



**PENALTIES FOR IMPERMISSIBLE TAX AVOIDANCE IN SOUTH
AFRICA**

by

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Declaration

I, **Matome Rotley Lelope**, do hereby declare that the work I am submitting for assessment contains no section copied in whole or part from any other source unless explicitly identified in quotation marks and with detailed complete and accurate referencing.

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Firstly, I need to thank God Almighty, for it is only through Him that we are able to start and complete such good works.

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I dedicate this work to my son Lelope Rotley Junior.

Abstract

Tax avoidance is a complex concept that creates uncertainty in the South African tax law system and results in revenue loss. Tax avoidance is a broad concept that constitutes permissible tax avoidance and impermissible tax avoidance. The main difference between impermissible tax avoidance and permissible tax avoidance is that the former is illegal and the latter is legal. To deal with, amongst other problems caused by impermissible tax avoidance, revenue loss, South Africa introduced the GAAR to curb impermissible tax avoidance. In doing so, the GAAR rejects tax avoidance arrangements that are found to be abusive and allows permissible tax avoidance.

The South African GAAR is aimed at curbing impermissible tax avoidance arrangements that, inter alia, result in tax benefits with the sole or main purpose to obtain that tax benefit. The problem with this GAAR is that it does not clearly differentiate between permissible tax avoidance and impermissible tax avoidance. A taxpayer who gets caught by the GAAR is subjected to the provisions of section 80B of the ITA. The consequences in section 80B are corrective measures and do not result in any disincentive to the taxpayer except that the taxpayer only pays the amount of tax that would have been due in the absence of the avoidance arrangement.

This research is aimed at investigating the effectiveness of the GAAR as a weapon against impermissible tax avoidance. In testing the effectiveness of the GAAR, the remedies available against taxpayers that enter into impermissible tax avoidance transactions are critically analysed. The South African GAAR is compared to three foreign GAAR's and it is recommended that South Africa consider introducing penalties as is the case in other countries such as Australia and the UK. In investigating the effectiveness of the GAAR as a weapon against impermissible tax avoidance, foreign legislation and case law is compared to South African legislation and case law in order to determine whether South African GAAR needs penalties to deter impermissible tax avoidance more effectively.

Acronyms and abbreviations

| | |
|--------|---|
| CILSA- | Comparative and International Law Journal of South Africa |
| CITA- | Canadian Income Tax Act |
| FA- | Finance Act |
| FCA- | Federal Court of Australia |
| GAAR - | General Anti-Avoidance Rule |
| HMRC- | Her Majesty's Revenue & Customs |
| ITAA- | Income Tax Administration Act |
| ITA - | Income Tax Act |
| SARS - | South African Revenue Services |
| TAA - | Tax Administration Act |
| VD - | Voluntary Disclosure |
| UK- | United Kingdom |
| USA- | United States of America |
| US\$- | United States of America Currency |

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CHAPTER 1

Introduction

1.1 Introduction and Background of the Research

Much has been researched and written about tax avoidance and the legislative provisions aimed at curbing impermissible tax avoidance, which is commonly referred to, in the USA as abusive tax shelters, in Australia as aggressive tax arrangements and in New Zealand as unacceptable tax avoidance. Impermissible tax avoidance is a complex problem worldwide and most countries have developed general anti-avoidance rules (GAARs) to curb it. The first GAAR in South Africa was enacted in section 90 of Act 31 of 1941 which was subsequently replaced by section 103 of the Income Tax Act 58 of 1962 (ITA). Section 103(1), South Africa's second GAAR, was deemed to have practical problems caused largely by weaknesses in the abnormality requirement.¹ This led to the creation of the current GAAR in sections 80A to 80L.² Currently there are no decided court cases regarding section 80A to 80L.

It is essential to define and distinguish between tax avoidance and tax evasion. It is also crucial to provide an introductory and explanatory note on impermissible tax avoidance. Tax avoidance has been defined in various ways but certain basic elements appear in all the definitions. For example, Van Schalwyk states that;

tax avoidance, by contrast, usually denotes a situation in which the taxpayer has arranged his affairs in a perfectly legal manner, with the result that he has either reduced his income or has no income on which tax is payable.³

Tax avoidance has also been defined as;

the reduction of a taxpayer's tax liability using the provisions of the fiscal legislation to his/her advantage and is legal, despite being unpopular with the revenue authorities.⁴

¹ Tax Avoidance and section 103 of the Income Tax Act 58 of 1962, Revised Proposal, at page 6.

² Part IIA of the Income Tax Act.

³ Koekermoer AD, Van Schalwyk L, Wilcocks JS et al, *Silke; South African Income Tax* (2013) at page 773.

From the above definitions, it can be deduced that tax avoidance is a lawful arrangement in which a taxpayer reduces his tax liability by utilising loopholes in legislation to pay less tax, or no tax at all.

On the other hand tax evasion is an illegal activity in which a taxpayer reduces his tax liability. In tax evasion;

“taxable income, profits liable to tax or other taxable activities are concealed, the amount and, or the sources of income are misrepresented, or tax reducing factors such as deductions, exemptions or credit are deliberately overstated.”⁵

Tax evasion is a criminal offence and sections 234 and 235 of the Tax Administration Act (the TAA)⁶ provide for penalties for tax evasion.

Tax avoidance is labelled legal as shown in the quotations above, but the GAAR was enacted to curb or combat impermissible tax avoidance, and section 80B, a part of the GAAR, provides remedies if the GAAR is successfully applied to a transaction. This shows that in South Africa, the broad term ‘tax avoidance’ entails both permissible and impermissible tax avoidance. Impermissible tax avoidance, the subject of the GAAR, refers to tax avoidance arrangements that have, inter alia, a sole or main purpose of obtaining a tax benefit. Furthermore, after the sole or main purpose of obtaining a tax benefit has been fulfilled, the presence of one or more of the tainted elements which may either be entered into in the context of business or in a context other than business is required.⁷ The ITA provides the tainted elements, in the context of business (the last two below are also applicable in a context other than business or in any context) as including;

- i. the business purpose test;
- ii. the commercial substance test;
- iii. the abnormal rights and obligation test;

⁴ Croome B, et al, *Tax law- An Introduction* (Juta 2013) at page 487.

⁵ *Addressing Tax Evasion and Avoidance*, GIZ Sector Programme Public Finance, Administrative Reform at page 9.

⁶ Tax Administration Act 28 of 2011.

⁷ Part IIA of the Income Tax Act, section 80A (a)-(c).

iv. and the misuse or abuse test;⁸

One of the major similarities between tax avoidance and tax evasion is that both have the effect of reducing revenue for the government. However there is a distinctive difference between the two in the sense that, as mentioned above, the TAA provides for penalties for tax evasion but there are currently no penalties for impermissible tax avoidance in South Africa.

Regarding tax avoidance, it is important to note the statements made in the well-known *IRC v Duke of Westminster*⁹ case where Lord Tomlin held that;

Every man is entitled if he can to order his affairs so that the tax attaching under appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

The judgment in the *Duke of Westminster*¹⁰ does not promote abusive or impermissible tax avoidance arrangements, but it does promote tax avoidance and for this reason, a number of countries including South Africa, have enacted the GAAR into their tax legislation which is aimed at informing taxpayers of the limits of permissible tax avoidance and preventing impermissible tax avoidance

Any taxpayer involved in an arrangement that qualifies as an impermissible tax avoidance arrangement is subject to section 80B of the ITA. Section 80B provides for consequences of the application of the GAAR. Unlike the penalties for tax evasion in the TAA, the power vested on the Commissioner in terms of section 80B of the ITA does not have a substantially adverse effect on the taxpayer who is involved in an impermissible tax avoidance arrangement. The application of the remedies vested on the Commissioner in terms of section 80B will result in the taxpayer being put in the same position he or she would have been had he or she not been involved in the impermissible tax avoidance arrangement. Consequently,

⁸ Groome B et al op cit note 4 at page 492.

⁹ *Duke of Westminster v IRC* [1936] AC 1.

¹⁰ Ibid.

this section does not discourage the taxpayers from involvement in impermissible tax avoidance arrangements since taxpayers do not lose anything for attempting to avoid tax by getting involved in arrangements that are found to be impermissible avoidance arrangements.

In spite of the fact that section 80B protects the tax base by ensuring that the taxpayer pays the tax that he or she is liable for, it does not deter the taxpayer from testing the limits of the GAAR. As a result, it can be argued that this section is not as effective in curbing impermissible tax avoidance arrangements as a more financially punitive section would. By contrast, there are severe statutory financial penalties for evading tax, which serve as a deterrent for taxpayers who might want to consider evading tax.¹¹ To supplement the effectiveness of the provisions of section 80B in curbing impermissible tax avoidance arrangement, it has to be considered whether financial penalties for impermissible tax avoidance need to be introduced.¹²

1.2 Problem statement and research question

As Museka¹³ notes; “the problem arises when taxpayers enter into schemes so as to avoid tax, hence obtaining an advantage to which they are not entitled”. This submission shows that the problem is not entering into schemes of avoiding tax but is one of obtaining an advantage to which the taxpayer is not entitled. The advantage obtained by a taxpayer engaging in impermissible tax avoidance is detrimental to the South African economy and results in SARS, and consequently government, losing revenue. The main problem is that when taxpayers enter into impermissible tax avoidance arrangements they do not suffer consequences that are detrimental to

¹¹ Section 235 of the Tax Administration Act provides for criminal offences relating to evasion of tax together with possible financial consequences for evading tax.

¹² Lessons may be learned from New Zealand where the Tax Administrative Act 1994, s141A to 141EB provides for penalties for tax avoidance. For a discussion of the penalties for tax avoidance in New Zealand see Prebble BC; Should Tax Avoidance be Criminalised? Tax Avoidance and Criminal Law Theory at 15) available at: <http://www.otago.ac.nz/law/research/journals/otago036330.pdf>. (last accessed on 20 March 2015)

¹³ Museka CP *Critical Analysis of the Requirement of section 80A of the new General Anti-Avoidance Rule* (LLM dissertation, University of Pretoria, 2012) at page 2.

their finances when their actions are inconsistent with anti-avoidance rules such as the GAAR. For example in *ERF 3183/1 Ladysmith (Pty) Ltd v CIR*,¹⁴ a case which dealt with the substance over form doctrine, the court struck down an impermissible tax avoidance scheme “by disregarding a ‘simulated’ agreement, involving leases and sub-leases, and giving effect to the parties’ real intention, and implementing the tax consequences that flowed from that real intention.”¹⁵

Williams RC¹⁶ summarised the consequences as follows;

“Consequently, in terms of paragraph (h) of the definition of gross income, the value of those improvements had to be included in the gross income of the latter company- in short, the value of those improvements were indeed taxable in its hands”.¹⁷

From the above mentioned case firstly, one needs to ask, what did the taxpayer suffer as a result of engaging in an impermissible tax avoidance scheme, apart from paying the taxes that the taxpayer thought it had avoided? In arrangements where section 80B is applicable, the taxpayer will be put in exactly the same position he/she would have been had the taxpayer not entered in the tax avoidance scheme, meaning the taxpayer will pay the tax that he is already liable for and, will not be subject to any punitive measure that is inconsistent with the law. The problem that this dissertation will investigate is therefore the absence of deterrent penalties for impermissible tax avoidance.

