0603 31/pj income

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TA-12

28 March 2004

PROPOSED REVISION TO SECTION 103 : GAAR : REPRESENTATION TO PARLIAMENTARY COMMITTEE

This representation is made in my personal capacity as well as in my position as National Technical (Tax) Partner of Ernst & Young South Africa.

Philosophy and general comment

where unacceptable tax avoidance – as opposed to the sensible and legitimate management of ones affairs -- starts and stops. For example, the proposal document acknowledges that the choice between lease and suspensive sale finance for the acquisition of a motor vehicle for one's business has differing tax consequences, and that making the choice based upon those tax consequences would not be unacceptable avoidance. I agree. But I also suggest that the answer to the question, where to draw the line, is by no means easy – genuine differences of sober opinion exist in this regard. We must therefore be careful not to create a situation in which commerce is nervous to enter into straightforward transactions with favourable commercial and tax results, but which might be seen by a zealous tax-gatherer as vulnerable to attack. For example, the well known financing transaction known as 'lease-back' in which a business raises capital for expansion by way of the sale of existing plant and machinery (or buildings) to a financial institution, and then leases them back, is known to be disliked by SARS (who regards it a loan in economic substance) and has previously been unsuccessfully attacked under section 103. But it is not, I believe, an appropriate target for the GAAR.

The overall impression left by the proposal document is that much time is spent by a variety of tax professionals in devising and promoting unacceptable avoidance schemes. To set the record straight, I believe the majority of tax professionals spend the vast bulk of their time in helping clients simply understand the exceedingly complex provisions of the law and its application to transactions that will or have already been entered into and which are devoid of tax engineering.

It is to be expected and indeed desired, that a healthy tension should exist between taxpayers and SARS in the application of the tax laws, since the ascertainment of what tax is properly due is dependent upon words crafted by man, and words are blunt instruments. This tension should however be used constructively, as it is in these hearings and should not be allowed to deteriorate into general or personal attacks by either side on the other.

Technical

General

As indicated I have no difficulty in principle with the thrust of the proposed amendments. But this is largely because I do not believe the proposals have a substantially different effect from the existing section 103(1). Indeed, I am concerned that SARS has not (to my knowledge) employed the existing section in court on more than one or two occasions. It seems to me that it would be far preferable for the existing section to be tested at the level of the highest courts so as to determine its precise effect, its successes and its shortcomings, before embarking on this exercise. It is my belief that the last amendments to the section in 1996 created a powerful deterrent to abusive avoidance schemes and I am disappointed that it has been applied so infrequently. This reluctance on the part of SARS to take perceived avoidance matters to court seems to be based in part upon the belief that the courts, including

our highest court of appeal (the SCA), interpret the existing law in a manner that does not reflect the intent of Parliament. With respect, the courts apply principles of interpretation which have been developed over many years and which are applied in relation to all legislation, not just that administered by SARS. Moreover, they do so in accordance with the principles of the constitution. I believe it is inappropriate and disrespectful for National Treasury or SARS to call these judgements, or the principles on which they are based, into question. It is not a matter of the rules of statutory interpretation being outmoded, but of a (purported) change in the intent of Parliament since the section was first enacted (and last amended) which must be remedied, if indeed there has been such a change.

Specific technical issues

Avoidance of an anticipated liability

The proposal document suggests that it is not necessary to elaborate on what constitutes the reduction, postponement, etc of an anticipated liability to tax. It is my view, that if the section is to be made substantially more effective than it is at present, this issue should be addressed. I believe the question of whether a new investment (where there is no pre-existing income stream) can ever result in the avoidance of an anticipated tax, is a strong defence to both the existing provision and the new proposal, notwithstanding that it has been raised only once before in the courts.

