



Tax Avoidance
and Section 103 of the
Income Tax Act, 1962

Introduction

⇒ Today's Message

- Section 103 is an essential part of the tax law
- Good fiscal citizenship and a growing tax base is vital for a developmental state
- Challenge to all role players to embrace this ideal
- Clear law and clear boundaries
- Effective administration
- Lessons from the rest of the world
 - Harmful impact
 - Methods to address
- A new section 103

Introduction

ROADMAP

- ⇒ What we have done so far
- ⇒ Open process
- ⇒ Today-
 - Guiding principles
 - Practical experience
 - Problems and weaknesses under current law
 - Proposals for change

Terminology

⇒ Tax evasion – illegal

- Hiding income or information
- Claiming deductions for expenditure not incurred

⇒ Impermissible tax avoidance

- Artificial or contrived arrangements
- Manipulate or exploit perceived “loopholes”
- Form over substance

⇒ Legitimate tax planning

Social, Economic and Corporate Harm

Prologue: A Collapse of Basic Standards

⇒ Unprecedented corporate scandals in number and scope

- Enron
- Worldcom
- Tyco
- Parmalat
- LeisureNet

The Role of Impermissible Tax Avoidance

- ⇒ Looking back at corporate scandals, “tax planning” was used in many cases to justify or disguise schemes to manipulate earnings or to enrich insiders
- ⇒ The Enron example –
 - More than 800 special purpose entities (SPEs) in tax haven jurisdictions
 - 662 in the Cayman Islands alone
- ⇒ Such SPEs have been a feature in scandal after scandal

