section 103(1).

Extensive judicial interpretation in itself is not necessarily harmful to the efficacy of a GAAR. Nevertheless, it is argued that there is a direct relationship between extensive judicial interpretation and the possibility of inconsistent interpretation. Where the need for extensive judicial interpretation is great, there is a concomitant increase in the possibility of inconsistent interpretation. This possibility, when coupled with the fact that the breadth of the South African GAAR is likely to invite judicial limitations to protect the right to avoid tax, compounds the adverse effects of uncertainty on the efficacy of this GAAR. As the experience with section 260 in Australia shows, a GAAR that invites extensive judicial interpretation to limit its uncertainty can quickly become emasculated by a series of judicial decisions.

In the light of the above, it is clear that the efficacy of the South African GAAR can be improved if the uncertainty it creates is reduced (as opposed to eliminated, which in any case is impossible). This would represent a new approach to a GAAR in South Africa, since all the South African GAARs to date have created uncertainty and have not been drafted to limit uncertainty, as seen in Chapters 4 and 5 of this research. It is argued that if uncertainty is reduced in the manner described in paragraph 2 below, the GAAR will retain its general and deterrent nature without simultaneously inviting substantial judicial activism, extensive judicial interpretation, and misleading SARS into challenging legitimate transactions.

### 1.1.2 The Problems with Individual Components of the GAAR

The GAAR also contains some problematic provisions and these are identified in this research as follows:

1. the abnormality provision;

---

2. the abnormality for bona fide (business) purpose provision;
3. the misuse or abuse provision;
4. the provision that authorises the isolation of a sub-arrangement in a composite arrangement; and
5. the commercial substance provision.

The abnormality provision in section 80A(c)(i) of the Act is problematic in the sense that it does not provide any guidelines on what constitutes abnormal rights and obligations between persons dealing at arm’s length. This provision can be traced back to Schreiner JA’s judgment in the *King* case. Schreiner JA made it clear that a GAAR should not target all tax avoidance transactions, but abnormal tax avoidance transactions. In making amendments to section 90 of the 1941 Act the legislature created a provision that would target abnormal transactions that create abnormal rights or obligations based on this judgment. It can be argued that Schreiner JA’s statement on abnormal transactions was made in an attempt to explain the function of a GAAR, and not in an attempt to create a comprehensive and certain indicator of impermissible tax avoidance. It is argued that an opportunity was missed to further explain the concept of abnormality after Schreiner JA’s judgment in *King* when section 90 was amended. This problem was carried over to section 103(1) of the Act, and to the current GAAR.

Both the Margo Commission (1986) and Katz Commission (1995) identified this provision as problematic in the sense that a transaction that was common, could not be regarded as abnormal. This led to the creation of a new abnormality provision but the old abnormality provision, was retained after the 1996 amendments to section 103(1) and when the current GAAR came into being in 2006. This means that total reliance has again been placed on the courts to explain what this provision entails, and this increases the probability for inconsistent interpretation and the uncertainty created by the GAAR.

The abnormality provision that was introduced after the 1996 amendments to section 103(1) led to another abnormality provision that targeted transactions that employed methods that are abnormal for a bona fide business purpose. Again there were no guidelines as to what is

216. Schreiner JA’s is discussed in detail in Chapter 4 par 2.1.2.
22 Paragraph 27.28.
23 *Third Interim report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* par 11.2.2.
24 For a discussion of case law on the abnormality provision and an in-depth analysis of the manner in which the courts have interpreted this provision see generally Chapter 4 par 3.4.
abnormal for a bona fide business purpose, and this provision was carried over to the current GAAR where it is contained in section 80A(a)(i) of the Act. This again means that total reliance has been placed on the courts to explain what abnormal means for a bona fide business purpose. This increases the probability of inconsistent interpretation and worsens the uncertainty created by the GAAR.

