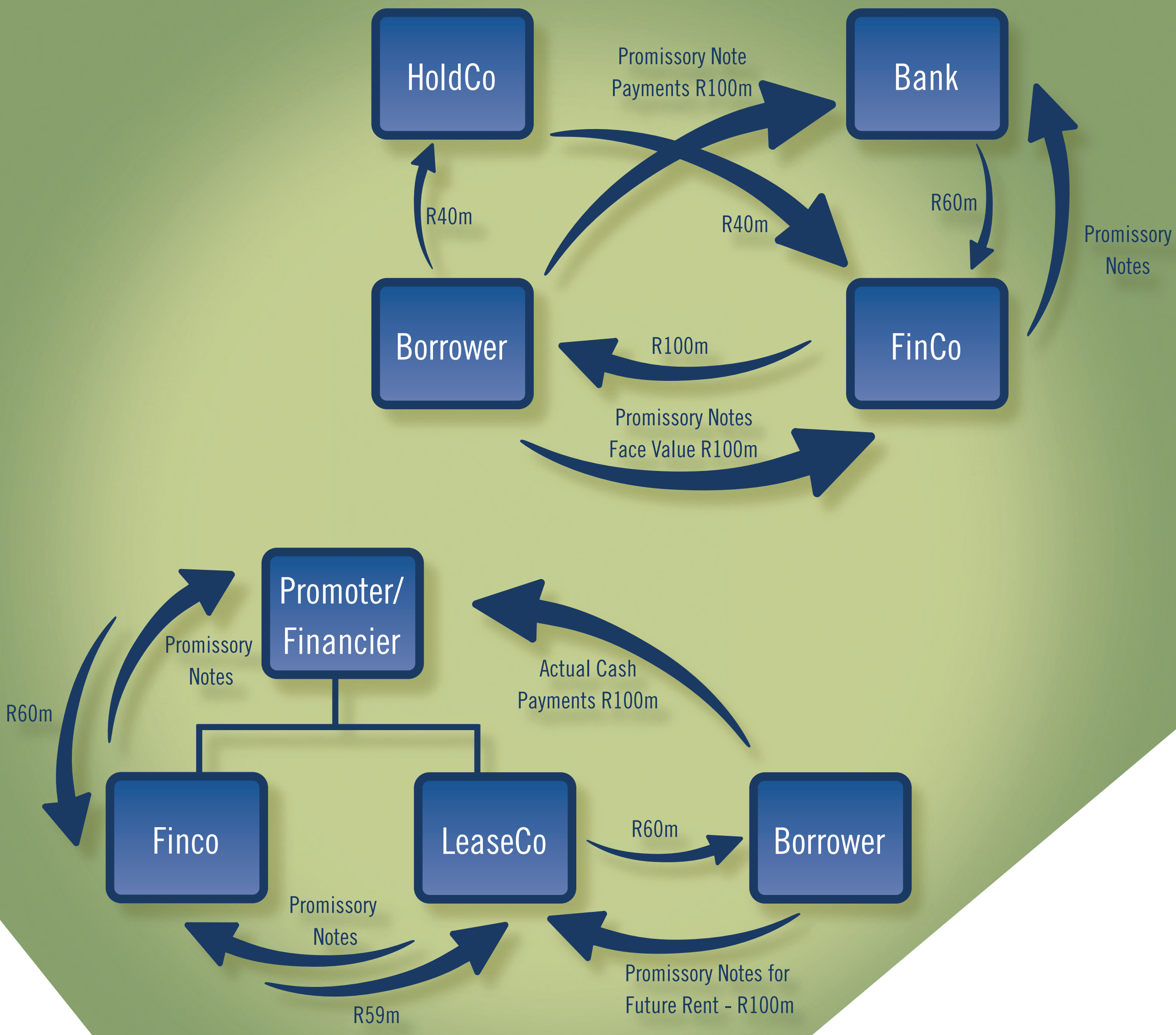
Discussion Paper



Discussion Paper on Tax Avoidance

and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)

SARS
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Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)

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Prepared by
Law Administration
SOUTH AFRICAN REVENUE SERVICE
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Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962)

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1. Introduction

Section 103 of the Income Tax Act, 1962 (Act No. 58 of 1962), contains the Act's General Anti-Avoidance Rule (GAAR). In its current form, the GAAR has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly complex and sophisticated tax "products" that are being marketed by banks, "boutique" structured finance firms, multinational accounting firms and law firms. These products typically involve the use of circular or offsetting flows of cash and property, special purpose entities or other accommodating parties, and complex financial instruments such as derivatives. The tremendous flexibility of derivatives, together with the ease with which they may be combined with, or substituted for, other financial instruments or arrangements, makes it extraordinarily difficult to combat these products through specific anti-avoidance legislation.

The pernicious effects of aggressive tax avoidance are manifold. They include not only the obvious short-term revenue loss, but longer term damage to the tax system and economy as well. These other effects include a corrosive effect upon the taxpayer compliance, the uneconomic allocation of resources, upward pressure on marginal tax rates, an unfair redistribution of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.

Both SARS and National Treasury firmly believe that the vast majority of South Africans are honest, hard working and willing to pay their fair share of tax. Practitioners, too, play a vital role in assisting those taxpayers in meeting their obligations under our tax laws. Unfortunately, those who engage in impermissible tax avoidance pose a problem for everyone else. It is the purpose of this Paper to start a discussion of these issues and of how best to address them on behalf of all South African taxpayers.[1]

[1] Combating impermissible tax avoidance is but one aspect of the much broader goal of improving taxpayer compliance generally. Other initiatives include taxpayer education and outreach, the new programs by SARS to assist small businesses on the ground, and the new Advance Tax Ruling System. These topics, however, are generally beyond the scope of this Discussion Paper.

2. Terminology

2.1. General Problem: Evasion, Avoidance and Planning

Discussions of tax avoidance often begin with an attempt to define and distinguish three broad concepts: (1) tax evasion; (2) "impermissible" tax avoidance; and (3) legitimate tax planning or "tax mitigation". While there is typically agreement over the meaning of "tax evasion", the other two categories are more contentious.[2]

2.2. Terms Used

Given the lack of alternatives, this Discussion Paper will continue to use these three basic categories, while being mindful of the problems and limitations inherent in them. While precise line-drawing may not be possible, these categories do help to identify types of behaviour across a spectrum that ranges from "plain vanilla" tax planning at one end to criminal tax evasion at the other. These categories also help to elucidate the points at which one type of behaviour may begin to cross the line from one category to another.[3]

The definitions below have been drawn from a number of sources, including publications by the Organisation for Economic Co-operation and Development (OECD), reports by revenue authorities and commissions in other countries, judicial decisions, and critical commentaries. It is hoped that they may help to minimise misunderstandings due to differences in semantics.

2.2.1. Tax Evasion

The OECD has defined "tax evasion" as encompassing "illegal arrangements through or by means of which liability to tax is hidden or ignored," that is, arrangements in

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[2] Some authorities have even criticised the third category as "unhelpful". See, for example, the comments of Lord Hoffman in MacNiven v Westmoreland [2001] STC 237 at p. 257. By the same token, Lord Hoffman's alternative distinction between "legal" and "commercial" concepts has likewise drawn criticism as "a difficult one to apply". Barclay's Mercantile Business Finance Ltd v Mawson [2003] STC 66 (Peter Gibson, LJ).

[3] Thus, as Cooke, P has stated in Hadlee and Sydney Bridge Nominees Ltd v CIR (1991) 13 NZTC 8,116 (CA) at p. 8,122: "The distinction between tax avoidance and tax mitigation is both authoritative and convenient for some purposes, but perhaps it can be elusive on particular facts". Similarly, the New Zealand Commissioner of Inland Revenue has also concluded, on balance, that "the distinction can still be convenient in considering whether Parliament intended the particular provision [of the tax law] to apply in the way argued for by the taxpayer".

which "the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities".[4] In an income tax context, it typically involves the non-payment of a tax that would properly be chargeable if the taxpayer made a full and true disclosure of income and allowable deductions. Common examples of tax evasion include a deliberate failure by a "cash" business to report the full amount of revenue received or the deliberate claiming of a deduction by a business for an expenditure it has neither incurred nor paid.

2.2.2. Impermissible Tax Avoidance

In Australia, the Ralph Review of Business Taxation has characterized "tax avoidance" as "a misuse or abuse of the law" that "is often driven by the exploitation of structural loopholes in the law to achieve tax outcomes that were not intended by Parliament but also includes the manipulation of the law and a focus on form and legal effect rather than substance".[5] Lord Templeman provided another definition in the Challenge Corporation case:

> "Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had".[6]

The economists Michael Brooks and John Head have struck a similar chord, noting that "[i]n legal discussions of tax avoidance, the primary focus is clearly on contrived and artificial schemes, which do not change the substantive character of an activity or

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4 OECD, *International Tax Terms for the Participants in the OECD Programme of Cooperation with Non-OECD Economies*.

5 Australia, *Final Report of the Review of Business Taxation, A Tax System Redesigned*, (Canberra: Australian Government Printing Service, July 1999) at s. 6.2(c) (hereinafter "*Ralph Final Report*"). The OECD similarly defines "tax avoidance", somewhat awkwardly, as "an arrangement of a taxpayer's affairs that is intended to reduce his liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow". OECD, *International Tax Terms . . .*" op. cit. n 4.

6 CIR v Challenge Corporation Ltd [1987] AC 155.

transaction but may serve nevertheless to bring the activity within some tax-exempt or more tax-favoured legal category".[7]

Drawing upon these definitions, the Discussion Paper uses the term "impermissible tax avoidance", in general, to refer to artificial or contrived arrangements, with little or no actual economic impact upon the taxpayer, that are usually designed to manipulate or exploit perceived "loopholes" in the tax laws in order to achieve results that conflict with or defeat the intention of Parliament. The term certainly includes, but is not limited to, arrangements that embody the common characteristics of the "abusive avoidance schemes" discussed in section 6 below.

2.2.3. Tax Planning

"Tax planning" is concerned with the organisation of a taxpayer's affairs (or the structuring of transactions) so that they give rise to the minimum tax liability within the law without resort to the sort of "impermissible tax avoidance" just described. As used in this Discussion Paper, it is similar to the concept of "tax mitigation" described by Lord Templeman:

> "Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. [The General Anti-Avoidance Rule] does not apply to tax mitigation because the taxpayer's advantage is not derived from an arrangement but from the reduction of income which he accepts or the expenditure which he incurs".[8]

In short, the "hallmark of tax mitigation . . . is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option".[9]

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7 Brooks, M and Head, J "Tax Avoidance: In Economics, Law and Public Choice", in Cooper, GS *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997) (hereinafter "*Tax Avoidance and the Rule of Law*") at p. 71.

8 CIR v Challenge Corporation [1987] AC 155.

9 CIR v Willoughby [1997] 4 All ER 65 at p. 73.

A basic example of legitimate tax planning would involve a taxpayer's decision to operate a new business as a company or sole proprietorship. Similarly, it would include a decision by partners in a two-person firm to transfer their business to a new company and to make an election to have the "roll-over" provisions for company formations apply to their disposal of allowance assets and goodwill.[10] By making this election, the partners may defer potential income tax in respect of any recoupment, as well as any potential capital gains tax. But this deferral is expressly provided for and intended by the statutory provisions in question. Subject to certain limitations, tax planning would also include a decision by a business to raise funds for new equipment through a straight loan or some form of finance lease. Unfortunately, the problems often begin to arise when the parties try to have it both ways, with the borrower seeking to claim a deduction for full rental payments (consistent with a finance lease) and the lender seeking to report only the interest component of those same payments (consistent with a loan).

2.3. GAAR and Duke of Westminster

The notion of tax planning captures the essence of the famous dictum by Lord Tomlin: "every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".[11] A GAAR, by its nature, operates in tension with this notion. It imposes limits upon the extent to which an "ordering of affairs" is to be respected for tax purposes. It thus helps to establish the boundary between legitimate tax planning and impermissible tax avoidance.[12]

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[10] Section 42(1)(c).

[11] IRC v Duke of Westminster [1936] 19 TC 490 at p. 520.

[12] The nature of this relationship has been articulated in both Australia and New Zealand. Thus, for example, in FC of T v Spotless Services Ltd (1996) 34 ATR 183 at p. 186, the Australian High Court noted that the Australian GAAR "is as much a part of the statute under which liability to income tax is assessed as any other provision thereof". Similarly, the Public Rulings Unit of New Zealand Inland Revenue recently explained: "While it can still be said that (consistent with the *Duke of Westminster* principle) a taxpayer is required to pay no more than the correctly imposed quantum of tax, it is also the case that under the Income Tax Act a taxpayer is not entitled to alter that proper statutory impost by entering into a tax avoidance arrangement". New Zealand Inland Revenue Department, Public Rulings Unit *Interpretation of Section BG1 and GB1 of the Income Tax Act 2004: Exposure Draft for External Consultation* (hereinafter "*NZ Exposure Draft*") at para. 4.4.10. Hefer JA expressed a similar notion in CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 at p. 1155, when he noted that while "a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner", the taxpayer must do so "[w]ithin the bounds of any anti-avoidance provisions in the legislation". This issue is addressed more fully in section 9 below.

2.4. The Role of GAAR

Richardson P of the New Zealand Court of Appeal has cogently explained the conceptual basis for a GAAR –

> "[The GAAR] is perceived legislatively as an essential pillar of the tax system designed to protect the tax base and the general body of taxpayers from what are considered to be unacceptable tax avoidance devices. By contrast with specific anti-avoidance provisions which are directed to particular defined situations, the legislature through [the GAAR] has raised a general anti-avoidance yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.
>
> 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 – as Lord Templeman put it in *Challenge* at p. 562, most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values.
>
> The function of [the GAAR] is to protect the liability for the income tax established under the other provisions of the legislation".[13]

It is equally important to emphasise what a GAAR is not. It is not a charging provision. While the application of the GAAR to impermissible tax avoidance may help to stem the tide of short-term revenue loss, the GAAR itself is not a revenue raising measure. It is intended to protect the tax base established by Parliament, not to expand it.[14]

In addition, a GAAR is not, and should not become, a substitute for well-drafted and well-designed legislation. The GAAR nevertheless reflects a fundamental recognition that even the best drafted, best designed tax legislation cannot anticipate every

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[13] CIR v BNZ Investments [2002] 1 NZLR 450.

[14] This protection may in turn provide the necessary and essential foundation for any future tax reform and simplification, particularly in the area of business taxes. For a general discussion of these issues, see Joffe, H "Never mind the technicalities of tax, let's hear the philosophy", *Business Day* (12 April 2005) at p. 8.

possible nuance and circumstance that may arise, let alone every scheme that may later be devised in response to it.[15]

3. Scope of the Problem

3.1. Worldwide Concern

Impermissible tax avoidance has been a growing problem internationally during the past ten years. Australia has repeatedly expressed concerns over tax avoidance and evasion, particularly in respect of schemes involving offshore tax havens such as Vanautu and the Channel Islands. In the United Kingdom, the 2005 Budget contained an array of new provisions designed to combat aggressive avoidance schemes, particularly in the cross-border context. Similarly, in the United States, a recent study by the General Accounting Office revealed that two-thirds of the companies operating in the US paid no federal income taxes on their profits between 1996 and 2000, and that for the year 2000, 94 per cent of all companies paid income taxes of less than five per cent of the profits they reported for financial accounting purposes.[16] Finally, the OECD has repeatedly expressed concern about harmful tax competition being driven, in part, by various tax havens around the world.[17]

3.2. Causes

The forces driving these trends are varied.[18] Major factors include globalisation, increasing deregulation, particularly in the financial markets,[19] and rapid advances in computer and telecommunications technology.[20]

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15 "No country has yet succeeded or is likely to succeed, in framing its tax laws in such a way that it is clear how the tax liability will be calculated on any conceivable set of facts. 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". Cooper, GS, "Conflicts, Challenges and Choices – The Rule of Law and Anti-Avoidance Rules" in *Tax Avoidance and the Rule of Law*, op. cit. n 7, at p. 13.

16 United States, *Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000* (Washington, D.C.: US General Accounting Office, 2004). The statutory rate applicable to most companies in the United States is 35 per cent.

17 OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

18 See generally, Tanzi, V "Globalization and the Work of Fiscal Termites", *Finance & Development Magazine* (March 2001). In this article, Vito Tanzi, former Director of the Fiscal Affairs Department of the International Monetary Fund identifies eight "fiscal termites" that are "gnawing away at the foundations of [national] tax systems" – electronic commerce, electronic money,

Changing attitudes and market forces also play a role. Thus, for example, the United States Department of the Treasury has noted that "[s]ome commentators explain the growth in corporate tax shelters as a reflection of more accepting attitudes of tax advisers and corporate executives toward aggressive tax planning".[21] At the same time, the lucrative market for tax avoidance schemes and "tax optimisation" plans has led to an increase in the resources and talent being devoted to those areas by professional firms in many countries.[22]

3.3. The South African Situation

The impact of these global forces on the problem in South Africa has been exacerbated by local factors as well. These include the major changes that have been made to the South African income tax system over the past few years, including the shift from source to residency based taxation, the concomitant enactment of new "controlled foreign company" rules, the introduction of a new tax on capital gains, and the adoption of new company restructuring rules. At its worst, the very complexity of some of these new provisions can interfere with legitimate business transactions, while in some cases actually creating new opportunities for mischief.

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intracompany trade, offshore financial centers, derivatives and hedge funds, a growing inability or unwillingness to tax financial capital, growing foreign activities, and foreign shopping.

19 As the US Department of the Treasury has noted, "[f]inancial markets have expanded dramatically, offering a mind-boggling array of products and creating the possibility to engineer new financial assets at very low costs". United States *The Problem of Corporate Tax Shelters – Discussion, Analysis and Legislative Proposals* (Washington, D.C.: United States Treasury Department, 1999) at p. 19 (hereinafter "*The Problem of Corporate Tax Shelters*"). These new sophisticated financial products do not fit neatly into existing tax regimes, whether foreign or South African. See generally Hutton, S "The Taxation of Derivatives in South Africa" 1998 *The Taxpayer* 163. Not surprisingly, taxpayers and their advisers have attempted "to exploit the uncertainty regarding the taxation of these instruments to create, among other things, the economic equivalence of a traditional investment without the unfavourable tax consequences". *The Problem of Corporate Tax Shelters*, op. cit. at p. 16.

