DID NEW ZEALAND GET IT RIGHT? LESSONS FOR THE SOUTH AFRICAN GAAR

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ABSTRACT

Tax avoidance has various harmful effects, one of which is the loss of revenue for governments. While an effective general anti-avoidance rule ('GAAR') may be instrumental in mitigating this risk, there is still uncertainty as to the effectiveness of the current South African GAAR and whether the latest amendments, in 2006, adequately addressed the weaknesses identified in its predecessor. This uncertainty is compounded by the fact that the current South African GAAR has never been subject to judicial enquiry in its entirety. This article seeks to identify potential weaknesses and improvements to the interpretation and application of the South African GAAR through comparison to its New Zealand counterpart.

Keywords: GAAR, general anti-avoidance rule, avoidance, tax, tax avoidance

I INTRODUCTION

Tax avoidance is defined by the Organisation for Economic Co-operation and Development ('OECD') as the arrangement of a taxpayer's affairs with the intention of reducing the taxpayer's tax liability in a legal manner but in contradiction to the law that the arrangement purports to follow.[1] One of the harmful effects of tax avoidance is the loss of tax revenue for governments;[2] it is estimated that the amount of tax revenue lost due to tax avoidance in a single year worldwide could cover the cost of fully vaccinating the world population more than three times against COVID-19.[3] In response to the harmful effects of tax avoidance, governments tend to impose three main anti-avoidance measures: general anti-avoidance rules ('GAARs'), common law, and specific anti-

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1 'Glossary of Tax Terms', *OECD* (Web Page) <https://www.oecd.org/ctp/glossaryoftaxterms.htm>.

2 'Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962', *SARS* (Report, November 2005) <https://www.ftomasek.com/DiscussionPaperGAAR20051103.pdf>.

3 *The State of Tax Justice 2021* (Report, November 2021) ('*State of Tax Justice* Report') <https://www.globaltaxjustice.org/sites/default/files/State_of_Tax_Justice_Report_2021_ENGLISH_15-11-2021_v13b.pdf>.

avoidance rules.[4] Some governments use only non-legislative measures such as common law, but South Africa uses all three methods to curb impermissible tax avoidance.[5] The South African GAAR has been the subject of criticism since it was first introduced,[6] and this criticism is compounded by the lack of judicial guidance on the interpretation and application of the GAAR. The South African GAAR contains four elements that must be present for an 'impermissible tax avoidance arrangement'[7] to exist. These are that:

- an arrangement must be present;
- the arrangement must result in a tax benefit;
- the sole or main purpose of the arrangement must have been to obtain a tax benefit; and
- one of the tainted elements must be present.

It should be noted that in order for an arrangement to fall foul of the South African GAAR, all four requirements must be met. While the New Zealand GAAR also encompasses inquiries into an arrangement, the tax motive and the purpose, there is no separate fourth requirement for an inquiry into the 'tainted elements' as in the South African GAAR.

In March 2021 South Africa saw the case of *ABSA and Another v CSARS*[8] (*'ABSA Bank'*) as the first reported case on the South African GAAR, fifteen years after its most recent amendment[9] – it remains questionable whether these amendments were sufficient to improve its efficacy after the GAAR was not successfully applied. The amendment to the South African GAAR aimed to address the weaknesses that had been identified and to improve the effectiveness of the GAAR by making changes to existing law.[10]

In summary, the taxpayer (ABSA) had purchased preference shares in a South African entity, which entitled ABSA to receive dividends that were free of tax when declared. These preference shares were invested back-to-back in an offshore trust. The resultant effect of a Double Tax Agreement between South Africa and Brazil was that the dividends received were tax free in both South Africa and Brazil. However, ABSA contended that it was unaware of the intermediation of other entities and the trust and therefore that it could not have participated in an impermissible tax avoidance arrangement. In *ABSA*

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4 AW Oguttu, 'International Tax Law: Offshore Tax Avoidance in South Africa' (2015) 133(2) *South African Law Journal* 456.

5 TM Pidduck, 'The Sasol Oil Case – Would the Present South African GAAR Stand up to the Rigours of the Court?' (2020) 34(3) *South African Journal of Accounting Research* 254 ('Sasol Oil').

6 SARS (n 2).

7 *Income Tax Act 58 of 1962* (South Africa) (*ITA 1962*') s 80A.

8 *ABSA v CSARS* [2019/21825] [2021] ZAGPPHC 127 (*'ABSA Bank'*).

9 It is submitted that it is not unusual for a GAAR to remain untested for some time after amendment. For example, the Australian GAAR remained untested for eight years before it was presented before the courts. T Calvert and J Dabner, 'GAARs in Australia and South Africa: Mutual Lessons' (2012) 7(1) *Journal of the Australasian Tax Teachers Association* 53, 56.

10 SARS (n 2). The weaknesses identified included those relating to administrative provisions and, after a number of failures in the courts, those relating to the abnormality and purpose requirements contained in the previous South African GAAR.

Bank, the Court was required to decide whether or not the taxpayer had participated as a 'party' in an 'arrangement', as contemplated in section 80L of the *Income Tax Act 1962* (South Africa) ('*ITA 1962*'), and in deciding that the taxpayer was not party to an arrangement, the Court held that participating in an impermissible arrangement requires a taxpayer to act with volition.[11] The South African GAAR therefore failed on the basis that the taxpayer in *ABSA Bank* had no prior knowledge of and did not wittingly participate in an arrangement to avoid tax.[12] There was brief consideration of the tax benefit requirement but no consideration of the other two requirements of the South African GAAR, being the sole or main purpose requirement and the presence of one or more of the so-called 'tainted elements' (the fourth and final requirement of the South African GAAR, as discussed in section D, below).

As a result of the lack of judicial interpretation on the application and interpretation of the South African GAAR, this article seeks to make two contributions. First, the article analyses and compares the interpretation and application of the South African GAAR with those of the New Zealand GAAR, with the aim of identifying weaknesses in the South African GAAR and lessons that can be learnt from its counterpart in New Zealand. Second, the article applies the South African GAAR to the facts of cases from New Zealand, with the aim of identifying nuances that are only facilitated when practical application occurs. This is particularly relevant in that the South African GAAR has not been subject to judicial interpretation and application in its entirety to date. This second practical component facilitates greater depth of analysis and triangulation across multiple cases in order to make recommendations for improving the South African GAAR.

A multi-method qualitative research design and methodology are undertaken for the purposes of this study in the form of a 'structured pre-emptive analysis'.[13] Structured pre-emptive analysis employs a combination of doctrinal and reform-oriented research methodologies:[14] the doctrinal aspect of the research involves a critical and conceptual analysis of the two GAARs, while the reform-oriented aspect involves an intensive evaluation of the adequacy of the South African GAAR, with the objective of recommending changes.[15] A combination of these approaches facilitates an analysis of convergences between the findings of the doctrinal and reform-oriented research in the form of triangulation, to strengthen validity.[16] Given that this approach is appropriate when legislation has not yet been subject to judicial inquiry, it is justified for the purposes of this study, as there are parts of the South African GAAR that have never been subject to

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11 *ABSA Bank* (n 8) 39.

12 In contrast to 'volition' as contained in the ABSA judgment, for the purposes of the New Zealand GAAR, a taxpayer may still be a party to an arrangement without having knowledge of the intricacies of the tax avoidance steps. Refer to 'A Arrangement' for further discussion and analysis.

13 TM Pidduck, 'Tax Research Methodology for Untested Legislation: An Exemplar for the Tax Scholar' (2019) 33(3) *South African Journal of Accounting Research* 205.