The misuse or abuse provision in section 80A(c)(ii) of the Act is a provision that targets transactions that avoid tax in a manner that is inconsistent with the purpose of tax legislation. Theoretically this is a good approach, because impermissible tax avoidance transactions largely comply with the letter but not the purpose of the law. However, this research has shown that this provision is often problematic in practice because of the following factors:

1. Purposive statutory interpretation can be subject to value judgments wherein the court interpreting the provisions and Act in question is influenced by its thinking of what the legislative purpose is.\(^{25}\)

2. Purposive statutory interpretation can create uncertainty on what misuse or abuse is because different interpreters can interpret statutory purpose differently. In some cases this can affect revenue authorities into challenging permissible transactions. Cases such as Canada Trustco and Barclays Mercantile are examples.\(^{26}\)

3. The experience with purposive interpretation in other jurisdictions, discussed in this research, has shown that the courts have often applied it inconsistently by using unconventional methods of interpretation. In Canada, for some time after OSFC Holdings Ltd v The Queen,\(^{27}\) the courts required the transaction to be inconsistent with a clear and unambiguous policy before misuse of abuse could be established. In the UK, the McNiven v Westmoreland,\(^{28}\) case where Lord Hoffman stated that some provisions require a legal interpretation and some require a commercial interpretation, shows that the courts can sometimes use confusing principles to establish statutory purpose. This creates uncertainty, and reduces the efficacy of purposive interpretation as a measure against impermissible tax avoidance. This research has also shown that

\(^{25}\) See generally Chapter 5 par 2.2.4.6.

\(^{26}\) In Geransky v. The Queen [2001] 2 CTC 2147 par 40 it was stated that “[w]hat is misuse or an abuse is in some instances in the eye of the beholder. The Minister seems to be of the view that any use of a provision is a misuse or an abuse if the provision is not used in a manner that maximises the tax resulting from the transactions”. Also see Kellough “Tax Avoidance 1945 – 1995” (1995) 43 5 Canadian Tax Journal 1819 1832.

\(^{27}\) 2001 4 CTC 82 par 67. See Chapter 7 par 4.2 for a discussion of this case and its effect on the efficacy of the Canadian GAAR.

while purposive interpretation is widely seen as modern and progressive, the literal interpretation of statutes has not been eradicated completely, and some courts have stated that tax provisions that are detailed will be interpreted with greater emphasis on their textual meaning. In the US there have been deliberations in favour of literal interpretation, and some commentators have argued that “[i]f we cannot rely on the language of the statutes and regulations, then what are we supposed to rely on?” The case Gitlitz v Commissioner also shows that the US courts may sometimes refer to the literal terms of the statute when deciding a tax avoidance case.

4. The purposive interpretation of statutes in tax avoidance cases has been criticised on the basis that it creates the scope for stretching statutory provisions in order to strike a transaction that is perceived to be abusive down. As Aaronson noted in his Report, HMRC v DCC Holdings is an example of a case where the court stretched the provisions in question, in order to strike the transaction down.

5. The purposive interpretation of statutes has also been seen as inadequate in some cases. Aaronson in his Report notes that Mayes v HMRC is an example of a case where the court could not find the statutory purpose required to strike the transaction down. This point and point 4 above led to the conclusion that the purposive approach under the Ramsay approach is inadequate, and that a targeted GAAR is needed for the UK.

Another problematic provision in the GAAR is section 80H that empowers the Commissioner to apply the GAAR to an individual step of the arrangement. This research has shown that the experience with similar Canadian and Australian provisions has been controversial. This controversy stems from the fact that the courts in these countries have not unanimously accepted the idea of ascribing purpose to a step that exists within a composite transaction that is different from the purpose of the composite transaction. In Australia, where schemes within a scheme qualify as schemes for Part IVA purposes, the High Court in Federal Commissioner

29 Canada Trustco par 11.
30 Kies “Letter to the Editor: Corporate Tax Shelters: It is Time to Come to Terms with the Data” (2000) 88 Tax Notes 133.
33 Paragraph 3.28. Points 1 – 4 above show that a lack of unanimity on the purpose of tax legislation can increase the uncertainty that needs to be limited in the GAAR. While lack of unanimity does not equal inefficiency; it is submitted that it increases uncertainty, which itself limits the efficacy of the GAAR.
35 Paragraph 3.13.
of Taxation v Peabody stated that a scheme should not qualify as a scheme if it cannot stand independently without losing all practical sense when isolated from the larger scheme. This approach was followed in Hart v Federal Commissioner of Taxation but was overturned and rejected in Federal Commissioner of Taxation v Hart. This controversy was seen in various other subsequent Australian cases. In Canada, the same controversy was experienced, as is evident from cases such as Canadian Pacific Ltd v Canada, Evans v The Queen, Makay v Canada, Desmarais v The Queen, Copthorne Holdings Ltd v The Queen, Lipson v Canada, and Canada Trustco.

