

# GENERAL ANTI-AVOIDANCE RULES: EXPLORING THE BALANCE BETWEEN THE TAXPAYER'S NEED FOR CERTAINTY AND THE GOVERNMENT'S NEED TO PREVENT TAX AVOIDANCE

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*The Aaronson report released in the United Kingdom in late 2011 addressed the need for a general anti-avoidance rule to be introduced into that jurisdiction's tax legislation. In considering the design of such a rule, the need to maintain certainty from the perspective of the taxpayer was given paramount importance. This paper draws upon the experiences with a general anti-avoidance rule in Australia, New Zealand and Canada, highlighting the uncertainty that such a rule has historically introduced into a nation's tax system.*

## 1. INTRODUCTION

Tax avoidance has existed as long as there has been taxation.<sup>1</sup> Avoidance activities reduce government revenue and undermine the integrity and equity of the tax system.<sup>2</sup> Governments in all jurisdictions face the issue of how to combat it. Many jurisdictions have introduced a statutory general anti-avoidance rule (GAAR) as a primary mechanism to target avoidance.<sup>3</sup> Even the UK, one of the

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<sup>1</sup> Krishna notes that over 6000 years ago some Mesopotamian citizens swam across a river to avoid a toll on the use of a ferry: V Krishna, *Tax Avoidance: The General Anti-Avoidance Rule* (Carswell, 1990) 8.

<sup>2</sup> Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) 7.

<sup>3</sup> Australia: *Income Tax Assessment Act 1936* (Cth) pt IVA (*ITAA 1936* (Cth)); Canada: *Income Tax Act*, RSC 1985 c 1 s 245 (*ITA 1985* (Canada)); Germany: *Abgabenordnung* [General Tax Code] (Germany) § 42; Hong Kong: *Inland Revenue Ordinance* (Hong Kong) cap 112, s 61A; Ireland: *Taxes Consolidation Act 1997* (Ireland) s 811; New Zealand: *Income Tax Act 2007* (NZ) s BG 1, s GA 1 (*ITA 2007* (NZ)); South Africa: *Income Tax Act 1962* (South Africa) ss 80A-80T.

few remaining developed tax systems without a GAAR, has announced that it will introduce a GAAR in 2013,<sup>4</sup> following a recent report by Aaronson QC.<sup>5</sup>

Broadly, tax avoidance is concerned with conduct that is *prima facie* lawful, but that produces tax benefits that are considered unacceptable. In this paper the Australian,<sup>6</sup> New Zealand,<sup>7</sup> and Canadian,<sup>8</sup> income tax GAARs are critically examined to understand how each jurisdiction has approached the distinction between acceptable and unacceptable tax related activities, and the resulting impact on taxpayer certainty. The focus on taxpayer certainty aligns with the recent Aaronson Report, which highlighted certainty as a major issue to be considered in drafting an appropriate GAAR.<sup>9</sup> It is hoped the conclusions drawn will prove useful as the UK enters a process of consultation regarding a GAAR for that jurisdiction.

In this section, GAARs and the concept of avoidance are introduced and the choice of jurisdiction adopted in this paper is explained. In section II, the concept of certainty, the standard against which the GAARs will be held, is introduced. It will be seen that certainty of taxation does not require that the outcome of every particular case be determinable in advance, only that the law is able to operate as a guide to conduct. Sections III and IV consider the Australian, Canadian, New Zealand and indicative draft UK GAAR. Section III outlines the structural elements present in each GAAR. It will be shown that these structural elements do not operate to distinguish acceptable and unacceptable activities. Section IV will critically examine any additional requirements or exceptions to the operation of each GAAR. It is argued that those GAARs considered do not provide any clear or coherent standards that could act as a

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<sup>4</sup> HM Treasury, '2012 Budget' (March 2012) [1.194].

<sup>5</sup> Graham Aaronson QC, 'GAAR Study' (UK Treasury, 2011) ('Aaronson report').

<sup>6</sup> *ITAA 1936* (Cth) pt IVA.

<sup>7</sup> *ITA 2007* (NZ) s BG 1, s GA 1.

<sup>8</sup> *ITA 1985* (Canada) c 1 s 245.

<sup>9</sup> Aaronson, above n 5, [3.13].

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guide to taxpayer conduct, and therefore create unacceptable uncertainty. Finally, in section V it is contended that a positive requirement of a misuse or abuse of a specific provision of a tax statute, having regard to legislated objective factors, best balances the need for certainty and the need to prevent tax avoidance.

### 1.1 What are GAARs?

A GAAR is a taxation law just like any other in many respects. It extends the reach of taxation legislation to arrangements that would not otherwise be caught by the taxation law, and therefore they are charging provisions, and not merely procedural or administrative provisions.<sup>10</sup> GAARs are a general expression of principle, directed at restoring liability to taxation to that which would have resulted from the operation of the ordinary provisions of the taxation law had they operated as intended.<sup>11</sup> A GAAR therefore differs from ordinary charging principles in two key respects. First, they operate generally as they do not seek to target any particular type of taxpayer or activity. Secondly, GAARs target ‘avoidance’ of liability to taxation. This factor is considered below. These differences create a series of challenges for those seeking to draft a GAAR that effectively strikes the balance between taxpayer certainty and the prevention of avoidance.

### 1.2 Avoidance

Avoidance is a slippery concept. This is inherent in the fact that it refers to activity that is perfectly legal yet somehow unacceptable.<sup>12</sup> One clear distinction can therefore be drawn: avoidance is legal. This can be contrasted with evasion of taxation.

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<sup>10</sup> Australia: G T Pagone, *Tax Avoidance in Australia* (Federation Press, 2010); Canada: Krishna, above n 1; Nabil Orow, *General Anti-Avoidance Rules: A Comparative International Analysis* (Jordans, 2000) 61; cf T E McDonnell, *Legislative Anti-Avoidance: The Interaction of the New General Rule and Representative Specific Rules* (Canadian Tax Foundation, 1989) ch 6.

<sup>11</sup> Orow, above n 10, 47, 58-60.

<sup>12</sup> Pagone, above n 10, ch 1.

Evasion involves not paying the correct amount of tax under the ordinary provisions of the law,<sup>13</sup> and usually requires an element of culpability, for example physically hiding income or information from the tax authorities.<sup>14</sup> GAARs are not concerned with evasion.

Historically, this distinction provided both the beginning and the end of the enquiry – if an arrangement was considered to be the *evasion* of a liability to taxation, it was illegal and ineffective. By contrast, those actions that *avoided* taxation were considered to be the legitimate use of the law to mitigate one's liability to taxation. Lord Tomlin in the *Duke of Westminster* case noted that:

Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.<sup>15</sup>

These days are long behind us. Today, governments look upon many avoidance arrangements with a level of distain once reserved for tax evasion.<sup>16</sup> Defined broadly, avoidance encompasses all actions that have the effect of reducing, eliminating or deferring tax liability that are not illegal.<sup>17</sup> Such a definition is so broad as to include physically avoiding incurring a tax liability, for example

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<sup>13</sup> United Kingdom, *Royal Commission on the Taxation of Profits and Income*, Cmd 9474 (1955). A similar definition was adopted by the Carter Commission in Canada: Canada, *Report of the Royal Commission on Taxation* (Queens Press, 1966).

<sup>14</sup> OECD, *International Tax Terms for the Participants in the OECD Programme of Cooperation with Non-OECD Economies* (OECD, 2007).

<sup>15</sup> *Commissioner of Inland Revenue v Duke of Westminster* [1936] AC 1, 19-20.

<sup>16</sup> See, eg, '[W]e are firmly resolved to tackle those who try and avoid tax. Our approach in this area is clear – to deter tax avoidance in any form': HMRC, 'Disclosure of Tax Avoidance Schemes', Consultative document (2009) 4 <<http://customs.hmrc.gov.uk>>. A similar point was made in Tracey Bowler, *Countering Tax Avoidance in the UK: Which Way Forward?* (Tax Law Review Committee, 2009) 10.

<sup>17</sup> Judith Freedman, 'Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle' [2004] *British Tax Review* 332.

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choosing to cross the Thames without incurring a toll,<sup>18</sup> as well as all actions that have the effect of reducing taxation, for example, incurring expenditure in circumstances that qualify for a deduction. Plainly, when governments and revenue authorities speak of countering avoidance, they do not mean to stop taxpayers from deducting expenditure, or to restrict their freedom in choosing how to cross a bridge. Thus, a second key distinction must be drawn. In this paper, acceptable or permissible tax avoidance will be referred to as ‘mitigation’. Unacceptable or impermissible forms of tax avoidance will be referred to as ‘avoidance’. Treated in this way for convenience, the concepts are mutually exclusive. In reality the concepts fall at opposite ends of a continuum. Defined so as to include only unacceptable or impermissible avoidance arrangements, clearly avoidance is an evil that should be combatted. Tax avoidance threatens the integrity of the tax system, and reduces government revenue.<sup>19</sup> In a self-assessment system, a perception of widespread tax avoidance reduces the incentive to comply, increasing the costs of detection and enforcement for revenue authorities.<sup>20</sup> Tax avoidance also undermines the equity of the tax system by enabling certain taxpayers to obtain unintended advantages, thereby distorting the intended distribution of the incidence of taxation.<sup>21</sup>

But exactly which activities are unacceptable or impermissible is a point upon which reasonable minds can and do differ. As Tiley notes, whether something is permissible or acceptable ‘is a conclusion and not a test’ and so merely restates the problem.<sup>22</sup> But the distinction is a necessary and helpful one. President Cooke of the New Zealand Court of Appeal stated that while the distinction ‘can

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<sup>18</sup> Malcolm Gammie, ‘Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom’ in Graeme Cooper (ed) *Tax Avoidance and the Rule of Law* (IBFD, 1997) 198-199.

<sup>19</sup> Review of Business Taxation, above n 2.

<sup>20</sup> Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain, 1799-1914* (Cambridge University Press, 2007).

<sup>21</sup> Brian Arnold, ‘Policy Forum: Confusion Worse Confounded: The Supreme Court’s GAAR Decisions’ (2006) 54 *Canadian Tax Journal* 167.

<sup>22</sup> John Tiley, *Revenue Law* (Hart Publishing, 6<sup>th</sup> ed, 2008) 102.

be elusive on particular facts', it is 'both authoritative and convenient for some purposes'.<sup>23</sup> While the Supreme Court of New Zealand recently considered the distinction to be unhelpful,<sup>24</sup> it is contended that the distinction can assist both in the identification of actions that are acceptable and those that are unacceptable, and also to elucidate factors that assist in determining which side of the line certain actions fall.<sup>25</sup>

A GAAR, being targeted at avoidance, and not mitigation, logically must contain explicit or implicit tests to determine whether a particular arrangement is impermissible. The dictum of Lord Nolan in the *Willoughby* serves as an appropriate working definition of avoidance:

The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.<sup>26</sup>

On this basis, avoidance refers to conduct that reduces, eliminates or defers a tax liability by using the specific provisions of the tax statute in a manner which they were not intended to be used.

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<sup>23</sup> *Hadlee and Sydney Bridge Nominees Ltd v Commissioner of Inland Revenue* (1991) 13 NZTC 8116, 8122.

<sup>24</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 328 [95].

<sup>25</sup> Cf *MacNiven v Westmoreland Investments* [2001] STC 237 [62] (Lord Hoffmann); Lord Walker, 'Ramsay 25 Years on: Some Reflections on Tax Avoidance' (2004) 120 *Law Quarterly Review* 412, 416.

<sup>26</sup> *Commissioner of Inland Revenue v Willoughby* [1997] 4 All ER 65, 73.

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### 1.3 Jurisdictions in the study

Most major Common Law jurisdictions have enacted statutory GAAR, including Australia, New Zealand, Canada, Hong Kong, South Africa and Ireland.<sup>27</sup> Each of these jurisdictions originally adopted the principle from *Duke of Westminster* that every taxpayer is entitled to order their affairs so as to minimise the amount of tax payable.<sup>28</sup> The jurisdictions therefore share a common heritage with the UK tax avoidance jurisprudence. From this list, Australia, New Zealand and Canada have been chosen. Each of these jurisdictions rely on a different approach to distinguish avoidance from mitigation. Additionally, each of these jurisdictions has maintained a GAAR in substantially the same form for at least 14 years,<sup>29</sup> and have been subject to a good deal of judicial analysis. The Irish and South African GAAR are more recent and have not been sufficiently considered by their highest court.<sup>30</sup> The Hong Kong GAAR is stated in relevantly identical terms to the Australian GAAR,<sup>31</sup> and so does not add to the analysis. The UK does not have a statutory GAAR, that jurisdiction historically relying on the judiciary to prevent tax avoidance.<sup>32</sup> In late 2010, Aaronson QC was asked by the Exchequer Secretary to the Treasury to conduct a study to consider whether a GAAR could deter and counter avoidance, whilst providing

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<sup>27</sup> See above n 3.

