TAX AVOIDANCE AND THE RULE OF LAW

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edited by

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PREFACE

This volume of essays arose out of a conference held in Sydney in May 1995 on the topic: *The Rule of Law and Anti-Avoidance Rules: Tax Administration in a Constitutional Democracy*. The object of the conference was to explore the tension between anti-avoidance rules — and a general anti-avoidance rule (GAAR) in particular — sometimes enacted in tax legislation and other important values in a constitutional democracy, particularly, the concept of the rule of law. Research being what it is, it was expected that by the time the conference was completed, the discussions would necessarily range over a broad range of related matters (and possibly even some unrelated matters) such as problems in legislative drafting, styles and trends in statutory interpretation, the division of powers in the Westminster tradition, the appropriate extent of the discretions given to tax administrators, and might even extend to notions arising from the civil liberties discourse and principles of human rights.

Although to some extent these issues are perennial, three developments in income taxation in Australia had raised their profile and served as the occasion for a re-assessment of the topic. First, the Joint Committee of Public Accounts of the Australian Parliament had released the results of its review of the tax administration in Australia.[1] Many of its recommendations were quite damning of several aspects of Australia's tax system and raised tangentially the kinds of issues raised here. Moreover, the Australian High Court handed down its decision in the *Peabody* case,[2] the first judicial examination at the most senior level in the judicial hierarchy of Australia's GAAR. There was some understandable apprehension that the GAAR, revamped in 1981 as a result of its earlier emasculation by a differently-constituted High Court, might prove no more robust than its predecessor. Finally, the Australian government decided to accept some of the Joint Committee's recommendations announcing, for example, that

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[1] Joint Committee of Public Accounts, *An Assessment of Tax* (Canberra, AGPS, 1993).

[2] *FCT v. Peabody* (1994) 94 ATC 4663.

it would establish a taxpayer bill of rights, a tax ombudsman and a small tax claims tribunal.

While these Australian developments provided one impetus for the conference, the same issues had surfaced again in other jurisdictions, albeit in slightly different ways. In Sweden, for example, a GAAR had been enacted but was subsequently repealed by the government after some dissatisfaction with its performance. Canada had recently decided to enact a GAAR, provoking some disquiet among tax professionals. At about the same time, taxpayers and their advisors began to focus on the Canadian Charter of Rights and Freedoms as an unusual tool to establish tax claims. One can surmise that this focus will surely shift to a more evident role for the Charter — exploiting its undoubted utility as a means of challenging administrative action, including, one can confidently predict, the terms and operation of the GAAR. In contrast, in the United States it has apparently not been necessary to create a statutory GAAR. While one might have expected to see some similar events in tax, given both the Canadian tax foray into the constitutional realm and the ubiquitous presence of constitutional and quasi-constitutional issues in US litigation generally, they have rather curiously not developed. Instead, robust judicial doctrines have served in the place of a GAAR. Similarly, in the UK, judicial activism has been relied upon, to the exclusion of a legislated GAAR, under doctrines such as fiscal nullity, although the retreat from this doctrine may indicate a degree of judicial skepticism or timidity in the task.

It was precisely these differences of approach and emphasis that the conference was designed to explore. The scholars who attended the conference represented several disciplines — taxation law, public economics, administrative law, public administration, constitutional law and human rights. Their contributions are reproduced here, along with contributions from other scholars who have contributed chapters in order to make this volume more complete and more thorough.

Additional funding for the conference was provided by the Australian Tax Research Foundation and the Taxation Law and Policy Research Centre at Deakin University. I also want to record my thanks to Rick Krever for his typically energetic work in conceiving and organsing the

conference, the staff of the International Bureau for Fiscal Documentation for their efforts in the publication of this volume and to Alexandra Mills for her contribution to its production.

Graeme S. Cooper
Paris
Toussaint, 1996

CHAPTER 1

CONFLICTS, CHALLENGES AND CHOICES — THE RULE OF LAW AND ANTI-AVOIDANCE RULES

Graeme S. Cooper

The topic of this volume of essays is the operation of the general anti-avoidance rules (GAARs) often enacted by governments in their tax statutes, and, in particular, the extent of any conflict between GAARs and the tradition of the rule of law. That topic implies several consequential questions but it is also, in some respects, already logically several steps beyond other important issues. A rigorous analysis of the topic would have to examine a more complete series of questions:

- What do we mean by this notion, the "rule of law"? In other words, why is a GAAR not a law for these purposes? It certainly has most of the characteristics of a law. Why is it thought that enacting a GAAR in a tax statute detracts from the rule of law? What are the salient features of a GAAR that lead to this conclusion?

- Why is the rule of law regarded as an important value in Western liberal democracies? Is it still important today, and is it important in this context?

- How important is it? For example, is it a value that should be given almost absolute primacy or might it need be modified or even abandoned for particular areas of law where the circumstances are appropriate?

- Whose responsibility is it to control tax avoidance and how is the task to be divided between the legislature, administration and judiciary in a constitutional democracy framed in the traditions of Western liberal democracies?

- What is a GAAR? How does it differ, for example, from the many other rules that commonly exist to adjust the tax consequences of transactions, most of which are, if not welcomed by the community, at least accepted. Common examples would be rules inserting fair market value or denying losses on certain transactions.

- Since a GAAR is enacted as one strategic element in solving tax avoidance, how important is that problem? Is it sufficiently important to justify the other fallout from the means employed to solve the problem? If governments choose to enact GAARs in the face of vocal opposition, what alternatives are open to government to achieve the goals sought but using less contentious tools?

This list could clearly be extended and amplified without much further effort, but it serves to announce in a general way, the issues that are at the heart of the papers in this volume.

Taxation as a Constitutional Issue

Several papers examine the constitutional aspects of taxation. Head reminds us that, although it is rarely formally acknowledged, the tax system is one of the foundational elements of a constitutional democracy. Asking, who is taxed, how much and for what purposes? is to ask fundamentally political questions — the kinds of questions which the political process traditionally resolves. Determining how tax obligations are imposed, administered and enforced raises questions that are more than simply mech-anistic — they too are constitutional questions. The imposition, administ-ration and enforcement of taxes raises problems about the rule of law, the proper division of powers, the role of the judiciary and so on.

The political questions raised by taxes are rarely far below the surface of modern popular debate, and a study of the history of taxation reveals that the latent political aspects of the taxation process have been well under-stood. Coffield puts it very aptly when he asks us to consider the "staggering thought that, had it not been for the insistence of George III and Lord North on retaining the 3d. a pound duty on all tea entering America, the American people today might be loyal subjects of the British Crown."[1]

But political processes are always constrained in western liberal democracies. Those constraints can be found in various places. Some will be implicit and be of general application — the periodic expression of the electorate's choice, for example, will control some decisions — although, as Brooks and Head remind us, the electoral process is both a constraint and an opportunity, as politicians vie for voter support through their tax policies. Some constraints are explicit in the legal system but of more limited application — international treaty obligations between

[1] J Coffield, *A Popular History of Taxation* (London, Longman, 1970) at 82.

nations, the rules of the written (or unwritten) constitution, or rules about the manner and form for validly passing legislation, for example. Others will be quite specific to the tax context — express constitutional or administrative rules about enacting tax laws or the administrative process for resolving disagreements in tax assessments, for example. Gammie recalls the power struggles between the Crown and Parliament in British history over the power to impose tax that lead to periodic declarations constraining the circumstances when the monarch (or parliament) could act. That legacy forms an important part of the background to the present discussion.

The Rule of Law - Its Scope and Limits

The idea of "the rule of law" is one of these constraints. It sets limits on the powers of governments and bureaucracies. But what does it prescribe? At least three separate ideas might be involved.

The first, and the most obvious idea, is that governments must act by laws, rather than by decree. In a tax context, it means that taxes will be imposed through a proper parliamentary process rather than through administrative discretion, or even judicial discretion. The excessive use of discretions, and even the delegation of legislative authority to bureaucrats, can contradict this notion since the bureaucrat may be (or some fear, will be) empowered effectively to decide what the law is. As Arnold observes, while revenue authorities might be given administrative discretion to deal with tax avoidance, "this type of broad administrative discretion is clearly unacceptable in the Canadian tax system because it is perceived to be contrary, at least in spirit, to the rule of law" although he goes on to note, "that such administrative discretion is a prominent part of several countries' tax systems."

Secondly, having enacted laws, the government and the administration must then comply with the laws that parliament passed. These two ideas recognise the parliament has extensive power to say what the law is, subject of course to any substantive constitutional prohibitions. As Gammie puts it,

> ... the rule of law appears not to place any substantive constraint on the laws the government may introduce, provided the government can secure their passage in Parliament. On this basis, the rule of law amounts to no more than the right at law to see that government follows whatever processes the statute lays down.

A third possible element of the notion is the most relevant for the purposes of this volume. It is the idea that what parliament enacts must be a law — it must have the characteristics that make a law. While parliament has extensive powers to write laws, that need not mean that every utterance by parliament that is labelled a law, will be a valid exercise of the law-making power. In a tax context, this idea is expressed by the argument that taxpayers should be able predict in advance (or at the very least, identify in retrospect) and with a sufficient degree of certainty, the tax consequences of their actions according to the rules created through the Parliamentary processes referred to. Mutén notes the views of a Swedish scholar that its GAAR would be unconstitutional since the constitution requires that taxes be imposed by written laws but the GAAR applies precisely where the tax so imposed would contradict the legislative purpose. This approach, he argues, implies a mandate to impose tax by analogy, not by law, which would be unconstitutional.

In some countries, this idea will be given effect as rules of constitutional or administrative law, albeit under various names. These rules might allow courts to strike down a law as void where it is too vague. Another variant would assert that a GAAR, as it is usually drafted in the countries that operate one, allows an uncontestable tax. Especially in the latter case, a GAAR threatens the kind of problems against which the rule of law is seen as the main bulwark, and it is for these reasons that the rule of law, framed in the manner described above, has been regarded as an important value in Western liberal democracies.

Arnold describes the current debate in Canada where the recently enacted GAAR is being challenged as unconstitutional on the basis that it is so vague that it contravenes the rule of law. He suspects, however, that, at least so far as Canada is concerned, the rule of law is concerned only with the first two ideas — it means principally that the government must act by laws rather than decrees and must then act in accordance with its laws. In these circumstances, vagueness might not be an adequate notion to attack the GAAR:

> Although courts have complained on several occasions about the complexity of tax legislation and the incomprehensibility of the statutory language, they have never declared a tax provision to be void for vagueness. Consequently, in my opinion, Canadian courts are likely to dismiss rather easily the void-for-vagueness argument concerning the general antiavoidance rule and to get on with the difficult task of applying the rule to control abusive tax avoidance.

Leaving these unresolved questions to one side — whether the rule of law comprehends these circumstances, and then whether it is actually offended by a GAAR — some speculation might even be aroused whether the rule of law is still important in the tax context. For example, the rule of law might be a value that should be given absolute primacy in cases where the curtailment of personal freedoms, or the expropriation of property without some attempts at lawful justification is threatened. But might be appropriate to modify or circumscribe its application in a tax context, especially one characterised by, say, a high degree of artificiality and a motive which taints the taxpayer's position?

This scepticism might be more appropriate in a tax context since taxpayers behave in such an idiosyncratic manner in tax matters. Attitudes to tax laws are quite unlike attitudes to other laws. As Wheatcroft put it, "when dealing with other areas of law citizens tend to stick to well-trodden paths; with tax law, they seek new ones."[2]

This creativity relies for its success upon the almost universal presumption that taxpayers are entitled to organise their affairs in ways that minimise their tax. Vanistendael notes, tax avoidance "is perfectly legal, because most countries recognise the right of the taxpayer to arrange his affairs in such a way as to pay less tax," citing judicial pronouncements drawn from the UK, the USA, Australia and Belgium. This proposition can be viewed as an application of the rule of law notion in a tax context — that government having stated through a law the tax consequences of various transactions and events is not free either to vary those consequences or to amplify them with the benefit of hindsight. No tax can be imposed unless the government has actually exercised the legal power to impose it. In some countries, such as France and Belgium, this "right" to choose untaxed alternatives is understood in constitutional rules enjoining the strict interpretation of laws.

The Role of the Judiciary

The ability of a court to find that the government has not effectively exercised its power to impose the tax through a law, and the consequences of it doing so, depend upon other elements of the constitutional framework — the doctrine of the separation of powers and the role of the judiciary.

