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The nature of the purpose requirement of an impermissible tax avoidance arrangement

Summary

The nature of an inquiry into the purpose requirement of an impermissible tax avoidance arrangement can either be objective or subjective. In essence, an objective inquiry has regard to the 'effect' of an arrangement, as opposed to a subjective inquiry which has regard to the taxpayer's *ipse dixit*. Although the purpose requirement under section 103(1) was a subjective inquiry, case law decided under section 103(1) revealed that a taxpayer's *ipse dixit* was weighed and tested against the surrounding facts and circumstances. This introduced an element of objectivity into the interpretation of the purpose requirement. Tax scholars have various opinions regarding the nature of the test in the new purpose requirement in sections 80A and 80G. It seems that the amendments to the purpose requirement merely confirm the approach which was applied by our courts under the repealed section 103(1). The nature of the purpose requirement, therefore, in essence, seems to have stayed unaltered.

Die aard van die oogmerkvereiste van 'n ontoelaatbare belastingvermydingsreëling

Die aard van 'n ondersoek na die oogmerk vereiste van 'n ontoelaatbare belastingvermydingsreëling kan òf objektief òf subjektief wees. In wese hou 'n objektiewe ondersoek verband met die "gevolg" van 'n reëling, in teenstelling met 'n subjektiewe ondersoek wat verband hou met die belastingpligtige se *ipse dixit*. Alhoewel die oogmerk vereiste ingevolge artikel 103(1) 'n subjektiewe ondersoek was, bring hofspraak wat ingevolge artikel 103(1) beslis is aan die lig dat 'n belastingpligtige se *ipse dixit* teen die omringende feite en omstandighede geweeg en getoets is. Dit het 'n element van objektiwiteit by die interpretasie van die oogmerk vereiste ingebring. Belastingskrywers het verskillende menings oor die aard van die toets in die nuwe oogmerk vereiste in artikels 80A and 80G. Dit blyk dat die wysigings aan die oogmerk vereiste bloot die benadering wat ons howe by die toepassing van artikel 103(1) gevolg het, bevestig. Die aard van die oogmerk vereiste blyk dus, in wese, onveranderd te gebly het.

1. Introduction

The general anti-avoidance rule was enacted in section 103(1) of the *Income Tax Act* 58 of 1962, as amended (the Act). This section was repealed by section 36(1)(a) of the *Revenue Laws Amendment Act*, 2006 and replaced by a new general anti-avoidance rule contained in Part IIA of the Act (sections 80A to 80L) which targets impermissible tax avoidance arrangements. These sections apply to any arrangement (or any steps therein or parts thereof) entered into on or after 2 November 2006.

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Section 80L defines an "impermissible avoidance arrangement" as any avoidance arrangement described in section 80A. Section 80A has four requirements for an arrangement to be characterised as an impermissible tax avoidance arrangement. The four requirements are:

1. An arrangement (as defined) is entered into or carried out;
2. It results in a tax benefit (as defined);
3. Any one of the following 'tainted elements' are present:
   - Abnormality regarding means, manner, rights or obligations;
   - Lack of commercial substance (as defined) in whole or in part;
   - Misuse or abuse of the provisions of the Act (including Part IIA);

   and
4. Its sole or main purpose is to obtain a tax benefit.

Requirement 4 is the purpose requirement and is contained in sections 80A and 80G of the Act. According to Meyerowitz[1] a purpose requirement is essential to any general anti-avoidance rule. The South African Revenue Services ("SARS") listed the problems surrounding the purpose requirement in the repealed section 103(1) of the Act in the Discussion Paper on Tax Avoidance and Section 103 of the *Income Tax Act* No. 58 of 1962[2] ("Discussion Paper"). They are the following:

- The Commissioner is placed in the difficult position of having to disprove a taxpayer's allegations through circumstantial evidence since most transactions in a business context have at least a colourable commercial rationale;
- Taxpayers have frequently argued that a commercial purpose, such as raising capital, for an overall transaction is sufficient to "inoculate" each and every step in it from challenge; and
- The purpose requirement entails a subjective test – it looks to the purpose the taxpayers purportedly intended to achieve when they carried out their scheme.

SARS[3] proposed that the purpose requirement be amended to reflect an objective inquiry in accordance with the practice in other countries. Whether the new wording of the purpose requirement is clear enough to indicate that it now requires an objective inquiry and not a subjective inquiry as in section 103(1), is unsure. De Koker[4] indicates that the subtle changes to the purpose requirement results in unnecessary confusion and may require elaboration by a court of law. Broomberg[5] is also unsure of where our law now stands with regards to the purpose requirement but submits[6] that the wording in section 80G(1) suggests that an objective inquiry might be required.

1 Meyerowitz 2005:201.
2 Meyerowitz 2005:43-44.
3 South African Revenue Services 2005:56.
4 De Koker 2010:19.6.
5 Broomberg 2007:5.
6 Broomberg 2007:132.

2. Objective and scope of the paper

The objective of this article was to establish how the nature (a subjective or objective inquiry) of the purpose requirement evolved, if at all, from its application under the repealed section 103(1) to its reinstatement in section 80A and 80G of the Act. An analysis of and comparison between the wordings of the two purpose requirements were done in order to give effect to this objective. International experience regarding the nature of the purpose requirement was considered and compared with the South African position.

Decisions in anti-avoidance tax cases decided in terms of section 103(1) which were won by the taxpayer because the purpose requirement was not satisfied, are discussed in order to determine whether they would still pass muster under the new legislation.

3. Research method

The research method adopted consists of a literature review. Dictionaries, foreign case law, domestic case law and the opinion of various tax scholars are referred to in order to analyse the evolution of the purpose requirement and its objective or subjective nature.

