

**TAX LAW REVIEW COMMITTEE**

**TAX AVOIDANCE**

November 1997

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## FOREWORD

*By the President of the Tax Law Review Committee  
The Rt. Hon. The Lord Howe of Aberavon CH QC*

In this Report, the Committee has taken on potentially its most contentious issue yet. There can be little quarrel with the general proposition that transactions entered into solely or mainly for the purpose of reducing tax, thereby defeating the intention of Parliament, should not be given their desired effect. Yet there is little agreement on the boundaries between transactions that fall foul of that proposition and other, acceptable action to mitigate tax liabilities.

Intense legal analysis has been applied to the issues raised by judicial and legislative approaches to tax avoidance but the day to day practicalities of advising taxpayers and administering the tax system are equally important to this subject. The general proposition to which I have referred has been settled law in the US federal tax system since the 1930s. The US courts have been evolving their judicial anti-avoidance doctrines gradually over the course of 60 years, in tandem with the growing complexity of tax law. Practitioners and the Revenue Service have been able to develop a good sense of the scope of the doctrine and how it will apply in a more sophisticated and innovative business and financial environment.

It is only recently that the UK courts have started to develop a similar approach to tax avoidance. The 1980s decisions in *Ramsay* and *Furniss* had a profound effect on the tax avoidance industry and the judicial process is continuing, as the recent case of *McGuckian* illustrates. The question that the Committee has had to consider is whether these judicial developments are a satisfactory way of tackling avoidance at a general level, or whether alternatives would be better.

A general statutory rule, as has been adopted in many other jurisdictions, might anticipate at a stroke the evolving judicial process. But taxpayers and their advisers

could find a statutory rule more difficult to absorb. The case-specific pronouncements of the courts are usually more limited in their scope and are digested more easily than broad legislation, the scope of which may not be immediately apparent. The outcome, if matters are misjudged, for ordinary commercial and family transactions and for the administration of the tax system should not be underestimated. The unintended consequences of change may always exceed expectations. These are issues that have concerned the Committee greatly.

Professor Brian Arnold, who is closely associated with work on the Canadian general anti-avoidance rule, has noted that<sup>1</sup>–

“...the introduction of a general anti-avoidance rule in any country is inevitably the occasion for an emotional debate. The issue of tax avoidance raises fundamental questions about the relationship between a taxpayer and the state...it is not surprising that the debate concerning a general anti-avoidance rule stirs great interest and strong feelings. The issues raised by a general anti-avoidance rule go to the foundations of a country’s tax system; they should be debated rationally and on an ongoing basis.”

The Committee presents its Report in that spirit, as a contribution to current debate by all those concerned in the UK with this difficult and important topic.

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<sup>1</sup> Arnold, *The Canadian General Anti-Avoidance Rule*, in *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (The Netherlands) 1997, page 243.

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# **TAX LAW REVIEW COMMITTEE**

## **TAX AVOIDANCE**

### **EXECUTIVE SUMMARY**

#### **Overview**

1. The question the Committee has addressed is whether current methods of dealing with tax avoidance are adequate and satisfactory and what, if any, other measures might be taken. The Committee's main conclusions are these—

- Specific anti-avoidance provisions should continue to be in the forefront of the battle against tax avoidance. There remains, however, the question of whether specific provisions should be supported by the deterrent effect of the developing judicial general anti-avoidance doctrines or a statutory general anti-avoidance provision.
- We prefer a sensibly targeted statutory general anti-avoidance provision, with a considered framework and appropriate safeguards for taxpayers (including a clearance procedure), to the continued development of judicial anti-avoidance doctrines.
- We believe that such a statutory provision could make a contribution to the effort to deter and counter-act tax avoidance and may offer some opportunities for simplifying existing legislation.
- A statutory provision that fails to address satisfactorily the issues to which we draw attention or to meet the criteria we identify (in particular for safeguarding taxpayers' rights), will inhibit the conduct of ordinary commercial and

personal affairs and prove an administrative nightmare for the Revenue authorities. The Committee would vehemently oppose such a provision.

## **Background**

2. In our two reports on tax legislation we considered how such legislation could be made more intelligible. Our conclusions were widely supported as sensible and useful. We are pleased to note that the Inland Revenue proposes to implement our main recommendations through its Tax Law Rewrite programme.

3. In tackling that initial topic, we started from a position of virtual consensus within the Committee (and, we believe, the tax-aware world at large) that something ought to be done to improve tax legislation. The subject of tax avoidance, however, is very different and highly controversial. Totally opposed views are expressed as to the nature and extent of the problem, or indeed whether tax avoidance is a ‘problem’ at all.

4. So why did we decide to tackle this issue? Initially, we recognised that if you wish to improve tax legislation, you must reach a view on how to deal with tax avoidance. Tax avoidance legislation accounts for some of the more complicated parts of the tax code. More recently, however, tax avoidance has moved to the top of the political agenda. Both in the final budget of the Conservative administration and in the first budget of the Labour administration, prominence has been given to the need to intensify the fight against avoidance.

5. At the beginning of our discussions on this topic it was unclear whether we could reach any consensus. The early discussions reflected the different perspectives of the members of the Committee. But, as the discussions progressed, a common position started to emerge, and the conclusions set out in this report represent the consensus view of the Committee. This is particularly significant, given that the members of the Committee have widely differing tax backgrounds and perspectives.

## **What is tax avoidance?**

6. We are concerned in this Report only with the issues of legal tax avoidance. We have not addressed the prevention and control of the illegal evasion of taxes.

7. We think it impossible to define the expression ‘tax avoidance’ in any truly satisfactory manner. People routinely alter their behaviour to reduce or defer their taxation liabilities. In doing so, commentators regard some actions as legitimate tax planning and categorise others as tax avoidance. No two commentators may agree on the categorisation of certain behaviour. So far as we have needed some broad framework within which to conduct our discussion of tax avoidance activity, we have regarded tax avoidance (in contra-distinction to legitimate tax mitigation or planning) as action taken to reduce or defer tax liabilities in a way that Parliament plainly did not intend or could not possibly have intended had the matter been put to it.

8. This is similar to the formulation used by the Law Lords in the recent *Willoughby* case that it is “a course of action designed to conflict with or defeat the evident intention of Parliament.”<sup>1</sup> As tax avoidance is a legal activity, however, we appreciate that any definition or description is bound to raise issues of who should say what Parliament’s intention was and what materials may be used to that end.

## **The extent of tax avoidance**

9. We have not sought to quantify the extent of tax avoidance, either in terms of the proportion of taxpayers who seek to avoid tax or in the amount of tax lost to the Exchequer. Sometimes the Revenue departments, Treasury ministers or commentators put a figure on the sums which they say a currently fashionable tax avoidance scheme is costing the Exchequer but it will frequently be the case that the accuracy of these figures is difficult to establish and, in any event, one cannot predict how taxpayers will alter their behaviour in the face of new anti-avoidance measures.

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<sup>1</sup> *IRC v Willoughby* [1997] STC 995, 1004c.

10. But quantifiable or not, and whether very large or relatively small, we recognise that tax avoidance represents a distortion in taxpayers' behaviour. No country allows unfettered attacks on the integrity of its tax system. Every country adopts measures to curb avoidance.

### **Does more need to be done to reduce tax avoidance?**

11. Some structures for levying taxation are more prone to avoidance than others. Complex legislation, imposing special tax penalties or conferring special tax privileges, on selected kinds of economic activity, may prove a standing invitation to avoidance. The proper and satisfactory response to avoidance may therefore be to change the structure of the system or elements within it. The question the Committee has addressed is whether current methods of protecting the government's chosen tax structure are adequate and satisfactory and what, if any, other measures might be taken.

12. In our view the combined effect of three factors will curtail future opportunities for taxpayers to exploit tax legislation in ways not intended by Parliament. These factors are: -

- i. The abandonment by the Courts of an excessively literalist interpretation of tax legislation. This was confirmed recently in the House of Lords in the *McGuckian* decision;<sup>2</sup>
- ii. The development of the *Ramsay* and *Furniss* decisions, which enable the Inland Revenue to tax a pre-ordained series of transactions in accordance with their overall effect rather than in accordance with each individual legal step. This again has received new emphasis in the recent *McGuckian* decision; and

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<sup>2</sup> *IRC v McGuckian* [1997] STC 908 in particular in the speech of Lord Steyn at 915j.

- iii. The Government's decision (accepting the conclusions of our own report on tax legislation) to rewrite tax legislation in more accessible language, and to accompany new legislation with a published memorandum explaining the legislation's purpose in non-statutory terms. In the long run this, combined with the more purposive interpretation adopted by the Courts, will in our view have a considerable impact in reducing the scope for tax avoidance.

13. We are concerned that the current political desire to "tackle avoidance" should not lead to the introduction of new measures that, given the factors we have listed, are not required and which unnecessarily extend the scope of Revenue powers in this field or that unduly fetter ordinary commercial or personal transactions. Nevertheless, we have considered in relation to paragraph 12(ii) whether we prefer a statutory general anti-avoidance provision to the continued development of judicial anti-avoidance doctrines.

### **The further development of the judicial anti-avoidance doctrine**

14. The judicial doctrine exemplified by the *Ramsay* and *McGuckian* decisions has played an important role in counteracting some of the most uncommercial tax avoidance operations. The refinement of this doctrine in future cases may work to keep in check the ingenuity of those intent on adopting any legal means to limit their tax liabilities.

15. Nevertheless, we have concluded that innovative judicial anti-avoidance techniques are unsatisfactory, for two main reasons:

- i. A judicial doctrine fashioned on a case by case basis through the hierarchy of the Courts produces considerable uncertainty. Uncertainty is a matter of degree. The tax effect of an arrangement may be certain if it need only satisfy an excessively literalist interpretation. The tax effect may be less certain if it must be demonstrated to the court that arrangement is consistent with the intentions of Parliament in passing the legislation in question. The

language of a statutory general anti-avoidance provision will not be certain and remains subject to interpretation by the courts. However, we think that undue uncertainty as to the direction a judicial anti-avoidance doctrine may follow is undesirable in taxpayers' private and commercial affairs and unsatisfactory also for the Government, which must respond to avoidance activity long before the Courts are able to express their view of particular arrangements.

- ii. A developing judicial doctrine—however radical—operates retrospectively and offers no clear framework within which it shall operate or not, which we consider unsatisfactory especially with the adoption of self-assessment for direct taxes.

We prefer a solution that avoids these problems.

16. We consider that tax avoidance should be countered principally by legislation rather than by the further development of the current judicial anti-avoidance doctrine. A statutory rule can attempt to make good some of the limitations inherent in a judicial rule and provide a proper framework for the application of a general anti-avoidance rule.

### **New legislation to curb tax avoidance**

17. We have considered the two basic types of anti-tax avoidance legislation that Governments can adopt, namely: (i) specific provisions and (ii) general provisions. It is implicit in what we have said regarding a judicial anti-avoidance doctrine that we believe that legislative provisions, of either nature, should operate prospectively and not retrospectively.



(i) Specific anti-avoidance provisions

18. Specific anti-tax avoidance provisions are a familiar part of tax legislation. They contribute significantly to the complexity of the legislation in many areas but they do offer the very considerable advantage of being targeted at specific areas of the tax code and the avoidance issues that arise in those areas. We believe that the willingness of the judges to look at the underlying purpose of the legislation, and the publication of memoranda explaining the purpose of the legislation, will make it easier to target specific provisions more accurately in the future. Specific provisions (in the absence of more fundamental structural change) should be the first lines of defence against avoidance.

19. There remains, however, the question of whether specific provisions should be supported by the deterrent effect of judicial anti-avoidance doctrines or a statutory general anti-avoidance provision to deal with continuing tax avoidance in areas which, ex hypothesi, the specific provisions do not cover.

(ii) A statutory general anti-avoidance provision

20. We have not in recent years had a general anti-avoidance provision as part of the UK tax code. Experience in other Common Law countries that have adopted this type of provision suggests the limitations of such provisions. They remain subject to judicial interpretation and we consider that it would be wrong to attempt to exclude the jurisdiction of the courts. Australia, however, provides a notorious example of a general anti-avoidance provision that was perceived as inappropriate and, as a result, was emasculated by the courts.

21. Australia has re-enacted its general anti-avoidance rule and Canada and Ireland are among other Common Law countries that have introduced such provisions in recent years. The Revenue authorities in Australia and Canada have now had some success in the courts with their provisions but there have been relatively few cases.

Meanwhile, tax avoidance remains an issue in those countries and each has continued to introduce and to rely upon specific tax avoidance provisions.

22. The experience of other common law countries underlines that a statutory general anti-avoidance provision is not a panacea. In principle, however, it can offer a number of advantages over judicial anti-avoidance doctrines—

- It can operate by reference to carefully considered and expressed criteria. In particular, it can describe the nature of the arrangements that fall within its scope of operation and—equally important—it can explicitly specify the arrangements that remain outside its scope.
- It can explicitly state the consequences of its application—which may sensibly require a transaction to be ‘reconstructed’ in the way that would go beyond what the Courts can adopt through a judicially developed anti-avoidance doctrine.
- The effect of a statutory rule would be prospective—i.e. it would only operate on transactions entered into after the rule were enacted (again, contrasting with a judicially developed doctrine which would necessarily apply to transactions entered into before the doctrine were pronounced).
- A general anti-avoidance provision could ensure greater consistency of application and replace the uncertainty produced by a developing judicial doctrine with a clear statutory framework within which the statutory rule would operate and be interpreted by the judges.
- Most important of all, in our opinion, a statutory general anti-avoidance provision could (and would need to) include an effective administrative clearance system under which taxpayers could quickly ascertain whether

proposed transactions would be regarded by the Revenue authorities as falling within the scope of the provisions.

23. A general anti-avoidance rule inevitably requires the Revenue authorities to form their opinion in the first instance whether transactions that have the effect of reducing tax liabilities fall within the Parliamentary intent or not. The critical balance, therefore, between the public interest in seeing that taxes are not unduly avoided and the legitimate interests of taxpayers in their commercial and private affairs, lies in ensuring that (a) the rule is sensibly targeted, (b) there are sensible procedures for invoking the rule and (c) there is proper oversight of its exercise.

24. We believe that a statutory general anti-avoidance provision, if adopted, should be directed to deterring or counteracting courses of action that are designed to conflict with or defeat the evident intention of Parliament as appearing from the legislation. We would not intend to deter legitimate tax planning or mitigation in taxpayers' ordinary commercial or personal affairs.

25. To that end, we consider that, if a general anti-avoidance rule were adopted, it should incorporate the following features—

- i. Its scope of operation should be limited to transactions which, judged as a whole, have tax avoidance as a main purpose or, in the case of multi-step transactions, when a particular step in the transaction has tax avoidance as its sole purpose.
- ii. It should exclude transactions that are consistent with the intention of Parliament, as appears from the legislation taken as a whole.
- iii. The provision should at its introduction be invoked centrally by the Head Office of the Revenue authority concerned (i.e. local or regional officers

should not be able to invoke the rule or offer clearances in respect of the rule).

- iv. An administrative clearance system should be established so that taxpayers can ascertain whether the Revenue authorities would regard a proposed transaction as falling within the scope of the new provision. A clearance application necessarily implies some delay but this should be kept to the minimum.
- v. There should be a single stage appeal to an independent tribunal against a refusal of a clearance, based on the papers submitted to the Revenue authority.
- vi. When invoking the rule against a completed transaction, the onus in the first instance should be on the Revenue authority to show why the transaction is of a nature that the general anti-avoidance rule ought to apply.
- vii. As part of the procedure for invoking the rule, the Revenue authority would be required to state the alternative transaction that it considers should be substituted for the actual transaction as the basis for assessing tax. If there were more than one permitted alternative transaction, that which attracts the least tax should be adopted.

26. We wish to emphasise the importance of points ii and iv above. We recognise that many taxpayers and their professional advisers may be cautious in the face of a new general anti-avoidance provision. As a result, the Revenue authorities could be asked to give clearance on just about every case that might be thought to come within the ambit of the provision. If the scope of a general anti-avoidance provision is too widely drawn, this would create a serious impediment to commercial and personal transactions, and the Revenue authorities would need to devote very substantial resources to operate the clearance procedure satisfactorily.

27. We do not envisage, however, that the Government can produce a satisfactory general anti-avoidance rule at no administrative cost. The provision must strike the right balance and must be capable of practical application. We believe that the Government can only achieve this if it accepts whatever cost is involved in providing the proper administrative framework and safeguards for taxpayers. If it were not prepared to incur this cost, it should not propose a statutory rule.

28. A statutory provision would be designed to give effect to the Parliamentary intent and policy of the legislation. We think it important, as regards point iii, to secure a consistent application of the provision and to avoid any perception that the provision is a bargaining tool that the Revenue authorities can use in auditing ordinary tax liabilities. We think it appropriate also that the Revenue authorities be required to report annually to Parliament on the operation of the provision.

29. In Chapter 5 we discuss a provision that illustrates the principles and structure that we think a statutory rule, if adopted, should follow. We do not intend that our illustration be examined as legislation. It serves to identify and outline a number of the difficult issues that the drafting of a satisfactory general anti-avoidance rule will involve. We believe that were legislation to introduce a rule that followed this form, it ought also to restrict the future development of the *Ramsay* doctrine.

## **Conclusion**

30. These, then, are our conclusions. We hope that they will make a significant contribution to the current debate on the topic. To this we would add a final note of warning. We have concluded that a sensibly targeted general anti-avoidance provision, with an appropriate clearance procedure, could make a contribution to the effort to deter and counteract tax avoidance; and we would prefer this to the development of some new judicial anti-avoidance doctrine. But, adopting a general anti-avoidance provision that fails to satisfy the criteria (in particular with respect to safeguards for taxpayers' rights) which we have set out or that fails to meet the requirements that we mention in paragraph 27, could well be a recipe for disaster, in

the disruption that it could create for ordinary commercial and personal affairs, and in the administrative problems it posed for the Revenue authorities. It would certainly be vehemently opposed by most, if not all, of the members of this Committee.

# CHAPTER 1. INTRODUCTION

## Background

1.1. The impetus for this project arose from concerns about the way tax avoidance, or the risk of avoidance, serves to complicate tax legislation.