<sup>28</sup> *Commissioner of Inland Revenue v Duke of Westminster* [1936] AC 1; applied in Australia: *Anderson v Commissioner of Taxes (Vic)* (1937) 57 CLR 233; New Zealand: *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, Canada: *Stuart Investments Ltd v The Queen* [1984] 1 SCR 536; Hong Kong: *Commissioner of Inland Revenue v Douglas Henry Howe* [1977] HKCFI 65; South Africa: *Commissioner of Inland Revenue v Conhage (Pty) Ltd* [1999] 4 SA 1149 (Supreme Court of Appeal); Ireland: *O'Sullivan (Inspector of Taxes) v P Ltd* (1962) 3 ITC 355.

<sup>29</sup> New Zealand: 1974; Australia: 1981; Canada: 1988.

<sup>30</sup> South Africa: 2006; Ireland: 1989.

<sup>31</sup> *Inland Revenue Ordinance* (Hong Kong), cap 112, s 61A.

<sup>32</sup> In recent times, HMRC has relied on scheme disclosure rules to uncover avoidance arrangements, with a view to either challenging schemes in the courts or closing down schemes by way of retrospective legislation: See *Finance Act 2004* (UK) c 12, ss 309-319.

certainty, retaining a tax regime that is attractive to business, and minimising costs for businesses and HMRC.<sup>33</sup> Aaronson QC released his report in November 2011.<sup>34</sup> Where appropriate, this paper will consider the indicative draft GAAR contained within the Aaronson report in light of the experiences of the other jurisdictions, to consider whether the draft GAAR is capable of achieving the lofty goals of Treasury.

## 2. CERTAINTY

It is widely recognised within democratic countries that a law's ends will never justify its means. The legitimacy of the system of law relies largely on the legitimacy of the processes and methods employed by individual laws.<sup>35</sup> A GAAR must itself be legitimate. Certainty of laws provides legal subjects with the ability to comply with the law, and the maximum freedom to act within the boundaries set by the legislature.<sup>36</sup> It is central to the rule of law. Specifically regarding taxation, in 1776, Adam Smith outlined his four canons of taxation: equality, certainty, convenience and economy. In relation to certainty, he noted:

The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer... The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of

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<sup>33</sup> Aaronson, above n 5.

<sup>34</sup> Ibid.

<sup>35</sup> Thomas Aquinas, *Summa Theologiae* (1274), I-II, 18, iv.

<sup>36</sup> Joseph Raz, 'The Rule of Law and its Virtue' (1977) 33 *Law Quarterly Review* 195, 204.



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inequality... is not near so great an evil as a very small degree of uncertainty.<sup>37</sup>

Echoing Adam Smith, the OECD Committee on Fiscal Affairs stated that taxpayers have a right to a high degree of certainty as to the taxation consequences of their actions.<sup>38</sup> The recent Aaronson report highlighted taxpayer certainty as a major issue to be considered in drafting an appropriate GAAR for the UK.<sup>39</sup> Without certainty, taxation is arbitrary. Certainty of taxation enables taxpayers to determine the tax implications of their activities prior to undertaking those activities.<sup>40</sup>

In this section, the concept of the rule of law is introduced as it relates to taxation laws. It will be demonstrated that what the ideal strives towards is not absolute certainty, but rather the ability to guide conduct. Having a specific law to cover every possible outcome (even if possible) would increase the length of the tax statute, but not improve certainty.<sup>41</sup> There will always be vagueness. Vague general terms abound in tax legislation without great controversy.<sup>42</sup> Absolute certainty is not the aim; rather the law should

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<sup>37</sup> Adam Smith, *An Inquiry into the Nature and Causes of The Wealth of Nations* (Encyclopædia Britannica, first published 1776, 1990) 405-6, cited in *British Columbia Railway v The Queen* (1979) 79 DTC 5020, 5025.

<sup>38</sup> OECD, *Taxpayer's Rights and Obligations: A Survey of the Legal Situation in the OECD Countries* (OECD, 1990) [2.21].

<sup>39</sup> Aaronson, above n 5, [3.13].

<sup>40</sup> Canada, above n 13, 554.

<sup>41</sup> J F Avery Jones, 'Tax Law: Rules or Principles?' [1996] *British Tax Review* 580, 581.

<sup>42</sup> See, eg, UK: *Corporation Tax Act 2009* c 4, s 78: Redundancy payments received in relation to two or more employers are to be apportioned 'on a just and reasonable basis'; New Zealand: *ITA 2007* (NZ) s DA 1: A deduction is allowed for expenditure that is incurred 'in the course of carrying on a business for the purpose of deriving [assessable income]', Canada: *ITA 1985* (Canada) s 248: '“Dividend rental arrangement” of a person means any arrangement entered into by the person where it may reasonably be considered that the main reason for the person entering into the arrangement was to enable the person to receive a dividend...', Australia: *ITAA 1936* (Cth) s 6: 'Permanent establishment... means a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes...(b) a place where the person has, is using or is installing substantial

operate as a guide, allowing taxpayers to plan their activities in advance.

## 2.1 Certainty as a goal

It is often suggested that taxpayers who engage in aggressive arrangements that attempt to push the boundaries of the legislation should not be entitled to a high level of certainty in the ordering of their affairs.<sup>43</sup> Recently in the Supreme Court, Lord Walker, anticipating a claim that uncertainty would result from the decision he was handing down, noted that any uncertainty created ‘will arise from the unremitting ingenuity of tax consultants and investment bankers determined to test the limits of [the specific provision].’<sup>44</sup>

Freedman<sup>45</sup> and Dunbar<sup>46</sup> have suggested that certainty, while important in tax law generally, is not the primary aim of a GAAR and so should not be the primary focus of any enquiry into the validity of the legislative rule. Freedman argues that unlike the line between conduct that is evasion and that which is not, the line between mitigation and avoidance need not be drawn with any great precision.<sup>47</sup> This is because sanctions for evasion include imprisonment, and therefore a high degree of certainty is required

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equipment or substantial machinery’. In the above provisions, the terms ‘just and reasonable’, ‘carrying on a business’, ‘the main reason’, and ‘substantial machinery’, are vague: they do not permit a precise line to be drawn between acceptable and unacceptable positions, and yet they operate to guide conduct.

<sup>43</sup> Lord Templeman, ‘Tackling Tax Avoidance’ in Adrian Shipwright (ed) *Tax Avoidance and the Law: Sham, Fraud or Mitigation* (Key Haven Publications, 1997) 3; David Dunbar, ‘A Comparative Study of Four Commonwealth Countries Approach to the Problem of Tax Avoidance: Lessons from the Past’ (Paper presented at Accounting Business and Financial History Conference, Cardiff, September 2008) <[www.caerdydd.ac.uk/carbs/conferences/abfh2008/dunbar.pdf](http://www.caerdydd.ac.uk/carbs/conferences/abfh2008/dunbar.pdf)>, 8.

<sup>44</sup> *Tower MCashback LLP v Revenue and Customs Commissioners* [2011] 2 AC 457, 491 [80].

<sup>45</sup> Freedman, above n 17, 354-355

<sup>46</sup> Dunbar, above n 43, 8.

<sup>47</sup> Freedman, above n 17, 346.

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even if it means that some questionable activities are not caught.<sup>48</sup> By contrast, to define avoidance with such precision would only lead to ‘creative compliance’ and thus have the unintended effect of *increasing* avoidance.<sup>49</sup>

This can all be readily acknowledged. A GAAR will derive its effectiveness against unforeseen and unpredictable forms of tax avoidance by relying on broad terms and principles,<sup>50</sup> and thus to define the outer limits of a GAAR with precision would likely render the provision ineffective. But this does not mean certainty is not a relevant consideration. Freedman’s and Dunbar’s arguments proceed on the basis that where avoidance is found, no penalties are imposed; merely tax is restored to that which it should have been.<sup>51</sup> Under this view, taxpayers lose nothing by seeking to avoid taxation unsuccessfully; therefore a fuzzy boundary between acceptable and unacceptable activities can be tolerated. But this ignores the real world pressures faced by taxpayers. Virtually all business transactions will be influenced by taxation considerations,<sup>52</sup> and often taxation considerations will determine whether or not planned activities are viable or not. It is fallacious to suggest that taxpayers will lose nothing where tax is imposed retrospectively. Such action would have significant dampening effects on economic activity.<sup>53</sup> In this regard, some measure of certainty must be provided to taxpayers. Additionally, in Australia and New Zealand, a significant penalty is

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<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*; the reference to ‘creative compliance’ is to Doreen McBarnet and Christopher Whelan, ‘The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control’ (1991) 54 *Modern Law Review* 848.

<sup>50</sup> *Orow*, above n 10, 244.

<sup>51</sup> *Freedman*, above n 17, 353-356; *Dunbar*, above n 43, 8-9.

<sup>52</sup> *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216, 227 [15]-[16] (Gleeson CJ and McHugh J).

<sup>53</sup> G T Pagone, ‘Tax Uncertainty’ (2009) 33 *Melbourne University Law Review* 886, 903.

imposed where the GAAR is found to apply.<sup>54</sup> In light of such consequences, the argument for certainty becomes even stronger.

## 2.2 The rule of law

The rule of law is one of the most important doctrines underpinning the system of law and government in democratic states.<sup>55</sup> While a difficult and complex concept, Hayek defines the essence of the rule of law as follows:

[G]overnment in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one’s individual affairs on the basis of this knowledge.<sup>56</sup>

This definition highlights two key factors that underpin the notion of the rule of law. Firstly, the emphasis on rules being fixed and announced in advance highlights that individuals must be governed by known rules and not by whim or discretion.<sup>57</sup> The second element is that emphasised by Raz, namely that the essence of the rule of law is that the law must be capable of guiding the behaviour of its subjects.<sup>58</sup>

## 2.3 Governed by law, not administrative discretion

The rule of law requires that individuals must be governed by law, and not by administrative discretion. All legal rules should meet various criteria, including, inter alia, that they be prospective, not

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<sup>54</sup> Australia: 50% of the shortfall amount (reduced to 25% where the position taken was ‘reasonably arguable’): *Taxation Administration Act 1953* (Cth) sch 1 s 284-160; New Zealand: 100% of the shortfall amount (reduced to 20% in certain circumstances): *Tax Administration Act 1994* (NZ) s 141D.

<sup>55</sup> Tom Bingham, *The Rule of Law* (Penguin, 2010) 171.

<sup>56</sup> F A Hayek, *The Road to Serfdom* (G Routledge & Sons, 1944) 54.

<sup>57</sup> See generally, A V Dicey, *Introduction to the Study of the Law of the Constitution* (Macmillan, first published 1885, 10<sup>th</sup> ed 1985) 188; Lon Fuller, *The Morality of Law* (Yale University Press, 2<sup>nd</sup> ed, 1969) 59-62.

<sup>58</sup> Joseph Raz, *The Authority of Law* (Clarendon Press, 1979) 214.

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retrospective; that they are possible to comply with; are published; and reasonably stable through time.<sup>59</sup> An uncertain law is in effect a retrospective law: it was not possible to determine what the law was prior to undertaking the relevant action. For a GAAR to meet this ideal, it would require a clear and coherent mechanism under which mitigation could be consistently distinguished from avoidance. A broad based administrative discretion would be insufficiently certain and thus contrary to the rule of law. The innocent 'should not have to depend on the administrative discretion of revenue officials as to whether they will suffer the full rigours of a too widely drawn provision.'<sup>60</sup>

But a GAAR, even when drafted with an appropriate mechanism to distinguish avoidance from mitigation, will rely, to some extent, on administrative discretion. This is an inevitable and often positive aspect of the tax system: administrative discretion is not an evil to be avoided at all costs. Administrative discretion allows for the efficient application of the GAAR on a case-by-case basis, in circumstances where parliament or the courts themselves could not effectively do so.<sup>61</sup> But there must be limits to the discretion. It must be borne in mind that the revenue authority is an administrative body that is charged with interpreting and applying the tax legislation, and collecting the tax calculated thereunder. The fox is in charge of the hen house. There is clearly a delicate balance between the revenue authority's role of dispassionately interpreting tax legislation on the one hand, while maximising tax receipts on the other. This balance can only be maintained where any discretion vested in the revenue authority is subject to clear and coherent standards against which the courts can compare their conduct. In the context of a GAAR, in the absence of such factors, the revenue authority is left to determine

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<sup>59</sup> Fuller, above n 57, 33-94.