The recently introduced UK GAAR utilises a different approach to steps in a composite transaction. In what can be interpreted as an attempt to avoid the problems experienced by isolating a transaction within a composite transaction for GAAR purposes, the UK GAAR in section 207(3) of the Finance Act states that “where the tax arrangements form part of any other arrangements regard must also be had to those arrangements”. It is submitted that if the controversy that has dogged similar provisions in Canada and Australia is to be avoided in South Africa, section 80H needs to be amended to bring it in line with the UK approach.

The commercial substance provision in section 80A(a)(ii), which is supported by sections 80C, 80D, and 80E of the Act, is another provision that is identified as problematic in this research. This is due to the fact that the in-built guidelines of this provision do not adequately explain its scope. It is argued that section 80C(1), which contains a basic explanation of the concept of commercial substance is inadequate, and there is insufficient explanation of terms such as legal form and legal substance, and self-cancelling. It is also argued that the position that South Africa is in regarding the basic definition of commercial substance in section 80C(1) is similar to the position the US was in when the economic substance doctrine was
created in *Gregory v Helvering*\textsuperscript{47} in 1935, and when this doctrine was still new and undeveloped. This compounds the uncertainty created by the GAAR as a whole, which in turn adversely affects the efficacy of the GAAR.

2. RECOMMENDATIONS

The problems noted above need to be addressed in order to improve the efficacy of the GAAR. It is submitted that these problems can be addressed by reducing the uncertainty created by the GAAR. The current South Africa approach of not paying due regard to the reduction of uncertainty is inconsistent with the facts established after research on the adverse effects of unlimited uncertainty on a GAAR’s efficacy, many of which have been experienced in South Africa itself. Reducing and limiting the uncertainty created by the South African GAAR can be achieved by:

1. Amending the problematic provisions identified above in order to provide more clarity on the scope of these provisions. In order to keep the open-ended nature of the GAAR this process should not be exhaustive.\textsuperscript{48}

2. The second approach is futuristic, and entails the approach South Africa could take when creating a future GAAR. In this regard it is argued that a future South African GAARs should not, as is currently the case, combine common indicators of impermissible tax avoidance into one rule, but should:
   a. Be based on the UK GAAR approach of making efforts to strike a balance between curbing impermissible tax avoidance and respecting the right to avoid tax by creating a targeted GAAR that targets transactions that are inconsistent with permissible tax avoidance or;

These recommendations will now be discussed in greater detail.

2.1 Amending the Uncertain or Problematic Concepts in the GAAR

2.1.1 Arrangement: Sections 80L, 80H and 80G

Section 80L defines a single step in a series of transactions as an arrangement for the purposes of the GAAR. This provision is supported by section 80H, which empowers the

\textsuperscript{47} 293 US 465 (1935).

\textsuperscript{48} As seen in Chapter 6, the Australian GAAR in Part IVA of the ITAA contains a list of eight factors that can be referred to when determining whether a transaction can reasonably be said to have a sole or dominant purpose to avoid tax. These factors are not exhaustive.
Commissioner to apply the GAAR to steps or parts of a composite arrangement. The isolation of a step in a composite arrangement is aimed at deterring taxpayers from inserting impermissible tax avoidance arrangements into commercial arrangements.

As stated earlier, similar provisions have caused controversy in Canada and Australia. To avoid this controversy sections 80L, 80H, and 80G(2) need to be amended. These amendments should follow the direction of court decisions that state that a transaction within a composite transaction should not be isolated for GAAR purposes. In this regard the provisions dealing with the isolation of steps in a composite arrangement in the GAAR should be amended as follows:

1. A step within a composite arrangement should not be isolated if doing so means that it loses its character, its practical meaning, and if it cannot stand independently.
2. A step within a composite arrangement may be isolated where it can reasonably be said that it was inserted into the arrangement to take advantage of the commercial purpose and nature of the arrangement. This would be the case, for instance, where the taxpayer intends to cleanse the impermissible nature of the step with the commercial nature of the transaction as a whole.

This approach would be similar to the one taken in the UK GAAR, particularly in section 207(3) of the FA referred to earlier.