The need for a GAAR flows from the way that tax legislation is interpreted and how legislation is interpreted depends on how it is drafted. The difficulties facing legislative drafters are well recognised. To quote Wheatcroft again,

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[2] GSA Wheatcroft, The Interpretation of Taxation Laws With Special Reference to Form and Substance (1965) vol La *Cahiers de Droit Fiscal* 7.

> No country has yet succeeded, or is likely to succeed, in framing its tax laws in such a way that it is clear how the tax liability will be calculated on any conceivable set of facts. Even the most accurate draftsman of a law will not always be able to find precise language to convey his meaning and the wisest legislator cannot forsee every possible situation that may arise.[3]

Indeed, Gammie reminds us that the attempts to do just this, even if theoretically desirable, are costly in terms of complexity and obscurity and may ultimately be self-defeating, not only in lost comprehensibility but also in the increased scope for non-principled action —

> There is a tension between the use of purposive construction techniques by the courts and the resort to increasing detail by the draftsman that may merely obscure whatever principles underlie the legislation. The development of legislative detail, so that users of the legislation find it more difficult to pick their way through the maze, is not an objection in itself. The reality, however, is that the detail merely obscures the effective practical discretion that the uncertainty of meaning confers on the administrator.

Richardson, the lone judge among the authors, concurs. He rejects,

> the argument that it is necessary to try to cover every situation so as to promote immediate certainty... Unfortunately that drafting approach tends to be destructive of the very certainty it favours.

Practical limitations, therefore, rather than any reason of principle, dictate that tax laws will never explicitly envisage the panorama of options that the collected creativity of all taxpayers can, at leisure, conceive. That being so, how should a court react when presented with, what it acknowledges, is an untaxed opportunity? Vanistendael presents the traditional response,

> It is clear that on the basis of considerations of economic efficiency and fiscal justice a taxpayer should not be able to use legal constructions or transactions to avoid similar situations being subjected to the same tax burden. The question is whether ensuring this does not happen is a task for the courts or for the legislators. The arguments against the courts doing this job are largely based on the principle of legality and the role of the courts vis-à-vis the legislator. The doctrine of the separation of powers holds that it is not for the judiciary to legislate.

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[3] *Id.*

Of course, the untaxed alternative is merely a worst-case (or best-case, depending on one's position) outcome on a continuum — it is simply the most graphic example of successful tax avoidance. Less ambitious avoidance raises exactly the same question — how should a court react when presented with, what it acknowledges, is a less-taxed opportunity?

Clearly, adopting the position that the taxpayer has truly found an untaxed or less-taxed alternative is itself a contingent position — it depends upon how the court has interpreted the legislation with which it is working, a process which is examined at length in the papers — but having come to that conclusion, the view which Vanistendael describes would conclude that judges have reached the limit of their explicit powers. Although he later goes on to criticise this position, Brooks puts it well — "statutory interpretation by unelected judges can be reconciled with representative democracy and majority rule only if judges make a good faith attempt to discern how the original legislator would have decided the case." Yet, one response to the problem of tax avoidance would be for courts to take matters into their own hands, so to speak, and for some types of avoidance, to develop judicial anti-avoidance doctrines.

Two papers in the volume present quite different visions of the opportunities and effectiveness of the courts in doing this. Gustafson describes the judicial creativity apparent in the US where a tradition of judicial activism has been evident from the earliest days of the income tax. He describes the genesis of the business purpose doctrine and the sham transaction doctrine, as well as a more ready willingness of US courts to find evidence of legislative intent, and to give effect to that discovery, in the resolution of tax cases. He refers to the "avoidance tests as reflections of usually unstated legislative intent [which] punctuate United States tax jurisprudence" and identifies this overall approach to judicial interpretation as introducing additional "eligibility tests on the basis of inferred legislative intention."

A rather less orthodox view is explored by Brooks in his essay on the role of judges in tax matters. He argues strongly for judges to "act as pragmatic tax analysts" in performing their "responsibility ... to give a meaning to the statutory language that will lead to the most sensible tax policy result in the particular case, given the general structure of the legislation." He laments how the Canadian judiciary conceives its role in tax cases. He argues that judges have fundamentally misconceived their role in tax matters because of a reluctance to venture explicitly into law-making. Consequently they voluntarily confine themselves to the role of interpreter:

> The mistake judges make in interpreting tax statutes is to assume that the only way to reconcile their role as unelected judges with the assumptions of majoritarian political theory is by attempting to apply an objective standard of interpretation that is anchored in statutory "plain meaning" or legislative "intent" or "purpose." They assume that when confronted with a problem in statutory interpretation they should begin (and end) by asking either: What is the plain meaning of this statutory language? What did the legislature intend when it passed this legislation? or, What is the purpose of this legislative enactment? ... Whatever specific approach is taken, it is inevitably foundationalist: it is based on one central idea, namely, that the role of judges is to act as agents of the legislature and to resolve cases by reference to some aspect of the legislative record.

He goes on to argue instead that "once the basic structure of the legislation is in place, it is then the responsibility of judges to resolve ambiguities and fill gaps in the legislation as these ambiguities and gaps become apparent in the administration of the legislation." They should act not as "single-minded originalist, attempting to divine the legislative meaning, intent or purpose, but instead ... as pragmatic tax [policy] analysts."

According to Brooks argument, judges should not ask, What did Parliament say? nor, What did Parliament mean to say? nor even, What was Parliament trying to accomplish? but rather, "What result would reflect the most sensible tax policy?" and then adjudicate on that basis. Clearly this is heady stuff. It is a radical departure from the orthodoxy recounted by Vanistendael. It is also a fundamental challenge to the traditional separation of powers doctrine. Recognising this, Brooks argues that,

> to require the courts to carry forward the public purposes of statutes, to build upon legislative judgments in a reasoned and principled way, to justify their results in terms of public policy objectives and evaluative criteria that are widely accepted in the subject area of the statute, and to decide cases in a way that will promote a more deliberative democracy is entirely consistent with legitimate democratic government and appropriate majoritarianism.

If, despite Brooks' argument, courts are reluctant to participate openly in the law-making process, the next logical question is whether the courts should allow some latitude to other decision-makers to overcome perceived inadequacies in the law, and on whom might this power be conferred. This question is examined later.

The Statutory Interpretation Process

The discussion above asked one question — *what* should courts do? Another aspect of this question is to ask, *how* should courts do it? This raises the issue of statutory interpretation. One would suspect that greater creativity and flexibility on the part of judges in interpreting the texts they apply might obviate the need to fortify the text with a GAAR — more robust judging might accommodate less hardy laws.

Interpreting the Statute

The statutory interpretation process is a difficult issue, and the difficulties increase when the tax system is used both as an instrument of economic and industrial policy and to achieve broader social aims.[4] Indeed the use of tax legislation for such purposes is often at the root of avoidance. Mutén reminds us of the nice irony that,

> a government that used tax policy measures to encourage certain economic behavior, had no standing to criticize taxpayers who, of course within the bounds of the law, tried to minimize their taxes. As a matter of fact, tax incentives would be fruitless, if taxpayers disregarded the tax factor in their business decisions.

But statutory interpretation is "a normative question" as Brooks puts it and his discussion of current theories of statutory interpretation shows just how value-laden the exercise is, whether or not the protagonists understand or even recognise it.

In his examination of judicial reasoning, Vanistendael points out that tax law is often viewed, and thus interpreted, like criminal law —

> Strangely enough, ... courts will fill up the gaps and loopholes left by the legislator in other areas of the law. The explanation for this distinction is often an explicit or implicit constitutional provision or quasi-constitutional constraint that limits the state's authority to tax in a similar way as its authority to impose criminal penalties is limited.

That approach to characterisation is not unproblematic.[5] As he points out, courts have to make decisions:

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[4] See ILM Richardson, Appellate Court Responsibilities and Tax Avoidance (1985) 2 *Australian Tax Forum* 3.

[5] An English judge, Lord Devlin, put it somewhat more colourfully,

> In the past judges have been obstructive... They looked for the philosophy behind the Act and what they found was a Victorian bill of rights favouring ... the liberty of the individual, the freedom of contract, and the sacredness of property and which was highly suspicious of taxation.

- whether tax laws should be interpreted strictly or more broadly, reasoning teleologically with a view to the "purpose" or "object" or "spirit" of a particular provision, or reasoning by analogy where precise rules are omitted for one variant of a transaction,
- how much attention to pay to the legal form of a transaction in preference to the substance of the transaction,
- whether tax laws ought to be subject to their own kind of "economic" interpretation — as Gammie puts it, whether tax laws are to be applied to what the taxpayer actually did or to the substance of what he or she did?
- how much attention should be paid to non-tax categories and concepts in interpreting and applying tax laws — a discussion that Brooks and Waincymer pursue.

The answers to these questions are not self-evident, and Brooks' analysis of theories of statutory interpretation, together with Vanistendael's exploration of the practice in the judgments of courts in several diverse jurisdictions, show the same tensions manifest in common law and civil law jurisdictions, in continental Europe, North America and elsewhere. Brooks tentatively accounts for this curious position by reminding us that,

> Judges have assumed that tax law is a form of government intervention in the more natural private ordering of our social and economic lives... They have treated tax law as if it were an unjustified interference with private property, therefore, they have reasoned that it should be construed strictly (whatever that means), and tax avoidance should be tolerated since taxpayers are only acting to protect what is rightfully theirs.

What is more strange is that at the same time that rigidity in interpretation is shown, more latitude is allowed in characterising transactions, an issue that I will turn to next. Curiously, however, Vanistendael finds little correlation between the rigidity of the interpretation process and the introduction of a supplementary GAAR.

Brooks offers a distinctly different vision of the statutory interpretation process. For him, the debate is not so much about the degree of purpose-oriented interpretation, or whether the disregard of an implausible form is permissible. Rather, it is about the role of the judiciary in the bigger process — "there should be no sharp distinction between tax policy and

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P. Devlin, *The Judge* (Chicago, University of Chicago Press, 1979) at 15.

tax interpretation." The interpretation of law should be simply the application of sound policy. This bold vision is in sharp contrast to Arnold's less promising assessment of the results of prior forays by Canadian courts into much less contentious ventures.

Yet Gustafson reminds us that judges can be very creative in their interpretation of statutes. American courts have developed judicial anti-avoidance doctrines, such as the business purpose doctrine, through a "very keen" perception of legislative intent. Several authors refer to the judicial doctrine of a "sham" evident in the common law world, and remark upon its similarities with the French and Belgian doctrine of "simulation" — where a transaction cast in one form can be recast as another which it more closely resembles. The example given by Vanistendael is of a gift, accompanied by substantial benefit for the donor or an associate, which can be recast as a sale. There is in civil law jurisdictions the notion of *abus de droit* — the idea that an individual's apparent rights may be circumscribed in order to protect the interests of his or her neighbour. As Richardson notes,

> in taxation law the same principle provides a technique that may be used to subordinate to the interest of the State as a tax collector the liberty of the individual to choose otherwise effective legal forms through which to channel income-earning activities.

But judges can just as often be an impediment to anti-avoidance activities, as Waincymer's paper painfully recounts, and the consequent problems for the interpretation process are seen as requiring their own solution. Vanistendael notes that at the same time that Australia introduced its GAAR, the parliament also amended the *Acts Interpretation Act* to incorporate a direction to judges how to interpret laws, and tax laws in particular. Waincymer comments that even "a directive such as s. 15AA does not clearly resolve how one is to discern the purpose of a Tax Act." But whether the possibility, let alone the statutory request, for judicial creativity means that judges should be "engaged in a cooperative law-making enterprise with legislatures" as Brooks suggests, is much more problematic.

Characterising Transactions

The characterisation of transactions is another, but logically distinct, aspect of the role of the courts. In interpreting the Act, a court is said to be guided by canons of construction or the precepts of an interpretation statute, but in characterising transactions there is little formal assistance available except the common sense of the judge and previous practices of the courts.

The debate about characterising transactions has always centred on form versus substance: the extent to which the court should be bound by the form in which a transaction has been cast, or whether the court may look instead to some underlying transaction — a variant on the one actually employed — and attach the tax consequences appropriate to that variant.

