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Video Transcription: The Basics of the General Anti-Avoidance Rules



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Hi there, my name is Riley, and in this video we will be looking at tax avoidance, and some of the anti-avoidance provisions of the Income Tax Act. Tax avoidance is the arrangement of one's financial affairs to minimise the tax liability within the law.

The courts have told us that “every man is entitled, if he can, to order his tax affairs so that the tax attaching is less than it otherwise would be”. What does this mean? The taxation of persons is an operation of law. That is, there are existing legal principles requiring persons to pay tax based on the outcome of their activities. However, within the law, there are opportunities to make choices in the way you conduct those activities that may result in different tax outcomes. We refer to the consideration of the tax effects of these choices as “tax planning”.

An example of legitimate tax planning would be the choice between operating a business as either a sole proprietor or a company. A sole proprietor is taxed at his or her effective tax rate, whereas a company is taxed at a flat rate of 28%, and any distributions to the owners of the company will be subject to dividends tax of 15%.

Another example would be the decision to either rent or buy an asset such as a factory. Renting a factory gives rise to a deduction of the rental payments, while owning the factory gives rise to capital allowances. The taxpayer should consider these different tax effects when deciding which option is best for their intended activities.

However, when is structuring your tax affairs in a tax efficient manner taking tax planning too far? At what point have you crossed over into the realm of impermissible tax avoidance?

Impermissible tax avoidance is any tax avoidance that the Income Tax Act specifically prohibits. In the Income Tax Act there are sections that deal with specific instances of tax avoidance. For example, giving an asset to your minor child would result in your child being taxed on the income from that asset instead of you. At the same time, because the child is a minor it is difficult to say whether that income is really no longer yours. Because of this, Section 7 of the Income Tax Act requires that the income earned from that asset be taxed in your hands, not your minor child's.

There are a number of sections like these that address specific actions. These specific sections, however, cannot always prevent taxpayers from manipulating their tax affairs to unfairly avoid tax. Therefore SARS introduced the general anti-avoidance rules (or GAAR), which provide general rules for evaluating any action that may be linked to the avoidance of tax. The GAAR are statutory rules that empower SARS to deny taxpayers the benefit of an arrangement that they have entered into for an impermissible tax-related purpose.

GAAR can be applied if an avoidance arrangement (in other words, an arrangement that results in a tax benefit) is an “impermissible avoidance arrangement”. A “tax benefit” is any tax benefit, and covers all taxes.



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An “impermissible avoidance arrangement” arises if:

- The sole or main purpose of the avoidance arrangement was to obtain a tax benefit; and
- A tainted element is present.

Let’s look at each of the two requirements necessary for there to be an impermissible avoidance arrangement. Firstly, let’s look at the requirement that the sole or main purpose of the arrangement must have been to avoid tax. In assessing this, SARS is allowed to presume that if *any* tax has been avoided or delayed, then this was the sole or main purpose of the arrangement. The onus is then on the taxpayer to prove that this was not the sole or main purpose of the arrangement.

Next, let’s look at the presence of a tainted element.

There are three potential tainted elements:

1. Abnormality,
2. Lack of commercial substance, or
3. Either non-arm’s-length-like rights and obligations, or a misuse or abuse of the provisions of the Act.

If any one of these three are present, then the second criteria of an impermissible arrangement has been met. An arrangement is abnormal if it would not be normal to have arisen in the context of business, or is genuine in a context other than business.

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.

Examples of indications of a lack of commercial substance, include:

- Situations where the legal substance of a transaction differs from the legal form;
- Round trip financing is present;
- There are tax-indifferent parties; or
- Elements are present that have the effect of offsetting or cancelling each other out.

Round trip financing is present, for example, where there is a transfer of funds between parties that results in a tax benefit and a significant reduction, offset, or elimination of business risk. A party is tax-indifferent if they receive an amount that has no impact on their or anyone else’s tax liability (they are, for example, not subject to tax, or the receipt is offset either by any expenditure, loss, or assessed loss).

Offsetting elements are present when one transaction creates a significant tax benefit while another transaction effectively neutralises the undesired consequences of the first transaction.

The courts have told us that “arm’s length” means each party to the transaction independently of each other would seek to strike a bargain which would gain for each party the maximum possible advantage from the transaction. The parties don’t need to be at arm’s length, they merely have to transact as such.



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Let's look at an example of the application of GAAR to identify impermissible tax avoidance. This example is in fact SARS's own example of when impermissible tax avoidance may exist.

Company X is a holding company that owns 100% of the shares in a subsidiary, Company Y. Company Y owns assets that have substantially appreciated in value and also has significant taxable income. Holding Company X forms a new subsidiary, Company Z. Company Z then borrows money from Bank A to purchase the assets of Company Y in a section 45 intragroup transaction. This means that Company Y does not pay any tax on the sale of the assets to Company Z. Company Y then invests the proceeds of the sale of the assets in preference shares issued by a Bank A subsidiary that has a large assessed loss for tax but not financial accounting purposes. The terms of the loan and the preference shares are substantially similar.

In this example, the arrangement would result in a tax benefit in the form of an interest expense deduction for Company Z, despite the fact that the money borrowed is invested by Company Y in preference shares yielding exempt dividends. Company Y is a tax-indifferent party because the amounts it derives from the avoidance arrangement are not subject to tax and it results in the conversion of a non-deductible expense into one that would be deductible but for the provisions of the new GAAR. In addition, the circular flow of funds from Bank A through Companies Z, Y and back to the Bank A subsidiary constitutes round trip financing, while the substantially similar terms of the loan and preference shares constitute an offsetting element within the arrangement.

Once there is an "impermissible avoidance arrangement" as defined, SARS has numerous options available to them. In general, SARS can determine the liability for tax as if the transaction had not been entered into.

SARS can also:

- Disregard or combine any steps in the arrangement;
- Deem different parties to be one and the same person; or
- Re-allocate or re-classify any receipts or accruals, expenditure, or rebates.

Any action that SARS takes must ensure the consistent tax treatment for all the parties to the arrangement.

SARS will notify the taxpayer of their intention to apply GAAR, together with reasons why GAAR is applicable. The taxpayer has the opportunity to reply to this notice, where they could explain why GAAR does not apply.

Therefore, when considering tax planning and structuring your tax affairs in such a way so as to legally avoid tax, it is important to consider whether the structures put in place contravene the general anti-avoidance rules. I hope you enjoyed watching the video.