2.1.2 Normality for a Bona Fide Business Purpose: Section 80A(a)(i)

This section defines impermissible transactions as those that are “entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit”. A similarly worded section was inserted into section 103(1) in 1996. It was not judicially interpreted before this section was repealed and replaced by the current GAAR, which means it remains uncertain what normal or abnormal for bona fide business purposes entails. However, when considered in the light of the business purpose doctrine in the US, as discussed in Chapter 8, a “manner” that is “not normally employed for bona fide business purposes” is one that lacks the following:

1. The possibility of profit. It is highly probable that business methods that do not give rise to the possibility of profit are not normally employed for a bona fide business purpose. There are no bona fide business operations that are aimed at making a loss.
2. A business objective. A *bona fide* business purpose is aimed at achieving a business objective. Tax purposes largely appear as a secondary objective. It is therefore abnormal for a taxpayer to start a business in order to obtain tax benefits but without a profit-making or business objective.

3. The investment of capital. Normal business transactions are those where capital is invested and a return is expected. Transactions where capital is not invested at all, or is in reality not invested, may be abnormal for *bona fide* business purposes.

4. *Bona fide* entities. Transactions that entail entities that cease to exist after the transaction has achieved its tax avoidance purpose, may be abnormal for *bona fide* business purposes. This is because in *bona fide* business, entities are created for a business purpose, and perform many functions and transactions to achieve this purpose. They cease to exist only when the business purpose has been achieved or is no longer viable, not when tax avoidance objectives have been met.

6. A plausible non-tax purpose aligned with the taxpayer’s conduct and economic situation.

7. It was presented to the taxpayer as a tax avoidance scheme whose tax benefits significantly overshadow the taxpayer’s investment in the transaction.

5. It is more complex than necessary

It is submitted that the above indicators of normality for a *bona fide* business purpose may be helpful in limiting the uncertainty of section 80A(a)(i) if they are incorporated into the GAAR.

### 2.1.3 Creation of Abnormal Rights or Obligations: Section 80A(c)(i)

It has been stated that “abnormal rights or obligations” has never been adequately explained in all the GAARs in which it has featured. It is admittedly difficult to define normal or abnormal for the purposes of the GAAR. In the UK, Aaronson’s Report provides guidelines on what abnormal transactions entail in section 7(3)(a) – (g) of the illustrative GAAR that is part of the Report. The following are identified as indicators of abnormal transactions:

1. transactions with characteristics that would not be present in a transaction without a sole or main purpose of avoiding tax;
2. transactions that involve a party, an element, or a document that would not have been included if the transaction was not designed to obtain a tax benefit;
3. transactions that exclude an element, a party, or a document that would have been included if the transaction had not been designed to obtain a tax benefit;

4. transactions through which assets are located where they would not have been placed or located if the transaction was not designed to obtain a tax benefit;

5. transactions through which individuals are put in a position where they would not have been put but for the tax avoidance purpose of the transaction; and

6. transactions that contain amounts or payments that are significantly different from market value or transactions whose business objectives are founded on terms that make no business sense.

As discussed in Chapters 4 and 5, the abnormality provision in the South African GAAR has created uncertainty because it does not provide sufficient guidance beyond stating that abnormal transactions are those that create rights and obligations that are not normally created in an “arm’s length” transaction. Case law on this provision, discussed in Chapter 4, is limited and does not establish consistency on the meaning of this indicator. It is submitted that if the above indicators of abnormal transactions are incorporated into the GAAR, the uncertainty surrounding section 80A(c)(i) may be reduced.

2.1.4 Commercial Substance: Section 80C(1)

The basic definition of “commercial substance” in section 80C(1) states as follows:

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

Section 80C(2) provides for some characteristics of transactions that lack commercial substance but states that these characteristics are not exhaustive. This means that the Commissioner may argue that a transaction lacks commercial substance even though its characteristics are not specifically provided for in this section. This creates uncertainty for taxpayers, which could be limited if the provision is explained further. To limit this uncertainty, the following indicators that are part of the US economic substance doctrine may be helpful if they are inserted into section 80C(2):

1. Reasonable expectation of profit. A transaction can be said to lack commercial substance for the purposes of the GAAR if it leads to tax benefits, but does not have a
reasonable expectation of profit. Reasonable expectation does not mean that profit must be obtained. Transactions with a reasonable expectation of profit are those that are structured in such a way that a reasonable businessperson would carry them out for their potential for profit. Consequently, section 80C(1) should not apply to transactions that result in a loss and tax benefits with no economic impact on the taxpayer if it can be proved that the transaction had a reasonable expectation of profit from the start, but due to unforeseen circumstances resulted in a loss which brought tax benefits.