Introduction

⇒ Criteria for any tax system

➤ Certainty

➤ Simplicity

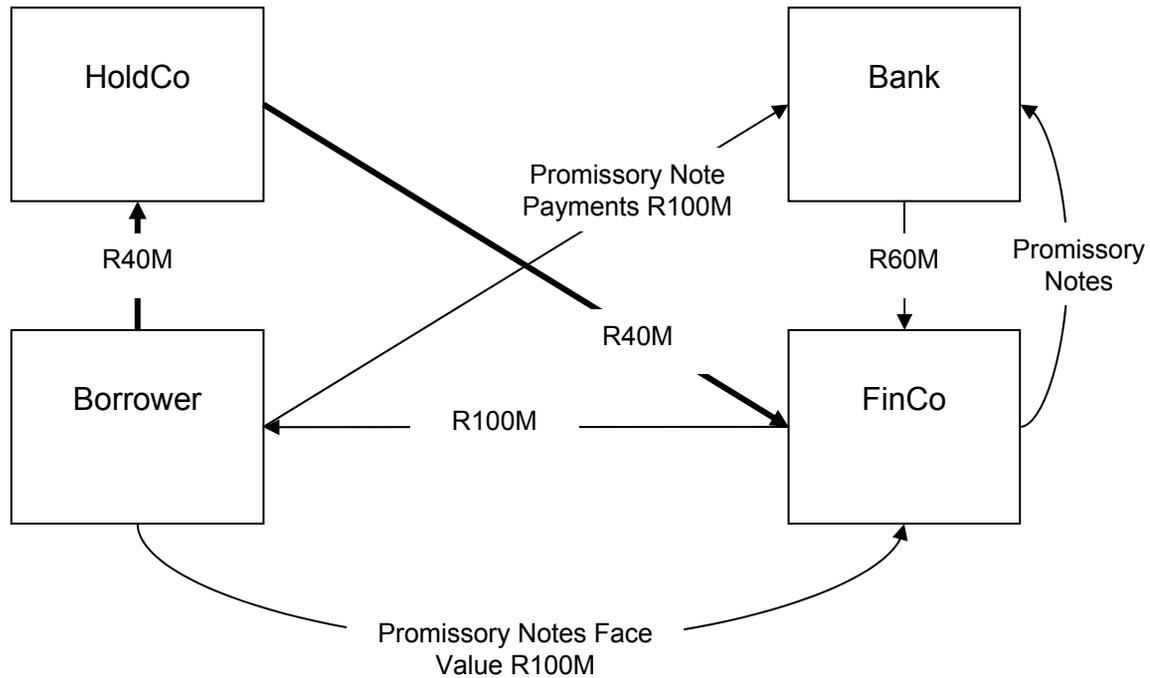
➤ Fairness

➤ Efficiency

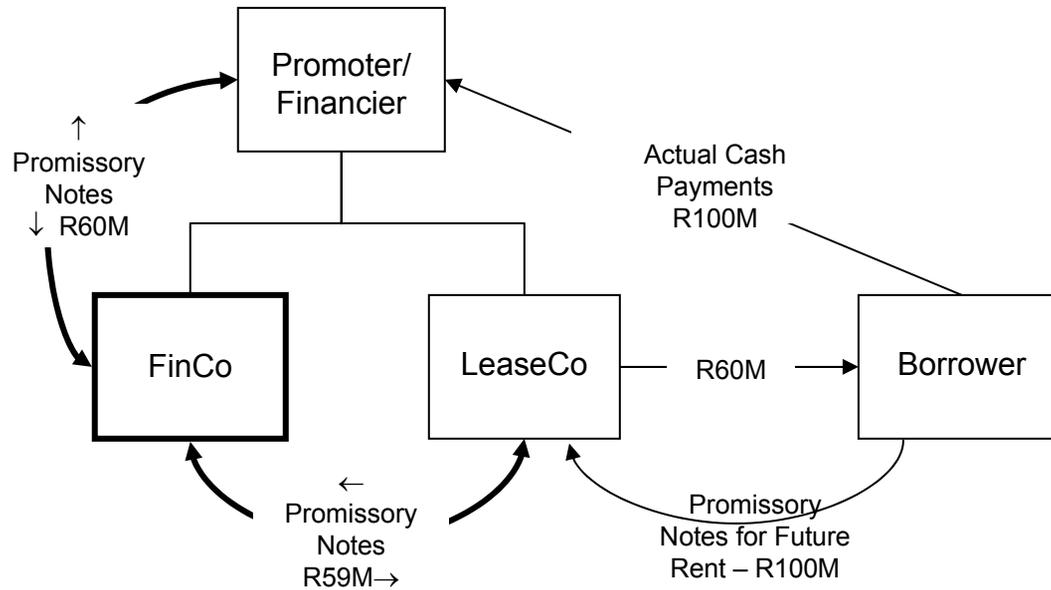
- Enhance economic development and transformation
- Compete internationally

⇒ Facilitate the building of a better life for all

Circular Flows



“Washing Machine”



A Problem of Global Magnitude

- ⇒ Impermissible tax avoidance has been staggering in its size and scope
- ⇒ Tax haven activity alone –
 - Up to \$11,5 trillion assets now held in tax havens, with up to \$435 billion in lost taxes
 - At least \$50 billion to developing countries
- ⇒ And tax havens have been just one part of a much bigger problem

Corrosive Effects Far Beyond Revenue Lost

- ⇒ Short term revenue loss is a major problem, especially for developing countries
- ⇒ But the damage done is far more pervasive and long-lasting –
 - Disrespect for the tax system and the law
 - Increased complexity
 - Costs to the economy
 - Unfair shifting of the tax burden
 - Especially from capital to labour
 - Undermines the ability of governments to set and carry out social and economic policies
- ⇒ For developing states, the constant pressure and erosion of the tax base deny them their fiscal independence and force them into borrowing or cutting vital programmes

Failures at Many Levels

⇒ Corporate leadership

- Directors
- Audit committees

⇒ Professional firms

- Accounting firms
- Law firms

⇒ Banks and other financial institutions

⇒ In many cases, a disintegration of fundamental values

Widespread Fallout

- ⇒ **Countless people hurt –**
 - Shareholders
 - Employees
 - Communities
 - Fellow citizens, especially the disadvantaged and the needy
- ⇒ **A loss of confidence in–**
 - Financial markets
 - Business leaders and professionals
- ⇒ **Growing cynicism about institutions**
 - Unfortunately, a minority of wrongdoers tarnished the reputations of those who played by the rules as well

Working Together to Rebuild

- ⇒ The scandals prompted a global response
 - New laws and regulations governing corporate behaviour
 - Transparency and accountability
 - Increased emphasis on corporate governance and social responsibility
 - Concerted efforts worldwide to stop impermissible tax avoidance and abusive avoidance schemes