<sup>60</sup> Robert Venables QC, 'Tax Avoidance: A Practitioner's Viewpoint' in Adrian Shipwright (ed) *Tax Avoidance and the Law: Sham, Fraud or Mitigation* (Key Haven Publications, 1997) 64.

<sup>61</sup> K Brooks, 'A Reasonable Balance: Revenue Authority Discretions and the Rule of Law in Canada' in Chris Evans, Judith Freedman and Rick Krever (eds) *The Delicate Balance: Tax, Discretion and the Rule of Law* (IBFD, 2011) 69.

which activities constitute avoidance. They are, in effect, being asked not merely to apply the law, but to create it. These are matters more appropriately left to parliament.

## 2.4 A certain law is a law that guides conduct

Generally speaking, laws should be clear enough to allow individuals to regulate their affairs in advance.<sup>62</sup> Yet vague and imprecise concepts are a regular feature within Common Law systems. General legal principles such as ‘reasonableness’ and ‘due skill and care’ are common examples, as are important technical concepts such as ‘income’ and ‘carrying on a business’.<sup>63</sup> Endicott has shown that vagueness is a necessary feature of all legal systems.<sup>64</sup> Vagueness, in this sense, does not mean that laws should be ‘obscure or radically indeterminate’, but rather is an acknowledgement that the application of rules within a legal system will give rise to significant range of ‘borderline cases’, where the application of laws is subject to doubt and disagreement.<sup>65</sup> Such vagueness will only be tolerated up to a point: individuals must still be able to plan their lives in accordance with law. A statute stipulating that a ‘reasonable’ amount of tax was to be paid by all taxpayers would be unacceptable for uncertainty. The fact that some indeterminacy will remain at the borderline is not a reason for wholly abandoning the concept of the rule of law. Endicott, discussing a legislative rule that required criminal prosecutions to be brought within a ‘reasonable time’, explained it as follows:

To make sense of the organising principle of the ideal [of the rule of law], we need to distinguish between using the law as a guide, and

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<sup>62</sup> Judith Freedman and John Vella, ‘HMRC’s Management of the U.K. Tax System: The Boundaries of Legitimate Discretion’ in Chris Evans, Judith Freedman and Rick Krever (eds) *The Delicate Balance: Tax, Discretion and the Rule of Law* (IBFD, 2011) 95.

<sup>63</sup> See generally, Timothy Endicott, *Vagueness in Law* (OUP, 2000) ch 3.

<sup>64</sup> Timothy Endicott, ‘Law Is Necessarily Vague’ (2001) 7 *Legal Theory* 379, 384-385; *ibid*, 190.

<sup>65</sup> Endicott, *ibid* n 64, 379.

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using the law to dictate an outcome in every possible case. We need to find a sense of ‘guide’ in which a requirement of trial within a reasonable time *can* guide behaviour. And, of course, it can – not by giving the prosecution a deadline, but by giving them a reason to act as soon as they are able to (not simply to avoid the hazard that a delay will be held unreasonable, but in order to be able to account for themselves as having reasons for the time they take).<sup>66</sup>

In this case, relying on the ‘vague’ concept of reasonableness is preferable to a series of specific rules setting out precisely what is acceptable in every possible scenario. Such rules, even if possible in reality, would not operate as a guide to conduct, but merely provide the prosecution with a mechanism to avoid being labelled ‘unreasonable’. Similarly, a GAAR must be a vague law. The UK Tax Law Review Committee noted that the virtually infinite number of possible fact patterns means that legislation ‘cannot realistically aspire to answer every question. In this sense, complete immediate certainty is unattainable.’<sup>67</sup> Avery Jones comments that the quest for greater certainty has resulted in more and more detail in an attempt to answer every possible question.<sup>68</sup> The result is extremely long and complex legislation, and, in the UK at least, an increased reliance on stretched (or strained?) interpretation,<sup>69</sup> by the courts in an attempt to find the appropriate outcome in each particular case. This has led to unacceptable uncertainty.

### 2.5 Beauty and the beast

An appropriately drafted GAAR would contain clear and consistent standards known to taxpayers in advance, but would not absolve the need for administrative discretion. A GAAR should provide taxpayers, the revenue authority and the courts with a clear and coherent mechanism able to be applied consistently to determine whether an arrangement is of a type caught by the GAAR. A GAAR

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<sup>66</sup> Endicott, above n 63, 203.

<sup>67</sup> Tax Law Review Committee Institute for Fiscal Studies, *Interim Report on Tax Legislation* (IFS, 1995) [3.21].

<sup>68</sup> Avery Jones, above n 41, 581.

<sup>69</sup> Aaronson, above n 5, [1.7].

in these circumstances would operate as a guide to conduct, not merely as a broad based administrative discretion. In this way, the GAAR would meet the needs of taxpayers, the revenue authority, the courts and the legislature, because:

- taxpayers would be able to foresee, with a reasonable degree of accuracy, the taxation consequences of their actions prior to undertaking a course of action;
- the revenue authority will have clear and coherent standards to apply to determine whether particular actions are acceptable or not; and
- the courts will have clear and coherent standards by which to give effect to the GAAR, and to test the appropriateness of the exercise of any discretion by the revenue authority.

### 3. GAARs

All GAARs share certain common characteristics. Broadly, a GAAR will operate where a taxpayer (i) undertakes an arrangement, that (ii) results in a tax benefit, where the taxpayer or arrangement (iii) has, or is deemed to have had, a proscribed purpose. These elements form the physical criteria of operation (i & ii) and the mental criteria of operation (iii) respectively.<sup>70</sup> All statutory GAARs also contain a reconstructive element, under which liability to taxation is restored to that which would have existed had the ordinary provisions of the taxation law operated as intended. In this section, the physical and mental definitional criteria will be outlined. It will be demonstrated that neither criterion provides any logical basis for distinguishing avoidance from mitigation.

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<sup>70</sup> Orow, above n 10, 75.



## GENERAL ANTI-AVOIDANCE RULES

### 3.1 Introducing the GAARs

The Australian GAAR was enacted in its current form in 1981.<sup>71</sup> It is contained in Part IVA of the *ITAA 1936* (Cth), comprising ss 177A to 177H of that statute.<sup>72</sup> The New Zealand GAAR is contained in ss BG 1 and GA 1 of the *ITA 2007* (NZ), with relevant terms defined in s YA 1 of the same act.<sup>73</sup> The current wording is identical to that used in earlier New Zealand GAARs since 1974.<sup>74</sup> The Canadian GAAR was enacted in largely its current form in 1988 as s 245 of the *ITA 1985* (Canada).<sup>75</sup>

### 3.2 Arrangement

For a GAAR to apply, it must firstly be shown that there was some transaction, scheme or arrangement undertaken by the taxpayer. While the language adopted in each jurisdiction is different: ‘scheme’,<sup>76</sup> ‘arrangement’,<sup>77</sup> or ‘transaction’,<sup>78</sup> all have the

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<sup>71</sup> *Income Tax Laws Amendment Act (No 2) 1981* (Cth). Note that the Australian Government has announced that changes to Part IVA are under consideration and any changes will be retrospective to 1 March 2012. Further details on these changes are not known: Mark Arbib, Assistant Treasurer, ‘Maintaining the Effectiveness of the General Anti-Avoidance Rule’ (Press Release, 010, 1 March 2012) <<http://www.treasurer.gov.au>>.

<sup>72</sup> For more information and background on the Australian GAAR, see Pagone, above n 10.

<sup>73</sup> For more information and background on the New Zealand GAAR, see James Coleman, *Tax Avoidance Law in New Zealand* (CCH New Zealand, 2009).

<sup>74</sup> *Land and Income Tax Amendment Act (No. 2) 1974* (NZ). See former *Land and Income Tax Act 1954* (NZ) s 108; *Income Tax Act 1976* (NZ) s 99; *Income Tax Act 2004* (NZ) s BG 1.

<sup>75</sup> *Bill C-139, An Act to amend the Income Tax Act 1988* (Canada). For more information and background on the Canadian GAAR, see Innes, Boyle and Nitikman, *The Essential GAAR Manual: Policies, Principles and Procedures* (CCH Canada, 2006)

<sup>76</sup> Australia: *ITAA 1936* (Cth) s 177C(3). ‘Scheme’ is defined in s 177A(1) to mean ‘(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and (b) any scheme, plan, proposal, action, course of action or course of conduct.’

same effect. Whichever term is adopted, it is defined in broad terms so as to include all forms of conduct entered into by taxpayers, regardless of whether it produces a tax benefit or not. In this way, the initial definitional element does not seek to distinguish between prohibited and acceptable conduct, but rather to ensure there is no prospect of taxpayers avoiding the operation of the GAAR by undertaking a particular form of dealing.

Each GAAR empowers the revenue authority to define the relevant scheme, arrangement or transaction entered into by the taxpayer.<sup>79</sup> How the arrangement is defined will be critical to the operation of the GAAR because it is the ‘arrangement’ that must produce the tax benefit; and the ‘arrangement’ that is tested to determine the objective purpose of the taxpayer. In this way all three definitional criteria are linked. How broadly or narrowly the arrangement can be defined will also have implications for the scope of the GAAR. Should a series of related transactions be considered as one single composite arrangement or as several independent arrangements? A broadly defined arrangement is more likely to be found to have an overall non-tax purpose. Conversely, narrowly construing the arrangement would render the GAAR more likely to apply to the arrangement. Courts in most jurisdictions have recognised this and sought to limit the specificity with which an

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<sup>77</sup> New Zealand: *ITA 2007* (NZ) s BG 1(1): ‘Tax Avoidance arrangement’ is defined in s YA (1) *ITA 2007* (NZ) as ‘any contract, agreement, plan or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect’. See also the proposed UK GAAR, Aaronson, above n 5, 53-54: an ‘arrangement’ – ‘(a) includes any plan or understanding, whether or not legally enforceable; and (b) also includes any step or feature which is intended to be included, and which is in fact included, as an element of an arrangement, whether or not the inclusion of that element as part of the arrangement is legally enforceable or factually inevitable.’

<sup>78</sup> Canada: *ITA 1985* (Canada), s 245(3): ‘Avoidance transaction’ includes ‘an arrangement or event’

<sup>79</sup> In the remainder of this paper, the term ‘arrangement’ is used for brevity, except where referring to the legislation of a specific jurisdiction, in which circumstance the legislative term is used.

## GENERAL ANTI-AVOIDANCE RULES

arrangement may be defined. The Canadian Supreme Court approaches this by defining the arrangement by reference to the tax benefit produced.<sup>80</sup> The majority of the Supreme Court of New Zealand in *Ben Nevis* implicitly followed the same approach by defining the arrangement, in that case, to be all those elements that led to a tax benefit.<sup>81</sup> In Australia, notwithstanding the very wide definition of ‘scheme’, the High Court has indicated that circumstances will not constitute a scheme where they are ‘incapable of standing on their own without being robbed of all practical meaning.’<sup>82</sup> This means that the revenue authority cannot identify one particular step of an arrangement as the relevant scheme unless it has some independent practical significance.

Therefore, in each jurisdiction ‘scheme’, ‘transaction’ or ‘arrangement’ is defined extremely broadly so as to include all forms of conduct entered into by taxpayers, regardless of whether it produces tax benefit or not. In this way, the first definitional element does not seek to distinguish between prohibited and acceptable conduct, but rather to ensure there is no prospect of taxpayers avoiding the GAAR on the basis of a particular form of dealing. The courts in each jurisdiction have sensibly sought to limit the specificity with which an arrangement can be defined, to ensure the GAAR does not operate too broadly.

### 3.3 Tax benefit

Secondly, the ‘arrangement’ as identified must produce a tax benefit or advantage. Australia<sup>83</sup> and Canada<sup>84</sup> refer to the obtaining of a ‘tax benefit’, while New Zealand refers to ‘tax avoidance’.<sup>85</sup> Again, the effect is broadly the same: the term chosen is defined in

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<sup>80</sup> *Cophorne Holdings Ltd v Canada* [2011] 3 SCR 721, [33] citing *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601.

<sup>81</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 333 [115].

<sup>82</sup> *Peabody v Federal Commissioner of Taxation* (1993) 181 CLR 359, 381.

<sup>83</sup> *ITAA 1936* (Cth) s 177C(1).

<sup>84</sup> *ITA 1985* (Canada) s 245(1).