1.3 Research questions

The research questions that will be answered in this dissertation are as follows:

- 1.3.1 How effective is section 80B as a remedy for a failure to refrain from impermissible tax avoidance arrangements?
- 1.3.2 Should South Africa’s tax system introduce penalties for impermissible tax avoidance arrangements?

¹⁴ *ERF 3183/1 Ladysmith (Pty) Ltd V CIR* 1996 (3) SA 942 (A), 58 SATC 229.

¹⁵ See Williams RC, *Income Tax in South Africa, Cases & Materials* 2 ed at page 567.

¹⁶ *Ibid.*

¹⁷ *Ibid.*

1.3.3 What is the experience in countries where penalties are imposed for impermissible tax avoidance transactions?

1.4 The aims and objectives of the study

The aim of the research is to investigate the need for the introduction of penalties for impermissible tax avoidance in South Africa. After this investigation, the research will make recommendations on the novel subject, in South African tax law terms, of penalties for impermissible tax avoidance.

1.5 Importance and significance of the study

This research is important because it will investigate the potential of penalties for impermissible tax avoidance in South Africa. The introduction of penalties for impermissible tax avoidance may help to limit or reduce impermissible tax avoidance and this may help SARS to generate more revenue, and at the same time increase the efficacy of the GAAR as an effective deterrent against impermissible tax avoidance.

1.6 Research methodology

This research will include a qualitative analysis of the laws of three countries and a critical analysis of section 80B of the ITA.

The GAARs in Australia and the UK, where penalties are applicable for impermissible tax avoidance, will be compared with the South African, and Canadian GAARs which currently do not provide for penalties for impermissible tax avoidance.

1.7 Literature review

Currently, there is no South African literature on the researched topic and this will be one of the first academic writings on the subject of penalties for impermissible tax avoidance in South Africa. This research is a new and unique topic in South Africa and for that reason, the research will largely rely on foreign sources that deal penalties for impermissible tax avoidance and this will include the Australian

Taxation Administrative Act 1953, Australian case laws, amongst others, the *Orica Limited v Commissioner of Taxation* case¹⁸ and the UK Finance Act 2016.

1.8 Outline of the study

Chapter 1 will deal with the introduction and background to the research. This chapter will also outline the research problem and questions, objectives of the research, importance and significance of the research and an outline of the study.

Chapter 2 will distinguish between tax avoidance and tax evasion and examine and critically analyse the contents of section 80A to 80L of the ITA.

Chapter 3 will deal with a comparative study from three countries namely, Australia, UK and Canada.

Chapter 4 will discuss the arguments for and against the introduction of penalties for impermissible tax avoidance arrangement in our GAAR system

Chapter 5 will conclude this research, present the findings of the research and make recommendations based on the findings.

¹⁸ *Orica Limited v Commissioner of Taxation* 2015 FCA 1399.

CHAPTER 2

Distinction between tax avoidance and evasion, and the analysis of the GAAR as a weapon to combat impermissible tax avoidance

2.1 Introduction

This chapter aims to proceed and go deeper with the distinction between tax evasion and tax avoidance by critically analysing the definition of both terms, the legality attached to them, and measures taken to address them. It will further examine and critically analyse the contents of section 80A to 80L of the ITA, which constitutes the GAAR. This chapter will be divided into two sections, the first will deal with tax evasion and tax avoidance and the second section will deal with the GAAR as contained in section 80A to 80L.

2.2 Distinction between tax evasion and tax avoidance

2.2.1 Tax Evasion

Tax evasion as defined above is an illegal activity in which a taxpayer reduces his/her tax liability.¹ It is further defined as an illegal action to evade paying tax which includes declaring false expenses or inflating expenses to benefit from a deduction; failing to declare income from all sources including salaries, commission, rental, interest and income earned from offshore investments; and claiming deductions for expenditure that was not actually incurred.² Tax evasion is a criminal offence and there are severe penalties for this behaviour, which will be discussed below.

¹ Addressing tax evasion and avoidance, page 9, GIZ sector programme public finance, administrative reform.

² Swart J, *The risk of tax evasion and avoidance*, at page 1, available at <http://www.legalandtax.co.za/in-the-media-/tax/risks-tax-evasion-avoidance/> (Accessed on 25/03/2015).

2.2.2 Measures taken to address tax evasion

In South Africa, Parliament has introduced a legislative control that is used to deter tax evasion by introducing penalties for tax evasion. In terms of section 235 of the TAA, any person who intentionally evades or assists another person to evade tax or to obtain an undue refund under a tax Act is guilty of an offence and, upon conviction, is liable to a fine or to imprisonment for a maximum period of five years. Tax evasion is a global problem and as a result, countries have enacted laws that deter tax evasion by criminalizing and introducing penalties for tax evasion against taxpayers who fail to comply with the tax laws.³ Imposing penalties and criminal offences on a non-compliant taxpayer coupled with the increased risk of detection and strong enforcement reduces tax evasion.⁴

Penalties for tax evasion and related conduct as imposed by section 223 of the ITA are classified as follows:

³ Commonwealth Association of Tax Administration (2006), Tax Evasion and Avoidance, strategies and initiatives used by CATA member countries, a joint CATA/GIDD project at page 24.

⁴ Ibid.

| 1 | 2 | 3 | 4 | 5 | 6 |
|-------------|--|----------------------|--|--|---|
| <i>item</i> | <i>Behaviour</i> | <i>Standard case</i> | <i>If obstructive, or if it is a repeat case</i> | <i>VD after notification of audit or investigation</i> | <i>VD before notification of audit or investigation</i> |
| (i) | Substantial understatement | 10% | 20% | 5% | 0% |
| (ii) | Reasonable care not taken in completing return | 25% | 50% | 15% | 0% |
| (iii) | No reasonable grounds for tax position taken | 50% | 75% | 25% | 0% |
| (iv) | Gross negligence | 100% | 125% | 50% | 5% |
| (v) | Intentional tax evasion | 150% | 200% | 75% | 10% |

Section 223 of the TAA has broken down the level of penalties that may be imposed in cases where tax is evaded. Voluntary disclosure before notification of audit or investigation attracts no penalty except in circumstances where the behaviour is gross negligence or intentional tax evasion, in which case 5 and 10% penalties are imposed respectively. The penalties imposed for voluntary disclosure after notification of audit or investigation ranges from 5% on substantial understatement up to 75% for intentional tax evasion. The highest penalty to be imposed for tax evasion is 200% for intentional tax evasion and if it was an obstructive or repeat case, and on standard case the penalty ranges from 10% to 150%. Penalties are harsh for intentional tax evasion and gross negligence in circumstances where the behaviour is obstructive or constitutes a repeat case. As a result of the penalties applicable to tax evasion, taxpayers have little incentive to evade tax intentionally because they are aware that if they evade tax and get caught, they will pay up to three times more than they would have paid.

2.2.3 Tax avoidance

Tax avoidance has been defined as a situation in which a taxpayer arranges his affairs in a perfectly legal manner, with the result that he has either reduced his/her income or has no income on which tax is payable.⁵ Barker, it is submitted, correctly defines tax avoidance by stating that “tax avoidance is properly described as non-criminal behavior, not as legal behavior”.⁶ Barker’s definition of tax avoidance outlines that tax avoidance is not a criminal offence and he avoided attaching legality to it. Saying that tax avoidance is legal but not allowed does not make academic sense because tax avoidance comprises of permissible tax avoidance and impermissible tax avoidance, and the legality must be attached separately to distinguish them from one another. The majority of the scholars who write and research on tax avoidance, including Zoë Prebble

⁵ Koekermoer AD et al, *Silke; South African Income Tax* (2013) at page 773.

⁶ William BB, *The Ideology of Tax Avoidance*, 40 *Loy. U. Chi. L. J.* 229 (2009), at page 242.

and John Prebble, support the idea that tax avoidance is legal and this can be found in their discussions of tax avoidance.⁷

The definition of tax avoidance is different from one jurisdiction to another. Tax avoidance is not defined in the ITA, however from the very same Act, it can be deduced that in the South African perspective, tax avoidance is divided into two forms.⁸ Permissible tax avoidance and impermissible tax avoidance are the two forms of tax avoidance that are dealt with directly and indirectly in the ITA.

Permissible tax avoidance can be any tax avoidance arrangement that is permitted and intended by the ITA. This means that permissible tax avoidance is within both the letter and spirit of tax law and includes, amongst others, deductions for medical and dental expenses paid by a taxpayer⁹; donations bequeathed to public benefit organisations,¹⁰ and expenses in respect of learnership agreements entered in to by the taxpayer as the employer.¹¹ From the above it is clear that tax mitigation and permissible tax avoidance refers to one and the same thing and the terms are used interchangeably by different scholars. Zoe Prebble and Prebble John¹² cite *Miller v C.I.R*¹³ wherein the court used the expression “tax mitigation” to refer to measures that reduce tax (or avoid it) but in circumstances where the reduction of tax is the result of the taxpayer adopting a course of action that is clearly encouraged by the relevant legislation.¹⁴ The authors go further and state that tax mitigation is a label for a conclusion that a scheme under examination

⁷ Prebble Z & Prebble J, *The Morality of Tax Avoidance*, *Creighton Law Review Vol.43* at page 702. The authors stated that tax avoidance is not illegal.

⁸ Ibid at page 706. The authors submit that some scholars use “avoidance” to include both acceptable and unacceptable tax minimization.

⁹ Section 18 of the ITA.

¹⁰ Section 18A of the ITA.

¹¹ Section 12H of the ITA.

¹² Prebble Z & Prebble J op cit note 7.

¹³ *Miller v C.I.R* [2001] 3 N.Z.L.R. 316 [9] (P.C).

¹⁴ Prebble Z & Prebble J op cit note 7.

that reduces tax is valid under relevant legislation, and not vulnerable to a GAAR, either statutory or judge-made.¹⁵ Tax mitigation was also defined in *IRC v Willoughby*¹⁶ wherein Lord Nolan stated that:

“the hallmark of tax mitigation, on the other hand, 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.”¹⁷

In contrast, impermissible tax avoidance refers to tax avoidance arrangements that have a sole or main purpose of obtaining a tax benefit which is neither intended nor allowed by the ITA. The law does not allow this form of tax avoidance and the GAAR has been enacted to curb it.

From the above and in a South African perspective, it is clear that the legality attached to the broad concept of tax avoidance is questionable. One needs to look at the definitions of permissible tax avoidance, and impermissible tax avoidance and link them with what is legal and illegal. Legal is defined as, not in violation of law and illegal as, in violation of statute.¹⁸

Section 18A, amongst many other sections in the ITA, provides for instances of permissible tax avoidance through deductions from income that are allowed by the legislation. The GAAR does not allow impermissible tax avoidance. When these forms of tax avoidance are linked with the above definitions of legal and illegal, it is clear that permissible tax avoidance is legal as it does not violate any law and impermissible tax avoidance is illegal because it violates the provisions of the ITA, results in revenue

¹⁵ Ibid.