4. Objective inquiry and subjective inquiry

Critical to this paper, and a useful starting point, is explaining the difference between an objective and subjective inquiry. A subjective inquiry assesses the purpose that the taxpayer intended to achieve when he or she entered into or carried out the scheme[7]. The evidence of the taxpayer, his or her *ipse dixit*, is of prime importance with a subjective inquiry. Literally translated *ipse dixit* means “what he (the taxpayer) says”.

With an objective inquiry a Court ignores the taxpayer’s *ipse dixit.* It simply decides whether, on the relevant facts and circumstances, it could be said that tax avoidance was the sole or main purpose of the arrangement[8]. The “effect” of a scheme is of prime importance with an objective inquiry[9] (see 5.1.2 below).

5. The repealed section 103(1)

The purpose requirement of section 103(1) was set out in subsections 103(1)(c) and 103(4) thereof. Section 103(1)(c) required a transaction, operation or scheme to be entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

Section 103(4) contained the rebuttable presumption that if it is proved that the transaction, operation or scheme would result in the avoidance, postponement

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7 South African Revenue Services 2005:44 and *CIR v Louw* 45 SATC 113.

8 Meyerowitz 2005:205.

9 *SIR v Gallagher* 40 SATC 39 at 48 and Meyerowitz 2005:205.

or reduction of tax, it is presumed, until the contrary is proved, that it was entered into or carried out for the sole or main purpose of obtaining a tax benefit.

Huxham & Haupt[10] submitted that because purpose is subjective and section 103(4) places an onus on the taxpayer to prove that his sole or main purpose was not to avoid tax, the Commissioner cannot be made to prove the taxpayer's purpose. The fact that a subjective test must be applied to determine the purpose of the taxpayer was confirmed in the three principal judgments in 5.1 below.

The nature of the purpose requirement, as contained in the repealed section 103(1), has been a debated issue in several Supreme Court cases in South Africa. Although a subjective test must be applied, the taxpayer's subjective intention was weighed against the objective surrounding facts in all three principal judgments below. This introduced an element of objectivity into the interpretation of the purpose requirement. These cases are now examined.

5.1 Case law regarding the nature of the purpose requirement

SIR v Geustyn, Forsyth and Joubert[11], *SIR v Gallagher*[12] and *CIR v Conhage (Pty) Ltd*[13] are, it is submitted, the principal judgments by the Supreme Court of South Africa in which the nature of the purpose requirement was considered.

5.1.1 *SIR v Geustyn Forsyth and Joubert*

Geustyn, Forsyth and Joubert had since 1961 practised in partnership as consulting engineers. In 1966 they formed an unlimited liability company which bought the partnership for a goodwill consideration of R240 000, determined on the basis of an aggregate of three years profits The former partners were each employed by the company at an annual salary of R10 000. The goodwill consideration was credited to the loan accounts of the erstwhile partners, now directors and shareholders. The Commissioner invoked section 103(1) of the Act and taxed the profits of the company in the hands of Geustyn, Forsyth and Joubert.

The creation of the loan accounts, so it was argued, resulted in substantial tax advantages since it enabled them to obtain, under the guise of capital and without paying tax thereon, what was in reality the profit of the engineering business. It thus had the effect of avoiding, postponing or reducing their liability for tax. The Commissioner, therefore, concluded that the avoidance of tax was at least one of the main purposes of converting the partnership into a company.

10 Huxham & Haupt 2006:374.

11 33 SATC 113.

12 40 SATC 39.

13 61 SATC 391.

Ogilvie Thompson CJ[14] stated the following with regard to the purpose requirement:

> This submission is not without some force but, for the reasons which follow, it cannot, in my judgment, succeed. While it may be that 'effect' and 'result' as respectively used in subsections (1) and (4) of section 103 of the Act have the same meaning, it is clear that the former subsection distinguished between *'effect'* and *'purpose'*. The vital inquiry on this part of the case relates to the question of whether or not avoidance, postponement or reduction of tax was 'the sole or one of the main *purposes*' of the conversion of the partnership into a company. The intention or purpose with which any particular transaction is entered into is a question of fact ... (Emphasis added)

Ogilvie Thompson CJ made a distinction between the words "effect" and "purpose". In *Newton v COT*[15] Lord Denning indicated that the word "effect" means the "end accomplished or achieved", that is, the "result of an action"[16].

The word "purpose", on the other hand, refers to the reason why something is done[17]. Thus, while a scheme may have the resulting "effect" of a tax benefit, this "effect" is not necessarily the 'purpose' for which the scheme was entered into or carried out[18].

An inquiry as to the "effect" of a scheme, it is submitted, is an objective inquiry. It requires an examination of that achieved or accomplished by the scheme. Ogilvie Thompson CJ indicated that section 103(1) referred to the "purpose" for which a scheme was entered into or carried out, not the "effect" of the scheme. Establishing the "purpose" for which a scheme was entered into or carried out requires a subjective inquiry.

Geustyn, Forsyth and Joubert contended that obtaining a tax benefit was not a factor in deciding whether to convert the partnership into a company (i.e. it was not their *ipse dixit*). Their subjective purpose was then weighed against the following objective surrounding facts:

- The South African Association of Consulting Engineers expressly sanctioned its members forming unlimited companies to conduct their practices;
- More than half of the Association's membership had already adopted that form of practice; and
- The majority of non-members to the Association practised in corporate form. Also, the bulk of consulting engineers in England, Canada, France, Switzerland and Japan, it was found, practised in corporate form.