20 Advances in computer technology and the availability of sophisticated software are well-documented. These developments have greatly enhanced the ability of investments banks, accounting firms and other tax advisers to create sophisticated tax and financial models and to market "cookie cutter" products to multiple taxpayers.

21 *The Problem of Corporate Tax Shelters,* op. cit. n 19, at p. 19.

22 "A taxing battle" *The Economist* (29 Jan. 2004) ("[A] revealing trend is the way in which the big accounting firms are beefing up their transfer-pricing departments. In Britain alone, the combined numbers employed by the four-biggest accounting firms in transfer pricing has tripled in recent years, even though their clients have themselves also been employing more people to deal with tax issues".)

At the same time, advances in computer and telecommunication technology have radically transformed the way in which multinational firms, particularly multinational accounting firms, can share and exchange information. As a result, new tax avoidance schemes that are developed in the UK or the US can now migrate to South Africa almost immediately for practical purposes, rather than taking months if not years to do so, as they might have in the past.[23] This effectively puts SARS on the front line with the most advanced tax administrations in the world in combating these schemes.

4. The Harms Caused by Impermissible Tax Avoidance

The harms caused by impermissible tax avoidance are varied and pervasive. They include short-term revenue loss, growing disrespect for the tax system and the law, increasingly complex tax legislation, the uneconomic allocation of resources, an unfair shifting of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.[24]

4.1. Short-Term Revenue Loss

The most immediate harm caused by impermissible tax avoidance is short-term revenue loss. Accurate estimates of the size of the problem are difficult to make, whether in South Africa or elsewhere. In part, these difficulties are due to disagreements about what constitutes impermissible tax avoidance; in part, to the fact that many schemes are deliberately designed to avoid detection. There is no question, however, that the amounts at stake are substantial.[25]

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23 Indeed, as the South African tax system becomes more aligned with the systems in OECD countries, such "migration" only becomes easier.

24 See generally *Ralph Final Report*, op. cit. n 5, at s. 6.2(c); Brooks, M and Head, J, op. cit. n 7, at p. 53. ("It has, of course, been recognised that tax avoidance . . . may seriously threaten the achievement of the standard public finance objectives of revenue-raising, equity, efficiency and simplicity".)

25 Estimates for the South African tax gap have ranged from a low of about 10% to a high of 33% or more. See, e.g., *First Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (18 November 1994) at para. 5.1.6; *Report of the Margo Commission*, para. 27.4.

4.2. Disrespect for the Tax System and the Law

While short-term revenue loss may be the most immediate problem, it is by no means the most serious. Impermissible tax avoidance also encourages "disrespect for the tax system – both by the people who participate in the tax shelter market and by others who perceive unfairness".[26] Even the New York State Bar Association – hardly a "pro-tax" organisation – has decried this "corrosive effect":

> "The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions".[27]

The result is an ugly "race to the bottom".[28]

The proliferation of arbitrary and contrived schemes also leads to a perception that the "system" is unfair. This may in turn discourage compliance, even by taxpayers that had not previously engaged in impermissible tax avoidance.[29]

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[26] *The Problem of Corporate Tax Shelters* op. cit. n 19, at p. 12. See also Kruger, D and Scholtz, W *Broomberg on Tax Strategy: Fourth Edition* (Durban: LexisNexis Butterworths, 2003) at p. 1 ("Most people, at the best of times, dislike paying tax: but nothing infuriates them more than the knowledge that others, in like circumstances are honestly and legitimately paying less tax"). Disagreements may exist, of course, regarding the legitimacy – and in some cases, unfortunately, the honesty – of various schemes and their participants. As the British have noted with characteristic understatement, "engagement in an avoidance scheme can encourage taxpayers to be economical with the truth". Freedman, J "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] British Tax Review No. 4, 332 at p. 349 (discussing the Tax Law Review Committee, *Tax Avoidance* (IFS, London, 1997) para. 1.24).

[27] Statement of Harold R. Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance (27 April 1999) at p. 2, quoted in *The Problem of Corporate Tax Shelters*, op. cit. n 19, at p. 3. James Holden, a former President of the Tax Section of the American Bar Association, has expressed similar misgivings: "Many of us have been concerned with the recent proliferation of tax shelter products marketed to corporations . . . the marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on". Holden, J "1999 Erwin Griswold Lecture before the American College of Tax Counsel: Dealing with the Aggressive Corporate Tax Shelter Problem", reprinted in (1999) 52 *Tax Lawyer* 369.

[28] *The Problem of Corporate Tax Shelters*, op. cit. n 19, at p. 2.

[29] OECD, *Harmful Tax Competition* . . . op. cit. n. 17, at para. 30.

4.3. Increasing Complexity

Another harm manifests itself in increasingly complex tax laws. This problem has two aspects: one, a proliferation of specific anti-avoidance measures that are enacted in response to particular schemes that are discovered on audit; the other, a tendency to try and pre-empt possible avoidance through increasingly complex and detailed legislation in the first instance. While this complexity may sometimes be self-defeating,[30] it invariably increases the compliance burden upon all taxpayers.[31]

4.4. Costs to the Economy

As the OECD has flatly stated: "Tax avoidance and evasion are economically costly".[32] These costs arise in a number of ways. At a basic level, to the extent that impermissible tax avoidance inevitably results in new amendments, more complex legislation and increasingly comprehensive and detailed reporting requirements, administrative costs and compliance burdens swell for both taxpayers and the government.[33]

Additional costs are reflected in the resources that are diverted from productive investment to the development, marketing, implementation and subsequent defence of

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30 Ironically, it has been observed that "[t]he more complex is the tax law, the more likely it is that aggressive taxpayers will be able to find and exploit discontinuities". *The Problem of Corporate Tax Shelters* op. cit. n 19, at p. 20. In this regard, it has also been noted that government suffers from the "first mover disadvantage" – it lays out delineated rules, which are then exhaustively analysed and parsed by taxpayers and their advisers precisely in order to find and exploit "loopholes". DM Schizer, DM "Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning" (200) 73 *S Cal Law Review* 1339, at p. 1349. Malcolm Gammie has expressed similar concerns from a UK perspective: "Taxpayers rely upon – or exploit – the boundaries that legislative words create and the absence of explicit provisions to reduce their tax liability. In this, taxpayers have the advantage because governments must put their goods on show for all to see". Gammie, M "Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom", in *Tax Avoidance and the Rule of Law*, op. cit. n 7, at p. 181. These problems may be particularly pronounced in the area of piecemeal reforms. See generally Scarborough, RH "Different Rules for Different Layers and Products: The Patchwork Taxation of Derivatives" 1994 *Taxes* 1031, at p. 1044 ("Piecemeal reforms, each designed to make the tax system more neutral and to reduce tax avoidance, have created inconsistencies that themselves may distort taxpayer behaviour and create tax avoidance opportunities").

31 On occasion, the practitioner community has betrayed a desire to have it both ways – to have simpler tax laws, but at the same time to be free to exploit any "loopholes" or "deficiencies" they can find.

32 OECD, *Forces Shaping Tax Policy*, at p. 165.

33 OECD, *Harmful Tax Competition . . .* op. cit. n 17, at para. 30.

impermissible tax avoidance schemes.[34] These so-called "avoidance costs" can be substantial. Professional fees can often amount to a significant percentage of the promised tax benefits, especially in situations involving contingent fee or "value billing" arrangements.[35]

At a deeper level, impermissible tax avoidance creates significant deadweight losses for the economy by distorting trade and investment flows.[36] In particular, avoidance schemes often involve a re- or misallocation of resources from productive investments to activities that are, at best, marginally profitable on a pre-tax basis.[37] These distortions reduce economic efficiency and impede growth.[38]

Promoters often try to justify their actions by claiming that they benefit the South African economy by providing borrowers with reduced financing costs through their schemes. In the case of various offshore schemes, such as schemes involving foreign films,[39] these claims simply do not withstand scrutiny. These schemes drain capital from the South African economy, often in contravention of the spirit if not the letter of prevailing exchange control regulations. Even in the case of purely domestic transactions, pre-tax financing costs actually increase as a result of these schemes – an increase that is only masked by the artificial tax "savings" that are generated. Indeed, most impermissible tax avoidance schemes in the structured finance area amount to nothing more than elaborately disguised forms of inflating and trafficking in tax losses and other tax attributes – activities that are plainly contrary to basic policies

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[34] See e.g., Slemrod, J and Yitzhaki, S "The Costs of Taxation and the Marginal Efficiency Cost of Funds" (March 1996) 43 *IMF Staff Papers* 172; see also Bankman, J "An Academic's View of the Tax Shelter Battle" at p. 31 ("Tax shelters siphon off resources from more productive ventures, redistribute the tax burden and threaten to undermine compliance").

[35] For example, in a new generation of film schemes that has surfaced in South Africa, fees charged by the promoters have actually exceeded the net financial benefits received by the film producers. These film schemes are described more fully in Annexure A.

[36] P Groenewegen, "Distributional and Allocational Effects of Tax Avoidance", in D Collins ed., *Tax Avoidance and the Economy*, (Sydney, Australian Tax Research Foundation, 1984) at p. 23.

[37] Ibid.

[38] See also Bankman, J, op. cit. n 35, at p. 18 ("The sad truth, known to economists, is that all else being equal, tax planning is a deadweight loss to the system").

[39] An example of such a scheme is discussed more fully Annexure A.

embodied in the Act[40] and that have been widely condemned by tax and policy experts worldwide.[41]

4.5. Unfair Shifting of the Tax Burden

Impermissible tax avoidance has a tremendous impact upon the equity and fairness of the tax system.[42] At the most basic level, it creates "a form of subsidy from those paying their fair share of tax according to the intention of the law to those shirking their similar obligations".[43] Taxpayers engaging in such impermissible tax avoidance have thus been seen as a "particular aspect of the free rider problem".[44]

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[40] Section 103(2) of the Act prohibits trafficking in loss companies generally, while section 20(1) and section 20A "ring fence" certain losses. Parliament has also imposed significant restrictions on the ability of taxpayers to use various devices such as sale and leaseback arrangements (see section 23G) and resale or repurchase agreements (see section 24J) in order to traffic in other tax attributes such as capital allowances. Many of the abusive schemes currently being marketing depend upon an exhaustive parsing of these specific anti-avoidance rules in order to find potential "loopholes".

[41] Burns, L and Krever, R "Taxation of Income from Business and Investment" (Chapter 16), at p. 23, in Thuronyi, V ed., *Tax Law Design and Drafting*, (Washington, D.C.: International Monetary Fund, 1998). In a business context, a system of loss trafficking would generally result in successful firms being taxed more heavily, in effect, to support less efficient firms. See Lounghouse, G "The 'Same Business' Test and Cleopatra's Ark" (1998) 28 *Australian Tax Review* 4, at p. 6 ("trafficking in company losses is undesirable for reasons both of economic efficiency and neutrality, as well as its cost to the revenue").

[42] In a tax context, "equity" is generally seen as having two aspects: horizontal equity and vertical equity. Horizontal equity is generally defined as a "[d]octrine which holds that similarly situated taxpayers should receive similar tax treatment, e.g. taxpayers who earn the same amount of income or capital should be accorded equal treatment". OECD, *International Tax Terms* . . . op. cit. n 4. Vertical equity is generally defined as a "[d]octrine which holds that differently situated taxpayers should be treated differently, i.e. taxpayers with more income and/or capital should pay more tax". Ibid.

[43] *Ralph Final Report*, op. cit. n 5, at s. 6.2(c). This problem has been recognised by the House of Lords itself. It is clearly reflected, for example, in the following observation by Lord Cooke in CIR v McGuckian [1997] 3 All ER 817 (HL): "I suspect that advisers of those bent on tax avoidance, *which in the end tends to involve an attempt to cast on other taxpayers more than their fair share of sustaining the national tax base*, do not always pay sufficient heed to the theme in the speeches in *Furniss*, especially those of Lords Scarman, Roskill and Bridge of Harwich, to the effect that the journey's end may not have been found" (emphasis supplied). Similar sentiments were expressed closer to home by MacDonald JP in COT v Ferera 1976 (2) SA 653, 38 SATC 66 at p. 70: "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 fiscus, but the effect must necessarily be to cast an additional burden on taxpayers who, imbued with a greater sense of civic responsibility, make no attempt to escape or, lacking the financial means to obtain the advice and set up the necessary tax-avoidance machinery, fail to do so".

[44] Waincymer, J "The Australian Tax Avoidance Experience and Responses: A Critical Review" in *Tax Avoidance and the Rule of Law*, op. cit. n 7, at p. 256. See also OECD, *Harmful Tax Competition* . . . op. cit. n 17, at para. 24 ("Investors in tax havens . . . who are resident of non-haven countries may be able to utilise in various ways those tax haven jurisdictions to reduce their domestic

At a more systemic level, impermissible tax avoidance, particularly in the context of globalisation and harmful tax competition, may severely constrain the ability of governments to tax income from capital and other relatively mobile sources.[45] These forces, in turn, have tended to result in a shift of the tax burden to less mobile factors such as labour and consumption.[46] At the same time, by eroding the tax base, impermissible tax avoidance exerts an artificial upward pressure on marginal rates.

4.6. Weakening the Ability of Parliament and National Treasury to Set and Implement National Economic Policy

The basic goals of any tax system include revenue raising, equity, efficiency and simplicity.[47] As discussed above, impermissible tax avoidance directly undermines each of these goals.

In addition, in South Africa as elsewhere, revenue legislation has become an increasing "mix of fiscal, social and economic policy objectives".[48] By manipulating the tax laws through artificial and contrived schemes that have little economic substance, impermissible tax avoidance severely undermines the ability of Parliament and National Treasury to set and implement economic and social policy for the country.[49] At a basic and obvious level, aggressive schemes can precipitate severe short-term revenue losses that limit government's ability to pursue its economic and

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tax liability. Such taxpayers are in effect 'free riders' who benefit from public spending in their home country and yet avoid contributing to its financing").

45 OECD, *Harmful Tax Competition* . . . op. cit. n 17, at para. 23.

46 Avi-Yonah, RS "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113 *Harvard L Review* 1575, at p. 1578. Taxes on labour and consumption also tend to be more regressive than income taxes, particularly income taxes with a progressive rate structure. These factors form the basis, in part, for the OECD's warning that harmful tax competition may also hamper "the achievement of redistributive goals". OECD, *Harmful Tax Competition* . . . op. cit. n 17, at para. 23. To the extent that such taxes are insufficient to make up revenue shortfalls, countries may be forced to borrow to fund deficit spending and/or to cut spending for the social programs.

47 To a large extent, these goals are often seen as originating in the four maxims articulated by Adam Smith – equality, certainty, convenience and freedom from economic burden. Smith, A *An Inquiry into the Nature and Causes of the Wealth of Nations* (Part 2, Chapter II, Book Five) (1776) (Chicago: William Benton, 1952 ed.). In an increasingly global economy, it is also important that a tax system be competitive – that is, to the extent possible, it should not put domestic companies at a disadvantage or be a disincentive to foreign direct investment.

48 Orow, N "Structured Finance and the Operation of General Anti-Avoidance Rules" Tax Research Network Conference, Oxford University, Oxford, United Kingdom, 2003, at p. 16.

49 See generally Brooks, M and Head, J, op. cit. n 7, at pp. 53 - 91.

social agenda. In addition, various "tax shelter" schemes divert scarce resources from their intended targets. The film and plantation schemes of the late 1980s are classic examples of such abuse.

South Africa and the world have changed enormously since Lord Tomlin made his famous statement in the Duke of Westminster case 70 years ago. South Africa is now a broad-based democratic society and government plays an increasingly vital role in securing the economic and social well-being of its citizens. And while some may still prefer to view government as nothing more than a revenue-maximising "Leviathan",[50] research and analysis have generally moved toward a more balanced and sophisticated view of the role of taxation in modern society. The right of taxpayers to minimise their liabilities within the bounds of the law is not to be denied – indeed, it is a principle found in democratic societies throughout the world, one that may well provide a healthy counterweight to the power of the "Taxman". At the same time, it is a right that still must be balanced against other rights and obligations.[51] Impermissible tax avoidance may not be a crime, but it is certainly not victimless.

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[50] Brennan, G and Buchanan, JM "Towards a Tax Constitution for Leviathan" (1977) 8 *Journal of Public Economics* 255. See generally M Brooks & J Head op. cit. n 7, at pp. 82 – 91. Perhaps surprisingly, Brooks and Head conclude that there is "no justification . . . for the adoption of a 'relaxed attitude' to tax avoidance" even "in terms of the Leviathan approach". Ibid. at p. 91.

[51] The need for such balance has been recognised repeatedly. Thus, for example, Woodhouse, J has noted that:

> "Nevertheless, since the House of Lords was obliged to consider the highly beneficial arrangements which were able to be made in 1930 on behalf of the Duke of Westminster, there has been a growing awareness by the legislature and the Courts alike that ingenious legal devices contrived to enable individual taxpayers to minimise or avoid their tax liabilities are often not merely sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned), but that they have social consequences which are contrary to the general public interest".

Elmiger v CIR [1966] NZLR 683 (SC) at p. 686. The House of Lords itself has recognised the limits of the Duke of Westminster case on more than one occasion. Thus, for example, Lord Diplock made the following statement in IRC v Burmah Oil Co Ltd [1982] STC 30 (HL) at p. 32: "Lord Tomlin's oft-quoted dictum . . . 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 otherwise attach to them if business transactions were conducted in a straight-forward way". Fifteen years later, Lord Steyn made the point even more bluntly: "While Lord Tomlin's observations in the *Duke of Westminster's* case still point to a material consideration, namely the general liberty of the citizen to arrange his financial affairs as he thinks fit, they have ceased to be canonical as to the consequences of a tax avoidance scheme". CIR v McGuckian [1997] 3 All ER 817 (HL).

5. The Anatomy of Impermissible Tax Avoidance

The previous sections have examined impermissible tax avoidance in terms of its scope, the major factors driving the current problem and the harms caused by it. This section begins to dissect the "anatomy" of impermissible tax avoidance in terms of its basic goals, the conditions in any tax system that make it possible, and the basic concept of "tax arbitrage" that underlies most if not all avoidance strategies. The next section then focuses on the common characteristics and features that are shared by most abusive avoidance schemes.

5.1. Deferral, Conversion, Elimination and Shifting

In practice, impermissible tax avoidance typically involves four basic goals: (1) the deferral[52] of a tax liability; (2) the conversion of the character of an item (for example, from revenue to capital or, in more aggressive products, the conversion of a taxable item such as interest to a tax-exempt one such as dividends); (3) the permanent elimination of a tax liability; and/or (4) the shifting of income (for example, from a taxpayer subject to the highest marginal rates to a taxpayer subject to a lower (or zero) rate of tax).[53] These goals are typically achieved by manipulating so-called "inconsistencies" and "discontinuities" inherent in any tax system.