¹⁶ *IRC v Willoughby* [1997] 1 WLR 1071.

¹⁷ Ibid.

¹⁸ Legal Terms and Definitions, available at: <http://dictionary.law.com/Default.aspx?typed=legal&type=1> (Accessed on 15 February 2016).

losses to SARS, growing disrespect for the tax system and the law,¹⁹ and unfair shifting of the tax burden.²⁰ Accordingly it is submitted that in the South African perspective, it is best if tax avoidance is first defined by stating the two forms of tax avoidance and thereafter attach the legality to each of the two forms of tax avoidance than attaching the legality to tax avoidance. This submission is based on the fact that some forms of tax avoidance are legal and others are not, so generalising and saying tax avoidance is legal is misleading.²¹ The legality attached to tax avoidance needs to be revisited so that impermissible tax avoidance can be penalised since it is illegal and not permitted by the ITA.²²

2.3 Measures taken to address impermissible tax avoidance: The South African GAAR

South Africa, amongst other countries²³, introduced a GAAR as one of the measures to curb and deter impermissible tax avoidance. This GAAR is contained in section 80A to 80L of the ITA, which provides guidelines for dealing with impermissible tax avoidance.

¹⁹ Bodlo NP, *The South African GAAR: striking a balance between permissible and impermissible tax avoidance* (LLM dissertation, University of Pretoria, 2015) at page 9.

²⁰ William BB op cit note 6, states that “where a taxpayer is not entitled to the fruits of his plan, it can hardly be said that taxpayer’s position is ‘legal’, that it conforms to the law, is according to the law, is not forbidden or discountenanced by the law, is good and effectual in law. It is instead illegal, that is, not authorized by law, contrary to the law, contrary to the principles of the law”.

²¹ Ibid. The author stated that “to say that evasion is illegal whereas illegitimate avoidance that does not work is legal is very misleading”.

²² Morton P agreed that the argument that tax avoidance is legal is clearly insufficient. Furthermore, Lenon C said that “I don’t think the “its legal” argument is very strong”. Also see to *Tackling tax avoidance: a delicate balance of legislation and corporate responsibility*, International Tax Review (2013) at page 2 available at <http://search.proquest.com/docview/1313708832?accountid=14717>. (accessed on 20 September 2016)

²³ Canada and Australia are some of the countries that have enacted a GAAR. Australia’s GAAR was introduced in 1936 and applies to schemes entered into after 1981, while Canada’s GAAR was introduced in 1988 and applies to schemes entered into after 12 September 1988.

Sections 80A to 80L of the ITA deal with a distinct structural component of the GAAR and the definitions of key terms used in the GAAR.²⁴ Section 80A to 80L only applies to impermissible tax avoidance arrangements entered into after 2 November 2006.

Section 80A lays down the basic requirements that must be satisfied before an avoidance arrangement can be said to be an impermissible tax avoidance arrangement. When determining whether an avoidance arrangement amounts to impermissible tax avoidance, there must be an arrangement; a tax benefit; and a sole or main purpose to obtain a tax benefit. Once the above three requirements, which will not be discussed in detail, are met then one of the tainted elements in sections 80A(a), 80A(b) and 80A(c) must exist and be applicable before an avoidance arrangement can be regarded as impermissible.²⁵ The tainted elements are abnormality as contained in sub-sections; 80A(a) (i); 80A(b); and 80A(c) (i) of the ITA, lack of commercial substance contained in section 80A(a) (ii) of the ITA and the misuse or abuse of the provisions of the Act contained in section 80A(c) (ii) of the ITA.²⁶

2.3.1 Abnormality test

The abnormality test, in different guises, applies in any context, in the context of business and in a context other than business. This test applies in a wide sense throughout the GAAR. According to Croome, “in the context of business the test considers whether an avoidance arrangement was entered into in a manner or through means that would not normally be employed for a bona fide business purpose, other than the obtaining of a tax benefit.”²⁷ Clegg notes that;

²⁴ Clegg D, *Income Tax in South Africa* Ch. 26 para 26.6.1 (Online version) (accessed 22 April 2015).

²⁵ De Koker AP & Brincker E, *Income Tax Silke on international tax* para 46.19 (online version) (accessed on 23 April 2015).

²⁶ Jordan K, *The General Anti-Avoidance Rule South African Tax Guide* available at www.sataxguide.co.za/general-anti-avoidance-rule-gaar/ (accessed on 27 March 2015).

²⁷ Croome B, et al, *Tax law- An Introduction* (Juta 2013) at page 493.

“the test does not require that the arrangement under examination should have a primary or substantial business purpose per se, but merely that the method employed should be normal in a business context”²⁸

The abnormality test in a context other than business considers whether the arrangement was entered into or carried out in a manner or through means which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit.²⁹ Herein the abnormality test applies to avoidance arrangements concluded outside business and mostly in relation to personal avoidance arrangements that result in a tax benefit.³⁰ In *ITC 1496*³¹ the court struck down a tax avoidance transaction under the old section 103 on the basis that a transaction contained a number of abnormal elements and therefore the transaction as a whole was abnormal and artificial.³²

The abnormality test to be applied in any context, whether in the context of business or in a context other than business, considers whether the avoidance arrangement has created rights or obligations which would not normally be created between persons dealing at arm’s length.³³

2.3.2 Lack of commercial substance test

Section 80A (a) (ii) provides for this test which only applies in the context of business. This sub-section when applied must be read with section 80C. Clegg has divided the

²⁸ Clegg D, op cit note 24 at ch 26 para 26.3.5.

²⁹ Section 80A (b) of the ITA

³⁰ Clegg D, submits that the test does not require that the means or manner used should be normal in relation to the particular transaction being examined but merely it is a means or manner which is normally used by person outside business context, to achieve (presumably) personal, familial or charitable aims.

³¹ *ITC 1496* (1990) 53 SATC 229.

³² Kujinga BT, *A comparative analysis of the efficacy of the General Anti-Avoidance Rule as a measure against impermissible tax avoidance in South Africa* (LLD Dissertation, University of Pretoria, 2013) at page 85.

³³ Section 80A(c) (i) of the ITA.

commercial substance test and notes that section 80C contains presumptive and indicative tests.³⁴

Section 80C reads as follows:

- (1) For the purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.
- (2) For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack commercial substance include but are not limited to-
- (a) the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or
 - (b) the inclusion or presence of-
 - (i) round trip financing as described in s80D; or
 - (ii) an accommodating or tax indifferent party as described in s80E; or
 - (iii) elements that have the effect of offsetting or cancelling each other.”

Section 80C attempts to make the application of the commercial substance test less complex because it provides guidelines by describing avoidance arrangements that lack commercial substance without limiting the application of the test. In terms of section 80C, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risk or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained.

Sections 80C(2)(a) and (b) of the ITA provide characteristics of an avoidance arrangement that are indicative of a lack of commercial substance. These indicators are discussed below.

³⁴ Clegg D, op cit note 24.

2.3.3 Characteristics of an avoidance arrangement that are indicative of a lack of commercial substance

The characteristics of an avoidance arrangement that is indicative of a lack of commercial substance are:

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

This research is aimed at investigating the need for the introduction of penalties for impermissible tax avoidance in South Africa and for that reason, only the substance over form and round trip financing will be discussed below as one of the indicators of a lack of commercial substance.

2.3.3.1 The legal substance or effect of an avoidance arrangement

Section 80C (2) (a) deals with the comparison of the legal substance or effect of the avoidance arrangement with the legal form of its individual steps. If the legal substance or effect of an avoidance arrangement is found to be inconsistent with the legal form of the individual steps, then it indicates a lack of commercial substance.³⁵

2.3.3.2 Round trip financing

Round trip financing as an indicator of a lack of commercial substance, exists where funds are transferred between the parties in an avoidance arrangement, and the effect of the transfer results in the obtaining of a direct or indirect tax benefit and in a

³⁵ Croome B, op cit note 27 at page 495.

significant reduction, or outright elimination, of any business risk incurred by any party involved in the avoidance arrangement.³⁶ Kujinga notes that “the concept of round trip financing entails arrangements with circular financial transfers that in actual fact pose no financial risk to the participants in the arrangements”.³⁷

2.3.3.3 Accommodating or tax-indifferent parties

Section 80E states that a party to an avoidance arrangement is an accommodating or tax-indifferent party if-

any amount derived by the party in connection with the avoidance arrangement is either-

not subject to tax; or

significantly offset either by any expenditure or loss incurred by the party in connection with that avoidance arrangement or any assessed loss of that party; and

either-

as a direct or indirect result of the participation of that party an amount that would have-

(aa) been included in the gross income or receipts or accruals of capital nature of another party would be included in the gross income or receipts or accruals of capital nature of that party; or

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

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

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

the participation of that party directly or indirectly involves prepayment by any other party.

Furthermore, S80E (2) states that a person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party. Section

³⁶ Kujinga BT, op cit note 32 at page 113.

³⁷ Ibid.

80E (3) excludes parties that would have been viewed as accommodating or tax-indifferent parties in instances where a party is engaged in active trading activities for a period of at least 18 months or is subject to a comparable foreign income tax which is equal to at least two-thirds of the normal tax which would have been payable in terms of the ITA.³⁸

2.3.3.4 Elements that have the effect of offsetting and cancelling each other-section 80C (2) (iii)

Section 80C (2) (b) (iii) provides elements that have the effect of offsetting and cancelling each other as one of the indicators of a lack of commercial substance. The section will challenge arrangements that create rights and obligations that are subsequently cancelled by a step in that arrangement or by another arrangement in the same transaction. Scholars interpret the section by stating that that the provision primarily targets avoidance arrangements that involve complex financial derivatives that create a gain in one leg of the arrangement, and a loss in the other to neutralise the tax implications.³⁹

2.3.4 The misuse or abuse test

The last tainted element is the misuse or abuse of the provisions of the ITA. Section 80A (c) (ii) of the ITA is very wide and applies to an avoidance arrangement in any context. This misuse or abuse test was adopted from section 245 (4) of the Canadian Income Tax Act.⁴⁰

Kujinga notes that the concept of misuse or abuse works to deny tax benefits that are obtained in a manner that conforms to the letter of the law but not with the purpose of

³⁸ Kujinga BT, op cit note 32 at page 114.

³⁹ Kujinga BT op cit note 32 at page 115.

⁴⁰ Kujinga BT, *Analysis of misuse and abuse in terms of the South African general anti-avoidance rule: lessons from Canada*, *Comparative and International Law Journal of Southern Africa* 2012 at pages 42-63.

the ITA.⁴¹ In terms of the misuse or abuse provision it is clear that the tax benefits which are arrived at as a result of a misuse or abuse of the provisions of the ITA will be disregarded.

