Tax Avoidance
and Section 103 of the Income Tax Act, 1962
Today’s Message

- Section 103 is an essential part of the tax law
- Good fiscal citizenship and a growing tax base is vital for a developmental state
- Challenge to all role players to embrace this ideal
- Clear law and clear boundaries
- Effective administration
- Lessons from the rest of the world
  - Harmful impact
  - Methods to address
- A new section 103
Introduction

ROADMAP

⇒ What we have done so far
⇒ Open process
⇒ Today-
  ⇒ Guiding principles
  ⇒ Practical experience
  ⇒ Problems and weaknesses under current law
  ⇒ Proposals for change
Terminology

- **Tax evasion** – illegal
  - Hiding income or information
  - Claiming deductions for expenditure not incurred

- **Impermissible tax avoidance**
  - Artificial or contrived arrangements
  - Manipulate or exploit perceived “loopholes”
  - Form over substance

- **Legitimate tax planning**
Social, Economic and Corporate Harm
Prologue: A Collapse of Basic Standards

Unprecedented corporate scandals in number and scope
- Enron
- Worldcom
- Tyco
- Parmalat
- LeisureNet
The Role of Impermissible Tax Avoidance

⇒ Looking back at corporate scandals, “tax planning” was used in many cases to justify or disguise schemes to manipulate earnings or to enrich insiders

⇒ The Enron example –
  • More than 800 special purpose entities (SPEs) in tax haven jurisdictions
  • 662 in the Cayman Islands alone

⇒ Such SPEs have been a feature in scandal after scandal
Introduction

Criteria for any tax system

- Certainty
- Simplicity
- Fairness
- Efficiency
  - Enhance economic development and transformation
  - Compete internationally

Facilitate the building of a better life for all
Circular Flows

- **HoldCo**
  - Payments: R40M
  - Promissory Notes Face Value: R100M

- **Borrower**
  - Promissory Note Payments: R100M
  - Payments: R100M

- **Bank**
  - Payments: R60M
  - Promissory Notes

- **FinCo**
  - Promissory Notes
  - Payments: R40M
  - Promissory Notes Face Value: R100M
“Washing Machine”

Promoter/Financier

FinCo

LeaseCo

Borrower

↑ Promissory Notes
↓ R60M

↑ Promissory Notes
↓ R59M

R60M

Promissory Notes

R100M

Promissory Notes for Future Rent – R100M

Actual Cash Payments
A Problem of Global Magnitude

- Impermissible tax avoidance has been staggering in its size and scope

- Tax haven activity alone –
  - Up to $11.5 trillion assets now held in tax havens, with up to $435 billion in lost taxes
    - At least $50 billion to developing countries

- And tax havens have been just one part of a much bigger problem
Corrosive Effects Far Beyond Revenue Lost

⇒ Short term revenue loss is a major problem, especially for developing countries
⇒ But the damage done is far more pervasive and long-lasting –
  ➢ Disrespect for the tax system and the law
  ➢ Increased complexity
  ➢ Costs to the economy
  ➢ Unfair shifting of the tax burden
    • Especially from capital to labour
  ➢ Undermines the ability of governments to set and carry out social and economic policies
⇒ For developing states, the constant pressure and erosion of the tax base deny them their fiscal independence and force them into borrowing or cutting vital programmes
Failures at Many Levels

- Corporate leadership
  - Directors
  - Audit committees
- Professional firms
  - Accounting firms
  - Law firms
- Banks and other financial institutions
- In many cases, a disintegration of fundamental values
Widespread Fallout

- Countless people hurt –
  - Shareholders
  - Employees
  - Communities
  - Fellow citizens, especially the disadvantaged and the needy

- A loss of confidence in–
  - Financial markets
  - Business leaders and professionals

- Growing cynicism about institutions
  - Unfortunately, a minority of wrongdoers tarnished the reputations of those who played by the rules as well
Working Together to Rebuild

