

Analysis of misuse and abuse in terms of the South African general anti-avoidance rule: lessons from Canada

Benjamin T Kujinga^{*}

Abstract

In terms of the South African general anti-avoidance rule, a transaction that misuses or abuses the provisions of the Income Tax Act may be disregarded for tax purposes. The misuse or abuse provision, along with the general anti-avoidance rule (GAAR), has not yet been judicially considered. It is argued that the provision brings further uncertainty and breadth to the general anti-avoidance rule. It calls for a purposive interpretation of tax legislation. This approach, however, creates uncertainty regarding the determination of purpose. In Canada, from which the provision was borrowed, the courts initially applied a policy approach in determining purpose but this disadvantaged the revenue authorities in a series of cases. The Minister of National Revenue was required to present a clear and unambiguous policy which in reality could not be found. The thrust of this article is to show that the misuse or abuse concept could turn out to be a lateral development in the South African GAAR because of the uncertainty it carries and if lessons on its application are not learned from the Canadian experience.

INTRODUCTION

A general anti-avoidance rule (GAAR) is a provision in tax legislation that works to curb impermissible tax avoidance. Impermissible tax avoidance is difficult to define because it is unpredictable and ever-changing. Broadly, it consists in the avoidance of tax that is inconsistent with the spirit of the tax laws. Other elements of impermissible tax avoidance transactions such as abnormality, artificiality, and a lack of commercial substance can be said to be founded in the broad definition. This is because, for example, it can never be the spirit of tax laws to allow taxpayers to avoid tax in a manner that lacks commercial substance or has no economic justification other than the tax

^{*} LLB, LLM (Fort Hare). LLD Candidate: Department of Mercantile Law, University of Pretoria.

benefits to be obtained. Permissible tax avoidance, on the other hand, consists in avoidance transactions that are permitted in terms of the letter and spirit of the tax law. Terms like tax planning and tax mitigation can all be said to be synonymous with permissible tax avoidance.

The primary purpose of a GAAR is that it must target only impermissible tax avoidance and allow permissible tax avoidance by drawing a clear distinction between the two. Countries like South Africa and Canada rely on a GAAR to curb impermissible tax avoidance while countries like the United States and the United Kingdom rely on judicially developed doctrines to do this.¹

GAARs the world over rely on different concepts to distinguish between impermissible and permissible tax avoidance. In South Africa, the abusive nature of a tax avoidance transaction is one of the elements that can lead to the application of the GAAR. In Canada, a tax avoidance transaction will not be impugned in terms of the GAAR unless it amounts to an abuse of the provisions of the Act. The misuse or abuse provision thus plays a significant role in both Canadian and South African GAARs.

The nature of a GAAR is such that it applies in an area of the law characterised by a perpetual clash between the taxpayer's entitlement to avoid taxes permissibly, and the government's need to protect the revenue base from impermissible tax avoidance. Therefore, for a GAAR to be effective, it must strike a balance between these two competing interests by drawing a line in the sand between permissible and impermissible tax avoidance. This article focuses on the misuse or abuse analysis and shows that for this concept to operate effectively in terms of the South African GAAR, certain lessons from the interpretation of the concept in certain Canadian court decisions should be noted. This is crucial, especially as the misuse or abuse concept in the South African GAAR is yet to be interpreted by the courts in South Africa. It will be shown that the misuse or abuse analysis, like many of the factors used to define the uncertain boundary between permissible and impermissible tax avoidance, can backfire because it is uncertain and open to incorrect application.

¹ In the United States, reliance is placed on the economic substance doctrine, the step transactions doctrine, and the business purpose doctrine. These doctrines are attributed to the decision by Judge Learned Hand in *Gregory v Helvering* 69 F 2d 809.

THE SOUTH AFRICAN GAAR

The South African GAAR is found in section 80A–L inclusive of the Income Tax Act.² It is deemed to apply to transactions entered into on or after 2 November 2008. In terms of section 80B, the Commissioner of the South African Revenue Service (SARS) has the power to reduce, eliminate, or neutralise tax benefits which arise from an impermissible avoidance arrangement.

Section 80A

This section contains the basic statutory structure of the GAAR. In terms of this section, the GAAR can only be applied to disregard a transaction if three basic elements – and a fourth which can be any one of the tainted elements – have been met. The three basic elements that need to be established to determine whether the transaction is in a business context or not are: an arrangement; a tax benefit; and the sole or main purpose of obtaining a tax benefit.

In the context of a business, the following are the tainted elements: the utilisation of abnormal means or manners which are not used for a *bona fide* business purpose other than to secure a tax benefit; the absence of commercial substance; the creation of rights and obligations which would not be created in an arm's length arrangement; and the misuse or abuse of the provisions of the Income Tax Act.

In a context other than business, the tainted elements are: the execution of an arrangement by abnormal means or manners not used for a *bona fide* purpose other than to secure a tax benefit; the creation of rights and obligations which would not be created in an arm's length arrangement; and the misuse or abuse of the provisions of the Income Tax Act.

The tainted elements are decisive in the application of the GAAR to an avoidance arrangement.³ The three basic elements draw no distinction between an impermissible and a permissible avoidance arrangement. The GAAR consequently uses the tainted elements to isolate impermissible tax

² 58 of 1962. The GAAR was inserted by s 34 (1) (a) of the *Revenue Laws Amendment Act* 20 of 2006.

³ In terms of s 80L of the Income Tax Act an arrangement means any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property. An avoidance arrangement is an arrangement that results in a tax benefit.

avoidance. Section 80A contains only the basic statutory structure of the GAAR. The elements it embodies are defined in greater detail in other sections constituting the GAAR.

Misuse or abuse

In terms of section 80A(c)(ii) of the Act, any avoidance arrangement which would result in a direct or indirect misuse or abuse of the provisions of the Act, including the GAAR, constitutes an impermissible avoidance arrangement.⁴ The concept of misuse or abuse works to deny tax benefits obtained in a manner that conforms to the letter of the law but not to the purpose of the Act. It is based on a view of impermissible tax avoidance as an abuse of the provisions it uses to obtain tax benefits. In a GAAR context, this concept is new to South Africa. However, in so far as the concept requires a purposive interpretation of tax legislation it does not introduce a new idea as this was called for in *Glen Anil Development Corporation Ltd v SIR*⁵ where Botha JA advocated a wide approach to interpretation encompassing the purpose behind the provision in question.

