



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

Revised Proposals

The Current GAAR

⇒ Section 103

⇒ Four Requirements

- Arrangement
- Tax Benefit
- “Abnormality”
- “Tax Avoidance” Purpose

Original Proposals

⇒ Abnormality Requirement –

- Objective factors
- Presumption of abnormality

⇒ Purpose Requirement

- Objective test
- “One of the main” purposes threshold

⇒ Clarifications

- Application to steps in a larger arrangement
- Use in the alternative

The Process So Far

- ⇒ Discussion Paper – 3 November 2005
- ⇒ Public Comment
 - Original deadline – 31 January 2006
 - Extended – 28 February 2006
- ⇒ Interim Response – 16 March 2006
- ⇒ Hearings before this Committee – March 2006
- ⇒ A professional and constructive debate
- ⇒ Extensive consultation with international experts

Balancing the Comments



- Certainty for *bona fide* transactions
- A stronger and more effective deterrent

Greater Certainty

⇒ Abnormality Requirement

- Factors refocused and moved
- Presumption eliminated

⇒ Purpose Requirement

- “Objective” test relaxed
- “One of the main purposes” test dropped

⇒ Explicit notice requirement

⇒ Language and format

A Better Deterrent

- ⇒ New tests
 - Commercial Substance
 - Statutory Purpose
- ⇒ Tax benefit loophole closed
- ⇒ Remedy strengthened
- ⇒ Steps in or parts of an arrangement
- ⇒ Use in the alternative

Impermissible Tax Avoidance

⇒ An Informal Definition

“A deal done by very smart people that, absent tax considerations, would be very stupid.”

Michael Graetz - Yale Law School

Commercial Substance

Broad Agreement

- ⇒ Tax driven arrangements with little or no commercial substance have no place in our tax system

- ⇒ Unfortunately –
 - “Sham” transaction doctrine often not applicable
 - “Abnormality” under increasing pressure
 - Globalisation
 - Financial deregulation

Commercial Substance: A New Test

- ⇒ Target problem directly
- ⇒ Applies to arrangements lacking commercial substance in whole or in part
- ⇒ Whether or not “abnormal”
- ⇒ Key features –
 - No substantial effect on a party’s –
 - Business or commercial risks
 - Net cash flow
 - Beneficial ownership of assets

Indicators

⇒ 5 key indicators

- Legal or economic effect/substance of the whole differs from the legal form of the parts
- Round trip financing
- Accommodating or tax-indifferent parties
- Offsetting or self-cancelling
- Inconsistent characterisation by the parties for tax purposes

⇒ Revised factors

Round Trip Financing

- ⇒ Replaces “circular flow of cash or assets”
 - Australia
 - United States
- ⇒ Three key features
 - Transfer of funds between or among parties
 - Creating a tax benefit
 - Reducing risk significantly
- ⇒ Means and manner irrelevant

Tax-Indifferent Parties

⇒ Accommodating and tax-indifferent parties

➤ Functional approach –

- Shifting income or deductions
- Converting –
 - Revenue to capital
 - Taxable to exempt
 - Nondeductible to deductible
- Absorbing pre- or accelerated payments

➤ Two “safe harbours”

- Subject to comparable foreign tax *or*
- Engaged in on-going substantive business activity

Guarding the Back Door

⇒ Common devices

- Accommodating parties
- Tax-indifferent parties
- Connected persons

⇒ The antidotes

- Authority to disregard accommodating or tax indifferent parties
- Combine connected persons

Two Types of ITA

- ⇒ Tax Shelters
- ⇒ Abusive avoidance schemes
- ⇒ Structured finance
 - Complex
 - Multi-step
- ⇒ Misuse or abuse of the tax laws
- ⇒ Excessively literal or hypertechnical readings
 - Exploit –
 - “Inconsistencies”
 - “Discontinuities”
 - Limits of language

Remedies

- Abnormality
- Commercial substance
- Purposive interpretation

Statutory Purpose

- ⇒ New test
- ⇒ Attempt to frustrate the purpose of the tax laws
- ⇒ Applies to any arrangement
- ⇒ Reinforces “modern” approach
- ⇒ Explicitly applies to the GAAR
 - Additional guidance given in GAAR
 - Inevitable some will try to abuse

