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Dear Sirs

Comments on SARS' Discussion Paper on Tax Avoidance

We are writing in response to the request to submit comments on behalf of our clients and ourselves on the SARS Discussion Paper on tax avoidance released last year. The comments and suggestions made below have been canvassed with as many of our clients as possible. Should it be useful to SARS to meet either with ourselves, or with any of our clients to discuss these issues, we would be happy to make such arrangements for this as may be considered appropriate.

We commend SARS on an extremely well researched and well written paper. Although it has not really been tested in the courts, which in our view is unfortunate, we are in agreement with SARS that the current version of section 103 may not always address the type of tax avoidance which we consider that SARS could legitimately challenge. Situations may exist in which the form of a transaction complies with the language of the tax legislation, but the transaction is nonetheless offensive to the Revenue because it has limited commercial substance, and is in essence purely tax driven. In counteracting such schemes, the existing provisions relating both to purpose and to abnormality may not always be effective from a SARS perspective. Subject to a number of very important caveats, discussed further below, we are therefore supportive of SARS' wish to strengthen the GAAR and make it more of a deterrent.

We also agree with SARS that tax planning can fall broadly into three categories, namely tax evasion, (which is clearly illegal and fraudulent), legitimate tax planning, and thirdly what SARS has referred to in your document as "impermissible tax avoidance". The challenge will be, however, to get taxpayers and SARS to agree on where the line should be drawn between impermissible and permissible tax avoidance.

To give an example, we do not support the view expressed in the Discussion Paper that a plain vanilla sale and leaseback transaction in terms of which a taxpayer makes

legitimate use of its assets to raise finance, should be regarded as impermissible tax avoidance.

There is a very real danger in our opinion that, in SARS' understandable drive to strengthen the GAAR, provisions may be enacted that have the effect of tarring commercially justifiable business transactions with the same brush as highly artificial and contrived schemes. This would, amongst other results, have a severely negative impact on foreign investment, in turn impacting negatively on the growth of our economy.

1. Accompanying changes to other provisions in the South African Income Tax Act

The proposed changes to the GAAR are clearly aimed at an approach which focuses more on the underlying substance of a transaction, rather than its form, to determine whether or not it falls into the category of impermissible tax avoidance. While we agree that this will help to reduce artificial and undesirable tax "schemes", care needs to be taken that this type of approach does not operate in one direction only.

Unlike the position in many other countries, the tax law in South Africa is in many respects very form driven. For example, no relief is generally given for interest on funds borrowed to acquire shares and there is no form of group relief. This results in taxpayers, in order to remain competitive globally and achieve a logical economic result, taking steps which could be challenged as artificial and tax driven, e.g. buying shares in a target and then undertaking further restructuring in order to ensure that the cost of funding the acquisition is effectively tax deductible. In many other countries it would simply not be necessary to take these additional steps, and hence the number of transactions which could be seen as tax driven is relatively lower.

Before the recent change to the FFIHC definition, a similar situation applied in cases where, because of the broad scope and arguably illogical application of certain aspects of the rules, companies which were clearly operational companies with significant substance ran the risk of being classified as FFIHCs. To avoid this, taxpayers would then take steps, e.g. putting additional operational assets into the company, which they would probably not otherwise have done, to ensure that the companies concerned no longer fell within the definition. Thanks to the recent changes to the definition, such artificial steps should no longer be required.

In short, the economic substance approach must work both ways. Serious consideration needs to be given to amending provisions in our tax law which are encouraging taxpayers (who or which would not normally engage in any type of impermissible tax avoidance) to take steps which are tax driven, in order to ensure that they are not being unfairly penalized. This penalization results from the application of tax law which operates illogically and inequitably because it is not aligned with commercial reality.

Similar problems arise in the case of tax legislation which is poorly drafted, and difficult to interpret or understand. Certainty of tax legislation is fundamentally important. Taxpayers choosing not to comply with law that is clear and logical must of course suffer the consequences. Where law is unclear, undesirable scope exists for

dispute between SARS and taxpayers, or for different SARS offices to adopt different interpretations, in regard to whether or not a taxpayer is potentially guilty of tax avoidance.