<sup>85</sup> *ITA 2007* (NZ) s YA 1.

broad terms to ensure that any arrangement that reduces the amount of tax payable, or provides a timing advantage,<sup>86</sup> can potentially be caught by the GAAR. In this way, it does not seek to distinguish between avoidance and evasion, but rather to ensure that all forms of tax benefit, acceptable or not, are caught.

But logically, how can there ever be a tax benefit? A taxpayer, in determining its liability to taxation will, in the absence of criminal evasion, apply the tax legislation to its circumstances as they exist at that time. They obtain a deduction only where the law so provides, and recognise income only where the law requires them to do so. In these circumstances it appears illogical to suggest that a tax benefit can be obtained: the tax payable is the tax payable, and there can be no benefit or detriment. This issue is overcome by comparing the amount of tax payable under the arrangement as defined, to a hypothetical determination of the amount of tax that would have been payable in the absence of the arrangement. The difference between the two amounts is the tax benefit.

Part IVA of the *ITAA 1936* (Cth) provides that a tax benefit arises where a scheme results in an amount not being included in the assessable income of the taxpayer, where that amount would have been, or might reasonably be expected to have been, included if the scheme had not been entered into or carried out;<sup>87</sup> or a deduction being allowable to the taxpayer where all or part of that deduction would not, or might reasonably be expected not to have been allowable if the scheme had not been entered into or carried out.<sup>88</sup> Part IVA therefore requires a comparison between what occurred and a hypothetical alternative scenario. Writing extra-judicially, Justice Pagone has emphasised that the purpose of this comparison is to ensure that it was the scheme itself that caused the tax benefit obtained: it must be shown that the *specific* benefit obtained would

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<sup>86</sup> By deferring the derivation of income or accelerating the deductibility of expenditure.

<sup>87</sup> *ITAA 1936* (Cth) s 177C(1)(a).

<sup>88</sup> *Ibid* s 177C(1)(b).

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not have been obtained in the absence of the scheme.<sup>89</sup> It is, therefore, irrelevant whether a different, equally beneficial, tax outcome would have been achieved by different means. In *Peabody*, the High Court stated that to be ‘reasonably expected’ a certain state of affairs must be more than a mere possibility, and sufficiently reliable to be considered reasonable.<sup>90</sup>

Section 245(1) of the *ITA 1985* (Canada) does not expressly refer to a hypothetical alternate state of affairs. ‘Tax benefit’ is defined there to mean a reduction, avoidance or deferral of tax or an increased refund of tax. Theoretically this would include every ordinary deduction, as even, for example, wages expense incurred by a business taxpayer reduces the amount of tax otherwise payable. Logically, the idea of a tax ‘benefit’ implies that there has been a comparison between two or more states of affairs, one of which produces a more favourable outcome. This was the approach adopted by the Canadian Tax Court in one of the first GAAR cases to come before it, where it was held that a reduction or avoidance of taxation requires the identification of a norm or standard against which the reduction or avoidance can be measured.<sup>91</sup> While the Supreme Court in *Canada Trustco* suggested that a deduction is on its own a reduction of tax, and therefore would constitute a tax benefit for the purposes of s 245,<sup>92</sup> this approach appears to have been abandoned in the more recent Supreme Court decision of *Copthorne* where the court held that to determine a tax benefit, it is appropriate to compare the transaction to what ‘might reasonably have been carried out but for the existence of the tax benefit.’<sup>93</sup>

Section YA 1 of the *ITA 2007* (NZ) defines ‘tax avoidance’ very broadly to include directly or indirectly altering the incidence of income tax, or avoiding, reducing or postponing any liability to

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<sup>89</sup> Pagone, above n 10, ch 4.

<sup>90</sup> *Peabody v Federal Commissioner of Taxation* (1993) 181 CLR 359, 385.

<sup>91</sup> *McNichol v The Queen* (1997) 97 DTC 111, 119.

<sup>92</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 612 [15].

<sup>93</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [35] citing David Duff et al, *Canadian Income Tax Law* (LexisNexis, 3rd ed, 2009) 187.

income tax. As with the Canadian provision, prima facie this definition would include every deduction, credit or other reduction in tax provided for under the legislation. Notwithstanding that this difficulty was recognised by the courts almost half a century ago,<sup>94</sup> the courts generally do not require any comparison to be drawn, and simply adopt the benefit as identified by the revenue authority without consideration.<sup>95</sup> In *Ben Nevis*, the Supreme Court held that once an arrangement is identified, the burden shifts to the taxpayer to show that the transaction was not a tax avoidance transaction.<sup>96</sup> While not undertaken in *Ben Nevis* itself, it appears that the Supreme Court does advocate the comparison to an alternative hypothetical scenario. The court cited *BNZ Investments Ltd* with approval where it stated that ‘something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify [the application of the GAAR].’<sup>97</sup> Presumably therefore, the existence of a tax benefit when compared to a hypothetical state of affairs, while not determinative of the application of the GAAR, would be a necessary precondition to its application.

But in each jurisdiction, the fact that a tax benefit has been obtained by entry into an arrangement that would not have been obtained in the absence of the arrangement does not necessarily mean that the arrangement should be considered to be tax avoidance.

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<sup>94</sup> ‘Nearly all dispositions of property or income must carry with them some consequential effect upon income tax liabilities’: *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683, 688 (Woodhouse J).

<sup>95</sup> ‘In establishing whether there is tax avoidance, the courts (including the Supreme Court in *Ben Nevis*) have typically come to a conclusion without embarking on any detailed analysis of the statutory definition of “tax avoidance” and, at times, have not referred to the definition at all’: New Zealand Inland Revenue Department, ‘Interpretation Statement: Draft for Comment and Discussion: Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007’ (16 December 2011) [170].

<sup>96</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 333 [115].

<sup>97</sup> *Ibid* 328 [96] citing *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 450, 463 [40].

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The fact that it was possible to pay more tax does not mean the arrangement should be disallowed without more. For example, deciding to lease an asset rather than purchase it often creates tax benefits. Parliament has expressly provided these benefits by enacting specific provisions with the effect that the tax consequences of leasing an asset are different to those where the same asset is purchased outright. The existence of these benefits does not mean that a GAAR should apply.

From the foregoing it is clear that the finding of a tax benefit does not distinguish avoidance from mitigation. Nor is it intended to. A finding that there is an arrangement which produced a tax benefit merely shows that there was some form of arrangement which, had it been undertaken in a different manner, would not have provided the benefit. Avoidance must be distinguished from mitigation in some other way.

### 3.4 Purpose

Each GAAR relies on a mental element in an attempt to distinguish avoidance from mitigation. This proceeds from the idea that impermissible avoidance occurs where a taxpayer enters into an arrangement with a purpose of avoiding taxation, whereas mitigation involves the obtaining of a tax benefit in circumstances where this was not the purpose for entering the arrangement. There is no basis in logic for this idea. Tax avoidance is a commercial purpose, and is identical to a purpose of mitigation, which is permissible. Additionally, given the many incentives and inducements provided through tax legislation, entering into an arrangement with the purpose of paying less tax may be consistent with the parliamentary intention.

Section BG 1(1) of the *ITA 2007* (NZ) applies to all arrangements that directly or indirectly have tax avoidance 'as its purpose or effect' or 'one of its purposes or effects' where that purpose or effect is 'not merely incidental'.<sup>98</sup> The GAAR applies

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<sup>98</sup> *ITA 2007* (NZ) s YA 1.

whether or not any other purpose or effect is referable to ordinary business or family dealings.<sup>99</sup> In *Challenge Corporation*, Woodhouse P held that ‘not merely incidental’ means ‘something that is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant.’<sup>100</sup> This will be a question of fact and degree in each case.<sup>101</sup> ‘Not merely incidental’ is an extremely low threshold. Such a low threshold of purpose means the GAAR will apply to many ordinary commercial activities.

In contrast to s BG 1(1), the Australian and Canadian GAARs require a stronger tax avoidance purpose. Part IVA of the *ITAA 1936* (Cth) operates where a taxpayer obtains a tax benefit, in connection with a scheme, in circumstances where it is concluded that the taxpayer entered into or carried out the scheme for the ‘dominant purpose’ of enabling a taxpayer to obtain a tax benefit.<sup>102</sup> The Australian courts have interpreted ‘dominant’ to mean the ‘ruling, prevailing or most influential’ purpose.<sup>103</sup>

In determining the dominant purpose of the taxpayer, the legislation specifies certain factors that the court must take into account:

- the form and substance of the scheme;
- the time at which the scheme was entered into and the duration of the scheme;
- the result in relation to the operation of this Act that, but for Part IVA, would be achieved by the scheme;

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<sup>99</sup> *Ibid.*

<sup>100</sup> *Commissioner of Inland Revenue v Challenge Corporation Ltd* [1986] 2 NZLR 513, 533 (Court of Appeal) cited in *Westpac Banking Corporation v Commissioner of Inland Revenue* [2011] NZSC 36 [208].

<sup>101</sup> *Challenge Corporation* [1986] 2 NZLR 513, 534 (Court of Appeal).

<sup>102</sup> *ITAA 1936* (Cth) s 177D(b), s 177A(5).

<sup>103</sup> *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 416.



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- any actual or reasonably expected change in the financial position of the relevant taxpayer or any connected persons; and
- any other consequences for the taxpayer and connected persons.<sup>104</sup>

The purpose enquiry is reversed under the Canadian GAAR, where a tax avoidance purpose is assumed in the absence of purposes for undertaking the arrangement other than a tax benefit. Section 245(3) of the *ITA 1985* (Canada) provides that every transaction that results in a tax benefit will be an ‘avoidance transaction’, and hence subject to the application of the GAAR, ‘unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.’

While each jurisdiction approaches the issue of purpose in a slightly different manner, each test requires a determination of the objective purposes of the taxpayer, or the arrangement itself. It then requires a weighing of the various and, presumably, competing purposes of the arrangement, both tax and non-tax, to determine whether overall a not-insignificant, dominant, or primary purpose was the obtaining of a tax benefit.

### 3.5 The problem with purpose

One difficulty with the use of purpose often raised by critics is that there is no common standard against which the different objective purposes of a taxpayer could be weighed,<sup>105</sup> and that even if it was possible to weigh the various purposes, the terms ‘dominant’, ‘primary’, or ‘not merely incidental’ are too vague and imprecise to ensure that the GAAR is applied consistently.<sup>106</sup> Such an objection can be dealt with swiftly. As outlined in section II, modern tax statutes are replete with vague expressions that operate as an effective guide to conduct and provide courts with the flexibility they need to ensure

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<sup>104</sup> *ITAA 1936* (Cth) s 177D(b).

<sup>105</sup> Walter Blum, ‘Motive, Intent and Purpose in Federal Income Taxation’ (1967) 34 *University of Chicago Law Review* 485, 509-510; Orow, above n 10, 128-130.

<sup>106</sup> Blum, above n 105, 509-510.

appropriate outcomes are achieved in specific cases.<sup>107</sup> The fact that a provision is vague is not itself a problem. Vagueness is acceptable so long as the provisions in question are capable of guiding conduct. Courts will have no difficulty determining whether a purpose is ‘dominant’, ‘primary’ or ‘not merely incidental’, or at least no more difficulty than they face in determining whether an amount is ‘ordinary income’ or finding that duties were undertaken with ‘due skill and care’. Therefore this particular objection should be ignored.

The more important difficulty faced in relying on purpose to distinguish mitigation from avoidance is that having tax avoidance as a purpose is not mutually exclusive from having a business or private purpose. The Canadian GAAR does not apply where a transaction is entered for bona fide purposes,<sup>108</sup> or bona fide commercial purposes,<sup>109</sup> *other than* the obtaining of a tax benefit. Obtaining a tax benefit, therefore, is considered to be a bona fide purpose in and of itself. The High Court of Australia in *Spotless* noted that an intention to avoid or mitigate liability to taxation could itself be a rational commercial decision:

A person may enter into or carry out a scheme, within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.<sup>110</sup>

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<sup>107</sup> See above n 42 and accompanying text.

<sup>108</sup> *ITA 1985 (Canada)* s 245(3).

<sup>109</sup> *ITA 1985 (Canada)* s 80A.

<sup>110</sup> *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404, 415.

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This is frequently referred to as the Part IVA ‘false dichotomy’.<sup>111</sup> Taxation is a significant and real commercial consideration for all taxpayers. In the context of companies, the directors are under a positive duty to act in the best interests of the company, which would presumably require them to minimise the amount of tax paid.<sup>112</sup> Virtually all business transactions will be influenced by taxation considerations. If reducing tax payable is a genuine commercial consideration, why should the intention to do so be a factor in determining whether that particular reduction is acceptable?