In addition, Ogilvie Thompson CJ indicated that there existed various reasons, quite unrelated to the incidence of tax, in favour of converting the partnership into a company: a partnership was liable to dissolution upon

14 33 SATC 113 at 122.
15 [1958] 2 All ER 759 at 763.
16 South African Concise Oxford Dictionary 2002:370.
17 South African Concise Oxford Dictionary 2002:948.
18 Webber Wentzel Bowens Attorneys 1997.

the death or resignation of a partner and restricted to the legal limit of twenty. Obtaining a tax benefit was, therefore, found not to be the sole or main purpose of converting the partnership into a company.

5.1.2 *SIR v Gallagher*

In 1968 Gallagher formed a company to which he sold assets and in which he was the sole shareholder. The purchase price owing by the company remained outstanding as an interest free loan. Gallagher then formed three trusts for the benefit of his three children, and donated his shares in the company to these trusts. The Secretary for Inland Revenue invoked section 103(1) and assessed Gallagher on the company's income during the 1969 to 1971 years of assessment.

The sole issue for decision by the court was whether or not the avoidance, postponement or reduction of tax was the sole or main purpose of the scheme entered into by Gallagher. In this regard the Secretary contended that an objective test should be applied. Corbett JA[19], however, stated the following:

> By an objective test in this context is evidently meant a test which has regard rather to the 'effect' of the scheme, objectively viewed, as opposed to a subjective test which takes as its criterion the 'purpose' which those carrying out the scheme intend to achieve by means of the scheme. Although appellant's counsel did not press this submission in argument before us, he did not abandon it. In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one.
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> Section 103(1) draws a clear distinction between the 'effect' of a scheme and the 'purpose' thereof (see requisites (b) and (d) above) and this virtually rules out an interpretation which seeks to give 'purpose' an objective connotation and to equate it, more or less, to 'effect'. If the subjective approach be adopted (as it must), then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of respondent, the progenitor of the scheme, as to why it was carried out.

Corbett JA rejected the Secretary's argument that an objective test (the "effect" of the scheme) rather than a subjective test (the evidence of the person carrying out the scheme) should be applied in determining the purpose for which the transaction, operation or scheme was entered into or carried out. He then cited[20] the following *dictum* delivered by Colman J in the court *a quo*:

> ... the sworn testimony of a witness, given with the appearance of truthfulness and candour, is not likely to be discarded unless some reason appears for disbelieving the witness. What he says may be discarded if there is credible evidence to the contrary, or if there are such weighty probabilities against what he has disposed to that the court does not feel justified in accepting his evidence.

19 40 SATC 39 at 48-49.
20 40 SATC 39 at 50.

Gallagher indicated that the purpose of the scheme (his *ipse dixit)* was to reduce estate duty. Neither the Special Court, nor the Supreme Court could establish any evidence to contradict his *ipse dixit*. The following objective factors were considered:

- The share-market was escalating which would have a tremendous impact on the taxpayer from an estate duty point of view.
- Mr Barnett, a partner in a firm of attorneys and an expert on trusts, whom was consulted by Gallagher, was not requested to prepare any calculations with regards to the saving of income tax.
- If the avoidance of income tax had been an object, there was a refinement which could have been introduced into the scheme which would have assisted the appellant in that regard. This was, however, not introduced.

Corbett JA, therefore, came to the conclusion that obtaining a tax benefit was not the sole or main purpose of the scheme. The approach followed by him in this case was in accord to that followed by Botha JA in *SIR v Geustyn, Forsyth and Joubert (supra):* the subjective purpose of the taxpayers was weighed against the objective surrounding facts.

5.1.3 *CIR v Conhage*

Conhage (Pty) Ltd and Firstcorp Merchant Bank Ltd entered into a sale-and-leaseback arrangement. This entitled Conhage (Pty) Ltd to deduct the full rental payment. If the parties entered into a loan arrangement only the interest portion of the repayment would have been deductible by Conhage (Pty) Ltd. The Commissioner, consequently, invoked section 103(1) and refused to allow the rental deductions.

Upon considering the purpose of the sale and leaseback arrangement, Hefer JA[21] referred to *SIR v Geustyn Forsyth and Joubert (supra),* and stated that “what has to be determined in every case is the subjective purpose of the taxpayer.”

Although considering the taxpayer’s *ipse dixit*, this was, in accord to that prescribed by the court in *SIR v Geustyn, Forsyth and Joubert (supra) and SIR v Gallagher (supra),* weighed up against the following objective surrounding circumstances:

- Conhage (Pty) Ltd required capital in order to finance its expansion programme; and
- If Conhage (Pty) Ltd did not need capital, there would not have been any transaction at all.

Hefer JA found that the purpose of the sale and leaseback transaction was not to alleviate the tax burden of Conhage (Pty) Ltd, but rather to enable it to acquire capital.

21 61 SATC 391 at 397.

5.1.4 Conclusion on the purpose in terms of section 103(1)

Under the regime of the repealed section 103(1), the purpose of a scheme was established from the evidence furnished by the taxpayer, that is, his *ipse dixit.* This is a subjective inquiry.

The taxpayer's *ipse dixit* was then tested against the probabilities and inferences drawn from the surrounding circumstances and established facts. The taxpayer's subjective purpose was thus weighed against the objective surrounding facts. The weighing of a taxpayer's *ipse dixit* is normal practise. Rabie CJ, said in *Malan v KBI:*[22]

> The taxpayer's own evidence about his intention and his credibility will be considered by a court but, because of subjectivity, self-interest, the uncertainties of recollection and the possibility of mere reconstruction, it will test that evidence against the surrounding facts and circumstances in order to establish his true intention.