5.2. Manipulation of "Inconsistencies" and "Discontinuities"

If all forms of income (including gains) and all taxpayers were subject to identical and fully symmetrical tax rules, the opportunities for impermissible tax avoidance would largely vanish. For example, if dividends and interest were subject to the same tax

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[52] As the term implies, "deferral" schemes are aimed at postponing the payment of a tax liability. The value of a deferral depends upon the "time value of money" and is generally quite significant, particularly in a comparatively high interest rate environment like South Africa. For example, at a 10% discount rate, the present value of a R100 000 liability drops to just R35 554 if that liability can be postponed for ten years. In essence, a taxpayer receives the equivalent of an interest-free loan from the government for the duration of the deferral scheme.

[53] Differences in emphasis have emerged in various studies. Thus, for example, Cordes and Galper have focused upon deferral, conversion, and "leverage" – the use of borrowed funds, particularly on a non-recourse basis, to finance abusive tax schemes. Cordes, JJ and Galper, H "Tax Shelter Activity: Lessons from Twenty Years of Evidence" (1984) 38 *National Tax Journal* 305. In another variation, Jeffrey Waincymer has identified seven main types of tax avoidance techniques: (1) the conversion of taxable gains to non-taxable gains; (2) the deferral of taxable gains; (3) the utilisation of tax shelters; (4) the prepayment of expenses; (5) the use of intermediary entities that are taxed at differential rates; (6) income splitting; and (7) offshore transactions. Waincymer, J, op. cit. n 44, at p. 255.

treatment (both in terms of rate and timing), schemes purporting to convert or substitute dividend income for interest income (or vice versa) would not yield any tax benefit. Similarly, if the granting of a deduction by one party were deferred until the amount in question were actually subject to tax in the hands of the counterparty to the transaction, schemes aimed at generating a deferral of tax liability would have little appeal (especially if the same rate applied to all taxpayers).

In reality, differences in treatment of different types of income and taxpayers are an inherent part of any tax system.[54] These differences exist for several reasons. Tax laws typically employ a number of simplifying conventions to address various considerations such as complexity, administrability, and liquidity.[55] In addition, tax laws frequently contain distinctions that can be manipulated, such as the distinction between debt and equity or the distinction between revenue and capital gain. Other differences arise from the imposition of different tax regimes for different types of taxpayers, such as pension or retirement funds. In addition, Parliament may provide tax benefits to taxpayers to encourage certain activities, creating additional differences in treatment.[56]

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[54] For a general discussion of these problems and their implications for a so-called "flat tax" system, see Kay, J "Flat Tax Falls Down on Income Definition" *Business Day* (9 Feb. 2005) at p. 11.

[55] Warren, Jr., AC "Financial Contract Innovation and Income Tax Policy", (1993) 107 *Harvard Law Review* 461, at p. 462.

[56] J Waincymer has neatly summarised the relationship between common "inconsistencies" or "discontinuities" in income tax systems and the type of avoidance transactions they typically engender:

> "Regardless of the social desirability or otherwise of any deviation from economic norms, such deviations induce others to arrange their affairs so as to utilise the provisions for their own ends. Progressive rates of taxation encourage income-splitting techniques; tax expenditures in favour of activities deemed worthy of encouragement, lead to the creation of tax-inspired shelters; preferential or tax-free status to capital gains, encourages commercial gains to be described as such; administrative necessities such as limiting the taxing exercise to a particular period, encourage manipulations of the timing of deductions and receipts of income streams; those jurisdictions which prefer to tax beneficiaries rather than controllers of income streams, encourage the use of discretionary trusts and other partial alienations".

Waincymer, J, op. cit. n 44, at p. 248.

5.3. The Concept of "Tax Arbitrage"

In finance, "arbitrage" is a means of profiting from a mismatch in prices. "Tax arbitrage", by contrast, involves attempts to manipulate and exploit inconsistencies and discontinuities in the tax system to generate tax savings.[57]

A Report by the New Zealand Committee on Experts on Tax Compliance has identified three conditions that need to be present for tax arbitrage or impermissible tax avoidance to exist. The first is a "difference between the effective marginal tax rates on economic income". The second is an "ability to exploit differences in tax by converting high-tax activity into low-tax activity". The third is that the high-tax "income must come back in a low-tax form".[58]

In many ways, tax arbitrage boils down to nothing more than an attempt to have it both ways. As mentioned above, the parties to a financing arrangement may try to structure it so that the payments by the borrower are fully deductible rental payments, while the payments received by the lender are treated as a combination of non-taxable principal repayments and taxable interest. In short, a high-tax item – rent – is partially converted into a no-tax item – the return of principal. Similarly, in a convertible loan scheme, the arrangement is structured to create an inflated interest expense deduction for the borrower, while eliminating those inflated amounts for tax purposes before they are received by or accrue to the lender. The explosion in new financial instruments over the past 25 years has only worsened the problem.

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[57] As AC Warren Jr. notes, the term is "generally used to describe transactions that involve tax advantages, but no other financial consequences, for the taxpayer". Warren, Jr., AC, op. cit. n 55, at p. 471. Tax arbitrage can occur either in a domestic or a cross-border context. "In the simplest terms, cross-border tax arbitrage refers to a situation in which a taxpayer or taxpayers rely on conflicts or differences between two countries' tax rules to structure a transaction or entity with the goal of obtaining tax benefits (for example, reduced or no taxation) overall". DM Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79. UK Inland Revenue has recently defined tax arbitrage as the "exploitation of differences between or within national tax codes". "Budget 2005: Avoidance through Arbitrage" Rev. 18 (16 March 2005), at para. 5.

[58] New Zealand *Report of the Committee of Experts on Tax Compliance: Chapter 6 – Tax Mitigation, Avoidance and Evasion* (Wellington: NZ Government Printer, 1999) (hereinafter "NZ Committee of Experts") at para. 6.22. As the Committee further explained: "The high-rate taxpayer may be able to divert income to a low-rate taxpayer or convert highly-taxed income into a lowly-taxed form. But this is pointless unless the high-rate taxpayer can be recompensed in a lowly-taxed form for diverting or converting his or her income into a low-tax category". Naturally, the anticipated tax benefit "must also exceed the transaction costs".

6. Abusive Avoidance Schemes

In a sense, impermissible tax avoidance can thus be seen as an attempt to defer or eliminate a potential liability by manipulating or exploiting perceived "inconsistencies" or "discontinuities" in the tax system through various "tax arbitrage" techniques. This section focuses specifically upon features and characteristics that can be found in many of the most aggressive schemes.

6.1. No Mechanical Definition or Bright-Line Test

Following a tremendous amount of study and critical analysis devoted to this topic internationally, there has been a growing realisation that a single mechanical definition of abusive avoidance schemes is simply not possible. Such schemes "appear in the guise of Proteus".[59]

6.2. Common Characteristics

Nonetheless, there has been a growing recognition that many of the most abusive avoidance schemes share common attributes – what have sometimes been called the "hallmarks" or "badges" of avoidance. These characteristics include: (1) the lack of economic substance (usually resulting from pre-arranged circular or self-cancelling arrangements); (2) the use of tax-indifferent accommodating parties or special purpose entities; (3) unnecessary steps and complexity; (4) inconsistent treatment for tax and financial accounting purposes; (5) high transaction costs; and (6) fee variation clauses or contingent fee provisions.[60] Schemes possessing most, if not all, of these characteristics are referred to herein as "abusive avoidance schemes".

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[59] Testimony of Lubick, DC, Assistant Secretary of the United States Department of the Treasury (Tax Policy), before the Senate Finance Committee (27 April 1999).

[60] Other characteristics could include significant marketing activities by promoters, which has been a serious issue, for example, in both Australia and the United States, and an involvement of taxpayers in activities outside their normal areas of expertise. Film and plantation schemes are typical examples of the latter, both in South Africa, *see* ITC1496 (1990) 53 SATC 229, and elsewhere. The list is not a mechanical "checklist". Various schemes may have some, but not all, of these characteristics.

6.2.1. Lack of Economic Substance

One of the most important characteristics of abusive avoidance schemes is the lack of economic substance. In many abusive avoidance schemes, the taxpayer purports to make a substantial investment. This investment, however, is largely an illusion. Through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary.[61]

In any investment, risk and return are related – the greater the risk, the greater the return. As a consequence, insofar as most abusive avoidance schemes typically involve little or no economic risk, they typically offer little or no opportunity for pre-tax gain.[62] Rather, the "return" to the "investor" takes the form of the significant tax benefits promised by the arrangement. In this manner, "a negligible pre-tax profit is transformed into a significant after-tax return".[63] Indeed, the mismatch between a limited (or non-existent) potential for pre-tax profit and the promise of very significant tax benefits is often a good indicator of an abusive avoidance scheme.

6.2.2. Use of Tax-Indifferent Accommodating Parties or Special Purpose Entities

Most abusive avoidance schemes also involve the use of accommodating parties or special purpose entities. Thus, as Lord Diplock has observed: "The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years . . . involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master-mind".[64]

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61 Circular cash flows were the common denominator, for example, in a variety of compulsory convertible debt schemes in the structured finance area that were targeted through amendments to section 24J in the Revenue Laws Amendment Act, Act No. 32 of 2004. For a general discussion of these schemes, see Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004, pp.20 – 23 and section 10.2 below.

62 Indeed, in many cases, the purported pre-tax profit is actually less than the transaction fees and costs. In other examples, the transactions actually produce pre-tax losses.

63 *The Problem of Corporate Tax Shelters*, op. cit. n 19, at p. 15.

64 IRC v Burmah Oil Co. Ltd [1982] STC 30 (HL) at p. 32. A special purpose entity (or special purpose vehicle, as they are sometimes called) may be defined as a legal entity formed or established with a limited purpose or life and may include companies, partnerships, or trusts.

In the context of an abusive avoidance scheme, the accommodating party is typically "tax indifferent". Such parties may include foreign persons, partnerships, trusts, pension funds, and taxpayers that can either generate offsetting deductions to absorb any income they derive from their participation in a scheme or utilise existing assessed losses. In practice, these parties typically receive a fee (often in the form of an above-market return on investment) for the service of absorbing income or otherwise "selling" their tax-advantaged status to the other participants in the scheme.

The role played by these tax-indifferent parties becomes clear when it is recognised that "the tax system has a built-in sort of fail-safe mechanism . . . [that] stems from the fact that the parties to an agreement often find themselves in an adversary position when it comes to tax planning".[65] A larger deduction for one party, for example, typically means greater income for the other. Tax-indifferent parties, by design, work to disable and defeat that mechanism. In South African planning circles, these tax-indifferent parties are sometimes referred to as "washing machines", an apt description of their true role in these schemes.

6.2.3. Unnecessary Steps and Complexity

Abusive avoidance schemes are often mind-numbingly complex. There are several reasons for this. These schemes often require the completion of certain formalistic steps to claim the desired tax result. In so-called "bare dominium" schemes, for example, promissory notes evidencing future rental obligations are typically discounted through a tax indifferent party in order to enable the financing party to avoid tax on the full amounts received (while the borrower in the transaction continues to claim deductions for the full amount of the "rent"). Steps may also be

[65] Kruger, D and Scholtz, W, op. cit. n 26, at p. 1.

inserted to prop up a claim of business purpose.[66] Similarly, a complex structure may be used to disguise the true nature of a scheme or "as a device to cloak the tax shelter transaction from detection".[67] More cynically, promoters may even deliberately add complexity for its own sake in order to justify higher professional fees.[68]

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[66] The cynicism with which promoters manufacture "business purposes" to defend schemes against anticipated challenges was revealed during a recent investigation by the US Congress into the marketing of abusive tax shelters by KPMG, one of the "Big Four" accounting firms. During 1998, KPMG had formed an internal working group charged with creating a new tax shelter product, called "OPIS", to replace an existing tax shelter product, "FLIP", being sold by the firm. According to an internal e-mail, the change was needed because the FLIP product was a potential "tax disaster". In particular, in order to generate the wished-for tax benefits, a purchaser of this tax "product", *inter alia*, had to buy a stock warrant in a Cayman Islands company that "was really illusory and stood out more like a sore thumb, since no one in his right mind would pay such an exorbitant price for such a warrant". See generally United States *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals – Four KPMG Case Studies: Flip, OPIS, BLIPS, and SC2,* Report by the Minority Staff of the Permanent Subcommittee on Investigations, Committee on Government Affairs, US Senate (2003) (hereinafter "*U.S. Tax Shelter Industry*").

These misgivings, however, did not stop KPMG from marketing FLIP, nor did it stop an attorney who was a member of that working group from issuing an opinion letter concluding that FLIP was "more likely than not" to survive a challenge by the IRS. Sheldon Pollack, a professor of business law and an expert on tax shelters at the University of Delaware, has observed that the e-mail in question reveals "much about how these guys put together their 'products' with an eye toward avoiding detection" and the degree to which they strain "to add some tiny bit of 'economic substance' and 'business purpose' to the whole phony arrangement". Pollack, S, quoted in Braverman, P "Still in the Shadows" *The American Lawyer* (1 October 2003).

The US affiliate of KPMG has recently issued a public apology, taking full responsibility for the unlawful conduct by certain of its former partners and expressing deep regret over the activities that occurred over a six year period from 1996 through 2002, and has just agreed to pay a US$ 456 million fine in settlement of criminal proceedings against it in connection with those activities. Criminal proceedings against certain individuals followed. See n 136 below.

Nor was the US affiliate of KPMG alone. The final report of the Senate Subcommittee also examined the role of two other "Big Four" accounting firms, a number of prominent law firms, and several international financial institutions in connection with such activities. United States, *The Role of Professional Firms in the U.S. Tax Shelter Industry: Report prepared by the Senate Permanent Subcommittee on Investigation of the Committee on Homeland Security and Governmental Affairs* (13 April 2005).

[67] *The Problem of Corporate Tax Shelters* op. cit. n 19, at p. 16. Indeed, these efforts to hide or disguise various aspects of these schemes in order to avoid detection or to mislead or confuse the revenue authorities is deeply troubling and begins to blur the traditional line between evasion and avoidance. Nor is such behaviour limited to the United States, as the following observations by Lord Browne-Wilkinson in CIR v McGuckian [1997] 3 All ER 817 (HL) make clear: "Thereafter there followed a long period during which the Inland Revenue sought to discover what had taken place. There was a prolonged correspondence between them and Mr. Taylor [the taxpayer's tax consultant] *who took every step to obfuscate what had happened and obstruct the revenue in discovering the true facts*" (emphasis supplied). As noted above, "engagement in an avoidance scheme can encourage taxpayers to be economical with the truth". Freedman, J "Defining Taxpayer Responsibility . . ." op. cit n. 26, at p. 349 (discussing the Tax Law Review Committee, *Tax Avoidance* (IFS, London, 1997) para. 1.24).

[68] See Bankman, J "The New Market in Corporate Tax Shelters" (21 June 1999) 83 Tax Notes 1775, at p. 1781 ("A client may simply be unwilling to pay millions for a clever reading of the tax law

The complexity of these schemes, coupled with the lack of any realistic possibility of a meaningful pre-tax profit, has led one expert to describe the typical abusive avoidance scheme as nothing more than "a deal done by very smart people that, absent tax considerations, would be very stupid".[69]

6.2.4. Inconsistent Treatment for Tax and Financial Accounting Purposes

In keeping with global trends, listed companies in South Africa appear to be placing a larger premium on tax savings, at least to the extent that these savings result in an increase in reported earnings per share. A corollary of this development has been a tendency by management to view the tax department as a "profit centre" within the firm.

In short, there has been an increasing emphasis on keeping a company's reported effective tax rate (i.e., the ratio of its income tax liability to its profits for financial accounting purposes) low and in line with the rates reported by competitors.[70] In order to do this, it is necessary to invent transactions in which the tax treatment varies from the financial accounting treatment. Thus, "structuring a transaction that results in either a deduction [for tax purposes] without a financial accounting charge or financial accounting revenue without the concomitant imposition of tax can be viewed as a real coup by the tax manager".[71]

This trend has clear implications for corporate governance. SARS' experience has been that shareholders rarely understand how far their companies are going to avoid

– even if the shelter around which the idea is built can save the client many times that fee . . . 'You can have the greatest shelter in the world, and clients won't pay for it if it is too simple,' notes one promoter. 'I've rejected a lot of great ideas for that reason.")

69 Herman, T "Tax Report" *Wall Street Journal* (10 Feb. 1999) at A-1 (Comments of Professor Michael Graetz). Peter Millet, QC, has expressed similar sentiments in the UK: "By the 1970s, sophisticated tax avoidance had reached such heights of artificiality and absurdity, that many schemes, brilliantly conceived and executed by leading practitioners, cried aloud for the simple man's reaction: 'Don't be silly!'" Millet, P, QC "Artificial Tax Avoidance: The English and American Approach" (1986) 6 *British Tax Review* 327, at p. 334.

70 In the South African context, for example, this emphasis on effective tax rates can be seen in the websites for a number of major professional firms offering tax planning services, particularly in the context of "international tax planning".

71 New York State Bar Association (Tax Section), *Report on Corporate Tax Shelters* (10 May 1999).

and, in extreme cases, evade tax. Even more concerning are those cases where members of the board either did not know or did not wish to know how far their financial colleagues were going.[72]

6.2.5. High Transaction Costs

Given the Byzantine complexity of many abusive avoidance schemes and the development and marketing costs often incurred by promoters, it is not surprising that fees tend to be extremely high. In a recent film scheme, for example, the fee paid to the promoter actually exceeded the amount that went to the film producer. In other financing transactions, fees can easily run into the millions.

