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31 January 2006

OUR REF DK/HB/td
YOUR REF

Law Administration
South African Revenue Service
Private Bag X923
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By email: *policycomments@sars.gov.za*

Dear Sir/Madam

Re: PROPOSED NEW FORMUALTION OF SECTION 103 OF THE INCOME TAX ACT, NO 58 OF 1962

As invited, we hereby provide our comments in regard to the proposed new general anti-avoidance rule for your kind consideration.

1. INTRODUCTION

1.1 Any discussion of tax avoidance would be incomplete without a consideration of what might be referred to as "permissible" tax avoidance or, perhaps more correctly, tax planning. Tax planning has been recognised by our courts and the South African Revenue Service ("SARS") generally as being legitimate and inoffensive. The exact meaning of tax planning in contradistinction to "impermissible tax avoidance" is a grey area and not always easy to delineate. That said, we submit that the following exposition by Lord Goff in the seminal English case of *English tankers (Leasing) Ltd v Stokes (Inspector of Taxes)*, and quoted with approval in the Appellate Division case of *Burgess v CIR* (55 SATC 185), provides a good touchstone:

"Unacceptable tax avoidance typically involves the creation of ***complex artificial structures*** *by which, by the wave of a magic wand, the taxpayer*

conjures out of the air a loss, or a gain, or expenditure, or whatever it may be, which otherwise would never have existed. These structures are designed to achieve an advantageous tax benefit for the taxpayer, and, in truth, are not more than raids on the public funds at the expense of the general body of taxpayers, and as such are unacceptable". (Our emphasis)

1.2 This concept of artificiality is further developed in the Discussion Paper on Tax Avoidance ("Discussion Paper") where the term "impermissible tax avoidance" is used to refer to ***"artificial or contrived arrangements"***, with little or no actual economic impact upon the taxpayer" (at page 4 – our emphasis). It is such "artificial or contrived" arrangements that an efficient and effective general anti-avoidance rule ("GAAR") should seek to attack, and not legitimate tax planning. Our general concern is that the proposed formulation of the new GAAR would bring within its ambit legitimate transactions that involve tax planning to mitigate a sometimes significant **cost – namely tax.** More specifically, we are concerned that some of the specified "abnormality" indicia provided for in the proposed section 103(2) are to be found in normal *bona fide* business transactions, thus further blurring the line between legitimate tax planning and "impermissible tax avoidance". This aspect is dealt with in more detail below.

1.3 It is accepted that if an artificial or contrived transaction falls within the ambit of "impermissible tax avoidance" (which is properly targeted by a GAAR, i.e. section 103 of the Income Tax Act, No 58 of 1962 - "the Act"), SARS is entitled to seek to apply the GAAR so as to negate the tax benefit generated by the transaction. If, however, the taxpayer so organises his or her affairs so as to minimise the amount of tax payable in relation to a transaction and the transaction does not fall within the ambit of GAAR, then there is no obligation on the taxpayer to pay more tax than he or she is obliged to pay on a strict application of the law. There is no room, in our respectful opinion, for an approach that seeks to impose an obligation on taxpayers to apply the "spirit of the law', rather than what is clearly the "letter of the law". Any changes to section 103 must have the effect of clarifying, and not blurring, the inevitably difficult distinction between legitimate tax planning and 'impermissible tax avoidance".

1.4 It is inevitable that taxpayers consider tax as a cost like any other, and will accordingly seek to minimise that cost as much as possible within the constraints of the law. This does not mean, however, that the vast majority will enter into artificial or contrived transactions solely to derive a tax benefit. Most taxpayers enter into transactions for sound business purposes and would consider and seek (as they are entitled) to minimise any tax cost associated with such transaction as a matter of course. The majority of taxpayers would not, and do not, enter into so-called "impermissible tax avoidance" as contemplated in the Discussion Paper.