- The scandals prompted a global response
  - New laws and regulations governing corporate behaviour
  - Transparency and accountability
  - Increased emphasis on corporate governance and social responsibility
  - Concerted efforts worldwide to stop impermissible tax avoidance and abusive avoidance schemes
Corporate Social Responsibility

- Commitment to contribute to sustainable economic development
  - Ethics and basic human and social rights
  - Environmental issues
  - Protection from over-development
  - Social responsibility in employment (fair labour relations, job security, etc.)
  - Being good both for business and for society

- Tax compliance a key component
Towards a Culture of Compliance
Working Together

- Tax is no longer just an issue between a company and the Taxman
- A matter of reputational risk for
  - The company itself
  - Its executives
  - Its advisers
- In this new environment, taxpayers and SARS must work together to achieve a culture of compliance
The Compliance Behavioural Model

- COMMITTED COMPLIANCE
- CAPITULATIVE COMPLIANCE
- CREATIVE COMPLIANCE: AVOIDANCE (GAAR)
- CREATIVE COMPLIANCE: EVASION
- NON-COMPLIANCE: EVASION
- NON-COMPLIANCE

EDUCATE / ENGAGE

- Monitor: inspect
- Monitor (lesser degree); examine; incentivise
- Identify; legal action; prosecute; investigate
- Monitor; Legal action to challenge; “compliance checks”
- Monitor; legal action; investigate

INCENTIVISE:
- accredited clients
- Monitor (lesser degree); examine; incentivise
- Incentivise; accredited clients
- Monitor; legal action; investigate
- Identify; legal action; prosecute; investigate

EDUCATE / ENGAGE
Great Progress in South Africa

- Compliance by existing taxpayers continues to improve
- Education and outreach continue to bring new taxpayers into the system
- Practitioners have played a vital role in helping taxpayers to understand and comply with often complex rules
SARS has a fundamental duty to ensure a level playing field for these taxpayers and practitioners who are playing by the rules.

SARS is committed as well to providing taxpayers and practitioners with greater certainty about their obligations both –

- To ease their compliance burden and
- To help them avoid reputational risk by making the boundaries between permissible and impermissible behaviour more clear.
The Goals We Are Trying to Achieve

➔ To clarify those boundaries through a stronger, better section 103
➔ To make section 103 consistent and effective deterrent to impermissible tax avoidance and abusive avoidance schemes in today’s modern, global economy
➔ To protect the tax base
➔ To help provide a foundation for possible reform, simplification and relief
➔ To help provide a better tax system for all
Lessons from the Rest of the World
Impermissible tax avoidance has been a serious international problem during the past decade.

One aspect of the collapse of standards.

Specific driving forces:

- Globalisation
  - Multinational enterprises and consultancies presenting new challenges to national authorities
  - Tax havens
- Financial deregulation
- Advances in information technology
Other Factors

▷ A more complex world
  ➢ Growing complexity of the tax laws
  ➢ Increasingly aggressive tax avoidance schemes

▷ Erosion of leadership and decline in values
  ➢ Practitioners
  ➢ Taxpayers

▷ Relaxed enforcement in good times
  ➢ The example of the United States
Tax Avoidance
and Section 103

In Step with Global Efforts
The Global Picture: A Multi-Faceted Response

- Multi-National
- Multi-Lateral
- Tax Avoidance
- National
- Bi-Lateral
Global Response

» Multinational Level
  ➢ OECD
    • Transparency and tax havens
    • Harmful preferential tax regimes
  ➢ European Union
  ➢ International Monetary Fund
Global Response

⇒ Multilateral and bilateral level
  ➢ Joint International Tax Shelter Information Center (JITSIC)
  ➢ Joint audit projects
  ➢ Bilateral information exchange
    • Formal – increased access to taxpayer data under treaties
    • Informal – greater sharing of experience, skills and knowledge
Global Response

唑National level

〳 Increased enforcement
  • Within just the past few weeks, Australia, the United Kingdom and the United States have all announced plans to beef up enforcement and close their “tax gaps”
〳 New specific anti-avoidance rules (SAARs)
〳 Strengthening general anti-avoidance rules
〳 New reporting requirements
〳 Promoter penalties
Global Progress