In South Africa, the interpretation of statutes is governed by two broad approaches, namely the modern approach and the traditional approach. The traditional approach is characterised by intentionalism and literalism, while the modern approach is characterised by purposivism and contextualism.⁶ Under the traditional approach, literalism is where the true meaning of a statutory provision is construed with reference to nothing but its wording. The words of the provision are paramount regardless of the absurdity that may result. Intentionalism states that the meaning of a provision must be determined in accordance with the intention behind it. The intention of the legislature in enacting the provision in question is thus paramount. In the modern approach, purposivism requires that the purpose sought to be achieved by a provision must be determined. Contextualism is where the meaning of a provision is analysed in the context within which it appears.

⁴ Cilliers 'Thou shalt not peep at thy neighbour's wife: section 80A(c)(ii) of the Income Tax Act and the abuse of rights' (2008) 57 *Taxpayer* at 87 states that misuse and abuse mean the same thing and that when analysing this section the presumption that every word in a provision must be given an independent meaning does not apply. He notes that '[i]n using both the word "misuse" and the word "abuse" the legislature merely acted *ex abundanti cautela*'.

⁵ 1975 4 SA 715 (A).

⁶ Van Schalkwyk & Geldenhuys 'Section 80A(c)(ii) of the Income Tax Act and the interpretation of Tax Statutes in South Africa' (2009) 17 2 *Meditari Accountancy Research* at 169–170.

The basic rule for the interpretation of statutes is that where the plain wording of a provision is clear and unambiguous, it must be applied as it is. An exception to this rule exists where applying the general rule would lead to absurdity so obvious that it cannot be said to have been contemplated when enacting the provision.⁷ When this absurdity arises, the intention of the legislature must be determined. It has to be understood that ‘it is dangerous to speculate on the intention of the legislature ...and the court should be cautious about departing from the literal meaning of the words of a statute ... Moreover it is not the function of the court to supplement a statutory provision ...’⁸ When there is ambiguity, a court is also required to look at the context in which the words appear to determine the intention of the legislature. The ordinary rules of statutory interpretation support a contextual approach in tax matters if a taxpayer avoids tax in a manner consistent with a literal interpretation of the Income Tax Act but which would produce absurd results. In other words, the avoidance would be so absurd that it can be said that it was not contemplated by the legislature.

The SARS noted that the reason behind the introduction of the misuse or abuse provision was to reinforce the modern approach to the interpretation of tax statutes.⁹ However, a series of recent cases shows that the modern approach to the interpretation of tax statutes in particular, is already well established. These are *De Beers Marine (Pty) Ltd v CSARS*,¹⁰ *Standard General Insurance Company Ltd v CCE*,¹¹ *CSARS v Airworld and Another*,¹² and *Metropolitan Life Ltd v CSARS*.¹³ Further evidence of the dominance of the modern approach in the interpretation of tax legislation, and indeed all legislation, can be seen in the South African Constitution.¹⁴ In terms of sections 1, 2 and 8 of the Constitution, the Constitution is superior to all law in the country. Subsections 39(1) and (2) of the Constitution state:

- (1) When interpreting the Bill of Rights, a court, tribunal or forum –
 - (a) Must promote the values that underlie an open and democratic society based on human dignity, equality and freedom;
 - (b) Must consider international law; and

⁷ *Venter v Rex* 1907 TS 910.

⁸ *Summit Industrial Corporation v Jade Transporters* 1987 2 SA 583 (A) 596 at 597.

⁹ SARS *Revised Proposals on Tax Avoidance and Section 103 of the Income Tax Act 58 of 1962 (Revised Proposals)* 16.

¹⁰ 2002 3 All SA 181 (A).

¹¹ 2004 2 All SA 376 (SCA).

¹² 2008 2 All SA 593 (SCA).

¹³ 70 SATC 162.

¹⁴ Act 108 of 1996.

- (c) May consider foreign law.
- (2) When interpreting any legislation and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.

By directing the interpretation of any other legislation to follow constitutional standards, the Constitution effectively requires legislation to be interpreted with reference to the modern approach.¹⁵ In *Glen Anil*,¹⁶ it was stated that ‘there seems little reason why the interpretation of fiscal legislation should be subjected to special treatment which is not applicable in the interpretation of other legislation’. This means that tax statutes have always been required to be interpreted purposively and contextually. The misuse and abuse provision could thus be superfluous.¹⁷ It is, however, clear that the misuse or abuse concept works to expand the scope of the GAAR to address as many forms of impermissible tax avoidance as possible. The concept broadens the application of the GAAR because it increases the scope of the tainted elements.

Analysis of the misuse or abuse element

In the context of a GAAR, the misuse or abuse concept is new to South Africa. Avoidance arrangements that amount to an abuse of the provisions of the Act are liable to the application of the GAAR. The misuse or abuse provision has been described as the ‘heart of section 80A’ because it applies in any context.¹⁸ This contention, with respect, is inaccurate because the provision is only one of the tainted elements. Even though it applies in any context, an avoidance arrangement can still be struck down by the GAAR without having to determine whether it amounts to an abuse of the provisions of the Act. It has also been argued that the provision is probably superfluous as it calls for a purposive interpretation of the provisions of the Act, something that is already in place.¹⁹ This criticism can be countered on the grounds that according to the ‘Revised Proposals’ the provision was not intended to introduce new interpretation methods but to reinforce the modern approach.²⁰ Moreover, when viewed as seeking to define impermissible tax

¹⁵ Van Schalkwyk & Geldenhuys n 6 above at 178.

¹⁶ *Glen Anil Development Corporation Ltd v SIR* n 5 above at 727.

