

060322 finance

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PROPOSED AMENDMENTS TO  
SECTION 103  
Portfolio Committee on Finance  
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The Starting Point

- the *Duke of Westminster* case (House of Lords, 1936): taxpayers are entitled to arrange their affairs to minimize tax
- Corollaries:
  - 1) taxpayers are taxed on the legal form (not economic substance) of their transactions
  - 2) taxpayer's motivation to avoid tax is irrelevant

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## The Starting Point

- *Duke of Westminster* principle and corollaries were derived from strict literal interpretation of tax statutes
- this is inappropriate in a modern tax system in which all statutes are construed in accordance with their purpose

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## Consequences

- allowed tax avoidance schemes to flourish
- easier to accomplish with globalization, deregulation, new financial products, etc.
- benefits those who can afford tax planning expertise
- increased tax burden on those who cannot avoid tax

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### Alternative Principle

- everyone should pay their fair share
- legislature could not have intended that some taxpayers be able to escape their tax obligations

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### Alternative Principle

- Judge Learned Hand in *Gilbert v. Com'r*:  
“The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions. ... If the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it, for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities it sought to impose.”

- 248 F.2d 399 (2d Cir. 1957)

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- general
- 4) judicial anti-avoidance doctrines
- limited (sham)
  - broad general (business purpose; substance over form)

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which a person reading in bad faith cannot misunderstand. It is all the better if he cannot pretend to misunderstand it."

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## Responses to Tax Avoidance

- better enforcement is not an adequate response
- specific statutory anti-avoidance rules don't work
- limited judicial doctrines are ineffective

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## Responses to Tax Avoidance

- tax avoidance requires multi-faceted response
- every tax system requires a general anti-avoidance rule (judicial or statutory) to deter unacceptable tax avoidance before it occurs

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## The Necessity for a GAAR

- International Fiscal Association, General Report, *Form and substance in tax law* (2002)
- 27 countries surveyed
- conclusions of the General Report:
  - 1) "The vast majority of the countries covered by this Report have some kind of general tax anti-avoidance rule."
  - 2) "General tax anti-avoidance rules are a necessary part of modern income tax systems."

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## Responses to Tax Avoidance

- some countries, such as Australia, New Zealand, and South Africa, adopted statutory GAARs
- some countries, such as the United States, developed judicial general anti-avoidance doctrines
- some countries, such as the United Kingdom and Canada, relied on specific anti-avoidance rules

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## United Kingdom and Canada

- in 1980s House of Lords began to impose limits on *Duke of Westminster* principle to control tax avoidance
- "The driving principle of the *Ramsay* line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."  
- *Arrowtown* [2003] HKCFA 46
- Canada adopted statutory GAAR in 1987

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## Other Countries with Statutory GAARs

Australia	Germany	The Netherlands
Belgium	Hong Kong	New Zealand
Canada	Ireland	South Korea
Finland	Israel	Spain
France	Italy	Sweden

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## Australian GAAR

- dominant purpose test
- economic substance relevant
- no specific exclusion for legitimate commercial transactions

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## Canadian GAAR

- primary purpose test
- does transaction misuse or abuse the Act?
- economic substance rarely relevant

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## New Zealand GAAR

- one of the purposes or effects, other than an incidental one
- does transaction frustrate underlying purpose of the Act?
- no specific exclusion for legitimate commercial transactions

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## South Africa

- South Africa has decided to control tax avoidance with a statutory GAAR
- therefore, the question is: what form should the GAAR take?
- it is generally acknowledged that existing section 103 is deficient
- what fundamental principles should guide the revision of section 103?

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## Key Principles for Revising the GAAR

- 1) the GAAR should apply if one of the taxpayer's main purposes, objectively determined, was to avoid tax
- 2) the GAAR should apply to a series of transactions as a whole and each transaction in a series
- 3) the relationship between the GAAR and other statutory provisions must be determined on a case-by-case basis
- 4) the GAAR should distinguish between legitimate tax planning and unacceptable tax avoidance on some principled basis

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## Key Principles for Revising the GAAR

- 5) the GAAR should require the economic substance of transactions to be taken into account
- 6) the GAAR should minimize uncertainty for taxpayers
- 7) if the GAAR applies, the taxpayer should be subject to a financial penalty

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## Assessment of Proposed Amendments to Section 103

- proposed amendments based on sound analysis in Discussion Paper
- Discussion Paper considers GAARs of other countries and borrows judiciously from them
- in general, section 103 will be significantly improved

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## Assessment of Proposed Amendments to Section 103

- 1) proposed section 103 introduces an objective one-of-the-main-purposes test
- 2) proposed section 103 applies to an arrangement or any step in an arrangement
- 3) relationship between proposed section 103 and other provisions?
- 4) distinction between legitimate tax planning and unacceptable tax avoidance is based on a normality test

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may be imposed

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the arrangement  
abnormal

- is the normality requirement appropriate?

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## Minor Concerns

- there is no definition of a multi-step arrangement
- is "arrangement" defined broadly enough to cover the making of an election or the occurrence of a year end, etc.?
- what is the meaning of "subject to any tax" in the definition of "tax-indifferent party"?
- does the presumption in s. 103(4)(b) apply only to business transactions?
- how do the presumptions in s. 103(4) affect the application of the GAAR by SARS?

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## Conclusions

- every tax system requires effective anti-avoidance rules
- existing section 103 is not very effective
- proposals to amend section 103 should send a strong, unmistakable signal to the courts and to taxpayers and their advisers that abusive tax avoidance will not be tolerated

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