14 Ibid.

15 Ibid

16 Ibid.

judicial enquiry.[17] Further, in order to address the subjectivity and bias that may be involved in selecting the case law, predefined criteria in the form of purposeful maximal sampling is used.[18] In terms of this criteria, preference is given to cases brought before the Supreme Court of New Zealand and the Court of Appeal, given that the decisions of these two Courts set judicial precedent.[19] The cases selected are *Penny v Commissioner of Inland Revenue*[20] ('*Penny and Hooper*'), *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[21] ('*Ben Nevis*') and *Commissioner of Inland Revenue v Frucor Suntory New Zealand Limited*[22] ('*Frucor*'). Admittedly, it may be considered difficult to generalise the outcome of a study that uses cases, but it is argued that the outcome is symptomatic of what is going on more generally.[23]

This article is presented in five parts. Following this introduction, Part II commences with an analysis and comparison of the South African and New Zealand GAARs, with a particular focus on the differences between them. Part II also highlights potential weaknesses of the South African GAAR that may be addressed by lessons learnt from its counterpart in New Zealand. In Part III, the key findings and outcomes of the application of the South African GAAR to the selected cases are discussed. Part IV contains recommendations for improving the efficacy of the south African GAAR, and concluding comments are made in Part V.

II ANALYSIS AND COMPARISON OF THE GAARS

The current South African GAAR is contained in *ITA 1962* ss 80A to 80L and was first introduced in 1941, followed by its latest amendments in 1996 and 2006.[24] The 2006 amendments to the South African GAAR aimed to address the weaknesses identified in order to improve its efficacy.[25] The weaknesses identified by the South African Revenue

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17 Ibid.

18 W Creswell and JD Creswell, *Research Design: Qualitative, Quantitative, and Mixed Method Approaches* (Sage Publications, 5th ed, 2018).

19 Ministry of Justice, 'Our New Zealand Court System: Overview of the Appeals Process' *Ministry of Justice* (Web Page, 2021) <https://www.justice.govt.nz/assets/Documents/Publications/our-nz-court-system.pdf>.

20 *Penny v Commissioner of Inland Revenue* [2011] NZSC 95 ('*Penny and Hooper*').

21 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115 ('*Ben Nevis*').

22 *Frucor Suntory New Zealand Limited v Commissioner of Inland Revenue* [2022] NZSC 113 ('*Frucor*'). It should be noted that the Supreme Court judgment for *Frucor* was only made available on 30 September 2022, despite the Court's having heard the case more than twelve months prior. It is standard practice for the Supreme Court to release judgments within six months of the hearing date (refer *Senior Courts Act 2016* (NZ) s 170(3).

23 R Gomm, M Hammersley and P Foster, *Case Study Method: Key Issues, Key Texts* (Sage Publications, 2000).

24 *Revenue Laws Amendment Act 36 of 1996* (South Africa); *Revenue Laws Amendment Act 20 of 2006* (South Africa).

25 SARS (n 2).

Service ('SARS') are listed below.

- It was not an effective deterrent to impermissible tax avoidance due to its failure to stand up to the rigors of the courts. The inconsistency and ineffectiveness of the South African GAAR resulted in significant time and resources being required to identify and prevent avoidance schemes.
- There were fundamental weaknesses within the abnormality requirement, such as hijacked techniques' – initially developed for *bona fide* business purposes – becoming commercially acceptable when widely used.
- The purpose requirement could only be met if it was proven that the sole or main purpose of a transaction was to obtain a tax benefit, where 'main' had been construed to mean 'predominant', excluding any transactions for which the tax benefit was not the 'predominant' purpose.
- Procedural and administrative issues existed, such as uncertainty relating to the scope of the previous GAAR and whether it could only be applied to a transaction as a whole or to individual steps within a transaction.[26]

Since its amendment in 2006, the South African GAAR, has referred to 'impermissible tax avoidance arrangement(s)', whereas its counterpart, the New Zealand GAAR, refers to 'tax avoidance arrangements'. The South African GAAR contains four elements that must be present for an 'impermissible tax avoidance arrangement' to exist.

- An arrangement must be present.
- The arrangement must result in a tax benefit.
- The sole or main purpose of the arrangement must have been to obtain a tax benefit.
- At least one of the tainted elements must be present. (The transaction was carried out in a manner not normally employed, was lacking in commercial substance, created rights or obligations not normally arising between parties dealing at arm's length, or resulted directly or indirectly in the misuse or abuse of the *ITA 1962*.)

New Zealand lays claim to having legislated the first GAAR in the world, as part of the *Land Tax Act 1878* (NZ).[27] The New Zealand GAAR also later underwent several amendments, which resulted in the current GAAR found in section BG 1 of the *Income Tax Act of 2007* ('*ITA 2007*') – which is supported by definitions in section YA 1 and GA 1.[28] The New Zealand GAAR contains three elements that must be present for a 'tax avoidance arrangement' to exist. Per *ITA 2007* s BG 1, these are:

- the presence of an arrangement;
- the arrangement's having tax avoidance as its purpose or effect, or as one of its purposes or effects; and

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26 Ibid.

27 C Elliffe, 'Policy Forum: New Zealand's General Anti-Avoidance Rule (GAAR) – A Triumph of Flexibility over Certainty' (2014) 62(1) *Canadian Tax Journal* 147; J Tretola 'Comparing the New Zealand and Australian GAAR' (2018) 25(1) *Revenue Law Journal* 1.

28 *Income Tax Act 2007* (NZ) s YA ('*ITA 2007*').

- the tax avoidance purpose or effect's being more than merely incidental.[29]

Section YA 1 defines these terms as follows:

- 'Arrangement' is a 'contract, plan or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.'
- Tax avoidance includes the direct or indirect altering of any income tax; the relief of any person from a lability (or potential or prospective liability) to income tax; or the avoidance, postponement or reduction of income tax liability (or potential or prospective liability).
- 'Tax avoidance arrangement' is an arrangement that has tax avoidance as its purpose or effect, or as one of its purposes or effects provided such purpose or effect is not merely incidental.

A comparison of the two GAARs reveals that both have three requirements, namely an arrangement, a tax benefit or tax avoidance, and an inquiry into the purpose of the arrangement. The South African GAAR, however, contains an additional fourth requirement, while the New Zealand GAAR only contains the three already mentioned. The additional requirement in the South African GAAR is in the form of the so-called tainted elements requirement, which must be present before an arrangement falls foul of the GAAR. It is submitted that the additional fourth requirement and the lengthier nature of the South African GAAR makes it more prescriptive, which may inhibit its successful application when presented before the courts. Conversely, the interpretation of the New Zealand GAAR has been left to the courts in determining whether an arrangement falls foul of the GAAR.[30]

A *Arrangement*

The first requirement for the provisions of both GAARs to apply is the presence of an arrangement. The definitions of arrangement in both jurisdictions are considered to be sufficiently wide to include all actions that may be undertaken to achieve a specific purpose or effect.[31]

Notwithstanding the above similarities between the arrangement requirements of the two GAARs, in *Peterson v Commissioner of Inland Revenue*[32] ('*Peterson*'), the Privy Council

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29 Ibid s BG 1.

30 J Cassidy, 'The Duke of Westminster Should Be "Very Careful When He Crosses the Road" in New Zealand: The Role of the New Zealand Anti-Avoidance Rule' (2012) (1) *New Zealand Law Review* 1.

31 *Meyerowitz v Commissioner for Inland Revenue* [1963] 25 SATC 287 [A]; *BNZ Investments Ltd v CIR* [2009] 24 NZTC 23,582 [HC] ('*BNZ*').