Additionally, from a tax policy perspective there is no obvious reason why a taxpayer’s purpose should play any role in distinguishing avoidance from mitigation.<sup>113</sup> Whether an arrangement is entered into for the purpose of avoiding tax, or for other non-tax reasons, it will have the same effect of reducing, eliminating or deferring tax liability.<sup>114</sup> It will reduce government revenue, and undermine the integrity and equity of the taxation system. Given that these are the reasons cited when justifying the need to combat avoidance,<sup>115</sup> it is not clear why taxpayer purpose should lead to a finding of tax avoidance. Unlike the criminal law, where purpose forms a clear distinction between those actions that are punished (because intentional) and those that are not (because unintentional), there is no similar clear distinction for taxation laws between those activities that are intentional and those that are not.<sup>116</sup> This is because an intention to avoid tax (which is impermissible) is indistinguishable from an intention to minimise tax (which is permitted). Both mitigation and avoidance arrangements are

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<sup>111</sup> *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 249.

<sup>112</sup> *IRC v Burmah Oil Co Ltd* [1982] STC 30, 37 (House of Lords); S E K Hulme, ‘Tax Avoidance’ in John Wilkes (ed) *The Politics of Taxation* (Hodder and Stoughton, 1980) 228.

<sup>113</sup> Orow, above n 10, 140.

<sup>114</sup> *Ibid* 140-141.

<sup>115</sup> See above nn 19-21 and accompanying text.

<sup>116</sup> Orow, above n 10, ch 4.

structured so as to maximise the resulting tax benefits. The same transaction can be carried out for tax reasons, or for private or commercial reasons,<sup>117</sup> and will therefore likely possess the same attributes. Any objective consideration of those attributes, therefore, will yield the same conclusion as to purpose. These problems are particularly pronounced given that the courts, at least in New Zealand and Canada, continue to uphold the right of taxpayers to conduct their affairs in a manner that minimises the amount of tax payable.<sup>118</sup> Given this right, it is both logical and reasonable to expect that taxpayers should be able to utilise it intentionally.<sup>119</sup>

Finally, the existence of a purpose of obtaining a tax benefit does not necessarily mean that the arrangement will frustrate the intention of parliament. Modern tax statutes are often used as a policy tool to encourage or discourage particular activities, in addition to simply raising revenue. Justice Estey in *Stuart Investments v The Queen* stated, in the Canadian context, that

[M]odern taxing statutes, may have a dual aspect. Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the

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<sup>117</sup> Ibid 125-6.

<sup>118</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 332 [111]: ‘Taxpayers have the freedom to structure transactions to their best tax advantage. They may utilise available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits. They cannot, however, do so in a way that is proscribed by the general anti-avoidance provision’; *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [65]: ‘Taxpayers are entitled to select courses of action or enter into transactions that will minimize their tax liability (see *Duke of Westminster*)’.

<sup>119</sup> Orow, above n 10, 142.

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taxpayer for whom the induced action would otherwise have no bona fide business purpose.<sup>120</sup>

Parliament often positively encourages taxpayers to undertake particular activities by providing incentives and inducements in the form of tax benefits, and by providing structural choices in the legislation. Taxpayers that organise their affairs so as to take advantage of the inducements or incentives, even where their sole purpose is to obtain the tax benefit, should not be caught by a GAAR, as their actions are furthering, not frustrating, the legislative intention.<sup>121</sup>

The many difficulties associated with reliance on ‘purpose’ in the application of a GAAR led the Aaronson committee to reject such a requirement in their indicative draft GAAR for the UK.<sup>122</sup> The report states that

[T]he various instances where the UK tax rules provide incentives and inducements indicates that in some instances tax avoidance is positively encouraged... [and] not something to be criticised... and thus should not be caught by the GAAR.<sup>123</sup>

The operation of the Aaronson indicative draft GAAR is for this reason not conditional upon a finding of taxpayer purpose. The GAAR instead relies on particular elements of the arrangement itself to trigger operation, namely, a conclusion that the arrangement is ‘abnormal’ having regard to certain factors.<sup>124</sup> Purpose, however, is not ignored entirely; the concept is relevant to the application of the GAAR in two respects.

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<sup>120</sup> *Stuart Investment Ltd v The Queen* [1984] 1 SCR 536, 575-576.

<sup>121</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 617 [42] cited in *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [67].

<sup>122</sup> Aaronson, above n 5, [5.14].

<sup>123</sup> *Ibid.*

<sup>124</sup> Discussed below at nn 192-194.

First, ‘abnormal arrangement’ is defined as an arrangement that includes a feature or features that were included for the *purpose* of achieving an advantageous tax result.<sup>125</sup> In this manner it appears that the same problems outlined above are imported into the GAAR, notwithstanding that no overall purpose analysis is undertaken. An added difficulty with this approach is that the references to ‘purpose’, unlike the GAARs considered above, appear to refer to the *subjective* purpose of the taxpayer. By relying on subjective purpose, the provision leaves itself open to manipulation by well-advised taxpayers. The High Court of Australia has noted that a consideration of subjective purpose would mean the application of a GAAR would depend upon the ‘fiscal awareness’ of taxpayers.<sup>126</sup> Well-advised taxpayers could easily create self-serving documentation to illustrate that each step did not have any purpose of achieving a tax benefit, thus avoiding the operation of the GAAR completely.

Secondly, purpose is relevant to exclude the GAAR from applying where a taxpayer can show that, while a step or feature of an arrangement did in fact create an advantageous tax result, it was not designed or carried out with an intention of achieving such a result.<sup>127</sup> This exclusion is intended to provide a safety net for taxpayers engaging in entirely non tax-driven arrangements, but would likely be of very little practical effect. The rule appears to protect only those negligent taxpayers that do not consider the tax consequences of an arrangement prior to its implementation.

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<sup>125</sup> Ibid.

<sup>126</sup> *Federal Commissioner of Taxation v Consolidated Press Holdings Ltd* (2001) 207 CLR 235, 264 [95].

<sup>127</sup> Aaronson, above n 5, 45-46, s 5.

## GENERAL ANTI-AVOIDANCE RULES

### 3.6 The reconstructive element

For completeness, the third element common to all statutory GAAR is the reconstructive element. Once there has been a finding of an arrangement producing a tax benefit which was entered into for a proscribed purpose, the reconstructive element imposes taxation by reference to a hypothetical state of affairs that it is reasonably considered that the taxpayer would have entered into in the absence of the arrangement.<sup>128</sup> These provisions raise issues which impact upon the consistent application of a GAAR, however the provisions do not affect taxpayer certainty. How tax is imposed once a GAAR is found to apply will not directly affect taxpayers' conduct, and therefore consideration of these provisions is beyond the scope of this paper.

### 3.7 Definitional criteria cannot distinguish avoidance from mitigation

It has been demonstrated that the definitional criteria do not provide any logical basis upon which avoidance can be distinguished from mitigation. These two concepts must be distinguished in some other way. Each of the jurisdictions considered has attempted to draw the line, whether legislatively or judicially. In the next section, these attempts will be critically evaluated.

## 4. AVOIDANCE AND MITIGATION

In section II, it was shown that certainty is a central aspect of the rule of law. Certainty in this context does not mean that the law specifies the answer to each and every possible scenario in advance, but rather that the law is able to guide conduct by providing clear and coherent standards capable of being applied consistently. In section III, the definitional elements of statutory GAARs were introduced. It was demonstrated that these elements could not logically distinguish between tax avoidance and mitigation. In addition to these structural

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<sup>128</sup> Australia: *ITAA 1936* (Cth) s 177F; New Zealand: *ITA 2007* (NZ) s GA 1; Canada: *ITA 1985* (Canada) s 245(2).

elements, each GAAR includes additional requirements that must be present before the GAAR will apply to an arrangement, or provide exceptions from the operation of the GAAR. In this section, the additional requirements and exceptions contained in the Australian, New Zealand, and Canadian GAARs are critically examined to understand how the provisions distinguish between avoidance and mitigation. It will be argued that a positive requirement of a 'misuse or abuse', supported by clear and coherent standards that are capable of being applied consistently, would provide the best guide to taxpayer conduct. These standards should be in legislative form. This will enable taxpayers to predict with a reasonable degree of accuracy the taxation consequences of their activities, and would ensure that revenue authorities and the courts have clear and coherent standards that they can apply consistently. In the absence of such standards, a GAAR will operate merely as an administrative or judicial smell test.

#### 4.1 Australia

Section 260 of the *ITAA 1936* (Cth) was the Australian GAAR from 1936 until it was replaced by Part IVA in 1981. Section 260 was expressed in extremely broad language, such that it had virtually unlimited application, operating to nullify any transaction that produced a tax benefit. Given that the legislature cannot have intended to cancel all arrangements with this effect, the courts sought to place sensible limits on the operation of s 260. This was achieved by reading a 'choice principle' into the provision. This principle was first expressed in *W P Keighery*, where a majority of the High Court noted that

whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny to taxpayers



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any right of choice between alternatives which the Act itself lays open to them.<sup>129</sup>

On the facts of that case, a private company taxpayer had issued a small number of redeemable preference shares to shareholders. Issuing shares in this manner did not change underlying effective control of the taxpayer, but had the effect of transforming the taxpayer from a private company to a public company for tax purposes. The legislation provided tax benefits to public companies over private companies. The High Court held that the choice taken was reasonably laid open to them by the statute, and therefore s 260 was inapplicable. In subsequent cases, the choice principle was expanded, to the extent that in 1977 in *Cridland*, the High Court held that taxpayers were entitled to create the circumstances that attracted favourable tax consequences without being caught by s 260.<sup>130</sup> In that case, a unit trust that carried on a modest pastoral farming business issued units, valued at \$1 each, to several hundred university students, to enable them to take advantage of income averaging rules that were intended to assist farmers. The High Court refused to apply s 260, holding that the choice made by the taxpayers was one reasonably laid open to them by the provision.<sup>131</sup> The choice principle, therefore, significantly restricted the scope of the GAAR.

The restrictive judicial interpretation of s 260 was a key factor leading to the introduction of Part IVA of the *ITAA 1936* (Cth) in 1981. As outlined in section III, Part IVA applies wherever a taxpayer enters into a scheme that produces a tax benefit where it is concluded, based on a consideration of certain objective factors, that the taxpayer's dominant purpose was to obtain a tax benefit. Section 177C(2) of the *ITAA 1936* (Cth) provides that an amount is not a tax benefit for the purposes of Part IVA, and therefore is excluded from the operation of the GAAR, if the benefit:

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<sup>129</sup> *W P Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66, 92.

<sup>130</sup> *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330, 339.

<sup>131</sup> *Ibid.*

- (i) ... is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice or option expressly provided for by this Act...; and
- (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised.

The exclusion is significantly more limited than the choice principle as applied under s 260, and likely renders that principle inapplicable to Part IVA.<sup>132</sup> The limited nature of the exception has resulted from the courts interpreting s 177C(2) to require that the choice must have been expressly provided for *by the Act*. In *AAT Case 5219*, Hartigan J held that the choice of a taxpayer to incorporate and take advantage of the trust provisions was not a choice expressly provided for by the statute, stating that ‘The mere fact that the Act recognises that there are such things as trusts, partnerships and so forth and then provides how those trusts and partnerships should be taxed does not mean that the mechanism is one expressly provided for by the Act’.<sup>133</sup> While on its face quite narrow, it is unlikely that higher courts will adopt a more expansive approach. This is because almost all forms of tax avoidance occur as a result of choices that are ‘permitted’ in some sense by the legislation, and therefore to include all choices impliedly permitted by the legislation would mark a return to the ‘choice principle’ and seriously emasculate Part IVA.

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<sup>132</sup> ‘In my opinion, as presently advised, unless the exclusions of sub- s. (2) and (3) operate, the choice doctrine applicable by judicial decision to s. 260 is inapplicable to Part IVA. However, I have no concluded view on that question’; *Spotless Services Ltd v Federal Commissioner of Taxation* (1993) 93 ATC 4397, 4418 (Lockhart J).

<sup>133</sup> (1989) 20 ATR 3777, 3779.