6.2.6. Fee Variation Clauses and Contingent Fee Arrangements

In addition to the high fees, many promoters, particularly in the structured finance area, include fee variations clauses in their agreements in order to insulate themselves from any tax risk. Thus, for example, one scheme involved a R145 million sale and leaseback financing arrangement with a five year term. This relatively straightforward transaction ultimately came to involve at least seven major participants, multiple special purpose vehicles (including a trust, a special purpose company, and a partnership), more than a dozen pre-arranged and interlocking steps, each represented by a detailed and lengthy legal agreement, and multiple circular flows of cash – all in order to generate inflated capital allowances of some R95 million for the promoter. If successful, part of the value of these allowances was to be passed on to the seller/lessee in the form of lower interest rates; if not, the rates were to be reset to market.[73]

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[72] There has been less and less tolerance for such attitudes in the wake of the many recent corporate accounting scandals, notably those involving Enron, Tyco and Parmalat. See generally Parker, A "Directors Warned to Look at Company Tax Plans", *Financial Times* (26 Jan. 2004) ("Directors must pay greater attention to tax planning and consider whether aggressive schemes will fall foul of authorities, according to the Organisation for Economic Co-operation and Development"). In this regard, Gabriel Makhlouf, the former chairperson of the OECD's Committee on Fiscal Affairs, has emphasised that "it is important that boards understand the extent to which tax planning undertaken on their behalf is aggressive or not, and what their home tax authority's attitude to it might be".

[73] The fees charged in connection with this transaction, over and above the interest on the actual financing provided, exceeded R8 million.

Alternatively, firms may enter into contingent fee arrangements with their clients. In these arrangements, the size of the fee depends upon the size of the tax benefits. Thus, for example, a promoter might arrange to receive a fee equal to 30% of the net tax benefits generated by a scheme. If the scheme generates tax savings of R10 million, the promoter would receive a fee of R3 million.

6.3. Other Aspects

Two other aspects of many abusive schemes are the use of new, complex financial instruments and "tax haven" arrangements. A detailed discussion of these subjects is beyond the scope of this Paper.[74] The following is just a brief overview of these topics.

6.3.1. New Financial Instruments

Increasing deregulation of financial markets, both in South Africa and throughout the world, has resulted in an explosion of sophisticated and often extraordinarily complex new financial instruments. Although differences in approach exist, these new instruments are often divided into three broad categories. The first consists of "derivatives"[75] and includes instruments such as futures, options, swaps, and Forward Rate Agreements, as well as Caps, Collars and Floors. The second consists of so-called "hybrid" financial instruments and would include items such as convertible and perpetual debt instruments.[76] The third consists of "synthetic instruments", which

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[74] The tax issues raised by new financial instruments typically need to be addressed through comprehensive legislative schemes, such as those in New Zealand and Australia. Similarly, the tax issues raised by tax haven arrangements need to be addressed in the first instance by controlled foreign company rules such as those in section 9D of the Act. In both cases, general anti-avoidance rules play a role by policing and protecting the basic lines drawn by Parliament.

[75] Derivatives include "those instruments which are in essence based on the value of a primary instrument but are not themselves primary instruments". OECD, *Taxation of New Financial Instruments*, (Note by Working Party No. 6) (15 December 1993) at p. 4. In more general terms, a "derivative" would include any financial instrument "whose value derives, as its name implies, from the value of an underlying asset or underlying reference rate or index". Group of Thirty, *Global Derivatives Study* 28 (1993).

[76] OECD, *Taxation of New Financial Instruments*, op. cit. n 75, at p. 4. Similarly, Tim Edgar defines a "hybrid instrument" as the "combination of two or more separate instruments in one legally distinct instrument". Edgar, T "Some Lessons from the Saga of Weak-Currency Borrowings" (2001) *Canadian Tax Journal* 1, at p. 6.

generally involve the combination of two or more legally distinct instruments to replicate the cash flow pattern associated with another legally distinct instrument.[77]

These new financial instruments have made it possible for promoters to mimic almost perfectly the risks and returns attributable to more traditional financial instruments such as equity shares or "plain vanilla" debt, without incurring, at least in theory, the tax consequences typically associated with them.[78] This situation, in turn, has presented almost unprecedented "'opportunities for 'pure tax avoidance' in the sense that a tax-preferred legal form can be substituted for another form without compromising important non-tax considerations".[79]

6.3.2. Tax Haven Arrangements

Tax havens present another major problem for revenue authorities across the globe.[80] It is difficult to overstate the size of this problem. Recent estimates of total assets

77 Ibid. As the OECD has also noted, the situation is further complicated by developments and refinements in respect of traditional debt instruments, including, for example, things like "'junk' bonds, deep discount bonds, note issuant facilities and revolving underwriting facilities as well as various forms of commercial paper". OECD, *Taxation of New Financial Instruments*, op. cit. n 75, at p. 4.

78 Victor Thuronyi of the International Monetary Fund has provided a clear and concise explanation of the challenges for existing tax regimes presented by new financial instruments:

> "Financial innovation upsets existing categories because it is possible to convert one type of income or instrument into another or into a combination of different types which are often treated differently for tax purposes. Financial instrument A may be equal to B + C, but where the tax treatment of A is not the same as the tax treatment of the combined instrument B and C, given differences in character of income, timing, and source, tax planning opportunities can arise and the income tax ends up being applied inconsistently to economically equivalent positions".

Thuronyi, V, Senior Counsel (Taxation), International Monetary Fund, *Taxation of New Financial Instruments*, paper presented at the Ad Hoc Group of Experts on International Cooperation in Tax Matters, Tenth Meeting, Geneva Switzerland 2001. Thus, as Tim Edgar has stated, "a tension exists between the reality of financial equivalences recognized by capital markets and the specified differences in tax treatment for certain conventional instruments embodied in the existing income tax system". Edgar, T "Some Lessons . . . " op. cit. n 76, at p. 5.

79 Ibid. at p. 16 (footnote omitted).

80 There is not a universally accepted definition of "tax haven". The OECD has developed four basic factors to identify such jurisdictions: (a) whether a jurisdiction imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence. . . . (b) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction; (c) lack of transparency and (d) the absence of a requirement that the activity be substantial . . ." OECD, *Harmful Tax Competition*, op. cit. n 17, at para. 52.

held in tax haven jurisdictions have ranged from four to eight trillion US dollars, with annual revenue losses to other countries in excess of 50 billion US dollars (R312,5 billion).

To a large extent, tax havens typically attract "geographically mobile activities, such as financial and other services, including the provision of intangibles".[81] Thus, the focus is typically upon the formation of entities like captive insurance companies, captive finance subsidiaries and intangible property holding companies. In many cases, the establishment of these vehicles involves little or no change in business or commercial practice for the participating company, but can generate significant, on-going tax savings.[82]

7. International Experiences and Responses

In order to provide a benchmark against which both the South African situation and the effectiveness of section 103 in combating abusive avoidance schemes and other impermissible tax avoidance can be measured, this section provides a brief overview of the recent experiences with, and responses to, these problems in six different countries: Australia; Canada; New Zealand; Spain; the United Kingdom; and the United States. The first three countries each have GAARs that are similar in concept, and to a lesser extent, form, to section 103. The remaining three countries, Spain, the United Kingdom, and the United States, do not.

7.1. Australia

7.1.1. Historical Background

A GAAR has been a part of the Australian tax landscape almost from the start.[83] Prior to 1981, it was found in section 260 of the Income Tax Assessment Act (ITAA).[84]

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81 Ibid.

82 On a positive note, both the OECD and the EU have made some significant inroads in this area, both in respect of commitments by tax haven jurisdictions to transparency and effective exchange of information and in respect of the elimination harmful preferential tax regimes in member countries. See generally OECD, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD: February 2004).

83 Speech by Pagone, J, *General Anti-Avoidance Provisions in Australia* (2002) at p. 1.

Section 260 was very broad on its face. Not surprisingly, perhaps, it was subject to a series of judicial decisions that severely limited its scope.[85] These decisions, in turn, prompted more and more aggressive behaviour by taxpayers and promoters, culminating in the so-called "Bottom of the Harbour" scandal.[86]

7.1.2. Current Provisions

Section 260 was replaced in 1981 by Part IVA of the ITAA.[87] Part IVA was intended to overcome the difficulties with the prior law and to provide "an effective general measure against the tax avoidance arrangements that – inexact though the words may in legal terms be – are blatant, artificial or contrived".[88]

Part IVA has three basic requirements. The first is that there must be a "scheme".[89] The second is that the taxpayer must derive a tax benefit from that scheme.[90] The third is that the scheme must have been entered into for the sole or dominant purpose of obtaining a tax benefit.[91]

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84 As Mr Justice Pagone notes, section 260 had antecedents "dating to at least 1915 and probably 1895". Ibid.

85 Ibid. at p. 2.

86 Waincymer, J, op. cit. n 44, at p. 248.

87 A copy of the current Australian GAAR is attached as Annexure B.

88 *Income Tax Laws Amendment Bill (No 2) 1981: Explanatory Memorandum* (Canberra: AGPS, 1981) at p. 2. This emphasis upon the artificiality or contrivance has been reflected in the subsequent case law as well. For example, in FC of T v Spotless Services Ltd, (1996) 34 ATR 183 at pp. 194-195, McHugh J observed that: "The facts of the present case show much more than a switch of investments resulting in a tax benefit. The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme".

89 A "scheme" is generally defined as "(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and (b) any scheme, plan, proposal, action, course of action or course of conduct". Section 177A(1). The term specifically applies a "unilateral scheme, plan, proposal, action, course of action or course of conduct". Section 177A(3).

90 Section 177C. The definition of tax benefit is very broad and includes, *inter alia*, the incurral of a capital loss during a year of assessment and the allowance of a foreign tax credit.

91 Section 177D.

This third requirement is generally the "critical question".[92] It requires an "objective determination" based upon eight tests or factors set forth in section 177D – and only those eight factors.[93] Broadly speaking, the factors fall into three overlapping sets: the first concerning how the scheme was implemented (factors one through three); the second concerning its effects (factors four through seven); and the third concerning the nature of any connection between or among the parties to the scheme (factor eight).[94] In applying these factors and determining whether Part IVA applies, "the scheme must be compared with the probable alternative".[95]

The Australian Tax Office recently summarised the workings of Part IVA as follows –

> "The moral is that the outcome under Part IVA cannot be manipulated by tactics. The conclusion whether Part IVA applies has been made an objective one: it is a matter for ultimate decision by the courts. The Commissioner cannot manipulate it to produce an outcome favourable to the revenue by disregarding the context of a scheme, but neither can a taxpayer prevent the application of Part IVA to the steps inserted into transactions solely to obtain a tax benefit by 'burying' them, or embedding them, in a wider transaction."[96]

It is also clear that a taxpayer "cannot succeed in defending a Part IVA assessment by reliance upon a subjective intention not to obtain a tax benefit". [97]

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92 FC of T v Hart, [2004] HCA 26; 2004 ATC 4599; 55ATR 712.

93 Australia *Tax Office Comments on the Operation of Part IVA* (17 March 2005) at p. 4. These eight tests may be summarised as follows: (1) the manner in which the scheme was implemented; (2) its form and substance; (3) the timing of the scheme; (4) the result which would be achieved by the scheme, but for Part IVA; (5) any change in financial position of the relevant taxpayer arising out of the scheme; (6) any change in the financial position of any other person; (7) any other consequences for the relevant taxpayer or any other person connected with the scheme; and (8) the nature of the connection between or among parties to the scheme.

94 Ibid. at p. 5.

95 Ibid. at p. 9 (footnote omitted).

96 Ibid. at p. 12. See also FC of T v Consolidated Press Holdings, 2001 ATC 4343; Pagone, J, op. cit. n 84, at p. 14 ("the impermissible anti-avoidance purpose may be found notwithstanding that the decision being taken by those entering into the transaction may bear the character of a 'rational commercial transaction'").

97 Pagone, J, op. cit. n 83, at p. 18.

7.1.3. Effectiveness

Following a somewhat slow and shaky start,[98] Part IVA has proven to be a significant improvement over its predecessor, particularly in combating aggressive mass-marketed tax avoidance schemes.[99]

7.2. Canada

7.2.1. Historical Background

For many years, Canada possessed a rudimentary anti-avoidance provision in the form of section 137 of the Canadian Income Tax Act (CITA). A 1984 decision by the Canadian Supreme Court expressly rejecting the adoption of a judicially developed business purpose test,[100] together with a subsequent announcement by Revenue Canada that it would issue advance rulings in respect of transactions lacking any business purpose, encouraged "taxpayers and their advisers [to become] increasingly aggressive".[101] A serious shortfall in corporate revenues ensued and ultimately led to the enactment of a new GAAR, the current section 245 of the CITA.

7.2.2. Current Provisions

The application of section 245 involves three steps.[102] The first is "to determine whether there is a 'tax benefit' arising from the 'transaction'".[103] The second is "to

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98 The Australian High Court did not issue a decision involving Part IVA until 1994, some 13 years after its enactment. In that decision, while the Court found that a "tax benefit" was present, it nonetheless concluded that the taxpayer assessed was not the taxpayer that had obtained it. FC of T v Peabody, (1994) 28 ATR 334. The Commissioner was also unsuccessful before the Full Federal Court in attempts to apply Part IVA to certain sale and leaseback schemes. FC of T v Metal Manufacturers Ltd [2001] ATC 4152; Eastern Nitrogen Ltd v FC of T [2001] ATC 4164.

99 See, e.g., FC of T v Spotless Services Ltd (1996) 34 ATR 183; FC of T v Consolidated Press Holdings 2001 ATC 4343; FC of T v Hart [2004] HCA 26; 2004 ATC 4599; 55 ATR 712.

100 Stubart Investments Ltd v the Queen [1984] CTC 294; 84 DTC 6305 (SCC). For a general discussion of the background to and fallout from the Stubart case, see Arnold, BJ, "The Canadian Anti-Avoidance Rule" in *Tax Avoidance and the Rule of Law*, op. cit. n 7, at pp. 223-224.

101 Ibid. at p. 224. Revenue Canada was the predecessor to the Canadian Revenue Authority.

102 Canadian Trustco Mortgage Co v Canada, 2005 SCC 54 (19/10/05), at para. 17; Matthews v Canada, 2005 SCC 55 (19/10/05), at para. 31.1. These two very recent cases represent the first decisions by the Supreme Court of Canada interpreting section 245. The taxpayer prevailed in Canadian Trustco, while the CRA prevailed in Matthews. In both instances, the Supreme Court of Canada affirmed decisions by the lower courts.

determine whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being 'arranged primarily for bona fide purposes other than to obtain a tax benefit'".[104] The third is "to determine whether the avoidance transaction is abusive under s. 245(4)".[105] In general, a transaction is considered to be an "abusive transaction" if that transaction would "result directly or indirectly in a misuse of the provisions of the [CITA] or an abuse having regard to the provisions of the [CITA], other than [section 245], read as a whole".[106]

Taxpayers bear the burden of proof in respect of the first two requirements.[107] "from a practical perspective", however, it is "for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated, when the provisions of the Act are interpreted in a textual, contextual and purposive manner".[108] Thus, "the practical burden of showing that there was abusive tax avoidance lies on the Minister".[109] Given the generally

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103 Canadian Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 17. As is the case under the Australian GAAR, the terms "tax benefit" and "transaction" are both very broadly defined. A "tax benefit" includes any reduction, avoidance, or deferral of tax or other amount payable under the CITA, as well as any increase in any refund of tax or other amount payable under the CITA. Section 245(1) CITA. A "transaction" is defined to include any "arrangement or event". Section 245(1), CITA. A copy of section 245 is attached as Annexure C.

104 Canadian Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 17. As the Supreme Court of Canada went on to explain, "[t]he function of this requirement is to remove from the ambit of the GAAR transaction or series of transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose". Ibid. at para. 21. In this context, section 245(10) extends the common law meaning of a "series of transactions" as described in cases such as Craven v White [1989] A.C. 398, p. 514, *per* Lord Oliver, so as "to include 'related transactions or events completed in contemplation of the series". Canadian Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 25 and 26. In general, this second requirement involves a "factual inquiry" in which "the possibility of different interpretations of events must be objectively considered". Ibid. at para. 29.

105 Canadian Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 17.

106 Section 245(4), CITA. This requirement involves a two-part inquiry. The first is "to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose". Canadian Trustco Mortgage Co. v Canada, 2005 SCC 54, at para. 44. This inquiry requires "a contextual and purposive approach . . . in order to find a meaning that harmonizes the wording, object, spirit and purpose of the provisions of the *Income Tax Act*". Ibid. at para. 47. The second is "to examine the factual context of a case in order to determine whether the avoidance transaction defeated the object, spirit or purpose of the provision in issue". Ibid at para. 55. Thus, the "GAAR will not apply to deny a tax benefit where it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively". Ibid. at para. 62.

107 Ibid. at para. 63.

108 Ibid. at para. 65.

109 Ibid. at para. 69.

factual nature of these requirements, where “the Tax Court judge has proceeded on a proper construction of the provisions of the *Income Tax Act* and on findings are supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error”.[110]

7.2.3. Effectiveness

Despite some initial success, subsequent court decisions have displayed an attitude that, in one commentator’s view, “will inexorably render the rule largely ineffective . . .”[111] One issue has been a tendency by the courts to conclude that “the purpose of any particular transaction in a series [of transactions] could not differ from the overall purpose of the series”.[112] Taken to an extreme, this approach would preclude the application of the GAAR to an extraneous set of contrived steps inserted into a larger transaction, so long as that larger transaction had a legitimate business purpose. In addition, the courts have generally refused to invoke the GAAR except where the Canadian Revenue Authority can show that the “avoidance transaction” has violated a “clear and unambiguous policy” under the relevant statutory provisions or the CITA as a whole.[113] In general, these decisions reflect a cautious, if not hostile, attitude toward the GAAR by some judges, who have described the provision variously as “an extreme sanction”, a “heavy hammer”, and the “ultimate weapon”.[114]

7.3. New Zealand

7.3.1. Historical Background

General anti-avoidance rules in New Zealand can generally trace their history back to section 108 of the Land and Income Tax Act of 1954. These provisions were superseded by section 99 of the New Zealand Income Tax Act (NZITA) of 1976, which were in turn superseded by sections BG 1 and GB 1 of the NZITA of 1994.

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[110] Ibid. at para. 66.7.

[111] Arnold, BJ “The Long, Slow Steady Demise of the General Anti-Avoidance Rule” (2004) *Canadian Tax Journal* 488.

[112] Ibid. at p. 494.

[113] Ibid. at pp. 496 – 503.

[114] Ibid. at pp. 489 – 491.

7.3.2. Current Provisions

The current GAAR is found in sections BG 1 and GB 1 of the NZITA of 2004.[115] Section BG 1 generally provides that a tax avoidance arrangement is void against the Commissioner and authorises the Commissioner to counteract any "tax advantage" obtained by a person from such an arrangement.