32 *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433 ('*Peterson*'). This case involved the taxpayer's forming a syndicate to finance the production of feature films within New Zealand that high-rate taxpayers financed, obtaining significant tax advantages through depreciation allowances on the cost of the investment and funding the production of feature films with money borrowed under a non-recourse loan agreement: at [9]. *Peterson* ran counter to the decision made in *CIR v BNZ Investments*

did not spend time defining an arrangement but rather focused on determining whether the taxpayers were parties to the arrangement. The Privy Council noted:

> Their Lordships do not consider that the arrangement requires a consensus or meeting of minds; the taxpayer need not be a party to the arrangement and in their view he need not be privy to its details either.[33]

The principle established in *Peterson*, as well as in *Russell v Commissioner of Inland Revenue*,[34] may be compared to the judgment in *ABSA Bank* relating to the South African GAAR, as the following was held by Sutherland ADJP:

> The section requires a taxpayer to participate or take part. Such conduct requires volition. A taxpayer has to be, not merely present, but participating in the arrangement.[35]

This comparison indicates a weakness in the South African GAAR, as taxpayers may use 'ignorance' as defence to avoid application of the South African GAAR. The efficacy of the South African GAAR may be improved by following a similar approach to New Zealand's in not requiring taxpayers to have prior knowledge or to act with volition.

B *Tax Benefit*

The second requirement of the South African GAAR is the presence of a tax benefit resulting from the arrangement. *ITA 1962* s 1 defines 'tax benefit' as the 'avoidance, postponement or reduction of any liability for tax', while section 80L defines 'tax' as 'any tax, levy or duty imposed by the Income Tax Act or any act administered by the Commissioner'.[36] The Court held in *Smith v Commissioner for Inland Revenue* ('*Smith*')[37]

Ltd [2001] 20 NZTC 17,103 which was a Court of Appeal case where there was initially a requirement that there had been a contract, agreement, plan or understanding to which the taxpayer was a participant, as well as a consensus between the taxpayer and others as to what the result of the arrangement would be. Therefore, the taxpayer did not have to know all the details of an arrangement and the resultant tax avoidance but needed to at least have a broad appreciation of the overall effect. In *BNZ*, Thomas J argued that the definition of 'arrangement' did not require conscious involvement or awareness of the tax avoidance. In *Peterson*, it was held that an arrangement does not require a consensus or the meeting of minds and that a taxpayer neither needs to be party to an arrangement nor has to bear knowledge of the arrangement's details to be affected by it.

33 Ibid 34.

34 *Russell v CIR* [2010] 24 NZTC 24,463 ('*Russell*'). In this case, Wylie J reiterated the understanding of consensus with regard to a taxpayer's being party to an arrangement when stating: 'In effect, Mr Russell provided consensus, although I doubt this is a necessary ingredient of any arrangement.' Ibid (102).

35 *ABSA Bank* (n 8) 39.

36 *ITA 1962* (n 7) ss 1, 80L.

37 *Smith v Commissioner for Inland Revenue* [1964] 26 SATC 1 ('*Smith*'). This case involved the taxpayer's establishing a trust to which the taxpayer became a trustee and on whose behalf the taxpayer rendered services. The taxpayer did not receive a salary from the trust for such services, and the net effect of the transactions was the transfer of virtually all income received by the trust to the taxpayer's own account for 'living expenses' for the taxpayer and his family. In the context of tax benefit, it needed to be

that tax benefit in the context of the South African GAAR refers to getting out of the way of, escaping or preventing an anticipated rather than an accrued or existing tax liability. A 'but for' test was also developed in *Smith* and was subsequently applied in *Commissioner for Inland Revenue v Louw*[38] to assist in determining the existence of a tax benefit by asking whether the taxpayer would have suffered tax 'but for' the arrangement.[39]

The second step in applying the New Zealand GAAR involves determining whether the arrangement has a tax avoidance purpose or effect. *ITA 2007* s YA 1 defines 'tax avoidance' as an arrangement that:

> (a) directly or indirectly alters the incidence of any income tax,
>
> (b) directly or indirectly relieves a person from a liability to pay income tax or from the potential or prospective liability to pay any future income tax
>
> (c) directly or indirectly avoids, postpones or reduces any liability to income tax or any potential or prospective liability to future income tax.[40]

This statutory definition of tax avoidance has been criticised for using broad terms that virtually include every possible transaction that reduces tax.[41] Furthermore, paragraphs (a) and (b) of this definition are said to introduce ambiguity, as they could refer to an accrued or a potential liability.[42]

The statutory definitions of 'tax benefit' and 'tax avoidance' seen in the South African and the New Zealand GAAR, respectively, contain similar wording, which indicates that both definitions are intended to apply to arrangements that have the effect of avoiding an anticipated or a prospective, rather than an accrued, liability.[43] It was, however, not the intention of New Zealand's Parliament to provide an exhaustive definition of tax avoidance, and as such, the courts in New Zealand have introduced judicial doctrines which do not require an extensive analysis of the statutory definition before the New Zealand GAAR can be applied.[44] This was illustrated in *Ben Nevis*, where the Supreme Court of New Zealand merely referred to the statutory definition of tax avoidance and

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determined whether these amounts received by the trust could have been regarded as a scheme to avoid income tax by the taxpayer, as contemplated in the previous South African GAAR: ibid [30].

38 *Commissioner for Inland Revenue v Louw* [1983] 45 SATC 113 [A] ('*Louw*'); *Smith* (n 38).

39 In *Louw*, a partnership was converted into a company through an allotment of shares against which the partners' loan accounts were credited, which were free of interest and not taxable in the hands of the directors. The loans were large sums of money amounting to more than double the combined salaries and dividend payouts and were thus considered abnormal.

40 *ITA 2007* (n 28) s YA 1.

41 M Littlewood, 'Tax Avoidance, the Rule of Law and the New Zealand Supreme Court' (2011) (1) *New Zealand Law Review* 263.

42 Ibid.

43 *Commissioner for Inland Revenue v King* [1947] 14 SATC 184 (A); Littlewood, 'Tax Avoidance' (n 43).

44 Cassidy (n 30).

focused on developing a parliamentary contemplation test[45] to assist in determining the presence of tax avoidance.[46]

The parliamentary contemplation test is a two-step process that is adopted in determining the existence of tax avoidance as follows:[47]

- The first step considers the taxpayer's use of the specific provisions of the legislation and whether those provisions have been used in a manner that is consistent with Parliament's intended scope.
- The second step considers the specific provision when viewed in the context of the arrangement as a whole and whether it is apparent that the specific provision has been used in a manner which could not have been within Parliament's contemplation and purpose when it enacted that provision.

In addition to the parliamentary contemplation test, the Court held in *Ben Nevis* that the economic and commercial reality of transactions may also be significant in the test for tax avoidance and considered the following a list of factors that may be relevant in determining the commercial reality of an arrangement and whether the arrangement is 'artificial' or 'contrived':[48]

- the manner in which the arrangement was carried out,
- the role of all the relevant parties and their relationships,
- the economic and commercial effect of documents and transactions,
- the duration of the arrangement,
- the nature and extent of the financial consequences for the taxpayer, and
- the circularity of cash flows.[49]

The above list only serves as guidance to taxpayers as to what will be considered by the courts and is not intended to be exhaustive.[50]

A comparison of the two GAARs reveals that the factors considered by the New Zealand courts in addition to the parliamentary contemplation test are comparable in some

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45 The parliamentary contemplation test was introduced in *Ben Nevis* but was only applied for the first time in *Penny and Hooper*. Through an analysis of *Penny and Hooper*, it is evident that, while the parliamentary contemplation test provides solid guidance with regards to factors indicating tax avoidance, it is not as straightforward as it appears. The Supreme Court was the only court that unanimously decided in favour of Inland Revenue. *Penny and Hooper*, along with earlier tax avoidance cases (*BNZ, Peterson*) demonstrates the difficulty the courts face when assessing avoidance cases.

46 T Hwong and J Li, 'GAAR in Action: An Empirical Study of the Transaction Types and Judicial Attributes in Australia, Canada and New Zealand' (2020) 68(2) *Canadian Tax Journal* 539.