2.3.5 Consequences of impermissible tax avoidance

The consequence of the application of the GAAR is the central theme to this dissertation. Section 80B deals with the consequences of impermissible tax avoidance. It reads as follows:

“(1) the Commissioner may determine the tax consequences under this Act of any impermissible avoidance arrangement for any party by-

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

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

From the above, it is clear that section 80B only applies where it is found that an impermissible avoidance arrangement is present as per the provisions of section 80A. This section gives the Commissioner the powers to disregard, combine or re-

⁴¹ Kujinga BT op cit note 32 at page 116.

characterise any steps in or parts of the impermissible avoidance arrangement. The effect of this section is that, should the Commissioner apply the consequences of section 80B, the taxpayer will be put in a position he or she would have been in, in the absence of the absence of the impermissible avoidance arrangement. The Commissioner is obliged in terms of section 80B (2), after taking in to account the time limits imposed in section 79, 79A (2) (a) and 81 (2) (b), to make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangements.

In the *ITC 1582*⁴² case which was decided under s103 (old South African GAAR), the court found that the taxpayers had entered into transactions that were abnormal as they were concluded in an abnormal manner and had created rights and obligations which would not normally be created by persons dealing in transactions of the same kind.⁴³ The transactions were found to be impermissible tax avoidance and the commissioner had to include the avoided amount in the assessable income for the purposes of income tax. The income tax was adjusted accordingly to include taxes that were impermissibly avoided but that did not result in any further financial disincentive to the tax avoider. The remedial action in this case is a reflection of the remedial action taken in all cases in which the GAAR was applied in South Africa. The taxpayer ended up paying the taxes that were due but for the impermissible tax avoidance transaction. This resulted in potential revenue loss being recovered, but unlike in tax evasion where revenue lost is recovered and more revenue obtained through penalties, no additional revenue was collected as a penalty for engaging in abusive tax behaviour.

It is submitted that the remedies available to the Commissioner are not deterrent enough to discourage persistent tax avoiders from entering into avoidance arrangements that are not allowed by the GAAR. The analysis of the GAAR above shows that it is broad and contains a number of concepts that are not fully defined and

⁴² *ITC 1582/1* (1994) 57 SATC 27.

⁴³ *Kujinga BT*, op cit note 32 at page 85.

whose scope is uncertain. This uncertainty can and does function as a deterrent that discourages some taxpayers from trying to test the limits of permissible tax avoidance.⁴⁴ However, should the deterrent value of a GAAR emanate only from its uncertainty? Should a GAAR's deterrent value be enhanced by penalty provisions? The idea stated by Barker⁴⁵, that, in engaging in tax avoidance, the taxpayer has no reason to worry about possible detection, expressly describe the current position in our tax law. In other countries like Australia, the detection of impermissible tax avoidance might lead to penalties being charged against the tax avoider while in South Africa there is no disincentive for being caught by the GAAR and only tax liability that would have been due in the absence of the impermissible tax avoidance is charged.⁴⁶ It is submitted that section 80B be amended, or that a new section be created in the TAA to enhance the deterrent value of the GAAR by providing for penalties for impermissible tax avoidance.

The above submissions are supported by the case law examples below:

CIR v Louw⁴⁷ **case**

In this case the court found that the Commissioner was entitled to apply the provisions of s 103 to the directors' loans to enable him to assess the respondent's additional income tax liability. The court's decision allowed the Commissioner to recharacterise the transaction and charge additional tax income tax that was avoided in the first instance.

⁴⁴ See generally Kujinga BT, "Factors that Limit the Efficacy of General Anti-Avoidance Rules in Income Tax Legislation: Lessons from South Africa, Australia and Canada" 2014 vol 47 (3) *Comparative and International Law Journal of Southern Africa* at page 429.

⁴⁵ William BB, op cit note 6 at page 243.

⁴⁶ Ernst & Young, *GAAR rising, Mapping tax enforcement's evolution*, February 2013 at page 34. Available at:

[www.ey.com/Publication/vwLUAssets/Mapping_tax_enforcement%E2%80%99s_evolution/\\$FILE/GAAR.pdf](http://www.ey.com/Publication/vwLUAssets/Mapping_tax_enforcement%E2%80%99s_evolution/$FILE/GAAR.pdf). Amongst other countries is Australia that charges a penalty of 25% where the taxpayer has a "reasonably arguable position" that the GAAR does not apply and 50% of the shortfall where a taxpayer does not have a reasonably arguable position. (accessed on 23 May 2015)

⁴⁷ 1983 (3) SA 551 (A), 45 SATC page 113.

The legal question in this case was, did the incorporation of the practice and the transfer of the partnership's assets to the company or the subsequent loans from the company to the directors, infringe s 103 (1)?⁴⁸ The court held that the incorporation of the practice and the transfer of the partnership's assets infringed section 103 (1). The court further held that there is a rebuttable presumption that the granting of the loans had the effect of avoiding or postponing liability for income tax and the respondent failed to rebut this presumption.⁴⁹ In the above case, a tax avoidance scheme was found to exist and subject to the application of section 103(1). The consequence of the avoidance arrangement was to include the amount avoided in the assessable income resulting in the payment of tax that would have been due in the absence of the avoidance transaction. No punitive measures were available to the Commissioner, and none were taken.

Coppell v FC of T⁵⁰

This case was an application to review a decision of the respondent to disallow objections against amended assessments of income tax for the years ended 30 June 1995, 1996 and 1997.⁵¹ The amended assessments had been issued as a result of an audit of the applicant's affairs and a determination that the provisions of Part IVA of the ITAA applied, as assessable income of the applicant, income previously included as income of a trust.⁵² The applicant was involved in a tax avoidance arrangement which was subject to the application of Part IVA and he was notified of a possible application of Part IVA of the ITAA in July 1997 and the notification showed a penalty of either 25%

⁴⁸ Williams RC, *Income Tax in South Africa: Cases and Materials*, 2ed, page 584.

⁴⁹ *Ibid* at page 588.

⁵⁰ *Coppell v FC of T, Administrative Appeals Tribunal of Australia (Victoria) 4 February 2000* available at: <http://www.iknow.cch.com.au/document/atagUio537830sl16692434/coppell-v-fc-of-t> (accessed on 18 July 2016).

⁵¹ *Ibid*.

⁵² *Ibid*.

or 50%.⁵³ As a result of applicant's engagement in tax avoidance arrangement, The Tribunal affirmed the decision to impose a penalty of clearly contemplated by the ITAA where it is reasonably arguable that Part IVA may not have applied in the way in which the responded applied those provisions by imposing 25% additional tax as a penalty.⁵⁴

The above cases dealt with situations where the taxpayers were involved in impermissible tax avoidance arrangements and were subsequently caught by the GAAR. The first case is a South African case where the taxpayer was only required to pay additional income tax on the amount avoided under the old section 103 whereas the second is an Australian case where the taxpayer was required, as per the amended s 226, to pay by a way of penalty, 25% additional tax of the amount avoided.

The lack of penalties for impermissible tax avoidance weakens our GAAR and at the same time, from the wording of section 80B, it is clear that the consequences in section 80B are not intended to punish the taxpayer for trying to deny SARS of taxes due to it. The remedies available to the Commissioner are more of a corrective measure against the taxpayer who is involved in impermissible avoidance arrangements.

2.4 Conclusion

Tax avoidance and tax evasion are different concepts but they have the same effect of reducing tax liability, which consequently results in revenue loss to SARS. The distinguishing factor between tax avoidance and tax evasion is the legality attached to both concepts. Tax evasion is deemed to be illegal while tax avoidance is not.⁵⁵ Tax avoidance in the South African tax law system is divided into two forms, namely permissible tax avoidance and impermissible tax avoidance. The former is legal and the

⁵³ Ibid.

⁵⁴ Ibid.

⁵⁵ Prebble Z and Prebble J op cit note 7 at page 700. The authors state that both tax evasion and tax avoidance aim to reduce or to minimize tax liability, but avoidance is legal whereas evasion is illegal.

latter is illegal. Impermissible tax avoidance is illegal because it is not allowed by South African GAAR.

Tax avoidance and tax evasion are serious problems in South Africa as they both reduce revenue for SARS which in turn affects the South African economy. To deter taxpayers from engaging in tax evasion, Parliament introduced penalties and has criminalised tax evasion in section 235 of the TAA, and to deter impermissible tax avoidance, sections 80A to 80L were introduced. Instead of introducing penalties as remedies for impermissible tax avoidance, Parliament opted for corrective measures as remedies for impermissible tax avoidance.

The GAAR is partially intended to function as a deterrent, but it has been argued that its deterrent value could be enhanced if section 80B, or any provision in the TAA, provided for consequences of impermissible tax avoidance that are also punitive and not merely corrective. Because of the lack of penalties for impermissible tax avoidance, when a taxpayer enters into impermissible tax avoidance, he or she is not overly worried about possible application of the GAAR because he or she stands to lose nothing more than the taxes that would have been paid in the first place. This is problematic. The following chapter will deal with the approach in selected jurisdiction regarding GAAR scope and penalties for impermissible tax avoidance.

CHAPTER 3

GAAR and the consequences of impermissible tax avoidance in selected countries

3.1 Introduction

This chapter deals with a comparative analysis of the rules used to combat impermissible tax avoidance in selected jurisdictions. The study will be limited to three countries which will include the UK, Canada and Australia. The above-mentioned countries have enacted the GAAR as a tool to deter tax avoidance and tax law abuse. Between the three countries, only Australia and the UK have existing provisions for penalties for impermissible tax avoidance in their GAARs.

The purpose of this chapter is to compare the GAARs of the three countries in their respective jurisdictions with the intention of highlighting some of the important aspects of the foreign GAARs that South Africa can learn from in order to develop its GAAR to deter impermissible tax avoidance more effectively. Firstly, the chapter will deal with the UK GAAR, followed by the Canadian GAAR. The Australian GAAR will be discussed last.

3.1.1 *Duke Westminster case*

Before discussing the provisions of the UK GAAR, it is important to highlight the position prior to the introduction of the UK GAAR because the UK GAAR applies simultaneously with the judicial doctrines and the so called targeted anti-avoidance rules (“TAARs”).

The *Duke Westminster case*¹ is the starting point of this discussion. The principle introduced in the *Duke Westminster case* established a right of the taxpayer to order the

¹ *Duke Westminster v IRC* [1936] AC 1.

form of his affairs, not the substance, in a tax- efficient manner.² This form over substance approach was rejected by the Ramsay principle³ before it was again wholly rejected by the UK GAAR.⁴ The tax arrangement in this case was that the Duke's servant was paid weekly. For the purposes of reducing tax, the Duke's advisers executed a deed of covenant in which it was said that the earnings were not really wages but annual payment payable by weekly installments. A tax deduction was available for a person who executed a deed of covenant, which was valid if no consideration was paid by the recipient.⁵ The arrangement allowed the taxpayer to claim deductions for the amounts he paid to the servant, where a regular payment of wages would not have conferred the same advantages to the taxpayer. The Commissioner wanted the arrangement to be disregarded by the court on the basis that such payments were remuneration for services rendered and as a result the deduction should be disallowed. From the Commissioner's argument, it can be deduced that the Commissioner wanted the court to ignore the legal position and regard the substance of the matter.