It is hoped that the Advance Tax Rulings System, when fully up and running, will play a key role here. Currently section 76G(2) gives the Commissioner a discretion to decline an application for a binding ruling if the application involves the application or interpretation of any specific or general anti-avoidance provision, including section 103. In our opinion, this discretion must be limited to situations in which the main focus of the ruling request is on whether or not a taxpayer has fallen foul of an anti-avoidance provision. In the case of other ruling requests, it would render the system uncertain and destroy any value in it if SARS could simply decline to rule on matters involving an interpretation of other sections of the Tax Act, because of some vague and unexplained concern that possibly section 103 might be relevant.

The ATR system will stand or fall by the technical expertise of the Revenue officials involved in it, and the speed with which they are able to rule on matters and provide certainty to taxpayers. Unless highly knowledgeable and experienced personnel are involved, and ruling requests are dealt with relatively quickly, the system will fail.

If tax legislation is clear, logical, aligned with commercial reality and in cases of doubt, an appropriate interpretation can be obtained via the ATR process, this will significantly reduce the number of taxpayers at risk of straying into the grey area of tax avoidance. For any who choose to do so, there will be no excuse. This should make the application of section 103 easier for SARS. If additional revenues raised through the use of a stronger GAAR are used to fund tax reform, this will help align a large portion of the taxpaying community behind SARS' efforts to crack down harder on impermissible tax avoidance.

2. Centralisation of SARS' decision-making re use of section 103

We note that the Discussion Paper makes reference to the development and implementation of procedures to ensure consistent application of the GAAR (section 10.7.) We are not sure what SARS has in mind in this regard. We believe there would be great merit in centralising the decision-making in respect of whether or not to challenge a taxpayer under the GAAR. Any situation in which an assessor is considering doing so should, we suggest, be referred to an appropriate committee, probably at the level of the Commissioner's Office. This would facilitate consistency of application of the section and help prevent misuse of the section by inexperienced and/or over- eager assessors. We would further recommend that there must be more than a simple majority agreement amongst the committee members before section 103 is used as the basis for a challenge, and that there should be a specified number of committee members voting in order to form a quorum.

3. Speed of challenge by SARS

We also believe that it is essential for SARS to move as quickly as possible to raise section 103 challenges and bring them to court when these are identified. This type of approach will act as a deterrent to other taxpayers considering similar schemes. We appreciate SARS may sometimes have difficulty with identifying abusive transactions

as soon as they arise, but the reportable arrangements provisions should be a significant help in this regard. In our experience, very few section 103 cases are actually brought to court and while we appreciate this is an expensive business for SARS (and of course for taxpayers), we believe it is important to develop a body of case law to provide greater certainty on the interpretation of the legislation.

At the same time, this needs to be balanced by a policy of invoking the GAAR as a measure of last resort. The GAAR should not be relied upon by SARS to assist them in arriving at the result they would like to see where, because of poorly drafted legislation, a precise interpretation of the specifically relevant provisions in the Act is difficult. Similarly, the GAAR should not be used as a standard "catch all" type of provision, invoked almost as a matter of routine just in case a challenge under other sections of the Act does not prove successful.

4. Comments on specific proposed amendments to section 103

4.1.Purpose requirement

We recognize that SARS should have the power to successfully attack transactions or schemes which are artificial in as much as the intended tax consequences are divorced from the economic substance through the interposition of a step or steps that serve no purpose other than to avoid tax.

We recommend, however, that the wording of the proposed amendments to the purpose requirement be changed. Specifically, the use of the words "one of the main purposes" simply causes confusion. How is a "main" purpose to be determined, and since "main" is generally defined as "principal" or "predominant", how can there be more than one main purpose? At what point does one of several purposes become a "main" purpose, when the transaction is viewed as a whole?

It seems probable to us that if the purpose of achieving a tax benefit is to be tested not as a primary or predominant purpose, but rather as one of two or more "major" purposes, then the moment any element of tax planning exists in a transaction, it will automatically be classified by SARS as a major purpose, and hence the purpose requirement in section 103 will be satisfied. While the main purpose of most business transactions is generally not tax avoidance, in structuring those transactions, the taxpayers involved will inevitably have regard to the tax consequences thereof, and be keen to avoid triggering tax unnecessarily. Care must be taken not to frame the legislation in such a way that the existence of this element of tax awareness in planning commercial transactions automatically makes them susceptible to an attack under section 103.