1.2. The Tax Law Review Committee published its *Interim Report on Tax Legislation* in November 1995. That report put forward various proposals for making the language of fiscal legislation simpler and more accessible, without losing necessary precision. Two of the main recommendations were that legislation should be drafted in plain English and that there should be explanatory memoranda to assist understanding and interpretation. But we recognised that there was a question whether different considerations should apply in the case of anti-avoidance legislation, which is an important topic in itself. We concluded, therefore, that we should examine the whole issue of tax avoidance separately in a later report.

1.3. More recently, the political climate has supported the case for reviewing how, in the UK, government seeks to counteract tax avoidance activity. The November 1996 and July 1997 Budgets emphasised the need for strong action to counter continuing avoidance. The new Chancellor has asked the Inland Revenue to consult on the desirability of adopting a general anti-avoidance rule for direct taxes. HM Customs & Excise have been considering such a rule for VAT, following publicity that avoidance activity was partly responsible for a shortfall of forecast VAT receipts. And in June 1997, the Law Lords suggested that the judicial approach to tax avoidance may be open to further development.<sup>1</sup>

## Evasion and the causes of avoidance

1.4. Our review does not consider tax evasion—the illegal non-payment of tax rightfully due to the Exchequer. It deals with the problems of tax avoidance—lawful actions taken by taxpayers which, if effective, will reduce their liability to tax. Because it is a legal activity, there are widely differing attitudes to avoidance and whether particular actions should be effective or not to reduce tax liabilities.

1.5. Taxation is central to the organisation of any modern state. But raising taxes involves the State trespassing upon another aspect of a modern civilised society, namely the respect for, and protection of, private property. The individual's interests may differ significantly from those of the State, which represents taxpayers as a body. The individual naturally looks to what he has to pay. The State, in representing the interests of taxpayers as a body, is more concerned with issues of equity and administration, as well as with the wider social and economic effects of taxation.

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<sup>1</sup> *IRC v McGuckian* [1997] STC 888.

1.6. As a result, there is often a tension between the need of the State to raise its revenues and the rights and interests of an individual taxpayer not to have his property taken away from him in an arbitrary manner and to minimise his liability to tax, if he can. The desire of the State to conserve its revenue streams can easily lead to the introduction of measures that interfere with legitimate commercial and family activity.

1.7. We think it reasonable to assume that a number of different factors drive avoidance activity. The tax to be avoided must justify the cost and potential risk involved in taking steps to avoid it but a natural starting point is the reluctance of taxpayers to pay any more tax than they have to. In this respect, the propensity of taxpayers to avoid tax may be influenced by their perception of whether or not a tax is “just” or proportionate in its effect. Then there are the factors that foster a climate for avoidance, such as the tax rate or the absolute amounts of tax at issue in any one particular case. Exemptions and reliefs that lend themselves to exploitation in ways not contemplated by Parliament and flaws in the legislation each play their part.<sup>2</sup>

1.8. A legal commentator might also claim that the traditional attitude of the UK Courts to the interpretation of tax law has in the past created the conditions that promote tax avoidance arrangements. This approach has seen the courts have regard only to the clear words of the taxing statute, without reference to the purpose or mischief at which the legislation is directed.

1.9. At the heart of the matter, we note that it is the structure of tax that creates opportunities for avoidance. Avoidance is a function of the tax base and the tax base must be a sustainable base if avoidance is to be kept in bounds. Avoidance, and the risk of avoidance, are at their greatest where there is a failure to base the tax on sound economic principle, where the tax creates unsustainable boundaries or where there are arbitrary rules. If governments wish to limit avoidance, they should avoid enacting the kind of legislation that positively invites it!

1.10. Our terms of reference, however, are to consider how the *existing* tax system should best aim to minimise or prevent avoidance. This does not enable us to deal with structural reform, or questions of tax policy or taxpayer behaviour.

## **The issues raised by tax avoidance**

### **What is “tax avoidance”?**

1.11. One of the main issues in any discussion of tax avoidance is what anyone means by the phrase. It seems implicit that a comparison has to be made between the tax consequences of what the taxpayer has actually done and some other course of

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<sup>2</sup> The development of the Business Expansion Scheme during the 1980s illustrated the ingenuity of taxpayers in bringing investments with little risk within the scope of a tax incentive for risky investments. The fundamental difficulty lies in finding the legislative words that adequately describe the degree of risk that Parliament thinks should attach to an investment if it is to qualify.



action that would produce a higher tax charge. If so, is the tax saving necessarily objectionable and why? If you believe that there is some sort of “fair share” of the overall tax burden that a taxpayer ought to be prepared to pay, what is it that distinguishes unacceptable avoidance and legitimate mitigation, since they both involve reducing tax liability? Is acceptable tax saving that which the courts consider acceptable, even though that may conflict with the views of the revenue departments? Is there a case to be made that avoidance is inevitable, introduces an important element of flexibility into the tax system and should be tolerated? “An economy breathes through its tax loopholes.”<sup>3</sup> One person’s tax avoidance may be another person’s prudent and sensible tax planning.

1.12. Given the existence of competing value systems, whose views should prevail?

1.13. Stated in these terms we think it desirable to avoid, if we can, value judgements about what is acceptable and unacceptable. So far as we have needed some broad framework within which to conduct our discussion of this subject, we have regarded tax avoidance as action taken to reduce or defer tax liabilities in ways that Parliament plainly did not intend or could not possibly have intended had the matter been put to it.<sup>4</sup> We recognise, however, that any such definition or description raises issues of who should say what Parliament’s intention was, what materials may be used to that end and how to deal with those instances where no intention can be divined?

### **Why “tax avoidance” matters**

#### ***The costs and extent of tax avoidance***

1.14. We have not attempted to quantify the extent of tax avoidance, either in terms of the proportion of taxpayers who seek to avoid tax or in the amount of tax lost to the Exchequer.<sup>5</sup> When announcing counter-measures, Treasury ministers or the Revenue departments may put a figure on the sums that they say a currently fashionable tax avoidance scheme is costing the Exchequer. The accuracy of these figures is, however, often difficult to establish, even on assumptions of unchanged behaviour by

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<sup>3</sup> B Bracewell-Milnes, *Tax Avoidance can be Good News for the Tax Collector*, Daily Telegraph, 16 July 1979.

<sup>4</sup> This is similar to the formulation used by the Law Lords in *CIR v Willoughby* [1997] STC 995 at 1004c that tax avoidance is “a course of action designed to conflict with or defeat the evident intention of Parliament.”

<sup>5</sup> One of the objectives of the Canadian general anti-avoidance rule was said to be stability of tax revenues and in 1985–86 Canadian corporate tax revenues were \$1.2 billion lower than the initial budgetary estimates, see Dodge, *A New and More Coherent Approach to Tax Avoidance*, (1988) 36 Canadian Tax Journal 1 at 3. Professor Brian Arnold held the view it was impossible to prove the extent or prevalence of abusive tax avoidance in Canada (even assuming agreement were possible on what is abusive). He regarded the empirical data on the cost of tax avoidance as too sketchy to support any convincing conclusion for or against a general anti-avoidance rule; see Arnold and Wilson, *The General Anti-Avoidance Rule—Part 2*, (1988) Canadian Tax Journal 1123 at 1127–8.

taxpayers, and in reality one cannot predict how taxpayers will alter their behaviour in the face of new anti-avoidance measures.<sup>6</sup>

1.15. Our difficulty in defining or quantifying avoidance does not affect our view that tax avoidance is an issue that matters. Most taxes involve some behavioural effects but we recognise that tax avoidance represents a particularly acute distortion in taxpayers' behaviour and one that may shift the burden of taxation between taxpayers in ways that were not intended and that may be regarded as unfair. Avoidance has an effect on the overall tax system, which leads Governments to attack avoidance in a number of different ways. It is thus a major cause of complex and obscure legislation. This in turn gives rise to uncertainty and added compliance costs for taxpayers.

### *Unfairness*

1.16. Tax avoidance narrows the chosen tax base and shifts the relative tax burden between taxpayers. It is likely to detract from the overall fairness of the tax system. One reason is because the opportunities for avoidance are unlikely to be distributed evenly across the tax paying population as a whole. The uneven spread of avoidance opportunities is not a matter of people's different inclinations to avoid tax or not. Nor does the uneven spread just reflect that those with access to sophisticated tax advice may fare better than those who cannot afford it.

1.17. Inclination and access are aspects of the matter. As between two taxpayers with equal inclination and access, however, the opportunities for avoidance may differ depending upon the nature of their activities, the sources of their income or the supplies they make. One activity, one source of income or one supply may offer better opportunities to avoid tax than exist for other activities, income or supplies, and it is these structural features that sophisticated tax planning will exploit.

1.18. Such opportunities may reflect the choice of tax base but a Government still needs to ensure that its chosen tax system is not totally subverted by ingenious tax planning. Avoidance also raises questions of social and economic policy. Successful avoidance, in specific cases or across a sector, may involve amounts of tax that mirror the revenue effect of politically significant decisions on public spending or taxation policy. We have been told that there comes a point where the Government is much less concerned with making fine distinctions between tax avoidance and tax planning and much more concerned with the effect on the yield to the Exchequer.

### *Complexity*

1.19. Because of its potential fiscal consequences, avoidance is a major influence on the framing of tax legislation and its complexity. Counter avoidance can add considerably to prolixity and complexity when the response to a perceived loophole is to introduce a specific anti-avoidance provision to block it. This may even create new avoidance opportunities by acting as a 'road map' for tax planners. A spiral develops

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<sup>6</sup> See, for example, the comments of the National Audit Office in its 1992 Report on VAT Avoidance regarding the accuracy of certain estimates given by HM Customs & Excise regarding various changes in the VAT regime.

in which the blocking of one loophole is followed by the identification of another, and so on.<sup>7</sup> And because it may be some years before the Courts finally pronounce on a scheme's success or not, Parliament continues to change the law pre-emptively, to prevent the loss of large amounts of revenue.<sup>8</sup>

1.20. The possibility that would-be avoiders will exploit weaknesses in the legislation causes the draftsman and policy advisers to seek to anticipate every eventuality and to make the legislation as avoidance-proof as possible. This approach infects all tax legislation, not just express anti-avoidance provisions. It is practically impossible, however, for the draftsman to deal with the infinite variety and rapidly changing pace of commercial and personal activity.

### ***Uncertainty***

1.21. To complexity, we can add uncertainty. Extensive and complex provisions may blur rather than focus the scope of provisions. As a result, taxpayers and their advisers routinely urge governments to use narrowly and precisely drafted, targeted provisions to give them the certainty they require. But these may fail in their objectives. The clearer the boundaries drawn by the legislation, the easier it may be for taxpayers to arrange their affairs to fall on one side of the boundary or another. There are incentives to draft anti-avoidance measures ever more widely, even at the risk of catching innocent transactions, and to deal with any cases caught unintentionally by administrative concession.<sup>9</sup>

1.22. There are an increasing number of more general anti-avoidance provisions targeted on a particular subject area such as groups,<sup>10</sup> shares<sup>11</sup> and land.<sup>12</sup> Widely drawn anti-avoidance provisions introduce an element of subjectivity and unpredictability, which would be unacceptable without some means for a taxpayer to determine his position in relation to a proposed transaction. Sometimes, measures incorporate a clearance procedure, which allows a taxpayer to apply in advance for a binding ruling.<sup>13</sup> Or there may be a detailed statement of practice, which tells taxpayers the kind of arrangements that the Revenue authorities consider to be covered by the anti-avoidance rule.<sup>14</sup> Such provisions raise important issues as to how the Revenue departments exercise their powers and administer the system. It may make it difficult for taxpayers to conduct their affairs with the requisite degree of confidence.

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<sup>7</sup> A recent example is the VAT (Buildings and Land) Order 1994 SI 3013, a measure that attacks property lease and leaseback schemes. Further action was taken in the 1996 Budget to attack further schemes that were developed in the light of the 1994 anti-avoidance rule.

<sup>8</sup> As, for example, with the interest creation scheme at issue in *Cairns v MacDiarmid* [1983] STC 178. The scheme ultimately failed in the Courts but section 38 Finance Act 1976 was enacted several years before to put the matter beyond doubt.

<sup>9</sup> E.g. the action taken in respect of Equity Notes, section 31 of the Finance (No. 2) Act 1992.

<sup>10</sup> Schedule 4 to the Finance Act 1996.

<sup>11</sup> Sections 703-709 ICTA 1988.

<sup>12</sup> Section 776 ICTA 1988.

<sup>13</sup> E.g. sections 703 and 776 ICTA 1988.

<sup>14</sup> As with the VAT groups anti-avoidance provisions.

## *Secrecy*

1.23. Avoidance is also a reason given for secrecy in the legislative process. Some avoidance measures take effect from the date they are announced because of the amount of revenue perceived to be at risk. There is pressure to enact them quickly. The need for speed and the difficulty of consulting on counter-avoidance can produce ineffective and unduly oppressive legislation.

1.24. Avoidance can also promote concealment and the withholding of information by taxpayers. It encourages the taxpayer not to draw attention to particular transactions that might be considered an avoidance transaction. It discourages the candid explanation of the reasons for a transaction and can even induce the taxpayer to be economical with the relevant facts (so that at the extreme the margin between legal tax avoidance and illegal tax evasion can be tenuous). It is in the interest of would-be avoiders to maintain secrecy as long as possible because official and public knowledge may be followed by legislative action.

### **How do governments deal with tax avoidance?**

1.25. One approach to tax avoidance is to reform those structural elements of the tax system that create the opportunities for avoidance. We accept that this may not be easy and may not be a course that government believes it can achieve within a satisfactory timescale. It may need to take shorter-term action.

1.26. It is possible to take the view that avoidance operates only at the margins of the tax system and that the best way to deal with it is by enacting precisely targeted statutory provisions promptly as avoidance emerges. This approach focuses on parliamentary action and is the traditional way of countering avoidance in the United Kingdom. Scrutiny of the Finance Acts for many years reveals a long list of specific anti-avoidance measures.

1.27. The courts play a basic and central role as interpreters of the basic tax code and the specific anti-tax avoidance elements within it. Their approach to this task may have a profound influence on the scope of tax avoidance activity and the nature of the government's response to avoidance. Courts in many jurisdictions have often acted to protect public revenues from taxpayer abuse. The judiciary here and abroad have developed various approaches—business purpose, step transaction and pre-ordination—to counter blatant tax avoidance devices. Civil Law systems have adapted from civil cases the general principle of “abuse of rights” or “fraus legis”, and applied it in a tax context to the benefit of the revenue authorities.

1.28. A further alternative is to adopt a statutory general anti-avoidance rule. The simple justification for such a rule is that there are limits to legislative language and the capacity for human prediction. Parliament cannot foresee all forms of arrangements entered into by taxpayers. Specific anti-avoidance rules will inevitably leave gaps, which taxpayers will exploit. A general rule may operate within the confines of a specific area of the tax code, or extend across all taxes. It may act alone or as a backstop to specific rules.

## **The structure of the Report**

1.29. We outline in Chapter 2 the type of anti-avoidance measures that UK governments have adopted and the attitude of the UK courts to tax avoidance. In Chapter 3 we examine how several other countries have dealt with avoidance. Thereafter, we consider what other measures the UK might consider taking.

## CHAPTER 2. THE UK APPROACH TO AVOIDANCE

### Legislative approaches to tax avoidance

#### Targeted anti-avoidance legislation

2.1. In general, UK governments have preferred targeted anti-avoidance provisions to deal with specific abuses. There are many and varied examples of these in the taxing statutes and we think it unnecessary in this Report to describe or summarise this variety. A targeted approach is consistent with the traditional UK legal view that legislation should state clearly the circumstances in which a liability to tax arises, leaving the minimum scope for the Revenue authorities to determine those circumstances.

#### Retrospective anti-avoidance legislation

2.2. A common technique with anti-avoidance measures is to announce that the law will be changed with immediate effect. The legislation is enacted later. In the meantime, more or less information may be available of the detail of the change. In some cases the announcement may be accompanied by draft legislation.<sup>1</sup> In others, there may be a brief statement and the detail only emerges at a later date.<sup>2</sup> We believe that this form of “legislation by announcement” is widely regarded as an acceptable way for government to deal with avoidance activity that it considers it must counter.

2.3. On occasion, and as a measure of last resort, governments have enacted specific anti-avoidance provisions that are retrospective in operation. By this, we mean that the provisions operate from a date earlier than the date the measures were announced.<sup>3</sup> There are obvious constitutional objections to retrospection and issues that arise from the European Convention on Human Rights. However displeasing his actions may be to the Chancellor or the Revenue authorities, the taxpayer must (in the absence of any prior announcement) be entitled to arrange his affairs in accordance with the rules at the time.

#### General anti-avoidance approaches in specific areas

2.4. The UK currently has no over-arching statutory general anti-avoidance rule. Sometimes, however, a compromise has been struck between the use of a specific anti-avoidance provision and a more general approach. The law draws a line around

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<sup>1</sup> See, for example, Inland Revenue Press Release, *Petroleum revenue tax—anti-avoidance legislation*, 23<sup>rd</sup> July 1996, [1996] Simon’s Tax Intelligence 1269. The draft legislation attached to the press release was incorporated as clause 106 of the first Finance Bill of 1997.

<sup>2</sup> See, for example, Inland Revenue Press Release, *Tax saving measures in respect of companies buying their own shares or paying special dividends*, 8<sup>th</sup> October 1996, [1996] Simon’s Tax Intelligence 1627. The legislation was incorporated as Schedule 7 to the first Finance Bill of 1997.

<sup>3</sup> See, for example, section 31 of the Finance Act 1978, which attacked loss relief claimed against commodity carry schemes. The legislation was made retrospective to 6 April 1976.

an area of potential abuse and empowers the Revenue authorities to counter any arrangement within that area that confers a tax advantage and fails to satisfy the required criteria.

2.5. This approach is not normally as drastic as the “annihilation” or “reconstruction” approaches that are commonly used in an over-arching statutory general anti-avoidance rule. A general provision within a targeted area of the tax code nevertheless leaves the Revenue authorities with much more flexibility to tackle all forms and variations of avoidance in that area, and to act with considerable administrative discretion.

2.6. An example of this approach that has been on the statute book since 1960 is found in sections 703 to 709 of the Income and Corporation Taxes Act 1988. This applies to certain transactions in securities and does allow a degree of “reconstruction” to occur for the purpose of determining the tax that shall be paid where transactions fall foul of the detailed provisions of these sections.