2. Risk of loss. A transaction without any risk of loss, but with guaranteed tax benefits may be indicative of a lack of commercial substance. This is because the usual badge of commercial transactions, namely the risk of loss is absent.

3. Actual profit or loss. A transaction that actually results in a profit apart from the profit attributable to the tax benefits has commercial substance.

4. To prevent the abuse or avoidance of section 80C this section must be supported by a provision that states that the economic impact of a transaction on the taxpayer must be real and not artificial.

2.1.4.1 Legal Substance v Legal Form: Section 80C(2)(a)

One of the indicators of a lack of commercial substance is a disparity between the legal form of a transaction and its legal substance, as provided for in section 80C(2)(a). This provision does not necessarily amount to a codification of the common law substance over form rule discussed in Chapter 3; rather, it refers to the substance over form principle followed under the Ramsay approach in the UK and under the US judicial doctrines. In this regard, it is submitted that there must be an explanation of legal substance and legal form in the GAAR. This explanation should be informed by the following:

1. Legal substance is the real effect of a transaction as a whole. In other words, a transaction that comprises of a series of individual transactions must be viewed as a single indivisible whole, and not as a series of individual transactions. Legal form is the opposite in the sense that it focuses on the effect of an individual transaction in a series without reference to the other transactions it is intended to work with.

49 As discussed in Chapters 8 and 9, legal form allows a taxpayer to avoid tax by entering into a series of transactions that are intended to work together to create a tax benefit by only focusing on the transaction that creates the text benefit and not on the series of transactions as a whole. Chapter 9 par 3 shows that legal form is a legacy of the IRC v Duke of Westminster 1936 AC 1 case and the Ramsay approach changed things through its legal substance over form approach.
2.1.4.2 Self-Cancelling Elements: Section 80C(2)(b)(iii)

According to this section, the presence of self-cancelling elements in an avoidance arrangement indicates the absence of commercial substance. However, this section is silent on details of the so-called offsetting or self-cancelling transactions. The following may be useful in bringing more clarity on what is meant by transactions with offsetting or self-cancelling elements.

1. Offsetting and self-cancelling transactions are transactions that are carried out in succession. Such transactions are usually instigated by a gain that is taxable and is sought to be neutralised.
2. The transactions are backed by an obvious or express intention that they will all be entered into.
3. The cumulative effect of the transactions is the reduction of taxable income.
4. It is no defence to state that the transactions are legally valid and binding, or are not simulated. All that needs to be established is that a taxable gain has been neutralised.

Section 80C(b)(ii) is also silent on the inter-connectedness of the self-cancelling transactions. This could affect transactions that are not connected but lead to losses for a taxpayer without any intention that the loss must neutralise an earlier taxable gain. To prevent this scenario from eventuating, this section must be amended in order to limit it to transactions that:

1. Are preordained to occur in a particular order to effectively neutralise each other or a prior gain. It may also be provided that there must be a practical likelihood that a particular transaction will be entered into after another. There must be no possibility that a transaction that effectively neutralises a gain is unrelated to the gain.

It is submitted that much of the uncertainty created by the current GAAR could be reduced if the recommendations made above are incorporated into the GAAR. As mentioned earlier, these recommendations are not meant to exhaustively provide for any eventuality; so as to maintain the flexibility of the GAAR.

2.2 Future GAARs in South Africa

It is likely that the current South African GAAR will, at some point in future, be amended or repealed for one reason or another. When this happens, it is argued that the future GAAR should be drafted in a way that is different from the current or historic South African
GAARs, in order to reduce uncertainty and unnecessary complexity. The approach that can be taken in future is described below.

2.2.1 Basing the GAAR on the UK GAAR Approach

The UK approach to a GAAR can be said to be a unique and substantially different to the approach taken in the GAARs studied in this research. This approach is characterised by, *inter alia*, the following:

1. Consulting with independent experts on whether the UK needs a GAAR. After extensive expert research on the international experience with GAARs, the Report was released. This Report concluded that a targeted, not broad, GAAR is needed in the UK.