- **United States**
  - Mass-marketed abusive tax shelters of the 1990s effectively dead

- **Australia**
  - Increased enforcement and emphasis on corporate governance has brought about changes in attitudes toward tax avoidance by taxpayers and practitioners

- **United Kingdom**
  - New reportable arrangements system paying handsome dividends

- **European Union**
  - Elimination harmful preferential tax regimes

- It is time for South Africa to move forward
Tax Avoidance
and Section 103

Two Illustrative Examples
International Preference Share Transaction

7. R1 Special Share Interest free loan

8. Purchase pref- supported by a Put Option to Co F.

9. Ord. shares +capital contribution

10. Share subscription

11. Loan supported by a security arrangement

12. Cession of dividend i.t.o. Put & Call Option

1. Loan

RSA

Off-shore

Co AB (Reg. Country C)

Co AC (Reg. Country D, operate via Branch in country E)

Co G (Reg. Country A)

Co H (Reg. Country B)

Co F

Co D

Co E

Hold Co

Sub Co

Co B

Co A

Bank X
International Preference Share Transaction

Substance of transaction

R45m Loan

R45m Principal
R55m Interest

Net effect:
Actual funding requirement- R45 million
Structure enables client to deduct capital and interest through the circular flow of funds.
International Preference Share Transaction

Transaction

- Consists of 26 agreements
- Requires the creation of 6 new special purpose vehicles
- Implemented through 6 different tax jurisdictions
Partnership Structure

Substance of transaction

Net effect:
Structure inflates and transfers losses to set off against future income. No recoupment – Asset Co. re-acquires shares in SPV
Partnership Structure

- Transaction consisted of 12 agreements
- Complex financial models
- Legal principles manipulated
Practical Implications

- **Insufficient disclosure of information**
  - Tax Returns
  - Financial Statements

- **Difficult to detect**
  - Information spread out amongst different files of parties involved
  - Information often provided on a piecemeal basis or lost in volumes of irrelevant information

- **Time consuming to reconstruct & deconstruct**
  - Three year investigation before an assessment could be issued on one of these transactions
  - Case by case approach for each of these schemes
Examples of the estimated revenue loss on some identified transactions over a five year term are:

<table>
<thead>
<tr>
<th>Transaction Type</th>
<th>Revenue Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compulsory convertible loans</td>
<td>±R6 bn</td>
</tr>
<tr>
<td>Defeasance structures</td>
<td>±R600 m</td>
</tr>
<tr>
<td>International preference share structures</td>
<td>±R400 m</td>
</tr>
<tr>
<td>Lease and leaseback structures</td>
<td>±R1,5 bn</td>
</tr>
<tr>
<td>Partnership structures</td>
<td>±R1 bn</td>
</tr>
<tr>
<td>Share block structures</td>
<td>±R1,2 bn</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>±R10,7 bn</strong></td>
</tr>
</tbody>
</table>
Problems Under Current Law
Where taxpayers make use of a potential “loophole”, which may arise from inevitable practical compromises, inconsistencies or discontinuities –

- The first step is to analyse their reliance on specific provisions
- The second is to consider application of section 103

If the specific provisions are lacking, attention must be given to improving their clarity and effectiveness

Section 103’s wicketkeeper role must also be maintained
Current Provision

⇒ Four requirements must all be satisfied before the Commissioner may invoke the statute
  ➢ Transaction, operation or scheme
  ➢ Tax effect
  ➢ Abnormality
  ➢ Tax avoidance purpose
Weaknesses and Problems

In practice, section 103 has proven to be an inconsistent and, at times, ineffective deterrent to impermissible tax avoidance and abusive avoidance schemes.