47 Elliffe (n 27).

48 Cassidy (n 30).

49 'Interpretation Statement: Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the *Income Tax Act 2007*', *Inland Revenue* (Report, 13 June 2013) <https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/interpretation-statements/is1301.pdf?la=en> ('Interpretation Statement: BG 1 and GA 1 of the *Income Tax Act 2007*').

50 C Elliffe and JM Cameron, 'The Test for Tax Avoidance in New Zealand: A Judicial Sea-Change' (2010) (16) *New Zealand Business Law Quarterly* 440.

respects to the so-called 'tainted elements' and the indicators of lack of commercial substance contained in the South African GAAR (these elements and indicators are discussed in section D, below). However, some of the factors seen in New Zealand are not contained in the South African GAAR, and it is submitted that the efficacy of the South African GAAR may be improved by the incorporation of these factors into the current tainted elements. Further comparison reveals that while the New Zealand GAAR considers these factors as part of the test for tax avoidance, the South African GAAR contains the tainted elements and indicators as a separate fourth requirement which results in a lengthier and more onerous GAAR. It is also submitted that having the tainted elements as a separate requirement creates a weakness in the South African GAAR, since the courts may fail to successfully apply the GAAR to transactions that result in a tax benefit if at least one of the tainted elements is not met. Therefore, the South African GAAR may be improved by including the tainted elements and the indicators of lack of commercial substance as part of the inquiry of the tax benefit requirement or in a manner that is similar to that of the parliamentary contemplation test as applied in New Zealand.

C *Sole or Main Purpose*

The third requirement of both GAARs involves an inquiry into the purpose of an arrangement. The South African GAAR requires that the sole or main purpose of the arrangement must be to obtain a tax benefit, while the New Zealand GAAR requires the arrangement to have a tax avoidance purpose or effect. In applying the New Zealand GAAR, once it has been determined that the arrangement has a tax avoidance purpose or effect, it must be considered whether that purpose or effect is more than merely incidental.[51]

In the South African GAAR, the sole or main purpose requirement is retained from its predecessor, and therefore, the judicial precedent set under the previous GAAR can be extended to understanding the sole or main purpose requirement in the context of the current GAAR.[52] *ITA 1962* s 80G allows the Commissioner to make a rebuttable presumption that the sole or main purpose requirement of the arrangement was to obtain a tax benefit, unless the taxpayer produces affirmative and conclusive evidence to the contrary.[53] Some commentators are of the view that the evidence produced by the taxpayer to this effect may not be accompanied by the taxpayer's stated intentions or assertions, making this an objective assessment,[54] but notwithstanding these views, South African courts illustrated in *Secretary for Inland Revenue v Gallagher*[55] and in *Secretary for*

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51 Tretola, 'Comparing the New Zealand and Australian GAAR' (n 30).

52 AP de Koker and RC Williams, *Silke on South African Income Tax* (LexisNexis, 2021); TM Pidduck, 'The South African General Anti-Tax Avoidance Rule Lessons from the First World: A Case Law Approach' (PhD Thesis, Rhodes University, 2017) ('ZA GAAR').

53 Ibid.

54 de Koker and Williams (n 52).

55 *Secretary for Inland Revenue v Gallagher* [1978] 40 SATC 39 [A]. This case involved taxpayers who sought short-term investments with the aim of yielding the highest returns. This particular short-term

Inland Revenue v Geustyn Forsyth and Joubert[56] ('*Geustyn*') that the sole or main purpose requirement is a subjective test which requires the courts to take cognisance of the taxpayer's stated intention. These opposing views create a weakness in the South African GAAR, as there is uncertainty regarding the application of this requirement due to its use of wording that is similar to that of its predecessor.[57]

In the context of the New Zealand GAAR, the words 'purpose' and 'effect' are said to pose an interpretive difficulty, as they are not defined in the *ITA 2007*.[58] They were interpreted in *Ashton v Commissioner of Inland Revenue*,[59] where it was held that they are intended to refer to the end result achieved by an arrangement and not to the motive of the taxpayer. Although the courts in New Zealand see this as a subjective test, the presence of some objective factors is likely to inform the court's decision; for example, the Supreme Court considered a statement made by the taxpayer in *Ben Nevis* when determining the purpose of the arrangement.[60]

It is evident that there are opposing views in both the South African and New Zealand jurisdictions regarding whether the test for purpose is objective or subjective, and further guidance is required. It is submitted that clarifying that the sole or main purpose requirement is an objective test may go some way in improving the efficacy of the South African GAAR and in reducing ambiguity in its interpretation.

The concept of 'merely incidental' is not defined in the *ITA 2007*, but it was held in

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investment involved the proposed floating of shares, where a private company is converted to a public company by issuing shares to the public as a form of financing instead of using company funds to fund the company's expansion. The intention of the taxpayers was considered, and it was determined that the investment (made in the Cook Islands) was chosen for its high returns and was chosen over other alternatives, but when calculating the return on investment, it became evident that the tax consequences were a 'consideration'. The interest rate in the Cook Islands was lower than that offered in Australia, with the only significant difference in returns being that which resulted from the tax consequences.

56 *Secretary for Inland Revenue v Geustyn Forsyth and Joubert* [1971] 3 ALL SA 540 [A] ('*Geustyn'*). This case involved an unlimited liability company that took over a partnership, where the three former partners became the sole directors who each held equal shares in the company. Each former director was employed by the company at an annual salary of ZAR10,000, and a payment of ZAR240,000 in respect of goodwill was payable to the partnership. No service contracts were signed with the former partners, nor was there any form of guarantee for the payment of the goodwill. The ZAR240,000 goodwill payment was credited to loan accounts of each partner in equal shares. Each partner received an annual salary lower than the agreed upon amount of ZAR10,000, and ZAR29,136 would have been payable by the company in normal tax. The Secretary for Inland Revenue applied the South African GAAR at the time and allocated the company's taxable income to the former partners in equal shares, resulting overall in no taxable income being reflected on the company's assessment.

57 Pidduck, 'ZA GAAR' (n 52).

58 C Atkinson, 'General Anti-Avoidance Rules: Exploring the Balance between the Taxpayer's Need for Certainty and the Government's Need to Prevent Tax Avoidance' (2012) 14(1) *Journal of Australian Taxation* 1.

59 *Ashton v Commissioner of Inland Revenue* [1975] 2 NZLR 717 [PC].

60 *Ben Nevis* (n 21).

Challenge Corporation Ltd v Commissioner of Inland Revenue[61] that a tax avoidance purpose would be considered merely incidental if it arose as a concomitant of a non-tax avoidance purpose or effect. Consequently, tax avoidance must arise naturally, without artificiality or contrivance, since artificiality and contrivance are likely to indicate that the tax avoidance purpose or effect is more than merely incidental.[62]

The 'merely incidental' requirement of the New Zealand GAAR may be contrasted with the 'sole or main purpose' requirement of the South African GAAR: the words 'merely incidental' in the New Zealand GAAR create a lower threshold for purpose, since the tax avoidance purpose need only be more than incidental. This indicates that it may be easier for arrangements with a dual purpose to fall foul of the New Zealand GAAR, even if the tax avoidance purpose is not the main or dominant purpose. In South Africa, the Court considered an arrangement that served a dual purpose in *Commissioner for Inland Revenue v Conhage (Pty) Ltd*[63] ('*Conhage*') and held that a taxpayer may choose a transaction which attracts the least amount of tax. This principle reveals a weakness in the South African GAAR, because following *Conhage*, taxpayers argued that merely referring to a commercial purpose was sufficient to prevent the Commissioner from successfully applying the GAAR.[64] This comparison indicates the possibility of improving the efficacy of the South African GAAR by including a 'merely incidental' test as opposed to the more onerous sole or main purpose test.