The terms "arrangement", "tax avoidance" and "tax avoidance arrangement" are all broadly defined. "Arrangement" means "an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect".[116]

The term "tax avoidance" is defined to include –

> "(a) directly or indirectly altering the incidence of any income tax;
>
> (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax;
>
> (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax".[117]

In addition, because the definition uses the verb "includes" rather than "means", the definition is not exhaustive. Thus, an arrangement may "entail tax avoidance even if not falling directly within any of (a), (b) or (c)".[118]

Finally, "tax avoidance arrangement" is defined as any arrangement, "whether entered into by the person affected by the arrangement or by another person, that directly or indirectly –

> (a) has tax avoidance as its purpose or effect; or

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[115] A copy of the current New Zealand GAAR provisions is attached as Annexure D. Certain relevant definitions are also found in section OB 1 of the NZITA of 2004.

[116] Section OB 1, NZITA 2004.

[117] Section OB 1, NZITA 2004.

[118] Miller (No 1) v CIR (1997) 18 NZTC 13,001 (HC) at p. 13,033.

(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental".[119]

The determination is an objective one that is to be made "by reference to the arrangement itself and not subjectively in terms of motive".[120] The language in clause (b) was added to the definition in 1974 and was intended to make it clear that an arrangement could not be excluded from the purview of the provision simply because, in the words of Lord Denning, it is "capable of explanation by reference to ordinary business or family dealings".[121] For purposes of this provision, "a 'merely incidental' purpose or effect is something which follows from or is necessarily and concomitantly linked to, without contrivance, some other purpose or effect".[122]

As in other jurisdictions, there has been recognition of "the tension between taxpayers arranging their affairs effectively and the need to protect the tax system from avoidance abuse".[123] Accordingly, there is an acknowledgement that the GAAR "should not be applied to override the specific provisions of the Act if to do so would defeat rather than promote the statutory purpose".[124] The "purpose of [the GAAR] is not to defeat the purpose of the legislation, but to protect the legislation from frustration".[125]

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119 Section OB 1, NZITA 2004.

120 Ibid. Thus, the "proper focus is on assessing the degree of economic reality associated with a given transaction. This focus is contrasted with any artificiality, contrivance, or the relative extent to which the transaction appears to exploit the statute in direct pursuit of benefits". Ibid.

121 Newton v FC of T [1958] 2 All ER 759 (PC) at p. 764. *Newton's* case was an Australian case involving former section 260 of the ITAA of 1936, a predecessor to the current Australian GAAR found in Part IVA. See generally *NZ Exposure Draft* op. cit. n 12, at para. 3.4.11 – 3.4.16. Thus, while it is still "necessary to predicate tax avoidance in the ordinary sense of positively determining the purpose or effect of tax avoidance", it is no longer necessary to limit "the inquiry to overt acts which fall outside the scope of 'ordinary business or family dealings'". Ibid. at para. 3.4.16.

122 Ibid. at para. 3.4.34.

123 Ibid. at para. 4.2.14.

124 Ibid. at para. 4.2.17.

125 Ibid. at para. 4.2.18.

7.3.3. Effectiveness

Court decisions have been somewhat mixed. In Accent Management Ltd,[126] for example, the New Zealand High Court held that a complex forestry investment scheme constituted tax avoidance under the New Zealand GAAR.[127] By contrast, in Peterson v CIR, [128] the Privy Council, over a strong dissent by two of its members, recently overturned a decision by the New Zealand High Court that had applied section 99 of the NZITA of 1976 to a film scheme.

7.4. Spain[129]

On 1 July 2004, Spain enacted a new "Conflict of Tax Law" provision to combat abusive tax avoidance.[130] The wording of this new provision "is designed to extend the scope of application to include other cases not foreseen in the provisions of the old GTA, such as reducing the tax assessment basis or tax burden".[131] Another objective

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126 Accent Management Ltd & Ors v CIR (2005) 22 NZTC 19027 (20 December 2004).

127 The scheme in question involved many of the common characteristics of abusive avoidance schemes, including the lack of economic substance, undue complexity, the use of special purpose vehicles and /or accommodating parties, the use of hybrid instruments, the involvement of tax haven jurisdictions, and investments by taxpayers in activities outside of their normal business activities or areas of expertise. The case also illustrates the tremendous resources that are required in order to combat such schemes, on what amounts to a case-by-case basis. In particular, the case involved testimony by some 17 expert witnesses, with the court's final decision running to over 400 paragraphs in length.

128 [2005] UKPC 5 (28 February 2005). The scheme involved non-recourse financing, together with a circular flow of funds. Unlike section 24F of the Act, the applicable New Zealand provisions did not contain an explicit "at risk" requirement.

129 Spain is similar to a number of other countries in Continental Europe with general anti-avoidance rules based upon the basic notion of "abuse of law" or *fraus legis*. The doctrine is also sometimes referred to as "abuse of rights" or *abus de droit*. In Germany, for example, section 42 of the General Tax Code provides that "legal constructions that are inappropriate to achieving the economic result sought by the taxpayer can be disregarded for tax purposes". Thuronyi, R *Rules in OECD Countries to Prevent Avoidance of Corporate Income Tax* at s. 1.e. "Many specific anti-avoidance rules also exist". Dörfler, O *Germany*, Paper Presented at American Bar Association – Section of Taxation, Economic Substance Around the World (Washington D.C., May, 2004) at p. 29. As one British practitioner has recently observed, due at least in part to these doctrines, "there is a clear gap between European and British attitudes to tax planning. We are constantly told that things which are regularly done in the UK would be unthinkable in other European countries". Cordara, R QC, "Anti-Avoidance – The Courts' Experiment" (May 2002) Tax Adviser.

130 Section 15 of the General Taxation Act (Act No. 58/2003) (GTA). A copy of this law is attached as Annexure E.

131 Carreno, F and Gonzales Tato, M "Spain's New Antiabuse Law" (2 August 2004) Tax Notes International, at p. 443.

"is to do away with the subjective or intentional element in the old GTA (such as 'for the purpose of evading payment of tax')".[132] Among other things, the statute is designed to counteract acts or transactions that are "notoriously crafty or improper for achieving the result obtained".[133]

7.5. United Kingdom

"The United Kingdom is unusual among developed countries in having neither a statute nor an established legal principle to counter tax avoidance in general".[134] Like Canada and the United States, however, the United Kingdom has adopted new disclosure requirements in respect of potentially abusive tax avoidance schemes. Promoters and in some instances users of certain tax schemes are obliged to disclose details of those arrangements when they are first available for implementation.

In addition, the United Kingdom has continued to battle new avoidance schemes through specific anti-avoidance provisions. In the 2005 Budget, for example, three new sets of broad anti-avoidance rules were introduced targeting avoidance through arbitrage, double tax relief avoidance, and financial avoidance.[135] Separate specific provisions were also announced to address various abusive film schemes.

7.6. United States

The United States has also moved against impermissible tax avoidance on a variety of fronts, including administrative initiatives, legislative changes, and litigation, including criminal proceedings against a number of "abusive tax shelter" promoters.[136]

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132 Ibid.

133 Section 15.1.a. of the GTA.

134 United Kingdom *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document* s. 4.3.

135 A number of the financial avoidance schemes being targeted were apparently identified through the UK's new disclosure regime, which shows that such a regime can work in practice.

136 As noted above, the KPMG's US affiliate recently agreed, *inter alia*, to pay a US$ 456 million fee in order to settle criminal probe launched by the US Justice Department. See n 66 above. This follows settlements of similar actions against the US affiliates of Ernst & Young and PricewaterhouseCoopers. In related proceedings, US federal prosecutors have also brought criminal indictments against 17 former KPMG executives, as well as an outside lawyer and an investment

One thrust of the US effort involves detailed disclosure requirements in respect of the promotion and sale of potentially abusive corporate tax shelters. In addition, Congress has recently enacted provisions aimed at the promoters of abusive schemes, including increased penalties, greater transparency in respect of transactions presented to taxpayers, and the granting of new authority to the Treasury Department to enjoin offending conduct. These moves reflect a Congressional belief that much of the tax shelter problem "is driven by the supply of tax shelters created by promoters and advisors rather than demand from taxpayers".[137]

Unlike their counterparts in other former English colonies, the courts in the United States have developed a variety of robust judicial doctrines to counter abusive avoidance schemes. These doctrines include the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, the assignment of income doctrine and the economic substance doctrine. Although distinct, these doctrines are closely related and generally reflect a willingness of the American courts to grapple with business and commercial realities in the tax arena. As commentators from outside the United States have noted, these doctrines reflect a view that "[t]ax is an intensely practical subject",[138] as well as a broader "common law tradition of legal analysis in which common sense plays an important role in the interpretation of facts and rules".[139]

adviser, which accuse them of attempting to defraud the Internal Revenue Service "'by devising, marketing, and implementing fraudulent tax shelters, by preparing and causing to be prepared, and filing and causing to be filed with the I.R.S. false and fraudulent individual income tax returns containing fraudulent tax shelter losses, and by fraudulently concealing from the I.R.S. those shelters'". Glater, JG "Indictment Broadens at KPMG" *NY Times* (18 October 2005). Among other things, the indictments also allege that "'[a]s [the defendants] well knew, the tax positions taken were not more likely than not to prevail against an I.R.S. challenge if the true facts were known to the I.R.S. . .'". Ibid. Prosecutors have described the case "as the largest criminal tax case ever filed" in the United States. Ibid.

[137] Deloitte, *The American Jobs Creation Act of 2004: Overview of Domestic and International Provisions* (2004) at p. 30.

[138] Millet, P, QC, op. cit. n 69, at p. 331.

[139] Vanistendael, F "Judicial Interpretation and the Role of Anti-Abuse Provisions in the Tax Law" in *Tax Avoidance and the Rule of Law* op. cit n 7, at p. 144.

As a result of these various efforts, one authority recently noted: "No one is selling the kind of junk that was being sold in 1999 . . . The market has pretty much dried up".[140]

8. Section 103 of the Act

Against this backdrop of international experience, the remaining sections turn specifically to the South African situation and seek to identify the major issues that have arisen under section 103, to discuss countervailing concerns that are often raised in opposition to a stronger GAAR, and to set forth and explain proposed amendments to the Act that attempt to address and balance those issues and concerns.

The South African GAAR was introduced in 1941 as section 90 of the Income Tax Act of 1941. Since that time, it has been amended on several occasions, most recently in 1996.

8.1. Brief Overview

Under current law, before section 103 may be applied, the Commissioner must be satisfied that four elements exist. In the case of a transaction "in the context of business", these requirements may be summarised as follows –

1. There must be a "transaction, operation or scheme" (the Scheme Requirement);
2. The transaction must result in the avoidance, reduction or postponement of a tax (the Tax Effect Requirement);
3. The transaction must have been entered into or carried out in a manner not normally employed for business purposes, other than obtaining a tax benefit, having regard to the circumstances (the Abnormality Requirement);[141] and
4. The transaction must have been entered into solely or mainly for the purpose of obtaining a tax benefit (the Purpose Requirement).

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140 Weber, J "Demolishing Shaky Tax Shelters" *BusinessWeek Online* (11 July 2005).

141 Outside "the context of business", this Requirement is satisfied by any transaction, operation or scheme entered into or carried out "by means or in 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." Section 103(1)(*b*)(i)(*bb*). The Abnormality Requirement also applies to any transaction, operation or scheme that "has created rights or obligations which would not normally be created between person's dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question." Section 103(1)(*b*)(ii).

A "tax benefit" includes "any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner".[142] Once the Tax Effect Requirement is satisfied, a rebuttable presumption arises that the sole or main purpose of the transaction was to obtain a tax benefit.[143]

If a transaction falls within the ambit of section 103, the Commissioner is empowered to determine the liability for tax as if the transaction had not been entered into or carried out, or, alternatively, "in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction".

8.2. The Margo and Katz Commissions

When the Margo Commission issued its report in 1986, it recognised that section 103 as it then stood suffered from serious deficiencies.[144] In particular, its Report stated:

> "The test of abnormality presents difficulties. If a particular form of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its utilization becomes normal. The concept of abnormality must therefore be qualified to this extent".

Parliament, however, did not act upon that recommendation.

In 1995, the Katz Commission again recognised that the abnormality requirement was the "Achilles heel" of section 103 and reiterated the concerns of the Margo Commission:

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[142] Section 103(7). The other laws administered by the Commissioner are the Customs and Excise Act, the Estate Duty Act, the VAT Act, the Transfer Duty Act, the Stamp Duties Act, the Uncertificated Securities Tax Act, the Skills Development Levies Act, the Unemployment Insurance Contributions Act, and the Tax on Retirement Funds Act.

[143] Section 103(4).

[144] Prior to the 1996 amendment, the Abnormality Requirement required the Commissioner to be satisfied that, having regard to the circumstances under which the transaction was entered into or carried out, the transaction either (1) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or the carrying out of the transaction in question, or (2) had created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction of the nature of the transaction in question.

> "the test of abnormality presents difficulties for revenue in that if a particular form of transaction is widely used for tax avoidance purposes, it may gain a commercial acceptability to the extent that its utilisation becomes normal".[145]

The Katz Commission also identified a "further difficulty with the normality test" in that "there is ambiguity as to whether it is objective, that is whether there exists an objective test to be applied despite the context of specific circumstances".[146] In order to remedy these problems, the Katz Commission recommended that "where a transaction occurs in the context of trade, a business purpose test should be substituted for the normality test".[147]

Following the Katz Commission Report, Parliament amended section 103 to read in pertinent part as follows:

> "(1) Whenever the Commissioner is satisfied that any transaction, operation or scheme . . .
>
> (b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –
>
>> (i) was entered into or carried out –
>>
>> (aa) in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit . . ."

This language continues to be in effect today.

Critical commentary at the time of the amendment was generally unfavourable. For example, RC Williams noted:

> "In my view, the only clear terrain for the amended s. 103(1) to apply is where the particular transaction had no *bona fide* business purpose at

[145] *Third Interim Report of the Commission into certain aspects of the Tax Structure of South Africa* (28 Nov. 1995), para. 11.2.2.

[146] Ibid. at para.11.2.3.

[147] Ibid. at para. 11.5.8.

> all, only a tax benefit. There may be some highly artificial "tax schemes" which fall into this category".[148]

Another commentator, L Olivier, observed:

> "The purpose in amending section 103(1) of the act was to clarify some of the issues. The legislator did not succeed in this. Instead of addressing some of the existing problems, the amendment created even more problems and this is regrettable".[149]

To date, this amended version of the Abnormality Requirement has only been the subject of one unreported decision. The Court accepted, without deciding, the Commissioner's argument that the amended Abnormality Requirement required that the transaction *in casu* be compared with the hypothetical model of a "normal" transaction and that the hypothetical model of the "normal" transaction should be determined by asking: How would business people generally, not motivated by tax considerations but rather by "*bona fide* business purposes", have structured the transaction. Cloete J, in finding that the transaction was "normal", relied upon the evidence of an expert who testified on behalf of the taxpayer.

8.3. Problems and Weaknesses

8.3.1. Not an Effective Deterrent

As noted at the outset, section 103 has proven to be an inconsistent, and at times, ineffective deterrent to abusive avoidance schemes and other impermissible tax avoidance.[150] For example, all of the schemes described in this Discussion Paper

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148 Williams, RC "The 1996 Amendments to the General Anti-Avoidance Section of the Income Tax Act" *SALJ* Vol. 114, Part IV, p. 675, at p. 682.

149 Olivier, L "Tax Avoidance: Options Available to the Commissioner for Inland Revenue" 1997 *TSAR* Vol. 4, p. 725, at p. 744.

150 Des Kruger and Wouter Scholtz provide a good picture of the troubled and sometimes turbulent waters in this area. Op. cit n 26, at pp. 229-230. On the one hand, they note, somewhat dryly, that there are "many accountants [who] seems to consider that the general anti-avoidance measures contained in the South African Income Tax Act are so potent and comprehensive that it is dangerous even to admire any transaction that has the effect of saving tax". On the other hand, they also observe that there are "certain officials in the Commissioner's department who believe that those same provisions are essentially ineffectually, except perhaps in the case of the most fanciful tax avoidance operations". The authors then conclude that the "law reports provide evidence in support of both attitudes, although, in one way or another, the Commissioner seems to be coming out on top, at the moment". Yet, on the very next page, they go on to state that "[r]egardless of existence of the general anti-avoidance provisions or a doctrine that seeks to determine the true intention of the parties,

were marketed following the enactment of the 1996 amendments. More important, aggressive and increasingly sophisticated schemes continue to be marketed today, largely by "boutique" financial institutions.

To be sure, SARS has improved its ability to detect and combat these schemes on audit. This process, however, entails a significant commitment of time and resources for both government and taxpayers.[151] In addition, the often lengthy battles that ensue frequently have a negative impact upon the relationship between SARS and taxpayers. Finally, despite the common features of most abusive avoidance schemes, the Commissioner is currently forced to proceed almost entirely on a case-by-case basis.[152]

8.3.2. "Abnormality" Requirement

The Abnormality Requirement itself suffers from two fundamental weaknesses. First, the tax world is not neatly divided into two types of arrangements, one for "*bona fide*" business transactions and the other for impermissible tax avoidance schemes. To the contrary, scheme promoters routinely "hijack" techniques that were originally developed for *bona fide* business purposes. Thus, for example, in the film industry, cash strapped independent film makers developed deferred payment arrangements, pursuant to which service providers would agree to postpone payment for some or all of their services until the films generated revenue, as a way to help finance their productions. Scheme promoters then abused this concept to inflate the cost of films in order to maximise any applicable film allowance. Similarly, finance leases and the discounting of promissory notes are both accepted types of *bona fide* business

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the plain fact is that a taxpayer can structure a transaction, operation or scheme which has the effect of avoiding tax, with a reasonable prospect of success in his endeavours". A GAAR that is only effective against sloppy, ill-advised or ill-conceived schemes is hardly an effective deterrent. In addition, the wide disparity of views in respect of the effectiveness of current section 103 is itself problematic, insofar as it is likely to contribute to uncertainty, misunderstanding and conflict.

[151] The recent New Zealand case, Accent Management Ltd & Ors v CIR (2005) 22 NZTC 19027 (20 December 2004), provides a vivid example of the time and effort that that is involved in challenging even a fairly blatant scheme under a GAAR, like the current section 103, with limited criteria to guide its application. Similarly, published reports indicate that the US Internal Revenue Service spent more than $2 million to litigate just one major anti-avoidance case, ACM Partnership v Commissioner of Internal Revenue, 157 F3d 231 (3rd Cir. 1998), affirming ACM Partnership v C.I.R., 73 T.C.M. (CCH) 2189.