Problem Areas –

- Abnormality Requirement
- Purpose Requirement
- Application to steps within a larger transaction
- Use in the alternative
- No “downside” for promoters
Abnormality Requirement

⇒ Long recognised as the “Achilles’ Heel”

⇒ Basic Problems
  ➢ Promoters typically hijack components of legitimate business transactions
  ➢ Because they hijack elements of legitimate business transactions, promoters can often give their schemes an undeserved semblance of “normality” and business purpose
  ➢ Current law lacks objective tests or guidelines despite the underlying common features of these schemes

⇒ Consequently, the Commissioner is forced to proceed on a case-by-case basis

⇒ Heavy burden
Purpose Requirement

⇒ Current law
  - “Sole or Main Purpose” Test
  - Subjective determination

⇒ Problems
  - Risk of inconsistent results
  - Experience both at home and abroad – promoters and their allies will “manufacture” plausible sounding business purposes

⇒ “Engagement in an avoidance scheme can encourage taxpayers to be economical with the truth”
Other Deficiencies

⇒ Application to steps in a larger transaction
  - Lack of clarity under current law
  - Contention that a *bona fide* business purpose for the larger transaction (e.g., raising financing) insulates any steps inserted into the transaction from review

⇒ Use in the alternative
  - Lack of clarity under the current law
  - Many cases involve complex transactions with issues under both specific provisions of the Act and section 103
  - Contention that the Commissioner must raise the assessment under the specific provision or section 103, but not both in the same proceeding

⇒ No downside for promoters
  - Problem worsened by promoters that aggressively sell their products to taxpayers
  - Other countries have introduced penalties specifically aimed at these promoters but South Africa lacks a similar deterrent
Countervailing Concerns

⇒ Potential for

- Uncertainty
- Interference with legitimate or innovative business transactions
- Tension between a GAAR and the rule of law
Proposed Amendments
General Approach

⇒ Use international experience as a guide
⇒ Retain current provisions where possible
⇒ Take countervailing concerns into account
⇒ Develop a South African solution
The basic four-pronged test –
- Transaction, operation or scheme
- Tax effect
- Abnormality
- Purpose

The definition of tax effect/tax benefit

The scope of “transaction, operation or scheme”
Proposed Changes

- **Abnormality Requirement**
  - Objective factors for determining abnormality
  - Presumption of abnormality

- **Purpose Requirement**
  - Objective test
  - Restoration of “sole or one of the main purposes” test

- **Other**
  - Application to steps within a larger transaction
  - Use in the alternative
  - New penalties for promoters and the substantial understatement of income
Proposed Abnormality Factors

- Form and economic substance
- Timing and duration of the transaction
- Tax result “but for” section 103
- Circular flow of cash or assets
- Participation of a tax-indifferent party
- Offsetting or self-cancelling steps
- Inconsistent tax treatment of items by the parties
- Non-arm’s length dealing by the parties
- Lack of change in financial position
- No reasonable expectation of pre-tax profit
- Value of tax benefit exceeds pre-tax profit potential
Common Factors

- Abnormality factors reflect common elements in impermissible tax avoidance
- These elements are often necessary to circumvent inherent failsafes
  - The tax system failsafe – Common characterisation of a transaction between taxpayers
    - Higher rent expense = higher rental income
    - More interest expense = more interest income
  - The financial accounting failsafe - Companies concerned about reported earnings
    - Lower tax bill no prize if the price is lower earnings
    - Financial accounting standards increasingly based on economic substance
Other Changes

- Clarify that section 103 may be –
  - Applied to steps with a larger transaction
  - Used as an alternative basis for raising an assessment

- Introduction of new penalties through separate legislation for –
  - Promoters
  - Substantial understatement of income
Comments Received and Way Forward
General acceptance of the notion of “impermissible tax avoidance”

General acceptance of the need for a stronger, more effective section 103

- Acknowledgement that section 103 has ceased to be a factor in tax planning

General agreement that the Commissioner must be able to apply section 103 to steps within a larger transaction

Comments and concerns have been received with respect to specific aspects of the proposed legislation
Way Forward

- SARS has issued an Interim Response to these comments and concerns
- It appreciates many of the concerns and issues that have been raised
- Additional comments are encouraged and, in particular, specific proposals in respect of how various issues and concerns might be addressed
- Legislation to be proposed later in 2006