At its worst, judicial approaches to the characterisation of transactions can amount to a style that Parsons calls "form and blinkers" — judges confining themselves to examining only the form in which a transaction is cast, examining only the legally enforceable elements of that form, and treating that form as determinative. As he puts it, "the doctrine of form in *I.R.C. v. Duke of Westminster* has not gone unnoticed."[6]

Yet many papers in the volume observe how judges can be much more comfortable and creative in re-characterising a transaction, especially when they can resort to a private law doctrine which will indirectly overturn the alleged tax consequences, citing examples such as:

- treating interest paid by a mother to her minor child on a promissory note not as interest, but as part of the gift,
- setting aside partnerships formed by parents with their children where the children did not contribute capital,
- treating partnership distributions as a gift to the extent that it exceeded a normal interest rate for the capital contributed by the child,
- refusing to characterise prepaid interest on long-term loans as interest,
- treating income from personal services as derived by the person who performed the services even though he had assigned the future income so that in property law terms he never owned it,
- treating payments as not being scholarships where the recipient was expected to recompense the provider by subsequent service.

If the court is not to be constrained by the form in which a transaction is cast many questions arise: which steps in the transaction can be impugned, why can those steps be impugned if they operate according to their apparent legal effect, what can the court substitute in the place of the challenged transaction, and so on.

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[6] RW Parsons, *Income Taxation In Australia* (Sydney, Law Book Co, 1985) para 2.420.

Unfortunately, the process of making and interpreting laws through cases does not allow systematic and comprehensive answers to these questions to emerge clearly and easily. Thus Gammie concludes that improving judicial processes are unlikely to be an adequate solution —

> No judicial doctrine is a complete answer to tax avoidance. No government can assume that the judges will consistently share its view of what amounts to tax avoidance. Why risk the outcome of litigation on the changing moods of the judiciary? Legislative measures accordingly remain pre-eminent.

Arnold confirms this opinion, at least in respect of Canada's courts.

If that is correct, and the experience of many countries suggests that they believe it is, it becomes necessary to consider a statutory GAAR.

Living With a GAAR

A GAAR is a tool for combatting tax avoidance — it is an anti-*avoidance* rule. This term, of course, instantly provokes the lawyers to search for a shared understanding and a workable definition for the scope and meaning of tax avoidance. Waincymer reminds us of the terminological confusion that can arise when tax evasion, tax avoidance, tax minimisation, tax planning are used as synonyms.

Several of the papers analyse the terms and operation of GAARs in jurisdictions such as Australia, Belgium, Canada, France, Germany, The Netherlands and Spain. Their discussions touch on those elements of design and expression of a GAAR that encourage the view that enacting a GAAR in a tax statute detracts from the rule of law. Arnold recounts the disapproval of Canadian practitioners to the idea of a GAAR, not only its terms. In the UK, similar views have been expressed:

> Such legislation as this is little short of a disgrace. Where is the certainty that a taxpayer is entitled to expect? How can taxpayers and their advisers legitimately and properly plan genuine business transactions not knowing how such woolly and imprecise legislation will be construed by judges brought up on common law concepts, rather than the alien principles imported into this section?[7]

A similar story could no doubt be told of most countries that have enacted, or simply contemplated in public, a GAAR.

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[7] C Masters, Is There a Need for General Anti-Avoidance Legislation in the United Kingdom? [1994] *British Tax Review* 647, at 670.

What are the salient features of a GAAR that lead to this view? The major objections are obviously the uncertainty of application and effect of these provisions — it is not clear when they will apply and, in some cases, what happens if they do. As Waincymer suggests, designers have to take seriously the challenge that "GAARs may be ... inherently indeterminate."

Substitution, Planning, Avoidance and Evasion

While lawyers have found the concept of "tax avoidance" comprehensible at one level, achieving any workable definition has been regarded as a very problematic undertaking. It is interesting to find similar scepticism from economists. Indeed they go further. Brooks and Head remark upon the functional similarities of the things between which lawyers try to find meaningful distinctions — behavioural responses, tax avoidance and even tax evasion — noting that all taxes simply provoke "behavioural adjustment involving the substitution of less heavily taxed activities for those that are more heavily taxed." While these adjustments might be effected in different ways, using different means and in varying degrees, "all involve tax reduction or tax minimisation with broadly similar economic consequences for the achievement, or rather the non-achievement, of standard tax policy objectives." They find little need for the concrete differentiation that defies the lawyers:

> In the face of such a variety of descriptively different forms of adjustment there appears to be no obvious basis on which to single out particular types of tax minimisation activity as "tax avoidance" in any special technical or pejorative sense.

Nevertheless, although the similarities are apparent, Brooks and Head acknowledge that, "tax avoidance in this generalised setting cannot, of course, be addressed ... either by targeted anti-avoidance provisions or by a ... GAAR."

At this point, we squarely face the dilemma facing the government in tax avoidance matters — what can and ought be the focus of anti-avoidance rules? And, more importantly for this discussion, can text be drafted which can still be called a rule, but for which there is no clear target, and, what is worse, not even agreement on what the target should be? How can the drafter prepare a weapon against something that, in the opinion of some, cannot be adequately defined and certainly cannot be identified *ex ante*? Presumably, it is precisely because the drafter cannot forsee an avoidance possibility that the drafter cannot write a precise rule to deal with it; but in an effort to deal with the unforseen and unforseeable possibility, the drafter does draft a rule — a GAAR. This is the paradox of a GAAR.

But it may be too easy to overstate the difficulties of this paradox. At the extremities of the avoidance notion, some ideas are clear — Vanistendael and Gammie both agree that behaviour modification is not "tax avoidance." Giving up smoking and drinking, or using the Blackwall Tunnel to cross the Thames, to quote their examples, do not involve tax avoidance, or at least such avoidance as should be within the scope of an anti-avoidance rule.

At the other extremity, evasion of tax by presenting false records, willful non-disclosure and so on, is also not within the purview of a GAAR. In theory, it is not needed — the solution to the problem is assessment on the basis of the unrevealed facts. This position is a little more complex, however, where the unrevealed "fact" for taxing purposes is a state of mind. As Gammie puts it, "the boundary between the two is not always clear where taxation depends upon motive."

In between benign behavioural adjustments and deliberate misrepresentation is the battleground of a fierce war. It is made even more complicated by a desire on the part of some to allow certain forms of activity, which might be considered tax avoidance, to survive.

Tax Avoidance in Theory - An Outcome, A Form or a State of Mind?

Deciding what are the distinguishing features that go to make up "tax avoidance" of the unacceptable variety is an enormously difficult task, even before one attempts the task of expressing that idea in writing in a law. In order to elucidate the notion, one might consider the position of a taxpayer who finds himself or herself paying less tax than another because of:

- provisions (or omissions) in the legislation which express some government policy,
- exercising an option or election that is explicit under the legislation,
- exercising an option or election that appears to be implicit in the legislation,
- omissions in the legislation through the negligence of the drafter,
- differing interpretations about the meaning and scope of a provision in the legislation,
- participating in a transaction using a structure which has commercial justification,

- participating in a transaction where the structure has little commercial justification.

In each case, the example could be clouded by adding an element of intent:

- deliberately attempting to bring oneself within a provision (or omission) in the legislation which express some government policy — that is, accessing unintended tax benefits,
- using a common legal construction or transaction which utilises a gap or a loophole in the law to place the taxpayer outside the reach of a charging provision,
- organising a transaction through an implausible, inconvenient and complex structure for which there is little commercial justification.

These examples, suggest that tax avoidance could be understood as referring to one or both of two ideas:

- The form of a transaction — in other words, the degree of coherence between the taxpayer's ultimate objective and the means chosen to achieve it. This view of tax avoidance seeks to define it objectively and in terms of observable external criteria apparent in the form of a transaction.
- The state of mind of the taxpayer — in other words, the possession of a particular purpose. This view of tax avoidance seeks to define it by reference to a state of mind although the state of mind might be presumed from identifiable external criteria such as the form in which the taxpayer organised the transaction.

The most appropriate test (or tests) for discerning avoidance is not obvious. Gammie argues that, "neither complexity nor artificiality provides a satisfactory criterion for identifying tax avoidance." Arnold argues that purpose should be avoided if possible because of the difficulties inherent in administering the test, but acknowledges that form too possesses inherent difficulties:

> Ideally, tax consequences should be determined on the basis of the legal and commercial results of a transaction and not on the taxpayer's purpose in carrying out the transaction. The use of "artificiality" as the test has one significant advantage in that it avoids the necessity of determining tax consequences on the basis of the purpose of a transaction. Nevertheless, this advantage is outweighed by several disadvantages. The meaning of "artificial" is ambiguous; it can mean both "unnatural" and "fictitious." The latter meaning is similar to

> "sham," which adds nothing to the existing law and which is clearly too narrow for a meaningful general anti-avoidance rule. Also, in Canada and in most countries, artificiality is not inherently offensive; many artificial or unnatural transactions are specifically permitted, either by statute or by administrative concession. Most important, an artificiality test by itself does not provide any criteria to resolve whether a transaction is normal or artificial.

Ultimately, he comes down on the side of purpose as the determinant of acceptability:

> A purpose test ... provides a reasonable basis for distinguishing between acceptable and unacceptable tax avoidance. If the primary purpose of a transaction, determined objectively, is something other than tax avoidance, the transaction represents acceptable tax planning. On the other hand, if the primary purpose is to obtain tax benefits and the transaction would not have been carried out in the absence of those benefits, the transaction is unacceptable tax avoidance. Admittedly, there will be some uncertainty concerning the characterization of transactions that have both tax and non-tax elements.

He notes that in Canada, the two approaches were debated and were considered a choice, not a combination.

Vanistendael comments that the German approach focuses on the first meaning — the degree of inconsistency between the form in which a transaction is undertaken and its tax consequences:

> An abuse exists under s. 42 when the legal form of the transaction or construction used by the taxpayer is not appropriate to the economic factual situation. Thus, the legal form of a transaction will be considered to be inappropriate when reasonable persons would not choose a particular legal form because they would consider it as inadequate to achieve a specific economic relationship, and in particular in view of achieving a specific economic goal...
>
> Generally speaking, in order for a legal transaction to be effective for tax purposes under Germany's general anti-avoidance provision, it will require a business purpose and an adequate legal form to achieve the business objectives of the taxpayer. It is clear that when there are several adequate legal forms to achieve these business objectives, the section will not be applicable, if the taxpayer chooses the legal form that minimizes his tax burden.

He contrasts this approach with that in other countries:

In many other tax systems, it suffices to have a business purpose, even if the legal form in which this business purpose is achieved may not entirely be appropriate.

In circumstances where the essence of avoidance is determined by the form of a transaction, the role of purpose may nevertheless be used as a defence or justification to remove the spectre of the provision applying. For example, taxpayers may be exculpated if they can demonstrate:

- a business or commercial justification for the form chosen,
- some other appropriate motive — they are exercising an "option" apparently available under the legislation.

It is an important question whether the kind of tax avoidance that should be the target of a GAAR can ever be meaningfully defined, even in theory — it is clearly not an easy matter and some of the verbal formulae that have been developed do not inspire a great deal of confidence. The Radcliff Committee in the U.K. defined tax avoidance as "some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement."[8] This formulation appears to rely only on purpose, not artificiality. The Carter Commission in Canada defined tax avoidance as "every attempt by legal means to reduce tax liability which would otherwise be incurred, by taking advantage of some provision or lack of provision in the law."[9] This formulation also relies upon intent. The Asprey Committee in Australia defined tax avoidance as "an act within the law whereby income, which would otherwise be taxed at a rate applicable to the taxpayer who but for that act would have derived it, is distributed to another person or between a number of other persons who do not provide a bona fide and fully adequate consideration."[10] This variant relies on form.

A different approach to defining tax avoidance seeks to define it principally in terms of the defeat of the policy apparent in the legislation. For example, Parsons suggests that tax avoidance is an incongruence between the tax outcome and the government's purpose which comes about by treating the law as expressing only its words rather than any underlying policy.[11] Interestingly, both the Swedish and Canadian legislation have

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[8] United Kingdom, Royal Commission on the Taxation of Profits and Income, *Final Report*, Cmnd 9474 (London, HMSO, June 1955) para. 1024.

[9] Canada, *Report of the Royal Commission on Taxation*, vol 3 (Ottawa, Queen's Printer, 1966).

[10] Taxation Review Committee, *Final Report* (Canberra, AGPS, 1975).

[11] Parsons, *supra* note 6, at paras 16.55-16.58.

this notion in their GAAR — in Sweden as test to trigger the GAAR and in Canada as a "defence" to its application.

This approach is contingent upon a view that tax laws do have particular policy purposes and that the provisions of the law may not always fully express those purposes. One virtue of an approach such as this is that it attempts to identify some activities which, although they have the effect of reducing a tax liability, will not be caught, since they advance a policy in the legislation. Unfortunately, as Gammie points out,

> the most serious problems of tax avoidance arise where there is no clear principle underlying the legislation. The formulation of any test to identify whether at the boundaries of the legislation an arrangement satisfies the Parliamentary intention or not will always be an expression of personal view rather than verifiable fact.