Corporate Social Responsibility

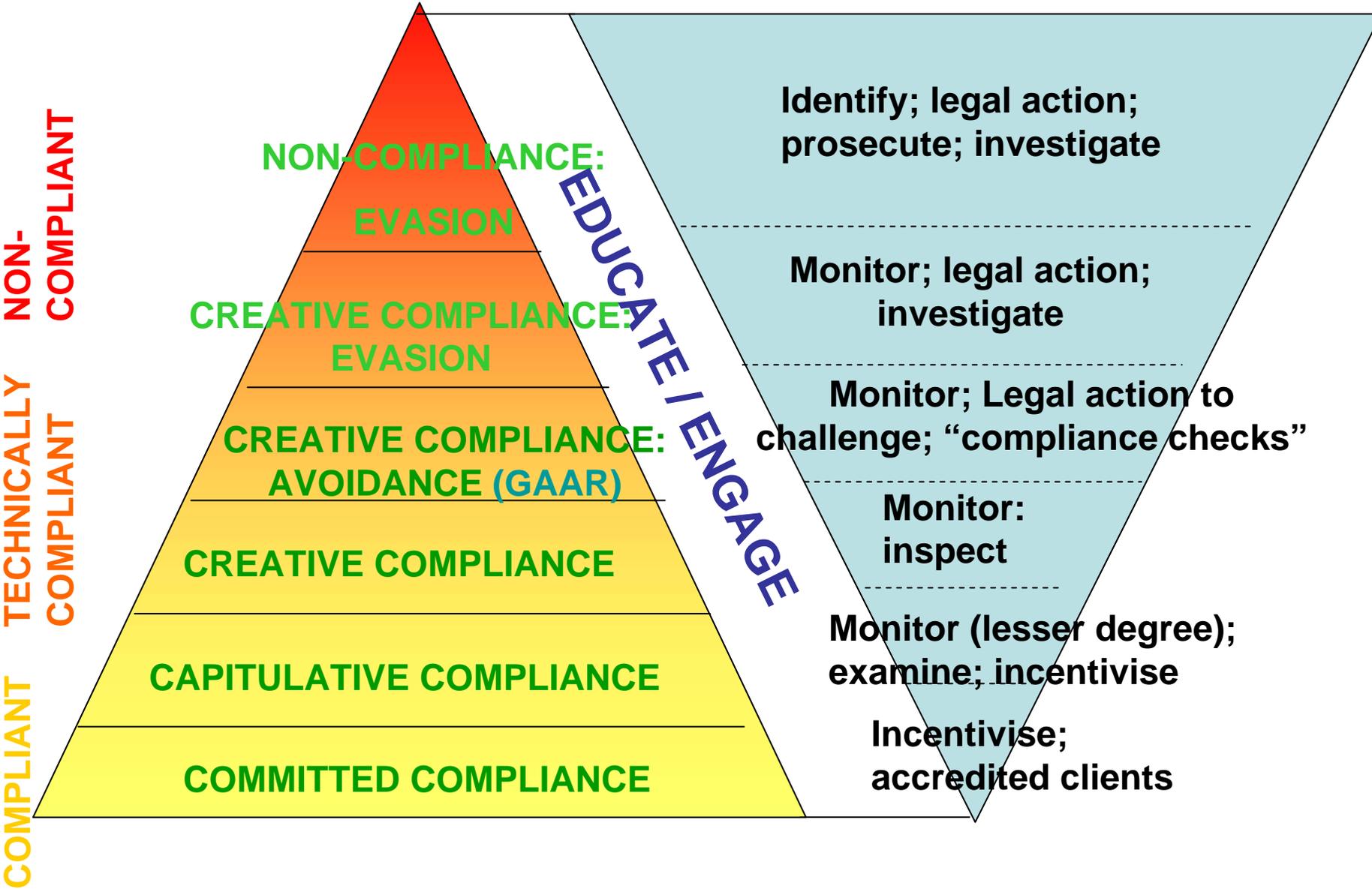
- ⇒ Commitment to contribute to sustainable economic development
 - Ethics and basic human and social rights
 - Environmental issues
 - Protection from over-development
 - Social responsibility in employment (fair labour relations, job security, etc.)
 - Being good both for business and for society
- ⇒ Tax compliance a key component

Towards a Culture of Compliance

Working Together

- ⇒ Tax is no longer just an issue between a company and the Taxman
- ⇒ A matter of reputational risk for
 - The company itself
 - Its executives
 - Its advisers
- ⇒ In this new environment, taxpayers and SARS must work together to achieve a culture of compliance

The Compliance Behavioural Model



Great Progress in South Africa

- ⇒ Compliance by existing taxpayers continues to improve
- ⇒ Education and outreach continue to bring new taxpayers into the system
- ⇒ Practitioners have played a vital role in helping taxpayers to understand and comply with often complex rules

An Obligation to Taxpayers

- ⇒ SARS has a fundamental duty to ensure a level playing field for these taxpayers and practitioners who are playing by the rules
- ⇒ SARS is committed as well to providing taxpayers and practitioners with greater certainty about their obligations both –
 - To ease their compliance burden and
 - To help them avoid reputational risk by making the boundaries between permissible and impermissible behaviour more clear

The Goals We Are Trying to Achieve

- ⇒ To clarify those boundaries through a stronger, better section 103
- ⇒ To make section 103 consistent and effective **deterrent** to impermissible tax avoidance and abusive avoidance schemes in today's modern, global economy
- ⇒ To protect the tax base
- ⇒ To help provide a foundation for possible reform, simplification and relief
- ⇒ To help provide a better tax system for all