2.7. There are more recent examples of this general approach to countering avoidance. Two are found in the Finance Act 1996. Paragraph 13 to Schedule 9 of that Act counters avoidance by companies under the loan relationship provisions by disallowing deductions in respect of a loan for “unallowable purposes”. Schedule 4 to the 1996 Act prevents companies exploiting the VAT group rules to enable recovery of VAT in unintended circumstances. In this latter case, HM Customs & Excise has produced a fifteen page Statement of Practice to explain the legislation and how Customs intend to apply it. It also gives examples of arrangements which are accepted as being inoffensive and of those where Customs say they would use their powers under Schedule 9A.

2.8. There are, however, other anti-avoidance provisions that occupy the uncertain ground between specific and general measures. These appear highly specific in their detail but the complexity and generality of the terms they use lead to the criticism of fundamental uncertainty and that, as a result, they give the Revenue departments considerable scope to decide how to interpret and apply the measures.<sup>4</sup>

## **Judicial approaches to tax avoidance**

### **Statutory interpretation**

#### ***Literalism and form over substance***

2.9. We noted in Chapter 1 that the traditional attitude of the UK Courts to statutory interpretation may be said to have created the conditions that promote avoidance arrangements. This approach, which has been both formalist and literalist, has inevitably influenced the framing of tax law. The language of a UK taxing statute is intentionally tight: the draftsman aims to leave no conceivable ambiguity or doubt

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<sup>4</sup> See, for example, Pearce, *Gains from Property Transactions—The Attack on Tax Avoidance* [1980] BTR 382.

that might mean that tax is not imposed in circumstances where it was intended that it should be.

2.10. The literalist approach is neatly summed up in Lord Cairns' famous statement in 1869 in *Partington v Attorney General*<sup>5</sup> that—

“...if the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of a statute.”

Rather more recently, in 1952, Viscount Simonds reiterated this approach in the context of tax avoidance legislation in *St Aubyn v Attorney General*<sup>6</sup>:

“The question is not at what transaction the section is, according to some alleged general purpose, aimed, but at what transactions its language, according to its natural meaning, fairly and squarely hits.”

2.11. When the literalist approach to statutory construction operates by reference to a formalist view of documents and the rights of the parties to them, the result is that transactions that might in other countries be seen as artificial and tax-driven are accepted at their face value. This combination of literalism and formalism was regarded for many years as sanctioned by *Duke of Westminster v IRC*.<sup>7</sup> The House of Lords in that case upheld an arrangement under which the Duke made covenanted payments to his staff in lieu of wages. The explanation for the arrangement was that in the 1930s the Duke could deduct from his income for tax purposes covenanted payments but he could not deduct the wages paid to his domestic staff, which were a personal expense.

2.12. A majority of the House of Lords held that the Duke should be taxed according to the legal form of the transactions, and not according to their economic substance. In the words of Lord Tomlin<sup>8</sup>—

“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...This so-called doctrine of ‘the substance’ seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.”

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<sup>5</sup> [1869] LR 4E&I App. HL 100.

<sup>6</sup> [1952] AC 15.

<sup>7</sup> [1936] 19 TC 490.

<sup>8</sup> At page 520.



That case represented the high-water mark in favour of the taxpayer and remained enormously influential over many years.

### *A more purposive approach*

2.13. The Courts have come some way from the strict literalism of Lord Cairns and Lord Tomlin. The literal approach to statutory construction is still important, in the sense that where the words of the taxing statute are clear, the Courts will normally give effect to them. But language is rarely confined to one interpretation only!<sup>9</sup> Emphasis is laid on the contextual or schematic method of construction. Lord Wilberforce commented in 1980<sup>10</sup>–

“A subject is only to be taxed upon the clear words, not upon “intendment” or upon the “equity” of an Act...What are “clear words” is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded.”

Although it may have begun quite a long time ago, this trend is developing and recent decisions have pushed it further.<sup>11</sup>

2.14. The courts may now also resort to Hansard as an interpretative tool to determine the purpose of legislation.<sup>12</sup> Reference to Parliamentary material is, however, confined to cases of ambiguity or obscurity, and only where the statement is by the promoter of the Bill and clearly discloses the mischief aimed at or the intention of the legislation. Ministerial statements relating to other provisions of the same Bill but which might have given guidance on the provision in question cannot be used.<sup>13</sup> Nor will the Courts use as an aid to construction the official Press Release issued at the time a provision comes into force.<sup>14</sup>

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<sup>9</sup> “I recognise that agile legal minds could probably find an ambiguity in as simple a request as “close the door please” and most certainly in even the shortest and clearest of the ten commandments.” Per Justice Cory in *Alberta (Treasury Branches) v MNR* [1996] 1 SCR 963 at 976.

<sup>10</sup> *Ramsay v IRC* [1981] STC 174, 179.

<sup>11</sup> *De Rothschild v Lawrenson* [1995] STC 623; *Chevron UK Ltd v CIR* [1995] STC 1712; *IRC v McGuckian* [1997] STC 908.

<sup>12</sup> In *Pepper v Hart* [1992] STC 898, the House of Lords had to consider whether Mr Hart, a schoolmaster at Malvern College, received a taxable benefit in kind for his child’s education at the College under a concessionary fees scheme available to children of members of staff. Had the Law Lords had regard only to the words of the legislation, they would have found that Mr Hart should pay tax on the benefit of paying reduced fees. But when the legislation was introduced, the Treasury Minister concerned had told Parliament that legislation only taxed the marginal cost of such arrangements. The House of Lords decided they could look at the Parliamentary record and found in Mr Hart’s favour as Mr Hart had already reimbursed the College for the marginal cost of educating his son.

<sup>13</sup> *Melluish v BMI (No 3) Ltd* [1995] STC 964.

<sup>14</sup> *Elf Enterprise v IRC* [1994] STC 785.

2.15. The greater use of purposive techniques has also been in evidence when the Courts have had to construe a statute based on European law. In European Community legislation, the purpose is set out in the preamble and there are certain general principles that underpin all Community law.

2.16. The Sixth VAT Directive 77/388/ EEC is the basis for VAT legislation. Where possible, the VAT Act 1994 has to be construed in a manner consistent with the Directive,<sup>15</sup> even where the plain words of the statute might suggest a different meaning. The Courts must also have regard to the developing jurisprudence of the European Court of Justice, which relies heavily on the teleological method of interpretation. When applying VAT legislation, the Judges have consistently looked at the whole scheme of the legislation and its underlying principles.<sup>16</sup> This has meant that tax avoidance schemes based on apparent loopholes in UK law are frequently unsuccessful.

### *The “new realism”<sup>17</sup>*

2.17. In the 1970s a new form of tax avoidance appeared. Tax avoidance became big business and schemes were commercially marketed. A characteristic scheme was directed at transactions that had already taken place. It was therefore too late for conventional tax planning but the scheme aimed to manufacture a loss, which could be used to offset the tax liability. It was important that the loss should not be a real loss; otherwise there would be no advantage to the taxpayer.

2.18. The “new realism” describes the approach adopted by the Courts to curb these complex and artificial tax avoidance schemes. If a backwards look is taken at the *Westminster* case, there is still no judicial doctrine that allows the Revenue departments to tax on the basis of the economic substance of transactions. The Courts have, however, emphasised the legal substance and nature of transactions over their form.

2.19. The new realism first gained acceptance in *W T Ramsay v IRC*,<sup>18</sup> when the Law Lords struck down a scheme as a fiscal nullity. The case demonstrated an example of a circular scheme in which transactions were entered into, money changed hands and documents were executed with legal effect. At the end of the day, however, everyone was back where he or she started apart from payment of a fee to the promoter of the scheme. Lord Templeman vividly described the artificiality of it all<sup>19</sup>–

“The facts...demonstrate yet another circular game in which the taxpayer and a few hired performers act out a play; nothing happens save that the Houdini

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<sup>15</sup> *Garland v British Rail Engineering Ltd* [1983] 2 AC 751.

<sup>16</sup> As in *C&E Commrs v Apple and Pear Development Council* [1986] STC 192; *Neuvalle v C&E Commrs* [1989] STC 395; *Schemepanel Trading Ltd v C&E Commrs* [1996] STI 800.

<sup>17</sup> Term used by Lord Oliver of Aylmerton, *Judicial Approaches to Revenue Law*, in *Striking the Balance: Tax Administration, Enforcement and Compliance in the 1990s*, eds. Gammie and Shipwright IFS (1996).

<sup>18</sup> (1979) 54 TC 101.

<sup>19</sup> At page 128.

taxpayer appears to escape from the manacles of tax...the play is devised and scripted prior to performance...The object of the performance is to create the illusion that something did happen, that Hamlet has been killed and that Bottom did don an ass' head so that tax advantages can be claimed as if something had happened.”

In the House of Lords the Inland Revenue argued successfully that the taxpayer had made no real financial loss and could not claim a loss for tax purposes. In a series or combination of transactions, intended to operate as such, it was the legal nature of the series that mattered. There was no requirement that each step had to be considered separately. The intermediate steps could be struck out.

2.20. The effect of this was underlined by Lord Diplock in *IRC v Burmah Oil*.<sup>20</sup> He said that the approach taken in *Ramsay* marked<sup>21</sup>—

“...a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable.”

2.21. The development of the doctrine continued in *Furniss v Dawson*.<sup>22</sup> The taxpayer wished to sell shares to an independent third party. Here the scheme, which involved making the sale of shares via an offshore intermediate company, was not circular but linear. By routing the transaction in this way, the taxpayer hoped to defer indefinitely the liability to capital gains tax that would have accrued on a direct sale of the shares. The House of Lords extended the *Ramsay* fiscal nullity doctrine to redefine what the taxpayer had done. There was a single composite transaction consisting of a pre-ordained series of transactions, into which steps had been inserted with no commercial purpose beyond the avoidance of tax. Where these conditions were present the Court would ignore the inserted steps and look to the end result to determine the tax consequences. Effectively, the exchange was not of a type that the courts would recognise as falling within the provisions allowing tax to be deferred.<sup>23</sup>

2.22. The new realism also embraces a new willingness to examine very carefully the actual legal effect of transactions, or a series of transactions, to decide precisely what are the true legal rights and obligations to which they give rise. The Courts are not bound by the labels which the parties themselves give to their transactions or by their form if the legal effect is something different. A good example of this is *Ensign*

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<sup>20</sup> (1981) 54 TC 200.

<sup>21</sup> At page 214.

<sup>22</sup> [1984] 55 TC 324.

<sup>23</sup> The House of Lords was adopting a similar approach to the one that used by Learned Hand J nearly 50 years earlier in the US tax case of *Helvering v Gregory* (1934) 69 F 2d 809, affirmed [1935] 293 US 465; see Millett, *Artificial Tax Avoidance: The English and American Approach* [1986] BTR 327.

*Tankers (Leasing) Ltd v Stokes*.<sup>24</sup> This involved an attempt to arbitrage capital allowances for film production costs without incurring the full amount of the expenditure against which the deduction was being claimed. Essentially, the tax avoidance scheme documents sought to characterise the balance of the costs as a non-recourse loan. The House of Lords analysed the transaction and concluded that, on a true construction of the documents and their legal effect as a whole, the taxpayer never paid or was liable to pay the full amount claimed. Accordingly, they got their allowances on the costs they had actually borne, and nothing more.

2.23. The sentiment of the *Ensign Tankers* case finds more recent expression in the following definition of tax avoidance offered by the House of Lords in *IRC v Willoughby*<sup>25</sup>—

“The hall mark 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 tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.”

### ***The limits of new realism***

2.24. A number of cases have focused on the question of what degree of pre-ordination is needed for this doctrine to apply. *Craven v White*<sup>26</sup> and *Fitzwilliam v IRC*<sup>27</sup> have served to limit the practical application of the *Ramsay* principle. Both cases took a narrow view of pre-ordination.<sup>28</sup> In *Craven*, a case very similar to *Furniss*, the taxpayer had not found a definite third party purchaser; in *Fitzwilliam*, an inheritance tax case, although numerous steps were involved the Court failed to identify a scheme that it could treat as a single composite transaction. What these cases have made clear is that the new realism will not strike down any avoidance arrangement simply because it is pre-planned.

2.25. The House of Lords in *IRC v McGuckian*<sup>29</sup> has, however, taken the opportunity to restate vigorously the *Ramsay* doctrine.<sup>30</sup> In doing so, the Law Lords

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<sup>24</sup> (1992) 64 TC 617.

<sup>25</sup> [1997] STC 995, 1003.

<sup>26</sup> [1988] STC 476.

<sup>27</sup> [1993] STC 502.

<sup>28</sup> Lord Oliver has expressed the view that: “*Craven v White* and the two associated appeals were examples of the Revenue attempting to push their luck beyond acceptable limits.” See Oliver, *Judicial approaches to revenue law*, op. cit. at page 185.

<sup>29</sup> [1997] STC 908.

<sup>30</sup> None of the Law Lords, however, chose to deal with *Craven v White* and *Fitzwilliam* and the limiting effect of these decisions on the *Ramsay/Dawson* doctrine in the light of *McGuckian* is unclear.

justified the doctrine as an approach to the construction of taxing statutes. Lord Browne-Wilkinson said<sup>31</sup>–

“The approach pioneered in the *Ramsay* case and subsequently developed in later decisions is an approach to construction, viz. that in construing tax legislation, the statutory provisions are to be applied to the substance of the transaction or series of transactions inserted only for the purpose of seeking to obtain a tax advantage. The question is not what was the effect of the insertion of the artificial steps but what was its purpose. Having identified the artificial steps inserted with that purpose and disregarded them, then what is left is to apply the statutory language of the taxing Act to the transaction carried through, stripped of its artificial steps.”

2.26. Lord Steyn noted that Lord Wilberforce’s speech in the *Ramsay* case marked the rejection by the House of Lords of pure literalism in the interpretation of tax statutes and of a formalistic approach to composite transactions. He explained the basis of the doctrine in these terms<sup>32</sup>–

“The new *Ramsay* principle was not invented on a juristic basis independent of statute. That would have been indefensible since a court has no power to amend a tax statute. The principle was developed as a matter of statutory construction...The new development was not based on a linguistic analysis of the meaning of particular words in a statute. It was founded on a broad purposive interpretation, giving effect to the intention of Parliament. The principle enunciated in the *Ramsay* case was therefore based on an orthodox form of statutory interpretation. And in asserting the power to examine the substance of a composite transaction the House of Lords was simply rejecting formalism in fiscal matters and choosing a more realistic analysis.”

2.27. Lord Steyn added that it would be wrong to regard the decision in *Ramsay* as necessarily marking the limit of the law on tax avoidance schemes. Lord Cooke of Thorndon echoed this sentiment with this warning to taxpayers and their advisers–

“In *Furniss* [1984] AC 474, 527 Lord Brightman spoke of certain limitations (a preordained series of transactions including steps with no commercial or business purpose apart from the avoidance of a liability to tax). The present case does fall within these limitations, but it may be as well to add that, if the ultimate question is always the true bearing of a particular taxing provision on a particular set of facts, the limitations cannot be universals. Always one must go back to the discernible intent of the taxing Act. I suspect advisers of those bent on tax avoidance, which in the end tends to involve an attempt to cast on other taxpayers more than their fair share of sustaining the national tax base, do not always pay sufficient heed to the theme in the speeches in *Furniss*, especially those of Lords Scarman, Roskill and Bridge of Harwich, to the effect that the journey’s end may not yet have been found.”

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<sup>31</sup> *Ibid* at 914.

<sup>32</sup> [1997] STC 908, 916.

2.28. In terms of statutory construction, the *Ramsay* principle can be regarded as an anti-avoidance principle of general application. As such, the courts have applied the principle in cases on income tax,<sup>33</sup> capital gains tax,<sup>34</sup> corporation tax<sup>35</sup> and stamp duty.<sup>36</sup> Following *Fitzwilliam*, however, it is uncertain in what circumstances it may apply to inheritance tax. Attempts have been made to apply it in the case of VAT<sup>37</sup> but without success. This may be due to the nature of VAT as a European tax and that it is, by definition, a tax on individual supplies which cannot be looked through or ignored.<sup>38</sup> The Sixth Directive has its own special procedures for dealing with cases of “abuse”.<sup>39</sup>

## Conclusion

2.29. As this brief summary of the current position illustrates, UK governments have adopted a variety of approaches to counter tax avoidance. Legislative provision ranges from highly specific tax avoidance provisions to more general approaches confined to specific areas of the tax code. To date, however, action has stopped short of the adoption of an over-arching statutory general anti-avoidance rule, such as is found in other countries. It has been left to the courts to develop a response to the more extreme and contrived actions of taxpayers to reduce their tax liabilities.

2.30. The question we address later in this Report is whether it is appropriate to continue to rely solely upon a judicial general anti-avoidance doctrine or whether a statutory general anti-avoidance rule is to be preferred. First, however, we look at the state of general anti-avoidance provisions enacted by a number of other countries.

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<sup>33</sup> *Moodie v IRC* [1993] STC 188.

<sup>34</sup> *Eilbeck v Rawlins* [1981] STC 174.

<sup>35</sup> *Coates v Arndale* [1984] STC 637.

<sup>36</sup> *Ingram v IRC* [1985] STC 835.

<sup>37</sup> *Friary Leasing Ltd v C&E Commrs* [Lon/88/1026Z]; *Faith Construction & West Yorkshire Independent Hospital (Contract Services Ltd) v C&E Commrs* [1989] STC 539.

<sup>38</sup> See Gammie, *Disappearing Billions: How Should VAT Avoidance be Controlled?*, VAT Intelligence, Volume 15, Number 8, August 1997, page 1434.

<sup>39</sup> Article 27 of the EC Sixth Directive allows the Council to authorise any Member State to introduce special measures derogating from the Directive in order to prevent certain types of tax evasion or avoidance.

## CHAPTER 3. OTHER COUNTRIES

### A world-wide problem?

3.1. In the previous Chapter we looked at the judicial and legislative approaches currently adopted in the UK to counter tax avoidance. In this Chapter we examine the methods used in a number of other countries, notably Australia, Canada and New Zealand, which share with us a Common Law background and methods of interpretation.

3.2. A comparative approach has its dangers. A country's taxation system is the product of its own history, experience and cultural perspectives. Unacceptable tax avoidance and tax mitigation are universally recognised concepts but the legislative, judicial and administrative approaches to them vary considerably between jurisdictions, within a jurisdiction, and even over time as government policies and social and judicial attitudes change. It is therefore entirely appropriate that we should be wary of importing legal doctrines or techniques from elsewhere. Nevertheless, it is useful to see what lessons might be learned from the way other countries tackle the common problem of tax avoidance.