A taxpayer would, therefore, not be able to refute an allegation as to having a sole or main purpose of obtaining a tax benefit by merely professing not to have such a purpose. The court, it seems, was unlikely to be swayed by contentions of the taxpayer which were incompatible with the objective factors surrounding the transaction, operation or scheme. The reality of the test applied to determine the purpose of the taxpayer in the above-mentioned cases therefore clearly shows that it was not a pure subjective test.

6. Sections 80A and 80G

Part IIA of the Act contains the purpose requirement in sections 80A and 80G. Section 80A states the following in respect of the purpose requirement:

> An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and …

Section 80A refers to the purpose of the arrangement, "its" purpose, as opposed to section 103(1)(c) which referred to the purpose for which a transaction, operation or scheme was entered into or carried out. Section 80G(1) contains a rebuttable presumption of the purpose of an arrangement which reads as follows:

> An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in the light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

The section 80G amendments to the old rebuttable presumption contained in section 103(4) are twofold and address the presumptions created as well

22 45 SATC 59 at 76-77.

as the type of test it involves. The differences between the two rebuttable presumptions are that:

- The presumption in section 103(4) deemed the purpose requirement to be met **if** the effect requirement (i.e. that the transaction, operation or scheme would result in the avoidance or postponement of any tax) was proved, while the presumption in section 80G deems the purpose requirement to be met **until and unless** proved differently.
- A party to a general tax avoidance transaction had to rebut the purpose presumption **if** tax was avoided or postponed, while a party to an impermissible tax avoidance arrangement has to rebut the purpose presumption **if** he wants to prove a sole or main purpose other than obtaining a tax benefit and not merely because the arrangement has a certain result.
- The presumption in section 103(4) **linked** the purpose and effect of a transaction, operation or scheme to each other once a tax levied by the *Income Tax Act* was avoided or postponed, while the presumption in section 80G treats the purpose and result of the arrangement **separately**.

Section 80G requires that consideration be given to the relevant facts and circumstances when rebutting the presumption of a tax benefit purpose. In its Discussion Paper SARS[23] indicated that the proposed amendments would change the purpose requirement to an objective test. In particular the proposed amendments would require the determination to be made objectively by reference to the relevant facts and circumstances.

However, in its Revised Proposals on Tax Avoidance in South Africa and Section 103 ("Revised Proposals"), SARS[24] confirmed that it was never the intent of the original proposals to prevent a taxpayer's explanation of the reasons for an arrangement from being taken into account. Rather it was intended to ensure that a taxpayer's statements of intent be rigorously tested against the relevant facts and circumstances. According to SARS section 80A and 80G are intended to better reflect the intent of the taxpayer and reinforce existing precedent in this regard. It is thus aimed, it is submitted, at reinforcing the principles laid down by the Supreme Court in *SIR v Geustyn, Forsyth and Joubert (supra), SIR v Gallagher (supra) and CIR v Conhage (Pty) Ltd (supra)*: testing the taxpayers *ipse dixit* against the relevant facts and circumstances. This implies a confirmation of the approach which was applied under the repealed section 103(1).

In New Zealand and Australia the courts have found the intention of the taxpayer to be irrelevant when considering the purpose requirement. The courts in Canada, however, seem to be in agreement with the South African position. This will be further discussed in 8 below.

However, it is, generally, presumed that where the legislature uses a different word or expression the strong inference is that this has been done

23 South African Revenue Services 2006: 21.
24 South African Revenue Services 2006: 21.

designedly to provide for a different result[25]. It is thus necessary to consult the opinion of various tax scholars to ascertain whether SARS is correct to assert that the approach which was applied under the repealed section 103(1) still stands or whether a different approach is required.

7. Opinion of various tax scholars

7.1 Clegg and Stretch

These tax scholars[26] argue that the courts will, despite the changes to the purpose requirement, have to take an "objective view of the facts and circumstances" — which includes the *ipse dixit* of the taxpayer — "in order to determine the actual purpose of the transaction". Although admitting to an objective inquiry these tax scholars, it is submitted, still require the *ipse dixit* of the taxpayer to be considered.

7.2 Davis, Olivier, Urquhart, Ferreira and Roeleveld

According to these tax scholars[27] the test, with regards to the purpose of an arrangement, is still subjective. They are of opinion that *SIR v Gallagher* is still authoritative: the court rejected an objective test to determine the purpose. They argue that the taxpayer's *ipse dixit* will still be evaluated, within the context of objective facts, so as to arrive at a conclusion of the true purpose.

7.3 De Koker

This tax scholar[28] predominantly, argues that section 80A specifically refers to the purpose of the arrangement (*its* sole or main purpose) and not the purpose of the taxpayer. This view is reinforced, apparently, by section 80G, which concludes as follows:

> … obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

According to De Koker the "purpose", as used in section 80A of the Act, is used in the sense of the "effect" (objective inquiry) of the arrangement and not the intention (subjective inquiry) with which the arrangement was entered into by the taxpayer.

25 De Koker 2010:9.6.
26 Clegg & Stretch 2010:26.3.4
27 Davis *et al* 2007:80A-7.
28 De Koker 2010:19.6.

7.4 Davis, Emslie, Van Dorsten and Dachs

These tax scholars[29] argue that the "sole or main purpose" test remain a subjective one, to be decided with reference to the actual purpose of the participants in the arrangement under consideration. This, they argue, is so despite the fact that section 80A refers to "its" – i.e. the avoidance arrangement's – sole or main purpose, as distinct from the purpose of the participants in that arrangement. An arrangement, they suggest, can never of itself have a purpose.

7.5 Broomberg

Broomberg[30] shares a similar opinion to that of De Koker: section 80A refers to the purpose of the arrangement (*its* sole or main purpose). According to him, also, the wording of the onus of proof provision in section 80G confirms this assertion. He states that the phrase "the sole or main purpose of the avoidance arrangement", contained in section 80G, has compelled the courts abroad to conclude that the test of purpose was objective.