¹⁷ This is illustrated by Clegg ‘Use it or abuse it’ (2007) 21 *Tax Planning* at 37 who notes ‘[i]s the section a mere judicious reminder to the judiciary that in applying the law that they must not forget to look for absurdity, ambiguity and purpose (as they already should, in any event?).’

¹⁸ Cilliers n 4 above at 86.

¹⁹ See generally, Van Schalkwyk & Geldenhuys n 6 above.

²⁰ *Revised Proposals* n 9 above at 16.

avoidance as an abuse of the law, this provision adds a new dimension to the South African GAAR.

The misuse or abuse provision provoked some musings on its meaning and on how this would be established. Cilliers²¹ submits that it called for a determination in terms of the abuse of rights doctrine. This is in line with the statement in the 'Explanatory Memorandum'²² that the provision is derived from certain views on tax avoidance in European jurisdictions. In terms of the abuse of rights doctrine as applied in taxation, a taxpayer has a right to avoid taxes but this right is limited and must not be abused. The concept of abuse of rights therefore limits the taxpayer's exercise of his rights. The anomaly that section 80A (c) (ii) refers to an abuse of the provisions of the Act and not of rights, can be dismissed as the taxpayer abuses his rights by abusing the Act. The reference in the 'Explanatory Memorandum' to certain European jurisdictions could thus make the analysis under the misuse or abuse provision two pronged. The analysis could become whether the arrangement utilises the provisions of the Act for the purpose for which they were enacted and whether the taxpayer has abused his right to avoid taxes. This could cause uncertainty because the doctrine of abuse of rights is a foreign concept developed in foreign jurisdictions. It is submitted that the courts are most likely to ignore the abuse of rights doctrine and use the test of whether the arrangement avoided tax in a manner consistent with legislative purpose.

The misuse or abuse concept was inspired by the Canadian GAAR, particularly section 245(4) of the Canadian Income Tax Act (CITA).²³ Cilliers is against borrowing legislative concepts from other countries. He notes:

At any rate this kind of legislative 'borrowing' from foreign jurisdictions creates a further layer of uncertainty about the meaning of section 80A (c) (ii). Apart from neglecting the treasure-chest of our own common law, it also leaves one with the uncomfortable feeling that the drafters are perhaps too easily tempted to borrow terminology from foreign legal systems, with unpredictable and potentially dangerous consequences.²⁴

²¹ See Cilliers n 4 above generally for a discussion of the abuse of rights doctrine and s 80A (c)(ii).

²² *Explanatory Memorandum on the Revenue Laws Amendment Bill 2006* at 63.

²³ RSC 1985 C 1 (5th Supp).

²⁴ Cilliers n 4 above at 107. Cilliers at 108 dismisses the misuse or abuse provision 'section 80A(c)(ii) is either a dead letter (because it does not seem to add anything material to the common law) or it is impermissibly nebulous and uncertain'.

The uncertainty brought about by the misuse or abuse provision stems from questions of whether the courts in South Africa will use the approach adopted by the Canadian Supreme Court in *Canada Trustco Mortgage Company v Canada*,²⁵ which is regarded as the leading case on the misuse or abuse provision in Canada. On the other hand, impermissible tax avoidance is a global phenomenon and taking anti-avoidance concepts from other jurisdictions is encouraged if those concepts contribute positively to the successful limitation of impermissible tax avoidance and the respect for taxpayers rights to avoid taxes.

Further criticism of the misuse or abuse analysis stems from that fact that the GAAR uses the analysis in a way that it is inconsistent with how it is used in Canada. In South Africa the provision is used as one of the tainted elements that could result in the application of the GAAR to an avoidance arrangement. In Canada the test to establish an avoidance arrangement is whether the arrangement would result directly or indirectly in a tax benefit unless it may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit.²⁶ The misuse or abuse provision in section 245(4) of the Canadian Income Tax Act works as a limitation to the Canadian GAAR. This means that the GAAR will not apply if the avoidance arrangement does not amount to a misuse or abuse of the provisions on the CITA. Taxpayers are able to defend their arrangements on this ground.

Broomberg²⁷ notes that the use of the misuse or abuse concept in Canada is very important because: a GAAR can empower the Commissioner to disregard transactions that comply with specific and clear provisions of a taxing Act which are laid down by elected representatives, and this is undesirable. Further, a GAAR creates uncertainty which might discourage economic activity in the country; and the wide nature of a GAAR means it can limit permissible tax avoidance. This can encourage courts to interpret it restrictively.

²⁵ 2005 SCC 54, discussed further below.

²⁶ Section 245(2).

²⁷ Broomberg 'Then and now – IV' (2008) 22 *Tax Planning* at 31. Broomberg argues that the problems with a GAAR that has no limitations is that it could be used to attack arrangements that parliament intended meaning that certain government economic policies are subject to the Commissioner's approval. This scenario is possible because if the Commissioner has challenged arrangements that should not have been challenged before he may not be trusted to honour arrangements that can be disregarded by the GAAR but that comply with legislative purpose.

As it is now, the South African GAAR does not use misuse or abuse as a limitation. This means that transactions which comply with the legislative purpose can be struck down by the GAAR. The fact that the GAAR has no limitations may appear to be a strength, but – as experienced with section 90 of the old Income Tax Act²⁸ in South Africa, and section 260 of the Income Tax Assessment Act (ITAA)²⁹ in Australia – this is likely to result in the courts placing their own limits on the GAAR. Broomberg³⁰ notes that ‘the new GAAR is now in an even more vulnerable condition. One can therefore anticipate hostile judicial reaction and this could prove costly to the fiscus.’ The annihilation of the GAAR as an effective deterrent against impermissible tax avoidance envisaged by Broomberg, is possible given the nature of the GAAR.