### Canada<sup>1</sup>

#### Judicial approach

3.3. The starting point for the recent development of Canada's approach to tax avoidance is *Stuart Investments Ltd v The Queen*.<sup>2</sup> Prior to the decision in *Stuart* in 1984, the approach adopted by the Canadian courts in tax avoidance arrangements was not entirely clear. In *Colgate-Palmolive-Peet Co Ltd v The King*,<sup>3</sup> the Supreme Court indicated that Revenue Canada's function was to ascertain *the character and substance of the real transaction* and to levy tax on the basis of that transaction. What the Court had in mind, however, was the substance of the legal arrangement entered into, and not its economic or financial outcome. Accordingly, the direction of judicial thinking in Canada was consistent with that adopted in 1936 by the House of Lords in the *Duke of Westminster's* case. In Canada, the long-standing judicial approach has been that taxpayers are entitled to arrange their affairs in any legal way to minimise their tax liabilities.<sup>4</sup>

3.4. Nevertheless, the Canadian courts, while unwilling to allow taxation by reference to the economic or financial substance rather than the true legal consequences of transactions, were not prepared to give taxpayers entirely free rein. A

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<sup>1</sup> For a detailed analysis of the Canadian GAAR and the background to it, see Arnold and Wilson, *The General Anti-Avoidance Rule*, (1988) 36 Canadian Tax Journal 829–887, 1123–1185, 1369–1410.

<sup>2</sup> [1984] CTC 294; 84 DTC 8305 (SCC).

<sup>3</sup> (1933) 1 DTC 238; [1933] SCR 131.

<sup>4</sup> See *Gibraltar Mines Ltd v The Queen* [1982] CTC 1 at 4.

number of decisions left some uncertainty as to whether the courts would be prepared over time to develop business purpose or step transaction doctrines as a response to avoidance.<sup>5</sup> The decisions usually involved combining a number of arguments—sham, business purpose, substance over form, step transaction and agency—as a means of defeating the tax avoidance arrangement. As a result, there emerged no single coherent judicial approach to counter avoidance.

3.5. Revenue Canada’s attempts to establish business purpose as a separate independent anti-avoidance rule were ended in *Stubart Investments*. The Supreme Court in *Stubart Investments* rejected the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide purpose.<sup>6</sup> It accepted, however, that a “modern” approach, based on the “object and spirit” of fiscal legislation, had replaced the strict approach to interpretation, namely that—

“...the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.”

3.6. At the same time, the Court in *Stubart* set out a number of guidelines designed to establish the proper role of the courts in interpreting the Income Tax Act where the Revenue authority relied on the general pattern of the Act to support its case.<sup>8</sup> Professor Arnold’s conclusion at the time was that the guidelines introduced no extra-statutory limits on tax avoidance and concluded that where the language of the Act was clear, it must be given its plain meaning.<sup>9</sup>

### **The general anti-avoidance rule**<sup>10</sup>

3.7. The *Stubart* decision coincided with a change in Revenue Canada’s administrative attitude and practices. The Department began to accept a more literal interpretation of the Act and to offer rulings on avoidance transactions. It issued a Declaration of Taxpayer Rights which told taxpayers that “you have a right to arrange your affairs in order to pay the minimum tax required by law.”

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<sup>5</sup> See *Smythe et al. v MNR* [1969] CTC 558; 69 DTC 5361 (SCC); *West Hill Redevelopment Co v MNR* [1969] CTC 581; 69 DTC 5385 (Ex Ct).

<sup>6</sup> [1984] CTC 294 per Mr Justice Estey at 314.

<sup>7</sup> The Court was following E A Driedger’s formulation contained in *The Construction of Statutes*, 2nd ed.

<sup>8</sup> For a discussion of these guidelines, see McDonnell and Thomas, *The Supreme Court and Business Purpose: Is There Life after Stubart?*, (1984) 32 Canadian Tax Journal 853.

<sup>9</sup> Arnold and Wilson, *The General Anti-Avoidance Rule—Part I*, (1988) 36 Canadian Tax Journal 829, 865.

<sup>10</sup> The following summary derives from Arnold, *The Canadian General Anti-Avoidance Rule*, in *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (The Netherlands), 1997. Professor Brian Arnold was a consultant to the Canadian Department of Finance during the 1987 tax reform exercise that led to the introduction of the general anti-avoidance rule in 1988.



3.8. Unsurprisingly, the incidence of aggressive tax planning increased, to a point at which the government became concerned for the integrity of the self-assessment system and the stability of tax revenues. Accordingly, in 1987 the Canadian government announced its intention to enact a general anti-avoidance rule. After a year's consultation on the form of the rule, it adopted section 245 of the Income Tax Act to operate alongside and reinforce the many specific anti-avoidance provisions in Canadian tax law.<sup>11</sup> An equivalent provision in the Excise Tax Act covers the Goods and Services Tax.<sup>12</sup>

3.9. The new rule is aimed at abusive tax avoidance and is not intended to inhibit legitimate commercial or family arrangements. In formulating the rule, two different approaches were considered to distinguish abusive and legitimate arrangements. Either the rule could focus on "artificial" transactions or it could attack transactions entered into primarily for avoidance purposes. The conclusion was that a test of artificiality would be too narrow and imprecise, and potentially inclusive of innocent transactions. The government decided that a primary purpose test would be better targeted but accepted that it could still catch transactions viewed as acceptable in policy terms. As a result the legislation was widely framed, but contained a safe haven for inoffensive transactions.

3.10. The anti-avoidance rule states that where any transaction is an "avoidance transaction" (widely defined), the tax consequences will be determined "as is reasonable in the circumstances" to deny the "tax benefit" (widely defined), unless the transaction "may reasonably be considered" to have been undertaken or arranged primarily for bona fide non-tax purposes. The rule focuses on the purpose of the transaction rather than the taxpayer's purpose and the language of the rule suggests an attempt to introduce some objectivity to the rule, rather than make its application depend solely on the taxpayer's stated purpose or intention.<sup>13</sup>

3.11. There is a general exception designed to cover acceptable tax saving and based on Civil Law *abus de droit* principles. The anti-avoidance rule does not apply where it may reasonably be considered that the transaction would not result directly or indirectly "in a misuse of the provisions of [the] Act or an abuse, having regard to the provisions of [the] Act...read as a whole." The legislation does not provide any criteria by which to judge whether a transaction should be regarded as a misuse of particular provisions or an abuse of the Act as a whole.

3.12. As guidance, the Department of Finance has explained the exception on the basis that a number of statutory provisions "either contemplate or encourage

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<sup>11</sup> See Appendix 1. The original section 245 was also an anti-avoidance provision in general terms but of far more limited application. It was the original section 245, however, that led the Supreme Court in *Stubbart Investments* to conclude against a judicial general anti-avoidance rule. This was on the basis that the legislature had enacted a general rule in the original section 245 and had thereby expressed an intention that the courts should not develop its own general doctrine.

<sup>12</sup> Section 274.

<sup>13</sup> As Arnold notes, even if the rule is subjective, a taxpayer's subjective intention must be verified by reference to objective facts.

transactions that may seem primarily tax motivated...It is not intended that section 245 will apply to deny the tax benefits that result from these transactions as long as they are carried out within the object and spirit of the Act read as a whole".<sup>14</sup> The *Stuart* principles envisage that the courts must interpret tax legislation according to the object and spirit of the Act. The precise scope and effect of the exception, and whether it will play a significant role in denying the application of the main rule, remain uncertain in the absence of significant judicial consideration.

### **Administrative application of the rule**

3.13. The explanatory notes to the rule indicated that it was intended to apply as a measure of last resort. Specific anti-avoidance provisions accordingly continue as a first line of defence against avoidance. The precise relationship between specific rules and the general rule, however, remains an open question that will presumably be explored on a case by case basis. Following the adoption of the rule, Revenue Canada issued an information circular confirming that they would apply the rule only to abusive tax avoidance and offering a number of examples of transactions to which the rule would or would not apply.<sup>15</sup>

3.14. To ensure consistency of approach, Revenue Canada has indicated that their Head Office will review all proposed assessments invoking the anti-avoidance rule. A special GAAR Committee has been established made up of senior officials from the Department of Finance, the Justice Department and Revenue Canada. The findings are not published and are not a matter of public record. At 30 June 1996, the GAAR Committee had considered 195 cases from audit and in 127 the Committee had recommended the rule be applied.<sup>16</sup> Revenue Canada will issue advance rulings with respect to the application of the general rule to proposed transactions, but no statistics are kept about referrals to the Committee from rulings.

3.15. Issues that have been considered by the Committee have been disclosed in a number of ways. Revenue Canada publishes summaries of the facts and rulings in those cases that will provide further guidance but are not themselves published. As previously noted, they have also issued Information Circulars that expand on their views as to what is acceptable and unacceptable tax planning. Practitioners do complain nevertheless that in practice it is not easy to get guidance about the possible tax consequences of transactions. Arnold considers, however, that the rule has not had the disastrous impact on commercial and family life that was predicted by practitioners in 1987.<sup>17</sup>

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<sup>14</sup> Dept of Finance, *Explanatory Notes to Legislation relating to Income Tax*.

<sup>15</sup> Revenue Canada, Taxation, Information Circular 88-2, October 21, 1988. They issued a first supplement to the Circular on July 13, 1990.

<sup>16</sup> See Taylor, *Current Tax Avoidance Cases*, in *Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report* (Toronto, Canadian Tax Foundation, 1996).

<sup>17</sup> See Arnold, *The Canadian General Anti-Avoidance Rule*, in *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (The Netherlands), 1997, page 241.

## **Judicial responses to the rule**

3.16. Most GAAR issues have arisen from tax audits and this explains the delay in cases coming before the GAAR Committee and the courts. Although the legislation has been in place for nine years, there have been only three decisions on its application, all recent and decided in favour of Revenue Canada.<sup>18</sup> The statutory rule leaves open a variety of issues for the courts to decide as and when appropriate cases come to them. It is therefore too early to predict how the Canadian courts will ultimately deal with the anti-avoidance rule. It is certainly still possible for the courts to emasculate the rule or, at the other extreme, to apply it so widely that it affects normal commercial activity far more severely than seems to have been the case to date.

3.17. The Canadian rule did not seek to alter how the courts should interpret tax legislation or restrain the future development of judicial anti-avoidance doctrines. Following *Stubbart Investments* the latter was presumably thought unnecessary. Decisions of some lower courts since *Stubbart Investments* have suggested, however, a willingness to strike down avoidance transactions on general judicial grounds.<sup>19</sup> Other decisions have confirmed that where the words of the statute are clear and unambiguous, they must prevail.<sup>20</sup> The more purposive approach is relevant only if ambiguity exists.<sup>21</sup>

## **Australia**

### **Rules of statutory interpretation**

3.18. In interpreting Australian tax legislation, the High Court has emphasised that “the fundamental object of statutory construction in every case is to ascertain the legislative intention by reference to the language of the instrument viewed as a whole.”<sup>22</sup> Section 15AA of the Acts Interpretation Act now requires the courts to adopt a purposive approach to resolve any ambiguity of meaning and section 15AB enables the courts to look at extrinsic aids to interpretation to support that approach.

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<sup>18</sup> A trade tribunal case covered by the Excise Tax provision, *Michelin Tires (Canada) Ltd v MNR* [1995] CITT No. 20 and very recently (17 January 1997) a decision of the Tax Court of Canada, *McNichol v The Queen*, Actions 94-1579(IT), 94-1578(IT), 94-1577(IT), 94-1677(IT); and (10 April 1997) *Equilease Corporation v The Queen* and *RMM Enterprises Inc v. The Queen*.

<sup>19</sup> See *The Queen v Fording Coal Ltd* (1995) 95 DTC 5672, [1996] 1 CTC 230; *The Queen v Continental Bank Leasing Corporation* (1996) 96 DTC 6355; *Canwest Broadcasting Ltd v The Queen* (1996) 96 DTC 1375. See also McDonnell, *Whose in Control Here?*, examining the Federal Court of Appeal decision in *The Queen v Duha Printers (Western) Ltd* [1996] 3 CTC 19 in *Current Tax Cases*, (1997) 45 Canadian Tax Journal 114.

<sup>20</sup> *Antoska et al. v The Queen* 94 DTC 6314; [1994] 2 CTC 25 (SCC); *Friesen v The Queen* 95 DTC 5551; [1995] 2 CTC 369 (SCC)

<sup>21</sup> See Meghji and Grenon, *An Analysis of Recent Tax Avoidance Cases*, Canadian Tax Foundation 1996 Conference Report, Volume 2, Section 66.

<sup>22</sup> *Cooper Brooks (Wollongong) Pty Ltd v FCT* (1981) 147 CLR 297.

### The history of the Australian general anti-avoidance provisions

3.19. The long-standing existence of a statutory general anti-avoidance rule has, however, made it unnecessary for the Australian courts to develop a judicial anti-avoidance doctrine.<sup>23</sup> Australia's use of a statutory general anti-avoidance provision dates back to the introduction of the federal income tax in 1916. Prior to 1981, the statutory provision was found in section 260 of the Income Tax Act 1936. The section provided that any contract, agreement or arrangement was void to the extent that it purported to alter the incidence of income tax, relieve a person from paying income tax, avoiding any liability to tax or preventing the operation of the Act in any respect. The provisions, although apparently of great width, failed to offer any guidance to distinguish between acceptable and unacceptable avoidance. Furthermore, it was an "annihilating" provision, it did not allow the substitution or recharacterisation of transactions where avoidance was present.

3.20. The Courts adopted three approaches to section 260: the predication test, the choice principle and the antecedent transaction doctrine. The Privy Council propounded the predication test in *Newton v FCT*. In Lord Denning's view,<sup>24</sup> section 260—

“is not concerned with [the taxpayer's] desire to avoid tax, but only with the means which they employ to do it...In order to bring the arrangement within the section, you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in a particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section...The section can still work if one of the purposes or effects was to avoid liability for tax. The section distinctly says “so far as it has” the purpose or effect. This seems to their Lordships to import that it need not be the sole purpose.”

This approach to the section was largely emasculated by the development of the choice principle. If the Act offered two explicit choices, the section could not defeat the taxpayer's right to choose the more tax efficient outcome.<sup>25</sup> This left little scope for the section to operate. Furthermore, the courts considered that the reference in section 260 to arrangements that “altered the incidence of any income tax” were satisfied only where there was an antecedent transaction that was then changed for tax purposes.<sup>26</sup>

3.21. The limitations that the courts placed on section 260 have been largely ascribed to the influence of Barwick CJ and in considering section 260 reliance was

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<sup>23</sup> *Patcorp Investments v FCT* [1977] 140 CLR 330.

<sup>24</sup> (1958) 98 CLR 2, at 8.

<sup>25</sup> *W P Keighery Pty Ltd v FCT* (1957) 100 CLR 66; *Cridland v. FCT* 77 ATC 4538; *Slutzkin v. FCT* 77 ATC 4076.

<sup>26</sup> *Mullens v FCT* 76 ATC 4288.

often placed on the approach adopted in the *Duke of Westminster's* case. With a change of judicial attitude to avoidance in the 1980s, however, the predication test for section 260 enjoyed a revival<sup>27</sup> but by that time a new general anti-avoidance provision in Part IVA had in 1981 replaced section 260.

### **The new general anti-avoidance rule**

3.22. The new rule in Part IVA<sup>28</sup> addresses a number of the failings of section 260. It is possible to reconstruct a transaction for tax purposes. The purpose of the taxpayer also has to be considered. Any other statutory provisions, such as specific anti-avoidance provisions do not limit the operation of Part IVA, but these are to be applied first, before the general rule.

3.23. For Part IVA to apply, the taxpayer must obtain a “tax benefit” (widely defined) in connection with a “scheme” (widely defined), the sole or “dominant purpose” of which is to obtain the “tax benefit”. This is determined objectively by having regard to the factors listed in section 177D.<sup>29</sup> Only when these specified criteria are met is the Commissioner empowered to make a determination in respect of the tax benefit and reconstruct the scheme for tax purposes. There is no general legislative safe harbour for acceptable tax driven transactions.

3.24. In the 16 years since the introduction of Part IVA, the Australian High Court (the apex of the judicial system) has given only two judgments dealing with its proper application.<sup>30</sup> The earlier<sup>31</sup> of the two cases was decided in favour of the taxpayer, mainly because the Commissioner failed to identify the relevant tax benefit that the taxpayer would receive in the year in question. It illustrates the difficulties revenue authorities may have in engaging in the hypothetical reconstruction of a transaction provided for in a general anti-avoidance rule.<sup>32</sup>

3.25. The second<sup>33</sup> was decided in favour of the Commissioner. It concerned an offshore investment that offered a lower pre-tax return than equivalent onshore investments but produced a better post-tax return given the Australian tax rules at the time. The judgement casts aside the *Westminster* doctrine as having no relevance in the context of Part IVA. It also suggests that there may be no judicial safe harbour for commercially motivated tax planning, because a tax avoidance purpose caught by Part IVA and a rational commercial purpose are not mutually exclusive.<sup>34</sup>

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<sup>27</sup> *Gulland v FCT, Watson v FCT and Pincus v FCT* (1984) 15 ATR 422; *Greghorn Investments Pty Ltd & Ors v FCT* (1987) 87 ATC 4988.

<sup>28</sup> See Appendix 1.

<sup>29</sup> See Appendix 1.

<sup>30</sup> There are other decisions on Part IVA by a non-judicial body but they have no precedential value and, generally, lack in-depth analysis of the principle.

<sup>31</sup> *FCT v. Peabody* 94 ATC 4663.

<sup>32</sup> See Passant, *Tax Avoidance in Australia: The Return of the Ghost?* [1996] BTR 453.

<sup>33</sup> *FCT v. Spotless Services Ltd* 96 ATC 5201.

<sup>34</sup> Passant, *Removing The Stain of Tax Avoidance in Australia* [1997] BTR 131; Krever, *The Ghost of the Duke of Westminster Laid to Rest in Australia?* [1997] 45 Canadian Tax Journal 122.

### **The administration of the new rule**

3.26. There is no equivalent of the Canadian GAAR Committee to look at cases where Part IVA is to be invoked. However, the Commissioner may make a private ruling on a taxpayer's taxation arrangements, which will be binding on the Commissioner. The Commissioner can refuse to make a private ruling if the application will require substantial investigation and all the facts cannot be established at the time of application. The Commissioner may also make a public ruling—a general statement of the law—that can be relied on by a taxpayer if clearly applicable to his case.