Richardson confirms this gloomy assessment:

> ... it is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible.

Acceptable and Unacceptable Avoidance

The difficulty of identifying the appropriate target is increased when the definition tries to "carve out" certain transactions from the scope of the notion. This is the distinction apparently implied by commentators who differentiate (acceptable) "tax planning" or "tax minimisation" from (unacceptable) "tax avoidance."

Sometimes, the criterion of purpose might appear as the means of distinguishing acceptable from unacceptable tax avoidance. Arnold, for example, argues for the differentiation of acceptable tax planning and unacceptable tax avoidance:

> ... any general anti-avoidance rule must distinguish between acceptable and unacceptable tax avoidance transactions. This distinction is central to any general anti-avoidance rule. Not all tax avoidance is offensive, but no tax system can tolerate or permit unrestricted tax avoidance.

Another method that is sometimes seen tries to exclude some transactions or circumstance on the basis that they are "normal" transactions. For example, the Explanatory Notes to the Canadian section say that it is intended to apply:

> to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish

between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

When Australia introduced its revised general anti-avoidance provision — Part IVA of the *Income Tax Assessment Act* 1936 — into the Act in 1981, the Treasurer used yet another form of words but one which presumably means the same thing. During the Second Reading Speech, the Treasurer's definition described prohibited avoidance but also said that some activities, which might on some definitions be termed avoidance, would nevertheless not be treated as avoidance:

> We are acutely aware that "tax avoidance" means different things to different people. Reasonable men and women are bound to differ on this crucial question and on the subsidiary matter of the appropriate tests for determining what behaviour a general anti-avoidance provision ought to proscribe.
>
> The proposed provisions ... seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.[12]

As Waincymer wryly points out, the epithets used to describe tax avoidance will "rang[e] from those connoting opprobrium to ones which almost suggest positive prescriptions of familial duty."

The Design of GAARs in Practice

The papers by Vanistendael, Arnold, Mutén and Waincymer analyse the design of the GAARs in several jurisdictions. Once the terms for attracting the provision have been decided, the problem shifts to a drafting question. In Sweden this process has generated drafts and redrafts of its GAAR in 1980, 1982 and 1989. Australia abandoned its first attempt and replaced it with a new GAAR in 1981. Clearly, drafting a GAAR which is effective but at the same time not unduly disruptive and interventionist is, in Arnold's words, "an enormously difficult task."

One issue that several papers consider is whether it is necessary to provide a written formula in the law which elaborates and refines the notion of tax avoidance, or whether it is preferable to be deliberately vague and afford a degree discretion to judges, allowing them to identify "tax avoidance" as they best see fit, without reference to stated criteria.

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[12] *Hansard, House of Representatives*, 27 May 1981.

If it is desirable to elaborate the notion, it is then necessary to consider how detailed that elaboration should be. Vanistendael contrasts the highly technical drafting style of the Australian GAAR with that of the European and Canadian provisions.[13] While all Australian tax legislation is extremely difficult to read, one can surmise that this style for the provision was chosen in an attempt to address the concern about uncertainty, although whether the appearance of precision is matched by precision in reality is another question. While taxpayers will want to see precision in the drafting for greater certainty, the Carter Commission warned that drafters cannot foresee all the possible avoidance transactions and that specific rules might create roadmaps for new tax planning.[14]

Obvious notions that might be defined within the law are:

- The outcomes will amount to avoidance.
- The amounts are "tax" for the purposes of the GAAR.
- The degree of artificiality of the form of a transaction that must be present.
- The state of mind that the taxpayer must possess.

Many of the papers in the volume explore the responses that have been, or might be, given to these questions.

When is Tax "Avoided"?

There is, for example, a choice to be made about the degree of precision in identifying the outcome which will amount to an "avoidance." For example, Australia and Canada both refer to a taxpayer obtaining a "tax benefit" but define it quite differently.

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[13] In contrast, the previous Australian GAAR provided quite simply,

> Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:
> (a) altering the incidence of any income tax;
> (b) relieving any person from liability to pay any income tax or make any return;
> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
> (d) preventing the operation of this Act in any respect;
> be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

Income Tax Assessment Act (Australia) s. 260.

[14] Canada, *Report of the Royal Commission on Taxation*, volume 3 (Ottawa, Queen's Printer, 1966) at 554-56.

Australia defines a tax benefit as the non-inclusion of an amount of income or the inclusion of an allowable deduction.[15] Canada on the other hand refers to "a reduction, avoidance, or deferral of tax or other amount payable under this Act."[16] The broader Canadian definition would incorporate, for example, schemes to defer tax.[17] Other questions might be whether either of the two texts would apply to a scheme which converted income in one form (say, interest) into income in another form (say, a dividend), or income from one source (say, foreign) into income from another source. More obscure, though no less important, possibilities could arise from schemes turning exempt income into taxable income where associated expenses might be important in reducing an overall tax burden.

What is "Tax" for the GAAR?

Another notion that might be defined is the exact taxpayer liabilities which will be treated as "tax" for the purposes of the law.

For example, the Canadian provision refers specifically to "tax or other amounts payable under this law."[18] This would encompass schemes to reduce interest and penalties, to reduce estimated tax instalments or to increase tax credits. The Australian GAAR makes no explicit mention of further possibilities.[19]

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[15] *Income Tax Assessment Act* 1936 (Australia) s. 177C provides:

(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;

[16] *Income Tax Act* (Canada) s. 245(1).

[17] *Income Tax Act* (Canada) s. 245(1). This is amplified in the definition of "tax consequences" which refers to changing the amount of gross income, taxable income, the source of income and any "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."

[18] *Income Tax Act* (Canada) s. 245(1).

[19] Elsewhere in the law, the corporate tax instalment provisions identify schemes to avoid the operation of these provisions as within the scope of the GAAR. *Income Tax Assessment Act* 1936 (Australia) s. 221AZU.

This raises an interesting question about the scope of the GAAR. Consider, for example, the position of a resident taxpayer constituted as the withholding point for collecting tax on interest and dividends payable to non-residents. If the resident taxpayer undertakes transactions designed to minimize the size of the payments that are subject to the withholding tax, is this transaction within the GAAR so far as the resident is concerned? Some person is obtaining a benefit but is it the resident (in the form of a lower cost of funds after payment of withholding tax) or the non-resident (in the form of a higher return net of withholding tax)? The answer is important if the GAAR also attempts to reconstruct the tax consequences that would have occurred but for the tax avoidance scheme.

Transactions in Abusive and Non-Abusive Forms

The German rule revolves around the notion of a mismatch between the legal form of a transaction and the specific economic goal to be achieved. Form is thus a critical notion. Mutén describes how the first version of the Swedish GAAR was triggered where an inappropriate form was chosen when a more normal and equivalent alternative course of action was open. This test was abandoned in the second draft of the law.

The Australian rules also looks to the form of the transaction by requiring the identification of the taxpayer's "scheme." Curiously, however, the scheme is used only to indicate the taxpayer's purpose. That is, the revenue authority must discern the taxpayer's purpose from examining the form in which the transaction is cast, but the notion of tax avoidance is not defined by the form of the scheme.[20]

Taxpayer's Purpose

If the essence of tax avoidance is a notion that revolves around the taxpayer's purpose — as it is constructed under the GAARs in Sweden, Canada and Australia — a series of questions then needs to be addressed. The papers in the volume discuss these issues in some detail:

- How is the offensive purpose described?[21]
- How is the taxpayer's purpose to be identified?
- Is it the taxpayer's subjective purpose that is relevant or an objectively determined purpose?

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[20] *Income Tax Assessment Act* 1936 (Australia) s. 177D.

[21] Compare *Income Tax Act* (Canada) s. 245(3) and *Income Tax Assessment Act* 1936 (Australia) s. 177D.

- How important must the offending purpose be and how are mixed motives to be dealt with?

Taxpayers and their advisors are generally concerned by rules that rely upon something as ephemeral as "purpose" as the metric for something as concrete as taxation. Gammie observes that "a substantial part of the literature on tax avoidance is devoted to analysing the concepts of motive, purpose and intention, and this reflects that taxation based on these concepts is less satisfactory than taxation based upon objective and verifiable fact." Yet as Arnold reminds us, "courts are accustomed to making similar determinations under other statutory provisions that require the determination of the purpose of a transaction."

Safe Harbours and Exceptions

It was mentioned above that the proponents of a GAAR may allow for exceptions or safe harbours for certain transactions in order to eliminate some of the potential difficulties of interpretation.

For example, the Australian rule allows a targetted exception for income which is not included because of "the making of a declaration, election or selection, the giving of a notice or the exercise of an option by any person [that is] ... expressly provided for by this Act" provided that the taxpayer's scheme was not entered into to create the circumstances necessary to enable the election to be made.[22]

Section 245(4) of the Canadian law provides a much broader exception for transactions that do not "result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole." Arnold raises some of the problems that the operation of such a provision might engender. He also notes that the business purpose test was expressly rejected as defining a safe harbour because it was felt that the test might still strike down some non-business-related transactions that should be within a safe harbour:

> The use of the term "business purpose" was rejected because of a concern that the courts would interpret it narrowly to exclude family and investment transactions (for example, intra-family transfers of property that do not have any business purpose but that are inoffensive because they do not have any tax avoidance purpose).

[22] *Income Tax Assessment Act* (Australia) s. 177C(2).

Altering the Tax Consequences

Another design question is what event should occur once the rule has been triggered. There are two aspects to this issue. One is whether penalties should be levied when the GAAR has been triggered, or whether the only consequence from attracting the provision is that the tax administration can re-assess the tax and impose interest. Arnold explores this issue in some depth and Mutén notes the 1989 Swedish proposal, as yet unenacted, to reconstruct the proper tax and to impose "a supplementary tax aimed at eliminating the improper tax advantage."

Another aspect is whether the rule, once triggered, should attempt to re-construct an alternative tax outcome by force of its own provisions, or whether the rule should simply permit the reconstitution of another out-come. Contrasting the Canadian and Australia provisions makes this choice apparent. The Canadian provision permits the revenue authorities to reconstruct "the tax consequences ... [that are] reasonable in the circumstances."[23] The Australian law allows (but probably requires) the revenue authority to determine the taxpayer in whose income the omitted amount would have been included and to include the amount in income under the most apposite provision.[24]

The danger of trying to reconstruct the tax consequences that would have occurred but for the tax avoidance, and indeed of all attempts at apparent precision, is manifest in the *Peabody*[25] decision in Australia which is discussed at length by Waincymer. The Australian GAAR requires the revenue authorities to identify the taxpayer who would have received the income, but for the tax avoidance scheme, and to make the adjustment to that person's income. Unfortunately for the revenue authorities, they chose the wrong person. The precision which taxpayers desire can negate the effect of the GAAR — it can be both a road-map for tax planners as the Carter Commission warned, and also a trap for the revenue authorities.

Interaction With Specific Anti-Avoidance Rules

Another important design question is to determine how should the GAAR interact with existing specific anti-avoidance rules (SAARs)? How do the two sit together in one Act? As Waincymer puts it,

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[23] *Income Tax Act* (Canada) s. 245(2). This provision is amplified, if that is possible, in s. 245(5) which contains a list of possible adjustments that the authorities might wish to consider.

[24] *Income Tax Assessment Act* 1936 (Australia) s. 177F.

[25] (1994) 94 ATC 4663.

If a taxpayer's transaction falls foul of a specific provision, there is no need for a general anti-avoidance provision. If on the other hand their transaction is perfectly legal and acceptable under the specific provisions of the Act, why should a general anti-avoidance provision be allowed to interfere?

Clearly, specific rules are an alternative to a GAAR — an alternative that Gammie notes has been the preferred approach of the UK. Mutén gives examples of such rules in Sweden introduced while it reconsiders whether to have a GAAR. Arnold notes that, while one option for a government is to pass a collection of specific anti-avoidance rules, he argues that, while "every developed tax system is full of such provisions ... specific legislation can never be an adequate response to controlling tax avoidance." The consequence of that view is that both sets of rules will exist in the same Act.

The question that then emerges is how they should operate in tandem. Gustafson describes the dilemma that arises from the use of SAARs based on the taxpayer's purpose. He suggests that they "invite the conclusion that Congress has considered and decided when tax advantages are going to be denied because of the taxpayer's intentions. The inference of such a conclusion is that intention in other circumstances should not be a disqualifying consideration."