The misuse or abuse concept brings uncertainty because of the difficulty involved in applying it. It assumes that there is a determinable use for each section in the Income Tax Act that is not abusive and which will be used to measure any other use of the provision. However, it leaves room for subjectivity in that abuse can potentially mean anything to anyone.³¹ The underlying purpose of tax legislation can be difficult to determine. This is because tax legislation is often used to encourage certain economic behaviour. Statements accompanying the introduction of new legislation are made in parliament but are not useful in determining purpose. The ‘Explanatory Memoranda’ issued with new amendments are also limited in the sense that they do not contain explanations of all provisions. The courts cannot rely on such sources and are therefore left with only the words of the

²⁸ 31 of 1941. In *CIR v King* 1947 (2) SA 196 (A), the first GAAR in South Africa was restrictively interpreted mainly because it was wide enough to target all forms of tax avoidance without isolating impermissible tax avoidance.

²⁹ 1936. The section 260 GAAR in Australia was too wide and would apply to both permissible and impermissible tax avoidance if interpreted literally. It was subjected to a series of restrictive judicial interpretations culminating in the so called choice doctrine as developed in cases such as *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66, *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290, *Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314 and *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330. In terms of the choice doctrine, s 260 could not be applied to a transaction in which a taxpayer made use of tax saving choices available in terms of the ITAA. Later cases like *Cridland*, gave the taxpayer the right to create the conditions necessary to exploit a tax saving choice. It is no surprise therefore that the choice doctrine and the line of cases in which it was advanced, played a central role in the demise of s 260 and the introduction of the current Australian GAAR in Part IVA of the ITAA.

³⁰ Note 27 above at 32.

³¹ Clegg n 17 above at 37 notes that ‘abuse is in the eye of the beholder. It is dependent upon a particular view or understanding of the “purpose” of the legislation which is said to be abused.’

provisions to guide them in establishing legislative purpose.³² In introducing the misuse or abuse analysis in the GAAR the uncertainty of the GAAR has been potentially extended. As will be noted, Canadian courts struggled with this concept. It is hoped that the South African courts can learn from the Canadian experience and establish a clear and workable standard showing how far they may go in relying on extra-statutory sources and how statutory purpose is to be determined.

THE CANADIAN GAAR

Unlike South Africa, Canada did not introduce its current GAAR (contained in section 245 of the CITA) on the basis of the failure of an earlier GAAR.³³ The current GAAR is the only GAAR Canada has had and was necessitated by the failure of a system of specific anti-avoidance rules and most importantly, the rejection of the business purpose doctrine by the Supreme Court in *Stubart Investments Ltd v The Queen*.³⁴

Section 245(2)

Section 245 (2) is the central provision of the GAAR. It states:

Where a *transaction* is an avoidance transaction, the *tax consequences* to a person shall be determined as is reasonable in the circumstances, in order to deny a *tax benefit* that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction. (my emphasis)³⁵

³² *Id* at 38. It is also stated here that the misuse and abuse provision's significance could be its direction to courts to refer to extra statutory sources to determine purpose more vigilantly than before.

³³ South Africa has had three GAARs namely s 90 of the old Income Tax Act, s 103 (1) of the Income Tax Act and the current GAAR s 80A–L. The current GAAR was introduced in part in response to the loss sustained in *CIR v Conhage (Formerly Tycoon)* 1999 4 SA 1149 (SCA) and the perception that s 103(1) had become inadequate. The statement accompanying the introduction of the current GAAR in South Africa in the SARS *Draft Comprehensive Guide to the General Anti-Avoidance Rule* at 5 noted that '[t]he GAAR has proven to be an inconsistent and, at times, ineffective deterrent to the increasingly sophisticated forms of impermissible tax avoidance that certain advisors and financial institutions are putting forward and some taxpayers are implementing. In addition it has become clear that the GAAR has not kept up with international developments. Finally, uncertainty has arisen with respect to the application of the GAAR in the alternative due to the conflicting court decisions in this regard.'

³⁴ 1984 CTC 294.

³⁵ This provision at first glance appears to be a wide reference to all tax avoidance transactions. It is however clear that the term 'avoidance transaction' limits the section to avoidance transactions which are defined in the GAAR. The term 'but for' means that the GAAR can only be applied if there is no other provision in *CITA* to deny the tax benefit – *Rousseau-Houle v The Queen* 2001 DTC 250 at par 24. In *Canada v Imperial*

The italicised terms are the key terms in the section. ‘Tax benefit’ refers to a reduction, avoidance or deferral of tax or other amount due in terms of the CITA. It includes a reduction, avoidance or deferral that would, but for the operation of a tax treaty, be due in terms of the CITA. Tax benefit further includes an increase in a tax refund applicable under the CITA due to the operation of a tax treaty.³⁶ ‘Tax consequences’ refer to the amount of income, earned in Canada or not, or other amount payable by or payable as a refund to a person in terms of the CITA; or any amount that is relevant to the computation of that amount. ‘Transaction’ refers to any arrangement or event.³⁷

An ‘avoidance transaction’ refers to any transaction that would, but for the GAAR, directly or indirectly result in a tax benefit. A transaction is not an avoidance transaction if it may reasonably be considered to have been carried out for *bona fide* purposes other than to obtain a tax benefit.³⁸ A transaction that is part of a series of transactions that would result directly or indirectly in a tax benefit but for the GAAR, will also be deemed to be an avoidance transaction. If, however, that transaction can be explained by reference to other *bona fide* purposes and not the obtaining of a tax benefit, it cannot be characterised as an avoidance transaction.³⁹

Oil Ltd [2004] FCA 36 at par 30 – 31 it was stated that ‘[t]he purpose of GAAR is to prevent abusive tax avoidance to which more specific anti-avoidance rules do not apply. Thus if a taxpayer does not satisfy the statutory requirements of a provision on which the taxpayer relies, the Minister need not resort to GAAR. Similarly, GAAR is not needed if a more specific anti-avoidance rule applies. In other words, GAAR is the anti-avoidance provision of last resort. It purports to provide a framework to distinguish between legitimate tax minimization and abusive tax avoidance.’

³⁶ Arnold ‘The Canadian General Anti-Avoidance Rule’ in Cooper (ed) *Tax avoidance and the rule of law* (1997) 223 at 231 notes that the definition of tax benefit is broadened to ensure that the GAAR will not only apply to transactions that avoid tax but to other transactions that result in any form of tax advantage including the deferral of tax. He notes further that the definition of tax benefit assumes that there is a real amount of tax a taxpayer should have paid. This amount is used to determine the extent of the reduction, deferral or avoidance of tax effected by the taxpayer.