3.27. In spite of the broad terms of the general anti-avoidance rule and the penalties associated with it, we understand that tax avoidance activity is still widespread in Australia. We have been told nevertheless that in practice it is often very hard for taxpayers and practitioners to distinguish between acceptable tax planning and a scheme which will be struck down by Part IVA, particularly following the *Spotless* decision. Since its introduction, Australian governments have continued to introduce specific anti-avoidance provisions.

## **New Zealand**

### **Judicial approach**

The courts adopt the basic rule that tax legislation should be strictly interpreted or construed. Effect must be given to legislative language if it is clear and unambiguous. Where there is ambiguity, however, section 5(j) of the Acts Interpretation Act 1908 requires that every Act shall receive “such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true intent, meaning and spirit.” This does not lead to construction in favour of the Revenue authorities but rather a neutral view of the Income Tax Act, favouring a view that does not lead to injustice or absurdity but accords with the evident purpose of the legislation.<sup>35</sup>

### **The general anti-avoidance rule**

3.28. Like Australia, New Zealand has a long tradition of specific anti-avoidance legislation coupled with a general anti-avoidance rule, although the Courts have shown a greater willingness to use the general rule to strike down avoidance arrangements.

3.29. Sections BB9 and GB1 (1)–(3) of the Income Tax Act 1994, formerly section 99 of the Taxes Act 1976, make void for tax purposes arrangements entered into with a purpose or effect of tax avoidance.<sup>36</sup> Section BB9 sets out the conditions that must be satisfied for an arrangement to be void, and GB1 gives the Commissioner the power to reconstruct the tax accounts of the taxpayer to counteract the tax advantage.

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<sup>35</sup> See *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175.

<sup>36</sup> See Appendix 1.

The general anti-avoidance rule is intended to protect the tax system from arrangements implemented to frustrate it. It does not operate as an independent charging provision.

3.30. For the general rule to apply, there has to be an “arrangement” (widely defined) and the “purpose or effect,” or one of them if there are more than one, must be “tax avoidance” (widely defined). “Ordinary business or family dealings” are specifically not exempted but the “avoidance” purpose or effect must be more than “merely incidental”. The test is an objective one determined by looking at the terms of the arrangement to see whether it was implemented in a particular way so as to avoid tax.

3.31. The Privy Council decision in the *Challenge*<sup>37</sup> case made it clear that the rule is of general application and may apply even where specific anti-avoidance provisions exist within an express relieving provision. In this respect, it can be difficult to distinguish between arrangements intended to take “legitimate” advantage of statutory reliefs and those implemented solely to avoid tax. The Privy Council attempted a distinction using concepts such as “artificiality”, “unreality” and “pretence”. Lord Templeman, speaking for the majority, said that<sup>38</sup>–

“Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer’s tax advantage is not derived from an “arrangement” but from the reduction of income which he accepts or the expenditure which he incurs.”

3.32. Later in the course of the decision, he said<sup>39</sup>–

“Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction to tax as if he had.”

3.33. Although the attitude of the Courts to the New Zealand anti-avoidance rule has been relatively robust, neither the existence of the rule nor the willingness of the judges to apply it has deterred avoidance activity completely. The “Winebox” enquiry into tax related transactions involving the Cook Islands illustrates that tax avoidance, particularly in the international sphere, remains an issue. There have been other cases of aggressive avoidance arrangements that have attracted the open disapproval of the

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<sup>37</sup> *CIR v. Challenge Corp. Ltd* [1986] STC 548.

<sup>38</sup> At page 554.

<sup>39</sup> At page 555.

Revenue authorities and the Courts.<sup>40</sup> As a result, amendments may be made in due course to the general anti-avoidance rule.

### **Administration of the rule**

3.34. The Commissioner has published a detailed policy statement on the application of the general anti-avoidance rule, and to ensure consistency of treatment decisions to apply it are taken at Head Office. The Commissioner's approach involves a four step analysis which looks at the scheme and purpose of the particular legislative provision in the context of the Act as a whole; the purpose and effect of the arrangement, and whether it can reasonably be inferred that there is a tax avoidance purpose that is more than incidental; and whether it can be inferred from the foregoing that the arrangement frustrates the underlying scheme and purpose of the legislation.

3.35. The Commissioner is able to give binding rulings on avoidance issues, but may only do so if the arrangement to be considered gives rise to a question of law. A binding ruling requires full disclosure, including the taxpayer's own arguments as to why the anti-avoidance rule should not apply, and the applicant of the ruling must at least seriously contemplate the transaction.

## **The United States of America**

### **Legislative response**

3.36. The United States has no statutory general anti-avoidance rule and no administration has ever proposed such a rule. The Internal Revenue Code does, however, contain numerous anti-avoidance provisions that range from the specific to the general. The following provides the perspective of two US tax practitioners<sup>41</sup>–

“Congressional action, in the form of both broad and ad hoc legislative intervention, has often been spurred by the perception that the judicial approach to tax [avoidance] is frequently ineffective and uncertain. This perception is due to both the subjective nature of jurisprudential rules based on business purpose and the uncertain “common law” process of extending judicial principles to arguably distinguishable factual situations. Accordingly, the provisions of the Internal Revenue Code now include both objective anti-avoidance standards that operate independently of underlying business purpose and subjective standards of enormous breadth. These statutory provisions have been supplemented with administrative provisions of increasing severity. Many are designed to force more elaborate information reporting by taxpayers and to discourage undue “creativity” by imposing substantial penalties on tax-driven transactions which are found to result in substantial under-reporting of taxable income.”

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<sup>40</sup> See for example Case R25 [1994] 16 NZTC 6120 and the hostile comments of the judgement of Barber DJ.

<sup>41</sup> Rowland and Bauer, *The right of a United States taxpayer to avoid taxes*, International Tax Review, July/August 1990, page 23.



3.37. There are several provisions of the Internal Revenue Code which look to the taxpayer's purpose in countering specific types of avoidance. Thus Code section 269 denies deductions, credits or other allowances in certain corporate acquisitions in which "the principal purpose for which such acquisition is made is evasion or avoidance of Federal income tax."<sup>42</sup> The statutory language of the Code is also supplemented in many areas by Regulations that fill in the detailed scheme of the legislation. In particular areas this may involve more general approaches to what is regarded as abusive tax avoidance.

3.38. With the exception of a statutory general anti-avoidance rule, most legislative techniques to curb avoidance can be found somewhere in the Internal Revenue Code, including the use of a minimum tax. The lack of a general anti-avoidance rule does not leave the United States revenue authorities as vulnerable as it might do in some other countries. A relatively anti-formalist approach to interpreting tax law is taken by the judges. In interpreting the Code and Regulations the courts will usually attempt to seek out the purpose of particular provisions and will resort to the legislative history as assistance. Hand-in-hand with this judicial willingness to adopt a purposive approach to legislative construction, is the development of a number of judicial anti-avoidance techniques to look at the substance of transactions, including their recharacterisation.

### **Judicial approach**

3.39. The US Courts have frequently asserted the right of taxpayers to minimise their taxes.<sup>43</sup> Nevertheless, the courts have also been active over many years in developing general anti-avoidance jurisprudence, relying on their inherent powers as Courts and not on statutory authority. There are a number of judicial anti-avoidance doctrines, such as the business purpose test<sup>44</sup> and the substance over form and step transaction doctrines. These allow the recharacterisation of transactions on the basis of their economic substance.

3.40. In many cases the judges have used a combination of these doctrines to defeat an apparent compliance with the technical requirements of the tax code. They are also more ready than their UK counterparts to see a transaction as a sham,<sup>45</sup> a concept that is equated with lacking in economic substance and does not require an element of deceit. Consequently, United States Courts are willing to ignore the strict legal form

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<sup>42</sup> For a list of provisions that adopt the test either of "the principle purpose" or of "a principal purpose", see Gustafson, *The Politics and Practicalities of Checking Tax Avoidance in the United States*, at pages 356–8 in *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (Netherlands), 1997.

<sup>43</sup> See, for example, Learned Hand J in *Internal Revenue v Newman* (1947) 159 F 2d 848.

<sup>44</sup> The seminal judicial decision is *Gregory v Helvering* 293 US 465 [1935] in which the Supreme Court applied a substance over form mixed with a business purpose approach. The case involved a corporate reorganisation carried out solely for tax purposes and which apparently met the technical requirements of the statutory provisions concerned. The Supreme Court, however, held that, to be recognised for tax purposes, a reorganisation had to be effected for a legitimate business purpose, tax avoidance not qualifying for the purpose.

<sup>45</sup> See for example *Knetsch v US* 364 US 361 [1960].

of documents and the rights of the parties to them and will give effect to the substance of transactions in order to defeat avoidance. But while the influence of these doctrines is pervasive, their application is criticised as unpredictable and indiscriminate. It is inevitably difficult to define what the limits should be.

## **European countries**

### **The concept of abuse of rights**

3.41. The civil law concept of “abuse of rights”, is usually concerned with the exercise by a person of rights for improper purposes. The concept has been extended in many civil law jurisdictions to tax law and is used to describe a strategy that is both lawful and carefully structured by the taxpayer so as to secure a tax benefit by arranging the facts and the legal basis of transactions. Thus it may apply where a taxpayer has a right to enter into a particular kind of transaction but exercises that right solely to avoid or reduce liability to tax. The courts will then nullify the sought after tax benefit.

3.42. The concept of abuse of rights goes against traditional common law thinking, where a person’s motives in exercising his rights are irrelevant to his entitlement to exercise those rights.<sup>46</sup> There is a similarity, however, between abuse of law and the modern judicial approach to tax avoidance and this is best illustrated by considering the judicial affirmation of a taxpayer’s right to minimise his taxes while at the same time striking down various artificial transactions designed to reduce those liabilities. The primary thrust of the abuse of rights doctrine in a tax context is similar to that of a business purpose test.<sup>47</sup>

3.43. Application of the abuse doctrine by civil law countries in taxation matters varies considerably. In some EU Member States, the doctrine has been developed partly by judicial decision (e.g. Netherlands); in others it has been codified as a general anti-avoidance rule in the legislation (e.g. Germany ); elsewhere it is not used at all for tax (e.g. Italy). Two countries—the Netherlands and Germany—suffice to illustrate the application of the doctrine in continental European countries.

### **Netherlands**

3.44. The Netherlands legislation includes a special provision, Article 31 AWR, that enables the Dutch Revenue to eliminate transactions that would not have taken place but for tax reasons. This procedure is referred to in the legislation as “proper taxation”.

3.45. The Supreme Court<sup>48</sup> has held that three conditions must apply in order to apply the proper taxation doctrine: tax avoidance must be the “controlling motive” of

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<sup>46</sup> See *Bradford Corporation v Pickles*[1895] AC 587.

<sup>47</sup> See Ward and Cullity, *Abuse of Rights and the Business Purpose Test as Applied to Taxing Statutes*, Cambridge lectures 1991, page 120.

<sup>48</sup> Hoge Raad 27 December 1967 BNB 1968/80.

the taxpayer; there must be abnormal use of permitted means; and there must be a conflict with the purpose and intent of the statutory provision. Tax avoidance is deemed to be the controlling motive if the arrangements are devoid of economic risk for the taxpayer or would have a negative effect if the tax benefit is ignored. The Parliamentary record can be used to ascertain the purpose of fiscal legislation.

3.46. Article 31 has been in abeyance since 1987 when the Dutch Ministry of Finance announced (initially for a five year period) that it would not rely on these proper taxation provisions. Currently, tax avoidance is challenged under the non-statutory “fraus legis” doctrine. The essential difference is that this is a reconstructive approach to avoidance transactions which imposes tax on a structure that would otherwise avoid tax, when an almost identical structure would be taxable. According to the Supreme Court<sup>49</sup>, the doctrine can be applied where tax avoidance is the sole or predominant motive of the taxpayer, and it would be contrary to the purpose and spirit of the legislation to allow the taxpayer to obtain a tax benefit from the transaction.

### **Germany**

3.47. The abuse of rights doctrine is embodied in section 42 of the German Tax Code. Section 42 reads :

“The tax law cannot be circumvented by an abuse of structure offered by the law. In the event of an abuse, tax is due as if a legal structure had been used which is appropriate to the economic substance of the transaction.”

3.48. For section 42 to apply, we understand that three features must be present in the arrangements–

- there must be a clearly established intention to avoid tax;
- the legal arrangement used must be inappropriate to the particular economic purpose of the arrangement; and
- there must be no other economic purposes (or other legitimate purposes) which would justify its use.

We have been told that the provision does have a deterrent effect, although the imprecision of its terms means that it creates a large number of disputes between taxpayers and the revenue authorities.

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<sup>49</sup> Hoge Raad 21 November 1984 BNB 1985/32.

## CHAPTER 4. APPROACHES TO TAX AVOIDANCE?

### Introduction

4.1. We think it inevitable that legislative action—whether through structural change or specific anti-avoidance measures—will remain in the forefront of the effort by governments to restrain action that it regards as tax avoidance. In our view, three factors will curtail future opportunities for taxpayers to exploit tax legislation in unintended ways. These are—

- the abandonment by the Courts of an excessively literalist interpretation of tax legislation;
- the development of the *Ramsay* and *Furniss* decisions; and
- the Government's decision to rewrite tax legislation in more accessible language, and to accompany new legislation with a published memorandum explaining the legislation's purpose in non-statutory terms.

4.2. The use of purposive interpretation techniques in the tax field has received the endorsement of the House of Lords in *McGuckian*. *McGuckian* indicates, however, that the scope of the *Ramsay* doctrine remains uncertain. The speeches of those Law Lords who participated in the *McGuckian* decision could lead in a number of different directions. The speeches of Lords Steyn and Cooke in particular suggest that the final lines of the doctrine may remain to be drawn.<sup>1</sup> Some would say that this is entirely correct. The lines ought never to be drawn. Uncertainty is a necessary, if unfortunate, protection against avoidance. Drawing lines merely invites renewed avoidance.

4.3. *Fitzwilliam* illustrates, however, that in some areas at least the doctrine may still not operate to counter every ritualised tax avoidance scheme. Furthermore, a judicial rule takes time to develop. The transactions under consideration by the House of Lords in *CIR v Ramsay* in 1981 originated in 1973. The share exchange in *Furniss v Dawson*, considered by the House of Lords in 1984, was effected in 1971. By 1984 statutory anti-avoidance provisions to prevent the abuse of the share exchange provisions had been in place for seven years.<sup>2</sup>

4.4. A judicial approach to avoidance can only evolve over time, on a case by case basis by reference to the facts of those cases. It is unavoidable that, over time, there will emerge different judicial attitudes and expressions of view on the scope of a judicial doctrine. Thus, the pendulum may swing from *Ramsay*, *Burmah* and *Dawson* to *Craven v White*, *Shepherd v Lyntriss* and *Fitzwilliam* and back with *McGuckian*. The difficult issue is to know when the doctrine has matured to a stage that offers a

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<sup>1</sup> Echoing Lord Scarman in *Furniss v Dawson*, who said that “[t]he limits in which this principle is to operate remain to be probed and determined judicially” [1984] STC 153 at 156.

<sup>2</sup> Finance Act 1977, section 40 in respect of issues of shares after 19<sup>th</sup> April 1977.

more stable role and influence as a counter to tax avoidance. Once it has reached a sufficient maturity, we might hope that policy makers and draftsmen could plan with some comfort as to the attitude of the courts to their legislation.

4.5. Against this background, the question we raise in this Report is whether government should await the evolution of the *Ramsay/Furniss* doctrine by the courts or whether it would be better to intervene in this process by enacting a statutory general anti-avoidance rule.

### **A judicial general anti-avoidance approach**

4.6. Many commentators have criticised the *Ramsay* doctrine.<sup>3</sup> The substance of much criticism is that the doctrine substitutes uncertainty and judge-made law for certainty and the Rule of Law as made by Parliament.<sup>4</sup> The decision of the House of Lords in *Dawson* gave rise to particular concerns because the approach taken by the Court went so far as to restructure for tax purposes the transactions actually entered into by the taxpayer.<sup>5</sup> On the other hand, the *Ramsay/Furniss* doctrine has been defended as an entirely appropriate adoption of principles similar to those used by the US courts to counter avoidance.<sup>6</sup>

4.7. A judicial anti-avoidance rule is unsatisfactory in several respects. We have referred to the time it takes for the doctrine to evolve and to the element of chance involved in the process, depending as it does upon the cases that come forward for decision and upon different judicial attitudes. But even a mature doctrine remains subject to continuing limitations. In particular, the judges must develop a judicial anti-avoidance doctrine within the constraints imposed by their role as interpreters of the law rather than as lawmakers.<sup>7</sup> As Lord Steyn noted in *McGuckian*, “The new *Ramsay* principle was not invented on a juristic basis independent of statute.”<sup>8</sup>

4.8. A judicial rule also lacks a formal framework that legislation can supply. Thus—

- As a rule of construction, the judicial rule cannot be disapplied. Yet it offers no method for taxpayers to ascertain in advance whether and how the doctrine may apply to their transactions. To the extent that the courts apply the doctrine only when the Revenue authority invokes it in

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<sup>3</sup> See, for example, Goldberg, *O Brave New World That Hath Such Decisions In It: And Herein Of The Separation of Powers* [1982] BTR 13; Bartlett, *The Constitutionality of the Ramsay Principle* [1985] BTR 338.

<sup>4</sup> See, for example, The Revenue Law Committee of The Law Society, *Tax Law in the Melting Pot*, The Law Society (1985).

<sup>5</sup> Special Committee of Tax Law Consultative Bodies, *Tax Law After Furniss v Dawson*, The Law Society (1988).

<sup>6</sup> Millett, *Artificial Tax Avoidance: The English and American Approach*, [1986] BTR 327.

<sup>7</sup> For a discussion of the different approaches of the US and the English courts, see Popkin, *Judicial Anti-Tax Avoidance Doctrine in England: A United States Perspective*, [1991] BTR 283.

<sup>8</sup> [1997] STC 908, 916.

argument, the Revenue authority can offer taxpayers some certainty through a general administrative rulings procedure. The Revenue authority must be prepared, however, to include the judicial doctrine among those aspects of the tax system on which it will rule.<sup>9</sup>

- With the *Ramsay* doctrine, a court may regard transactions as a tax nullity and adopt a substantive rather than a formalistic analysis of transactions. The scope this offers to reconstruct transactions to counteract the tax advantages sought may be seen as both limited and uncertain. The effects of reconstruction are limited to the tax in issue in the appeal and the parties involved. The form of the alternative transaction may be uncertain, as also its effect on other parties and other tax consequences.
- A developing judicial doctrine operates retrospectively because English Courts declare the law as it always has been. There is no equivalent in English law to the doctrine under which the European Court of Justice can limit the effect of a ruling e.g. to one of prospective application only.