Another possibility is the clash of the anti-avoidance rules. Quite commonly, incentives will be protected by SAARs which might be framed using concepts quite different from those that have been chosen for the GAAR. More importantly, the SAAR might represent an earlier and less elaborate rule. Mutén describes the current dilemma in Sweden whether the GAAR can be used to supplement the so-called "stop legislation" rules.

Arnold suggests that no absolute ordering can be prescribed —

In some cases, the general anti-avoidance rule should override specific provisions because otherwise tax planners will be able to manipulate the technical provisions to achieve unintended tax benefits. However, the general rule should not take precedence over specific provisions in all cases. For example, it would be perverse to apply the general anti-avoidance rule to cases where a taxpayer is simply obtaining a tax incentive specifically provided by the statute. Therefore, the courts must decide in each particular case whether the general anti-avoidance rule or another provision should prevail.

Richardson echoes the position, adding that the relationship between provisions must itself be a matter of statutory interpretation —

> The general anti-avoidance section thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and the general anti-avoidance provision and of the relationship between them. That is a matter of statutory construction.

The Alternatives

The papers in the volume also examine how governments might try to deal with tax avoidance in ways other than by using a GAAR. Clearly, deciding to enact a GAAR involves a strategic choice — the decision that the damage to other values is insufficient to outweigh the benefits from a GAAR. That balance depends on judgments which deserve to be explored.

In order to do so, it is necessary first to come to some conclusion about whether tax avoidance is a sufficiently important problem to warrant a GAAR — the "sledgehammer-to-crack-a-nut" problem. Brooks and Head, using the example of substituting taxed labour for untaxed leisure, confirm the conventional wisdom that tax avoidance practices do indeed create problems for the important criteria by which tax systems are judged — revenue production, equity and efficiency.[26] They then extend their example to incorporate other forms of substitution behaviour more commonly explored by taxpayers and their advisers, such as the re-allocation of an investment, the means of structuring it, and using exotic forms of business organisation and financing to avoid tax. They conclude

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[26] See generally, P Groenewegen, Distributional and Allocational Effects of Tax Avoidance, in D Collins ed, *Tax Avoidance and the Economy* (Sydney, Australian Tax Research Foundation, 1984) at 23:

> There are a number of important resource allocation consequences of the tax avoidance industry. These arise from the direct application of scarce resources to tax avoidance activities, from the re-allocation of resources for investment, or employment of variations in pre-tax and post-tax returns as a result of tax avoidance, from the dead weight welfare losses associated with these re-allocations as well as from the free rider problem arising from tax avoidance. Unfortunately little quantitative light can be shed on these resource allocation matters.

that, "the same issues of equity and efficiency can and do arise in all dimensions of behavioural adjustment."[27]

Waincymer explores this issue with a more general description of the consequences of avoidance — the effects of diminished government revenue, the reallocation of resources, increased administration costs and adverse distributional results — and notes that "given that governments spend much of their revenue providing public goods, tax avoidance is a particular aspect of the free rider problem."

Head is a little more circumspect in his assessment and notes that,

> experience of tax avoidance in liberal democratic countries, including Australia, suggests indeed that a tradition of taxpayer compliance can become so firmly rooted that easy opportunities to avoid tax may be widely, if not universally, ignored.

If this is true, it has implications for governments about the value of embarking upon the GAAR adventure.

Some Non-Solutions

Before embarking upon the discussion of the merits and drawbacks of feasible alternatives, it is worth remarking upon a few alternatives that are more or less discarded by the papers in the volume.

One possible solution that is generally discounted is greater reliance upon specific and targetted anti-avoidance rules (SAARs). Arnold, for example, argues that, specific legislation can never adequately deal with tax avoidance. This might come as a surprise to policy-makers in the US and UK who clearly do not agree with the generally pessimistic assessment. Gammie notes that this has been the preferred approach of the UK.

Waincymer takes this position even further. He argues against the temptation for Parliament to rectify all avoidance by using SAARs once new schemes have been discovered for two reasons. First, these kinds of provisions "add much cumbersome detail to the legislation." More importantly, he notes,

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[27] Their examination of the emerging "pure" theory of tax avoidance — a notion which suggests that tax avoidance can be costless in the sense that it involves no welfare cost to society and no decrease in horizontal equity — concludes that this outcome is possible only in special situations where the untaxed option has largely replaced the taxed option. Unfortunately, as they note, "in the area of capital income taxation ... examples of perfect or near-perfect substitutability abound ... both in the theory and practice of tax avoidance."

> Such provisions ... can even adversely affect the extent to which judges adopt a purposive approach to interpretation. For example, the complex style of legislative drafting generally adopted in Australia has been described ... as leading to a reversal of roles between Parliament and the Courts, with Parliament preoccupied with detail and the courts trying to sift purposes and principles from out of the legislative fog

Gustafson provides a lengthy discussion of two different styles of using targetted rules, both of which are evident in the US legislation. He refers to:

- rules that refer specifically to a tax avoidance purpose in order to deny access to certain benefits (such as tax-free corporate acquisitions, reorganisations, stock distributions, and so on), and
- rules that deny access to certain benefits where certain facts and circumstances exist on the presumption that these facts are adequate evidence of a tax avoidance purpose.

The latter rules — he includes the hobby loss rules, the personal foreign investment company rules, the controlled foreign company rules, passive activity loss rules, the expatriation rules, and so on — present an interesting approach to avoidance. They simply presume it. He describes this as, "a discernible trend in the direction of generalized conclusions about tax avoidance instead of or in addition to specific transactional analyses."

But clearly there are many options that could be addressed as measures to deal with tax avoidance. One possible strategy that is not seriously advocated in the papers is the pursuit of better legislative drafting, although the interaction of GAARs with both drafting styles and the interpretation process is examined. Some papers regard it as a danger of a GAAR it will have deleterious effects on the drafting of legislation. Requiring a certain amount of legislative precision is not impossible, nor has it produced inadequate results in the US, although as Gustafson shows, there is clearly a trade-off between volume and precision which must be managed. The US has chosen to enact many specific anti-avoidance rules but at the expense of increasingly the size and complexity of their legislation and administrative materials exponentially. Mutén expresses the fear that, "the GAAR by its very existence threatens to lower the standards of precision applied by the legal draftsmen."

And it is worth remarking upon the point that Mutén makes — a GAAR is not a solution to deficiencies in other parts of the taxing process:

There are shortcomings among each one of these three pillars of the tax system, the law, the judiciary, and the administration. Countries tend to make up for the failures of one by putting more weight on another. To take the case in point: if the law is deficient and the courts apply it as if it were a pattern of perfection, there is a temptation to let a GAAR make up for the shortcomings of the law, and turn the responsibility to the courts and the administration. If the administration is weak and auditors gullible, tax laws might have to be Draconian, whereas, if applied by a more competent audit service, the law can leave more room for administrative judgment.

And the efficacy of GAARs is viewed with caution in the countries that possess them. A GAAR may be thought to be a "quick fix" for tax avoidance but it might prove not to be a "fix" at all. Waincymer presents the unhappy history of Australia's 2 GAAR experiments. He recounts the story of the first provision and its "interpretation" by successive courts. That interpretation rendered the provision subject to doctrines which he enumerates as "the predication test, the choice principle and the antecedent transaction doctrine" — arcane terms for judicially imposed limitations on the operation of the provision. He describes two further problems that were read into the provision:

> ... one of the main problems with s. 260 was its use of the word "avoidance" without giving any particular criteria for determining where this occurs. The second major drafting problem was the failure to allow any reconstruction power for the Commissioner.

He then examines how these difficulties were addressed in some cases in the successor provision. Curiously, not all of the difficulties were addressed and he comments on how some of them have been repeated in the successor provision. The inauspicious inauguration of the replacement provision may be the portent of its imminent emasculation.

The suggestions that are developed at greater length in the volume indicate that a comprehensive framework for solving tax avoidance by other means is feasible, and that observation implies that the reluctance of governments to embark upon the venture should be regarded more as a product of lethargy or ambivalence than of a dearth of options.

Better Taxes

What other less dangerous and less contentious, alternatives are open to government to control tax avoidance? What might be done instead?

Brooks and Head argue that base-broadening is an appropriate anti-avoidance strategy which still has much to commend it. This is because the degree of loss for society associated with avoidance is determined by the ease of substitution between the taxed and untaxed alternatives — a result which informs their proposition that base-broadening is an appropriate alternative anti-avoidance strategy:

> Short of the special case of perfect or near-perfect substitutability ... high substitutability increases tax avoidance and therewith the inefficiencies and welfare cost of taxation. Such problems greatly strengthen the general tax policy presumption in favour of removing, and as far as possible avoiding, discrimination and arbitrary distinctions between different types and sources of income. This policy should indeed be vigorously pursued both in the area of labour income and capital income under income taxation; and a similar policy needs to be applied on the "uses" side in the area of indirect consumption taxes. Since high substitutability is an especially significant feature in the capital income area, the need for uniform and consistent treatment of different capital income components is, however, particularly pressing.

This view is echoed by Mutén and Gustafson, each of whom identifies tax incentives as the source of the problem, providing the "lesser taxed way" in many cases. Where the tax base is insufficiently comprehensive, and invites taxpayers to respond by offering them untaxed options, it is disingenuous of the government to complain. Gustafson reminds us that,

> the effectiveness of all techniques for addressing unacceptable degrees of tax avoidance are infected by the continued propensity of the Congress to enact tax advantages for particular industries and particular transactions.

Waincymer too offers a list of common forms of tax avoidance and emphasises the structural elements in common tax regimes which induce each one:

> Progressive rates of taxation encourage income-splitting techniques; tax expenditures in favour of activities deemed worthy of encouragement, lead to the creation of tax-inspired shelters; preferential or tax-free status to capital gains, encourages commercial gains to be described as such; administrative necessities such as limiting the taxing exercise to a particular period, encourages manipulations of the timing of deductions and receipts of income streams; those jurisdictions which prefer to tax beneficiaries rather than controllers of income streams, encourage the use of discretionary trusts and other partial alienations.

Importantly, he adds a degree of scepticism to the discussion, noting that despite Australia's tax reforms during the late-1980s, most of the common tax avoidance devices "are still 'live' issues." Better taxes may be desirable, but they may not be enough.

The case for better taxes as a substitute to a GAAR is taken one step further by Gammie. He emphasises that,

> tax avoidance is a symptom of an affliction that affects all tax systems and a common failing of governments is to tackle the symptom rather than address the underlying cause. Tax avoidance does not reflect the inadequacy of legal language. Most tax avoidance stems from a failure in the underlying principles of what governments seek to tax.

He advocates the benefits of abandoning income tax in favour of more robust taxes, meaning taxes on transactions which are less open to manipulation or dissembling:

> Successful taxes are those that reflect two factors — a well-defined and sustainable economic concept that recognise a person's ability to pay, and the ability of government to administer, collect and enforce the tax.

In particular he draws attention to the difficulties presented in trying to impose and administer an income tax, especially one based around the Haig-Simons net accretion concept. It is, he argues, simply too fragile to withstand the attacks of concerted tax avoidance. If, "a measure of the success of a tax system lies in the lack of opportunities that it offers for tax avoidance," then the income tax is not a good performer. He contrasts this with taxes on consumption. While he concedes that they too can be avoided, nevertheless he argues, "a consumption base avoids many of the problems of the income base because it taxes outcome not opportunity."

Mutén reminds us of "those who have described tax avoidance as a necessary safety valve preventing excessive tax laws from taking their full, detrimental effect." While this counsel may be too glib, we might still agree that uncontrollable tax avoidance is symptomatic of other and larger problems.

Releasing Judicial Creativity

It was noted above that one possible response to the problem of some kinds of tax avoidance is for courts to take matters into their own hands, so to speak, and to develop judicial anti-avoidance doctrines. Such a procedure, if it could be brought about, would avoid some of the problems associated with a statutory rule that were mentioned above, and at the same time has greater flexibility and responsiveness. The case for judicial creativity is put most forcefully by Brooks who argues that if judges did their job more effectively and conceived of their tasks differently, it wouldn't be necessary to have a GAAR.

The usual criticism of such a proposal is the separation of powers issue, but that is not the only criticism. Arnold implies that the means for judicial creativity do not yet exist,

> The adoption of a statutory rule is more acceptable than a judicial rule to those persons who consider that it is the legislature's exclusive responsibility to develop the tax laws. The introduction of a statutory rule is subject to all of the safeguards of the legislative process, including the consultative process. The limits of a statutory rule can be established with more specificity than the limits of a judicial rule, even if only by way of explanatory notes and administrative guidelines which help to reduce uncertainty.