Lessons from the Rest of the World

Impermissible Tax Avoidance in a Global Context

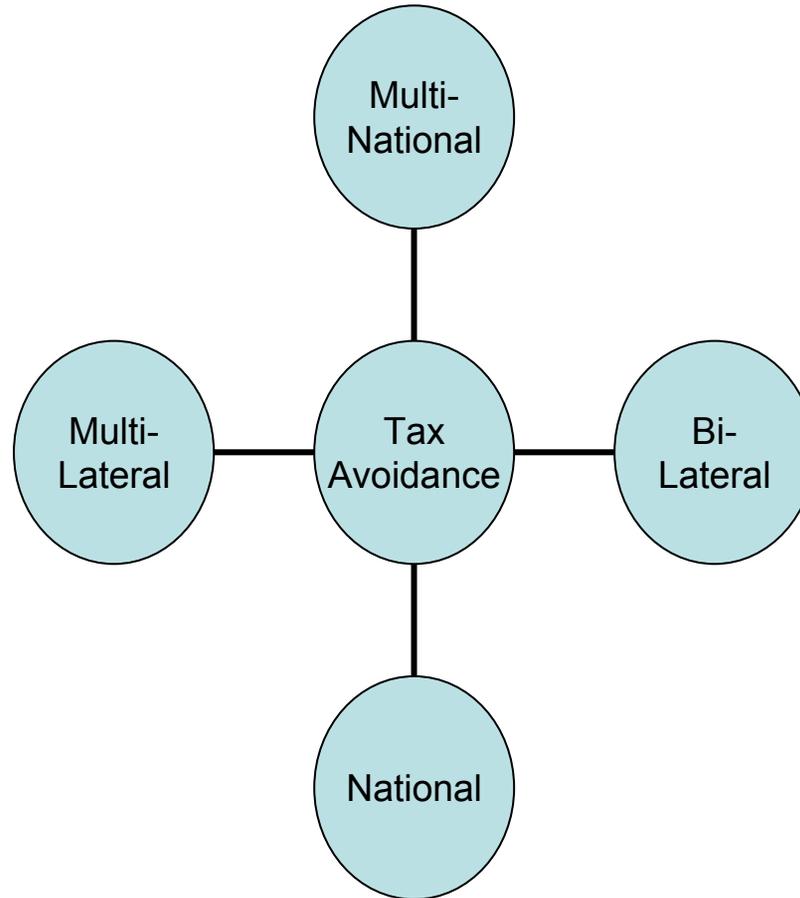
- ⇒ Impermissible tax avoidance has been a serious international problem during the past decade
- ⇒ One aspect of the collapse of standards
- ⇒ Specific driving forces
 - Globalisation
 - Multinational enterprises and consultancies presenting new challenges to national authorities
 - Tax havens
 - Financial deregulation
 - Advances in information technology

Other Factors

- ⇒ A more complex world
 - Growing complexity of the tax laws
 - Increasingly aggressive tax avoidance schemes
- ⇒ Erosion of leadership and decline in values
 - Practitioners
 - Taxpayers
- ⇒ Relaxed enforcement in good times
 - The example of the United States

In Step with Global Efforts

The Global Picture: A Multi-Faceted Response



Global Response

⇒ Multinational Level

➤ OECD

- Transparency and tax havens
- Harmful preferential tax regimes

➤ European Union

➤ International Monetary Fund

Global Response

⇒ Multilateral and bilateral level

- Joint International Tax Shelter Information Center (JITSIC)
- Joint audit projects
- Bilateral information exchange
 - Formal – increased access to taxpayer data under treaties
 - Informal – greater sharing of experience, skills and knowledge

Global Response

⇒ National level

➤ Increased enforcement

- Within just the past few weeks, Australia, the United Kingdom and the United States have all announced plans to beef up enforcement and close their “tax gaps”

➤ New specific anti-avoidance rules (SAARs)

➤ Strengthening general anti-avoidance rules

➤ New reporting requirements

➤ Promoter penalties

Global Progress

⇒ United States

- Mass-marketed abusive tax shelters of the 1990s effectively dead

⇒ Australia

- Increased enforcement and emphasis on corporate governance has brought about changes in attitudes toward tax avoidance by taxpayers and practitioners