The court rejected the Commissioner's arguments and held that, "this so called doctrine of 'the substance' seems to be nothing more than an attempt to make a man pay

² Kujinga BT, *a comparative analysis of the efficacy of the General Anti-Avoidance Rule as a measure against impermissible tax avoidance in South Africa* (LLD Dissertation, University of Pretoria, 2013) at page 252. Kujinga describes one enduring part of this principle by stating that "the principle set in the *Duke Westminster* case is the idea that a taxpayer has a right to choose business methods that attract the least amount of tax." This principle, it is submitted, is still applicable today because it is only Lord Tomlin's tolerance for legal form over legal substance that was done away with as mention in the main text above.

³ *WT Ramsay Ltd v CIR* [1981] STC 174.

⁴ Roberts B, *The new UK GAAR- a journey into the unknown?* 1. Available at http://www.rpc.co.uk/index.php?option=com_easyblog&view=entry&id=763&itemid... (accessed on 9 July 2015).

⁵ Kujinga BT op cit note 2 at page 249 para 2.1.

notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable”.⁶

The Ramsay principle developed in *WT Ramsay Ltd v CIR*⁷ rejected the form over substance approach which was applied in *Duke Westminster* case by highlighting the fact that the principle in *Duke Westminster* prevented a court from looking at the real nature of a transaction. The Ramsay principle required the courts to ascertain the legal substance of any transaction to which a tax or a tax consequence was sought to be attached.⁸ If the transaction was a series or combination of transactions, intended to operate as such, it is that series or combination that would be given regard, not the individual transactions in the series⁹ In *Duke Westminster case* the the House of Lords refused to disregard the legal character (form) of the deeds because the same result (substance) could be brought about in another manner.¹⁰ This means that the court looked at a single transaction and not all the steps involved as opposed to the *Ramsay* case where all the series of steps involved where regarded as a single indivisible whole in taking a decision. The Ramsay principle set a precedent for the courts to look at all the steps in a series of transactions and regard the composite scheme as a whole rather than individually.

3.2 The UK GAAR

Prior to 2013, the UK did not have a general anti-avoidance provision save for the TAARs and the judicial doctrines (Ramsay principle) that were used to deter and counteract impermissible tax avoidance. The GAAR was enacted in the Finance Act (“FA”) 2013 in Part 5 and only applies to transactions entered into after 17 July 2013.

⁶ *Duke Westminster* op cit note 1.

⁷ *WT Ramsay Ltd v CIR* op cit note 3.

⁸ *Landmark avoidance cases* available at: <http://www.taxation.co.uk/taxation/content/landmark-avoidance-cases> (accessed on 14 April 2016).

⁹ *Ibid.*

¹⁰ McLaughlin M *The Ramsay Principle* available at: <http://www.taxationweb.co.uk/tax-articles/general/the-ramsay-principle.html> (accessed on 14 April 2016).

The UK GAAR is only targeted at abusive tax avoidance, hence it is referred to as the General Anti-Abuse Rule instead of the common General Anti-Avoidance Rule.

Section 206 (1) of the FA provides for the purpose of the GAAR which is to counteract tax advantages arising from tax arrangements¹¹ that are abusive. The UK GAAR is intended to be a targeted GAAR which seeks to draw a line between what is permissible or impermissible by focusing on clearly abusive arrangements¹² while other GAARs, like the South African GAAR, seek to draw that line by distinguishing between permissible and impermissible tax avoidance. . Section 206 (3) (a) - (g) provides a list of taxes to which the GAAR applies to.

Section 207 of the FA is the heart of the UK GAAR in the sense that it provides for both the meaning of tax arrangement and the form of tax arrangement that is abusive. The definition of an abusive tax arrangement in section 207 provides a double reasonableness test which is the key provision.¹³ Only a court of law can decide whether the test is applicable or not.¹⁴ Furthermore the section provides a list, which is not exhaustive, of examples which might indicate that a tax arrangement is abusive.¹⁵ Like other GAARs, in terms of section 207 (1), for the UK GAAR to apply to an abusive arrangement, the main purpose or one of the main purposes must be to obtain a tax advantage.¹⁶

In terms of the structure of the UK GAAR and the judicial doctrines, it can be deduced that the UK has a substantially different approach to deterring abusive tax avoidance.¹⁷

3.2.1 Consequences of the application of the GAAR

In terms of section 209, tax arrangements that are abusive are to be counteracted by the making of an adjustment. The consequences in this section are certainly not different from the approach in section 80B of the South African GAAR except that

¹¹ For the definition of an arrangement, please see s214 of the FA.

¹² Kujinga op cit note 2.

section 209(4) makes provisions that the adjustments may include those that impose or increase a liability to tax. In terms of this section, there are possibilities that the tax liability might be higher than it would have been charged in the absence of the impermissible tax avoidance.

Section 211 of the FA places the onus of proof on HRMC to show that there are arrangements that are abusive and that the adjustment made to counteract the tax advantage arising from the arrangements are just and reasonable. Prior to 15 September 2016, there were no penalties in the UK GAAR for entering into abusive tax arrangements to which the rule may apply and consequently the GAAR did not discourage taxpayers from entering into abusive tax arrangements schemes any more than its South African counterpart.¹⁸

3.2.2 The introduction of penalties for abusive tax avoidance in the UK

The UK Government through section 212A of the Finance Act 2016 No. 2, introduced penalties for abusive tax avoidance in order to tackle those who persistently enter into tax avoidance or abusive schemes that are defeated by HMRC.¹⁹ A tax-geared penalty will be applied against a taxpayer whom gets caught by the GAAR.²⁰ Consequently a

¹³ Seely A, *Tax Avoidance: A General Anti-Abuse Rule* (last updated 6 February 2015) 47.

¹⁴ Ibid.

¹⁵ For the list of examples that indicates that tax arrangements are abusive, please see s207 (4) (a) - (c).

¹⁶ Please see s208 of the FA which provides the meaning of a tax advantage.

¹⁷ Kujinga BT op cit note 2 at page 275 para 6.1.1 sub-para 2.

¹⁸ TUC, *The Deficiencies in the General Anti-Abuse Rule, paragraph e 7*.

¹⁹ White S, *FB2016: clause 63 to curb serial users of defeated tax avoidance schemes*. Available at <https://www.accountancylive.com/fb2016-clause63-curb-serial-users-defeated-tax-avoidance-schemes> (accessed on 31 February 2016).

²⁰ Renz P, *The Budget 2015- Tax Avoidance and Fraud* (18 March 2015) available at <http://www.scott-moncrieff.com/news/news-updates/the-budget-2015-tax-avoidance-and-fraud1>. (accessed on 17 March 2016).

taxpayer engaging in abusive tax avoidance schemes which get caught by the GAAR will be charged a penalty of 60% of the value of the counteracted advantage.²¹

HMRC still feels that, despite considerable progress in tackling tax avoidance, there remains a small but persistent number of tax avoiders who are undeterred from engaging in abusive tax avoidance.²² For the above reasons, the UK government wants to change the behaviour of the most persistent tax avoiders who continue to try by all means to avoid their tax obligations by strengthening the deterrent effect of the GAAR and ensuring that there is an effective disincentive from entering into abusive tax avoidance in the first place.²³

60% of the counteracted tax advantage (tax benefit) can be said to be a little on the harsh side. However, this penalty must be viewed in the light of the provisions of the UK GAAR, which is designed to counteract arrangements that are so patently abusive that there is no reasonable person who would view them otherwise. A heavy penalty for the most abusive arrangements is therefore not undesirable. It can be noted that the first ever UK GAAR was introduced in 2013, and it has taken about three years for the UK to impose penalties for abusive tax avoidance in order to enhance the deterrent effect of its GAAR. This can be contrasted with the current position in South Africa, where there has been a GAAR for a much longer time but no penalties to further deter impermissible tax avoidance. It is submitted that the position in South Africa must move towards the imposition of penalties for impermissible tax avoidance as a way of increasing the deterrent value of the GAAR.

²¹ HMRC, *Overview of Legislation in Draft*, (9 December 2015) at page 156. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/484588/OLD.pdf (accessed on 15 January 2016).

²² Ibid.

²³ Ibid.

3.3 The Canadian GAAR

Canada's GAAR is contained in section 245, under Part XVI, of the Canadian Income Tax Act ("CITA"). It is intended to counteract and deter abusive tax avoidance transactions. Like the UK GAAR, the Canadian GAAR is also intended to be used as a supplementary rule used to deter abusive tax avoidance where the other anti-avoidance rules fail.²⁴ Section 245(1) of the CITA provides the meaning of a "tax benefit", "tax consequences" and "transaction". In the case of *Canada Trustco Mortgage Co. v Canada*²⁵ the court stated that in a GAAR analysis, the following three questions needs to be asked:

1. Was there a tax benefit arising from a transaction under s 245(1) and (2)?;
2. Was the transaction giving rise to the tax benefit an avoidance transaction under s 245(3)? and
3. Was the avoidance transaction giving rise to the tax benefit abusive under s 245(4)?²⁶

As stated above, the analysis or application of the GAAR involves three steps with the onus on the taxpayer to refute points 1 and 2 above and on the minister to establish point 3.²⁷ Section 245(2), which is the charging provision, provides that:

²⁴ Krishna V *Fundamentals of Canadian Income Tax, An introduction* 3 ed at page 875 par 4.

²⁵ *Canada Trustco Mortgage Co. v Canada* [2005] 2 S.C.R. at page 601, 2005 SCC 54.

²⁶ *Ibid* at page 66.

²⁷ *Ibid*.

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.

Section 245(2) provides an action that will follow a transaction that amounts to tax avoidance in order to deny the tax benefit resulting from that transaction. These consequences will be applied to a taxpayer who gets caught by the GAAR. This section is silent about penalties for impermissible tax avoidance.

Section 245(3) provides a wider meaning of an avoidance transaction and at the same time provides for instances where it does not give rise to an avoidance transaction. This section applies to any transaction, including that which is part of transactions, which would result, directly or indirectly, in a tax benefit but does not extend to transactions which may reasonably be considered to have been arranged primarily for bona fide purposes other than obtaining a tax benefit. Section 245(3) is also targeted at a transaction that is part of a series of transactions and amounts to a tax avoidance transaction. This type of transaction is usually found in a complex series of transactions entered into for the purposes of hiding the true nature of the transaction.

Krishna notes that where a transaction is carried for a combination of bona fide non-tax purpose and avoidance, the primary purpose of the transaction must be determined.²⁸ Krishna notes further that this will likely involve weighing and balancing the tax and non-tax purpose of the transaction.²⁹ The Canadian GAAR does not require a transaction to satisfy a business purpose test, all that is required is that the transaction must have been arranged primarily for a *bona fide* purposes other than for the purpose of obtaining a tax benefit.³⁰

²⁸ Krishna V op cit note 24 at page 881.

²⁹ Ibid.

³⁰ Ibid at page 881 sub-par c.