But clearly the potential for the creativity of judges to be released is borne out by Gustafson's description of the judicially-developed anti-avoidance doctrines in the US. Indeed, one fear that is mentioned in the papers is that an express GAAR may operate in some senses as a brake on judicial creativity. Waincymer, for example, suggests that "the very detailed style of statutory drafting may invite judges to adopt interpretive presumptions to the effect that matters not specifically mentioned were not intended to be covered." This view is echoed by a English judge quoted in the volume. Although Mutén says he can observe "no clear indication that the existence of the GAAR has turned the generally applied interpretation rules more restrictive," Arnold notes that,

> the Supreme Court of Canada expressly rejected [a judicially-developed anti-avoidance rule], primarily because such a test was inconsistent with what the court characterized as a general statutory anti-avoidance rule in former subsection 245(1). In other words, since Parliament had spoken on the matter, it was inappropriate for the courts to usurp the role of Parliament in dealing with tax avoidance by adopting a general anti-avoidance rule judicially.

This would be a curious outcome from what is presumably intended to be a "liberating" procedure, but apparently not an uncommon one. Although Gustafson gives examples of cases where US courts were unconcerned by the existence of specific (but inapplicable) statutory limitations in various provisions, he later suggests that this trend may be occurring in the US as well:

> The propensity of courts to create barriers to tax avoidance by the imposition of tests not articulated in the taxing statute ... seems to be

diminishing. There are several apparent reasons for this tendency. As the decades pass and experience with the taxing mechanism accumulates, the most obvious instances of tax avoidance through loophole exploitation are likely to have been addressed directly.

Administrative and Institutional Reform

More despairingly, Richardson agues that the task of regulating economic behaviour and of controlling tax avoidance is now probably beyond conventional legislation implemented through courts and the time has come to more or less abandon the legislation and consider substitute solutions —

> I have become less sanguine about the capacity of the New Zealand tax system to control economic behaviour. As a result I have come to the view that there should be less emphasis on the invoking of anti-avoidance provisions and on essentially discretionary judgments by tax officials and the courts as a control mechanism, and that there should be more emphasis on reducing incentives for tax planning, on changing the drafting approach, on restructuring the tax agency and on reorganising the tax collecting system to recognise and reflect central features of tax collecting.

He elaborates the paradigm for realistic administrative action so that it takes into account legal constraints, limited resources, modern technological opportunities and the need to sustain voluntary compliance. This environmental scan leads to suggested means for enhancing policy development, administrative implementation, taxing structures and taxing processes.

Some of the suggestions are radical — reconstructing the process by which tax policy is formulated, taking compliance costs seriously, revising legislative instruments, greater quality control within tax authorities, re-organising the operational units within the tax administration. He makes a cogent case both for the inadequacies of a GAAR as a solution to tax avoidance and for the alternate prescriptions —

> ... the design of tax legislation and the design of the tax collection system. By reducing incentives for uncontrolled tax planning, by developing a clear customer focus, by changing structures and processes of tax administration and the culture of the organisation so as to recognise and reflect central features of tax collecting, and by balancing incentives and sanctions for both taxpayers and tax administrators, we are likely to improve tax collecting overall.

Some of these same prescriptions can be seen in Gustafson's discussion of US approaches to solving tax avoidance. The sections of the *Internal Revenue Code* which presume a tax avoidance purpose where appropriate facts exist are one example.

Another is the use of the Alternate Minimum Tax — a device which taxes individuals and corporations not on their taxable profit as computed under the existing rules, but on another figure if that is higher. Taxable profit under the alternative formula adds back some tax preferences and thus eliminates the benefits of schemes designed to secure access to these preferences. This approach is not directed precisely at tax avoidance — the issue is a bigger one of tax preferences generally — but it has the interesting and, one can suppose, not entirely unintended, consequence that avoidance activities which attempt to secure access for a taxpayer to tax benefits that it was never intended to receive become less beneficial. It makes even successful tax avoidance less valuable.[28]

Gustafson also identifies the new procedures for scrutinising transfer pricing as examples of new means for attacking tax avoidance. Here, though, the emphasis is on stricter administrative oversight:

> The new departures in confronting transfer pricing may be the leading edge of the systematic enlargement of administrative force through the creation of additional record-keeping requirements, establishing special and steep penalties, and inviting scrutiny by the Internal Revenue Service before transactions are implemented.

Before leaving this topic, however, it is worth reflecting on the consequences of changes to institutions and processes, particularly those which confer greater power and further discretion on the tax administration. The alarm arising from such provisions, expressed by Waincymer, is that there will be "no guarantee that the administrator will be impartial, fair or would appropriately balance the interests of taxpayers against the interests of revenue collection." Gammie takes up this topic and concludes that one can "reach the stage at which legal definition is neither possible nor (for the government) advisable" and that when this occurs, when "resort to discretion is inevitable," it is important to recognise the position and deal with it rather than resist —

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[28] The same outcome can also result from imputation systems which track tax actually paid at the corporate level. They convert corporate tax avoided into shareholder tax deferred. See generally, GS Cooper, The Effect of an Income Tax on Corporate Tax Evasion, in J Head ed, *Corporate and Shareholder Tax Reform* (Sydney, Australian Tax Research Foundation, 1996) forthcoming.

However it is approached, the issue to address is always how best to balance the interests of the taxpayer and the State — for taxpayers to know what tax they must pay other than through an unfettered demand, and for government to be assured that it can raise the revenue it requires. Adherence to the fiction of legislative certainty in areas for which government must ultimately claim a discretion may merely inhibit the development of satisfactory mechanisms to balance the various interests involved. Ultimately, such mechanisms may function more satisfactorily to preserve the rights of the general body of taxpayers and to uphold the rule of law than the illusory appearance of a certain tax code.

Entrenching the Tax Constitution

Another alternative, which is explored by Head and by Brooks and Head, is to address the conditions that permit avoidance. As was noted above, Brooks and Head suggest that the use of broader-based taxes can prevent the opportunities for the substitution that is the object of tax avoidance. But why and how do these lesser-taxed opportunities come about? Their application of the public choice literature to tax avoidance reminds us that the substitutes are not immanent — they are deliberately sought by voters and provided by politicians as one outcome of a majoritarian political decision-making process. While policies that eliminate avoidance opportunities should be considered valuable by voters and are likely to be socially optimal, they will not always be advanced if informational problems and organisational costs are large.[29] They argue that,

> If political competition under majority voting cannot be relied upon to control problems of inefficiency, inequity and tax avoidance satisfac-

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[29] In these remarks they reflect the work of Knut Wicksell's *Finanztheoretische Untersuchungen und das Steuerwesen Schweden's* (Inquiries Into the Theory of Public Finance) published in 1896 where he argued for super-majority voting requirements to allow minorities to thwart these redistributive possibilities. K Wicksell, Ein nueus Prinzip der gerechten Besteuerung, in *Finanztheoretische Untersuchungen und das Steuerwesen Schweden's* (1896) reproduced in English as K Wicksell, A New Principle of Just Taxation, in RA Musgrave & A Peacock eds, *Classics in the Theory of Public Finance* (London, Macmillan, 1958) at 72. For a discussion of Wicksell's work on this and other topics reviewing material in English, German and Swedish, see generally CG Uhr, Knut Wicksell - A Centennial Evaluation (1951) 41 *American Economic Review* 829; CG Uhr, *Economic Doctrines of Knut Wicksell* (Berkeley: University of California Press, 1962). See also DR Escarraz, K Wicksell and E Lindahl: Theories of Public Expenditure and Tax Justice Reconsidered (1967) 20 *National Tax Journal* 137.

torily, the obvious inference is that new and/or supplementary rules of a constitutional or quasi-constitutional character may be required. Since the majority voting rule serves to expose the budgetary decision-making process to distributional influences and distortions, measures calculated to limit such influences and reduce deadweight losses need to be considered. Voter-taxpayers must be encouraged to focus on long-term possibilities for achieving mutual gains rather than on short-term sectional interest or redistributional concerns.

Head notes that this may require changes to the voting system to entrench the constitutionality of the tax system, to legitimise its authority and minimise the opportunities and effects of lobbying which creates the avoidance possibilities:

> It has, however, long been recognised that complete unanimity may never be achieved and high decision-making costs could be involved. Full compensation is seldom, if ever, possible, and recalcitrant minorities may be encouraged to behave strategically, seeking to exploit the veto in an attempt to capture the lion's share of mutually available gains. The quasi-constitutional character of the tax system and of the tax reform process, properly conceived, does nevertheless suggest a case for requiring a more highly qualified majority in allocation branch decision-making. This would also help to reduce the well known dangers under simple majority voting of socially wasteful policy reversals or cycling phenomena.

This observation brings us nicely back to the point from which I began — the constitutional dimension of tax issues. While taxation is an important element in the constitutional framework of a society, it is perhaps not taken sufficiently seriously in that framework.

Perhaps the most appropriate point with which to conclude is to remark upon one very nice tax irony. It is conceivable that GAARs might support the rule of law or, at least, respect for law and the rule of law. A GAAR is a response to the problem of tax avoidance and, in so far as it can be an effective curb on unchecked avoidance, it may serve to bolster legal and constitutional traditions. Freiberg makes the point in his discussion of the period of the most aggressive Australian tax "avoidance," if not tax fraud, generally referred to as the "bottom the harbour" schemes:

> There was a serious danger that the legitimacy of the taxation system could have been destroyed, if not ultimately the legitimacy of the government. Widespread cynicism is not a basis for good government. The fragile trust between citizens and government officials, professionals

and their clients, employers and employees is easily destroyed, as is the tenuous social solidarity between groups at different levels of society.[30]

A GAAR is clearly desirable to counter tax avoidance which undermines the confidence of taxpayers in the integrity of their institutions. Mutén observes that in Sweden the term translated into English as the "rule of law" has two meanings, one of which is that —

> in the tax context, it should be understood to include not just the safety of the individual against unlawful actions of the fiscal authorities, but also the assurance of the loyal taxpayer that he is not abused and taken for a ride, whereas smarter people get away with tax avoidance schemes.

Head puts it this way —

> Without a strong and complex supporting structure of standards, norms and moral values, the political, legal and fiscal institutions of liberal democratic society would lack the stability necessary for their effective functioning and could not long survive. These basic institutions and the associated value structures are properly to be regarded as public capital, as the social infrastructure of liberal democratic society. In this enriched version of the quasi-constitutional approach to the design and reform of democratic institutions, standards, norms and moral values can clearly be seen as the "cement of society" without which instability and disintegration of our political, legal and fiscal institutions can be predicted.

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[30] A Freiberg, Ripples From the Bottom of the Harbour: Some Social Ramifications of Taxation Fraud (1988) 12 *Criminal Law Journal* 136, at 158.

PART I

THE RULE OF LAW AND THE CONSTITUTIONAL FRAMEWORK

CHAPTER 2

TAX AVOIDANCE: IN ECONOMICS, LAW AND PUBLIC CHOICE

Michael Brooks & John Head

Introduction

Tax avoidance, as discussed by tax lawyers and administrators, has for too long been a rather neglected issue in the literature of public finance and public economics. It has, of course, been recognised that tax avoidance in this familiar sense does exist and may seriously threaten the achievement of the standard public finance objectives of revenue-raising, equity, efficiency and simplicity. Some effort has indeed been devoted to the analysis of seemingly related issues in the area of tax evasion, utilising principles derived from the modern economics literature on crime and punishment due to Becker.[1] A sharp, perhaps sometimes oversharp, distinction is, however, conventionally drawn between tax avoidance, which is legal, and tax evasion, which is not. And there has hitherto been little effort by economists to set the legal concept of tax avoidance within the framework of modern tax policy analysis, either of the more orthodox public finance variety or in the alternative public choice mode. A brief but useful discussion is, however, to be found in a recent paper by Slemrod.[2]

One aim of the present paper is to contribute, at least in a preliminary way, towards remedying this deficiency. For this purpose conceptual clarification is obviously required. As we shall see, the concept of tax avoidance that comes most naturally to an economist tends to be much broader and more sweeping than the concept that has been the particular

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1 GS Becker, Crime and Punishment: An Economic Approach (1968) 67 *Journal of Political Economy* 169.