1.5 Taxpayers must be entitled to structure a *bona fide* business transaction that would have been entered into regardless of the tax consequences in such a manner as to minimise the tax that attaches itself to the transaction. A GAAR that does not so provide will discourage both international investment and entrepreneurship by South African business people. The inevitable result will be a negative effect on economic growth. This in turn will result in a reduction of the amount of taxable revenue generated by the majority of law-abiding citizens. This principle was eloquently stated by Lord Upjohn in a 1967 case when he said: "*My lord I will conclude my judgement by saying only that when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out, one by paying the maximum amount of tax, the other by paying no or much less tax, it would be quite wrong as a necessary consequence to draw the inference that in adopting the latter course one of the main objects is for the purpose of this Section avoidance of tax.*". He added "*No commercial man in his sense is going to carry out commercial transactions except on the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the special Commissioners to decide after consideration of all the relevant evidence before them and the proper inference to be drawn from the evidence.*" He therefore supports the view that if one of the main objects was to avoid tax it might be considered offensive, but if it's a genuine commercial transaction then the sensible thing for every commercial man to do is to enter into the commercial transaction in such a way as to ensure that his tax liability remains as low as possible.

1.6 We comment on the proposed new GAAR within the context of what was noted above.

2. DETERRENT?

2.1 It is argued that the present GAAR formulation has proven to be an "inconsistent, and at times, ineffective deterrent to abusive avoidance schemes and other impermissible tax avoidance" (at page 41). By way of example, the Discussion Paper notes that the avoidance schemes mentioned in the document were marketed subsequent to the 1996 amendment, which introduced the so-called "*bona fide* business purpose" test (see 3 below). With respect, the fact that there has only been one unreported decision that considered this new requirement can be construed as evidence of its success. In addition, it is perhaps because of the uncertain outcome of litigating this requirement that so many of the participants in the avoidance schemes mentioned in the Discussion Paper have settled instead of taking their chances in court.

2.2 In addition, it is perhaps instructive to note that the *bona fide* business purpose requirement provided for in the VAT GAAR has been singularly successful.

2.3 In summary, we are not as negative as regards the deterrent value of the present GAAR formulation and as a general proposition see no need for its reformulation.

3. ABNORMALITY REQUIREMENT

3.1 It is argued (pages 42/43) that the abnormality requirement suffers from two fundamental weaknesses, namely the failure to "neatly" distinguish *bona fide* transactions from "impermissible tax avoidance schemes", and secondly because "it is relatively easy for promoters to 'manufacture' plausible sounding 'business purposes'".

3.2 As suggested above, it would seem to us to be too early to write off the relatively newly introduced "*bona fide* business purpose" test in this manner. With respect, it seems to us that the aforementioned weaknesses are more illusory than real.

3.3 As mentioned, we are of the opinion that, support for the argument that the current abnormality test has not been sufficiently tested by the courts, can be found in the many settlement agreements concluded by SARS and a significant number of taxpayers. While certain of these taxpayers may have entered into

these settlement agreements under duress in the sense of choosing the settlement option in order to avoid the impact uncertainty would have had on their business operations, most, we venture, were unwilling to test their transactions against the "*bona fide* business purpose" test.

4. ABNORMALITY TEST - PRESUMPTION THAT A TRANSACTION IS AN AVOIDANCE SCHEME

4.1 The proposed section 103(4)(b) provides as follows: "Whenever in proceedings relating to subsection (1) it is provided that...any of the factors set forth in paragraphs (d) through (k) inclusive, of subsection (2) exist in respect of the arrangement, or step therein or part thereof, ***it is presumed, until the contrary is proved***, that the arrangement, or any step therein or part thereof, was entered into or carried out by means or in a manner which would not normally be employed for *bona fide* business purposes (other than obtaining a tax benefit)."

4.2 We are concerned about this presumption in context of the following:

4.2.1 A large number of the "abnormality" indicia cited in paragraphs (d) through to (k) of the proposed section 103(2) are present in a significant number of normal commercial transactions.

4.2.2 The mere presence of "abnormality" indicia of the nature cited might result in overzealous SARS representatives applying the new GAAR without a proper analysis of the relevant transactions, resulting in time-consuming and costly interactions between SARS and the affected taxpayer.

4.2.3 It is our view that the proposed amendments to the abnormality test will cause the test to be more complex. The courts have difficulty in dealing with the abnormality test in its current format (albeit a small number of cases). Surely SARS should aim to make the test ***less*** complex and therefore create certainty for taxpayers as opposed to more uncertainty as to what would be considered abnormal. He proposed test appears to attempt to provide for specific eventualities, without establishing an underlying general principle, such as reasonability.

