Dear Sir/Madam

COMMENTS ON DRAFT COMPREHENSIVE GUIDE TO THE GENERAL ANTI – AVOIDANCE RULE

We thank you for the opportunity to provide input on the Draft Comprehensive Guide to the General Anti-Avoidance Rule (“Guide”). We set out below our submission comments.

Page 1 Glossary: Insert No. as indicated in the following:
Income Tax Act No. 58 of 1962
Value-Added Tax Act No. 18 of 1991

1.4.4. The Guide does not refer at all to the recent case of CSARS v NWK Limited (2010) ZASCA 168 decided on 1 December 2010. This case would be relevant to the discussion in the Guide as it appears to suggest that the doctrine of substance over form also requires one to examine the commercial sense of a transaction i.e. whether there is a commercial purpose in a transaction other than a tax incentive. While the Guide does only relate to the law in 2008, comments on this case arguably should be included given its impact on the law. Furthermore, guidance on when the NWK doctrine applies versus GAAR would be appreciated.

1.4.4 Top of page 5: SARS indicates that substance over form may be relied upon ‘in the alternative or in addition to any other ground of assessment’. This is not strictly speaking correct. The new GAAR permits this, specifically, but for other provisions, substance over form implies that the law has not been complied with, so one cannot simultaneously argue that the facts have not been properly applied to a particular piece of law. In practice it is practical for a court to allow the alternatives to be put forward so that if substance over form fails, SARS does not need to come to the courts again.

2: Requirement 2 in the table: Typo ‘an tax benefit’ should be ‘a tax benefit’.
2.5.1 The third line in the flow chart is incorrect since the box to its right is a statement not a question.

3.1.2 Part (b) of the definition must be expanded to say ‘or is effectively managed in the Republic’. Otherwise it is incomplete.

3.2.4 The last line states that capital gains were ‘exempt’ at the time of the judgement. However, this is not correct. At the time capital gains were simply ‘not taxable’.

3.2.5 Example 1. This example mentions compulsory convertible loan structure. However, such a structure has not been found to fall foul of GAAR, and SARS may not, consequently, infer that such a structure automatically falls within the relevant provisions. The example here and in other places in the document should not therefore refer specifically to such a structure, but rather to a (generic) finance structure, which is rather more hypothetical.

3.3 Tax benefit requirement – last bullet on Page 16. It is explained that the general or “presumptive” commercial substance test contained in section 80C(1) and the indicative commercial substance test in section 80C(2) are not alternative tests.

On page 26, the second paragraph, second sentence, it is clearly stated: ‘If even one of the indicators is present, provided the presumptive test contained in section 80C(1) is satisfied, this may be sufficient to render the avoidance arrangement an impermissible avoidance agreement’.

The same principle is stated on page 29, first paragraph, second sentence, as well as in the paragraph before Example 7, and in the third sentence of Example 7.

Question:

1. Does an avoidance arrangement lack commercial substance only if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flows of that party (section 80C(1))?

If the answer is yes, then the interpretation would be that section 80C(1) can stand alone and that section 80C(2) is an alternative test to indicate a lack of commercial substance. However, if the answer is no, then the interpretation would be that the lack of commercial substance described in section 80C(1) must also be indicated by characteristics as described in section 80C(2). If this is the case, it is proposed that section 80C(2) should be changed to: ‘For the purpose of subsection 1 (this Part) …’

2. Must the avoidance arrangement also have the characteristics that are indicative of a lack of commercial substance (section 80C(2))?
The interpretation would be that the lack of commercial substance described in section 80C(1) must also be indicated by characteristics as described in section 80C(2). If this is the case, it is proposed that section 80C(2) should be changed to: ‘For the purpose of subsection 1 (this Part) ...’

3.4 Example 4: The example is less specific than in 3.2.5 and therefore, more acceptable, but the last sentence implies GAAR applies, without referring to the other requirements.

4.1 First bullet: The last sentence states ‘This difference leads to a more objective requirement for the purpose’. Purpose, however, denotes intention and this is always subjective. (Gallaher’s case below in 4.2 confirms this with: ‘If the subjective approach be adopted (as it must’)). Only the result can be objective. Furthermore an arrangement itself cannot have a purpose to reduce tax, since an arrangement itself cannot benefit from a tax benefit. It can only result in a tax benefit. Only the participants can enjoy that tax benefit, so it is their purposes/intentions that must be looked to.