³⁷ Section 245(1).

³⁸ Arnold n 36 above at 231 notes that the non-tax purpose test is the essence of the definition of the avoidance transaction. The non-tax purpose test, he notes, is actually an expanded form of the business purpose test. The legislature did not specifically use the term ‘business purpose’ because it was concerned that the courts would narrowly interpret it by excluding family and investment transactions due to the fact that for Canadian tax purposes, the term business has a very established meaning: ‘reasonably considered’ requires an objective test with reference to what the taxpayer did and the legal, commercial and tax consequences of his actions as opposed to subjective motive and intentions.

³⁹ Section 245(3).

Section 245(2) referred to above will only apply to a transaction if it may reasonably be considered that the transaction would directly or indirectly result in a misuse of the CITA, the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other Act that is relevant when computing tax or any amount due or refundable to a person in terms of the CITA.⁴⁰ Section 245(2) encapsulates the power of the GAAR by empowering the Minister of National Revenue to disregard the transaction and impose tax. In summary therefore: three conditions must be satisfied before section 245 can be applied. These are that a tax benefit must result from a transaction; the transaction must be an avoidance transaction; and the avoidance transaction must be abusive. It satisfies this requirement if it results directly or indirectly in the misuse of the CITA or is abusive of the provisions of the CITA read as a whole.⁴¹

The burden lies on the taxpayer to refute the presence of a tax benefit and that the transaction is an avoidance transaction.⁴² The minister must prove that the avoidance transaction is abusive and amounts to a misuse of the provisions of the CITA read as a whole.⁴³ Where the existence of abusive tax avoidance is unclear, the taxpayer is accorded the benefit of the doubt. In terms of the Canadian GAAR, abusive tax avoidance (termed impermissible tax avoidance in South Africa) exists where the relationships a transaction establishes and a transaction's details do not have a proper basis in relation to the object and spirit of the provisions that are being used to obtain a tax benefit.

Misuse or abuse in the Canadian GAAR

This is the final stage in the inquiry and provides for immunity from the GAAR. A tax avoidance transaction will not be impugned by the GAAR unless it can reasonably be considered that the transaction directly or indirectly misuses the provisions of the CITA or abuses these provisions as a whole.⁴⁴ The misuse and abuse provision serves a central role in the GAAR by basing the distinction between permissible and impermissible tax avoidance on the abusiveness of the transaction. Section 245(4) provides that the GAAR will 'not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a

⁴⁰ *Id* at (4).

⁴¹ *Canada Trustco* n 25 above at par 17.

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ Krishna *The fundamentals of Canadian Income Tax* (2002) at 870 describes this limitation as 'the single most significant'.

misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole'. The 'Technical Notes'⁴⁵ explain this section as follows:

Even where a transaction results, directly or indirectly, in a tax benefit and has been carried out primarily for tax purposes, section 245 will not apply if it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole. This measure is intended to apply where a taxpayer establishes that a transaction carried out primarily for tax purposes does not, nonetheless, constitute an abuse of the Act. Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax. It also recognizes, however, that a number of provisions of the Act either contemplate or encourage transactions that may seem to be primarily tax motivated.

Reference to the two words 'misuse' and 'abuse' may be superfluous as the Supreme Court of Canada in *Canada Trustco*⁴⁶ found the term 'abuse' broad enough to encompass 'misuse'. Section 245(4) and its reference to the misuse and abuse analysis has been described as the 'key and most difficult issue in the application of the GAAR'.⁴⁷ In *Canada Trustco*⁴⁸ the court, in

⁴⁵ *Technical Notes* (30 June 1988).

⁴⁶ This can be contrasted with the decision in *Canada v Imperial Oil Ltd* n 35 above where it appears that misuse and abuse are two separate concepts to be determined separately. It was noted in this case that where there is no misuse, the court must determine whether the transaction is an abuse, having regard to the provisions of the Act, other than those dealing with GAAR, when read as a whole. The court also stated that the question is whether the transaction contravenes any policy or policies underlying the provisions of the Act as a whole. If the policy is contravened the transaction constitutes an abuse for the purpose of GAAR. The consideration of misuse and abuse as two separate concepts is, with respect, unnecessary because the two words mean basically the same. This approach may have been informed by the fact that the Act provides for misuse and abuse implying that there must be two separate tests.

⁴⁷ Hogg, Magee & Li *Principles of Canadian income tax law* (2010) at 685. This section does not state the criteria the tax authorities or the courts must apply when determining whether a transaction or series of transactions amounts to a misuse or abuse of the provisions of the *CITA*. The Canada Department of Finance *Explanatory Notes to Legislation Relating to Income Tax, June 1988 s 245* state that 'subsection 245(4) draws on the doctrine of 'abuse of rights' which applies in some jurisdictions to defeat the schemes intended to abuse the tax legislation' it is stated that 'transactions that comply with the object and spirit of other provisions of the Act read as a whole will not be affected by the application of this general anti-avoidance rule' and that 'it is not intended that section 245 will apply to deny the tax benefits that result from these transactions as long as they are carried out within the object and spirit of the provisions of the Act read as a whole'. This means that the misuse and abuse provision calls for a purposive

showing that the abuse element is central, noted that the GAAR was intended to curtail abusive tax avoidance and also to protect the taxpayer's right to engage in tax planning. As such, the abusive nature of the transaction must be clear before the GAAR can be applied.

It was further stated⁴⁹ that the GAAR mandates a purposive interpretation of the CITA. The court identified two steps in the determination of whether a transaction is abusive of the provisions of the CITA. The first step involves a contextual, textual, and purposive interpretation of the provisions the taxpayer relies on to obtain the tax benefit. This is clearly a question of law. The second step involves a determination of whether the facts of the transaction fit with the purposive analysis of the relevant provisions. If not, an abuse of the provisions has occurred and the GAAR can be used to disregard the transaction. The second step is a factual inquiry. It was noted in *Canada Trustco*⁵⁰ that:

Section 245(4) imposes a two part inquiry. First, the courts must conduct a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the Context of the whole Act. Second, the court must examine the factual context of the case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s 245(4). However, any finding in this

interpretation of the CITA.