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Another shortcoming of s 177C(2) is that it does not apply where the taxpayer takes active steps to create a state of affairs to enable it to take advantage of an election or choice. This is because many elections and choices provided by the legislative provisions require a certain state of affairs to be in existence before the election or choice can be made. For example, Australia's tax consolidation provisions provide significant tax benefits to groups of wholly owned companies that elect to be treated as a single taxpayer.<sup>134</sup> A group head company taxpayer, that effects a corporate reorganisation to allow the group to form a consolidated group, will have effected that corporate reorganisation for the purpose of enabling the election to be made, and therefore s 177C(2) would be unlikely to provide protection from Part IVA in relation to any tax benefit that arose. By contrast, a new business venture that incorporates a head company and subsidiaries, then elects to consolidate, would likely not be said to have been incorporated so as to make the election, and therefore would be protected from Part IVA. Why should a person be forced to maintain an inefficient structure where a different person, in choosing to set up new entities, can do so with protection from the operation of the GAAR? Section 177C(2) cannot ensure that only avoidance transactions are caught by the operation of the GAAR.

An example of when Part IVA has arguably gone too far is *Spotless*, which concerned the application of Australia's foreign source income provisions.<sup>135</sup> In that case, the taxpayer had surplus funds, which it wished to invest in the short term. The taxpayer considered two main alternatives. The first was to deposit the money in Australia to earn interest income. An alternative was to invest the money in the Cook Islands, where a lower nominal rate of interest applied. Section 23(q) of the *ITAA 1936* (Cth) provided that income of an Australian resident that is derived in a country that has taxed the income is exempt from Australian tax. The application of s 23(q) resulted in the Cook Islands investment providing a higher after-tax

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<sup>134</sup> Including the pooling of losses and tax credits and the ability to ignore intra-group transactions: *Income Tax Assessment Act 1997* (Cth) pt 3-90.

<sup>135</sup> *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404.

return due to the tax rate in the Cook Islands. The High Court held that Part IVA applied to the scheme. The court held that in the absence of the tax benefit, the Cook Island investment would have made no commercial sense, and, therefore, objectively viewed, the dominant purpose of the arrangement was to gain the tax advantage provided by s 23(q).

In one sense, this is true. If the arrangement is defined narrowly as the decision to invest in the Cook Islands, then clearly the dominant purpose of the arrangement was to take advantage of the exemption from Australian tax provided by s 23(q).<sup>136</sup> But the taxpayer, a corporate actor seeking the highest after-tax return for its shareholders, merely took advantage of a provision that was aimed at ensuring taxpayers are not taxed twice on their foreign sourced income. There was no sham or artifice, or contrived arrangement, but rather a straightforward investment of funds overseas for profit, upon which tax was paid at source. If this is avoidance, what is the purpose of s 23(q)? More generally, how is a taxpayer to know whether their use of a choice provided by the legislation is to fall foul of the rule? It is clear that Part IVA, in its current form, does not operate as a guide to conduct. It places taxpayers at the mercy of the administrator in applying a provision that *prima facie* applies every time a tax benefit is obtained. Justice Pagone, writing extra-judicially, summarised the position thus:

The uncertainty, in short, is embedded in the application of part IVA and acts as a sword of Damocles over the heads of taxpayers each time a taxable event occurs or a taxable transaction is entered into. We have adopted, as the provision of last resort, a provision which may operate at least in part from fear of the unknown (with the full impact of the chilling effect upon commerce and economic activities which that may bring).<sup>137</sup>

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<sup>136</sup> Cf if the scheme was defined broadly; see above n 79 and accompanying text.

<sup>137</sup> Pagone, above n 53, 903.

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### 4.2 New Zealand

The New Zealand GAAR contained in s BG 1 of the *ITA 2007* (NZ) is drafted in terms that are prima facie even broader in operation than Part IVA. Section BG 1 renders void any arrangement that has tax avoidance as a purpose or effect that is ‘not merely incidental’. Interpreted literally, the provision would operate in an extremely wide range of circumstances. This would prima facie include, for example, a decision to lease equipment rather than purchase it, because objectively it is likely that a not incidental purpose for leasing the equipment is the tax benefit obtained. Thus it has been left to the New Zealand Courts to fill the void left by parliament, to seek out sensible limits on the scope of the provision. In relation to an earlier provision, expressed in identical terms to s BG 1, McCarthy P stated that:

[The GAAR] cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the Courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers.<sup>138</sup>

The operation of s BG 1 has recently been clarified, following a reinterpretation of the provision by the Supreme Court of New Zealand in *Ben Nevis*.<sup>139</sup> In that case, the court outlined a two-step process to applying s BG 1, where a taxpayer relies on a specific provision, as follows:

1. First, determine whether the provision has been used within its intended scope.
2. Secondly, consider the taxpayer’s use of the specific provision in

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<sup>138</sup> *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279, 280.

<sup>139</sup> [2009] 2 NZLR 289, cited in *Penny v Commissioner of Inland Revenue* [2011] NZSC 95. This decision marks the ‘diplomatic rejection’ of the previous approach taken by New Zealand courts following the Privy Council decision in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1987] AC 155 and thus now reflects the test in New Zealand: *Westpac Banking Corporation* [2011] NZSC 36 [176].

light of the arrangement as a whole.

The taxpayers in *Ben Nevis* were engaging in a forestry business, which had taken up a licence over land in order to grow a forest of fir trees. The taxpayers agreed to pay licence fees of NZD 2.05 million per hectare plus NZD 50 per hectare per year. The total fee for 484 hectares was NZD 992 million, but this total amount was not payable until 2048, by which time the trees would have matured. The taxpayers purported to discharge the liability immediately by issuing promissory notes for NZD 992 million, then sought to write off NZD 2.05 million per hectare over the term of the licence (NZD 41,000 per hectare per year). Under the specific provisions of the *ITA 2007*, the taxpayers were entitled to a deduction of NZD 41,000 per hectare per year for a cash outlay of NZD 50. A majority of the Supreme Court held that but for the GAAR, the arrangement would have succeeded.<sup>140</sup> The court was unanimous in finding that when viewed in light of the arrangement as a whole, the arrangement included additional features that affected the method and timing of payment, and therefore was a tax avoidance arrangement. The majority elaborated on the two-step process:

If, when viewed in that light [of the arrangement as a whole], it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement. ... A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.<sup>141</sup>

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<sup>140</sup> [2009] 2 NZLR 289, 331 [107] (Tipping, McGrath and Gault JJ). The minority (Elias CJ and Anderson J) disagreed (at [6]): 'We think it doubtful that the claims fell within the scope of the relevant specific statutory provisions, properly construed'.

<sup>141</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 331-332 [107-108].

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These comments raise two key issues. First, what does it mean for a GAAR to refer to the ‘purpose of parliament when it enacted the provision’, and how, if at all, is this different from purposive statutory interpretation? Secondly, what does it mean to say that an arrangement has been structured in an artificial or contrived way? The corporation is an artificial construct. Surely the use of a corporation within a business structure would not render the use of this structure to be tax avoidance?

The test put forward by the Supreme Court requires a court to consider the arrangement in a commercially and economically realistic way to determine whether the use of the provision was ‘consistent with Parliament’s purpose’.<sup>142</sup> The Supreme Court stated that a classic indicator of a use outside parliamentary contemplation is where a tax benefit is obtained in an ‘artificial or contrived’ way. But what does it mean for a transaction to be ‘artificial’? One possible meaning of the term ‘artificial’ is that the transaction is fictitious.<sup>143</sup> But a fictitious transaction will be a sham and therefore of no legal effect. In any event, this cannot be what the Supreme Court meant in *Ben Nevis*, as they expressly considered and rejected the contention that the transaction in question was a sham.<sup>144</sup>

Alternatively, ‘artificial’ may refer to a divergence between the ‘legal’ and ‘economic’ effects of the transaction. The court could be taken to be suggesting that to avoid the operation of s BG 1, the taxpayer must have suffered a loss or incurred expenditure in both fact (economic reality) and appearance (legal form). This proceeds from an assumption that parliament seeks to impose tax by reference to the economic reality of transactions, not merely the form. Indeed, artificiality can act as a useful device to distinguish avoidance from mitigation, as a factor that indicates that the arrangement in question constitutes avoidance. Typical examples of artificial or contrived arrangements include round-robin transactions, where deductions are

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<sup>142</sup> *Ibid*, 332 [109].

<sup>143</sup> *Oxford Dictionary of English* (OUP, 2<sup>nd</sup> ed, 2008) definition 3(a).

<sup>144</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 314 [38-39].

created without any corresponding change in the true economic position of the parties, or where transactions are structured so that legal ownership of an asset changes hands without the usual risks of ownership.<sup>145</sup> But not every divergence from economic reality will mean there is tax avoidance.<sup>146</sup> Many activities we would not find offensive employ various artificial structures. The concept of ‘income’<sup>147</sup> and the corporation<sup>148</sup> are artificial constructs. A finding of artificiality may indicate that a transaction is an avoidance transaction, but this will only be where the specific provision in question is intended to apply by reference to economic reality, and not legal concepts. An example is the case of *Ben Nevis* itself, where a cash outlay of NZD 50 entitled the taxpayers to a deduction of NZD 41,000 under the ordinary provisions of the taxing statute. But a finding of artificiality would not be conclusive on its own, and should be only one factor indicating the existence of tax avoidance.

Leaving aside ‘artificiality’, modern taxation statutes are complex, technical documents which often do not clearly articulate any overriding ‘parliamentary purpose’ that could operate to guide taxpayer conduct. This can be for two reasons. First, tax statutes are often drafted in significant detail, leaving little or no room beyond the express words for an inference as to the purpose of a provision. Referring to a tax provision in the United States, Learned Hand J noted that ‘as the articulation of a statute increases, the room for interpretation must contract.’<sup>149</sup> A second reason is that tax provisions are often unclear, incoherent or lacking of a consistent policy framework, such that it is difficult to discern any underlying parliamentary purpose. As Richardson J noted in *Challenge Corporation*:

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<sup>145</sup> Keith Kendall, ‘Tax Avoidance after Penny’ [2010] *New Zealand Law Journal* 245, 246.

<sup>146</sup> *Macniven v Westmoreland Investments Limited* [2003] 1 AC 311, 329 [40].

<sup>147</sup> Freedman, above n 17, 343.

<sup>148</sup> *R v Redpath* [1984] CTC 483, 491-492.

<sup>149</sup> *Gregory v Commissioner of Internal Revenue* 69 F 2d 809 (2<sup>nd</sup> Cir, 1934), 810 cited in Pagone, ‘Tax Uncertainty’, above n 53, 900.



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Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible.<sup>150</sup>

If we are to assume, however, that there is a clear and coherent purpose underlying the specific tax provision, a parliamentary intention type test appears to offer an attractive solution to the problem. After all, tax avoidance, it will be recalled, can exist only where the specific tax law has been complied with, and therefore the only logical distinction between mitigation and avoidance, one may argue, is that mitigation involves the use of the provisions in a manner *intended* by Parliament, whereas tax avoidance does not.

But how, if at all, does this differ from an ordinary purposive interpretation? The role of the judiciary, in interpreting any specific provision, including tax laws, is to seek out and declare the statutory intention.<sup>151</sup> Furthermore, modern approaches to statutory interpretation require a purposive interpretation to be undertaken.<sup>152</sup> Lord Diplock, in determining the meaning of an exception within the *Landlord and Tenant Act 1954*, noted that:

A conclusion that an exception was intended by parliament, and what that exception was, can only be reached by using the purposive approach. This means answering the questions: what is the subject-matter of Part II of the Landlord and Tenant Act 1954? What object in relation to that subject-matter did Parliament intend to achieve? What part in that achievement of that object was intended to be played by the prohibition in section 29(3)? Would it be inconsistent with achievement of that object if the prohibition were absolute? If so, what exception to or qualification of the prohibition is needed to

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<sup>150</sup> *Challenge Corporation* [1986] 2 NZLR 513 (Court of Appeal) 549.

<sup>151</sup> Francic Bennion, *Bennion on Statutory Interpretation* (LexisNexis, 5<sup>th</sup> ed, 2008) 469; LexisNexis, *Halsbury's Laws* (5th ed, 2010) vol 13 [165].

<sup>152</sup> Indeed, in Australia it is required by statute: *Acts Interpretation Act 1901* (Cth) s 15AA.

make it consistent with that object?<sup>153</sup>

A court interpreting a particular law should interpret that law in accordance with the object or purpose of the provision as construed from the words used in their wider context. Therein lies the chief difficulty with the New Zealand GAAR. Section BG 1 is intended to apply where a specific provision has failed to achieve the purpose that it was intended to achieve. But if the specific provision has been construed and applied according to its purpose, how can the specific provision have failed to achieve that purpose? This is not just a case of the literal words producing an outcome inconsistent with the legislative purpose, but rather that the words of the statute, purposively construed, have produced a tax benefit.