2. The introduction of a GAAR that is governed by principles such as the reduction of uncertainty, and striking a balance between the counteraction of impermissible tax avoidance and respecting the right to avoid tax.

3. The introduction of a GAAR that focuses on what makes permissible tax avoidance permissible, and using this as a basis for targeting impermissible transactions.

4. The introduction of a test that states that if it is reasonable to conclude that a transaction is a reasonable course of action taking into consideration various factors contained in the GAAR, the transaction will be permissible. This test takes into account the different views on whether a particular transaction is permissible or not. The double reasonableness test ensures that a transaction will not be struck down merely because a court or any party views it as unreasonable but because it is reasonable to view the transaction as an unreasonable course of action. Crucially, this test does not seek to draw a clear but narrow line between permissible and impermissible tax avoidance. Rather, it seeks to define a certain range of actions in the problematic grey area between permissible and impermissible tax avoidance as permissible if:

   a. it can reasonably be concluded that is a reasonable course of action; and
   b. it cannot be said with certainty that it is an unreasonable course of action, which means that the case will be decided in the taxpayer’s favour.

It is argued that if this approach is taken the adverse effects of uncertainty on the efficacy a GAAR may be mitigated, taxpayers will have a clearer idea of the limits of permissible tax
avoidance and the double reasonableness test will help to reduce judicial activism to protect the right to avoid tax by interpreting the GAAR restrictively.
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<table>
<thead>
<tr>
<th>Case</th>
<th>Year/Volume</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC v McGuckian</td>
<td>[1997] 3</td>
<td>All ER 817</td>
</tr>
<tr>
<td>IRC v Plummer</td>
<td>[1979] STC</td>
<td>793</td>
</tr>
<tr>
<td>IRC v Ross and Coulter and Others (Bladnoch Distillery Co Ltd)</td>
<td>[1948] 1</td>
<td>All ER 616</td>
</tr>
<tr>
<td>IRC v Wesleyan Assurance Society</td>
<td>(1948) 1</td>
<td>All ER 555 (HL)</td>
</tr>
<tr>
<td>Latilla v IRC</td>
<td>1943 AC 377</td>
<td>(HL)</td>
</tr>
<tr>
<td>Levene v Inland Revenue Commissioners</td>
<td>1928 AC 271</td>
<td></td>
</tr>
<tr>
<td>Lord Howard de Walden v CIR</td>
<td>1942 1 KB</td>
<td>389</td>
</tr>
<tr>
<td>MacRae v Inland Revenue Commissioner</td>
<td>(1961) 34</td>
<td>TC 20</td>
</tr>
<tr>
<td>Matrix – Securities Ltd v Inland Revenue Commissioners</td>
<td>[1994] 1</td>
<td>All ER 769</td>
</tr>
<tr>
<td>Moodie v Inland Revenue Commissioners and Another and Related Appeal</td>
<td>[1993] 2</td>
<td>All ER 49</td>
</tr>
<tr>
<td>Norglen Ltd v Reeds Rains Prudential Ltd</td>
<td>[1999] 2</td>
<td>AC 1</td>
</tr>
<tr>
<td>Partington v Attorney General</td>
<td>(1869) LR</td>
<td>4 HL 100</td>
</tr>
<tr>
<td>Pepper v Hart</td>
<td>[1993] 1</td>
<td>All ER 42</td>
</tr>
<tr>
<td>Pott’s Executors v IRC</td>
<td>(1951) 1</td>
<td>All ER 76</td>
</tr>
<tr>
<td>Ransom v Higgs</td>
<td>(1974) 50</td>
<td>TC 1</td>
</tr>
<tr>
<td>Re Weston’s Settlements</td>
<td>[1969] 1 Ch</td>
<td>223</td>
</tr>
<tr>
<td>Snook v London and Westriding Investments</td>
<td>[1967] 1</td>
<td>All ER 518</td>
</tr>
<tr>
<td>Tennant v Smith</td>
<td>[1892] AC</td>
<td>150</td>
</tr>
<tr>
<td>The Charlotta</td>
<td>(1814) Dods &amp; Adm 387</td>
<td></td>
</tr>
<tr>
<td>Vestey v IRC</td>
<td>[1980] STC</td>
<td>10</td>
</tr>
<tr>
<td>Vestey’s (Lord) Executors and Another v Inland Revenue Commissioners</td>
<td>[1949] 1</td>
<td>All ER 1108</td>
</tr>
<tr>
<td>Vickers Sons and Maxim Ltd v Evans</td>
<td>[1910] AC</td>
<td>444</td>
</tr>
<tr>
<td>WT Ramsay Ltd v IRC, Eilbeck (Inspector of Taxes) v Rawling</td>
<td>[1981] 1</td>
<td>All ER 865</td>
</tr>
</tbody>
</table>