4.9. It has been suggested that legislation is necessary to fill in the gaps in the *Ramsay* doctrine and to provide proper procedures and safeguards for taxpayers.<sup>10</sup> The safeguards desired either are incapable of being introduced by judicial decision or, if they could be, might take years before they become established. A statutory rule can attempt to make good some of the limitations inherent in a judicial rule and provide a proper framework for the application of a general anti-avoidance rule.

### **A statutory general anti-avoidance rule**

4.10. Can a statutory general anti-avoidance rule offer a solution to the unsatisfactory aspects of a judicial rule? Statutory general anti-avoidance rules, like judicial anti-avoidance doctrines, are uncertain in their scope and application. The words of the statute do *not* say with precision in what circumstance tax will be imposed.

4.11. This is hardly surprising. If Parliament could adequately describe in advance the circumstances in which tax was to be charged, it would legislate to that effect. A general anti-avoidance provision attempts to deal with those actions that legislators cannot anticipate. At the same time, Parliament complicates matters further because it views some kinds of tax saving benevolently or even encourages certain action that has the effect of reducing tax liabilities. Where and how is the line to be drawn?

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<sup>9</sup> The Inland Revenue's 1995 consultative document on pre-transaction rulings suggested that any UK rulings system would probably exclude transactions potentially involving the avoidance of tax, see Inland Revenue, *Pre-Transactions Rulings: A Consultative Document*, November 1995, paragraph 2.13.

<sup>10</sup> Stephen Oliver QC *The Ramsay/Dawson Doctrine—The Quest for the Relevant Transaction*, *Recent Tax Problems* (Current Legal Problems).

4.12. A statutory general anti-avoidance rule shares several of the same deficiencies as a judicial rule and the literature on the uncertainties of a statutory rule is voluminous, as is the literature on judicial doctrines. Most particularly, unless the statutory rule excludes resort to the courts entirely (and we consider that it would be wrong to attempt to do so), its scope and effectiveness depend ultimately upon the interpretation of the provision by the courts. We have noted, for example, criticisms such as the following recent comment in relation to the new Australian rule in Part IVA<sup>11</sup>–

“However clear their application may be, [general anti-avoidance provisions] are, by their very nature, inherently inequitable. Unlike substantive tax rules, a general anti-avoidance provision can be applied only after the fact to protect a disputed assessment. In the context of a self-assessment income tax system, a general anti-avoidance provision can be invoked in only a few cases drawn from the small group of taxpayers who are actually audited and then challenged on a disputed issue. Even then, the general anti-avoidance provision can often be invoked successfully only in cases pursued to the courts. Moreover, tax authorities will inevitably find the precedential value of the successful cases to be limited by the application of the provision to the particular facts of the cases in which it was invoked. As tools of fiscal regulation, general anti-avoidance provisions are remarkably inefficient.”

4.13. We do not suggest that a statutory rule can provide all the answers but we do recognise that there are competing arguments and values to support a statutory rule. In contrast to a judicial doctrine, a statutory rule can–

- attempt at the outset to set down the scope and core principles of the rule without being tied to specific cases;
- attempt to set out the scope and principles of permissible tax mitigation and identify existing tax havens that it will respect;
- specify sensible consequences for its application;
- incorporate the administrative procedures and safeguards that will protect the interests of taxpayers, and
- specify the date from which it applies.

## **Conclusion**

4.14. In our view, structural reform of particular taxes to tackle the causes of avoidance and specific anti-avoidance provisions must remain the principal responses to avoidance. These remain the first lines of defence against avoidance in those countries that do have a statutory general anti-avoidance rule. There is little to suggest

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<sup>11</sup> Krever, *The Ghost of the Duke of Westminster Laid to Rest in Australia?* [1997] 45 Canadian Tax Journal 122 at 129.

that *in practice* the existence of a statutory general rule removes the need for structural reform or specific anti-avoidance provisions. A general rule ordinarily functions as a provision of last resort.

4.15. Nevertheless, the question in the UK remains whether we would do better to support specific provisions through a developing judicial doctrine or by a statutory general anti-avoidance rule. A statutory rule cannot solve all the problems inherent in a general approach to tax avoidance. In principle, however, it can attempt to make good some of the limitations inherent in a judicial rule and provide a proper framework for the application of a general rule.

4.16. Other countries' experience suggests that what a statutory general anti-avoidance rule does not do is *guarantee* simpler tax legislation. General rules often co-exist with long and convoluted tax legislation. Nevertheless, if a statutory rule can offer the Parliamentary draftsmen and those instructing them greater confidence that they will be able to counter those arrangements that they view as objectionable, there may be some beneficial effect on future legislation.

4.17. We have been told that the development of the *Ramsay* doctrine made it unnecessary to introduce some specific anti-avoidance provisions. We might hope that a general rule would help to dispense with some of the legislative complexity and prolixity that is characteristic of a lot of anti-avoidance law.<sup>12</sup> Certainly, we think that the existence of a general rule should militate against the development of the legislative spirals that we have witnessed in the past, when the blocking of one possible loophole is followed by the identification of another, and so on. It might restrain any tendency to indulge in "overkill" in specific anti-avoidance provisions.

4.18. The relative merits of a judicial and a statutory general anti-avoidance rule can only adequately be considered in the context of a draft provision. Accordingly, we set out in Chapter 5 a general anti-avoidance provision that illustrates the principles and structure that we think a statutory provision, if one were adopted, should follow. We are conscious of the difficulties that a statutory general anti-avoidance rule might create and are aware that a rule must be capable of operation in a practical manner without inhibiting commercial or personal activities. Nevertheless, we consider that the advantages that a sensible rule can bring make it preferable to a continued development of a judicial anti-avoidance rule.

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<sup>12</sup> We understand that in the Australian rewrite exercise, although a conservative attitude has been taken to the removal of redundant rules, it has been possible to scrap some provisions enacted before Part IVA on the basis that they would now be struck down by the general anti-avoidance rule.



## CHAPTER 5. AN ILLUSTRATIVE STATUTORY GENERAL ANTI-AVOIDANCE PROVISION

### Introduction

5.1. The literature on avoidance reflects that this is a subject that commentators can debate at great length but without identifying any clear or agreed principles that point to a satisfactory resolution of the issues. Accordingly, we have considered how to approach the subject in a way that stimulates constructive debate rather than leads to the immediate occupation of entrenched positions.

5.2. We have chosen to resolve this dilemma by asking ourselves this question: “If the government were to decide to introduce a statutory general anti-avoidance rule, what form should that rule take?” If we, as a Committee with widely differing tax backgrounds and perspectives, could agree on the framework that a statutory provision should follow, this would offer a context within which all concerned could conduct a wider constructive debate.

5.3. In this Chapter we have drafted an illustrative general anti-avoidance clause. The illustrative clause, without the commentary, is reproduced in Appendix 4. At the outset, we must emphasise three points—

- The clause is *illustrative* only. We have not drafted it as a clause to be read as legislation for enactment. We do not pretend that it is in the language or form that Parliamentary Counsel would adopt were he instructed to draft for some future Finance Bill a general anti-avoidance provision that adopted our approach.
- It is not for us to say whether the government should adopt a statutory general anti-avoidance rule or what form a rule should take. These are political decisions. We do, however, regard the framework of our illustrative clause as of fundamental importance in attempting to balance the interests of government and the rights of taxpayers, and to achieve a practical outcome.
- We are concerned that the current political desire to “tackle avoidance” should not lead to the introduction of measures that, for the reasons we gave in paragraph 4.1., are not required and which unnecessarily extend the scope of Revenue powers in this field or that unduly fetter ordinary commercial or personal transactions.

5.4. A general anti-avoidance rule inevitably requires the Revenue authorities to form their opinion in the first instance whether transactions that have the effect of reducing tax liabilities fall within the Parliamentary intent or not. The critical balance between the public interest in seeing that taxes are not unduly avoided and the legitimate interests of taxpayers in their commercial and private affairs lies in ensuring that

- the rule is sensibly targeted,
- there are sensible procedures for invoking the rule, and
- there is proper oversight of its exercise.

5.5. We do not envisage that it is possible to produce a satisfactory general anti-avoidance rule at no administrative cost. The provision must strike the right balance and must be capable of practical application. This is only likely to be achieved if government accepts whatever cost is involved in providing the proper administrative framework and safeguards for taxpayers. If it were not prepared to incur this cost, it should not propose a statutory rule.

### **Relationship with the *Ramsay* principle**

5.6. A statutory general anti-avoidance rule would raise important questions about its relationship with the existing judicial approach to tax avoidance as expressed in *Ramsay* and subsequent cases. Should the courts remain free to apply *Ramsay* principles in applying a statutory general anti-avoidance rule to transactions? Should the Revenue authorities remain free to argue that *Ramsay* principles operate to defeat tax arrangements, independently of the statutory rule?

5.7. We do not envisage that a statutory rule would have a lesser scope than the *Ramsay* principle, although we acknowledge that the limits of that principle, following *McGuckian*, may be uncertain. One of the objectives of a statutory rule would be to provide an administrative framework within which taxpayers can resolve uncertainty. To what extent, therefore, might a statutory approach constrain further development of *Ramsay*? Could *Ramsay* be left in abeyance, on the basis that the Revenue departments would not seek to invoke it and the judges would not exercise their discretion to revive it in circumstances not covered by the statutory rule?

5.8. We would prefer that the *Ramsay* doctrine should not be capable of being used in combination with a statutory general anti-avoidance rule or being developed as an independent judicial general anti-avoidance rule. There are precedents for legislation explicitly replacing judicially developed common law principles. On the other hand, we would not want a statutory general anti-avoidance rule to inhibit a more purposive approach to statutory interpretation. Nor do we think that a statutory rule should restrict a court's ability to decide, as a general matter, the true legal effect of the arrangements a taxpayer has entered into. Any legislative restriction of the *Ramsay* doctrine would accordingly need to preserve these aspects of the doctrine.

### **The illustrative clause: the general anti-avoidance rule**

#### **1. Purpose of the rule**

**The purpose of this rule is to deter or counteract transactions that are designed to avoid tax in a way that conflicts with or defeats the evident intention of Parliament. This rule shall be interpreted and applied in a manner consistent with that purpose.**

## Commentary

5.9. In constitutional terms (and ignoring for present purposes European issues), Parliament is and should remain the body that gives us our tax laws. A statutory general anti-avoidance rule should not confer upon the Revenue departments a power to tax or not as they please. The purpose and intent of Parliament, both with respect to individual statutory provisions and the statute taken as a whole, is therefore of central importance.

5.10. In interpreting legislation, the Courts endeavour to give effect to parliamentary intention and, in administering the taxing statutes, the Revenue departments ought to be guided by similar considerations.<sup>1</sup> There will always be circumstances, however, where the intention of Parliament is difficult to ascertain from the words of the statute. In our view, the use of statements of purpose to preface detailed primary legislation and the publication by Government of an explanatory memorandum with each Finance Bill clause ought to assist interpretation and application in many areas of the tax code.

5.11. The fundamental problem is likely to be establishing in the case of highly complex or novel transactions what Parliament intended or what Parliament would have intended had its mind been directed to those transactions. If Parliament were able to anticipate a taxpayer's every action and reach a judgment on the matter, it would be able to express its view in legislation as to how such action should be taxed. It is precisely because Parliament lacks such prescience, that we are driven to consider a statutory provision of this general nature.

5.12. Nevertheless, we think it right to express at the outset as an overriding requirement of the rule that it should only be capable of being invoked to give effect to what can justifiably be discerned or established (ultimately to the satisfaction of the courts) to be the intent of Parliament. This should underpin the use by the Revenue departments of the rule to restructure the taxpayer's arrangements to bring the substance of those arrangements within the taxing intent of Parliament. Conversely, the taxpayer should be free to argue that the terms of the statute are such as to indicate that Parliament would regard his actions as effective to mitigate tax.

## **2. The basic rule**

- (a) Where a person carries out a tax driven transaction, he shall be taxed as if he had carried out the normal transaction.**
- (b) If, because the tax driven transaction does not have any non-tax objective, there is no normal transaction then he shall be taxed as if it did not take place.**

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<sup>1</sup> *Pepper v Hart* illustrates a case where the Revenue could be said to have failed in this respect.

### 3. **Safeguard**

**This rule shall not apply where the transaction is a protected transaction; and when a transaction is a multiple step transaction, it shall not apply where that transaction (taken as a whole) is entirely or mainly a protected transaction.**

### 4. **Burden of proof**

(a) **In the application of this rule it shall be assumed that a transaction is not a tax driven transaction unless the contrary is demonstrated.**

(b) **In the application of this rule it shall be assumed that a tax driven transaction is not a protected transaction unless the contrary is demonstrated.**

### Commentary

5.13. The Committee feels that a workable anti-avoidance doctrine must revolve round three core definitions:

- the tax driven transaction
- the alternative or “normal” transaction
- the protected transaction

5.14. The burden of proof proposed at each step in the process is set out in 4 above. In placing the initial burden with the Revenue authority we assume that the Revenue authority will be able to obtain the information it requires of the transactions to enable it to make a prima facie case.

5.15. We think that the Revenue authorities should be very specific when they invoke the general anti-avoidance doctrine against a tax driven transaction. They must identify the “normal transaction” that is to be the basis of the tax charge they are seeking to establish.

### 5. **Explanation of terms**

#### (a) ***“Tax driven transactions”***

**A “tax driven transaction” is a transaction that has as its sole purpose, or as its main purpose, or as one of its main purposes, the avoidance of tax.**

**In determining whether a transaction is a tax driven transaction, the following shall be taken into account–**

**Its legal form including the legal rights and obligations created by the transaction; its economic and commercial substance; the timing of any step; the expected duration of any step or any feature in the transaction; the change in the financial or other circumstances of the taxpayer or**

**anyone connected with the taxpayer, as a result of the transaction; the expected tax consequences of the transaction on the assumption that this rule does not apply.**

Commentary

5.16. What should be the “trigger” for the rule? Can we define the essential nature of avoidance and what distinguishes unacceptable avoidance from effective tax mitigation? Most debates on these questions concentrate on two aspects of the subject—

- the form of the transactions, and
- the purpose that underlies the taxpayer’s actions.

Ideally, we would prefer to adopt some objective standard of tax avoidance—to be able to describe those transactions that we wish to categorise as tax avoidance. The most obvious contenders are artificiality and complexity. Transactions that may have some of the hallmarks of avoidance, such as artificiality, however, are tolerated by Parliament or the revenue authorities, or may even be normal commercial or family practice. Artificiality is a feature of much tax planning but is not necessarily objectionable and is often a feature of real-life highly complex transactions. The use of tax incentives to achieve economic and social policy objectives encourages taxpayers to arrange their affairs in ways that might otherwise not have been contemplated but are seen as tax efficient.

5.17. The difficulty of describing what are the objective features of tax avoidance has accordingly led us to look at the purpose that underlies the taxpayer’s action. Without more, however, this is unlikely to be satisfactory. There is room for debate about how purpose should be demonstrated and, if necessary, proved to a court. No rule can depend upon for its application on the mere assertion by the taxpayer of the purpose underlying his actions. The assertion must be capable of being sustained by an objective assessment of all the surrounding circumstances and evidence. We accordingly suggest that an objective approach to a taxpayer’s purpose, similar to the criteria used to evaluate purpose in Australia, should be adopted to counter the in-built unpredictability of a purpose test.

5.18. What degree of tax purpose should suffice for the rule to apply? We consider that the rule should not apply where the avoidance of tax is only a minor objective of the arrangements. Conversely, we consider that a test that requires the avoidance of tax to be **the** main purpose is too restrictive, and also very difficult for the courts to apply. Our proposal, therefore, is that the rule should apply where tax avoidance is **a** main purpose of the transaction.

**(b) “Tax”**

**In this context, “tax” means [to be specified]**

(c) **“Avoidance of tax”**

**“The avoidance of tax” includes [to be specified].**

Commentary

5.19. We have noted that it is not always clear which taxes are covered by a judicial anti-avoidance doctrine. In particular, the *Ramsay* approach has yet to be used successfully by Customs in the VAT context. A statutory provision would specify those taxes to which it applied and define tax avoidance in a manner appropriate to the taxes in question.

5.20. What taxes should be covered by a statutory general anti-avoidance rule? Certainly, we can see no reason why it should not be possible to have a general rule that applied to income tax and not to VAT, or vice versa. In principle, however, it is difficult to argue against the extension of a general anti-avoidance provision to all taxes. If the criteria used to apply the rule to one tax are satisfied for other taxes or duties, why should the rule not also apply to the latter?

5.21. It may be more difficult, however, to devise a single provision to cover all taxes. The different scope and nature of different taxes may require different detailed provisions. A tax such as stamp duty operates in a different manner and circumstances from VAT or income tax. VAT involves a European dimension. The expression of the tax advantage may vary according to the tax. Thus, reduction and deferment of tax may be thought of as obvious characteristics of income tax avoidance. The definition of VAT avoidance would need also to cover an increase in input tax recovery. Similarly, the permitted safe harbours need to be drawn with the particular tax in mind and may depend upon the nature of transactions that are currently tolerated, in some instances to get round acknowledged deficiencies in the legislation.

(d) **“Transaction”**

**A “transaction” includes a transaction that is carried out in more than one step (a “multiple step transaction”), to the extent that a subsequent step was planned or envisaged by the time when the first step is taken. In this context it is unnecessary for the precise nature or timing of a subsequent step to have been planned so long as the general nature of such step was planned or envisaged and its implementation was expected. It is also immaterial whether any particular step had a commercial or other non-tax objective.**

Commentary

5.22. The definition of a transaction to include a multi-step transaction extends the concept of a “tax-driven transaction” to the form of composite transactions contemplated by *Furniss v Dawson*. The rule then needs to lay down the criteria that will weld several separate steps into a single multi-step transaction. The judicial approach has been to rely on the idea of “pre-ordination” and the draft could merely

adopt this term. This would allow reference to be made to existing judicial dicta on the meaning of “pre-ordination”.