We would also suggest that possibly, rather than applying the purpose test to the transaction as a whole, the purpose test be used only when analyzing each and every step involved in the transaction. By taking this approach, we believe that it will be relatively easy to identify any step which has as its main (in the sense of predominant) purpose, the obtaining of a tax benefit. If any one such step is identified in the transaction, SARS should have the power both to ignore that step in assessing the tax implications of the transaction overall, and to ask the question whether the transaction (absent the step in question) would still make, or have made, commercial sense. We

acknowledge that SARS has included proposed wording which indicates an intention to apply a step by step analysis and we support this. A similar approach should be followed in regard to the abnormality requirement.

4.2. Abnormality requirement

- As has been famously said of pornography, abnormality from a tax avoidance perspective is very difficult to define, yet relatively easy to recognize. We are strongly opposed to the inclusion in the legislation of the list of factors currently found in the draft version of section 103 in the document. Listing these factors in an Interpretation Note or Practice Note may achieve the valuable goal of deterring developers of schemes intending to utilize one or most probably many of these factors. By listing the factors in the legislation however, a real danger exists that a very mechanical approach will be established to the invocation of section 103, causing SARS and taxpayers to become embroiled in a multitude of debates which will irritate taxpayers and achieve no revenue for SARS. By listing these factors in an Interpretation or Practice Note, SARS will simply be formalizing an approach which is already followed by them. Since the Interpretation or Practice Note will not have the force of law, we do not believe it will not be giving SARS additional powers. By including the list in the law, this could even work against SARS if an inexperienced assessor, faced with a transaction which is abusive, but which contains none of the factors listed, decides as a result that section 103 must not be applicable. (This notwithstanding that the proposed legislation states that the list is not exhaustive).

- Certain of the factors listed, e.g. the reference to circular cash flows, and to the use of tax indifferent parties, are over-broad i.e. too far reaching in their consequences. This will be a serious problem if, as has been proposed, the presence in a transaction of any one of these factors will result in a prima facie presumption of abnormality! To give an example, one of the factors is the presence in the structure of a "tax indifferent party" as defined. In terms of this definition, which in our view is far too broad (refer discussion below) , a foreign investor coming into South Africa and seeking to buy two target companies here may well wish to set up a new holding company in this country to make the acquisition. Such a holding company, being specially formed for this purpose, will be a "tax indifferent party" as defined and hence a presumption of abnormality will be triggered! Many similar examples exist. To resolve this problem, we would like to see the presumption of abnormality if any one of the listed factors is present, disappearing.

- The definition of "tax indifferent party" is too broad as a result of sub-sections (b) and (c) in the definition. With regard to subsection (b), in a vast number of cases, income on one side will be matched by some type of expenditure on the other (e.g. wholesalers or retailers which purchase goods and on-sell them, companies which take up interest-bearing debt to buy assets which are rented out or sold on installment sale in the ordinary course of their business, etc, etc). With regard to subsection (c), the use of one or more entities specially formed for the transaction can occur in a multitude of situations

which are in no possible way tax abusive. We recommend that if the definition is to be retained in the legislation, it be restricted to entities which are either outside the scope of South African tax or specifically exempt from South African income tax. In this case, it is essential that a presumption of abnormality is not triggered by the presence of only one listed factor (otherwise all cross-border transactions involving non-resident entities, e.g. the making of a loan by a foreign parent to its South African subsidiary or the purchase of goods by a South African company from its foreign parent would automatically trigger a presumption of abnormality!)

- We are also opposed to the reversal of the onus of proof in the abnormality section. Constitutionally, reversing an onus of proof must be justified and we are not convinced that justification exists in this instance. However, if SARS is adamant that the list of factors be retained in the legislation, and that they must be linked to a presumption of abnormality (both of which we oppose) then no presumption of abnormality should be triggered unless, as an absolute minimum, at least three or more of the listed factors are present.

5. Penalties

We support the idea of promoter penalties and believe it is justifiable to make these. significant. The Commissioner's discretion as to whether or not to impose such penalties (or any other penalties under section 103) should not, however, be curtailed or eliminated in any way. Furthermore, we recommend that the promoters which are the target of such penalties be defined to include only parties which earn fees out of the transaction on a basis other than time charged. To give an example, if a merchant bank designs a transaction and approaches a tax advisor for an opinion, and the tax advisor charges a once off, normal time- based fee to the merchant bank for opining on the transaction, the tax advisor should not fall within the definition of promoter.

Thank you for giving us the opportunity to comment on the proposed legislation. We would be happy to expand on any of the issues discussed above should this be required.

Yours faithfully

Deloitte & Touche