**US**

<table>
<thead>
<tr>
<th>Case</th>
<th>Volume</th>
<th>Source</th>
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<tbody>
<tr>
<td>ACM Partnership v Commissioner</td>
<td>157</td>
<td>F. 3d 231 (3d Cir. 1998)</td>
</tr>
<tr>
<td>American Bantam Car Co v Commissioner</td>
<td>11 TC</td>
<td>397 (1948)</td>
</tr>
<tr>
<td>ASA Investerings Partnership v Commissioner of Inland Revenue</td>
<td>201 F. 3d 505 (DC Cir 2000).</td>
<td></td>
</tr>
<tr>
<td>Atlantic Coast Line v Phillips</td>
<td>332</td>
<td>US 168 (1947)</td>
</tr>
<tr>
<td>Boyce Motor Lines, Inc v United States</td>
<td>342</td>
<td>US 337</td>
</tr>
<tr>
<td>Casebeer v Commissioner</td>
<td>909</td>
<td>F. 2d 1360</td>
</tr>
<tr>
<td>CIR v National Carbide Corp</td>
<td>167</td>
<td>Fed (2d) 304 (1948)</td>
</tr>
<tr>
<td>CMA Consolidated Inc v Commissioner</td>
<td>89 TCM</td>
<td>(CCH) 701 (2005)</td>
</tr>
<tr>
<td>Coltec Industries Inc v United States</td>
<td>454</td>
<td>F. 3d 1340 (Fed Cir 2006); 62 Fed. CI. 716 (2004); 454 F. 3d (Jan 2007) 7.</td>
</tr>
<tr>
<td>Commissioner v Brown</td>
<td>380</td>
<td>US 563 (1965)</td>
</tr>
<tr>
<td>Commissioner v Court Holding Co</td>
<td>324</td>
<td>US 331 (1958)</td>
</tr>
<tr>
<td>Commissioner v Cuthbert</td>
<td>337</td>
<td>US 733 (1949)</td>
</tr>
<tr>
<td>Commissioner v Gordon</td>
<td>391</td>
<td>US 83 (1968)</td>
</tr>
<tr>
<td>Commissioner v Newman</td>
<td>159</td>
<td>F.2d (2d Cir 1947) 848.</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Author</th>
<th>Title</th>
<th>Location</th>
<th>Date</th>
<th>Access Details</th>
</tr>
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### Canada

<table>
<thead>
<tr>
<th>Author</th>
<th>Title</th>
<th>Location</th>
<th>Date</th>
<th>Access Details</th>
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### South Africa

<table>
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<th>Author</th>
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<th>Location</th>
<th>Date</th>
<th>Access Details</th>
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### UK

<table>
<thead>
<tr>
<th>Author/Source</th>
<th>Title</th>
<th>URL</th>
<th>Access Date</th>
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### US

<table>
<thead>
<tr>
<th>Author/Source</th>
<th>Title</th>
<th>URL</th>
<th>Access Date</th>
</tr>
</thead>
</table>

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#### Australia

<table>
<thead>
<tr>
<th>Act</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth Income Tax Act (Cth)</td>
<td>1915.</td>
</tr>
<tr>
<td>Commonwealth Land Tax Assessment Act 1910 (Cth).</td>
<td></td>
</tr>
<tr>
<td>Explanatory Memorandum: Income Tax Laws Amendment Bill (No2) 1981 (Cth).</td>
<td></td>
</tr>
<tr>
<td>Income Tax Act 1895 (Vic).</td>
<td></td>
</tr>
<tr>
<td>Income Tax Laws Amendment Act (No 2) of 1981.</td>
<td></td>
</tr>
<tr>
<td>Land and Income Tax Act 1895 (NSW).</td>
<td></td>
</tr>
</tbody>
</table>

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