⁴⁸ *Canada Trustco* n 25 above at par 50.

⁴⁹ *Id* at par 44.

⁵⁰ *Id* at par 44. Sandler 'The Minister's Burden under GAAR' (2006) 54 1 *Canadian Tax Journal* at 3 notes that the court did little to explain the operation of s 245. He refers to the two stage inquiry to establish misuse or abuse as confusingly described as the 'overall inquiry' which, in turn, entails a 'mixed question of fact and law'. The manner in which the court describes the form of the inquiry should not however deflect attention from the substance. The words 'misuse' and 'abuse' are potentially ambiguous and uncertain and the court must take credit for setting up a test that clarifies their meaning. In the end it is easy to decipher from the overall description of the test in par 44 that there is in fact a two stage inquiry. The first stage is a legal one where the relevant provisions are interpreted to determine the purpose and spirit behind them. The second inquiry is a factual one in which the facts of the scheme are analysed with reference to the findings of the first inquiry to determine whether they actually abuse the provisions they utilise to obtain tax benefits.

respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance.

Since the GAAR warrants a purposive interpretation of the CITA, it can be said that an avoidance transaction is abusive if it defeats or frustrates the purpose of the statutory provisions.⁵¹ This does not necessarily extend to the policy underlying the provisions. This is because the policy is difficult for both the taxpayer and the revenue authorities to ascertain. In *Canada Trustco*⁵² the court stated:

[The] search for an overarching policy ... that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs.

The dictates of section 245(4) therefore mean that a transaction that amounts to an abuse of the provisions of the CITA will be disregarded even if it complies with a literal interpretation of the provisions. In other words, this section allows the GAAR to stop the CITA from self destruction, which is possible if a literal interpretation is followed.

Regarding the importance of economic substance, the direction from the court is inconsistent. In *Canada Trustco* it was stated that the lack of economic substance does not necessarily make an avoidance transaction abusive. It was stated that 'motivation, purpose and economic substance are relevant under subsection 245(4) only to the extent that they establish whether the transaction frustrates the purpose of the relevant provisions'.⁵³ The lesson seems to be that only abuse of the provisions of the CITA read as a whole would suffice for the GAAR to be applied. However, in *Mathew*⁵⁴ the lack of economic substance was held to be important and the abusive nature of the transaction in question was established by reference to the 'vacuity and artificiality of the transactions'.

⁵¹ Hogg *et al* n 47 above at 687: 'a transaction can result in an abuse and misuse of the Act where the result of the avoidance transaction is an outcome that the provisions relied on seek to prevent, defeats the underlying rationale of the provisions relied on, or circumvents certain provisions in a manner that frustrates the object, spirit or purpose of those provisions'.

⁵² *Canada Trustco* n 25 above at par 42. It is noted in par 50 that the GAAR was intended to prevent abusive tax avoidance and preserve taxpayer's right to tax planning and without sacrificing fairness and certainty.

⁵³ *Canada Trustco* n 25 above at par 57.

⁵⁴ *Mathew v Canada* 2005 SCC 55 at par 57.

Misuse and abuse concept not applied consistently

The GAAR depends on the misuse and abuse concept to draw the line between permissible and impermissible tax avoidance. However, in some cases this concept has been applied in a manner that is inconsistent and threatens the foundation of the GAAR. Before *Canada Trustco* where the Supreme Court settled the misuse or abuse inquiry, the courts referred to a policy approach which placed the minister at a great disadvantage. The origin of this approach can be traced to the Federal Court of Appeal's decision in *OSFC Holdings v The Queen*⁵⁵ where Rothstein J stated:

It is also necessary to bear in mind the context in which the misuse and abuse analysis is conducted. The avoidance transaction has complied with the letter of the applicable provisions of the Act. Nonetheless, the tax benefit will be denied if there has been a misuse or abuse. This is not an exercise of trying to divine Parliament's attention by using a purposive analysis where the words used in a statute are ambiguous. Rather, it is an invoking of a policy to override the words Parliament has used. I think, therefore, that to deny a tax benefit where there has been strict compliance with the Act, on the grounds that the avoidance transaction constitutes a misuse or abuse, requires that the relevant policy be clear and unambiguous. The court will proceed cautiously in carrying out the unusual duty imposed upon it under subsection 245(4). The court must be confident that although the words used by Parliament allow the avoidance transaction, the policy relevant provisions of the Act as a whole is sufficiently clear that the court may safely conclude that the use made of the provision or provisions by the taxpayer constituted a misuse or abuse.⁵⁶

The court made use of the word 'policy' which must be 'clear and unambiguous'. Rothstein J⁵⁷ noted that policy meant a reference to the purpose, object and spirit of the provisions of the Act. However, it would have been far better had he not used the collective term 'policy', which could be interpreted to mean something other than the Act's purpose, object and spirit. Rothstein J's interpretation of misuse and abuse also seemed to hold that policy and the words of the CITA are polar opposites where the taxpayer complies with the provisions of the CITA in a tax avoidance transaction. The court can in this case only apply the GAAR if the policy is clear and unambiguous. This approach makes it extremely difficult for the Minister of

⁵⁵ 2001 DTC 571.

⁵⁶ *Id* at par 67.

⁵⁷ *Id* at par 66.