7.6 Meyerowitz

Meyerowitz[31] indicates that it could become a logical impossibility for the taxpayer to prove an objective purpose, when the purpose is to be presumed. He then quotes the words of Lord Devlin in *Chandler v Director of Public Prosecutions*[32]:

> I shall begin by considering the word 'purpose', for both sides have relied on this word in different senses. Broadly, the appellants contend that it is to be given a subjective meaning and the Crown an objective one. I have no doubt that it is subjective. A purpose must exist in the mind. It cannot exist anywhere else.

7.7 Louw

This scholar[33] argues that the change in wording indicates that when applying the purpose requirement, regard must be had to the effect of the arrangement, and not the purpose of the taxpayer. Such change, he notes, could result therein that our courts will have to apply an objective test when determining the "purpose", and ascertain from the relevant facts and circumstances if tax avoidance was the sole or main purpose of the arrangement.

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29 Davis *et al* 2009:181.
30 Broomberg 2007:5.
31 Meyerowitz 2005:205.
32 (1962) AER 142 (HL) at 155.
33 Louw 2007:24.

7.8 Conclusion: Opinions of tax scholars

The opinion of tax scholars varies between a subjective approach, which takes into account the *ipse dixit* of the taxpayer and then weighs it up against the surrounding facts and circumstances, and a purely objective approach, which ignores the *ipse dixit* of the taxpayer. An unanimous opinion, as to the nature of the purpose requirement, is not shared by tax scholars.

It is submitted that that the opinions of Clegg and Stretch in 7.1, Davis, Olivier, Urquhart, Ferreira and Roeleveld in 7.2, and Davis, Emslie, Van Dorsten and Dachs in 7.4 confirms what SARS have stated in the Revised Proposals[34] ("it was never the intent of the original proposals in the Discussion Paper to introduce Part IIA to prevent a taxpayer's explanation of the reasons for an arrangement from being taken into account") and contradicts what SARS has said in the Discussion Paper[35] ("the proposed amendments would change the purpose requirement to an objective test").

It is further submitted that, in reality, the type of test required for the purpose requirement under section 80G can never be a purely objective inquiry which ignores the *ipse dixit* of the taxpayer because a purpose must exist in the mind. It cannot exist anywhere else. It therefore seems that the amendments to the purpose requirement merely confirm the approach which was applied by our courts under the repealed section 103(1).

According to Broomberg,[36] Part IIA was culled from the laws of many nations. In order to further elaborate on the nature of the purpose requirement, international experience in this regard is considered.

8. International experience

The Discussion Paper creates the notion that Part IIA was drafted using international benchmarking[37]. These nations include, amongst others, New Zealand, Australia and Canada[38]. SARS notes that the amendments to the purpose requirement were intended to bring South Africa in line with the practice in other countries [39].

8.1 New Zealand

In New Zealand a "tax avoidance arrangement" is defined in Part YA of the *Income Tax Act* 2007 No 97 as an arrangement that "has tax avoidance as its purpose or effect". According to Part BG1 any tax avoidance arrangement is void against the Commissioner for income tax purposes. In *Newton v COT* Lord Denning stated the following at page 763:

34 2006:21.
35 2005:56.
36 Broomberg 2007:3.
37 South African Revenue Services 2005:48.
38 South African Revenue Services 2005:27-38.
39 South African Revenue Services 2005:56.

> The word 'purpose' means, not motive, but the effect which it is sought to achieve – the end in view. The word 'effect' means the end accomplished or achieved.

In *Ashton & Anor*[40] *v CIR* the Judicial Committee stated the following at page 61,034:

> If an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose and oral evidence to show that it has a different purpose or different effect to that which is shown by the arrangement itself is irrelevant to the determination of the question whether the arrangement has or purports to have the purpose or effect of in any way altering the incidence of income tax or relieving any person from his liability to pay income tax.

In New Zealand the "purpose or effect" requirement is determined objectively. Oral evidence of the taxpayer, his *ipse dixit*, is ignored. McMullin J indicated in *Tayles v CIR*[41] that whatever difference or meaning there may be in dictionary terms between the words "purpose" or "effect" they usually have been looked on in the cases as a composite term. This is, however, not true for South Africa. In *SIR v Gallagher (supra)* Corbett JA, at page 48 to 49, made a clear distinction between the meaning of the words "effect" and "purpose".

8.2 Australia

The Australian general anti-avoidance rule is contained in Part IVA of the *Income Tax Assessment Act* 1936. Section 177D thereof provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to eight specified factors (par (b) of the section), it would be concluded that a person who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit.

The eight factors may be summarised as follows:

(1) the manner in which the scheme was implemented;

(2) its form and substance;

(3) the timing of the scheme;

(4) the result which would be achieved by the scheme, but for Part IVA;

(5) any change in financial position of the relevant taxpayer arising out of the scheme;

(6) any change in the financial position of any other person;

(7) any other consequences for the relevant taxpayer or any other person connected with the scheme; and

40 (1975) 2 NZTC 61,030 (PC).
41 (1982) 5 NZTC 61,311 CA at 61,318.

(8) the nature of the connection between or among parties to the scheme.

In *Peabody v Commissioner of Taxation*[42] Hill J observed the following, at 542, with regards to section 177D:

> It will be seen that the determination of what schemes fall within s 177D requires an objective conclusion to be drawn, having regard to the matters referred to in par (b) of the section, but no other matters. It is notable that the actual subjective purpose of any relevant person is not a matter to which regard may be had in drawing the conclusion.