[152] This problem is exacerbated by the practice of some promoters to limit the number of times they sell a particular scheme before they abandon or modify it.

arrangements. The problem arises when these components are put together in various schemes to create situations in which the borrower/lessee seeks to claim a deduction for its full "rental" payments while the lender/lessor seek to include only the "interest" component of those same payments in its income.

The second problem is closely related. Precisely because impermissible tax avoidance schemes hijack techniques that were originally developed for *bona fide* business transactions, it is relatively easy for promoters to "manufacture" plausible sounding "business purposes". Thus, for example, in various lease-in/lease out and "sale and buy-back" schemes, taxpayers have sought to achieve significant tax deferrals by accelerating payments in one leg of the transaction and deferring them in the other.[153] Promoters would typically contend that these payment terms are "normal", with accelerated payments, for example, reflecting concerns about a borrower's creditworthiness and deferred payments reflecting perhaps a party's projected future cash flows. In most cases, however, there is little or no evidence that the creditworthiness of the borrower was ever a serious consideration or that the payment terms ever varied due to a party's "projected cash flow profile".[154]

8.3.3. "Purpose" Requirement

The problems under the Abnormality Requirement are exacerbated by the current Purpose Requirement. As a threshold matter, the Purpose Requirement can only be met if obtaining a tax benefit is the sole or main purpose of a transaction. The term "main" has generally been construed to mean predominant. In a simple example, if a transaction has both a tax and a commercial purpose, the Purpose Requirement can be satisfied only if it can be proven that the tax purpose was the predominant one. Since most transactions in a business context have at least a colourable commercial rationale,[155] the Commissioner is placed in the difficult position of having to disprove a taxpayer's allegations through circumstantial evidence. In addition, under the

[153] The recipient of the accelerated payment would typically be a tax indifferent party. The effectiveness of many of these schemes has been limited through the enactment of section 23H.

[154] By contrast, pricing and payment terms in these arrangements do often vary depending upon the projected taxable income of the participants.

[155] The experience both here and abroad has shown the ease with which promoters can often devise or manufacture the requisite business purpose. See n 66 above.

current statute, following the Conhage case,[156] taxpayers have frequently argued that a commercial purpose, such as raising capital, for an overall transaction is sufficient to "inoculate" each and every step in it from challenge.

The difficulties encountered under the Purpose Requirement are compounded by the fact that it entails a subjective test – one that looks to the purpose the taxpayers purportedly intended to achieve when they carried out their scheme.[157] Consequently, as RC Williams has observed:

> "In essence . . . a taxpayer could with impunity enter into a transaction with the (subjective) sole purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner or in the rights and obligations which it created. Conversely, a taxpayer could with impunity enter into a transaction which was objectively 'abnormal' provided that he did not, subjectively, have the sole or main purpose of tax avoidance".[158]

8.3.4. Procedural and Administrative Issues

Two other concerns relate to uncertainties about the scope and application of section 103. First, as noted above, there is currently uncertainty about the extent to which section 103 may be applied to steps within a larger transaction or scheme. Second, there is also uncertainty about the Commissioner's authority to assert or apply section 103 "in the alternative" where another provision, such as section 11(a), is also in dispute. Both of these concerns are addressed in section 10 below.

9. Countervailing Concerns

Any attempt to strengthen the GAAR brings with it legitimate countervailing concerns. One is that such a move would result in increased uncertainty for taxpayers.[159] A second, and closely related, concern is that a stronger section 103 would inhibit innovative financial arrangements and/or interfere with legitimate

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156 CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391.

157 CIR v Louw 1983 (3) SA 551 (A), 45 SATC 113; SIR v Gallagher 1978 (2) SA 463 (A), 40 SATC 39.

158 Williams, RC, op. cit. n 148, at p. 675.

159 See, e.g., Orow, N, op. cit. n 48, at p. 3 ("The adoption of a general anti-avoidance rule has created significant scope for uncertainty in commercial dealings particularly in the context of corporate reorganisations and structured finance").

business transactions.[160] Almost inevitably, Black Economic Empowerment transactions are invoked as potential casualties in this regard. Thus, as Sir Ivor Richardson has aptly stated, a GAAR needs to chart a "middle course" that "recognise[s] that tax is an important and proper factor in the making of business decisions" while counteracting "arrangements which are outside the range of acceptable business and family practices".[161]

The third and perhaps most basic issue from both a practical and conceptual standpoint concerns the "uneasy tension" between a GAAR and the basic notion of the rule of law.[162] In this regard, Graeme Cooper has identified three separate ideas that may be involved here. The first is that taxes ought to be "imposed through a proper parliamentary process rather than through administrative discretion, or even judicial discretion".[163] The second is that "having enacted laws, the government and the administration must then comply with the laws that parliament passed".[164] As Mr. Cooper notes, "[t]hese two ideas recognise that parliament has extensive power to say what the law is, subject of course to any substantive constitutional prohibitions".[165] In short, "government having stated through a law the tax consequences of various transactions and events is not free either to vary those consequences or to amplify them with the benefit of hindsight".[166]

The third idea is that "what parliament enacts must be a law – it must have the characteristics that make a law . . . In a tax context, this idea is expressed by the

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160 Ibid. at p. 6 ("Financial innovation and engineering has strained many of the traditional approaches and concepts. Lack of uniform theory to guide the design and application of taxation rules to structured or hybrid financial arrangements has resulted in haphazard and inconsistent rules and outcomes. Often taxation principles were punitive in effect and designed to discourage and stifle financial innovation").

161 Quoted in *2001 New Zealand Master Tax Guide* para. 33-090 (Auckland: CCH Publishing, 2001).

162 Meyerowitz, D "Tax Avoidance Legislation" *The Taxpayer* (April 2005) Vol. 54, No. 4, at p. 61.

163 Cooper, GS "Conflicts Challenges and Choices . . ." op. cit. n 15, at p. 15.

164 Ibid.

165 Ibid.

166 Ibid. at p. 17.

argument that taxpayers should be able to predict in advance (or at the very least, identify in retrospect) and with a sufficient degree of certainty, the tax consequences of their actions according to rules created through the Parliamentary processes referred to".[167] Thus, to the extent that a GAAR grants (or appears to grant) the government unfettered authority to recast a transaction for tax purposes or to vary the applicable tax consequences, the provision can be seen as authorising a form of taxation by administrative decree or analogy – or even worse, the imposition of what may amount to an incontestable tax.[168]

Certainty and predictability are undeniably important in the tax arena. However, as both Lord Templeman and Richardson, P have observed, they are "not absolute values".[169] There has also been a growing recognition that a GAAR cannot be overly precise if it is to be effective.[170]

More important, any uncertainty created by a stronger GAAR would leave the overwhelming majority of ordinary taxpayers and ordinary business transactions unaffected. As one commentator has noted:

> "The root cause of unpredictability is aggressive tax planning by taxpayers and their advisers, who seek to apply a wide variety of provisions of the code and regulations in contexts in which they were never intended to be applied to produce results they were never intended to produce.
>
> The level of predictability is not unmanageable in the vast bulk of cases involving transactions in the ordinary course of the taxpayer's business. Unpredictability abounds and is inevitable, however, in cases involving transactions outside the ordinary course of business,

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167 Ibid. at pp. 15-16.

168 Ibid. at p. 16.

169 CIR v BNZ Investments [2002] 1 NZLR 450; CIR v Challenge Corporation Ltd [1987] AC 155.

170 In this regard, the Carter Commission in Canada has "warned that drafters cannot foresee all the possible avoidance transactions and that specific rules might create roadmaps for new tax planning". Cooper, GS "Conflicts Challenges and Choices . . ." op. cit. n 15, at p. 33, discussing the *Report of the Royal Commission on Taxation, volume 3* (Ottawa, Queen's Printer, 1966) at pp. 554-56. See also *NZ Committee of Experts*, op. cit. n 58, at para. 6.47 ("If a general anti-avoidance provision is to be effective, it cannot be precise").

> especially transactions designed specifically to produce tax losses vastly disproportionate to before-tax losses and transaction costs".[171]

Indeed, as Lord Greene succinctly put it more than half a century ago: "It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers".[172] At a more fundamental level, it is important to emphasise that while the "legal right of the taxpayer to decrease the amount of what would otherwise be his taxes, or all together avoid them, *by means which the law permits*, cannot be doubted",[173] the success or failure of any scheme ultimately depends upon the tax laws themselves and section 103 is one such law.[174]

As discussed more fully below, the proposed amendments attempt to balance these concerns in two major ways. First, they would establish for the first time a non-exclusive list of factors to be used in determining "abnormality". Second, it is anticipated that the Advance Tax Ruling System would be modified as it is phased in to permit taxpayers to obtain greater guidance and certainty in this area.

10. Proposed Changes

To paraphrase Lord Wilberforce,[175] Parliament and SARS are not obliged to stand still while the techniques of tax avoidance progress and are technically improved. Globalisation, deregulation, technological change and the movement of professional firms toward the marketing of tax "products" (or, in the post Sarbanes-Oxley world, tax "ideas" or tax "strategies") have driven impermissible tax avoidance and abusive avoidance schemes to new levels of complexity and sophistication. On another level, the inherent "discontinuities" that exist in any tax system, together with an almost endless supply of new financial instruments, make it clear that specific anti-avoidance measures alone can never solve the problem. Yet section 103 remains substantially the same today as it was in 1959.

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171 M McMahon, Jr., "Economic Substance, Purposive Activity, and Corporate Tax Shelters" (25 February 2002) 94 *Tax Notes* 1017.

172 Lord Howard de Walden v IRC [1942] 1 All ER 287.

173 Gregory v Helvering [1935] 293 US 465.

174 See n 12 above.

175 WT Ramsay Ltd v IRC [1982] AC 300.

The proposed amendments would make five changes to existing law. First, they would introduce a non-exclusive set of factors to be considered in determining abnormality for schemes in the context of business and create a rebuttable presumption of "abnormality" where certain of those factors are present. Second, they would require the Purpose Requirement to be determined objectively by reference to the relevant facts and circumstances. Third, they would clarify that section 103 may be applied to steps within a larger scheme (and that a general business purpose for a larger scheme is not sufficient to shield each and every step in that scheme from review). Fourth, they would authorise the Commissioner to apply section 103 in the alternative. Fifth and finally, separate proposed amendments would introduce new penalties for scheme promoters and for taxpayers that substantially underreport their income.

10.1. International Benchmarking

In comparison with its counterparts in Australia, Canada and New Zealand, section 103 fairs reasonably well with respect to what might be called the "necessary conditions" for its application. Thus, each GAAR has two basic requirements. The first is that there must be some sort of arrangement or scheme, and the second that the arrangement or scheme in question must result in impermissible tax avoidance or an impermissible tax benefit.

The South African courts have generally adopted broad and workable definitions for both of these requirements under section 103. Thus, they have taken a practical approach toward the definition of the term "scheme" and, more importantly, have recognised that all of the elements of a scheme "need not be in contemplation from the very outset".[176] Similarly, the courts have generally given a broad interpretation to the notion of "tax avoidance":

> "The ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability . . . The Afrikaans rendering of the phrase is 'wat die uitwerking het dat dit aanspreeklikheid vir die betaling van 'n belasting . . . op inkomste vermy'. The ordinary meaning of 'vermy' is 'ontwyk' or 'voorkom'.

[176] CIR v Louw 1983 (3) SA 551 (A), 45 SATC 113 at p. 145; Meyerowitz v CIR 1963 (3) SA 863 (A), 25 SATC 287.

> That wider meaning is the meaning to be ascribed to the phrase, unless it is clear that a different meaning is intended. . . .
>
> The same applies in regard to the reference to 'postponing liability for any tax . . . on income'. The more obvious way of postponing such a liability would be to postpone the accrual or receipt of the income".[177]

The courts have also wisely declined to draw a "vertical line . . . somewhere along that wide range of meanings in order to delimit the connotation of 'an anticipated liability'".[178] Accordingly, while there are still disputes from time to time in respect of the meaning and scope of these two requirements, amendments to them are not believed to be necessary at this time.

The weaknesses in section 103 become apparent, however, when the "sufficient conditions" for its application are considered. In each of the other countries surveyed, the sufficient condition is a single, objective "purpose" test.[179] By contrast, section 103 has two separate and distinct conditions – the Abnormality Requirement and the subjective Purpose Requirement. As discussed above, each of these Requirements has caused its own problems and anomalies. In combination, they have contributed significantly to the uncertainty in this area and to the inconsistent, and at times ineffective, performance of section 103 as a deterrent to impermissible tax avoidance.

Finally, section 103 also falls short in respect of the uncertainties regarding its applicability to steps within a larger scheme and the Commissioner's authority to apply it as an alternative basis for assessment.

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177 Smith v CIR 1964 (1) SA 324 (A), 26 SATC 1 at pp. 12 - 14. In response to the charge that such an interpretation would lead to the "absurdities" identified by Watermeyer CJ in CIR v King 1947 (2) SA 196 (A), 14 SATC 184, Steyn CJ explained:

> "It is not common practice for a taxpayer to divest himself completely and for all time by a transaction, operation or scheme displaying the abnormal characteristics mentioned in the section, of an income-producing asset or of the fruits of his labour, merely for the purpose of avoiding or postponing liability or reducing the amount thereof, without creating or retaining, as in the present case, the means of recovering the income, or a substantial portion thereof, in some form or another, not subject to tax or subject to a lesser tax, at some time in the future".

178 Hicklin v SIR 1980 (1) SA 481 (A), 41 SATC 179 at p. 193.

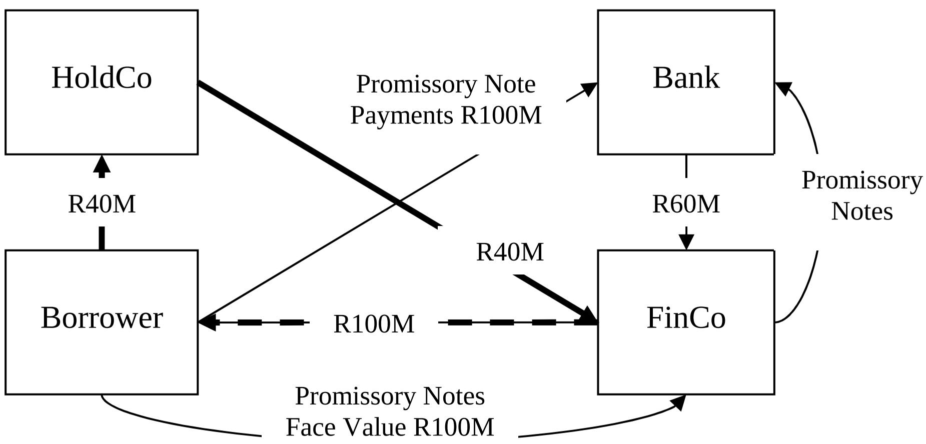
179 Thus, as discussed above, once the "necessary conditions" have been satisfied, the Australian GAAR applies if the "sole or dominant purpose" of the scheme is to obtain a tax benefit; the Canadian GAAR applies unless the transaction is undertaken or arranged "primarily for *bona fide* purposes other than to obtain a tax benefit"; and the New Zealand GAAR applies to an arrangement if tax avoidance is "one of its purposes or effects" unless that purpose or effect is "merely incidental".

10.2. Indicia of Abnormality

South Africa is unique among the countries surveyed in having a specific Abnormality Requirement. This Requirement, moreover, has long been recognised as the "Achilles heel" of section 103 and the problems with it have largely continued despite the 1996 amendments.

As discussed above, a major concern here is the need to pursue each abusive avoidance scheme on a case-by-case basis, even though their essential elements are identical. At the same time, as Lord Templeman observed, "every tax avoidance scheme involves a trick and pretence".[180] In South Africa, the trick and pretence often involve a circular flow of funds and a step involving a tax indifferent party. These elements often work in tandem. In a so-called compulsory convertible loan, for example, the circular flow of funds is designed to inflate the amount of the deduction for the borrower. The step through the tax indifferent party – or "washing machine" – is designed to eliminate that inflated amount before it becomes taxable in the hands of the lender.[181]

A convertible loan scheme, stripped to its essentials, is illustrated in the diagram below, with the circular cash flows shown in bold:



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[180] R v IRC *ex parte* Matrix Securities Ltd [1994] 1 WLR (HL) at p. 345C.

[181] As the New Zealand Committee of Experts on Tax Compliance has noted, a necessary condition for tax arbitrage is that "income must come back in a low-tax form." *NZ Committee of Experts*, op. cit. n 58, at para. 6.22. See discussion at n 62 above. In South Africa, the "washing machine" has typically performed that function.

In this scheme, Borrower wants to borrow R60 million for a ten-year term for legitimate business reasons. Bank, the true lender, proposes a scheme pursuant to which Borrower would instead “borrow” R100 million from FinCo, a tax-indifferent accommodating party. This inflated loan would be “repayable” in new shares to be issued by Borrower at the end of the loan in ten year’s time.[182] As part of the scheme, Borrower would immediately repay the extra R40 million via HoldCo,[183] while simultaneously issuing R100 million in Promissory Notes (PNs) to FinCo in respect of its future “interest” obligations under the inflated loan. Finally, FinCo would “discount” those PNs to Bank for R60 million.[184]

From an economic standpoint, Borrower has only borrowed R60 million and its true interest expense, in this example, would only be R40 million. As a result of the scheme, however, Borrower would seek to claim a deduction for R100 million in interest expense – the “interest” due under the R100 million “loan” and reflected in the PNs. FinCo, the “washing machine” in this transaction, would claim deductions in connection with its disposal of the PNs and the underlying loan that offset any income it receives, leaving it essentially neutral, both economically and tax-wise, except for any fee that it earned for participating in the scheme.[185] Finally, Bank would treat the PNs as an “instrument” for purposes of section 24J of the Act and seek to limit any taxable interest income to R40 million, the difference between the amount it “paid” for the PNs and total amount to be received in respect of them. In sum, Borrower would seek to claim deductions for R100 million in interest expense while Bank would seek to report only R40 million in interest income in connection with the same transaction.

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[182] The issuance of shares by a company generally does not result in the receipt or accrual of any income or gain by it under the Act.