Section 245(4) limits the application of the GAAR by stating that subsection 2 applies to a transaction only if it may reasonably be considered that the transaction would result directly or indirectly in a misuse of the provisions of CITA or an abuse having regard to the provisions of CITA, other than this provision, read as a whole. This section limits the GAAR to apply only to transactions that abuse or misuse the provisions of CITA, Income Tax Regulations, Income Application Rules, tax treaties and any other enactment that is relevant in computing tax. This means that, in terms of section 245(4), the GAAR does not apply even if a transaction or a part of a series of transactions is arranged in primarily for tax purposes as long as it does not misuse or abuse the Acts listed in section 245(4).³¹

In terms of the CITA, once it has been determined that the GAAR applies, the Minister has powers to ignore the tax benefits of the transaction in question.³² In terms of section 245(5), any deduction, exemption or exclusion in computing income may be disallowed in whole or in part, allocated to any person and the nature of any payment or other amount may be recharacterized. The whole of section 245(5) is aimed at remedying the effects of impermissible tax avoidance and protecting tax due to Revenue Canada. Tax benefits arising from abusive transactions or transactions that misuse the provisions of any one of the Acts listed in section 245(4) (a) are dealt with in terms of section 245(5) with the consequences being disallowing the tax benefit in whole or in part, recharacterising the payment or treating the transaction as if it was entered into between people dealing at arm's length in order to deny such tax benefits. In *Mathew's case*³³ the court struck down an abusive tax avoidance arrangement and it was stated that:

[t]he Minister properly disallowed the taxpayers' deductions under the GAAR. To allow the taxpayers to claim the losses in this case would defeat the purposes of [s. 18\(13\)](#) and the partnership provisions. Interpreted textually, contextually and purposively,

³¹ Krishna V op cit note 24 at page 887.

³² Ibid.

³³ *Mathew v Canada* (2005 SCC 55).

[s. 18\(13\)](#) and [s. 96](#) of the [Income Tax Act](#) do not permit arm's length parties to purchase the tax losses preserved by [s. 18\(13\)](#) and claim them as their own. The purpose of [s. 18\(13\)](#) is to transfer a loss to a non-arm's length party in order to prevent a taxpayer who carries on a business of lending money from realizing a superficial loss. The purpose of the broad treatment of loss sharing between partners is to promote an organizational structure that allows partners to carry on a business in common, in a non-arm's length relationship. [Section 18\(13\)](#) preserves and transfers a loss under the assumption that it will be realized by a taxpayer who does not deal at arm's length with the transferor. Parliament could not have intended that the combined effect of the partnership rules and [s. 18\(13\)](#) would preserve and transfer a loss to be realized by a taxpayer who deals at arm's length with the transferor. To use, as here, these provisions to preserve and sell an unrealized loss to an arm's length party results in abusive tax avoidance under s. 245(4).³⁴

There was no disincentive on the taxpayer after the transaction was found to be abusive tax avoidance transaction save for the recharacterization of the transaction to include the avoided amount in the assessable income. Just like South African GAAR, the Canadian GAAR does not provide for penalties for impermissible tax avoidance. They all rely on recharacterising the transactions and making adjustments in order to deny the tax benefits. This shows that while the absence of penalties for impermissible tax avoidance may adversely affect a GAAR's deterrent nature, South Africa is not the only country in the world without such penalties.

³⁴ Ibid at page 58.

3.4 The Australian GAAR

The Australian GAAR is contained in Part IVA which was added into the Income Tax Administration Act 1936 (“ITAA”) by the Income Tax Laws Amendment Act 2 of 1981.³⁵ The introduction of Part IVA of the ITAA meant the end of section 260 which was repealed by the same Act in 1981. Part IVA was enacted to target impermissible tax avoidance and allow permissible tax avoidance.

Part IVA of the ITAA has three main elements or requirements that must be present for a transaction to be impermissible. First, there must be a scheme, secondly, there must be a tax benefit and lastly, any one of the persons who entered into the scheme or part of the scheme must have done so for the dominant purpose of giving the taxpayer the relevant tax benefit.³⁶ This means that if there is a scheme, that scheme must result in a tax benefit and any person who entered into that scheme, must have done so for the dominant purpose of obtaining a tax benefit. Should any of the elements be missing in a transaction, then the GAAR will not apply.³⁷

Section 177A contains guidelines on the interpretation of Part IVA and section 177B is more focused on the operation of Part IVA of the ITAA. A scheme has been defined broadly to refer to any understanding, arrangement, agreement, promise, or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by a legal proceeding and it has been defined further to include any plan, proposal, action, course of action or cause of conduct.³⁸ In *Federal Commissioner of Taxation v Spotless Services Ltd*³⁹ it was stated that it is not difficult to determine the existence of a scheme but it must be on the basis of fact and reality and not determined by reference to a desired outcome. Identifying the scheme will help to determine

³⁵ Kujinga BT op cit note 2 at page 146.

³⁶ Waincymer J, *Australian Income Tax Principles and Policy*, 2 ed at page 503.

³⁷ Kujinga BT op cit note 2 at page 148.

³⁸ Section 177A (1) (a) and section 177A (1) (b) of Part IVA of the ITAA.

³⁹ *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 95 ATC 4775.

whether or not, a taxpayer has obtained a tax benefit in connection with the scheme and the taxpayer's dominant purpose was to obtain the resultant tax benefit. From the above definition of a scheme, it is clear that any transaction concluded by a taxpayer will fall within the definition of a scheme, however, for the purpose of Part IVA, it will be excused only if there is no tax benefit or there is no dominant purpose to obtain a tax benefit.

Tax benefit refers, amongst others, to:

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.⁴⁰

Furthermore, tax benefit can include any amount resulting from deductions allowable to the taxpayer, capital loss incurred by the taxpayer, and foreign income tax offset allowed to the taxpayer.⁴¹ As mentioned above, once it is identified that there is a scheme, it must be determined whether that scheme has resulted in a tax benefit or not. If it has or there is a connection between the tax benefit and the scheme, then the provisions of the GAAR may be invoked. The Commissioner has powers to cancel the tax benefit wholly or in part in circumstances where a tax benefit has been or is about to be obtained.⁴²

Section 177D requires a dominant purpose of a person entering into a scheme, rather than the purpose of the transaction.⁴³ This dominant purpose test has to be determined

⁴⁰ Section 177C (1) (a) of the ITAA.

⁴¹ Please see s 177C of the ITAA for amounts included and excluded from the definition of a tax benefit. Since this section is very wide, it has limitations within which provides for transactions that can be or cannot be caught by the GAAR.

⁴² See s 177F for circumstances in which a tax benefit may be cancelled by the Commissioner.

⁴³ Pagone GT *Part IVA: The General Anti-Avoidance Provisions in Australian Taxation Law*, (2003) *Melbourne University Law Review*, Vol 27, 770-799, at page 779.

in accordance with the provisions of section 177D (2) which contains (inexhaustive) factors that are to be used as guidelines to determine same.⁴⁴ In terms of this section, a transaction that is commercially sound can still be attacked by Part IVA only if a dominant purpose to avoid tax is found to exist.⁴⁵

Before applying Part IVA of the ITAA, there must be a scheme which results or will result in a tax benefit being obtained. After it has been determined that a tax benefit has been obtained or will be obtained, then the Commissioner will determine the dominant purpose of the taxpayer in accordance with section 177D. After the above has been determined and if it is found that Part IVA applies to the scheme, then the provisions of section 177F may be applied accordingly. In terms of section 177F, the Commissioner has the powers to cancel a tax benefit resulting from a scheme. This section is aimed at denying the taxpayer a tax benefit resulting from an impermissible tax avoidance scheme. Section 177F has a recharacterising effect on the transaction and the Commissioner has powers to adjust the tax benefit accordingly by denying the tax benefit wholly or partially.

The application of Part IVA is dependent on whether there is a scheme or not and whether a tax benefit has been obtained or not. If it is determined that there is a scheme and that a tax benefit has been obtained and in addition to the finding, it is determined that the sole or dominant purpose of the taxpayer who entered into or carried out the scheme was to enable that taxpayer to get the tax benefit then section 177F applies. Section 177F grants the Commissioner powers to cancel the tax benefit. This can be done by:

(1) including the amount, in whole or part, not included in the assessable income of the taxpayer of that year of income; or

⁴⁴ Kujinga BT op cit note 2 at page 158.

⁴⁵ Pagone GT op cit note 43. Pagone states that the overall commercial purpose of a transaction will not prevent the application of Part IVA where a part of the structure of the transaction is to be explained by reference to section 177D purpose, at page 795.

- (1) Disallowing the tax deduction, in whole or part, that was allowed to the taxpayer in relation to that year of income; or
- (2) Treating a capital loss or part of a capital loss as if it was not incurred by the taxpayer during that year of income; or
- (3) Disallowing a tax benefit, that is referable to a foreign income tax offset, or part of a foreign income tax offset, that was allowed to the taxpayer; or
- (4) Disallowing a tax benefit that is referable to an exploration credit, or part of the exploration credit that was allowed to a taxpayer; and

Where the Commissioner makes such a determination, he or she shall take such action as he or she considers necessary to give effect to that determination.⁴⁶

The above powers enable the Commissioner to adjust or recharacterise a scheme to enable him or her to deny a tax benefit resulting from a scheme.

Administrative penalties for scheme benefits in Australia

Furthermore, the Commissioner is entitled to take any necessary action that will give effect to his determination. The action may include charging a penalty for impermissible tax avoidance in accordance with subdivision 284 – C, in schedule 1 of the Taxation Administration Act 1953. In terms of section 284 – 140, a taxpayer may be liable for an administrative penalty if the taxpayer has obtained a scheme benefit. This scheme benefit is connected to the scheme in Part IVA because for the administrative penalty to apply the taxpayer would, but for an anti-avoidance provision such as Part IVA and other similar provisions in Australian Goods and services tax system, have obtained a scheme benefit. It must also be reasonable to conclude that the taxpayer entered into the scheme or carried it out with the sole or dominant purpose of obtaining a tax benefit, which according to the Commissioner is an objective test.⁴⁷ A sole or dominant purpose to obtain a tax benefit is also part of the Part IVA enquiry as discussed above.

Section 284-160 provides for what is known as base penalty amount as follows:

⁴⁶ Section 177F (1) of Part IVA of the ITAA.

⁴⁷ Deutsch R, Fiezer M, Fullerton I, Hanley P and Snape *The Australian Tax Handbook* at page 1853.

- (1) The base penalty amount for a scheme to which subsection 284-184(1) applies, subject to section 284-224:
- (a) 50% of the scheme's shortfall amount; or
 - (b) 25% of the scheme's shortfall amount if it is reasonably arguable that the adjustment provision does not apply.

Section 284 – 150(1) defines a scheme benefit, and states that it exists if, apart from the scheme, the taxpayer's tax liability for an accounting period was reduced or it can reasonably expected to be less than what it would have been.⁴⁸

The base penalty amount for a scheme to which subsection 284-145(2B) applies is worked out using a table⁴⁹ and section 284-224 if relevant. The base penalty amount that is applicable is calculated on the scheme benefit amount. The base penalty amount is lowered to 25% where it is reasonably arguable that the provisions of Part IVA would not apply. A position is reasonably arguable if having regard to the facts of the transaction that the argument that Part IVA does not apply is "about as likely to be correct as it is incorrect or is more likely to be correct than incorrect."⁵⁰ In *Walstern Pty Ltd v FCT*⁵¹ it was held that the question is whether, on a balance of probabilities, the position taken can be said to be one that can be arguable on rational grounds to be right, even though it is in fact wrong. The lowering of the base penalty amount to 25% in these circumstances shows an attempt to treat transactions that are borderline impermissible more leniently than transactions that are doubtlessly impermissible (where 50% base penalty amount applies). The above penalties have been applied to the *Orica Limited v Commissioner of Taxation*⁵² where an additional tax was imposed by

⁴⁸ In *FCT v Star City Pty Ltd (No2)* (2009) 74 ATR 431, it was stated that where a scheme does not provide a benefit due to the operation of another tax law, there arises no scheme benefit and no penalty under subdivision 284 – C can be imposed.