D *Tainted Elements*

The fourth and final requirement of the South African GAAR is for the arrangement to be characterised by at least one of the four tainted elements contained in *ITA 1962* s 80A. The Commissioner may rely on the non-exhaustive list of guidelines and definitions contained in *ITA 1962* ss 80C to 80E when proving that an arrangement is tainted by one of these elements.[65] In comparison, the New Zealand GAAR does not structurally have a fourth requirement, as the factors that may be considered comparable to the tainted elements in the South African GAAR are considered part of the parliamentary contemplation test in the New Zealand GAAR. It is submitted that the additional requirement contained in the South African GAAR makes it more prescriptive, which may limit its successful application. It is therefore also submitted that considering the additional factors as part of the parliamentary contemplation test is more effective and that the South African GAAR

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61 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513.

62 Inland Revenue, 'Interpretation Statement: BG 1 and GA 1 of the *Income Tax Act 2007*' (n 53).

63 *Commissioner for Inland Revenue v Conhage (Pty) Ltd* [1999] [4] SA 1149 ('*Conhage*'). This case involved a sale and leaseback of a manufacturing plant and equipment. The Commissioner contended that there was no real intention for ownership to pass, even though the parties had thought the agreements sufficient to procure the tax benefits. Ibid [3].

64 SARS (n 2).

65 BT Kujinga, 'A Comparative Analysis of the Efficacy of the General Anti-Avoidance Rule as a Measure Against Impermissible Income Tax Avoidance in South Africa' (LLD Thesis, University of Pretoria, 2013) 111.

may be improved by following a similar approach in including the tainted elements as part of the tax benefit requirement. The tainted elements are discussed individually below but are summarised as follows:

- abnormality,
- lack of commercial substance,
- the creation of non-arm's length rights and obligations, and
- misuse or abuse of the *ITA 1962*.[66]

1 *Abnormality*

Despite receiving criticism under the South African GAAR's predecessor, the abnormality element is still a requirement of the current GAAR, meaning that the current GAAR may have likewise inherited some of its predecessor's weaknesses.[67] The weakness identified in the abnormality element is that transactions cease to be abnormal if they become commercially acceptable, as more taxpayers enter into similar transactions, resulting in the inefficacy of the GAAR.[68] Furthermore, contrary to its predecessor, the current test for abnormality is intended to be an objective rather than a subjective assessment.[69]

With the exception of the *Income Tax Case* 1712 [2000] 63 SATC 499,[70] where it was held that the abnormality element requires a comparison between a normal transaction and a transaction entered into for *bona fide* business purposes, there is currently no guidance on what constitutes a normal transaction, and this could lead to inconsistent judicial decisions that undermine the efficacy of the GAAR.

The abnormality requirement of the South African GAAR may be comparable to considering the manner in which an arrangement is carried out in the context of the New Zealand GAAR. Considering the manner in which an arrangement is carried out assists in determining what is achieved economically and commercially with the arrangement by examining the particular way it is structured and whether it has features that differ from usual commercial practice.[71] Given the lack of guidance regarding the application of the abnormality element in the South African GAAR, it is submitted that considering the manner in which a transaction is carried out may improve the efficacy of the South African GAAR by providing guidance on the application of the abnormality element.

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66 T Calvert, 'An Analysis of the 2006 Amendments to the General Anti-Avoidance Rule: A Case Law Approach' (MCom Mini Dissertation, North West University, 2011) 28-29.

67 SARS (n 2).

68 Ibid.

69 de Koker and Williams (n 52).

70 *Income Tax Case* 1712 [2000] 63 SATC 499. This case involved a lease of tank containers with a view to sub-lease them. The rentals payable within the first two years made up the bulk of the total rental payment, and it was found that the transaction was abnormal due to the uneven spread of rental payments and the resultant excessively high tax deductions in the first two years.

71 *BNZ* (n 31).

2 *Lack of Commercial Substance*

Lack of commercial substance applies to transactions entered into in a business context. It is generally defined in *ITA 1962* s 80C(1) as an avoidance arrangement that results in a significant tax benefit without having a significant effect on the business risks or net cash flows of the parties involved.[72] However, the *ITA 1962* does not provide any guidance on what constitutes a 'significant effect upon business risks or net cash flows' or a 'significant tax benefit' and as a result, a level of subjectivity may therefore arise when interpreting this definition.

The general test for lack of commercial substance per the South African GAAR may be considered similar in some respect to the nature and extent of financial consequences for the taxpayer, as well as transactions where the investor incurs no risk, in the context of the New Zealand GAAR. Unlike the South African GAAR, the factors contained in the New Zealand GAAR, such as the test for the nature and extent of financial consequences for the taxpayer and transactions where investors incur no risk, do not contain terms such as 'significant business risks' or 'significant tax benefit'. It is submitted therefore that the test used in New Zealand GAAR is preferable and should be adopted for the South African GAAR, as it is simpler and thus leaves it to the courts to determine whether the financial consequences suffered by the taxpayer are ones that can be expected from such an arrangement, without referring to problematic terms such as 'significant'.

ITA 1962 s 80C(2) contains a list of factors that are indicative of an arrangement that lacks commercial substance.[73] The list is non-exhaustive, and the factors given are intended to serve as guidelines when determining whether an arrangement lacks commercial substance. These indicators are discussed individually below:

(a) *Substance over Form*

The *ITA 1962* does not provide any guidance for determining whether an arrangement's legal substance differs from its legal form. While this indicator is derived from the common law doctrine of substance over form, in the context of the GAAR it is intended to be given a wider meaning.[74] The common law substance over form test determines whether the legal form of an arrangement is consistent with the true intentions of the parties to that arrangement and whether the risks and rewards are consistent with those that can be expected from the arrangement.[75] The recent case of *Sasol Oil v CSARS*[76] applied the previous South African GAAR, and the judgment in this case indicates that determining whether the substance of a transaction differs from its legal form is

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72 *ITA 1962* (n 7) s 80C(1).

73 Ibid s 80C(2).

74 National Treasury, 'Explanatory Memorandum on the Revenue Laws Amendment Bill' (Explanatory Memorandum, National Treasury, 2006).

75 de Koker and Williams (n 52).

76 *Sasol Oil v CSARS* [2018] ZASC 153 [A].

subjective.[77] The subjectivity involved in this test creates uncertainty regarding the application of the South African GAAR.[78]

(b) *Round-trip Financing*

This involves the deceptive use of funds in a circular manner between parties to an arrangement.[79] Round-trip financing is defined in *ITA 1962* s 80D, and the definition includes words such as 'among', 'between', 'reduce', 'offset', 'eliminate' and 'significant business risk'.[80] These terms have neither been defined in the *ITA 1962*, nor have they been judicially interpreted, which could raise uncertainties regarding the correct interpretations and applications thereof.

Considering the circularity of cash flows within an arrangement in the context of the New Zealand GAAR may be considered similar to the round-trip financing indicator of lack of commercial substance in the South African GAAR. However, for the purposes of the South African GAAR, an arrangement can only be tainted by the presence of round-trip financing if it meets the requirements listed in *ITA 1962* ss 80D(1)(a) and 80D(1)(b), while the New Zealand GAAR does not include a prescribed list of requirements that need to be met before the circularity of cash flows is considered present in an arrangement. It is submitted that to improve the efficacy of the GAAR, South Africa should follow an approach similar to New Zealand's in not providing a prescriptive definition of round-trip financing, leaving it to the courts to determine whether a transaction is tainted by this indicator's presence.