⇒ United Kingdom

- New reportable arrangements system paying handsome dividends

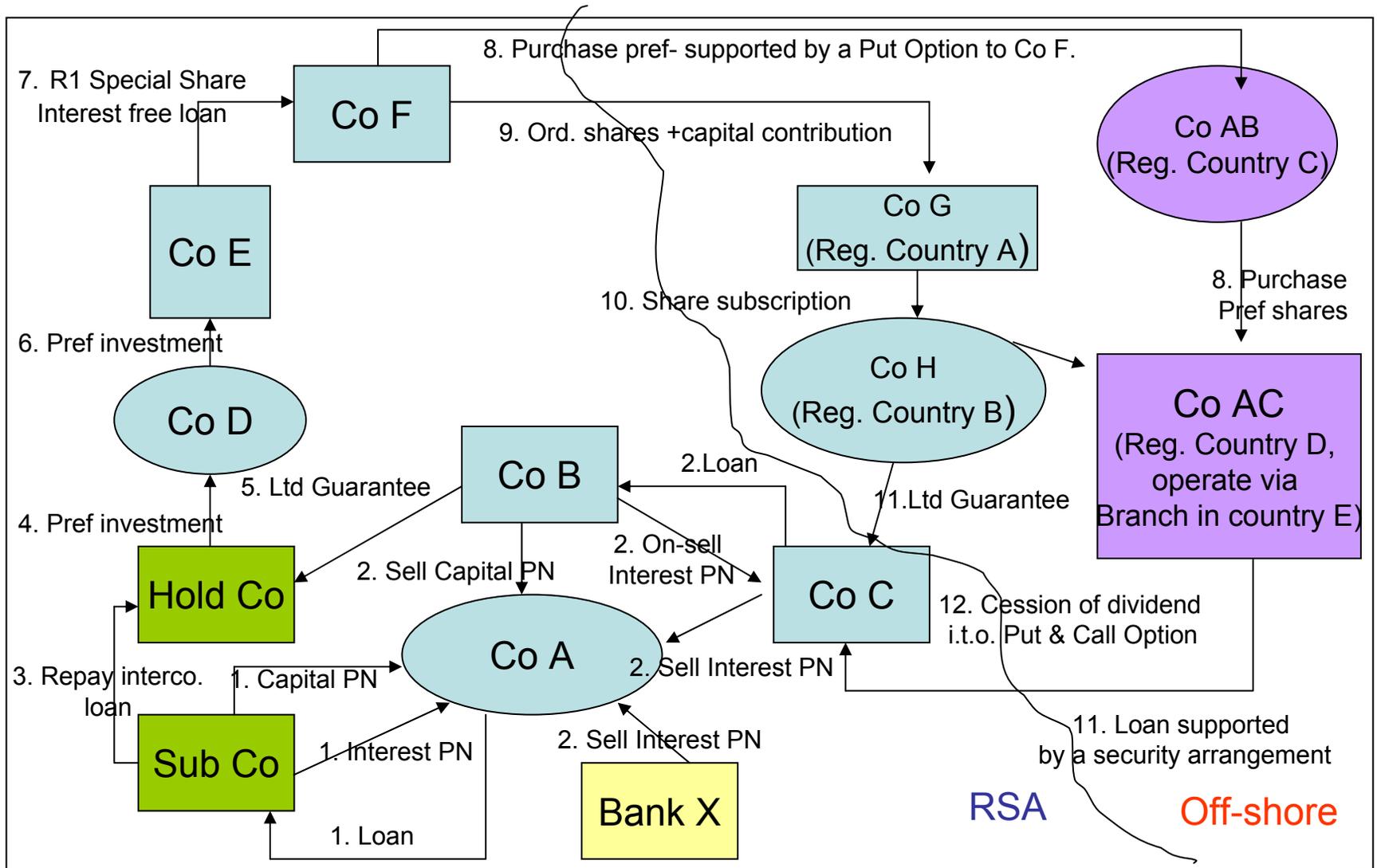
⇒ European Union

- Elimination harmful preferential tax regimes

⇒ It is time for South Africa to move forward

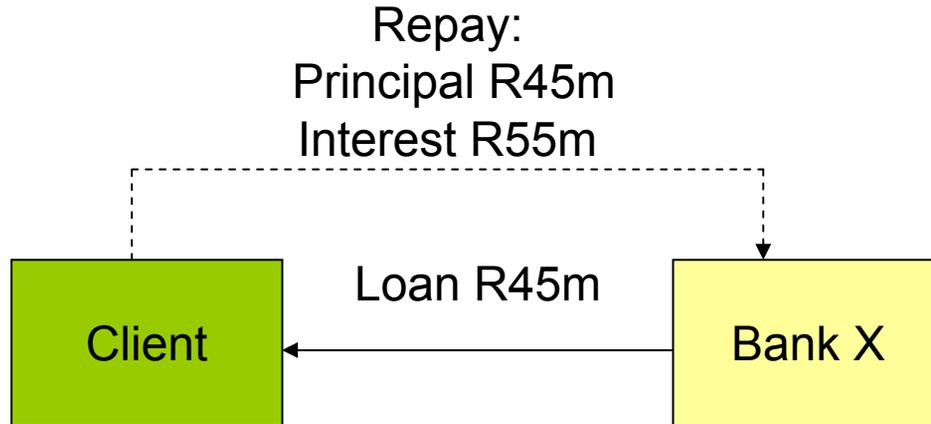
Two Illustrative Examples

International Preference Share Transaction



International Preference Share Transaction

Substance of transaction



Net effect:

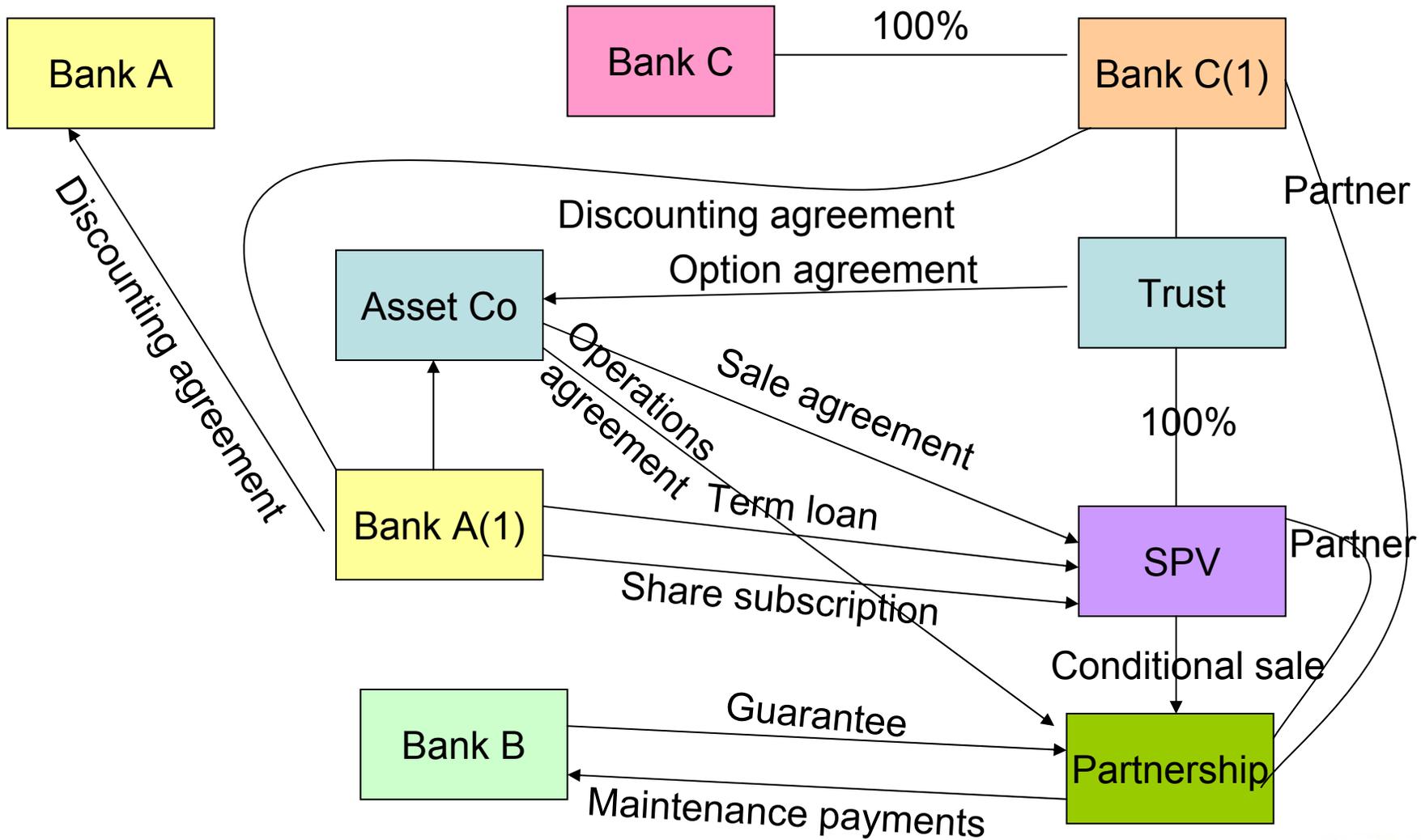
Actual funding requirement- R45 million
Structure enables client to deduct capital and interest through the circular flow of funds.