An objective assessment has been approved numerous times by the Federal Court of Appeal in Australia. In *Metal Manufactures Ltd v Commissioner of Taxation*[43] Emmett J indicated at par 274 that the "subjective state of mind" of a taxpayer is not relevant for the purposes of Part IVA.

Carr J cited the above dictum of Hill J in *Peabody v Commissioner of Taxation (supra)* at paragraph 83 of his judgment in *Eastern Nitrogen Ltd v Commissioner of Taxation*[44]. He indicated that section 177D requires an objective test and stated the following at paragraph 81:

> The whole tenor of the language in which s 177D(b) is expressed is that of ascertaining an objective purpose by having regard to objective facts.

In *Commissioner of Taxation v Zoffanies Pty Ltd*[45] Hill J reiterated that the evidence of the taxpayer is irrelevant in establishing the purpose under section 177D. He stated the following at paragraph 54:

> It is sometimes said that the conclusion under s 177D is a conclusion of objective purpose. That way of putting it is correct if what is meant by it is that the conclusion is not one drawn from evidence of the actual purpose of the relevant taxpayer or other taxpayers.

The High Court of Australia considered the nature of section 177D in *FCT v Hart*[46]. Gummow and Hayne JJ made the following statement at paragraph 65:

> Of course the loan was structured in the way it was in order to achieve the most desirable taxation result. But those are statements about why *the respondents* acted as they did or about why the lender (or its agent) structured the loan in the way it was. They are not statements which provide an answer to the question posed by s 177D(b). That provision requires the drawing of a conclusion about purpose from the eight identified objective matters; it does not require, or even permit, any inquiry into the subjective motives of the relevant taxpayers or others who entered into or carried out the scheme or any part of it.

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42 (1993) 40 FCR 531 (FCA/FC).
43 [1999] FCA 1712.
44 [2001] FCA 366.
45 [2003] FCAFC 236.
46 [2004] HCA 26.

The purpose of the scheme under consideration is thus determined objectively by the High Court of Australia. The taxpayer's *ipse dixit* is considered irrelevant.

8.3 Canada

The Canadian general anti-avoidance rule is contained in section 245 of the *Income Tax Act* (1985, c. 1 (5th Supp.)). Section 245(3) thereof contains the following prohibition: a transaction is not an avoidance transaction if it "may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." In *OSFC Holdings Ltd. v Her Majesty the Queen*[47] Rothstein J stated the following:

> The words 'may reasonably be considered to have been undertaken or arranged' in subsection 245(3) indicate that the primary purpose test is an objective one. Therefore the **focus** will be on the relevant facts and circumstances and not on statements of intention (own emphasis).

Rothstein J, it is submitted, did not exclude consideration of the taxpayer's *ipse dixit*, he merely indicated that the "focus" should be on the "relevant facts and circumstances". This was confirmed by Sexton JA in *Her Majesty the Queen v Canadian Pacific Limited*[48]:

> This test is an objective one and therefore the **focus** must be on the relevant facts and circumstances and not on statements as to the intention by the taxpayer.

The test in Canada, it seems is not entirely exclusive of a subjective element. In *Canada Trustco Mortgage Company v Canada*[49] the Court stated the following:

> According to s. 245(3), the GAAR does not apply to a transaction that 'may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit'. … The words of the section simply contemplate an objective assessment of the relative importance of the driving forces of the transaction. Again, this is a factual inquiry. The taxpayer cannot avoid the application of the GAAR by **merely stating** that the transaction was undertaken or arranged primarily for a non-tax purpose. The Tax Court judge must weigh the evidence to determine whether it is reasonable to conclude that the transaction was not undertaken or arranged primarily for a non-tax purpose. The determination invokes reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

The word "merely stating", it is submitted, indicates that the test in Canada does not exclude the taxpayer's *ipse dixit*. It seems that the taxpayer's evidence (his *ipse dixit*) must be weighed against the objective factors established. The

47 2001 FCA 260 at 46.
48 2002 DTC 6742 at 16.
49 2005 SCC 54 at 27 to 29.

Faculty of Law at the University of Toronto hosted a symposium[50] to discuss the implications of, among others, *Canada Trustco Mortgage Company v Canada (supra).* With regards to section 245(3) the following was stated:

> Assuming that there is a tax benefit, the second branch of inquiry is whether the transaction was undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. … this is a factual determination and that the onus resides with the taxpayer. But how does the taxpayer meet this onus? Arguments of subjective intent are not very convincing, and the taxpayer would probably have to show an objective result.

Again, it seems that the taxpayer's *ipse dixit* is not excluded when determining the purpose for which a transaction was undertaken or arranged. In *MacKay v The Queen*[51] Campbell J indicated at paragraph 58 that the above cited paragraphs from the Court in *Canada Trustco Mortgage Company v Canada (supra)* "underscore that the facts in each case will be central to a determination with respect to avoidance transactions and echo Justice Rothstein's comments in *OSFC Holdings Ltd. v Her Majesty the Queen (supra)* at 46".

The position in Canada, it is submitted, is similar to that which reigned in South Africa under the repealed section 103(1): the court must weigh the taxpayer's *ipse dixit* against the relevant facts and circumstances.

8.4 Conclusion: International experience

Legislation in New Zealand refers to the "purpose or effect" of an arrangement and in Australia to the "purpose" with which a scheme was entered into or carried out. The courts in these respective jurisdictions have established that the intention of the taxpayer is irrelevant. In these countries the test is purely objective: would a person viewing the arrangement, transaction or scheme reasonably conclude that a tax benefit was the purpose of the arrangement.

In Canada the relevant legislation refers to the purpose for which a transaction was undertaken or arranged. The position in Canada was found to be similar to that which reigned in South Africa under the repealed section 103(1): the court must weigh the taxpayer's *ipse dixit* against the relevant facts and circumstances. SARS's motive of amending the purpose requirement to reflect an objective inquiry in accordance with the practice in other countries therefore appears not to have been fully met.