5.23. Lord Oliver in *Craven v White*, for example, has described preordination as amounting to—

“...whether an intermediate transfer was, at the time when it was effected, so closely interconnected with the ultimate disposition that it was properly to be described as not, in itself, a real transaction at all but merely an element in some different and larger whole without independent effect.”<sup>2</sup>

Lord Keith in *Fitzwilliam* said that<sup>3</sup>—

“...the correct approach...is to ask whether [the series of transactions] is realistically constituted a single and indivisible whole in which one or more of them was simply an element without independent effect and whether it is intellectually possible so to treat them.”

5.24. As these descriptions suggest, however, the use and description of “pre-ordination” reflect the limitations of the judicial power to reconstruct transactions. A court can examine a transaction to ascertain its real nature—is it a gift or a sale? If, however, it is truly independent of any other steps, even though it may be part of an overall plan, it is not possible (as a judicial matter) to deny the transaction real effect.

5.25. A statutory rule need not be subject to these limitations and it is possible to relate transactions that are part of an overall arrangement or plan without the need for each step to have the same degree of inter-dependence as the judicial concept of pre-ordination suggests. The linking of independent steps through the existence of an overall plan or arrangement extends the current judicial rule but is balanced by the need still to be able to describe the alternative “normal transaction” that is consistent with what can justifiably be said to be the intention of Parliament.

**(e) “Multiple step transactions”**

**Where a transaction is a multiple step transaction, it shall be regarded as a tax driven transaction not only if, taken as a whole, it falls within (a) above but also where the avoidance of tax is the [sole] purpose of any step in the transaction.**

Commentary

5.26. It is unlikely that every step within a multiple step transaction will be solely tax motivated. Where the overall purpose of the transaction, judged according to the criteria outlined in (a) above, is tax motivated, the rule will apply. These transactions are, however, unlikely to present the real problem in this area.

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<sup>2</sup> (1988) 62 TC 1, 199.

<sup>3</sup> [1993] STC 502, 513.

5.27. Many commercial transactions, in particular, are carried through in several steps and to ensure maximum tax efficiency, some of the steps in the overall plan are designed to achieve the required tax efficiency. The overall transaction has a commercial purpose but the only commercial purpose of certain steps may be to save tax.

5.28. Three specific issues arise when considering such commercial transactions—

- Should the rule only be applied by reference to the entire multiple step transaction or can the Revenue authority pick one step or several steps (being a subset of the multiple step transaction) and apply the rule independently to that step or subset?
- When looking at any step within a multiple step transaction, what degree of tax purpose must attach to that step to trigger the rule—should tax be the sole purpose for the step, the dominant purpose or merely one of the main purposes?
- If the rule applies to a step or subset of steps within a larger multiple step transaction, how far may the transaction as a whole be reconstructed or is the reconstruction limited to the step or subset of steps that fall within the rule?

5.29. It is very difficult to give general answers to these questions because it is impossible to envisage every circumstance that may arise. We would not intend to deter legitimate tax planning or mitigation in taxpayers' ordinary commercial or personal affairs. In our view, therefore, practical considerations must guide the answers. The scope of the rule and its administrative procedures must be such as do not in practical terms require taxpayers to apply for clearance before undertaking any commercial deal in a tax efficient manner. If it were otherwise, it would unnecessarily inhibit commercial activity and would be equally unworkable for the Revenue authority.

*(f) “Normal transactions”*

**The “normal transaction” is the transaction that it would be reasonable to assume would, if the avoidance of tax had not been a purpose of the tax driven transaction, have been carried out to obtain the same or similar commercial or other non-tax objectives as the tax driven transaction was intended to achieve. If there are two or more alternative transactions that satisfy this description, then the transaction that would be least burdensome to the taxpayer in terms of tax shall be taken as the normal transaction.**

Commentary

5.30. Once a transaction has fallen into the category of a tax driven transaction, the Revenue authorities must identify the transaction that the taxpayer would have



adopted, had tax not motivated his actual actions. This “normal transaction” will form the basis on which the Revenue authority seeks to recover tax.

5.31. Recharacterisation of transactions, which involves an assessment of what a taxpayer could have done, rather than what he actually chose to do, is unavoidably a difficult and contentious exercise. The taxpayer may be told that he undertook a transaction in a form that he would never have contemplated and at a cost in tax terms that would have led him to abandon the whole venture.

5.32. The intention of Parliament may be of little assistance as a guide to reconstructing the transaction. The Revenue authority can always claim that Parliament would have intended certain tax consequences to follow had the taxpayer undertaken the transaction in this form, rather than the form he adopted. The need to seek the Parliamentary intention extends primarily to the transaction that the taxpayer actually undertook: would Parliament have intended that transaction to have had the tax consequences sought or would it have characterised it differently for tax purposes?

5.33. How far may the Revenue authority recharacterise the entire multiple step transaction merely because one step or subset of steps, is tax motivated? Must the overall shape of the multiple step transaction remain the same, but with elements within it reconstructed to eliminate the tax advantage, or should the rule allow the Revenue authority to redraw the overall transaction merely in a way that achieves the same commercial outcome?

5.34. Again there are no fundamental principles to provide the answers to these questions. The answers should be dictated by the practical considerations of ensuring that commercial activity is not unduly hampered by the rule and that the clearance mechanisms are administratively workable.

5.35. We believe that the rule should not afford the Revenue authority the opportunity to levy the maximum taxation, as if the transaction had been effected in the least tax efficient manner. This is not to say that taxpayers can only ever have second best tax planning. The concept of a “protected transaction” contemplates that some forms of tax planning are effective. If transactions can be recharacterised in several ways, none of which would themselves fall foul of the rule, the one most favourable to the taxpayer should apply.

**(g) “Protected transactions”**

**A “protected transaction” is a transaction that satisfies any one or more of the following tests–**

- (i) It can reasonably be regarded as encouraged by legislation;**
- (ii) It falls within an exception to, or an exclusion from, other anti-avoidance provisions (that is to say, other provisions having the main purpose of preventing or counteracting the avoidance of tax);**

- (iii) **It otherwise does not conflict with or defeat the purpose of legislation.**

#### Commentary

5.36. We think it important that a statutory provision should attempt to spell out some criteria for identifying legitimate tax mitigation. We envisage that the Revenue department would build upon the statutory criteria by administrative statement and guidance, explaining its views. One issue is that of “defensive” tax planning, where transactions aim to deal with some accepted deficiency in existing provisions. Another concerns transactions that are tacitly accepted—for example, the use each year of an annual capital gains tax allowance through “bed and breakfasting” transactions—where the presumed intention of Parliament may not be clear.

5.37. The difficulty in defining the appropriate criteria for protected transactions arises from the fundamental requirement that the clause give effect to the intention of Parliament. A transaction that satisfies the safe harbour criteria would arguably be outside the statutory rule in any event as the parliamentary intent would be not to counter the tax mitigation involved.<sup>4</sup> We consider that this objection should not detract from the inclusion in the structure of any clause of such a safe haven provision.

5.38. One important aspect of a general anti-avoidance rule is that some attempt should be made to specify its relationship to specific anti-avoidance rules. Paragraph (ii) envisages that a general anti-avoidance provision should fill gaps or loopholes in more specific legislation but should not catch transactions that would otherwise benefit from a safe haven deliberately included in specific legislation.

### **The illustrative clause: administrative provisions**

#### **Resolving uncertainty and controlling discretion**

5.39. With no clear dividing line that we can define between acceptable tax mitigation and unacceptable avoidance, a general anti-avoidance doctrine is inherently uncertain. Uncertainty pulls in two directions—

- Is it sufficient to deter unacceptable avoidance?
- Is it more than taxpayers can tolerate in the conduct of their ordinary commercial or private affairs?

5.40. These questions are equally applicable whether the rule is judge-made or statutory. The real issue at the borderline is who decides which side of the line a taxpayer falls. The courts have the final word in either case, through the development of their doctrine or the interpretation of the statutory language. In practical terms,

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<sup>4</sup> Professor Brian Arnold makes this point in relation to the Canadian rule. Jeffrey Waincymer has made a similar point in relation to the Australian rule. See *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (The Netherlands), 1997, Chapters 7 and 8.

uncertainty from either source allows the Revenue departments to decide matters in the first instance.

5.41. The administrative procedures that apply in either case are an important factor in choosing between the two approaches. The only procedure that a judicial rule offers is the ordinary appeal process and the cost and ease of appeal will determine how far a judicial rule vests in the Revenue authority a power of determination. While a statutory rule remains subject to judicial interpretation, which over time may significantly affect its scope, a statutory rule can incorporate special administrative procedures, which in turn will influence the scope of the statutory rule.

## **6. Procedure for invoking the rule**

**Only the Board may invoke this rule. Where it does so, the Board shall give a written notice to every person whose tax liability would be affected by the application of this rule—**

- (a) Specifying the tax-driven transaction in relation to which it is invoking the rule;**
- (b) Identifying the normal transaction by reference to which it proposes to charge tax;**
- (c) Stating that in its opinion the tax-driven transaction is not a protected transaction; and**
- (d) Giving details of every other person to whom it has given written notice relating to the same tax-driven transaction.**

**The “Board” means the Commissioners of Inland Revenue or of Customs and Excise, as the context requires.**

### Commentary

5.42. A general anti-avoidance rule should be effectively a weapon of last resort. It is important, therefore, to ensure that it is applied sensibly and consistently, with a minimum risk of partial and uneven application. In Australia, Canada and New Zealand, to ensure consistency of approach, decisions to invoke the general rule are dealt with under exclusive central control. Canada has gone so far as to set up a special committee with representatives from the Department of Finance and Revenue Canada to review cases where the general rule might be used. Centralised decision-making should promote uniformity and the development of expertise in what is likely to be a sensitive and difficult area of tax administration.

5.43. What should be the position if a general rule applies to several taxes under the care and management of different Revenue departments? Should each Revenue department retain control over its application to those taxes for which it is responsible, or should a single unitary authority take responsibility for invoking the rule in respect of all taxes?

5.44. There are obvious grounds for leaving the administration of the rule for a particular tax with the department responsible for that tax. In the case of value added tax, there are issues of Community law that do not yet affect direct taxes. There are equally obvious grounds in that case for ensuring close co-operation between different departments if the restructuring of a transaction under the rule is intended to apply for all tax purposes.

5.45. It is important that the taxpayer should know how the Revenue authorities formulate against him any claim based on the general anti-avoidance rule. Only in this way will he have a fair chance of answering the case against him. Thus, the notice should specify the normal transaction on which the Board bases its assessment, with details of the transaction(s) that it proposes to disregard or recharacterise. As mentioned in relation to the burden of proof, the procedure presupposes that the Board has sufficient information about the tax-driven transaction to invoke the rule and specify the normal transaction.

## **7. Request for review**

- (a) Where the Board has invoked this rule by notice given to any person, that person shall have the right to require the Board to review its decision.**
- (b) The request for review shall be made in writing to the Board within 30 days of receipt of the notice given by the Board.**
- (c) The request for review may be on the grounds that the transaction is not a tax driven transaction, or that it is a protected transaction, or that the transaction identified by the Board as the normal transaction is not appropriate to the circumstances. Any request must also include a sufficient statement of the facts and circumstances relating to the transaction to enable the Board to make a proper review.**
- (d) The Board shall duly review its decision and shall, within 30 days of receipt of the request, notify the taxpayer of its final decision as to whether this rule should be applied to the transaction (either in the manner originally specified or in such modified manner as is stated in the notification).**

### Commentary

5.46. The Board is likely only to invoke the rule after a course of investigation and discussion with the taxpayer. In those circumstances the suggested time limits for action seem appropriate. An internal review within the revenue authority guarantees the taxpayer the right to advance counter-arguments, including any defence that may be available to him. It also offers the comfort of a view detached from the original investigation and course of dealing between the taxpayer and those acting for the revenue authority. This procedure may also enable both sides to define the issues for the benefit of the appeal tribunal.

5.47. The Board may have served notice on several participants in the arrangements and in that case it will be important that the procedures enable more than one request for review of the same arrangement to be handled on a consolidated basis.

## **8. Appeals**

- (a) Where the Board notifies any person of its decision to apply this rule, that person may appeal against the Board's decision by notice of appeal given to the Tribunal within 30 days of receipt of the Board's notification.**
- (b) Where a request for review has been made, no appeal may be made unless and until the Board notifies its final decision to apply this rule, and must then be made within 30 days of receipt of that notification.**
- (c) The notice of appeal must specify the grounds of appeal and state whether the appeal is on the basis that the transaction is not a tax driven transaction, or is a protected transaction, or that the transaction identified by the Board as the normal transaction is not appropriate to the circumstances.**
- (d) On any appeal the Tribunal shall have jurisdiction to decide whether and how the rule should be applied to the transaction (including, if appropriate, whether the rule should apply by reference to a normal transaction that is different from the one specified by the Board).**
- (e) Where there are two or more appeals relating to the same transaction, those appeals may be heard and dealt with as a single appeal.**

**The "Tribunal" means the Special Commissioners or the VAT and Duties Tribunal, as the context requires.**

### Commentary

5.48. It would be for consideration whether the existing appeal tribunals should have jurisdiction to hear appeals in these matters or whether some special tribunal should be established. We prefer to give jurisdiction to the existing tribunals, subject to the proposals we have put forward for a unified tax appeals tribunal.<sup>5</sup>

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<sup>5</sup> See Tax Law Review Committee, *Interim Report in the Tax Appeals System*, IFS, November 1996.

**9. Prior clearance procedure**

- (a) A person who proposes to carry out a transaction may ask the Board for confirmation that it will not apply this rule to the transaction.**
- (b) The request may be made on either or both of the following grounds–**

  - (i) The transaction is not a tax driven transaction;**
  - (ii) The transaction is a protected transaction.**
- (c) The request shall be made in writing and must set out all the facts and circumstances material to the Board’s evaluation of the transaction.**
- (d) The Board shall respond in writing within [30] days of receipt of the request. If the Board considers that it has received insufficient information, it may request further information within that time, and shall not be obliged to give its decision on the request until [30] days after the receipt of that further information.**
- (e) If the Board fails to respond within the time allowed, it shall be treated as having confirmed that the rule should not be invoked with respect to the transaction.**
- (f) If the Board’s response is or is treated as being that the rule should not be invoked with respect to the transaction, then that response shall be binding on the Board unless it transpires that the request was made on the basis of inadequate or misleading information.**
- (g) If the Board’s response is that the rule should be invoked with respect to the transaction, then there shall be a right of appeal against that response to the Tribunal. Such appeal shall be made within 30 days of receipt of the response. The Tribunal shall consider the appeal by reference only to the documents sent to the Board in support of the clearance application and to the Board’s response. Neither the taxpayer nor the Board shall be entitled or permitted to address further arguments to the Tribunal or to attend the appeal. The decision of the Tribunal on such appeal, which shall be given within [30] days, shall be final and unappealable.**

**10. Publication**

**Summaries of clearance requests and their outcome may be published by the Board in such form as it considers appropriate, providing that such summaries do not divulge the identity of the parties to the transaction or any other material that may reasonably be regarded as confidential.**

## Commentary

5.49. We envisage that there would be a clearance system with an appeals procedure based on the existing rules of section 138 of the Taxation of Chargeable Gains Act 1992. There is an important relationship between the substantive rule and the clearance procedure. A clearance offers taxpayers certainty for their transactions. On the other hand, if the substantive rule is cast too widely, the clearance procedure may become administratively unworkable and inhibit ordinary commercial or family transactions. Taxpayers may see a clearance as a necessary requirement for a transaction that aims to be tax efficient and their advisers may see it as a necessary protection. Both may need to understand when they are passing from permissible areas of tax planning into the less certain waters of the rule, necessitating a clearance if they are wise. We would wish to see clearances published to help build up a volume of material indicative of the Revenue authorities' attitude and approach to tax avoidance and mitigation transactions.

5.50. At the same time, it is desirable that clearances should be capable of being given promptly. This is essential where the timetable for a transaction depends upon other factors. In this respect there is a tension between local and central operation of the clearance procedure. Locally, those who are familiar with the taxpayer's affairs may be able to react more quickly to a clearance request. Centrally, we would hope for greater consistency but at the expense of familiarity and with the possible delay inherent in having to liaise at a local level with the taxpayer's inspector.

### **11. Operation of the rule**

- (a) This rule comes into effect with respect to transactions entered into on or after [the operative date].**
- (b) Where the transaction is a multiple step transaction, it shall come into effect where the first step in the transaction is entered into on or after [the operative date].**

### **12. Annual Report**

**The Board shall present each year a report to Parliament giving full details of its operation of this rule.**

## Commentary

The purpose of the rule is to give effect to the intention of parliament in those areas where it is difficult for parliament to specify in advance the type of transaction or arrangement against which it would act. It seems appropriate, therefore, that the Revenue departments should account to parliament for its actions in this area, through a report on its operation of the rule.

## CHAPTER 6. PENALTIES

### A penalty for “abusive” tax avoidance

6.1. One attitude to tax avoidance is to ask what risk is involved in a scheme. Avoidance is seen as attracting a minimal “penalty”—the creation of an additional tax liability—and as offering great rewards if it is successful or unchallenged. The risk of an arrangement being challenged and found to be unsuccessful avoidance is taken account of and factored into a tax planning arrangement. If the risk is limited to the costs of the scheme and of defending it, if challenged, almost any arrangement may be worth trying.

6.2. That has been traditional position in the United Kingdom. There is no interest or specific penalty attaching specifically to avoidance unless the arrangement strays into the territory of under-declaration of tax or incorrect returns. Some of the issues involved here were considered by the Keith Committee in its review of the enforcement powers of the Revenue Departments.<sup>1</sup>

6.3. The picture is now different in some of the other jurisdictions where positive steps have been taken to increase the downside risk attaching to avoidance. In the following paragraphs we outline briefly the position in New Zealand, Australia and Canada, as we understand it to be at present.

### New Zealand

6.4. New Zealand has enacted in the Tax Administration Amendment (No.2) Act 1996 a new taxpayer compliance, penalties and disputes resolution regime. This is designed to reinforce taxpayer’s obligations in a self-assessment system. The legislation introduced onerous penalties for breaching tax obligations, which take effect from the start of the 1997 income tax year. For our current purposes, there are a range of graduated fixed civil penalties called shortfall penalties, enabling the Commissioner to impose a penalty in addition to interest in some cases where a taxpayer pays less tax than is due.