(c) *Accommodating or Tax-indifferent Parties*

The presence of an accommodating or tax-indifferent party within an arrangement is another indicator of an arrangement that lacks commercial substance. The use of accommodating or tax-indifferent parties within an arrangement is usually intended to defeat the balance between tax deductibility in the hands of one party and taxable income in the hands of another.[81]

In addition, section 80E(3)(b) excludes a foreign business establishment in terms of *ITA 1962* s 9D(1) from being a tax-indifferent party.[82] *ITA 1962* s 9D is an anti-avoidance section that requires the income of a resident to include a proportional amount of a foreign company's net income where that foreign company is controlled by the resident.[83] The exclusion of foreign business establishments from the definition of accommodating or tax-indifferent parties is problematic, because the use of Controlled Foreign Companies in the context of multinational enterprises is not unusual and creates the opportunity for

77 Pidduck, 'Sasol Oil Case' (n 5).

78 Ibid.

79 Kujinga (n 65).

80 *ITA 1962* (n 7) s 80D.

81 SARS (n 2).

82 *ITA 1962* (n 7) ss 9D(1), 80E(3)(b).

83 Ibid s 9D.

multinational enterprises to use these entities in such a way as to comply with *ITA 1962* s 9D but avoid tax.[84]

The accommodating or tax-indifferent parties indicator may be considered similar to considering the roles of all relevant parties and their relationships with the taxpayer in the context of the New Zealand GAAR. This factor from the New Zealand GAAR was considered in *BNZ Investments Ltd v CIR*,[85] where a tax benefit was split between unrelated parties. A comparison of the two GAARs reveals that the South African GAAR contains a prescriptive definition for an accommodating or tax-indifferent party, while the New Zealand GAAR leaves it to the courts to ascertain the roles of all relevant parties to an arrangement. It is submitted that the test used for the purposes of the New Zealand GAAR is less restrictive and may be adopted to improve the efficacy of the South African GAAR.

(d) *Offsetting or Cancelling Effects*

The presence or inclusion of elements that have the effect of offsetting or cancelling each other is an indicator contained in *ITA 1962* s 80C(2)(b)(iii), which uses words that have neither been defined nor interpreted by the courts, such as 'offsetting each other' and 'cancelling each other'.[86] It is submitted that defining these words may provide guidance on how they should be applied in the context of the GAAR.

3 *Rights or Obligations Not at Arm's Length*

ITA 1962 s 80A(c)(i) provides a third tainted element that must be considered in any context.[87] The section provides that an avoidance arrangement would be tainted if it had created rights and obligations not normally created between parties dealing at arm's length; however, the *ITA 1962* does not provide any guidance on how the concept of 'arm's length' should be interpreted in the context of the GAAR. The section also contains words such as 'normal', which are not defined. The concept of 'arm's length' was considered in *Geustyn*[88] in determining what unconnected persons would have agreed upon in the same situation. The efficacy of the South African GAAR may be improved by defining the concepts of 'arm's length' and 'normal'.

4 *Misuse or Abuse of the Act*

The 'misuse or abuse' element was not present in the South African GAAR's predecessor, and thus, the terms are neither defined in the *ITA 1962*, nor have they been interpreted by the courts. Consequently, uncertainty is created in the interpretation and application of this provision. While the South African GAAR makes use of a separate requirement for

84 Pidduck, 'Sasol Oil Case' (n 5).

85 *BNZ* (n 31).

86 *ITA 1962* (n 7) s 80C(2)(b)(iii).

87 Ibid s 80A(c)(i).

88 *Geustyn* (n 61).

the tainted element of misuse or abuse of the Act, which results in a lengthier and more complex GAAR, the New Zealand GAAR includes consideration for misuse of the legislation as part of the parliamentary contemplation test by considering whether a specific provision has been used in a manner that is consistent with Parliament's contemplation and purpose when Parliament enacted that provision.[89] It is submitted that the misuse or abuse of the Act element in the South African GAAR should form part of the tax benefit requirement.

In the next part of this article, the South African GAAR is applied to the facts of New Zealand cases with the aim of identifying nuances that are only facilitated when practical application occurs.

III APPLICATION OF THE SOUTH AFRICAN GAAR TO NEW ZEALAND CASES

Before the South African GAAR is applied to the selected New Zealand cases in order to identify further weaknesses, the facts of the cases are briefly discussed below.

A *Penny and Hooper*

Mr Penny and Mr Hooper were two orthopaedic surgeons who each practiced in their own separate capacity, and all of the income generated by their respective practices was personal income. Shortly after the personal income tax rate in New Zealand increased from 33% to 39% on 1 April 2000, the taxpayers adopted a structure to reduce their personal incomes. Each sold his practice – from which each earned substantial income – to a different incorporated company and became an employee of the company as well as the company's sole director. Although each of the taxpayers had different circumstances, both had common features: a company registration of which the taxpayers were the sole directors and the fact that the shares of each company were held by a family trust.

The Commissioner of Inland Revenue contended that the actions of Penny and Hooper amounted to tax avoidance and subsequently made assessments increasing the taxable income of the taxpayers for the tax years ending 31 March 2002, 2003 and 2004 by an amount equal to the difference between the salaries actually paid and what the Commissioner assessed as commercially realistic salaries for their services. The Commissioner contended that the actions considered were the creation of the company-trust structures, together with the reduced incomes, in totality and the cumulative effect thereof.[90] After investigations by the Commissioner began, Hooper and Penny declared larger salaries, reflecting the actual salaries earned, to avoid any penalties going forward if the Commissioner's view prevailed.

89 Elliffe and Cameron, 'Test for Tax Avoidance' (n 50).

90 Ibid 12.

B *Ben Nevis*

The taxpayers in *Ben Nevis* were investors in a 50-year forestry investment syndicate that was involved in the development of a forest that was expected to be harvested in 2048. The taxpayers entered into a license agreement for the occupation of the land to be used for the development of the forest. Part of this agreement required the taxpayers to pay a license premium per hectare as well as an insurance premium at the end of the agreed license period to protect the taxpayers in the event of a shortfall in the net proceeds from the sale of the forest. The taxpayers claimed annual tax deductions for the insurance premiums and the license premium, amortised over a period of 50 years, even though the actual cash flows were only set to take effect in 2047.[91] The Commissioner argued that the taxpayers had taken an abusive tax position and that the GAAR was applicable.

C *Frucor*

In *Frucor*, Danone Asia Pty (Ltd) subscribed for equity shares in Frucor Suntory New Zealand Limited; however, this subscription was effectively structured as a loan from Deutsche Bank in order for Frucor to obtain a tax benefit in the form of tax-deductible interest. The loan was structured in an artificial and contrived manner, where the interest was, in substance, repayment of principal and interest to Deutsche Bank. During September 2020, the New Zealand Court of Appeal ruled in favour of the Commissioner and found that the arrangement entered into was a tax avoidance arrangement to obtain a tax benefit through the interest deductions claimed by Frucor when the arrangement should have been treated as an equity subscription. Both parties (Frucor and the Commissioner) appealed to the Supreme Court, and during September 2022, Frucor's appeal on the tax avoidance was dismissed. As a result, the arrangement remains subject to the provisions of *ITA 2007* s BG 1.[92]

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91 Ibid.

92 The Supreme Court did, however, allow the Commissioner's cross-appeal on the shortfall penalties. See (n 23).

D *Application of the GAAR*

The South African GAAR was applied to the facts of the above three cases, and the findings are summarised using the framework in Table 1 below.

