Obscure law gives Sars power to pierce the corporate veil

By Alec Basson

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A relatively unknown piece of legislation could be a new ace up the sleeves of the South African Revenue Service (Sars) as it tries to catch shareholders who hide behind a company to avoid paying tax.

Image source: Getty/Gallo

“Section 20(9) of the Companies Act 71 of 2008, allows the Sars commissioner to pierce the corporate veil or disregard the separate legal personality of a company as a remedy against impermissible tax avoidance when taxpayers use companies predominantly to achieve a tax benefit,” says Dr Albertus Marais, who recently obtained his doctorate in mercantile law at Stellenbosch University.

As part of his study, Marais considered how people may use a company as a legal entity to obtain more beneficial tax consequences, and whether such use may be appropriately described as an “abuse” of corporate personality. He also looked at whether either the common law, the Companies Act 71 of 2008 or the Income Tax Act 58 of 1962 may be used to address such instances of abuse.

Marais says companies are separate legal persons and therefore also separate taxpayers. He points out, however, that in practice it has become much easier to use a legal personality to ensure better tax consequences for those behind a specific corporate structure.

By using the separate legal personality of a company, shareholders may often abuse that separate legal personality when they use it primarily for tax reasons.

Combatting abuse

He says his study tried to define when an “abuse” of legal personality will amount to an “unconscionable abuse” which is the test for piercing of the corporate veil in the Companies Act.

Piercing the corporate veil typically involves “looking through” the company and regarding it and its shareholder(s) as being the same person. It doesn’t mean, however, that the company’s existence is being cancelled, but rather that its existence is ignored for a specific enquiry only such as the determination of tax consequences.

Marais says his study showed that there exists a clear remedy against use of the corporate veil for tax purposes in section 20(9) of the Companies Act.

“Section 20(9) appears to be much more effective in combatting abuse of the corporate veil for tax purposes than reliance by Sars on the General Anti-Avoidance Rules contained in the Income Tax Act.

“Once it is determined when an instance of tax avoidance would amount to impermissible tax avoidance, perpetrated through an unconscionable abuse of the corporate veil, the Sars commissioner would be entitled to ‘pierce’ a company’s corporate veil to determine whether a person is liable to pay tax.”

Marais points out that shareholders may use the corporate veil to avoid taxes by transferring shares held by an individual or a trust to a company of which the individual or trust is a shareholder.

“In this way, dividends taxes of the underlying share portfolio is avoided, since South African companies, as shareholders, are typically exempt from dividends taxes on dividends declared to them.

“For income tax purposes in particular it may be beneficial for individuals to involve companies or layered company structures in transactions due to the beneficial regimes that the Income Tax Act affords companies.”

Piercing the corporate veil

According to Marais, piercing of the corporate veil could be quite successfully applied in the tax context, especially in cases where existing remedies in the Income Tax Act would not suffice.

“This particular doctrine has never before been applied in South Africa in a tax context but this could change, especially since the ‘piercing remedy,’ which is traditionally a common law one, has now been legislated to a certain extent.”

Marais adds that it is important to create awareness about the potential application of section 20(9) as a remedy against impermissible tax avoidance because the Income Tax Act’s broad and powerful general anti-avoidance rules do little to address this problem.

“Tax avoidance is a distinctly grey area and the line between permissible and impermissible avoidance is far from clear. Hopefully this study will contribute to make that distinction slightly clearer, especially where tax planning through use of companies is involved.”

ABOUT THE AUTHOR

Dr Alec Basson is the senior science writer at Stellenbosch University.