⁴⁹ For this table, please see s 284-160 (3) in schedule 1 of the Taxation Administration Act 1953.

⁵⁰ Deutsh et al at page 1850, also see generally section 284 – 15(1).

⁵¹ (2003) 54 ATR 423, also see *Prebble v FCT* (2002) 51 ATR 459 and *RE Cachia and FCT* (2008) 73 ATR 233 for other interpretations of the provision that results in the lowering of the base penalty amount.

⁵² *Orica Limited v Commissioner of Taxation* 2015 FCA 1399.

a way of penalty at a rate of 50%. The effect of the base penalty amount is an increase in the revenue collected, which ends up being 25% or 50% more than the tax collected as a denied tax benefit.

Krampel Newman Partners Pty Ltd v Commissioner of Taxation,⁵³

In the case of *Krampel Newman Partners Pty Ltd v Commissioner of taxation*, the Commissioner struck down a tax avoidance scheme to which Part IVA applied and imposed additional tax by a way of penalty at a rate of 50%. The applicants applied to the Federal Court of Australia challenging the assessment by way of penalty of additional tax equal to 50% of the shortfall and contended that it should only have been imposed at the rate of 25%.⁵⁴ The challenge by the applicants was rejected by the court and the application was dismissed.⁵⁵ The above penalty was imposed under the repealed s226 of the ITAA.

The Australian GAAR is structured in such a way that a taxpayer who avoids tax will be made to pay for his attempts to deprive the Australian Government of the tax due to it. Accordingly a taxpayer who is aware of the provisions of section 284-160 and Part IVA of the ITAA will have more reasons to refrain from avoiding tax and that is what gives the Australian GAAR the added advantage as a deterrent to impermissible tax avoidance over GAARs that do not have penalty provisions.

3.5 Conclusion

The objective of studying the different GAARs was to identify some of the important aspects of the GAARs regarding the structure and the effectiveness of the GAARs in combating impermissible tax avoidance. Furthermore, it is important to note the lessons that South Africa can take cognizance of to better curb impermissible tax avoidance.

⁵³ *Krampel Newman Partners Pty Ltd v Commissioner of Taxation* [2003] FCA 123.

⁵⁴ *Ibid* at 114.

⁵⁵ *Ibid* at 122.

The UK GAAR is a unique GAAR in the sense that it targets only the most abusive arrangements. This might be explained by the reference to the fact that it is not the only general anti avoidance mechanism in the UK, with the Ramsay principle still applicable to arrangements that do not meet the GAAR's threshold of strong abuse. The nature of the UK GAAR also helps to explain the heftiness of the penalty imposed for abusive tax avoidance, 60%, which is higher than the Australian top base penalty amount of 50%. The theoretical justification seems to be that if an arrangement is abusive enough to be struck by a GAAR that already sets a high threshold, then it must be subject to a high penalty. There is no provision for a lower penalty, even for arrangements that are struck down in terms of the Ramsay principle.

In Australia, Part IVA has been used to strike down commercial transactions, simply because they were structured in a particular way to confer tax benefits, over and above the commercial benefits. The Australian GAAR sets a much lower threshold than the UK GAAR. There are two base penalty amounts applicable to scheme benefits to which Part IVA applies, namely 50% and 25% if it can reasonably be argued that Part IVA does not apply to the transaction. The provision of a lower base penalty amount is to distinguish between transactions that are clearly impermissible and those that are marginally impermissible, and punishing the former harder than the latter. Penalties for impermissible tax avoidance clearly augment the deterrent value of the respective GAARs and also allow revenue authorities to collect more revenue than just the taxes due in the first place.

The absence of penalties for impermissible tax avoidance in Canada shows that the current position in South Africa is not necessarily unique. However, it is argued that the better approach is to have penalties and that lessons on the structuring of the penalties can be learnt in countries such as the UK and Australia.

CHAPTER 4

Arguments for and against the introduction of penalties for impermissible tax avoidance

4.1 Introduction

Introducing penalties for impermissible tax avoidance in any jurisdiction is likely to elicit a hostile taxpayer response. This chapter is aimed at discussing the reasons in support of and against the introduction of penalties for impermissible tax avoidance in South Africa. The discussions held in Chapter 2 and 3 above which dealt with the South African, UK, Canadian and Australian GAARs will be instrumental in this discussion as they provide guidance on what any proposed penalties will be based on. As indicated in Chapter 1, there is currently no scholarship on penalties for impermissible tax avoidance in South Africa, and the arguments presented below are the author's own original presentations on the idea.

4.2 Arguments for the introduction of penalties for impermissible tax avoidance in South Africa

It is submitted that South Africa needs a dedicated section that authorizes the Commissioner to impose penalties for impermissible tax avoidance within the GAAR. These penalties will enable the Commissioner to levy penalties on taxpayers whose avoidance arrangements get caught by the GAAR and as a result may help SARS generate more revenue. The current consequences for impermissible tax avoidance in section 80B are not sufficiently effective in deterring tax avoidance because the effect of the consequences is only a recharacterisation of the transaction to deny the tax benefit. In short the taxpayer is put in a position he or she would have been had he not avoided tax or maybe possibly pay interest. These consequences cannot improve the deterrent value of the GAAR, and scarcely discourage taxpayers from entering into impermissible transactions. The introduction of penalties will help to ensure that taxpayers that formulate stratagem aimed at abusing the tax law and at avoiding taxes impermissibly suffer financial penalties over and above the taxes that would have been paid in the first place.

4.2.1 Impermissible tax avoidance is abusive

The first argument for the imposition of penalties is that impermissible tax avoidance is abusive. Tax evasion is defined as an illegal activity in which a taxpayer reduces his or her tax liability.¹ As seen in Chapter 2 above, penalties chargeable for a taxpayer that evades tax can be up to a maximum percentage of 200% of the taxes due in the first place. The reason the penalties can be harsh and aggressive, especially in repeat or obstructive cases, is because tax evasion is an illegal activity and a criminal offence. In short tax evasion disregards and violates the tax laws. On the other hand, impermissible tax avoidance is said to be abusive of the law and results in revenue loss, but there are no penalties payable for (impermissible) tax avoiders. If one looks at the intention of the legislator when the GAAR was introduced or the purpose of the GAAR, it can be said that the GAAR is aimed at curbing and deterring avoidance arrangements that are consistent with the indicators of impermissible tax avoidance namely misuse or abuse, abnormality and lack of commercial substance.

Any impermissible tax avoidance transaction to which the GAAR has been applied will be struck down and be recharacterized by the Commissioner. The reason penalties for impermissible tax avoidance should be introduced is because the intention of the legislator is to deter impermissible tax avoidance and for the legislator to succeed, the introduction of penalties may play an integral part. Like tax evasion, impermissible tax avoidance is an abuse to the tax laws and penalties should be introduced for such.

¹ *Addressing Tax Evasion and Avoidance*, GIZ Sector Programme Public Finance, Administrative Reform at page 9.

4.2.2 Penalties may discourage taxpayers from entering into impermissible tax avoidance transactions²

Currently there are no financial losses for avoiding tax impermissibly, meaning that there is no discouragement for taxpayers to refrain from entering into transactions that amount to impermissible tax avoidance.³ Should penalties for impermissible tax avoidance be introduced, taxpayers may be less inclined to test the limits of the GAAR by entering into questionable avoidance arrangements. In other words, no taxpayer or fewer taxpayers will want to risk being penalized for trying to avoid tax impermissibly because of the enhanced deterrent effect of the GAAR. This may help reduce the tax gap and enable SARS to raise revenue and contribute to economic growth and the delivery of public services.

4.2.3 Experience in other countries that impose penalties and those that don't impose penalties

In Australia, the problem of tax avoidance is dealt with in accordance with what is proposed for South Africa above. There is a GAAR that, when applied, has the effect of giving the Commissioner powers to reconstruct the taxpayer's transaction to deny any tax advantage obtained from the transaction and in addition to the above consequences, penalties exist for tax avoidance arrangements. It is submitted that these penalties can discourage taxpayers from entering into arrangements that amount to impermissible tax avoidance because they have effects of inflicting harm to the taxpayer's financials. For example, in *Orica Limited v Commissioner of Taxation*,⁴ the

² Just like HMRC's view that the introduction of penalties will strengthen the deterrent effect of the GAAR by ensuring that there is an effective disincentive from entering into abusive tax avoidance in the first place, it is submitted that a discouragement in a form of penalty will help strengthen South Africa's GAAR to be an effective deterrent in combating impermissible tax avoidance.

³ see TUC's submissions in *The Deficiency in the General Anti-Abuse Rule*, where they argue that they believe that a penalty should apply if a person made use of a scheme knowing that the Rule was likely to apply to it. Penalties have since been introduced in the UK.

⁴ *Orica Limited v Commissioner of Taxation* 2015 FCA 1399.

court held that Part IVA applied to a scheme where deductions of US\$112 million were claimed for interest on inter-corporate group and a 50% penalty was charged on the taxpayer who tried to avoid tax.⁵ For example, if the US\$112 million was the amount of tax avoided, the taxpayer would pay that amount plus 50% of that amount as a penalty. In this case the taxpayer would have lost US\$56 million as a penalty for avoiding tax. This is the disincentive that the South African government needs in order to raise revenue or protect the revenue due to it and to strengthen the deterrent effect of the GAAR. In Australia, taxpayers are obliged to pay the correct amount of tax or be penalized under the Act.⁶

Amongst other countries that have penalties for impermissible tax avoidance but are not discussed in this research, USA imposes a strict 20% penalty for underpayment attributable to any disallowance of claimed benefits by reason of a transaction lacking commercial substance.⁷ The penalty increases to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the treatment.⁸ Like the USA tax system, the Australian taxation system has been designed and implemented to ensure that as many people as possible pay their fair share of taxes.⁹

South Africa and Canada do not impose penalties for impermissible tax avoidance. The Commissioner in the above countries is granted powers to recharacterise the transaction according to what would have happened in the absence of the

⁵ Morgan J, *Orica v FCT* – Federal Court found that interest deductions for an international ‘round-robin’ were denied by Part IVA, available at <http://taxtechnical.com.au/36508-2/> (accessed on 22 April 2016).

⁶ Ivan P *Thinking about Tax Avoidance*, at page 6.

⁷ Dr Lampreave P, *an assessment of the Anti-Tax Avoidance Doctrines in the United States and the European Union* *Bulleting for International Taxation* at page 160.