9. Application of new legislation to case law decided under section 103(1)

Decisions in anti-avoidance tax cases decided in terms of section 103(1) which were won by the taxpayer because the purpose requirement was not

50 Alarie *et al* 2005:1036.
51 2007 TCC 94.

satisfied, are now discussed in order to determine whether they would still pass muster under the new legislation.

Since the taxpayer's subjective purpose was weighed against the objective surrounding facts in all of the three cases in 5.1 above, it is submitted that the new section 80G would have had no effect on the outcome of any of the decisions if the cases were heard under the new legislation. A discussion of the last two such cases decided under the old section 103(1) follows below.

9.1 *CIR v Bobat and others*[52]

Taxpayer Moosa and the wives of two other taxpayers (sisters of taxpayer Moosa) were beneficiaries of a vesting trust set up by their father. The trust controlled two companies. In order to avoid an estate duty problem and due to the necessity of tidying up the group, especially because of the complications resulting from the cross holdings between the companies in the group, a scheme was devised and carried out in the 1990 tax year.

The vesting trust was substituted with a discretionary trust. A vast majority of the shares in the two companies were issued at a substantial premium to a dormant company. The share premium account was reduced by making payments to the beneficiaries. In 1990 dividends payable to an individual were taxable, but those payable to a company were exempt from tax. At the time, the definition of a dividend in the Act excluded cash paid to a shareholder to the extent that it represented a reduction of the share premium account. Therefore, the result was that the beneficiaries were not taxed on the payments made to them.

The Commissioner contended that the sole purpose of the scheme was the avoidance or reduction of income tax, applied section 103(1) and taxed the said receipts as dividend income in the hands of the three taxpayers. In dealing with the sole or main purpose requirement the judge stated that the scheme had two relevant effects. The one was the avoidance or reduction of liability for estate duty and the other was the tidying up of the group. The question in issue was whether either of these consequences had been the sole or main purpose of the scheme as these two consequences were also the only purposes behind the scheme. In order to achieve these purposes, there were various possible forms that the scheme could have taken. The route that was followed was one which would at the same time avoid or reduce the payment of income tax by the taxpayers on what was paid out by the trust.

The taxpayer insisted that the avoidance of estate duty and the tidying up of the group had been the only purposes behind the scheme. He freely admitted that the route that was followed, as would behove any sensible person, was the one which would at the same time avoid or reduce the payment of income tax by the taxpayers. This had however not been one of the purposes behind the scheme, but on the contrary had been nothing more

52 67 SATC 47.

than one of the possible methods by which the two true purposes behind the scheme were achieved.

The court found that not only do they have no doubt about the credibility of the taxpayer's evidence in this regard, but that his explanation was in any event consistent with the probabilities. The court recognised the real and substantial difficulty that the cross-holdings must have given rise to, and held that there was no reason to suppose that it was dominated by the estate duty problem.

The court was satisfied that the two purposes of the scheme were at least of equal significance and held that it would be speculative to conclude, as far as purpose was concerned, that the estate duty problem had dominated the tidying up of the group. Since the purpose requirement had not been met, the court held that section 103(1) did not apply to the scheme.

It is submitted that, even though the taxpayer's two purposes were not specifically tested against a list of objective factors, it would, in light of the fact that the court was satisfied that there were two purposes of equal importance and not one main or sole purpose, be speculative to suggest that the outcome of this decision would have been different if the case was heard under the new legislation.

9.2 *CSARS v Knuth and Industrial Mouldings (Pty) (Ltd)*[53]

Knuth and Mattheus were equal shareholders in Knuth (Pty) (Ltd) ("Oldco") which they ran from 1983. In 1988 they parted company and Knuth undertook to purchase Mattheus's half share of the company for R225 000, which was half of the net asset value on the books. Knuth's bank refused to lend him the money to buy Mattheus's half share. On the advice of his attorney he obtained an option to purchase Mattheus's half share at the agreed price.

Knuth was referred to an accountant, who in turn introduced him to Financial Associates Corporation ("FAC") in order to arrange the necessary finance. On their suggestion the plant and machinery of Oldco was valued by Snowball. The valuation of R1 192 250 by far exceeded the R450 000 then reflected in the company's books as being the net asset value. On the strength of Snowball's valuation FAC implemented a scheme on behalf of Knuth which, according to the evidence, is quite commonplace. It did so through the medium of a company known as Attest Finance (Pty) Ltd ("Attest").

The court *a quo* pieced together the following chronology of the implementation of the scheme:

- Oldco was incorporated and later renamed Industrial Mouldings (Pty) (Ltd) (This is "Newco", the appellant in case number 10176 of the Special Court)).

53 62 SATC 65.

- Knuth appointed Attest as his nominee to exercise the option for the purchase of Mattheus's share.
- Attest took the option and bought out Mattheus for R225 000.
- Knuth sold his share in Oldco to Attest for R941 929.
- Knuth invested the full proceeds in Newco, raising a director's loan in his favour.
- Oldco declared a dividend *in specie* of its total distributable reserves in favour of its sole shareholder, Attest.
- Attest sold the business of Oldco to Newco for R1 166 878.
- Newco paid the purchase price out of Knuth's investment of R941 929 and a bank overdraft of at least R225 000.

The court *a quo* came to the conclusion that the net effect therefore was that Knuth acquired the full shareholding of Newco by means of a payment to Mattheus by Newco out of the loan obtained by it from its bank. Based on Snowball's valuation Newco claimed section 12B wear and tear at 50% of the value at which the plant and machinery purchased from Attest had been brought into Newco. The Commissioner allowed a deduction of 25% of the old book value of Oldco's plant and machinery and applied section 103(1).