Table 1: Framework for applying the GAAR to the facts of the court cases

Framework	***Penny***		***Ben Nevis***	***Frucor***
	Penny	**Hooper**		
1 – Is there an arrangement?	Yes	Yes	*	Yes
2 – Does the transaction/operation/scheme result in a tax benefit?	Yes	Yes	Yes	Yes
3 – Is the sole or main purpose to obtain such a tax benefit?	Yes	*	Yes	*

** Indicates that significant doubt exists as to the efficacy of the South African GAAR for this component of the GAAR.*

Based on the application of the South African GAAR to the above court cases, the following weaknesses were identified that may render the South African GAAR an ineffective deterrent to impermissible avoidance arrangements:

1 *Arrangement*

It is likely that an arrangement was present in all three cases. However, the arrangement in *Ben Nevis* included the incorporation of an insurance company (CSI Insurance) in the British Virgin Islands to which the insurance premiums were to be paid by the taxpayers at the end of the license agreement. The taxpayers in *Ben Nevis* argued that because they were not aware of the contents of CSI Insurance's business plan, they were not party to this step of the arrangement. In light of *ABSA Bank*, this reveals a weakness in the South African GAAR in instances where the Commissioner decides to apply the GAAR to steps within an arrangement, as taxpayers may argue that they were not aware of the particular step that is considered contrary to the GAAR by the Commissioner. It is submitted that the definition of a party to an arrangement should be amended to ensure that a taxpayer cannot use ignorance as a defence against the South African GAAR.

2 *Sole or Main Purpose*

It likely that the sole or main purpose of the arrangements in all three cases was to obtain a tax benefit. However, the following evidence was provided by the relevant taxpayers:

- The stated intention of the taxpayers, Hooper and Penny, was evident from *Penny and Hooper* when it was noted that both taxpayers said under cross-examination that the restructuring of their practices was 'because of a concern about exposure to medical negligence claims which might not be covered by the accident compensation scheme'. However, Penny only reduced his income (income from the practice compared to the salary he earned from the company) once the tax rate

changed in 2000, and therefore, the objective factors did not support Penny's stated intention.

- The stated intention of the taxpayers in *Ben Nevis* was evident from a statement made by Dr Muir, who was responsible for designing the arrangement, regarding the incorporation of CSI Insurance:[93] '… the real benefits of the deal are the tax concessions that can be obtained now by the investors and the foundation. One of the conditions required to gain the tax relief is that the insurance must be in place. The actual outcome of the deal in 50 years' time is not considered material.' The objective factor that supported this stated intention was the fact that the financial services company that assisted in incorporating CSI Insurance advertised its own services as providing clients with opportunities to 'reduce, defer and avoid taxes',[94] and Muir was aware of this fact.
- Frucor argued that its stated intention for the arrangement was the legitimate refinancing of a subsidiary in New Zealand. Stanley Marcello Jr, the Senior Director of Tax for Danone North America, gave several objective factors in support of this stated intention, suggesting several reasons why the transaction may have been entered into (apart from achieving the tax benefit).[95] These reasons were cash accumulation/retention benefits, future expanded capital base, Singaporean tax treatment, lower fixed interest rate funding for Frucor, local currency funding and an improved debt/equity ratio for Frucor. The purpose of the arrangement was, however, confirmed by Danone in a document stating that the point of the scheme was to allow Danone Asia Pty Ltd to finance the purchase of Frucor in a manner that would entitle it to tax credits.[96]

On a balance of probabilities, it is likely that the objective effect did not support the stated intention of the taxpayers, as is evident in the three cases discussed above. Nevertheless, in light of *Conhage*, if the taxpayers were able to provide a commercial reason for entering into the arrangements, this would have resulted in the sole or main purpose requirements' not being met. The efficacy of the South African GAAR may be improved by following the New Zealand approach, where the tax benefit must have been just one of the purposes, provided it is not merely incidental. This would place the Commissioner in a more favourable position, as it is submitted that if the taxpayers in the three cases discussed above had been able to provide other objective factors in support of their subjective intents, the South African GAAR may not have been applicable to these arrangements.

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93 *Ben Nevis* (n 21) 136.

94 Ibid 139.

95 *Commissioner of Inland Revenue v Frucor Suntory New Zealand Limited* [2020] NZCA 383.

96 *Frucor* (n 22) 41. The judgment in the Supreme Court contrasted with that of the High Court with regard to economic substance, as can be noted at 77: 'It follows that, contrary to the finding of fact in the High Court, the purpose of the arrangement was not to alter, by increasing, the debt/equity ratio of Danone. In substance its effect and purpose [were] quite the reverse.'

3 *Tainted Elements*

(a) *Lack of Commercial Substance*

While it is submitted that it is likely that the taxpayers in all three cases were able to obtain significant tax benefits without incurring significant business risks, it cannot be said with absolute certainty that the tax benefits obtained were significant and that there was no significant effect upon the investors' business risks, as the word 'significant' is not defined in the South African GAAR.

Nevertheless, it is evident in *Penny and Hooper* that the reduction of salaries enabled the companies to distribute the profits by way of dividends to the family trusts, avoiding payment of the highest personal tax rate (for the taxpayers) and that these dividends were then used by the trust for the taxpayers' family purposes, including benefiting Penny through loans and Hooper through funding the family home and holiday home. Therefore, the arrangement had an effect on the taxpayers' net cash flows, as they did not receive all of the income that they would have received had they not entered into the arrangement. There was an effect on the net cash flows for the taxpayers. This reveals a potential weakness in the South African GAAR, as a taxpayer may exercise indirect control over funds or cash flows even where direct control is not immediately apparent. In this case, it may have been through influence over the decisions made by trustees or even through influence over the use of the funds when received by the beneficiaries of the trust. This weakness may be addressed if the GAAR were to consider whether the taxpayer has direct or indirect control over the funds (even if the amounts were not received by the taxpayer), the relationships between the taxpayer and the recipients of the funds, or how the funds are applied.

While the taxpayers both restructured their personal income affairs, it should be noted that Penny had established the company-trust structure several years prior to the increase in the tax rates, and subsequently limited his income from the company when the tax rate increase took place. In contrast, Hooper restructured his practice shortly after the tax rate change. As per Table 1, above, it is noted in *Penny and Hooper* that there is significant doubt regarding the efficacy of the South African GAAR and the lack of commercial substance tainted element requirement when applied to this case and Penny's circumstances. This uncertainty is not necessarily limited to the timeframe in which the tax rate change took place; rather, the commercial benefit is probably the effect of the tax benefit[97] (tax rate change) alongside the annual fixing of low salaries.

In *Ben Nevis,* the insurance company used (incorporated in the British Virgin Islands) had no office, telephone line, employees or stationery.[98] These factors may be considered for the purposes of lack of commercial substance, drawing the substance of the insurer into question as part of the arrangement. In the context of the South African GAAR, the factors

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97 By virtue of *ITA 1962* (n 7) s 80C(1), a taxpayer may not use the tax benefits derived to justify the commercial substance of an arrangement.

98 *Ben Nevis* (n 21) [134].

mentioned above may have been considered for the purposes of business risk, but it is uncertain if it would have met the 'no significant effect on the business risks' requirement.

(b) *Round-trip Financing*

The arrangements in *Ben Nevis* and *Frucor* included an element of reciprocity, as there was a transfer of funds between parties that resulted in tax benefits. However, in *Penny and Hooper*, it is uncertain whether the transfer of the funds by the trust to the beneficiaries, and not the taxpayers, would be considered a reciprocal action. The Court in *Penny and Hooper* held that Penny and Hooper could be expected to control the trusts, even though neither of them was a trustee of the relevant trust, as it is expected that the trustees chosen by them would act according to their instructions, meaning that Penny and Hooper were in fact in control of the funds.[99] This reveals a weakness in the current South African GAAR, as it does not consider the role of all relevant parties to the arrangement when considering the existence of round-trip financing. The efficacy of the South African GAAR may be improved by considering the role of all relevant parties and any relationship that they may have.