⁸ Perkins RH, *Forcing Cooperation: A strategy for improving tax compliance*, *University of Cincinnati Law Review*, Vol. 79, No. 4, 1415-1459, 2011 at page 1446.

⁹ Ivan P op cit note 6.

impermissible tax avoidance transaction.¹⁰ This will result in the taxpayer being put in a position he or she would have been had he not avoided the said tax. This position, as compared to the position in Australia, shows that for a GAAR to be a more effective deterrent, penalties for impermissible tax avoidance need to be included within or linked to the GAAR. By way of comparison, the countries without penalties for impermissible tax avoidance are more likely to suffer losses in their revenue because there is nothing protecting their revenue. For example a taxpayer who avoids tax and gets caught by the GAAR of the said countries, the taxpayer in a country without penalties for impermissible tax avoidance will only pay the tax that would have been due to that government if avoidance had not taken place while on the other hand, the taxpayer in a country with penalties for impermissible tax avoidance will pay what would have been due to that government in the absence of tax avoidance and a certain percentage of the amount of tax avoided in a form of a penalty. The taxpayer in the former countries does not suffer any financial loss except for the interest while a taxpayer in the latter country will suffer a huge loss.

4.3 Arguments against the introduction of penalties for impermissible tax avoidance

4.3.1 No clear line between what is permissible or impermissible

There is one fundamental argument against the imposition of penalties for impermissible tax avoidance that one can conceive. As noted by Kujinga, impermissible tax avoidance is difficult to define because it is unpredictable and ever-changing.¹¹ It can be argued that, it is important to clearly distinguish between impermissible tax

¹⁰ For the position in Canada, please see Ernst & Young, GAAR rising, Mapping tax enforcement's evolution (2013) page 40.

¹¹ Kujinga BT, *A comparative analysis of the efficacy of the General Anti-Avoidance Rule as a measure against impermissible tax avoidance in South Africa*. (LLD Dissertation University of Pretoria, 2013) at page 42.

avoidance and permissible tax avoidance before imposing penalties.¹² This is because there must be certainty on when an avoidance arrangement becomes impermissible before imposing penalties on it. The distinction will provide guidelines as to what is permissible and impermissible. Currently, the South African GAAR does not provide a clear line between what is permissible or impermissible. Since, in terms of the current GAAR, it is difficult to establish whether a transaction amounts to impermissible tax avoidance or not, the penalties for impermissible tax avoidance might not be applied or may be applied incorrectly to transactions that should not amount to impermissible tax avoidance. However, this argument can be countered by structuring the penalty provision in such a way that avoidance arrangements that are clearly abusive and on the extreme end of impermissible tax avoidance are subject to a higher penalty than avoidance arrangements whose impermissibility is disputable and that can evoke a reasonable argument that the GAAR should not have applied, as is the case in Australia.

4.4 Conclusion

The arguments for the introduction of penalties for impermissible tax avoidance outweigh the arguments against the introduction of same. The GAAR is partially aimed at deterring impermissible tax avoidance but as it stands, according to the consequences that will follow should the GAAR apply to the transaction, it can be argued that it is not as effective as it should be. Something that is a deterrent must have an effect of preventing an action from taking place but the consequences in South Africa's GAAR are aimed at correcting the action instead of preventing it. For it to be preventive, it should discourage taxpayers so that they refrain from entering into impermissible tax avoidance arrangements. A reasonable taxpayer will consider not entering into impermissible avoidance transactions if he or she is aware that should it be

¹² Steenkamp LE Combating impermissible tax avoidance through efficient administrative approaches: what SARS can learn from its Canadian counterpart *Comparative and International Law Journal of Southern Africa* 2012, V45 at 228-257.

struck down by the GAAR, that taxpayer may end up paying a significant amount of the tax avoided in the form of penalty. This will have an adverse effect on the taxpayer's financial affairs. The most important argument against the introduction of penalties for impermissible tax avoidance is that there is no clear line between what constitutes permissible and impermissible transactions, which might lead to penalties being charged to transactions that should not be caught by the GAAR. However, by having different penalty levels for abusive and less abusive avoidance arrangement, this concern can be significantly mitigated.

CHAPTER 5

5.1 Conclusions

The main aim of this research was to investigate the need for the introduction of penalties for impermissible tax avoidance. The research was carried out in a manner that tested the effectiveness of the current South African GAAR and compared it to the effectiveness of foreign GAARs in combating impermissible tax avoidance. The research also looked at the effectiveness of section 80B of the GAAR as a remedy for a failure to refrain from impermissible tax avoidance arrangements and whether it is necessary to introduce penalties for impermissible tax avoidance.

5.1.1 The legality attached to tax avoidance

A problematic issue identified was the legality attached to tax avoidance as it is defined as an act in which a taxpayer has arranged his affairs in a perfectly legal manner, with the result that he has either reduced his income or has no income on which tax is payable.¹ The legality attached to impermissible tax avoidance adds to the fact that there is no fine line between what is permissible and impermissible. It is difficult to draw this fine line because both permissible and impermissible tax avoidance are labeled 'legal'. The definition of tax avoidance is so broad that it includes both forms of avoidance which are permissible and impermissible tax avoidance. If both are legal, then one needs to ask himself the reasons for differentiating between the two if they have the same legal status, and for allowing the one while disallowing the other. The rules of law enacted to combat impermissible tax avoidance makes it clear that impermissible tax avoidance is not allowed in terms of those rules of law, therefore it is unlawful. Anything that is unlawful is illegal but this does not mean that it is a criminal act. Consequently, it is submitted that impermissible tax avoidance be seen as an illegal concept that must attract the same financial consequences as tax evasion, which is illegal.

¹ Silke; *South African Income Tax*, 2013, at page 773.

5.1.2 The South African GAAR structure

With regard to the structure of the South African GAAR as compared to other GAARs, there are lessons that can be learned from those GAARs. In terms of structure, the South African GAAR is complex due to the presence of a number of open ended tainted elements, some of which are unique to this GAAR namely abnormality for a bona fide business purpose and the creation of abnormal rights and obligations.² The South African and Canadian GAARs have the misuse or abuse of the tax laws indicator, while the Australian GAAR is centered on the objective sole or dominant purpose of obtaining a tax benefit indicator.³ All the GAARs have consequences attached to a transaction that is caught or may be caught by the GAAR. These consequences have the effect of recharacterising the transaction and adjusting the tax benefit obtained by the taxpayer. In the South African GAAR these consequences are contained in section 80B of the ITA. While the complexity and uncertainty of the South African GAAR does function as a deterrent, the consequences of the application of this GAAR do not enhance the deterrent value of the GAAR. This is because when these consequences are applied, they have the effect of putting the taxpayer in a position he or she would have been in the absence of such tax benefit. State resources are lost in trying to recover the tax avoided but the taxpayer who gets caught does not suffer any financial loss.

5.1.3 Lack of penalties for impermissible tax avoidance in South Africa as a major distinguishing factor from the Australian and UK GAAR

One of the substantial differences between the Australian GAAR and the other GAARs as discussed is that the Australian GAAR, even though it also has the same consequences as the other GAARs regarding reconstruction and recharacterisation, is backed up by penalties for impermissible tax avoidance. A 50% penalty for impermissible tax avoidance was applied in Australia in *Orica Limited v Commissioner*

² Kujinga BT, *A comparative analysis of the efficacy of the General Anti-Avoidance Rule as a measure against impermissible tax avoidance in South Africa* (LLD Dissertation University of Pretoria, 2013).

³ Ibid.

of *Taxation* case,⁴ where the court held that Part IVA applied to a scheme where deductions of US\$112 million were claimed for interest on inter-corporate group loans.⁵ The court dismissed the taxpayer's claim that the dominant purpose was not to obtain a "tax benefit" but to generate income for the US companies.⁶ Pagone J found that the scheme penalty amount under section 284-145 of schedule 1 should not be reduced to 25% because the taxpayer's position was not 'reasonably arguable', as contemplated by section 284-15(1). The taxpayer was charged a penalty of 50% in terms of section 284-160. The tax that was avoided in the *Orica Limited v Commissioner of Taxation* case was recovered and the taxpayer was required to pay 50% of the avoided tax as a penalty.

Taking into account the above case and the provisions of the Australian GAAR system, it is submitted that penalties for impermissible tax avoidance should be introduced in South Africa. For as long as South Africa does not have penalties for impermissible tax avoidance, taxpayers will have no deterrent disincentive to creating ingenious avoidance arrangements. The arguments for introducing penalties for impermissible tax avoidance outweigh the arguments against the introduction of impermissible tax avoidance. Where there is abuse of the law, there must be penalties that must be suffered by the abuser.

5.2 Recommendations

The South African GAAR should be strengthened by introducing penalties for impermissible tax avoidance. The consequences in section 80B need to be more compelling and in the form of a penalising measure instead of a corrective measure. The penalties may be categorised from not overly abusive which attracts less penalties to serious abuse which attracts deterrent penalties as follows:

⁴ *Orica Limited v Commissioner of Taxation* 2015 FCA 1399.

⁵ Morgan J, *Orica v FCT* – Federal Court found that interest deductions for an international 'round-robin' were denied by Part IVA, available at <http://taxtechnical.com.au/36508-2/> (accessed on 22 April 2016).

⁶ *Ibid.*

- (a) Where there is an intentional avoidance on the taxpayer's part with the main or sole purpose of avoiding tax, and a clear presence of any one of the tainted elements the penalty should be between 50 and 75% of the amount of tax avoided;
- (b) Where it is a repeated case of paragraph (a) by the taxpayer, the penalty must be raised to 100% of the amount of tax avoided; and
- (c) Where there is a reasonably arguable position that the provision of the GAAR do not apply, then the penalty should be equal to or lower than 30% of the tax avoided.

Paragraph (a) will apply to cases where the taxpayer intentionally enters into transactions with the main or sole purpose of avoiding tax, and any one of the tainted elements are clearly present and provable. This would be a clear abuse of the tax laws because there is an intention to deprive the SARS of the taxes due to it notwithstanding the fact that the act is prohibited by the provision of sections 80A-80L of the ITA. The penalty needs to be harsh to safeguard against intentional and clear abuse of the tax laws. The penalty in paragraph (b) needs to be harsher and higher than paragraph (a) because it would be targeted at repeat or serial impermissible tax avoiders

With regard to paragraph (c) where there is a reasonably arguable position that the provision of sections 80A-80B do not apply, the penalty needs to be more considerate of the fact that the taxpayer was uncertain of the impermissibility of the arrangement and that the taxpayer took reasonable steps to respect the South African tax laws. The taxpayer can prove that there is a reasonably arguable position that the provisions of sections 80A-80B do not apply by, for instance, showing that the main purpose of the arrangement was both to obtain a tax benefit and to achieve other bona fide non tax objectives, or that the establishment of the tainted element in relation to the arrangement is not a straightforward exercise. The introduction of the above penalties will increase the deterrent effect of the GAAR and make sure that there is an effective disincentive for tax avoiders who persistently avoid tax impermissibly. It is recommended that the South Africa government adopt the same system as the Australian and UK governments in its quest to deter tax avoidance.

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