The "one of the main purposes" test

It seems to me that the proposed test may be difficult to interpret and apply. I think that tax avoidance constituting one of several "main purposes", could only be identified if the transaction concerned would be entered into for its tax benefit effect alone, irrespective of any other consequences. That would, I think, be a most unusual situation and could only be true where the tax benefit clearly exceeds all cash outflows arising from the transaction. I am doubtful that a court would be prepared to find that a 'main' tax benefit purpose can co-exist with a real and substantial commercial purpose arising from the same single transaction. If that is so, then the section will effectively remain one which requires the main purpose of a scheme or a part of a scheme, to be tax avoidance before it can be applied.

Objectivity in the purpose test

The objectivity requirement has led to much discussion since release of the proposals. It is my view that on the proposed wording, the test remains at least partly subjective since the "facts and circumstances" must include the taxpayer's stated intention. To my mind, the requirement does no more than set out the process that a court should in any event follow under the terms of the existing section.

Arrangement or 'part or step thereof' in the purpose and abnormality tests

It seems to me that the term "part" and "step" both contemplate distinct transactional elements of a scheme, rather than subsidiary terms or conditions of such an element. Clarity on government's intention in this regard would be valuable. I have no difficult with the provision (assuming that my understanding is correct) since I consider that it does no more than set out more clearly, the required analysis under the existing section 103.

Abnormality – the 'business purpose test'

I have no difficulty with the way the existing abnormality tests of section 103(1) have been rearranged. However, I note that the substance of the so-called "business purpose test" remains unchanged from the existing provision. That being so, it occurs to me that any transaction which has a real and valuable business consequence which would lead the taxpayer to enter into it irrespective of the tax consequences, must pass the business purpose test and not be struck down by the section. I submit this is an appropriate limitation on the power of section 103 since any interference with that principle would be harmful to the legitimate pursuit of commercial activity. But if that is so, then I also consider that the proposed section is no more effective than the old, from SARS' perspective.

Abnormality – the presumptive tests
I consider that in general, the tests set out are those which a court should in any event consider in determining abnormality under the existing section 103. However, it seems to me that certain of them are framed in exceedingly wide terms and could be difficult to apply in practice. I have taken up these issues with SARS directly, but by way of example: A neurosurgeon who chooses to fly in his own aircraft to hospitals around the country may earn no more in fees (and hence have no increase in pre tax profit as envisaged by the proposed subsection (2)(j)), but be substantially more relaxed and effective in the operations that he does perform and be at far lest risk of malpractice suits. How then are the tax depreciation allowances on the cost of the aircraft to be treated?

Having said that, it is my view that the presumption of abnormality, particularly in relation to the business purpose test, is the most valuable (from SARS' perspective) of the proposed amendments, since it creates a burden of proof difficulty for the taxpayer who cannot clearly demonstrate the reality of his competing business purpose, in the application of that test.

But, very importantly, clarity is required as to when the presumptions take effect. Neither the proposal document nor SARS' initial response to submissions (released this week) deals crisply with this. Simply, the presumption arises in any "proceedings", unless the contrary is proved – prima facie, therefore, the presumptions only apply in court but confirmation of this interpretation and greater clarity in the legislation itself is required. Moreover, it must be made clear to assessors that at the level of tax return submission/assessment, no presumption arises (if a presumption does arise at that level, then any arrangement exhibiting one of the presumptive features would generate a section 103 assessment, irrespective of the objective merits).

Penalties
The proposal document makes it clear that tax avoidance and even unacceptable tax avoidance as envisaged by SARS – is legal. It is therefore inappropriate, in my view, to impose penalties, especially where a presumptive test and the burden of proof may place an innocent taxpayer at a considerable disadvantage. At the very least, provision should be made for the Commissioner to waive penalties in the appropriate circumstances and any penalty decision should be subject to objection and appeal.

Advance ruling system
SARS' acknowledgement in its initial response to comments on the proposal, that the alignment between the advance ruling system and section 103 is important, is welcomed. I wish to emphasise that for so long as the advance ruling system is prohibited from considering aspects of section 103(1), the proposed new section will be not just a deterrent to abusive tax avoidance but a very substantial hindrance to effective business decision making, particularly in complex merger and acquisition and BEE transactions and especially in respect of inward fixed investment.

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