National Revenue because in actual fact there is no clear and unambiguous policy document to be read with the CITA.⁵⁸

Rothstein J noted that the approach of the court referred to above would not make the GAAR difficult to apply. He stated:

In answer to the argument that such an approach will make the GAAR difficult to apply, I would say that where the policy is clear, it will not be difficult to apply. Where the policy is ambiguous, it should be difficult to apply. This is because subsection 245(4) cannot be viewed as an abdication by Parliament of its role as lawmaker in favour of the subjective judgment of the Court or particular judges. In enacting subsection 245(4), Parliament has placed the duty on the Court to ascertain Parliament's policy, as the basis for denying a tax benefit from a transaction that otherwise would meet the requirements of the statute. Where Parliament has not been clear and unambiguous as to its intended policy, the Court cannot make a finding of misuse or abuse, and compliance with the statute must govern.⁵⁹

The minister thus had either to provide clear evidence of an unambiguous policy or accept that a transaction was not abusive. The correct approach would have been to require the minister to prove that the transaction used a provision or provisions in a manner not intended by the legislator. In spite of Rothstein J's assurances to the contrary, the determination of policy in analysing whether a transaction constituted a misuse or abuse was unduly problematic for the minister in subsequent cases where the term policy was used and what it meant in *OSFC* – namely object, spirit and purpose – was ignored.⁶⁰

In *Hill v The Queen*⁶¹ the misuse and abuse analysis adopted in *OSFC* was decisive in swaying the decision of the court in the taxpayer's favour. The transaction in this case involved the conversion of accrued interest to principal in a circular fashion. The minister conceded that the case had to be

⁵⁸ Arnold 'The long, slow, steady demise of the General Anti-Avoidance Rule' (2004) 52 2 *Canadian Tax Journal* at 499 notes that the court erred in setting up an opposition between the words and policy of the CITA. He argues that the GAAR is the same as any words used in the Act thus it would have been fairer for the court in *OSFC* to interpret the misuse and abuse concept as entailing the use of some words used by parliament to override other words used by parliament, instead of using policy to override the words parliament has used.

⁵⁹ *OSFC Holdings Ltd v The Queen* n 55 above at par 70.

⁶⁰ Even though Rothstein J noted that in discussing policy he meant spirit object an intent, his further comments on the matter showed something more akin to policy than legislative purpose.

⁶¹ 2003 4 CTC 2548.

limited to a determination of the abusive nature of the transaction. It was contended that the transaction avoided paragraph 20(1)(a) of the CITA. The minister needed to comply with the ruling in *OSFC* in establishing a clear and unambiguous policy. This was done by noting the CITA's provisions allowing the deduction of simple interest on an accrual basis and denying compound interest on an accrual basis.

In response, the taxpayer admitted that the transaction was undertaken to ensure that the interest flowing and payable would be simple not compound interest. The taxpayer, however, contended that the transaction had not been proved to be abusive by arguing that in line with *OSFC*, the minister had failed to establish any policy in existence, or any clear and unambiguous policy if a policy indeed existed, aimed at preventing borrowing money to pay interest where the purpose of the borrowing was to avoid compound interest. Miller J pointed out that:

I now find myself at GAAR's doorstep in a case that enticingly beckons me to open the door and apply the GAAR provisions in favour of the Respondent. Yet when those provisions are applied in the manner as set forth by justice Rothstein in the *OSFC* case, the result is by no means inevitable. Indeed while I am led to the inexorable conclusion that the transactions are avoidance transactions within the meaning of subsection 245(3) of the Act, they are saved from the application of subsection 245(2) by the grace of subsection 245(4) as they are not avoidance transactions which result in a misuse of the provisions of the Act or an abuse of the Act read as a whole.⁶²

This statement shows that the court actually found that the transaction would warrant the application of the GAAR but for the interpretation of misuse and abuse in *OSFC*. It can be seen that the misuse and abuse concept intended to isolate impermissible tax avoidance, can, if wrongly interpreted, lead to the same transactions being allowed. To show that the abuse analysis was wrong one can refer to the response of the court to the minister's submissions on policy. Miller J dismissed the submissions stating that:

I can glean no identifiable policy from this argument. It is simply a reiteration of what the Act itself says, that is, simple interest can be deducted on a paid or payable basis and compound interest must be paid to be deductible. That is not the underlying policy statement, that is a summary of the legislation. I was not referred by the respondent to any materials that would assist me in understanding why the government permitted the

⁶² *Id* at par 59.

deduction of simple interest on a payable basis and only permits the deduction of compound interest on a paid basis. What is the policy? It is not my role to speculate; it is the respondent's role to explain to me the clear and unambiguous policy. He has not done so. I am therefore unable to find that there has been a misuse or abuse as contemplated by subsection 245(4) of the Act. Consequently, subsection 245(2) does not apply to the appellant's avoidance transactions.⁶³

What therefore started as a reference to policy, proceeded to become a test completely divorced from spirit, object and purpose. While Rothstein J stated in *OSFC* that policy represented object, spirit and purpose, Miller J in *Hill* went further and the above quoted statement from his decision shows that the minister was now required to come up with some tax policy reasons behind a statutory scheme. The use of the misuse and abuse concept as an indicator of impermissible tax avoidance and indeed the GAAR, was now becoming even more difficult for the minister to use in practice.⁶⁴ A lot can be read into the manner in which the taxpayer admitted that the transaction was meant to obtain a tax benefit but that the minister had not identified the relevant policy. The fact that the taxpayer based his defence on the minister's failings, and not on the legitimacy of the transaction, could mean that the taxpayer was confident from the start that the minister had an extremely onerous, if not impossible, onus to discharge.

Miller J conceded in *Canada Trustco Mortgage Company v The Queen*⁶⁵ that the policy approach was difficulty and risky. He noted:

What this analysis highlights is the difficulty and risk in determining tax issues based on policy. Certainly GAAR invites such an approach, and the Federal court of Appeal has made it clear that the only way to determine if there has been a misuse or abuse is to start with the identification of a clear and unambiguous policy. No clear and unambiguous policy – no application of GAAR. But at what level do we seek policy? And, as previously mentioned, do “policy”, “object and spirit” and “intended use” all mean the same thing? Is there a policy behind each particular provision, a policy behind a scheme involving several provisions, a policy behind the act itself? Is the policy fiscal? Is the policy economic? Is the policy simply a regurgitation of the rules? Does the identification of policy require a deeper

⁶³ *Hill v The Queen* n 61 above at par 62.