Purpose Requirement

⇒ Relaxed “objective” determination rule

- Subjective intent
- Tested against objective facts and circumstances
- Reinforce existing case law
- A balanced approach

⇒ Dropped the “one of the main” purposes test

Notice Requirement

⇒ Written notice

- At the start
- Reasons
- Opportunity to respond

⇒ Codifies existing practice

⇒ Prior internal review and approval

Summary

⇒ Four Factors

- Arrangement
- Tax Benefit
- Tax Avoidance Purpose
- Tainted Element
 - Abnormality
 - Commercial Substance
 - Statutory Purpose

⇒ Multifaceted problem

⇒ Multifaceted solution

Reportable Arrangements

⇒ Disappointing results

- Only 55 arrangements reported
- 53 “plain vanilla”

⇒ Weaknesses in the legislation

- Narrow trigger
 - Fee variation clause
 - R5 million benefit threshold
- Definition of tax benefit
- Penalty issues

⇒ Resistance by the financial services industry

Proposed Changes

- ⇒ Greater coordination with new GAAR
- ⇒ Retains existing trigger and adds –
 - Commercial substance indicators
 - Lack of pre-tax profit or an insignificant pre-tax profit in comparison to tax benefit
- ⇒ New definition of “tax benefit”
- ⇒ Substantial monetary penalty for non-compliance, which may be reduced if –
 - Extenuating circumstances
 - Disproportionate to tax benefit
- ⇒ Reduced initial reporting requirements

Promoter Penalties

- ⇒ International trend
- ⇒ A “supply side” problem
- ⇒ Response mixed
 - Some in favour
 - Some opposed
- ⇒ Has behaviour changed?

Cause for Concern

- ⇒ New aggressive schemes
 - Imports
 - United States
 - United Kingdom
- ⇒ Foreign tax credit schemes
- ⇒ Abuse of the corporate rules
- ⇒ CFC avoidance schemes
- ⇒ Film schemes
- ⇒ Cross-border financing schemes
- ⇒ Cross-border intangible property schemes
- ⇒ Derivative financial instrument schemes

Warning Signs from Abroad

“Tax authorities chasing a moving target”

Headline, Financial Times, 31 August 2006

“At present, the recent spate of avoidance legislation and the new disclosure rules have given advisers pause for thought. However, as the new regimes become more familiar, it is likely that new transactions will emerge”

Louise Higginbottom, UK Tax Professional

Drawing the Line

⇒ Tax Evasion

Tax evasion is characterized by fraud and deceit. It refers to all those activities deliberately undertaken by a taxpayer to free himself from the tax that the law charges upon his income, for example, the falsification of returns, books and accounts and the conclusion of sham transactions.

⇒ Tax Avoidance

Tax avoidance, on the other hand, is characterized by open and full disclosure.

Silke, paragraph 19.1

Crossing the Line?

- ⇒ “Engagement in an avoidance scheme can encourage taxpayers to be economical with the truth”
- ⇒ Actual examples –
 - Surrounding schemes in “structural fog”
 - Using uncommon “alternative accounting treatments” to make it harder for the Inland Revenue “to see this transaction for what it is”.
 - Reporting transaction separately “might set the IRS on top of the reasons why the partnership was constructed in the first place and thus planned tax losses might be denied by the IRS”.
- ⇒ Open and full disclosure?

A Clear Choice

⇒ Looking Backward

- Continue with the old regime
- Permit taxpayers to avoid their tax liabilities through tax-driven arrangements with little or no economic substance
- Undermine
 - Fairness of the system
 - Respect for law
 - Ability of tax incentives to accomplish their purpose
 - International competitiveness due to upward pressure on rates
 - Economic growth as a result of deadweight losses

⇒ Looking Forward

- Keep in pace with international trends
- Recognise that the right to minimise tax is not absolute and must be balanced against other rights and obligations
- Build a system based upon transactions with genuine commercial substance
- Promote
 - Fairness
 - Respect for the law
 - Effective tax incentives
 - International competitiveness
 - Fiscal independence

Conclusion

- ⇒ Draft legislation to follow shortly
- ⇒ A set of better balances
- ⇒ Once legislation is in place SARS will
 - Monitor behaviour
 - Work more closely with
 - Other revenue authorities
 - International organisations
 - Litigate appropriate cases
- ⇒ Refinements based on feedback and results