International Preference Share Transaction

⇒ Transaction

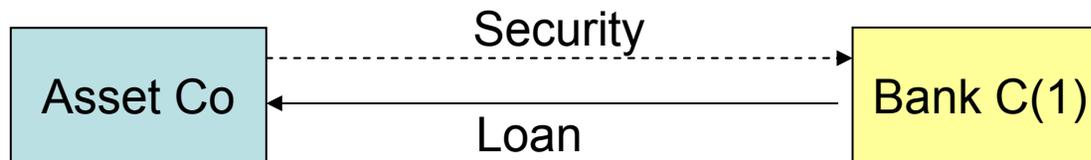
- Consists of 26 agreements
- Requires the creation of 6 new special purpose vehicles
- Implemented through 6 different tax jurisdictions

Partnership Structure



Partnership Structure

Substance of transaction



Net effect:
Structure inflates and transfers losses to set off against future income. No recoupment – Asset Co. re-acquires shares in SPV

Partnership Structure

- ⇒ Transaction consisted of 12 agreements
- ⇒ Complex financial models
- ⇒ Legal principles manipulated

Practical Implications

⇒ **Insufficient disclosure of information**

- Tax Returns
- Financial Statements

⇒ **Difficult to detect**

- Information spread out amongst different files of parties involved
- Information often provided on a piecemeal basis or lost in volumes of irrelevant information

⇒ **Time consuming to reconstruct & deconstruct**

- Three year investigation before an assessment could be issued on one of these transactions
- Case by case approach for each of these schemes

Estimated Revenue Loss

- Examples of the estimated revenue loss on some **identified** transactions over a five year term are:

Compulsory convertible loans	±R6 bn
Defeasance structures	±R600 m
International preference share structures	±R400 m
Lease and leaseback structures	±R1,5 bn
Partnership structures	±R1 bn
Share block structures	±R1,2 bn
Total	±R10,7 bn

Problems Under Current Law

Approach to Gap

- ⇒ Where taxpayers make use of a potential “loophole”, which may arise from inevitable practical compromises, inconsistencies or discontinuities –
 - The first step is to analyse their reliance on specific provisions
 - The second is to consider application of section 103
- ⇒ If the specific provisions are lacking, attention must be given to improving their clarity and effectiveness
- ⇒ Section 103’s wicketkeeper role must also be maintained

Current Provision

- ⇒ Four requirements must all be satisfied before the Commissioner may invoke the statute
 - Transaction, operation or scheme
 - Tax effect
 - Abnormality
 - Tax avoidance purpose

Weaknesses and Problems

- ⇒ In practice, section 103 has proven to be an inconsistent and, at times, ineffective **deterrent** to impermissible tax avoidance and abusive avoidance schemes
- ⇒ Problem Areas –
 - Abnormality Requirement
 - Purpose Requirement
 - Application to steps within a larger transaction
 - Use in the alternative
 - No “downside” for promoters

Abnormality Requirement

- ⇒ Long recognised as the “Achilles’ Heel”
- ⇒ Basic Problems
 - Promoters typically hijack components of legitimate business transactions
 - Because they hijack elements of legitimate business transactions, promoters can often give their schemes an undeserved semblance of “normality” and business purpose
 - Current law lacks objective tests or guidelines despite the underlying common features of these schemes
- ⇒ Consequently, the Commissioner is forced to proceed on a case-by-case basis
- ⇒ Heavy burden

Purpose Requirement

⇒ Current law

- “Sole or Main Purpose” Test
- Subjective determination

⇒ Problems

- Risk of inconsistent results
 - Experience both at home and abroad – promoters and their allies will “manufacture” plausible sounding business purposes
- ⇒ “Engagement in an avoidance scheme can encourage taxpayers to be economical with the truth”

Other Deficiencies

⇒ Application to steps in a larger transaction

- Lack of clarity under current law
- Contention that a *bona fide* business purpose for the larger transaction (e.g., raising financing) insulates any steps inserted into the transaction from review

⇒ Use in the alternative

- Lack of clarity under the current law
- Many cases involve complex transactions with issues under both specific provisions of the Act and section 103
- Contention that the Commissioner must raise the assessment under the specific provision or section 103, but not both in the same proceeding

⇒ No downside for promoters

- Problem worsened by promoters that aggressively sell their products to taxpayers
- Other countries have introduced penalties specifically aimed at these promoters but South Africa lacks a similar deterrent