The minority decision in *Ben Nevis* draws out this difficulty. Two out of the five judges in the Supreme Court in that case held that while the arrangement in question was an avoidance transaction, and thus the outcome did not turn upon this point, it was ‘doubtful that the claims fell within the scope of the relevant specific statutory provisions, properly construed’.<sup>154</sup> The minority may have been satisfied to rely on a purposive interpretation of the specific provision to deny the tax benefit, without recourse to s BG 1.

Purposive statutory interpretation permits a court to go only so far. Lord Hoffmann noted that the intention of Parliament can be expressed only through statute, and it is the words of that statute, as interpreted by the courts, that embodies the intention.<sup>155</sup> Similarly, Lord Nicholls of Birkenhead noted that the ‘intention of parliament’ is an objective, and not subjective concept.<sup>156</sup> ‘Thus, when the courts say that such-and-such a meaning “cannot be what the parliament

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<sup>153</sup> *Kammins Ballroom Co Ltd v Zenith Investments (Torquay) Ltd* [1971] AC 850, 880.

<sup>154</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289, 307 [6].

<sup>155</sup> Lord Hoffmann, ‘Tax Avoidance’ [2005] *British Tax Review* 197, 204.

<sup>156</sup> *R v Secretary of State for the Environment, Transport and the Regions ex parte Spath Holme* [2001] 2 AC 349, 396.

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intended”, they are only saying that the words under consideration cannot reasonably be taken as used by parliament with that meaning.’<sup>157</sup> In short, Parliament does not have a purpose outside of the words of the statute and appropriate secondary materials. It appears that the Supreme Court has viewed the GAAR as requiring resort to an idea of a parliamentary intention that somehow goes beyond the purpose of the specific provision applied in its wider context. In this way a court, in applying s BG 1, in effect asks itself ‘what would parliament do’ and then imposes tax by reference to the answer to this question. The reality is that tax statutes are the product of compromises both at the time of enactment and with each subsequent amendment. To speak of a parliamentary ‘purpose’ beyond the words of the statute is without basis in fact.

The recent Supreme Court case of *Penny and Hooper*<sup>158</sup> demonstrates these difficulties. On the facts of that case, the taxpayers Mr Penny and Mr Hooper were orthopaedic surgeons who had previously practiced as sole practitioners. The taxpayers incorporated their practices by transferring their respective practices to a related company, owned by a family trust. Under this structure, instead of the taxpayers being taxed personally on all profits of the practice, the operating company would pay the taxpayers a salary, with any remaining profit distributed as dividends to the family trust and ultimately distributed to other family members. The taxpayers received a salary from the companies of just below the top marginal income tax rate threshold, so as to avoid imposition of the top personal income tax rate (39%) which was higher than the corporate tax rate (33%). In Mr Hooper’s case, his taxable income decreased from NZD 650,000 to NZD 120,000. The taxpayers claimed that the primary reason for the restructure was concerns about personal liability for medical negligence claims, and other non-tax related reasons. The Supreme Court held that s BG 1 applied to the arrangement, and therefore the Commissioner could tax the taxpayers by reference to a ‘commercially realistic’ salary. The court

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<sup>157</sup> Ibid 396.

<sup>158</sup> *Penny v Commissioner of Inland Revenue* [2012] 1 NZLR 433.

held that the use of the structure by the taxpayers was ‘beyond parliamentary contemplation’ and therefore constituted a tax avoidance arrangement.

This decision demonstrates that s BG 1 can apply to even standard business restructures. The Supreme Court acknowledged that this was not an arrangement that would typically be called ‘artificial’ or ‘contrived’, and that it consisted of the operation of a business through a typical business structure.<sup>159</sup> The court focussed almost exclusively on the reduction in income for the taxpayers. Thus it appears that, as may be the case in Australia under Part IVA, an existing corporate structure that is inefficient for tax purposes is placed at a significant disadvantage vis-à-vis newly formed entities. It would be very strange indeed if a newly qualified surgeon who wished to operate his or her practice through a corporation would be attacked under s BG 1, although as Kendall notes, from the perspective of legal method it would perhaps be stranger still if a different outcome would apply than did in *Penny and Hooper*.<sup>160</sup>

The New Zealand approach places too much power in the hands of the courts to determine whether a transaction will fall foul of s BG 1, by reference to the questionable notion of parliamentary intention. In each case, a court is called upon to in effect determine what parliament would have decided if it had considered the specific scenario that is now before the court. This places an unenviable burden upon taxpayers when filing their annual tax return. So interpreted, s BG 1 does not operate as a guide to conduct.

### 4.3 Canada

The Canadian GAAR has an additional positive requirement, not contained in the Australian or New Zealand GAARs, which must be fulfilled before the GAAR will operate. Section 245(4) of the *ITA 1985* (Canada) provides that the GAAR will apply to a transaction

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<sup>159</sup> Ibid 453 [33].

<sup>160</sup> Kendall, above n 145, 246

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only if it may reasonably be considered that the transaction would directly or indirectly result in a ‘misuse’ of the provisions of an income tax act, or an ‘abuse’ of the act read as a whole. This appears to encapsulate most accurately what is most offensive about avoidance arrangements: they use the specific provisions in a manner which they were not intended to be used. The difficulty is how to distinguish those uses that were intended from those that were not in a consistent and coherent manner. No guidance is provided in s 245(4) itself as to when an arrangement may constitute a misuse or abuse of the provisions or the act. It has thus been left to the Canadian courts to determine the substance of the GAAR.

Prior to the Supreme Court decision in *Copthorne* in late 2011,<sup>161</sup> the Canadian courts had given the GAAR a very restrictive interpretation. In *Canada Trustco*, the Supreme Court stated that it is not possible to abuse the act as a whole without also misusing its provisions, and therefore s 245(4) did not require a two-stage test.<sup>162</sup> The result was that the GAAR was read down to a simple rule of statutory construction: ‘Section 245(4) does not rewrite the provisions of the Income Tax Act; it only requires that a tax benefit be consistent with the object, spirit and purpose of the provisions that are relied upon.’<sup>163</sup>

As in New Zealand, a jurisdiction faces the problem that if a GAAR is construed as a rule of construction, it takes us no further than an ordinary purposive interpretation of the provision. If an arrangement is designed and carried out in a manner inconsistent with the object and spirit of the particular provisions, then it will constitute a misuse or abuse in the relevant sense and the GAAR would therefore override the application of the ordinary provisions and disallow any resulting tax benefits. But the modern approach to statutory interpretation is to interpret specific provisions in accordance with the object or purpose of the provision as construed

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<sup>161</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721.

<sup>162</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 619 [38].

<sup>163</sup> *Ibid.*, 625 [54].

from the words used in their wider context.<sup>164</sup> Where a taxpayer seeks to rely on a provision in circumstances where it would be a misuse or abuse of the provision, presumably the tax benefit in question would not be available: the use will not accord with the object or purpose of the provision as construed from the words in their wider context. There would be no need to apply a GAAR. Where, however, the arrangement is consistent with the purpose of the provision, the tax benefit will be available. How then could the provisions of the statute ever be misused or abused? Arnold noted that the Supreme Court's interpretation of s 245 only makes sense if the ordinary provisions of the act are interpreted literally.<sup>165</sup> The difficulty with this approach, Arnold notes, is that not only would this require tax statutes to be interpreted differently from all other statutes, but also that the Supreme Court has expressly rejected literal interpretation of tax statutes.<sup>166</sup>

In *Canada Trustco* the Supreme Court stated that this restrictive approach to the interpretation of the GAAR was required because notwithstanding the fact that the provision is intended to prevent avoidance, 'parliament nonetheless intended to preserve predictability, certainty and fairness' in the tax law.<sup>167</sup> These purposes would be frustrated if the minister or the courts could override specific provisions of the act 'without any basis in a textual, contextual and purposive interpretation of those provisions.'<sup>168</sup> The court noted that the GAAR operates as a 'provision of last resort',<sup>169</sup> and therefore should be applied only 'where the abusive nature of the transaction is clear'.<sup>170</sup>

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<sup>164</sup> See above nn 152-153 and accompanying text.

<sup>165</sup> Brian Arnold, above n 21, 174-176.

<sup>166</sup> *Ibid* 177-179; *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 625-626 [56].

<sup>167</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 617 [31].

<sup>168</sup> *Ibid* 620-621 [42].

<sup>169</sup> *Ibid* 614 [21].

<sup>170</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 624 [50]; cf *Lipson v Canada* [2009] 1 SCR 3 [21].

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In late 2011, the Supreme Court in *Copthorne* subtly reinterpreted the exception in s 245(4),<sup>171</sup> holding that the misuse or abuse exception requires a single, two-stage test, as follows. First, one must determine the ‘object, spirit or purpose of the provisions ... that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids.’<sup>172</sup> This requires determining the rationale that underlies the words of the provision.<sup>173</sup> Secondly, consider whether the transaction respects or frustrates this purpose.<sup>174</sup> If the transaction, so considered, either achieves an outcome that the provision was intended to prevent, or defeats the underlying rationale for the provision, or circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose, it will constitute avoidance.<sup>175</sup>

In so framing the enquiry, the court sought to ensure that the GAAR is not rendered useless, but has some independent work to do in addition to ordinary statutory construction. The first step outlined above is an application of ‘the same interpretive approach employed by this Court in all questions of statutory interpretation — a “unified textual, contextual and purposive approach”.’<sup>176</sup> But the court emphasised that notwithstanding the same approach is taken, it has a different objective to other (non-GAAR) cases. Whereas in undertaking ordinary statutory interpretation, the objective is to determine what the words of the statute mean, a GAAR analysis looks beyond the meaning of the words in search of ‘the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.’<sup>177</sup> The court emphasised that this

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<sup>171</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 621 [43]; *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [73].

<sup>172</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 625 [55]; *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [69].

<sup>173</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [69].

<sup>174</sup> *Ibid* [71].

<sup>175</sup> *Ibid* [72].

<sup>176</sup> *Ibid* [70], citing *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 622 [47].

<sup>177</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [70].

is not an exercise in ‘value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do’.<sup>178</sup> However, in light of the earlier reservations about any general search for a parliamentary purpose beyond the words of the statute,<sup>179</sup> it is not clear how any deeper purpose beyond that elicited from a purposive examination of the provision in its wider context could be found by any other means. The Supreme Court in *Canadian Trustco* had earlier warned against such an approach:

To send the courts on a search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.<sup>180</sup>

On the facts of *Copthorne*, the Supreme Court determined that the taxpayer, by rearranging its corporate structure so as effectively to double count its paid-up capital and allow a tax-free return of capital, had ‘artificially’ structured its affairs ‘in a way that frustrated the purpose of [the act]’.<sup>181</sup> Economic reality was thus employed as an important factor in the wider question as to whether the taxpayer’s actions were an abuse of the provision relied upon, but not determinative in and of itself. One may query why, on a purposive interpretation of the specific provision, the double counting of paid-up capital satisfied the specific provision at all?<sup>182</sup> And if it did not fall outside the purpose of that provision, then why did it fall foul of the GAAR under the same exercise?<sup>183</sup> The response must be that under the latter enquiry, factors such as artificiality or economic

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<sup>178</sup> Ibid [70]

<sup>179</sup> See above nn 155-157 and accompanying text.

<sup>180</sup> *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 620 [41].

<sup>181</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [127].

<sup>182</sup> Brian Arnold, ‘The Canadian Tax System Gets a Christmas Present from the Supreme Court’ on Brian Arnold, *The Arnold Report* (22 December 2011) <[http://www.ctf.ca/ctfweb/EN/Newsletters/The\\_Arnold\\_Report/BArnold\\_Archive.a\\_spx](http://www.ctf.ca/ctfweb/EN/Newsletters/The_Arnold_Report/BArnold_Archive.a_spx)>.

<sup>183</sup> Ibid.



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reality are taken into account to determine if the activity abused the statute as a whole. But unless these factors are explicit and applied in a consistent manner, taxpayers will have no clear and consistent guide to conduct, as the courts declare and enforce factors in an ad-hoc manner, placing the formulation of tax policy in the hands of the judiciary.

The Supreme Court did confirm the role of the GAAR as a provision of last resort. The court emphasised that any one decision on the operation of the GAAR may have implications for ‘innumerable “everyday” transactions’ and therefore should not be imposed without consideration of these consequences.<sup>184</sup> The court quoted from *Canada Trustco* with approval: ‘[p]arliament must . . . be taken to seek consistency, predictability and fairness in tax law.’<sup>185</sup> But the court appeared willing to enlarge the scope of the GAAR beyond that envisaged by the earlier court in *Canada Trustco*. The majority noted that ‘[w]hile Parliament’s intent is to seek consistency, predictability and fairness in tax law, in enacting the GAAR, it must be acknowledged that it has created an unavoidable degree of uncertainty for taxpayers.’<sup>186</sup> Unfortunately, in the absence of consistent factors to be taken into account in determining the applicability of the GAAR, this ‘degree of uncertainty’ is bound to be significant.