4.3 The wording of section 80A (see the second box) ‘if its sole or main purpose’ refers to an avoidance arrangement. The wording of section 80A has always been limiting since an arrangement itself is inanimate and can have no purpose. Only, its creator can have a purpose. As an analogy, the function of a cork screw is to pull a cork. However, it is the purpose of the person using it to actually get a cork out of a bottle. One may say that the cork screw’s purpose is to remove the cork. However, it has no purpose. It cares not if it never actually pulls out a cork. Similarly, an arrangement might have the function (objective) of avoiding tax, but only the person using it can have the purpose of doing this.

4.3 4th para beginning “secondly...” alleges that ‘plausible sounding business purposes were manufactured’. This is supposition. The sentence should be rather that it left it open for such purposes to be manufactured not that they were.

4.3 5th para: This is meaningless as they are one and the same.

4.3 7th para: This paragraph is not logical in that it implies that an expense e.g. salary would have the effect of reducing tax and would therefore objectively have that as its purpose. Only by looking at the intention/purpose of the person incurring the expense can one determine the purpose for which it was made. If it is not read in this latter way sole or main purpose equals has a tax benefit as a result, and including both requirements in the section would render one of them redundant. The next paragraph confirms that it is the tainted elements that are the objective tests.

6.4 1st para: This implies that section 103 did not require commercial substance. However, it did require it, but this was not spelt out in so many words.
6.4.2 The flowchart on page 27 can be interpreted that section 80C(1) and section 80C(2) can stand alone.

6.4.2.1 The Guide suggests that the onus to show that an arrangement does not lack commercial substance falls effectively on the taxpayer. The Commissioner merely has to form an opinion that an arrangement lacks commercial substance for the onus to shift to the taxpayer to prove that it does. In 9.8 of the Guide it is stated however that the Commissioner has under the GAAR the onus of proving the existence of “tainted elements” i.e. elements that demonstrate a lack of commercial substance. The Guide is thus confusing as to the question of onus. It should be made clearer on to whom the onus of proving or disproving the commercial substance of a transaction rests.

6.4.3 Example 8 see note above re stating CCL.

6.4.3 b) Last para: Money always ‘round trips’: Farmer sells grapes to Co Op. Co Op makes wine and sells to shop; Shop sells wine to farmer. (Costs of growing grapes, making wine and running shop are all deductible: Does GAAR apply?)

6.4.4 Flowchart 2nd box down on the left, last line: ‘of’ should be ‘or’. Further the flowchart uses party in a confusing way....needs to say party A or party B.

6.4.5 a) The term ‘subject to income tax’ needs to be clarified. Is this the tax rate? What if there are exemptions? Does it mean 2/3 of tax actually paid/payable?

6.4.5 Example 9: see prior note on term CCL. Also 2nd line should say ‘business’ establishment not permanent establishment.

In 6.4.6 of the Guide, the term “offsetting or cancelling” characteristics are dealt with very cursorily and vaguely. It appears to define these characteristics very widely and does not assist at all in the understanding of what is meant by the use of this term in the GAAR. In terms of the wide understanding of this phrase set out in the GAAR, the simple transaction of sale could have offsetting or cancelling characteristics by virtue of the fact that seller’s right to claim payment of the purchase price is “cancelled” or “offset” when that purchase price is paid. The Guide needs to elaborate upon or narrow the meaning of this term.

6.4.7 a) This assertion lacks commercial reality. It is natural for a businessman to measure his after tax return when making any investment/entering into any transaction. It would be negligent of him to ignore the tax, and in fact, the after tax line can render the transaction not viable, whereas the before tax line looks good. Similarly, a transaction may be more favourable after tax if performed one way versus another and a businessman must assess on this basis. A simple example would be invest in shares or loan. What is the after tax anticipated return of both? The one with the best after tax return will, after assessing the relative risks attached to both options, likely be chosen.
6.4.7 d) This is not a reasonable assertion. Deferred tax arises as a consequence of provisions being disallowed, or prepayments being claimed. Thus, it cannot be said that the raising of deferred tax indicates a lack of commerciality.

In 6.4.7 of the Guide, Example 11 must be incorrect. It is not clear why Company A is avoiding tax of R2,9 million merely if it concludes a sale with the foreign subsidiary of Foreign Bank D which then on-sells it to Company B. This would only occur if Company A sold the product to Foreign Bank D for no value but this is not expressly said anywhere in the example. Surely this is an error?

In 6.4.7 of the Guide under para (g) it is intimated a non-refundable upfront fee charged by a promoter represents a “fee variation clause” or a provision where by tax risk is shift to a particular party. It is not clear though why this should be so.

9.3 2nd line the ‘by’ in ‘by shifting’ is redundant.

Overall the guide, although of interest does not really add a lot to the legislation. It largely reiterates what the legislation says. More interpretation would be appreciated.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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