Knuth testified that his sole or main purpose was to become the sole owner of the company conducting the business and denied that it was his intention to obtain a tax benefit. The court found that the following objective factors supported Knuth's testimony:

- If his bank had been prepared to advance the necessary funds, he would have purchased Mattheus's share without entering into the scheme; and
- Oldco lacked the liquidity to pay out as substantial a cash dividend as would have been required to enable Knuth to purchase Mattheus's share.

The Commissioner argued that, based on the strength of Snowball's valuation, Knuth could have obtained a loan from the bank but led no evidence to the effect. The court held that it cannot speculate on this issue and was satisfied that Knuth embarked on a scheme, not in order to avoid going back to the bank for a loan which might now have been successful, but to obtain Mattheus's share in the business, which had been conducted by Oldco until then. It was therefore held that Newco discharged the onus under section 103(4) and that section 103(1) could not be applied by the Commissioner.

It is submitted that without the advice of his attorney and his introduction to FAC, Knuth would not have decided or have been able to implement a scheme of this vast extent. It would be speculative to suggest that Knuth would not have been able to discharge his onus, and since his subjective purpose was tested against objective factors, it is further submitted that the outcome of this decision would not have been different if the case was heard under the new legislation.

It is further submitted that section 80H could have been used to apply the new rule to at least a part of the scheme if Knuth did not discharge his onus in respect of all the steps of the scheme.

9.3 Conclusion: Case law

It is submitted that the taxpayers in the case law discussed in 9.1 and 9.2 above would have pass muster under the new legislation. In the light of the uncertainties regarding how the South African courts would determine the purpose of an avoidance arrangement in terms of section 80G, and whether a heavier burden of proof rest on taxpayers, it would be premature to venture an answer as to the effect the new wording of the sole or main purpose requirement will have on the outcomes of tax avoidance cases in future.

It is, however, submitted that taxpayers might find it more difficult to discharge the onus of proving that the sole or main purpose of the arrangement was not to obtain a tax benefit because the Act now specifies that the taxpayer must prove his purpose in light of the relevant facts and circumstances (or as the Revised Proposals[54] stated "it was intended to ensure that a taxpayer's statements of intent be rigorously tested against the relevant facts and circumstances") whereas, under section 103(1), the objective facts and circumstances were merely taken into account by our courts as part of the interpretation process in spite of not having been required to do so by the Act.

De Koker[55] submits that to discharge the s 80G onus a taxpayer is required to give affirmative evidence that satisfies a court, upon a preponderance of probability, that "reasonably considered in light of the relevant facts and circumstances", the obtaining of the tax benefit was not the sole or main purpose. Presumably he must be able to point to some compelling commercial reasons for the entering into of the arrangement. The courts take an objective view of the facts and circumstances – which include the *ipse dixit* of the taxpayer as an important evidentiary factor – and it is unnecessary for a taxpayer to prove any point beyond a reasonable doubt or even for him to be faced with too high a standard of proof. The onus is discharged if the court has no reason to disbelieve the taxpayer and his evidence is not contradicted by objective facts. On the other hand, mere statements not corroborated by evidence are hardly sufficient to discharge the onus. The section 80G burden of proof applies only to questions of fact. It cannot arise on questions of law.

10. Conclusion

The purpose requirement contained in the repealed sections 103(1)(c) and 103(4) of the Act, required a subjective inquiry. It referred to the purpose for which a transaction, operation or scheme was entered into or carried out. The Supreme Court indicated that the purpose had to be established from the taxpayer's *ipse dixit.* Although this is a subjective inquiry, the court weighed

54 South African Revenue Services 2006: 21

55 De Koker 2010:19.6

and tested the taxpayer's *ipse dixit* against the surrounding facts and circumstances. This introduced an element of objectivity into the interpretation of the purpose requirement. A pure subjective inquiry was therefore not made under section 103(1).

The purpose requirement contained in section 80A and 80G refers to the purpose of the arrangement, ("its" purpose), and indicates that the person obtaining a tax benefit, when rebutting the assumed sole or main tax benefit purpose, should prove "reasonably considered in the light of the relevant facts and circumstances" that this is not the case. Although not explicitly requiring the purpose to be determined objectively, section 80A and 80G certainly has the potential of being construed as an objective measure.

This is true, especially if one takes into consideration that Part IIA, apparently, was drafted using international benchmarking. It seems to have been culled from the laws of, amongst other, New Zealand, Australia and Canada. An objective purpose requirement is applied in both Australia and New Zealand. In Canada, however, a similar position to that which reigned under the repealed section 103(1) was found to exist: the taxpayer's *ipse dixit* is tested against the objective facts.

It is submitted that, in reality, the type of test required for the purpose requirement under section 80G can never be a purely objective inquiry which ignores the *ipse dixit* of the taxpayer. An arrangement, as suggested by Davis *et al,*[56] can never of itself have a purpose. SARS indicated in its Revised Proposals that the subtle changes to the purpose requirement were never intended to prevent a taxpayer's explanation of the reasons for an arrangement from being taken into account. Rather it was intended to ensure to better reflect the intent of the taxpayer and reinforce existing precedent in this regard.[57] The majority of tax scholars confirms with this.

It therefore seems that the amendments to the purpose requirement merely confirm the approach which was applied by our courts under the repealed section 103(1). The nature of the purpose requirement, therefore, in essence, seems to have stayed unaltered. The truth of this will have to be proved in case law decided in terms of the new legislation, which is yet to happen.

56 Davis *et al* 2009:181.
57 South African Revenue Services 2006: 21.

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