So in Canada, as in New Zealand, it has been left to the revenue authority in the first instance, and the courts on appeal, to distinguish between avoidance and mitigation. The Canadian GAAR contains no criteria by which taxpayers, administrators or the courts can determine whether a particular provision has been misused or abused. The result has been the courts attempting to elicit a purpose of provisions that exists beyond the meaning of the words as construed in their wider context, by reference to factors introduced as the courts see fit. Because the factors taken into account in

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<sup>184</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [67].

<sup>185</sup> *Ibid* citing *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 620-621 [42].

<sup>186</sup> *Copthorne Holdings Ltd v Canada* [2011] 3 SCR 721 [123].

determining whether the GAAR should be invoked are not contained in the legislation, the judiciary is left to formulate tax policy, a role for which they are not equipped. The Canadian GAAR, as interpreted under *Copthorne*, is too uncertain. It does not provide any meaningful guide to conduct. In practice the GAAR operates as a judicial ‘smell test’ to disallow tax benefits on an ad-hoc basis.

#### 4.4 A European alternative: abuse of rights

The explanatory notes to the Canadian GAAR note that the misuse and abuse exception contained in s 245(4) draws on the ‘abuse of rights’ doctrine which is employed in some jurisdictions as a means of countering tax avoidance arrangements.<sup>187</sup> One example is the German GAAR:

- (1) The tax law may not be circumvented by an abuse of possible legal arrangements. If there is such an abuse, the taxpayer shall be taxed as if he had chosen an adequate legal arrangement.
- (2) Subsection 1 applies unless its applicability is expressly excluded by law.<sup>188</sup>

The German courts have interpreted ‘abuse’ to mean that the legal arrangement is entered by a taxpayer in circumstances where an objective hypothetical taxpayer in the same economic position as the taxpayer would not have proceeded in that manner.<sup>189</sup> Arrangements that are more unusual or artificial will be less likely to be adequate.<sup>190</sup> As discussed above, unusual features and artificiality

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<sup>187</sup> Explanatory Notes, Explanatory Notes to Legislation Relating to Income Tax, June 1988 (Canada), s 245.

<sup>188</sup> *Abgabenordnung* [General Tax Code] (Germany) § 42 (John Prebble and Zoe Prebble trans, ‘Comparing the General Anti Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law’ (2008) *Bulletin for International Taxation* 151, 153).

<sup>189</sup> John Prebble and Zoe Prebble, ‘Comparing the General Anti Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law’ (2008) *Bulletin for International Taxation* 151, 153-154.

<sup>190</sup> *Ibid* 153.

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may indeed indicate that the arrangement is an avoidance arrangement, however should not be conclusive on its own. This appears to be the approach taken by the German courts, however as in Canada, no criteria are contained within the legislation itself. It therefore faces the same difficulties as s 245(4) of the *ITA 1985* (Canada).

‘Abuse of rights’ doctrines originally developed in Civil Law systems, and have not historically formed part of Common Law legal systems.<sup>191</sup> That is not a reason to reject the doctrine. An abuse of rights type requirement in a GAAR can encapsulate what it is that we find offensive about particular arrangements. The problem with such a provision as enacted in Canada and Germany is that there are no legislated factors capable of consistent application that the revenue authority and ultimately the courts can take into account to determine whether or not an arrangement is acceptable or not. In the absence of such factors, there will be unacceptable uncertainty, as the law will not operate as a guide to conduct.

### 4.5 United Kingdom

The recent Aaronson report to HMRC concluded that any GAAR for the UK should apply only to ‘abnormal’ arrangements.<sup>192</sup> An abnormal arrangement is defined as an arrangement that either as a whole has no significant purpose apart from achieving an abusive tax result; or has features that would not be in the arrangement if it did not also have an abusive tax result as one of its main purposes.<sup>193</sup> The ‘features’ proposed by the Aaronson report are:

- receipts or deductions differing from ‘true economic’ income or cost;
- transactions occurring on non-commercial terms;
- parties acting inconsistently with their existing legal duties;

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<sup>191</sup> See, eg, J E Sholtens, ‘Abuse of Rights’ (1958) 75 *South African Law Journal* 39, 48-49.

<sup>192</sup> Aaronson, above n 5, [5.15].

<sup>193</sup> *Ibid* s 6.

- locating an asset or person offshore; or
- including (or not including) a person, transaction, document or significant terms in a document, which would not be (or would be) expected to be included in the absence of the abusive tax result.<sup>194</sup>

Leaving to one side the difficulties with subjective purpose,<sup>195</sup> the listing of specific factors that the revenue authority will consider when applying the GAAR, and that the court can consider when reviewing the application on appeal, would significantly increase the GAAR's ability to guide taxpayer conduct. In the following section, it is contended that a positive requirement of misuse or abuse, supported by legislated factors to be taken into account, best balances the need for certainty with the prevention of tax avoidance.

## 5. CERTAINTY AND THE GAAR

In the preceding sections, it has been shown that the Australian, New Zealand and Canadian GAARs do not provide any clear and consistent standards that can be used to guide taxpayer conduct. Prima facie, each of these GAARs will apply to any arrangement that produces a tax benefit, where objectively tax was a not insignificant, dominant or primary purpose of the taxpayer or transaction. The revenue authority is relied upon to determine which arrangements are unacceptable. Where appealed, the courts have no standards against which to test the appropriateness of this exercise of discretion. Each GAAR operates to disallow retrospectively those benefits deemed inappropriate by the revenue authority and the courts. Given that penalties are imposed upon those transactions that are caught by the GAAR in Australia<sup>196</sup> and New Zealand,<sup>197</sup> the level of uncertainty inherent in these rules is unacceptable.

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<sup>194</sup> Aaronson, above n 5, 47-48.

<sup>195</sup> See n 126 and accompanying text.

<sup>196</sup> 50% of the shortfall amount (reduced to 25% where the position taken was 'reasonably arguable'): *Taxation Administration Act 1953* (Cth) sch 1, s 284-160.

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It has been contended that a positive requirement of a ‘misuse or abuse’, similar to that used in Canada, appears most accurately to encapsulate what it means to engage in avoidance arrangements. Such arrangements use the specific provisions in a manner which they were not intended to be used. But without legislative guidance as to when an arrangement may constitute a misuse or abuse of the provisions of the statute, such a GAAR cannot operate as a guide to conduct.

### 5.1 How certainty can be improved

A legislative GAAR should spell out in advance those factors that indicate that an arrangement is an avoidance arrangement. The distinction between avoidance and mitigation should not be drawn by way of ad hoc judgement on a case-by-case basis, but by reference to a set of clear and coherent general principles which can be applied consistently by taxpayers, revenue authorities and the courts. This will provide taxpayers with an appropriate level of certainty to conduct their affairs, without rendering the GAAR ineffective.

But doesn't the Australian GAAR already include objective factors? Indeed, Part IVA applies where, having regard to the form and substance of the scheme, the timing of entry into and duration of the scheme, the result that would have been achieved in the absence of the GAAR, and any actual or reasonably expected consequences for the taxpayer or any connected persons, it would be concluded that the scheme was entered into for the dominant purpose of obtaining a tax benefit.<sup>198</sup> Freedman states that listing specific factors in this manner ‘gives the judges the tools they need to go beyond normal rules of statutory construction to construe the specific legislation before them, not contrary to its purpose but according to these broader principles.’<sup>199</sup> The problem with this conclusion is that the

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<sup>197</sup> 100% of the shortfall amount (reduced to 20% in certain circumstances): *Tax Administration Act 1994* (NZ) s 141D.

<sup>198</sup> *ITAA 1936* (Cth) s 177D.

<sup>199</sup> Judith Freedman, ‘Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament’ (2007) 123 *Law Quarterly Review* 53, 81.

factors in Part IVA are not aimed at determining whether an arrangement constitutes avoidance. Instead they are used to determine whether the arrangement had a dominant *purpose* of avoiding tax. But why does this matter? In section III, it was demonstrated that whether tax is avoided deliberately or accidentally does not alter the fact that the integrity and equity of the tax system is undermined and government revenues reduced. Additionally, attempting to distinguish between commercial purposes and tax purposes involves reliance on a ‘false dichotomy’, as reducing tax payable is itself a genuine commercial purpose. Finally, tax laws frequently provide inducements and incentives to taxpayers to engage in particular activities, so often a purpose of avoiding taxation will further, not frustrate, the legislative intention.

While a consideration of whether the form and substance of the scheme differ, or the timing of entry into the scheme, may indeed show that the taxpayer did have the dominant purpose of obtaining a tax benefit, this is not the reason why it should be caught by a GAAR. It is submitted that those same factors should be used, not to determine the taxpayer’s purpose, but to determine whether or not the arrangement misuses or abuses the provision sought to be relied upon. A GAAR would only apply where the arrangement entered, having regard to particular objective factors contained within the legislation, is considered to misuse or abuse the provision relied upon. This approach is preferable to leaving the courts to establish the criteria. The Australian, New Zealand and Canadian courts have at times radically altered their approach to interpreting their respective GAARs, resulting in an unacceptable level of uncertainty. It is the legislature’s exclusive role to develop the taxation laws.<sup>200</sup> Statutory rules are subject to the safeguards of the legislative

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<sup>200</sup> Brian Arnold, ‘The Canadian General Anti-Avoidance Rule’ in Graeme Cooper (ed) *Tax Avoidance and the Rule of Law* (IBFD, 1997) 221. This is particularly important in Canada and Australia where the legislature’s exclusive power to make laws with respect to taxation is entrenched in the constitution: *Constitution of the Commonwealth of Australia 1901* (Cth) s 51(ii); *Constitution Act 1867* (Imp), 30 & 31 Vict, c 1, s 90(3).

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process, including consultation processes, and unlike judicial factors, are promulgated in advance of their application. The factors would enable taxpayers to foresee, with a reasonable degree of accuracy, the taxation consequences of their actions prior to undertaking a course of action. Taxpayers will not be forced to choose between engaging in the conduct and hoping for a favourable outcome, or not undertaking the transaction with a potentially dampening effect on economic activity. It would provide revenue authorities with clear and coherent standards, ensuring consistency in the GAAR's application. It would also allow the courts, on review, to apply these same standards to test the appropriateness of the actions of the revenue authority, and give effect to the legislative intention.

As to which factors should be included, wide consultation and debate would need to be undertaken to distinguish appropriately between avoidance and mitigation. There are many differences in the nature and size of different economies, and other differences between tax systems.<sup>201</sup> Whether the factors ultimately adopted are those already contained in Part IVA,<sup>202</sup> or those factors suggested by the Aaronson review,<sup>203</sup> or some other factors, will depend upon the particular jurisdiction that is seeking to implement a GAAR. This paper does not seek to advocate a particular set of standards that should be included in each and every GAAR. Rather, it is advocated that each jurisdiction identify a set of standards that operate to determine whether an arrangement constitutes a misuse or abuse of the law. These standards should take a legislative form, and operate prospectively. Such an approach should provide an appropriate guide for taxpayers, and allow the revenue authority and the courts to distinguish consistently avoidance and mitigation.

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<sup>201</sup> David Pickup, 'In relation to General Anti-Avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect their Tax Revenues' in Judith Freedman (ed) *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (OUCBT, 2008) 9.

<sup>202</sup> See above n 104 and accompanying text.

<sup>203</sup> See above n 194 and accompanying text.

## 6. CONCLUSION

Certainty is a central requirement of the rule of law. Certainty of taxation requires that the law should operate as a guide to conduct. Tax avoidance is a problem that faces all jurisdictions today. It undermines the integrity and equality of the tax system and reduces government revenue. But the ends cannot justify the means: the rule of law requires that laws should provide a coherent guide to conduct that is capable of consistent application. Certainty requires that those arrangements that are acceptable (mitigation) be adequately distinguished in advance from those that are not (avoidance). The Australian, New Zealand and Canadian GAARs do not draw this distinction upon any logical basis. It has resulted in the respective GAARs operating as judicial smell tests, retrospectively testing arrangements against unclear and frequently changed criteria. This paper contends that every GAAR should contain a positive requirement of a misuse or abuse of the law, as determined having regard to legislatively enacted criteria. Such a requirement most accurately encapsulates what it means to engage in tax avoidance, and would appropriately strike the balance between countering avoidance arrangements and ensuring certainty for taxpayers.