6.5. The level of penalty increases with the level of “culpability”. The fixed penalty can be revised upwards if there is “obstruction” by the taxpayer and mitigated downwards if the taxpayer makes a voluntary disclosure or the tax shortfall is temporary in nature.<sup>2</sup>

6.6. Section 141D of the Act introduces a penalty for *abusive* tax avoidance positions where the tax shortfall exceeds \$10,000. The penalty is 100 per cent. of the shortfall, rising to 125 per cent. if there is obstruction. An important point is that the shortfall penalty is reduced by 75 per cent. if there is adequate disclosure of the tax

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<sup>1</sup> Cmnd 8822, March 1983, Chapter 7.

<sup>2</sup> I.e. was permanently reversed or corrected before a pending tax audit and will not recur.



position at the time of filing the tax return.<sup>3</sup> The Commissioner may at any time specify the type of information required for adequate disclosure and the form in which the information must be provided.

6.7. In contrast, there is a penalty of 20 per cent. for simply taking an incorrect tax position involving an interpretation or application of tax law, if the shortfall exceeds both \$10,000 and the lesser of \$200,000 or 1 per cent. of the total tax liability for the appropriate return period. The aim here is to ensure that in a self-assessment environment taxpayers who take a position which has significant tax consequences take extra care. It is a measure directed at large taxpayers with sophisticated tax affairs. Smaller taxpayers are unlikely to be affected because of the de minimis limits that apply.

6.8. The penalty for tax *evasion* is 150 per cent., rising to 187.5% if there is obstruction. At 100 per cent. the level of the penalty for abusive avoidance has been strongly criticised as being much too close to that for evasion and for blurring the important distinction between the two.<sup>4</sup>

6.9. An “abusive tax position” is defined as one that involves taking “an unacceptable interpretation” of a tax law and, viewed objectively, is entered into with a “dominant purpose” of tax avoidance.

6.10. The concept of abusive or blatant tax avoidance first appeared in a New Zealand Government discussion document issued in August 1994. That document proposed that a penalty should apply to a specified type of abusive avoidance arrangement.

“A specified arrangement could be defined as one in which it may reasonably be concluded that a dominant or substantive objective of the taxpayer (regardless of any other objective) was to promote a tax advantage. Criteria to determine whether it could be reasonably be concluded that a dominant or substantive objective was to produce an income tax advantage would include, but not be limited to, the following:

- the presence of artificiality, circularity of funding, contrivance or pretence in the arrangement;
- the extent to which the terms and conditions of the arrangement are consistent with those which could reasonably be expected to apply to normal transaction;
- the extent to which the attainment of the tax advantage involves concealment or non-availability of evidence.”

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<sup>3</sup> Section 141H.

<sup>4</sup> *Blurring the Distinction Between Avoidance and Evasion—The Abusive Tax Position* [1996] BTR No.5 at p. 483.

6.11. The new legislation has a purpose statement for “abusive tax positions”.<sup>5</sup> It states—

“The purpose of this section is to penalise those taxpayers who, having applied an unacceptable interpretation to a tax law, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions, that reduce or remove tax liabilities or give tax benefits.”

6.12. An “unacceptable interpretation” is defined as a tax position that fails to meet the standard of being, viewed objectively, about as likely as not to be the correct tax position.<sup>6</sup> The commentary to the Bill, which in the absence of judicial authority is permitted as an acceptable authority, states :

“...the words ‘about as likely as not correct’ are intended to confirm that it need not be a 50% or more expectation that the taxpayer’s position is the better view. A slightly lower expectation will be accepted.”

This means that the prospect of the taxpayer’s interpretation being upheld by the Courts must be substantial although not necessarily 50 per cent. In other words, the test is a test of the degree of authority for the position taken.

6.13. Because the penalty regime is such a recent innovation, it is extremely difficult to gauge what its longer-term effect might be on taxpayer behaviour. We have been told that for the moment there has been a substantial impact upon the way taxpayers think about their tax obligations and that, in view of the potential quantum of penalty that could be imposed, the general anti-avoidance rule in particular is now seen as a significant deterrent.

## **Australia**

6.14. Australia does not have a precise equivalent to the New Zealand concept of abusive avoidance but the operation of its general anti-avoidance provision is backed up by penalty.

6.15. Where the Commissioner acts under Part IVA (the general anti-avoidance provision) and cancels the tax benefit, the taxpayer is liable to pay a penalty that is equivalent to 50 per cent. of the tax assessed to be properly due. The penalty is reduced to 25 per cent. if the taxpayer can establish that it is reasonably arguable that Part IVA ought not to apply. In determining whether the taxpayer has a reasonably arguable position, regard is paid to such factors as the wording of the legislation, judicial decisions and public rulings of the Commissioner.<sup>7</sup>

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<sup>5</sup> Section 141D(1). The purpose statement is relatively new to New Zealand tax law and is intended to give further guidance on what Parliament intended to achieve.

<sup>6</sup> Section 141B.

<sup>7</sup> This concept is similar to the “about as likely as not” test adopted in New Zealand.

6.16. The Australian penalty regime is much less severe than its New Zealand counterpart. Not only is the rate of penalty lower (50 per cent. as against 100 per cent.) but there is less of a cliff-edge when comparison is made with other penalties. Where Part IVA is inapplicable, but there is a tax shortfall, the taxpayer will be liable to a penalty of 25 per cent. of the shortfall. The comparable New Zealand figure is 20 per cent.

## **Canada**

6.17. Although the Canadian general anti-avoidance provision was introduced as a result of concerns that tax avoidance was undermining the system of self-assessment, there are no specific penalties attached to abusive tax avoidance.

6.18. Professor Arnold has expressed the following view on this<sup>8</sup>—

“In my opinion, a general anti-avoidance rule that applies only to clearly abusive tax avoidance schemes should be subject to a penalty. Abusive tax avoidance imposes significant costs on a country’s tax system and should be discouraged. A reasonable penalty would constitute a signal to the tax authorities and the courts that the rule should be applied only in clear cases of abuse. I recognise, however, that the imposition of a penalty is a very controversial subject.”

## **Conclusion**

6.19. As Professor Arnold’s remarks indicate, it is difficult to reach a conclusion on the question of a penalty regime without knowing the precise nature and scope of the general rule, and whether it is meant to signal a particular attitude on the part of the Revenue authorities and judiciary.

6.20. A penalty regime should also be considered in the broader context of specific anti-avoidance provisions, the self-assessment regime and the ordinary rules that operate to secure compliance with those provisions and that regime. This goes beyond our current study. Accordingly, we express no view at this stage upon whether, were the government to adopt a statutory general anti-avoidance rule, it should be accompanied by a penalty regime.

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<sup>8</sup> Arnold, *The Canadian General Anti-Avoidance Rule*, in *Tax Avoidance and the Rule of Law*, ed. Cooper, IBFD (The Netherlands), 1997 at page 241.

# APPENDIX 1

## STATUTORY GENERAL ANTI-AVOIDANCE PROVISIONS IN CANADA, AUSTRALIA & NEW ZEALAND

### Section 245 Income Tax Act (Canada)

#### **Definitions**

- (1) In this section,

***“tax benefit”***

A “tax benefit” means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act.

***“tax consequences”***

A “tax consequences” to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount.

***“transaction”***

A transaction includes an arrangement or event.

#### **General Anti-avoidance provision**

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

#### **Avoidance transaction**

- (3) An avoidance transaction means any transaction:
- (a) that, but for this section, would result, directly or indirectly, in a tax benefit 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; or
  - (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, 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.

### **Provision not applicable**

- (4) For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

### **Determination of tax consequences**

- (5) Without restricting the generality of subsection (2),
- (a) Any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or part,
  - (b) Any such deduction, any income, loss or other amount or part thereof may be allocated to any person,
  - (c) The nature of any payment or other amount may be recharacterised, and
  - (d) The tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

In determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

### **Request for adjustments**

- (6) Where with respect to a transaction
- (a) A notice of assessment, reassessment or additional assessment involving the application of subsection (2) with respect to the transaction has been sent to a person, or
  - (b) A notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to a transaction

Any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the mailing of the notice, to request in writing that the Minister make an assessment, reassessment or additional assessment applying subsection (2) or to make a determination applying subsection 152(1.11) with respect to that transaction.

### **Sec.248(10) Series of transactions**

For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series.

## **Part IVA (Australia)**

### **Section 177A Definitions**

- (1) In this Part, unless the contrary intention appears, “**scheme**” means—
  - (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.
- (3) The reference in the definition of “scheme”...to a scheme, plan, proposal, action, course of action or course of conduct shall be read as including a reference to a unilateral scheme, plan, proposal, action course of action or course of conduct, as the case may be.
- (4) A reference in this Part to the carrying out of a scheme by a person shall be read as including a reference to the carrying out of a scheme by a person together with another person or other persons.
- (5) A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to a scheme or the part of the scheme being entered into or carried out by a person for 2 or more purposes of which that particular purpose is the dominant purpose.

### **Section 177C Tax Benefits**

- (1) Subject to this section, a reference in this Part to the obtaining by a taxpayer of a tax benefit in connection with a scheme shall be read as a reference to—
  - (a) An amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
  - (b) A deduction being allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out;

### **Section 177D Schemes To Which Part Applies**

This Part applies to any scheme...where—

- (a) a taxpayer (in this section referred to as the “**relevant taxpayer**”) has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and

- (b) having regard to—
  - (i) the manner in which the scheme was entered into or carried out;
  - (ii) the form and substance of the scheme;
  - (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
  - (iv) the result in relation to the operation of the Act that, but for this Part, would be achieved by the scheme;
  - (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
  - (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
  - (vii) any other consequence for the relevant taxpayer, or any person referred to in sub-paragraph (vi), of the scheme having been entered into or carried out; and
  - (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in sub-paragraph (vi),

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).

**Section 177F Cancellation of Tax Benefits Etc.**

(1) Where a tax benefit has been obtained, or would but for this section be obtained, by a taxpayer in connection with a scheme to which this Part applies, the Commissioner may—

- (a) ...determine that the whole or a part of [the amount not included in income] shall be included...
- (b) .....that the whole or a part of the deduction or of the part of the deduction...shall not be allowable...

## **New Zealand**

### **Section BB9 Agreements purporting to alter the incidence of tax to be void**

Every arrangement made or entered into shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,—

- (a) Its purpose or effect is tax avoidance; or
- (b) Where it has 2 or more purposes or effects, one of its purposes (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to or are referable to ordinary business or family dealings,—

whether or not any person affected by that arrangement is a party thereto.

### **Section GB1 Agreements purporting to alter incidence of tax to be void**

(1) Where an arrangement is void in accordance with section BB9, the assessable income of any person affected by that arrangement shall be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of the preceding provisions of this subsection, the Commissioner may have regard to such income as, in the Commissioner's opinion, either—

- (a) That person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or
- (b) That person would have derived if that person had been entitled to the benefit of all income, or of such part of the income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

### **Section OB1 Definitions**

**“Arrangement”** means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect.

**“Tax avoidance”**...includes—

- (a) Directly or indirectly altering the incidence of any income tax:
- (b) Directly or indirectly relieving any person from liability to pay income tax:
- (c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax:



## **APPENDIX 2**

### **AN ILLUSTRATIVE STATUTORY GENERAL ANTI-AVOIDANCE PROVISION**

**1. Purpose of the rule**

The purpose of this rule is to deter or counteract transactions that are designed to avoid tax in a way that conflicts with or defeats the evident intention of Parliament. This rule shall be interpreted and applied in a manner consistent with that purpose.

**2. The basic rule**

- (a) Where a person carries out a tax driven transaction, he shall be taxed as if he had carried out the normal transaction.
- (b) If, because the tax driven transaction does not have any non-tax objective, there is no normal transaction then he shall be taxed as if it did not take place.

**3. Safeguard**

This rule shall not apply where the transaction is a protected transaction; and when a transaction is a multiple step transaction, it shall not apply where that transaction (taken as a whole) is entirely or mainly a protected transaction.

**4. Burden of proof**

- (a) In the application of this rule it shall be assumed that a transaction is not a tax driven transaction unless the contrary is demonstrated.
- (b) In the application of this rule it shall be assumed that a tax driven transaction is not a protected transaction unless the contrary is demonstrated.

**5. Explanation of terms**

**(a) *“Tax driven transactions”***

A “tax driven transaction” is a transaction that has as its sole purpose, or as its main purpose, or as one of its main purposes, the avoidance of tax.

In determining whether a transaction is a tax driven transaction, the following shall be taken into account–

Its legal form including the legal rights and obligations created by the transaction; its economic and commercial substance; the timing of any step; the expected duration of any step or any feature in the transaction; the change in the financial or other circumstances of the taxpayer or anyone connected

with the taxpayer, as a result of the transaction; the expected tax consequences of the transaction on the assumption that this rule does not apply.

**(b) “Tax”**

In this context, “tax” means [to be specified]

**(c) “Avoidance of tax”**

“The avoidance of tax” includes [to be specified].

**(d) “Transaction”**

A “transaction” includes a transaction that is carried out in more than one step (a “multiple step transaction”), to the extent that a subsequent step was planned or envisaged by the time when the first step is taken. In this context it is unnecessary for the precise nature or timing of a subsequent step to have been planned so long as the general nature of such step was planned or envisaged and its implementation was expected. It is also immaterial whether any particular step had a commercial or other non-tax objective.

**(e) “Multiple step transactions”**

Where a transaction is a multiple step transaction, it shall be regarded as a tax driven transaction not only if, taken as a whole, it falls within (a) above but also where the avoidance of tax is the [sole] purpose of any step in the transaction.

**(f) “Normal transactions”**

The “normal transaction” is the transaction that it would be reasonable to assume would, if the avoidance of tax had not been a purpose of the tax driven transaction, have been carried out to obtain the same or similar commercial or other non-tax objectives as the tax driven transaction was intended to achieve. If there are two or more alternative transactions that satisfy this description, then the transaction that would be least burdensome to the taxpayer in terms of tax shall be taken as the normal transaction.

**(g) “Protected transactions”**

A “protected transaction” is a transaction that satisfies any one or more of the following tests—

- (i) It can reasonably be regarded as encouraged by legislation;
- (ii) It falls within an exception to, or an exclusion from, other anti-avoidance provisions (that is to say, other provisions having the main purpose of preventing or counteracting the avoidance of tax);
- (iii) It otherwise does not conflict with or defeat the purpose of legislation.

**6. Procedure for invoking the rule**

Only the Board may invoke this rule. Where it does so, the Board shall give a written notice to every person whose tax liability would be affected by the application of this rule—

- (a) Specifying the tax-driven transaction in relation to which it is invoking the rule;
- (b) Identifying the normal transaction by reference to which it proposes to charge tax;
- (c) Stating that in its opinion the tax-driven transaction is not a protected transaction; and
- (d) Giving details of every other person to whom it has given written notice relating to the same tax-driven transaction.

The “Board” means the Commissioners of Inland Revenue or of Customs and Excise, as the context requires.

**7. Request for review**

- (a) Where the Board has invoked this rule by notice given to any person, that person shall have the right to require the Board to review its decision.
- (b) The request for review shall be made in writing to the Board within 30 days of receipt of the notice given by the Board.
- (c) The request for review may be on the grounds that the transaction is not a tax driven transaction, or that it is a protected transaction, or that the transaction identified by the Board as the normal transaction is not appropriate to the circumstances. Any request must also include a sufficient statement of the facts and circumstances relating to the transaction to enable the Board to make a proper review.
- (d) The Board shall duly review its decision and shall, within 30 days of receipt of the request, notify the taxpayer of its final decision as to whether this rule should be applied to the transaction (either in the manner originally specified or in such modified manner as is stated in the notification).

**8. Appeals**

- (a) Where the Board notifies any person of its decision to apply this rule, that person may appeal against the Board’s decision by notice of appeal given to the Tribunal within 30 days of receipt of the Board’s notification.

- (b) Where a request for review has been made, no appeal may be made unless and until the Board notifies its final decision to apply this rule, and must then be made within 30 days of receipt of that notification.
- (c) The notice of appeal must specify the grounds of appeal and state whether the appeal is on the basis that the transaction is not a tax driven transaction, or is a protected transaction, or that the transaction identified by the Board as the normal transaction is not appropriate to the circumstances.
- (d) On any appeal the Tribunal shall have jurisdiction to decide whether and how the rule should be applied to the transaction (including, if appropriate, whether the rule should apply by reference to a normal transaction that is different from the one specified by the Board).
- (e) Where there are two or more appeals relating to the same transaction, those appeals may be heard and dealt with as a single appeal.

The “Tribunal” means the Special Commissioners or the VAT and Duties Tribunal, as the context requires.

#### **9. Prior clearance procedure**

- (a) A person who proposes to carry out a transaction may ask the Board for confirmation that it will not apply this rule to the transaction.
- (b) The request may be made on either or both of the following grounds–
  - (i) The transaction is not a tax driven transaction;
  - (iii) The transaction is a protected transaction.
- (c) The request shall be made in writing and must set out all the facts and circumstances material to the Board’s evaluation of the transaction.
- (d) The Board shall respond in writing within [30] days of receipt of the request. If the Board considers that it has received insufficient information, it may request further information within that time, and shall not be obliged to give its decision on the request until [30] days after the receipt of that further information.
- (e) If the Board fails to respond within the time allowed, it shall be treated as having confirmed that the rule should not be invoked with respect to the transaction.
- (f) If the Board’s response is or is treated as being that the rule should not be invoked with respect to the transaction, then that response shall be binding on the Board unless it transpires that the request was made on the basis of inadequate or misleading information.

- (g) If the Board's response is that the rule should be invoked with respect to the transaction, then there shall be a right of appeal against that response to the Tribunal. Such appeal shall be made within 30 days of receipt of the response. The Tribunal shall consider the appeal by reference only to the documents sent to the Board in support of the clearance application and to the Board's response. Neither the taxpayer nor the Board shall be entitled or permitted to address further arguments to the Tribunal or to attend the appeal. The decision of the Tribunal on such appeal, which shall be given within [30] days, shall be final and unappealable.

**10. Publication**

Summaries of clearance requests and their outcome may be published by the Board in such form as it considers appropriate, providing that such summaries do not divulge the identity of the parties to the transaction or any other material that may reasonably be regarded as confidential.

**11. Operation of the rule**

- (c) This rule comes into effect with respect to transactions entered into on or after [the operative date].
- (d) Where the transaction is a multiple step transaction, it shall come into effect where the first step in the transaction is entered into on or after [the operative date].

**12. Annual Report**

The Board shall present each year a report to Parliament giving full details of its operation of this rule.