4.2.4 We note that while the introduction of the specified "abnormality" indicia is intended to provide an objective basis for determining the means and manner in which a transaction was entered into, we have difficulty in understanding why once any one of the indicia specified in (d) to (k) have been proved to be present, there is then a presumption (albeit that it may be rebutted) that the transaction was entered into by means or in a manner that would not normally be employed for *bona fide* business purposes? This in effect means that the onus of proving that the transaction was in fact entered into by acceptable means and manner shifts to the taxpayer. ***We note that no such presumption is provided for in the foreign jurisdictional GAARs referred to in the Discussion Paper.***

4.3 As regards the specific "abnormality" indicia, we would comment as follows:

4.3.1 It is not clear to us what the distinction is between paragraphs (f) and (i), which seem to us to provide for the same circumstances, the only difference being no change in the taxpayer's "economic" versus "financial" position. In addition, the fact of the matter is that nearly all *bona fide* business transactions fall foul of this indicia, in that payment for goods or services would arguably leave the taxpayer in the same economic or financial position.

4.3.2 As regards indicia (h), it is evident that parties to a transaction, even if tax avoidance is the driving force, will generally act at arm's length, as it would be extremely unusual for someone to do something for less than perceived full value.

4.3.3 The indicium provided for in paragraph (j) is predicated on a "reasonable expectation of pre-tax profit". What is meant by "reasonable? This would be open to much debate and is extremely subjective.

4.3.4 It is difficult to understand how the "abnormality" indicia provided for in paragraph (k) would be determined.

5. SOLE OR MAIN PURPOSE

5.1 The "tax benefit" purpose test provided for in section 103(1)(a) of the proposed new GAAR requires that the transaction must have as its "sole or one of its main purposes" the obtaining of a tax benefit. Given that our courts have confirmed that "main" means more than 50%, it is difficult to conceive of how a taxpayer could be said to have more than one "main" purpose. Rather, the existing tax benefit purpose test should merely be made applicable to the different steps of the arrangement that is under consideration.

5.2 We propose that the purpose ***and effect*** of a transaction should be considered as per the Canadian GAAR provisions.

6. ARGUING GAAR IN THE ALTERNATIVE

6.1 The purpose of any GAAR should be to negate tax consequences, which would not have been negated through the application of the specific provisions, contained in the Act. The seemingly extra-statutory power given to SARS in terms of the proposed GAAR to apply GAAR in the alternative would in essence allow SARS to override normal provisions of the Act.

6.2 Stated differently, if a transaction stands up to scrutiny, for example the taxpayer claimed a deduction – correctly – then the law will allow the deduction. The purpose of the GAAR is surely not to give the SARS the power to simply override the law. It would seem to us that to allow SARS to argue GAAR in the alternative in effect allows it to make law.

7. PENALTIES TO BE LEVIED ON ADVISORS

7.1 It is proposed that a new penalty is to be introduced to penalise promoters of "abusive avoidance schemes". We comment as follows:

7.2 The introduction of the penalties would be draconian. The Act already contains provisions (section 104 of the Act) that would impose sanctions on any person who assists any other person to ***evade*** tax. The proposed introduction of penalties would have the result of criminalising tax avoidance – this surely cannot be the intention.

7.3 The majority of the "promoters" of so-called "abusive avoidance schemes" are not reckless promoters of "abusive avoidance schemes" as would be

suggested. The reputable promoters usually, as a matter of course, obtain various opinions from a number of professionals before a scheme is promoted or introduced to the market place. The opinions usually include opinions from counsel. It is also not uncommon to find that the various professionals consulted do not all agree with each other as to the outcome of all or some of the aspects incorporated in a scheme. The fact that various professionals do not agree as regards to the outcome on the same set of facts can be seen from the fact that the invariably learned advisors land up arguing the same set of facts before the courts from different perspectives.

8. TAX INDIFFERENT PARTY

8.1 A "tax indifferent party" is defined, *inter* alia, as "(a) any person that is not subject to any tax imposed by this Act", or "(c) any company or other entity which is established specifically for the purpose of participating in that arrangement".

8.2 As regards criteria (a), it must be noted that this would encompass all non-residents. This seems unintended and the definition should be amended to exclude non-residents.

8.3 Criteria (c) would encompass all special purpose vehicles ("SPV") that are established to facilitate BEE deals and securitisation transactions. As in the case in 8.2, this aspect of the definition is also too widely stated and should be limited in some manner.

Please do not hesitate to contact us should you require any clarification or additional assistance.

Yours sincerely
MALLINICKS INC

Per:

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