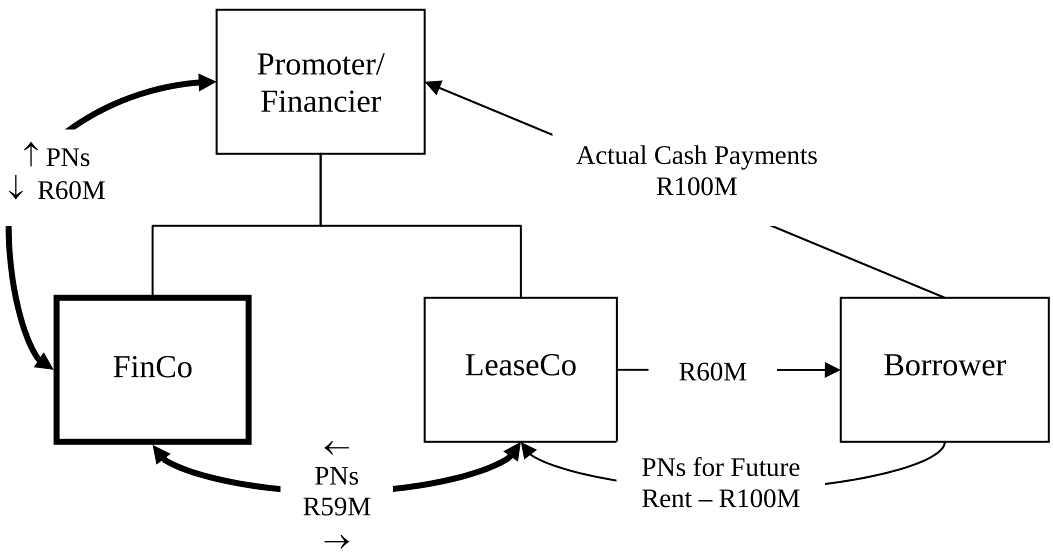
[183] This repayment is typically accomplished through two steps. First, Borrower would transfer the extra cash to HoldCo, for example, in pay for an existing inter-company loan or similar obligation. HoldCo would then enter into a prepaid forward purchase agreement with FinCo for the very same shares that are to be issued in ten year’s time to “repay” the loan. As can be seen, except for an instant in time, ownership of Borrower would remain completely unchanged as a result of this transaction.

[184] The numbers in this example have been simplified for purposes of illustration. The actual figures would depend upon present value calculations based upon the actual cash flows and prevailing interest rates at the time of the transaction.

[185] As the diagram illustrates, FinCo immediately receives back the R100 million it “loaned” to Borrower, with R40 million coming back from HoldCo and R60 million coming back from Bank.

"Washing machines" also appear in various finance lease schemes. In a business context, a borrower is normally entitled to deduct the interest, but not the principal, payable in connection with a loan. Similarly, a lender is typically subject to tax on that interest, but not the principal. In a finance lease, by contrast, the borrower/lessee is entitled to deduct its rental payments (which consist of both interest and principal), while the lender/lessor is generally subject to tax on those same rental payments.[186] In an abusive arrangement, however, the lessor and lessee typically use a "washing machine" to create a situation in which the lessee still gets a deduction for the full rental payments but the lessor is only subject to tax on the interest component.

A finance lease scheme, again stripped to its essentials, is illustrated below, with the participation of the tax-indifferent party shown in bold:



Again, Borrower only needs R60 million. In order to obtain a deduction for both the interest and principal, however, the parties structure the transaction as a finance lease. Borrower then immediately issues promissory notes (PNs) with a face value of R100 million in respect of its future rental obligations under the lease. LeaseCo then discounts those PNs to FinCo, which in turn discounts them to the Promoter. If all goes according to plan, Borrower will claim deductions for the full R100 million in

[186] Depending upon the circumstances, the lender/lessor may be entitled to an offsetting benefit in the form of capital allowances in connection with the underlying leased assets.

rent, while Promoter will only report R40 million as income – the difference between the amount it paid for the PNs and total amount to be received in respect of them.[187]

In practice, few schemes are ever as simple or straightforward as these examples. Indeed, most schemes are extraordinarily complex, and it can often require months of painstaking work simply to piece them together. It is not uncommon, moreover, for an arrangement to involve multiple circular cash flows and multiple tax indifferent parties, often located in tax haven jurisdictions. More important, there are endless ways that promoters can package and repackage the basic elements of these schemes. In some cases, like the film scheme in Annexure A, the "loan" proceeds may simply be returned to the promoter in the form of a long-term "deposit". In more sophisticated transactions, the proceeds may be paid to an accommodating party as a "guarantee" or an "insurance premium". Under the circumstances, establishing "abnormality" on a case-by-case basis is truly a Sisyphean task.

With these considerations in mind, the proposed amendments would create a *non-exclusive* list of factors to be considered in determining abnormality. These factors are –

> *(a)* the form and economic substance of the arrangement, or any step therein or part thereof;
>
> *(b)* the time at which the arrangement, or any step therein or part thereof, was entered into and the length of the period during which the arrangement, step or part was carried out;
>
> *(c)* the result in relation to the operation of this Act which would, but for the application of this section, have been achieved by the arrangement;
>
> *(d)* any circular flow of cash or assets between or among parties to that arrangement;
>
> *(e)* the participation of any tax indifferent party in that arrangement;

187 FinCo would typically report R1 million in income, based upon the difference between the amount it paid for the PNs and the amount it received for them. LeaseCo would typically enter into several related transactions to generate offsetting deductions against any income or gain incurred in connection with the transaction, thus leaving it in a tax neutral position.

(f) the inclusion of steps or transactions that offset or cancel each other, without a substantial effect upon the economic position of the parties;

(g) the inconsistent treatment of any items or amounts for tax purposes by parties to the arrangement (such as the treatment of a payment as a deductible interest expense by the payer and as an exempt dividend by the recipient);

(h) a failure by any parties to the arrangement to deal at arm's length (without having regard to whether the parties are connected persons in relation to each other), including paying more than market value for any assets or service involved in that arrangement;

(i) the lack of any change in the financial position of any person resulting from that arrangement;

(j) the absence of a reasonable expectation of pre-tax profit in connection with the arrangement after taking into account all costs and expenditure incurred in connection with the arrangement; or

(k) the value of the tax benefit that would have resulted from the arrangement, but for the application of this section, exceeds the amount of pre-tax profit reasonably expected in connection with that arrangement.

A tax-indifferent party would include any person that is not subject to the taxes imposed by the Act, as well as any person that participates in an arrangement in such a way that any amount derived by that person in connection with the arrangement is substantially matched or offset by expenditure or loss incurred in connection with the arrangement. The definition is intended to capture, *inter alia*, any party that plays the role of a "washing machine" in a scheme and specifically encompasses any company or other entity that is established specifically for the purpose of participating in an arrangement.[188] A rebuttable presumption of abnormality would also arise whenever any of the factors listed in (d) through (k), inclusive, are present. As can be seen, the proposed factors include but are not limited to many of the common characteristics of abusive avoidance schemes in South Africa and elsewhere.[189]

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188 It is anticipated that additional guidance in respect of application of these factors will be provided in the Explanatory Memorandum accompanying the final legislation.

189 A number of other approaches were also explored. One was to abandon the Abnormality Requirement entirely and adopt a single objective "purpose" test based upon the Australian and New

In the examples above, the circular flows of cash and assets, the participation of tax-indifferent parties, the inconsistent treatment of items for tax purposes by the parties to the arrangement, the lack of change in financial position in connection with the circular elements of the schemes, and the tax benefits produced (but for section 103) would all signify "abnormality" under the proposed amendment. This result would apply, moreover, irrespective of the mechanisms used to achieve the circular flows or the participation of the tax-indifferent party in the scheme. Thus, for example, the parties to a convertible loan scheme could not alter the result by substituting a married put/call arrangement for the forward purchase agreement or by having the borrower "repay" the loan in cash with the lender then "subscribing" for shares for the same amount.

The factors relating to circularity and tax-indifferent parties target two of the basic building blocks of abusive avoidance schemes. To borrow from the New Zealand Committee on Experts, these elements are typically employed to achieve the "third condition" that is necessary for impermissible tax arbitrage – the ability to convert high-tax activity into low- or no-tax activity.[190] Similarly, the factors relating to offsetting and self-cancelling arrangements and other transactions that have little or no impact upon the economic position of the parties apart from the anticipated tax benefits are directed at schemes in which taxpayers are simply trying to "game the system" by exploiting "discontinuities" or perceived loopholes in the tax law. In effect, the proposed factors are intended to make the application of section 103 as clear as possible, without being so specific that they open the door to new avoidance opportunities or provide a "roadmap" for new forms of impermissible tax avoidance.[191]

As a final note, concerns have occasionally been raised that the phrase "having regard to the circumstances" re-introduces an element of "subjectivity" into the Requirement.[192] The determination is objective in all cases, but still must be made

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Zealand models. Another was to develop new provisions, in addition to general anti-avoidance rule in section 103, to specifically target "circular" and "step" arrangements.

190 See discussion at section 5.3 above.

191 See n 30 and n 170 above.

192 See, e.g., Olivier, L, "Tax Avoidance . . ." op. cit. n 149, at p. 738.

with due regard to the actual facts and circumstances involved. For example, payment terms that might be appropriate for a borrower with a poor credit history are likely to be abnormal where the borrower actually has an excellent credit rating. The consideration given to particular circumstances, however, does not and is not intended to reopen the opportunity for an "everyone's doing it" defence to the Abnormality Requirement.

10.3. An Objective Purpose Requirement

The proposed amendments would also change the Purpose Requirement to an objective test in accordance with the practice in other countries. In particular, the proposed amendment would require the determination to be made "objectively by reference to the relevant facts and circumstances". The amendment is intended to preclude the anomalous results identified by RC Williams that could potentially arise under the current provisions.[193] It is anticipated – and intended – that it will be very difficult for a taxpayer to rebut the presumption of a "tax avoidance" purpose in any case in which a tax effect has been established and the taxpayer has been unable to rebut a presumption of "abnormality" arising under the proposed amendment to the Abnormality Requirement.

10.4. Application to Steps in a Larger Scheme

As noted above, there is uncertainty as to whether or not section 103 may be applied to discrete steps that are inserted in a larger transaction for tax avoidance purposes, where there is some business rationale for that larger transaction. While an affirmative answer is consistent with older case law,[194] dicta in the Conhage case[195] has been seized upon by many in the practitioner community as authority for a contrary view. The proposed amendment would resolve this issue by bringing South Africa into line with both Australia and New Zealand.

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193 Williams, RC, op. cit. n 148, at p. 675. See discussion in section 8.3.3 above.

194 See Meyerowitz v CIR, 1963 (3) SA 863 (A), 25 SATC 287, and ITC 1606, (1995) 58 SATC 328 (where parties which have been brought into the picture purely in order to give effect to the reduction of tax liability, the transaction can be seen in its entirety as being abnormal and not one at arm's length and such parties may be ignored and tax the income to whom it really belonged).

195 CIR v Conhage (Pty) Ltd 1999 (4) SA 1149 (SCA), 61 SATC 391.

10.5. Application in the Alternative

Again, as noted above, due to a conflict between a reported and an unreported decision, there is also uncertainty as to whether or not the Commissioner may apply section 103 in the alternative.[196] In many cases, there is often a threshold dispute in respect of the applicability of a specific provision. For example, given the complexity of many derivatives, an audit may well involve a very technical dispute as to whether or not a particular arrangement constitutes an instrument for purposes of section 24J. At the same time, the arrangement may be so artificial and contrived that the application of section 103 may also be appropriate (in the event that the arrangement does avoid section 24J on technical grounds). Permitting the Commissioner to raise section 103 as an alternative basis for an assessment, after giving proper notice to the taxpayer, simply makes sense from the standpoint of administrative and judicial economy and would bring South Africa into line with Australia, Canada, and New Zealand. It is therefore proposed that section 103 be amended accordingly.[197]

10.6. Penalties

Experience from other jurisdictions, including Australia, Canada, the United Kingdom and the United Sates, has shown that a significant portion of the tax avoidance problem is attributable to the aggressive marketing of abusive avoidance schemes by various promoters. At present, however, the Act does not contain any penalties specifically applicable to them. Given the lucrative fees involved and the extent to which promoters can protect themselves through devices like fee variation clauses, such penalties are an essential element of any effort to deter impermissible tax avoidance. In addition, separate amendments would also be proposed to introduce a new penalty that would be imposed in the event of a substantial understatement of income by a taxpayer.

[196] The reported decision is ITC 1625, (1996) 59 SATC 383 (Commissioner may not invoke section 103 in the alternative).

[197] In connection with this change, the references to the "Commissioner's satisfaction" would also be deleted from subsection (1).

10.7. Implementation and Related Issues

As noted above, it is anticipated that the Advance Tax Ruling System would be modified as it is phased in so as to permit taxpayers to obtain greater guidance and certainty in respect of the application of the new provisions. It is also anticipated that the Commissioner will develop and implement procedures to ensure their consistent and appropriate application. Changes to the Reportable Arrangement rules would also be made in order to capture transactions embodying the factors giving rise to a presumption of abnormality. Finally, as noted above, these provisions may provide the necessary and essential foundation for possible tax reform and simplification in the future, to the extent that they prove, in practice, to be an effective deterrent against, and remedy for, impermissible tax avoidance.[198]

11. Conclusion

As Lord Roskill declared over 20 years ago: "the ghost of the Duke of Westminster and of his transaction has haunted the administration of this branch of the law for far too long".[199] The honest, hard-working taxpayers of South Africa deserve better. More importantly, experience in other countries has shown that meaningful progress can be made.

The amendments proposed in this Discussion Paper are intended to create a more effective deterrent to impermissible tax avoidance and to do so as fairly and efficiently as possible. In the final analysis, it is this goal, rather than the contents of any specific proposal, that is paramount. It is hoped that this Discussion Paper will begin a healthy and constructive dialog on how best to reach that goal.

DISCLAIMER

This Discussion Paper is solely intended to serve the purpose of providing a basis and framework for discussion and should therefore not be used as a legal reference.

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198 As a final note, certain provisions currently found in section 103 that are not, strictly speaking, part of the general anti-avoidance rule itself, such as subsection 103(2) and 103(5), would be moved to other places in the Act.

199 Furniss v Dawson [1984] AC 474 at p. 515.

Cross-Border Film Schemes – An Example

The most recent generation of film schemes illustrate many of the common characteristics of abusive avoidance schemes. These schemes are designed to exploit the "film allowance" granted to film owners under section 24F of the Act, while at the same time fully insulating scheme participants from any actual commercial film risk.

The dynamics of these schemes can best be illustrated through a simplified example. Stripped to its essentials, the basic film scheme involves three basic parties: (1) a promoter/bank (the Promoter); (2) a partnership consisting of high net worth South African residents (the Partnership) that has been formed by the Promoter; and (3) a film producer, either domestic or foreign, that has completed a film (the Producer). For purposes of this example, it is assumed that the film cost R10 million to make.

The basic steps in the scheme may be summarised as follows –

1. The Producer enters into "pre-sale" agreements in respect of the film with *bona fide* distributors in the major markets for the film, usually North America and Europe.[200]

2. The Partnership agrees to purchase any residual "rights" in the film. Although these rights typically have little market value, the Partnership generally agrees to pay the Producer an amount equal to 100% of the film's production cost – in this example R10 million.[201]

3. The Partnership then borrows 80% of the purchase price from the Promoter.[202]

4. The Producer simultaneously agrees to license back these same residual rights from the Partnership for a term equal to the term of the loan.[203]

[200] Although the specific terms of these agreements may vary, they typically involve the sale of the primary distribution rights to the film in specified geographic areas.

[201] In an illustration of the non-commerciality of these schemes, one promoter in the United Kingdom has emphasised that "[i]t is in both the Seller's and the Buyer's best interest to obtain the highest possible purchase price for the film". For the Buyer, this simply inflates the tax deduction, the true object of the deal.

[202] The term of the loan typically ranges from 10 to 15 years, with the principal repayable at the end of the loan. The Partnership raises the remaining 20% of the purchase price through capital contributions from its partners. The goal here is to maximise the length of the deferral generated by the scheme.

[203] The license fee payments are generally pre-set to offset the interest expense incurred by the Partnership on the loan.

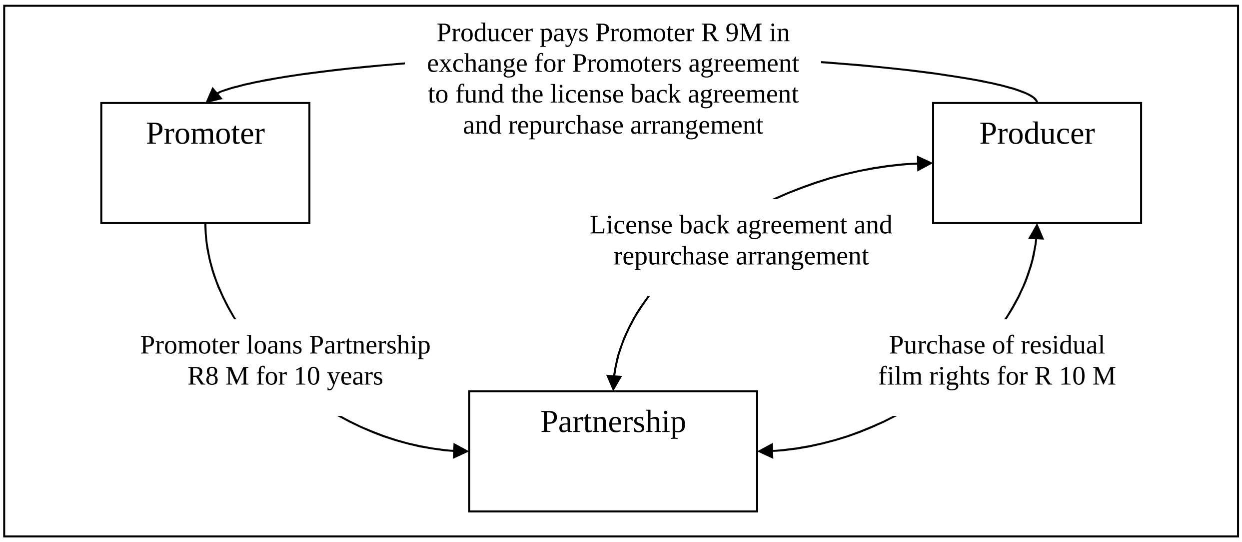
5. The Producer then enters into an arrangement with the Partnership to repurchase the residual films rights at the end of the license back agreement (typically for an amount equal to approximately 90% of the purchase paid by the Partnership).[204]

6. The Producer then enters into a "funding" or defeasance agreement with the Promoter.[205]

7. The Promoter then invests this "payment" from the Producer in a low-risk deposit account with terms that offset the loan agreement between the Promoter and the Partnership. As a result, the Promoter pays the interest earned on this deposit to the Producer, who in turn pays it to the Partnership (as the fee due under the license back agreement), who in turn pays it right back to the Promoter (in the form of interest on the loan).