(c) *Accommodating or Tax-indifferent Parties*

According to the strict definition of an accommodating or tax-indifferent party, as contained in *ITA 1962* s 80E(1), a taxpayer is considered an accommodating or tax-indifferent party if the amount derived by that party is not subject to normal tax.[100]
In all three cases, it is likely that the amounts were subject to normal tax, even though they were taxed at lower rates. In *Penny and Hooper*, prior to the restructuring, Penny and Hooper should have been subject to tax at the maximum individual tax rate of 39% on a significant portion of their generated income. However, as a result of the restructuring, the income of the trusts was taxed at 33% on the retained earnings (or, if distributed, the rate of the individual beneficiaries). Therefore, it is evident that Penny, Hooper, the companies, the trusts and the beneficiaries were subject to normal tax albeit at differing rates in certain instances. Furthermore, in *Ben Nevis*, CSI Insurance was incorporated in the British Virgin Islands, which is considered a well-known tax haven, indicating that the insurance company effectively transferred its tax advantage of being subject to tax at a lower rate on the insurance premiums to the taxpayers.[101] In addition, in *Frucor*, a similar trend was identified, where the accommodating party (the company incorporated in Singapore) was subject to normal tax, albeit at a lower rate. This reveals an additional weakness in the current GAAR: where a party is subject to normal tax on amounts earned (just at a reduced rate), the party(ies) would not be considered accommodating or tax-indifferent parties in South Africa.

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99 *Penny and Hooper* (n 20) 35.

100 *ITA 1962* (n 7) s 80E(1).

101 Will Fitzgibbon, 'Tax Havens: British Virgin Islands Corruption Scandal Threatens its Dependable Tax Haven Reputation', *ICIJ* (Web Page, 26 January 2021) <www.icij.org>.

(d) *Offsetting or Cancelling Effects*

Certain offsetting and cancelling elements can likely be identified in all three cases. However, in *Ben Nevis*, the 'risks' incurred by the taxpayers were effectively offset by the insurance arrangement entered into with CSI Insurance in exchange for insurance premiums. The nature of an insurance arrangement is inherently offsetting, as the risk incurred by one party is taken over by another in exchange for premiums. Analysis of this case in the context of the South African GAAR reveals that contracts such as those for insurance may inherently contain features that fall foul of the GAAR. In *Frucor*, further weaknesses in the South African GAAR were identified, as the forward purchase agreements, convertible notes and share buy-backs present in this case may also be considered inherently offsetting due to the nature of these transactions. The scope of the South African GAAR may be extended beyond the legislature's intention by including arrangements that contain elements that are inherently offsetting and may unfairly prejudice taxpayers who enter into arrangements where these elements are present. Therefore, the efficacy of the South African GAAR may be improved by allowing for the discretion of the judiciary in a manner that more closely resembles that of the parliamentary contemplation test, following a similar approach as New Zealand where the interpretation of this indicator is left to the courts as opposed to the application of the prescriptive list that is currently employed.

Although it is evident that the two GAARs contain similarities, the applications thereof are different. Section IV of this study includes recommendations to improve the efficacy of the South African GAAR based on the lessons learnt from the New Zealand GAAR.

IV RECOMMENDATIONS

The doctrinal analysis and the reform-oriented research undertaken in sections II and III, respectively, have identified weaknesses that exist in the South African GAAR. As a result of the analysis and triangulation of the findings, it is submitted that the following recommendations may contribute to improving the efficacy of the South African GAAR:

- An approach similar to New Zealand's may be followed by not requiring a taxpayer to be party to an arrangement, meaning that prior knowledge and volition are not required from the taxpayer in identifying an arrangement.
- An approach similar to New Zealand's may be followed by requiring a purpose that is more than merely incidental instead of the current sole or main purpose requirement. It is further submitted that the inquiry into the purpose of an arrangement should be an objective test which is not affected by the taxpayer's stated intention.
- An approach similar to New Zealand's may be followed by considering the tainted elements as part of the tax benefit requirement; this may improve the efficacy of the South African GAAR, as only three requirements would need to be met instead of the current four.
- The exclusion of foreign business establishments from the 'accommodating or tax indifferent party' element of the current South African GAAR should be repealed, as the use of one or more controlled foreign companies in a multinational enterprise context is not unusual, and the use of controlled foreign companies may result in this element's not being applicable.

- The definition of an accommodating or tax-indifferent party should be amended to include parties that are subject to tax at a lower rate.
- The role of all relevant parties should be considered, as well as any relationship that they may have, in order to address the weakness identified under the round-trip financing indicator.
- Additional factors should be incorporated into the tainted elements, thereby allowing courts to consider more characteristics of an arrangement so as to draw an accurate conclusion based on the parliamentary contemplation test for the purposes of the tax benefit requirement. These factors may include those relating to:
    - transactions that have no commercial purpose;[102] and
    - transactions where the investor faces no risk.
- Consideration should be given to defining undefined terms to increase certainty and to ensure a consistent application of the South African GAAR.

V CONCLUSION

The tax lost due to cross-border tax avoidance alone in a single year could cover the cost of fully vaccinating the world's entire population against COVID-19 more than three times.[103] Therefore, it is imperative for countries to equip themselves with effective measures to combat impermissible tax avoidance. While the South African GAAR may be used as a defence against tax avoidance schemes, it has not yet been subjected to judicial inquiry to its full extent since its amendment in 2006, and it can therefore not be concluded whether or not the GAAR is an effective deterrent to impermissible tax avoidance arrangements.

This article has made two contributions to improving the efficacy of the South African GAAR, using lessons from New Zealand. Firstly, it has analysed and compared the interpretation of the South African GAAR with New Zealand's, with the aim to identify weaknesses in the South African GAAR and lessons that can be learnt from its New Zealand counterpart. Secondly, the article has applied the South African GAAR to the facts of three New Zealand court cases to further identify weaknesses in the South African GAAR, in order to propose amendments to improve its efficacy. While the New Zealand GAAR was used for comparative purposes, it is worth noting that the New Zealand GAAR itself is not without issue, and an embedded uncertainty remains. Cases from as early as *BNZ*, until *Frucor* reiterate the complexity in avoidance cases. Similarly, reflecting on the delay in the *Frucor* decision results in an unavoidable sense of uncertainty.

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102 This factor considers whether an arrangement has a commercial and non-tax avoidance purpose, even though the arrangement is not precluded from being a tax avoidance arrangement merely because a taxpayer is able to refer to a commercial reason for entering into it. Considering whether a transaction has a commercial purpose is not directly relevant to the parliamentary contemplation test but rather assists in understanding the arrangement. See Inland Revenue, 'Interpretation Statement: BG 1 and GA 1 of the *Income Tax Act 2007*' (n 53).

103 *State of Tax Justice* (n 3).

This article has followed a structured pre-emptive analysis by first analysing the South African GAAR using doctrinal analysis and then applying the GAAR to the facts of selected case law, using a reform-oriented approach. Only the facts that were considered in the judgments have been applied; consequently, this may constitute a limitation, as the facts that were not included in the judgments have not been considered.

The selected research design and methodology used in this article involves the use of a case or cases. While this can prove to be a limitation, as it may be difficult to generalise the outcome of a study that uses this approach, the case or cases investigated in such a study may be representative of what occurs within a larger system or society.[104]

The comparison performed between South Africa's and New Zealand's GAARs has revealed that guidance should be provided in order to address the uncertainties in the interpretation and application of the South African GAAR, so as to prevent inconsistencies that may limit its efficacy. In addition, the South African GAAR should be consolidated into a three-part enquiry instead of the current four-part enquiry, which may be achieved by considering the tainted elements as part of the tax benefit requirement instead of as a separate fourth requirement that makes the South African GAAR more onerous to apply. Finally, the sole or main purpose requirement should be amended so that it need not be the sole or main purpose to avoid tax but rather just one of the purposes, provided that the tax avoidance was not merely incidental.

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