General anti-avoidance rule (GAAR)

This article explains the important topic of the promulgated general anti-avoidance rules in the Income Tax Act. SARS is serious about tax compliance and does not respond kindly to any tax avoidance scheme. When it was promulgated, Minister Trevor Manuel stated clearly in parliament that SARS is now empowered with the new anti-avoidance rules to bring to book all the anti-avoidance schemes that escaped the tax net for a number of years.

The Duke of Westminister appeared in the number 1 spot of the “Rich List” as published by the London Sunday Times some decades ago. This very same Duke was the defendant in the most famous tax avoidance case in modern history. The judges of that court ruled in favour of the Duke and stated that:

“every man is entitled, if he can, to order his affairs so that the tax attaching is less than it otherwise would be”

This raises an interesting question “is there a correlation between tax planning and wealth and is this quote still relevant in the twenty-first century” What follows may lead to the conclusion that the new GAAR rules are indeed a new beginning.

Introduction: The anti avoidance rules

Section 103(1) contained the acts’ general anti-avoidance rule (GAAR) for a number of years. This provision did, however, contain certain inherent weaknesses with the result that a new GAAR was incorporated within the Act. These new provisions were inserted in sections 80A to 80L and apply to any arrangement entered into on or after 2 November 2006.

Section 80A describes what an “impermissible avoidance
arrangement” is. The powers that the Commissioner has with respect to an impermissible avoidance arrangement are set out in s 80B. The remaining provisions expand on these first two provisions and deal with certain procedural issues that arise.

Section 80L defines the terms “arrangement”, “avoidance arrangement”, “impermissible avoidance arrangement”, “party” and “tax benefit” for use in the GAAR. It is important to note that these terms draw heavily on the provisions and interpretation of the previous s 103(1), with the exception of the new terms “impermissible avoidance arrangement” and “party”.

New legislation is always complicated, especially if one is confronted with unfamiliar terms. Diagram 1 will provide the reader with an overview of the new rules and will assist in the understanding of these new rules.

The consequences of the application of GAAR (s 80B)

Once all the s 80A requirements of an “impermissible tax avoidance arrangement” are present, s 80B empowers the Commissioner to take certain action:

• A general remedy is provided for in s 80B(1)(f). The Commissioner may in terms of this general remedy determine the liability for tax as if the transaction had not been entered into or carried out, or, alternatively, “in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit”. The Commissioner is also provided with specific remedies to impermissible tax avoidance arrangements. The specific remedies are contained in ss 80B(1)(a) to (e). These specific remedies allow the Commissioner to, for example, • disregard or combine any steps in the arrangement, • deem different parties as one and the same person, • or to re-allocate or re-classify any receipts or accruals, expenditure or rebates. The Commissioner must, in terms of s 80B(2), make
the necessary and appropriate adjustments to the applicable tax liabilities to ensure the consistent treatment of all the parties to the arrangement. These adjustments are subject to the normal three year prescription rules. The adjustments are also subject to objection and appeal. It is important to note that the provisions of s 80 may be applied to any part of an arrangement or to the arrangement as a whole (s 80H).

When can the general anti-avoidance rule (GAAR) be applied? (s 80A)

The general anti-avoidance rule can be applied if an avoidance arrangement (in other words, an arrangement that results in a tax benefit) is an “impermissible avoidance arrangement”.

An impermissible avoidance arrangement arises if: • the sole or main purpose of the avoidance arrangement was to obtain a tax benefit (it is always presumed that an avoidance arrangement was entered into with the sole or main purpose of obtaining a tax benefit (s 80G) and • Atainted element is present. There are three tainted elements: • Abnormality (ss 80A(a)(i), ss 80A(b) and 80A(c)(i); or • Lack of commercial substance (s 80A(a)(ii)); or • Misuse or abuse of the provisions of the Act (s 80A(a)(ii)). A “lack of commercial substance” (s 80C) Section 80C provides a general rule for determining whether an avoidance arrangement lacks commercial substance for the purposes of s 80A, as well as a non-exclusive set of characteristics that serve as indicators of a lack of commercial substance.

The general rule is that an avoidance arrangement lacks commercial substance if it results in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flow of that party (s 80C). Examples of indicators of a lack of commercial substance, according to s 80C(2), include: • situations where the legal substance of a transaction differs from the legal form, or • round trip financing is present, as described in s
80D, or a tax-indifferent party, as described in s 80E, is introduced as part of the arrangement, or elements are present that have the effect of offsetting or cancelling each other. These elements are typically present when one transaction creates a significant tax benefit while another transaction effectively neutralises the undesired consequences of the first transaction.

Section 80D provides a non-exclusive description of round trip financing. This essentially relates to a transfer of funds between parties that results in a tax benefit and a significant reduction, offset or elimination of business risk.