2 J Slemrod, Income Creation or Income Shifting? Behavioral Responses to the Tax Reform Act of 1986 (1995) 75 *American Economic Review* 175. See also JJ Cordes & H Galper, Tax Shelter Activity: Lessons from Twenty Years of Evidence (1985) 38 *National Tax Journal* 305.

preoccupation of tax lawyers and administrators. Both the narrow legal concept and the broader economic and public choice concepts are, however, of great policy concern in their own right. The effects on tax policy objectives and the contrasting policy implications of these alternative types of tax avoidance will therefore be explored in some detail. For this purpose some attempt will be made to clarify and further develop some of the major policy issues that have been discussed and debated by practitioners in the more traditional area of tax avoidance narrowly construed, utilising some of the simpler tools of economic analysis.

The Economist's Concept of Tax Avoidance

To an economist there would seem, at first blush, to be no distinction to be drawn between different types of tax avoidance defined generically to cover the complete range of legal tax minimisation activities. Under income taxation as imposed by industrial countries over the past century, different sources, forms and uses of income have been subject to widely varying effective rates of taxation. As a result the taxpayer is faced with incentives for behavioural adjustment involving the substitution of less heavily taxed activities for those that are more heavily taxed. Although such adjustments are possible in different types, areas and dimensions of economic activity, all involve tax reduction or tax minimisation with broadly similar economic consequences for the achievement, or rather the non-achievement, of standard tax policy objectives. Analogous issues arise, of course, in areas other than income tax; but, for the purposes of this paper, the analysis and illustrative examples will focus exclusively on income taxation.

At a very broad level, adjustments may be made in, for example: the amount or type of work done or the form of remuneration; the level and composition of savings; the risk characteristics of investments made; the allocation of investment between different sectors, industries or types of equipment; the form of business organisation and methods of financing; and the composition of personal or household consumption. In the face of such a variety of descriptively different forms of adjustment there appears to be no obvious basis on which to single out particular types of tax minimisation activity as "tax avoidance" in any special technical or pejorative sense.

There is, however, a strong general presumption in the tax policy literature that all such adjustments are economically undesirable and inequitable. Following the well known work of Henry Simons,[3] it has generally been accepted among economists that income taxation should be based on the most comprehensive feasible economic income concept. On this view, as far as possible all the different types and sources of income should be taxed uniformly and consistently. Tax preferences and tax concessions of all types are prima facie highly suspect and cannot in general be justified, for example, as compensation for externalities or market imperfections. As emphasised in the modern tax expenditure literature, direct subsidies or related measures of a non-tax character are generally to be preferred for such purposes.[4]

Labour Income Taxation: The Example of Work-Leisure Choice

In order to illustrate the extremely broad sweep of tax avoidance terminology as applied in economic analysis, and in order to identify in a fairly simple setting some of the major consequences of tax avoidance for equity and efficiency, we begin by considering possible adjustments in work-leisure choice. Figure 1 depicts a simple society consisting of just two persons I and II with differing work-leisure preferences, as represented by their differing demand schedules D^{I} and D^{II} for a single income-earning activity. Their initial incomes are assumed to be identical, as represented by the common initial market equilibrium at point E. In this model it is evident that person I, with the more elastic supply of labour or demand for income, will find it easier to avoid income taxation than person II. Faced with income taxation imposed at a uniform rate $\underline{t}$ = AB, person I accordingly does less work and pays less tax than II, achieving equilibrium at point C, as compared with II's equilibrium at point F. I's tax is shown by the area of the rectangle ABCD while II pays ABFG. Measured against the benchmark of zero behavioural adjustment, tax avoidance by person II is FGEH while I avoids CDEH.

As a result of these behavioural adjustments, however, the supply of labour by both persons is distorted and "excess burdens" or "deadweight losses" are generated. This "extra burden" or loss of consumer surplus for person I is measured as the area of the triangle CDE, while person II incurs a smaller excess burden of amount EFG. Clearly these differences

[3] HC Simons, *Personal Income Taxation* (Chicago, University of Chicago Press, 1938).

[4] S Surrey, *Pathways to Tax Reform* (Cambridge, Harvard University Press, 1973).

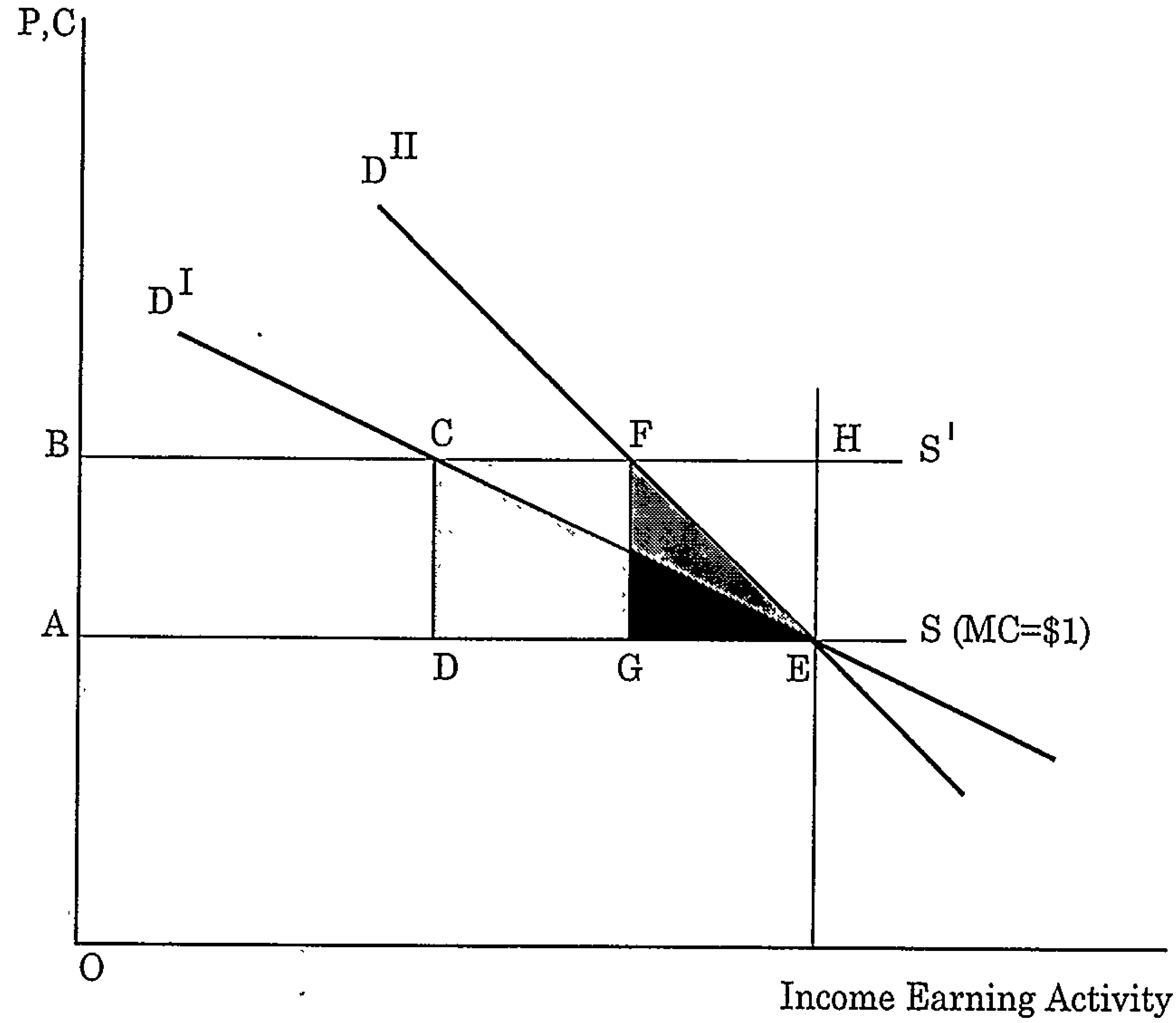

Figure 1

in excess burden partially offset the greater tax savings achieved by person I. Tax avoidance is not therefore costless, either to the individual or to society; and the benefits from tax avoidance enjoyed by individual taxpayers are clearly overestimated if we focus exclusively on the tax savings and ignore the excess burdens.[5]

In an important early paper Buchanan[6] has accurately characterised the additional tax share borne by person II as a result of the more successful tax minimisation activities of person I as an "externality" (like pollution). As a result, the public expenditure benefits that can be enjoyed in common by both persons will have to be reduced; or, in the conventional

[5] G Brennan & J M Buchanan, Tax Reform Without Tears, in HJ Aaron & MJ Boskin eds, *The Economics of Taxation* (Washington, Brookings Institution, 1980).

[6] JM Buchanan, Externality in Tax Response (1966) 23 *Southern Economic Journal* 35.

"equal revenue" framework of tax policy analysis, the uniform rate of tax $\underline{t}$ will have to be increased on the narrower revenue base in order to make up for the lost revenue, thus further increasing the excess burden. Clearly person I enjoys in this context a differential benefit as a result of her greater ability to avoid tax.

Apart from the economic distortions suffered by society at large, it follows that the tax system that we have described is highly discriminatory. The differential burden suffered by person II, while it can quite accurately be described as an externality, is more commonly characterised in the public finance literature as a horizontal inequity. In the pre-tax situation persons I and II have the same income and, in accordance with horizontal equity principles, they should pay the same amount of tax. Due to their differing abilities to avoid tax, their total burdens (tax + excess burden) in fact diverge markedly. Horizontal equity is thus clearly violated. It is easy to see, therefore, in this very broad application of the familiar terminology, that tax avoidance in the sense of behavioural adjustment is in general highly objectionable on grounds of both horizontal equity and efficiency.

It is, however, quite commonly argued that there is an equally if not more serious objection to tax avoidance on grounds of vertical equity, since the wealthy are perceived to be avoiding relatively much larger amounts of tax than those on lower incomes. While the nominal rate scale is quite progressive, effective progressivity may be much reduced as a result of the differential incidence of tax avoidance. This argument too can be explored within the same diagrammatic framework, appropriately modified.

Figure 2 depicts a similar two-person society in which the two persons I and II now have different initial incomes as represented by their pre-tax market equilibrium positions at E and H, with person I enjoying a much greater income (Y^I) than person II (Y^{II}). Their ability to avoid tax, as indicated by the slope of their respective demand schedules D^I and D^{II}, is assumed to be identical. Under a progressive rate schedule of the usual variety they will, however, face different marginal rates of tax t^I (=JH) and t^{II} (=AB), with high income person I facing the higher tax rate. In response to these differing marginal tax rates, income-earning activity is reduced by person I to $\overline{Y}^I$ and by person II to $\overline{Y}^{II}$. I's tax is ABKH + HJCD while II pays ABFG.

In this model it is clearly the case that high income person I avoids more tax than person II, as measured by the rectangular areas CDEL and

FGHK for persons I and II respectively. Assuming no behavioural adjustment, person I would have paid in tax an amount of ABKH + HJLE, while person II would have paid ABKH. By substituting untaxed leisure for fully taxable income, both individuals can and do avoid some tax. But, as a result of greater tax avoidance by wealthy person I, "nominal" tax progressivity is clearly much reduced, as reflected in the fall in I's average tax rate from (ABKH + HJLE)/Y^{I} to an effective rate of (ABKH + HJCD)/Y^{I}, while II's average rate falls by a lesser percentage from ABKH/Y^{II} to ABFG/Y^{II}.