⁶⁴ Arnold n 58 above generally notes that the approach taken was prejudicial to the government because of the difficulty involved in ascertaining a clear and ambiguous policy and presenting it to the court. Arnold states further that if the approach was correct, the GAAR would seldom apply.

⁶⁵ [2003] 4 CTC 2009.

delving into the *raison d'être* of those rules? How deep do we dig? The success or failure of the application of GAAR left to the Court's finding of a clear and unambiguous policy inevitably invites uncertainty. That is simply the nature of the GAAR legislation in relying upon such terms as misuse and abuse. As many have stated before, this is tax legislation to be applied with utmost caution as it directs the Court to ascertain the Government's intention and then rely on that ascertainment to override legislation. This is quite a different kettle of fish from the accepted approach to statutory interpretation where policy might be sought to assist in understanding legislation. Under GAAR policy can displace the legislation.⁶⁶

In this statement Miller J blamed the difficulty of establishing policy on the inherent nature of the GAAR, saying that a GAAR that relies on the misuse and abuse concept is uncertain in any event. This uncertainty, he noted, arose from the fact that the court could not be sure of the extent to which it could go when determining policy and how the policy could be determined. Miller J's reasoning also shows that the GAAR had a weakness in that it was dependent on judicial interpretation for efficiency. The Federal Court of Appeal⁶⁷ affirmed the decision. The court noted that the minister's gleaning of policy from the provisions in question was insufficient, and noted that a policy source that clearly and unambiguously shows that the transaction had abused or misused the provisions of the Act had not been identified.⁶⁸

The policy approach was used in *Canada v Jabin Investments Ltd*⁶⁹ where the court rejected the minister's reference to the 'Carter Commission on Tax Reform Report'⁷⁰ noting that the Report was not a policy source because parliament had not adopted the proposals it contained *en masse*. It was stated that 'because policy invoked by the Minister is to override the words that Parliament has used, the policy must be clear and unambiguous if it is to be applied'.⁷¹ In *Canada v Imperial Oil Ltd*⁷² the same approach was followed and it was stated that the guide that the policy must be clear and unambiguous was implicit in the language of section 245(4).⁷³ The policy approach was also used in *Canada v Produits Forestiers Donohue Inc.*⁷⁴ The

⁶⁶ *Id* at par 91.

⁶⁷ *The Queen v Canada Trustco Mortgage Company* 2004 DTC 6119.

⁶⁸ *Id* at par 1–3.

⁶⁹ [2003] 2 CTC 25.

⁷⁰ *Report of the Royal Commission on Taxation* (1966)

⁷¹ Note 69 above at par 3.

⁷² [2004] FCA 36.

⁷³ *Id* at par 39.

⁷⁴ 2002 FCA 422.

line of the cases which followed the *OSFC* analysis of policy when determining misuse and abuse is thus long, and it can be seen that if a misuse or abuse analysis is not correctly set, serious prejudice can follow.

As has been seen, the Supreme Court in *Canada Trustco* did away with the policy approach and properly established the purposive approach. One can note that the transaction in this case was not abusive after all because the Supreme Court, using a purposive approach, upheld it just as the lower courts using the policy approach had done. Nevertheless, the line of cases using the policy approach provide a country like South Africa, which has a misuse and abuse provision, with vital lessons on how properly to conduct a misuse and abuse analysis in terms of its GAAR.

Abuse concept liable to abuse

The abuse concept in the context of a GAAR is based on the premise that a tax avoidance transaction is not abusive and thereby impermissible, if it complies with the spirit, object and purpose of the provisions of the Act. It represents an attempt to do away with literalism. Since the application of the GAAR to transactions has relied on abuse, there have been musings on the haste with which transactions are deemed to be abusive by the minister. Kellough⁷⁵ notes:

In my experience, Revenue Canada has adopted the object and spirit approach in virtually every transaction it finds objectionable but cannot fit within a specific provision of the Act. There is usually no indication of where the object and spirit of the provision comes from, much less the legal basis for applying such a test.

In *Geransky v The Queen*⁷⁶ Bowman ACJ noted:

Subsection 245(4) excludes from the operation of subsection 245(2) transactions that do not result “directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.” What is misuse or an abuse is in some instances in the eye of the beholder. The Minister seems to be of the view that any use of a provision is a misuse or an abuse if the provision is not used in a manner that maximises the tax resulting from the transactions.⁷⁷

⁷⁵ Kellough ‘Tax avoidance 1945–1995’ (1995) 43 5 *Canadian Tax Journal* at 1832.

⁷⁶ 2001 2 CTC 2147.

⁷⁷ *Id* at par 40.

These statements show that in spite of the introduction of an abuse concept to determine whether a transaction is permissible or not, the GAAR is still far from achieving certainty. This concept, therefore, fails to draw a clear line between permissible and impermissible tax avoidance because any transaction not seen in a favourable light by revenue authorities is likely to be challenged as abusive. The SARS in South Africa must in future resist the temptation to label transactions abusive in the manner the Canadian Revenue Agency has been criticised of doing.

CONCLUSION

The search for an incontrovertible indicator of impermissible tax avoidance will not and cannot be expected to end with the introduction of a misuse or abuse element in the South African GAAR. While misuse or abuse is a new feature in terms of South African GAAR jurisprudence, it has long been used in other jurisdictions. The experience in these jurisdictions, especially Canada, shows that the concept can bring uncertainty and prolonged analysis. Drawing from this experience it is likely that a purposive analysis will bring more uncertainty than success for SARS in curtailing impermissible tax avoidance.

Cases like *Canada Trustco* show that the abusive nature of a transaction is not easy to determine, and what revenue authorities in both Canada and South Africa might view as abusive, may actually turn out to be compliant with the spirit and purpose of the taxing Acts. This scenario is a real possibility if lessons are not taken from the *OSFC* line of cases in Canada which determined purpose by reference to policy which in reality is impossible to ascertain. It is therefore recommended that to limit the controversy of a purposive analysis and to enhance the efficacy of the South African GAAR, the courts here must set standards in line with those set by the Canadian Supreme Court in *Canada Trustco*.