8. At the conclusion of the loan, the Promoter pays the principal amount of the deposit to the Producer, who in turn pays it to the Partnership (in the form of the price due under the repurchase arrangement), who in turn immediately pays most of the amount right back to the Promoter (as repayment of the loan amount).

The major steps of this transaction are illustrated below.[206]



204 This repurchase price is also wholly unrelated to the projected or estimated market value of those rights. The repurchase arrangement, moreover, is usually disguised through the use of accommodating parties, special purpose vehicles and/or derivative financial instruments to avoid the application of section 24J.

205 Pursuant to this agreement, the Producer pays the Promoter an amount equal to the repurchase price due to the Partnership under the repurchase arrangement in exchange for the Promoter's promise to assume the Producer's obligations to the Partnership under the repurchase arrangement and license-back agreement.

206 As complicated as these steps may sound, they are quite simple compared to the abusive avoidance schemes actually seen in practice. An actual cross-border film scheme, for example, would be likely to use a number of special purpose vehicles located in tax havens, as well as complex derivatives to disguise the circular flows of cash.

On a pre-tax basis, the Partnership in this instance suffers a loss of approximately R1,1 million over the life of the investment. The partners, however, claim an immediate income tax deduction of R10 million. At the current 40% tax rate, that deduction translates into tax savings of R4 million – or an amount equal to twice their initial out-of-pocket investment of R2 million. This deduction would then be recouped, if at all, only at the end of the transaction.

Film schemes of this sort have been aptly described as nothing more than a "pretend" investment in the film.[207] At the inception of the transaction, the purported loan proceeds flow from the Promoter through the Partnership to the Producer and then immediately back to the Promoter. At the conclusion of the scheme, again, by pre-arrangement, the funds simply reverse their course, this time flowing from the Promoter through the Producer to the Partnership and then immediately back to the Promoter.

[207] Bardeen, WT and Shaw, C "Tax-Motivated German Financing of the U.S. Film Industry" (Spring 2004) Chazen Web Journal of International Business (Columbia University School of Business), at p. 5.

The Australian GAAR

SECTION 177A INTERPRETATION

177A(1) [Definitions]

In this Part, unless the contrary intention appears:

capital loss has the meaning given by subsection 995-1(1) of the *Income Tax Assessment Act 1997*.

foreign tax credit means a credit within the meaning of Division 19 of Part III.

"scheme" means:

(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(b) any scheme, plan, proposal, action, course of action or course of conduct;

["section 159TL rebate"] (Omitted by No 208 of 1992)

"taxpayer" includes a taxpayer in the capacity of a trustee.

177A(2) [Taxpayer]

The definition of "**taxpayer"** in subsection (1) shall not be taken to affect in any way the interpretation of that expression where it is used in this Act other than this Part.

177A(3) [Unilateral scheme]

The reference in the definition of "**scheme"** in subsection (1) to a scheme, plan, proposal, action, course of action or course of conduct shall be read as including a reference to a unilateral scheme, plan, proposal, action, course of action or course of conduct, as the case may be.

177A(4) ["Carrying out"]

A reference in this Part to the carrying out of a scheme by a person shall be read as including a reference to the carrying out of a scheme by a person together with another person or other persons.

177A(5) [Purpose of scheme]

A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is the dominant purpose.

177A(6) (Omitted by No 208 of 1992)

SECTION 177B OPERATION OF PART

177B(1) [Part not limited by other provisions]

Subject to subsection (2), nothing in the provisions of this Act other than this Part or in the *International Tax Agreements Act 1953* or in the *Petroleum (Timor Sea Treaty) Act 2003* shall be taken to limit the operation of this Part.

177B(2) [Division 16C excluded]

This Part shall not be taken to affect the operation of Division 16C of Part III or the operation of Schedule 2G.

177B(3) [Specific provisions to apply before Part IVA]

Where a provision of this Act other than this Part is expressed to have effect where a deduction would be allowable to a taxpayer but for or apart from a provision or provisions of this Act, the reference to that provision or to those provisions, as the case may be, shall be read as including a reference to subsection 177F(1).

177B(4) [Deduction otherwise allowable]

Where a provision of this Act other than this Part is expressed to have effect where a deduction would otherwise be allowable to a taxpayer, that provision shall be deemed to be expressed to have effect where a deduction would, but for subsection 177F(1), be otherwise allowable to the taxpayer.

177B(5) (Omitted by No 208 of 1992)

177B(6) (Omitted by No 208 of 1992)

SECTION 177C TAX BENEFITS

177C(1) [Obtaining a tax benefit]

Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to:

(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or

(b) a deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out; or

(ba) a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out; or

(bb) a foreign tax credit being allowable to the taxpayer where the whole or a part of that foreign tax credit would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out;

and, for the purposes of this Part, the amount of the tax benefit shall be taken to be:

(c) in a case to which paragraph (a) applies - the amount referred to in that paragraph; and

(d) in a case to which paragraph (b) applies - the amount of the whole of the deduction or of the part of the deduction, as the case may be, referred to in that paragraph; and

(e) in a case to which paragraph (ba) applies - the amount of the whole of the capital loss or of the part of the capital loss, as the case may be, referred to in that paragraph; and

(f) in a case where paragraph (bb) applies - the amount of the whole of the foreign tax credit or of the part of the foreign tax credit, as the case may be, referred to in that paragraph.

177C(2) [Exclusions]

A reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as not including a reference to:

(a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out where:

(i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act other than section 160ZP or 160ZZO of the *Income Tax Assessment Act 1997*) by any person, except one under Subdivision 126-B, 170-B or 960-D of the *Income Tax Assessment Act 1997*; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be; or

(b) a deduction being allowable to the taxpayer in relation to a year of income the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out where:

(i) the allowance of the deduction to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act or the *Income Tax Assessment Act 1997*, except one under Subdivision 960-D of the *Income Tax Assessment Act 1997*; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be; or

(c) a capital loss being incurred by the taxpayer during a year of income the whole or part of which would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out where:

(i) the incurring of the capital loss by the taxpayer is attributable to the making of a declaration, agreement, choice, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act or the *Income Tax Assessment Act 1997*) by any person, except one under Subdivision 126-B, 170-B or 960-D of the *Income Tax Assessment Act 1997*; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, notice or option to be made, given or exercised, as the case may be; or

(d) a foreign tax credit being allowable to the taxpayer the whole or a part of which would not have been, or might reasonably be expected not to have been, allowable to the taxpayer if the scheme had not been entered into or carried out, where:

(i) the allowance of the foreign tax credit to the taxpayer is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act; and

(ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised, as the case may be.

177C(2A) [Further exclusions]

A reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme is to be read as not including a reference to:

(a) the assessable income of the taxpayer of a year of income not including an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out where:

(i) the non-inclusion of the amount in the assessable income of the taxpayer is attributable to the making of a choice under Subdivision 126-B of the *Income Tax Assessment Act 1997* or an agreement under Subdivision 170-B of that Act; and

(ii) the scheme consisted solely of the making of the agreement or election; or

(b) a capital loss being incurred by the taxpayer during a year of income the whole or part of which would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out where:

(i) the incurring of the capital loss by the taxpayer is attributable to the making of a choice under Subdivision 126-B of the *Income Tax Assessment Act 1997* or an agreement under Subdivision 170-B of that Act; and

(ii) the scheme consisted solely of the making of the agreement or election.

177C(3) [Exclusions deemed attributable to declarations, etc]

For the purposes of subparagraph (2)(a)(i), (b)(i), (c)(i) or (d)(i) or (2A)(a)(i) or (b)(i):

(a) the non-inclusion of an amount in the assessable income of a taxpayer; or

(b) the allowance of a deduction to a taxpayer; or

(c) the incurring of a capital loss by a taxpayer; or

(ca) the allowance of a foreign tax credit to a taxpayer is taken to be attributable to the making of a declaration, election, agreement or selection, the giving of a notice or the exercise of an option where, if the declaration, election, agreement, selection, notice or option had not been made, given or exercised, as the case may be:

(d) the amount would have been included in that assessable income; or

(e) the deduction would not have been allowable; or

(f) the capital loss would not have been incurred; or

(g) the foreign tax credit would not have been allowable.

177C(4) [Application of para (1)(a) to schemes]

To avoid doubt, paragraph (1)(a) applies to a scheme if:

(a) an amount of income is not included in the assessable income of the taxpayer of a year of income; and

(b) an amount would have been included, or might reasonably be expected to have been included, in the assessable income if the scheme had not been entered into or carried out; and

(c) instead, the taxpayer or any other taxpayer makes a discount capital gain (within the meaning of the *Income Tax Assessment Act 1997*) for that or any other year of income.

177C(5) [General application of Part]

Subsection (4) does not limit the generality of any other provision of this Part.

SECTION 177CA WITHHOLDING TAX AVOIDANCE

177CA(1) [Application]

This section applies in relation to a particular amount if a taxpayer is not liable to pay withholding tax on an amount where that taxpayer would have, or could reasonably be expected to have, been liable to pay withholding tax on the amount if a scheme had not been entered into or carried out.

177CA(2) [Tax benefit]

For the purposes of this Part, if this section applies in relation to an amount, the taxpayer is taken to have obtained a tax benefit in connection with the scheme of an amount equal to the amount mentioned in subsection (1).

SECTION 177D SCHEMES TO WHICH PART APPLIES

177D This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where-

(a) a taxpayer (in this section referred to as the "**relevant taxpayer"**) has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and

(b) having regard to-

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) 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;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

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 in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).

The Canadian GAAR

245. (1) Definitions – In this section,

"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;

"tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount;

"transaction" includes an arrangement or event.

(2) 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.

(3) An avoidance transaction means any transaction

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

(4) For greater certainty, subsection 245(2) does 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.

(5) Without restricting the generality of subsection 245(2),

(*a*) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(*b*) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,

(*c*) the nature of any payment or other amount may be recharacterized, and (*d*) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

(6) Where with respect to a transaction

(*a*) a notice of assessment, reassessment or additional assessment involving the application of subsection 245(2) with respect to the transaction has been sent to a person, or

(*b*) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction,

any person (other than a person referred to in paragraph 245(6)(a) or 245(6)(b)) shall be entitled, within 180 days after the day of mailing of the notice, to request in writing that the Minister make an assessment, reassessment or additional assessment applying subsection 245(2) or make a determination applying subsection 152(1.11) with respect to that transaction.

(7) Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment or determination pursuant to subsection 152(1.11) involving the application of this section.

(8) On receipt of a request by a person under subsection 245(6), the Minister shall, with all due dispatch, consider the request and, notwithstanding subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection 245(6).

The New Zealand GAAR

BB 3 Overriding effect of certain matters

BB 3(1) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage from a tax avoidance arrangement.

BG 1 Tax avoidance

BG 1(1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

BG 1(2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

GB 1 Agreements purporting to alter incidence of tax to be void

GB 1(1) Where an arrangement is void in accordance with section BG 1, the amounts of assessable income, deductions, and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to—

> (a) such amounts of assessable income, deductions, and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
> (b) such amounts of assessable income and deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of assessable income, or of such part of the assessable income, as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

GB 1(2) Where any amount of assessable income or deduction is included in the calculation of taxable income of any person under subsection (1), then, for the purposes of this Act, that amount is not included in the calculation of the taxable income of any other person.

GB 1(2A) Without limiting the generality of the preceding subsections, if an arrangement is void in accordance with section BG 1 because, whether wholly or partially, the arrangement directly or indirectly relieves a person from liability to pay income tax by claiming a credit of tax, the Commissioner may, in addition to any other action taken under this section,—

> (a) disallow the credit in whole or in part; and

(b) allow in whole or in part the benefit of the credit of tax for any other taxpayer.

GB 1(2B) For the purposes of subsection (2A), the Commissioner may have regard to the credits of tax which the taxpayer or another taxpayer would have had, or might have been expected to have had, if the arrangement had not been made or entered into.

GB 1(2C) In this section, credit of tax means the reduction or offsetting of the amount of tax a person must pay because—

(a) credit has been allowed for a payment of any kind, whether of tax or otherwise, made by a person; or
(b) of a credit, benefit, entitlement, or state of affairs.

GB 1(3) Without limiting the generality of subsections (1) and (2), section BG 1, or the definitions of arrangement, liability, tax avoidance, or tax avoidance arrangement in section OB 1, where, in any tax year, any person sells or otherwise disposes of any shares in any company under a tax avoidance arrangement under which that person receives, or is credited with, or there is dealt with on that person's behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as dividends in that tax year, or in any subsequent tax year or years, whether in 1 sum in any of those years or in any other way, an amount equal to the value of that consideration, or of that part of that consideration, is deemed to be a dividend derived by that person in that first-mentioned tax year.

OB 1 Definitions

arrangement means an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect

tax avoidance includes—

(a) directly or indirectly altering the incidence of any income tax:
(b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
(c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

(a) has tax avoidance as its purpose or effect; or
(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental

The Spanish Anti-Avoidance Rule

Section 15. Conflict in applying the tax law.

1. A conflict in applying tax law is understood to exist where a taxable fact is avoided in whole or in part or the tax assessment basis or tax liability is reduced by means of acts or transactions in which the following circumstances are given:

a. Where, taken individually or as a whole, the acts or transactions are notoriously crafty or improper for achieving the result obtained.

b. Where no material legal or economic effects are achieved by using the acts or transactions in question, other than tax savings and similar effects to those that would have been achieved with the usual or normal acts or transactions.

2. So that the Tax Administration may find that there is a conflict in applying the tax law, a prior report to that effect is required from the Consultative Committee referred to in Section 159 of this Act.

3. In assessments drawn up as a result of what is foreseen in this Section, tax shall be claimed by applying the provisions for the usual or normal acts or transactions or by doing away with the tax benefits obtained, and interest for delayed payment shall be charged, without any sanctions being imposed.

Proposed New Section 103

Arrangements for avoiding or postponing liability for or reducing amounts of taxes

103. (1) Whenever any arrangement which has been entered into or carried out has the effect of obtaining any tax benefit, the liability for any tax and the amount thereof must be determined as if the arrangement had not been entered into or carried out (or in such other manner as in the circumstances of the case is appropriate for the prevention or diminution of that tax benefit), if that arrangement, or any step therein or part thereof,—

(a) has as its sole or one of its main purposes, the obtaining of a tax benefit; and

(b) having regard to the circumstances under which that arrangement, or any step therein or part thereof, was entered into or carried out—

(i) has created rights or obligations which would not normally be created between persons dealing at arm's length under an arrangement of the nature of that arrangement; or

(ii) was entered into or carried out by means or in a manner which would not normally be employed—

(aa) for *bona fide* business purposes (other than obtaining a tax benefit), in the case of an arrangement in the context of business; or

(bb) in entering into or carrying out an arrangement of the nature of the arrangement in question.

(2) For purposes of subsection (1)*(b)*, the normality of the arrangement, step therein or part thereof, or the means and manner in which the arrangement, step or part was entered into must be determined objectively with reference to the relevant facts and circumstances, including but not limited to, the following—

(a) the form and economic substance of the arrangement, or any step therein or part thereof;

(b) the time at which the arrangement, or any step therein or part thereof, was entered into and the length of the period during which the arrangement, step or part was carried out;

(c) the result in relation to the operation of this Act which would, but for the application of this section, have been achieved by the arrangement;

(d) any circular flow of cash or assets between or among parties to that arrangement;

(e) the participation of any tax indifferent party in that arrangement;

(f) the inclusion of steps or transactions that offset or cancel each other, without a substantial effect upon the economic position of the parties;

(g) the inconsistent treatment of any items or amounts for tax purposes by parties to the arrangement (such as the treatment of a payment as a deductible interest expense by the payer and as an exempt dividend by the recipient);

(h) a failure by any parties to the arrangement to deal at arm's length (without having regard to whether the parties are connected persons in relation to each other), including paying more than market value for any assets or service involved in that arrangement;

(i) the lack of any change in the financial position of any person resulting from that arrangement;

(j) the absence of a reasonable expectation of pre-tax profit in connection with the arrangement after taking into account all costs and expenditure incurred in connection with the arrangement; or

(k) the value of the tax benefit that would have resulted from the arrangement, but for the application of this section, exceeds the amount of pre-tax profit reasonably expected in connection with that arrangement.

(3) For purposes of subsection (1)*(a)*, the sole or main purposes of an arrangement, or step therein or part thereof, must be determined objectively by reference to the relevant facts and circumstances.

(4) Whenever in proceedings relating to subsection (1) it is proved that—

(*a*) the arrangement results in a tax benefit, it is presumed, until the contrary is proved, that the arrangement was entered into or carried out with the sole purpose of, or with one of the main purposes being, obtaining the tax benefit; or

(*b*) any of the factors set forth in paragraphs *(d)* through *(k)* inclusive, of subsection (2) exist in respect of the arrangement, or step therein or part thereof, it is presumed, until the contrary is proved, that the arrangement, or any step therein or part thereof, 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).

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

(6) The Commissioner may apply this section in respect of an arrangement, or any step therein or part thereof, in the alternative for or in addition to any other basis for raising the assessment.

(7) For purposes of this section—

'arrangement' means any transaction, operation or scheme and includes the alienation of property;

'tax' includes any tax, levy or duty imposed by this Act or any other law administered by the Commissioner;

'tax benefit' includes any avoidance, postponement or reduction of liability for payment of any tax;

'tax indifferent party' in relation to an arrangement includes—

(a) any person that is not subject to any tax imposed by this Act;

(b) any person that participates in that arrangement in such a way that any amount derived by that person in connection with the arrangement is substantially matched or offset by any expenditure or loss incurred in connection with the arrangement; or

(c) any company or other entity which is established specifically for the purpose of participating in that arrangement.

Notes:

1. Provisions currently found in section 103 that are not, strictly speaking, part of the GAAR itself, such as section 103(2) and 103(5), are to be moved to other places in the Act.
2. Provisions in respect of penalties discussed in section 10.6 above are to be dealt with elsewhere in the Act.
3. The proposed amendment to section 103 is to apply to any arrangement, or step therein or part thereof, entered into or carried out on or after the date of promulgation of the amending legislation or another specified date.

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