Countervailing Concerns

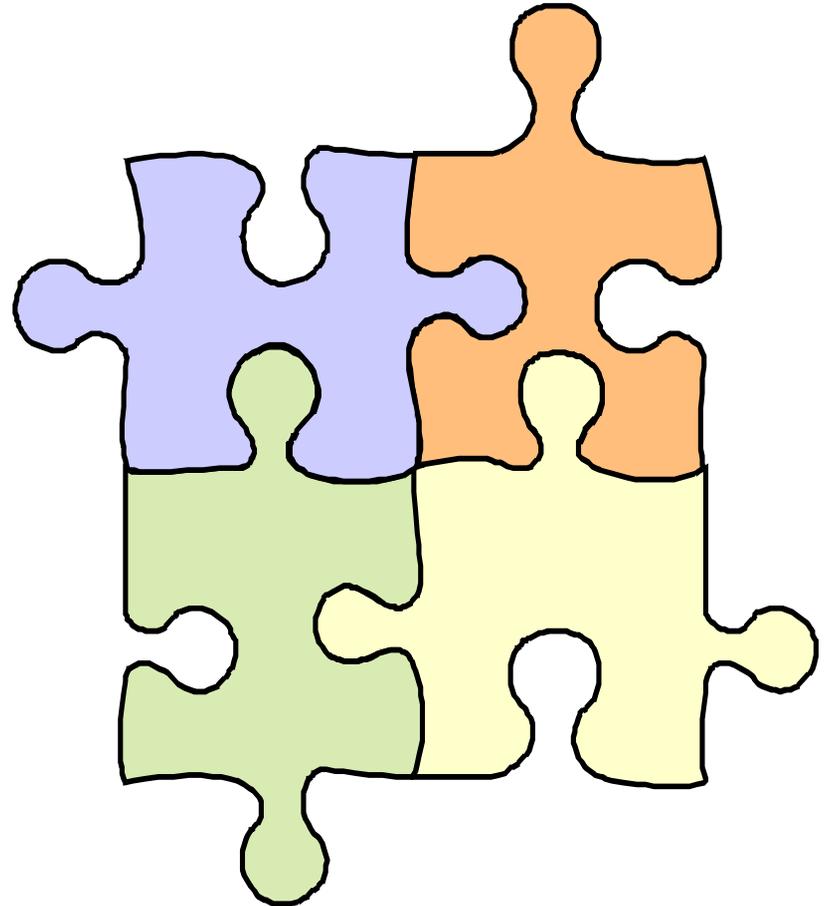
⇒ Potential for

- Uncertainty
- Interference with legitimate or innovative business transactions
- Tension between a GAAR and the rule of law

Proposed Amendments

General Approach

- ⇒ Use international experience as a guide
- ⇒ Retain current provisions where possible
- ⇒ Take countervailing concerns into account
- ⇒ Develop a South African solution



Features Retained

- ⇒ The basic four-pronged test –
 - Transaction, operation or scheme
 - Tax effect
 - Abnormality
 - Purpose
- ⇒ The definition of tax effect/tax benefit
- ⇒ The scope of “transaction, operation or scheme”

Proposed Changes

⇒ Abnormality Requirement

- Objective factors for determining abnormality
- Presumption of abnormality

⇒ Purpose Requirement

- Objective test
- Restoration of “sole or one of the main purposes” test

⇒ Other

- Application to steps within a larger transaction
- Use in the alternative
- New penalties for promoters and the substantial understatement of income

Proposed Abnormality Factors

- ⇒ Form and economic substance
- ⇒ Timing and duration of the transaction
- ⇒ Tax result “but for” section 103
- ⇒ Circular flow of cash or assets ✓
- ⇒ Participation of a tax-indifferent party ✓
- ⇒ Offsetting or self-cancelling steps ✓
- ⇒ Inconsistent tax treatment of items by the parties ✓
- ⇒ Non-arm’s length dealing by the parties ✓
- ⇒ Lack of change in financial position ✓
- ⇒ No reasonable expectation of pre-tax profit ✓
- ⇒ Value of tax benefit exceeds pre-tax profit potential ✓

Common Factors

- ⇒ Abnormality factors reflect common elements in impermissible tax avoidance
- ⇒ These elements are often necessary to circumvent inherent failsafes
 - The tax system failsafe – Common characterisation of a transaction between taxpayers
 - Higher rent expense = higher rental income
 - More interest expense = more interest income
 - The financial accounting failsafe - Companies concerned about reported earnings
 - Lower tax bill no prize if the price is lower earnings
 - Financial accounting standards increasingly based on economic substance

Other Changes

- ⇒ Clarify that section 103 may be –
 - Applied to steps with a larger transaction
 - Used as an alternative basis for raising an assessment
- ⇒ Introduction of new penalties through separate legislation for –
 - Promoters
 - Substantial understatement of income

Comments Received and Way Forward

Comments Received

- ⇒ General acceptance of the notion of “impermissible tax avoidance”
- ⇒ General acceptance of the need for a stronger, more effective section 103
 - Acknowledgement that section 103 has ceased to be a factor in tax planning
- ⇒ General agreement that the Commissioner must be able to apply section 103 to steps within a larger transaction
- ⇒ Comments and concerns have been received with respect to specific aspects of the proposed legislation

Way Forward

- ⇒ SARS has issued an Interim Response to these comments and concerns
- ⇒ It appreciates many of the concerns and issues that have been raised
- ⇒ Additional comments are encouraged and, in particular, specific proposals in respect of how various issues and concerns might be addressed
- ⇒ Legislation to be proposed later in 2006