**Example – Round trip financing and GAAR**

Holdco owns all the shares of company A and company B. Company A owns an administrative building on which no capital allowances can be claimed. A sale-and-lease back transaction was concluded between company A and company B in terms of which Company A sold the building to company B who immediately leased the same building back to company A. Company B has an assessed tax loss and therefore incurs no tax cash flow resulting from the lease income that it receives. Company A entered into this arrangement to eliminate the risk associated with the ownership of the building.

**Is round trip financing present**

Round trip financing is present in this arrangement. Funds were transferred from company B to company A when the building was bought. Company A will repay the same funds to company B by means of the future lease payments. Company A obtains a tax benefit from this transaction since the lease expenses can now be claimed as a tax deduction by company A.

**Can the new GAAR be applied?**

Question 1 (see diagram): Was an arrangement entered into? Yes, a number of transactions were entered into, a sale
transaction as well as a lease transaction was entered into.

Question 2: Is a tax benefit obtained? The deduction of the lease expense presents a tax benefit, thus the arrangement now constitutes an avoidance arrangement as defined.

Question 3: Is it an impermissible avoidance arrangement? Yes, there is a lack of commercial substance for a number of reasons: (1) round trip financing is present and (2) there is a significant tax benefit for a party but it does not have a significant effect upon either the business risks or the net cash flow of that party.

The business risk of Holdco remained unchanged, but a tax benefit arose for one of its subsidiaries. One may argue that Holdco is not a party to the transaction. This will not have any impact since the Commissioner may deem connected persons as one and the same party (s 80F(a)). Alternatively, different entities may be deemed to be the same party for GAAR purposes (s 80F(b)).

The GAAR can certainly be applied. The sale and lease back transaction as well as the resulting tax benefits may be ignored when SARS raises a tax assessment. Interest will also be levied on the amount of taxes that would have been paid if the transaction was never entered into.

The round tripping provision applies to any round tripped funds without any regard to the timing or the sequence, means or manner in which round tripped amounts are transferred (s 80D(2)). The fact that the flow of funds takes place during different years of assessment is therefore irrelevant.

**Accommodating a tax indifferent party (s 80E)**

One of the indicators of a lack of commercial substance in a transaction is when a tax-indifferent party is accommodated in the transaction.
A tax-indifferent party is accommodated when: • A party receives an amount that has no impact on his tax liability (he is, for example not subject to tax or the receipt is offset either by any expenditure, loss or assessed loss of his) and • That amount would have had an impact on the tax liability of another party if the amount was received by this party. If, for example, this second party would have been subject to tax on that amount if he received it or the amount would have constituted a non-deductible item for him. (Section 80E(1)).

A person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any other party (s 80E(2)).

The presence of a party to a transaction will not be considered as accommodating a tax-indifferent party if: • the tax actually paid in other jurisdictions amounts to more than two-thirds of the income tax that would have been paid in the Republic (s 80E(3)(a)), or • if ongoing active business operations (of at least 18 months) in connection with the avoidance arrangement are carried out through a substantial business establishment in the Republic or elsewhere (s 80E(3)(b)). These safe harbour rules under which section 80E does not apply is very necessary " if, for example, a South African company buys a stock item from a foreign company, the transaction could (in the absence of the safe harbour rules) have being classified as “accommodating a tax-indifferent party”. This is because the proceeds of the sale of the stock item would have been subject to tax in the Republic if those stock items were bought from a South African company. The safe harbour rules of s 80E(3) may assist in an attempt to ensure that the foreign company is not seen as a tax-indifferent party to the transaction.

General provisions

Section 80F allows the Commissioner to combine connected persons and disregard an accommodating or tax-indifferent
party or to combine it with another party for the purposes of determining: • whether an avoidance arrangement lacks commercial substance or • whether a tax benefit exists. The Commissioner must give notice, with reasons, of an intention to invoke the GAAR. The taxpayer generally has 60 days to reply to the notice but may request an extension to reply. On receipt of the reply or expiry of the period for a reply the Commissioner has 180 days to raise further queries, withdraw the notice, or invoke the GAAR. If additional information comes to the knowledge of the Commissioner the reasons for invoking the GAAR may be modified or a new notice may be issued if a prior notice has been withdrawn (s 80J).

Interest charges by SARS may not be waived in terms of s 89quat(3) or (3A) if the GAAR has been invoked (s 80K). The implication of this is that SARS must levy interest on the amounts of tax that was not paid due to the fact that the taxpayer entered into a tax avoidance arrangement.

Conclusion:

All future transactions should be considered for abnormality, lack of commercial substance or misuse of the Income Tax Act. Any of these factors may result in the application of the new general anti-avoidance rules. The question is, do we “misuse” the Act by planning our tax affairs? If we do, GAAR applies!

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