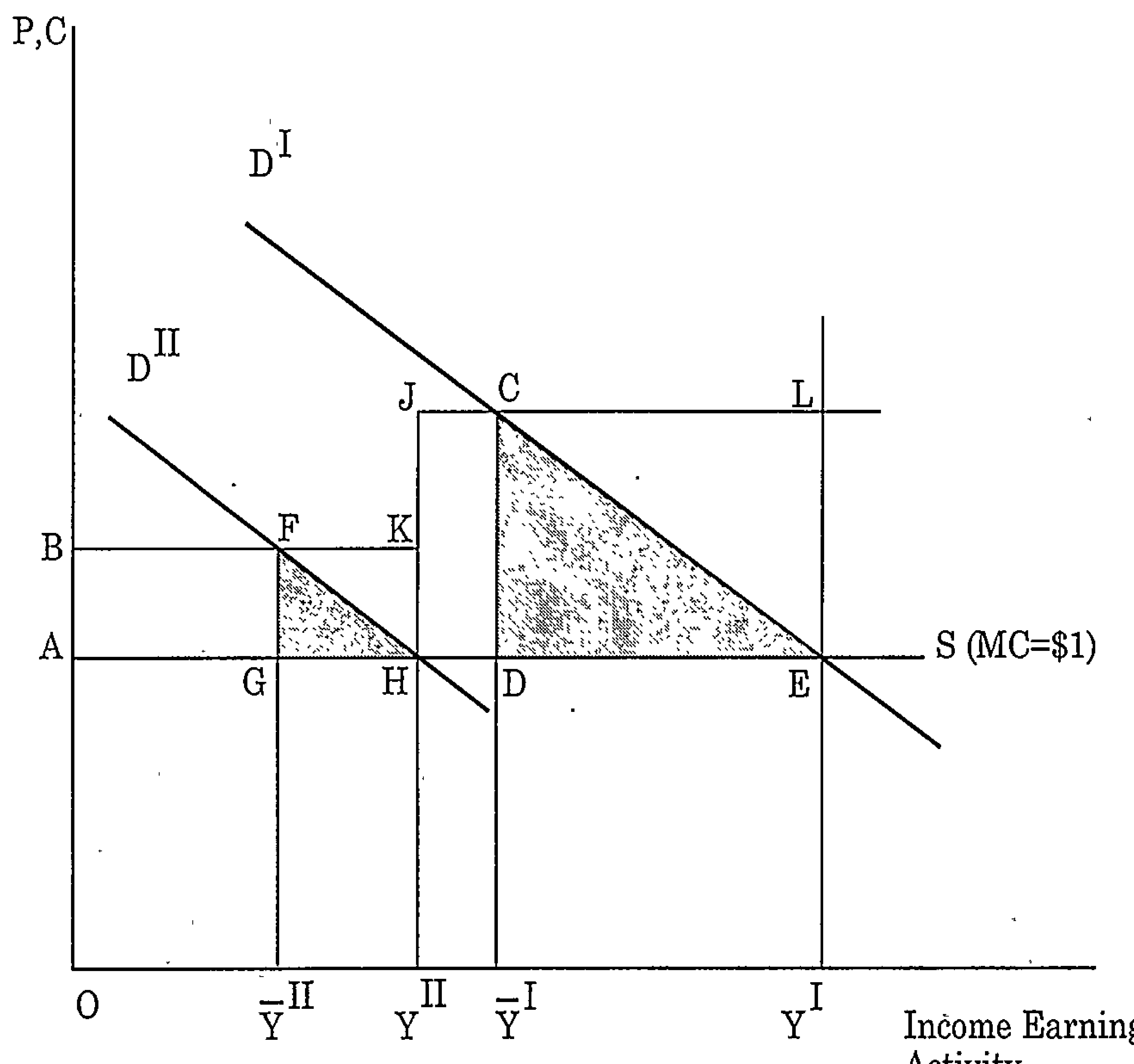

Figure 2

Here again, however, it is necessary to account for the "excess burden" of the tax. The progressive income tax distorts the supply of labour by both persons, and the resulting excess burden impacts differently on I and II. For person I the excess burden is measured by the area of the triangle

CDE, while person II bears only FGH. As in our previous model, tax avoidance is costly, both to the individual and to society. In addition, the greater tax savings enjoyed by the wealthy are partially offset by a larger excess burden. In terms of total burden (tax + excess burden) progressivity may be little changed as a result of tax avoidance; and any possible reduction is significantly less than it might appear from standard measures of tax progressivity.[7]

The results we have derived depend, of course, on the specific assumptions of the two models we have considered. Although these assumptions serve to illustrate very nicely some of the common characteristics of tax avoidance problems within the general framework of work-leisure choice analysis, other results are possible and may be more relevant in important special cases. This may be more particularly the case when we move beyond the work-leisure framework into other areas of behavioural adjustment in which the tax avoidance terminology has been more commonly applied. Although other examples could be cited, work-leisure choice represents perhaps the classic case of an application within the public finance literature of the very broad concept of tax avoidance that, we have argued, comes most naturally to an economist. From a tax policy viewpoint the failure to tax leisure under either income or consumption taxation is, moreover, among a handful of the most "natural" and most intractable constraints facing the policy-maker in the design of an equitable and efficient tax system.

Policy Implications

As a result of this latter feature, the policy implications of tax avoidance in this more "general" setting lack perhaps the most important and most characteristic thrust of modern tax reform proposals, notably base broadening. Excess burden and horizontal equity in this model result from the failure to include leisure in the tax base. This is, however, an inevitable feature of income and consumption taxes alike, and it must simply be accepted. Somewhat ironically, this has been a major area of policy concern in the newer "optimal tax" tradition, and one of the most prominent findings of optimal tax analysis has been that excess burden can be reduced if the flat rate of tax we assumed in Figure 1 is replaced with a differentiated rate structure involving higher effective rates of tax on less elastic factors (person II) and lower rates on more elastic factors

[7] Brennan & Buchanan, *supra* note 5.

(person I).[8] In practice, however, the information necessary for the design of such a system is not available, and the administrative requirements and political acceptability features must anyway render such an approach totally impractical.

In the work-leisure example the main thrust of the policy analysis is accordingly directed, in Figure 2, at reform of the progressive rate structure. Where, as we have assumed, abilities to avoid tax are identical, as reflected in the equal slopes of the demand schedules D^{I} and D^{II} for persons I and II, excess burden can be reduced with little, if any, sacrifice in effective progressivity by flattening the tax rate scale. If progressivity is reduced as a result of tax avoidance anyway, efficiency can be promoted without significant cost in terms of vertical equity objectives. This alternative tax reform strategy has been strongly advocated in a well known paper by Brennan and Buchanan.[9]

This important proposition is, however, subject to major reservations when we allow for the existence of full- and part-time secondary earners on lower-middle incomes with higher estimated elasticities of labour supply and greater ability to avoid tax. In this more general setting a progressive rate scale can serve as a method of reducing relative marginal rates of tax on this particular category of wage-earners with favourable implications for excess burden.[10]

Tax avoidance in this generalised setting cannot, of course, be addressed through anti-avoidance legislation in the more familiar legal sense. Adjustments in work-leisure choice clearly cannot be dealt with either by targeted anti-avoidance provisions or by a general anti-avoidance rule (GAAR). In an interesting recent paper it has been argued by Musgrave[11] that tax avoidance in this generalised sense violates a social contract. In the relevant quasi-constitutional setting, therefore, behavioural adjustment and associated excess burdens should be disallowed. It

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[8] This argument goes back to the pioneering article, FP Ramsey, A Contribution to the Theory of Taxation (1927) 37 *Economic Journal* 47.

[9] Brennan & Buchanan, *supra*, note 5.

[10] PA Apps, Tax Transfer Options: A Critique of Joint Income and Flat Rate Proposals, in JG Head & R Krever eds, *Flattening the Tax Rate Scale* (Melbourne, Longman Professional, 1990).

[11] RA Musgrave, Social Contract, Taxation and the Standing of Deadweight Loss (1992) 22 *Journal of Public Economics* 369.

is, however, unclear from Musgrave's analysis how this might be accomplished.[12]

It is a central proposition of the present paper that the same basic characteristics of tax avoidance that we have identified in the case of work-leisure choice carry over without significant modification into other possible areas of behavioural adjustment. There is, in other words, no fundamental distinction to be drawn between adjustments in work-leisure choice and a whole host of alternative forms of adjustment in areas such as saving, risk-taking, intersectoral and interindustry allocation of investment, and forms of business organisation and financing. Essentially we shall contend that the same issues of equity and efficiency can and do arise in all dimensions of behavioural adjustment, though some differences in emphasis may be in order to accommodate special cases.

Tax avoidance terminology, however, has been applied more commonly by economists and others in these other areas, notably in the area of capital income and in such specific matters as the choice of business form and methods of financing. Special treatment of behavioural adjustment in some of these areas has indeed been a feature of the economics literature. Detailed consideration of these cases is necessary therefore in order to determine whether there may after all be some basis for a more categorical distinction between types of tax avoidance.

Capital Income Taxation

The taxation of capital income has long been a major disaster area in the income tax systems of industrial countries. It is in this area that tax avoidance terminology has most frequently been applied, and associated policy problems have been the subject of continual, indeed almost non-stop, debate.

High Substitutability

One basic difficulty identified by economists is that different types and sources of capital income tend to be very close substitutes. Since adjustments to reduce tax are frequently so easy and inexpensive, differences in tax treatment generate large amounts of tax avoidance and involve substantial revenue losses. In terms of our previous analysis, large excess burdens would therefore generally be expected. Particular concern has also been expressed regarding the impact of tax avoidance in this area on tax progressivity. Since capital income is observed to be heavily concen-

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[12] JG Head, Tax Reform: A Quasi-Constitutional Perspective, in this volume.

trated at the top of the income scale, large reductions in progressivity due to tax avoidance are a strong possibility. Such reductions in progressivity as conventionally measured would, however, be offset to some degree by excess burden.

These problems, although they may be more serious, are not, however, qualitatively different from those we have already identified in our introductory analysis of adjustments in the area of work-leisure choice. In a more complete analysis of possible adjustments in the labour income area, we might, for example, have noted the close substitutability existing between different forms of remuneration, in cash or in kind, current or deferred, which has in turn generated serious tax avoidance problems in the areas of non-cash fringe benefits and superannuation. Similarly, with widening inequality of earnings over the past decade, and with existing and also newly-emerging problems of tax avoidance at high labour income levels, e.g. through incorporation of professional consultancies, the vertical equity issue of reduced income tax progressivity due to tax avoidance is now a matter of increasing concern in the labour income area. The major tax avoidance problems most commonly cited in the area of capital income taxation thus have close counterparts in the area of labour income taxation. In these matters at least, such differences as may be distinguished are differences only of degree. However, special cases and specific examples have been cited that may provide the basis for a more fundamental distinction, and these must now be considered in detail.

Horizontal Inequity and Resource Flows

It has, for example, been argued by economists that problems of *horizontal inequity*, commonly encountered in other areas of tax avoidance, have no counterpart in the area of capital income. The underlying argument, due to Feldstein,[13] is that, where markets function efficiently, differences in the tax treatment of alternative forms of investment will be fully compensated by differences in pre-tax rates of return. According to Feldstein, market processes of tax capitalisation and resource flows generally can be expected to equalise net-of-tax rates of return. Under an established tax system there can therefore be no inequality in the post-tax situation of those with similar pre-tax wealth and income earned by investing in different types of capital assets. Horizontal inequity can arise in

[13] M Feldstein, On the Theory of Tax Reform (1976) 6 *Journal of Public Economics* 77.

this setting only as a result of changes to the tax system, which will inevitably generate windfall gains and losses for those with different investments or asset portfolios.

If income taxes were applied at a flat uniform rate, there could, for example, be no tax advantage, after an initial transition period, from tax shelter investments, since the pre-tax return from such investments would be reduced by market forces to compensate for the tax advantage. The allocation of resources would be distorted and excess burdens would arise, but there would be no horizontal inequity. Although Feldstein's argument is subject to some reservations, mainly in regard to the treatment of risk, and vertical equity problems may well arise under progressive rate structures,[14] it does appear that a significant distinction can be drawn on this basis between the effects of tax avoidance in the capital income area and problems of tax avoidance more generally.

Just as some types of tax avoidance may generate no horizontal equity problems, others have been identified which may generate no problems of inefficiency or excess burden. Where, for example, markets fail to function, tax discrimination between different types of investments will not generate distorting resource flows. Horizontal inequities will remain, but excess burdens do not arise.[15] While some degree of market failure can no doubt be expected, and pockets of inefficiency can often be identified, the Feldstein proposition clearly remains the more important consideration for policy in this area.

Policy Implications

From a policy viewpoint, however, it makes little difference whether the effects of tax avoidance are confined mainly or exclusively to inefficiency and excess burden (as in the Feldstein analysis) or to horizontal inequity (where markets fail to function). In either case standard base-broadening strategies provide the appropriate solution.

Short of the special case of perfect or near-perfect substitutability — which we shall consider shortly — high substitutability increases tax avoidance and therewith the inefficiencies and welfare cost of taxation. Such problems greatly strengthen the general tax policy presumption in

[14] On vertical inequity complications under progressive rate structures, see Cordes & Galper, *supra*, note 2.

[15] See, for example, BI Bittker, Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities? in HJ Aaron & MJ Boskin eds, *The Economics of Taxation* (Washington, Brookings Institution, 1980).

favour of removing, and as far as possible avoiding, discrimination and arbitrary distinctions between different types and sources of income. This policy should indeed be vigorously pursued both in the area of labour income and capital income under income taxation; and a similar policy needs to be applied on the "uses" side in the area of indirect consumption taxes. Since high substitutability is an especially significant feature in the capital income area, the need for uniform and consistent treatment of different capital income components is, however, particularly pressing.

Since tax avoidance by high income taxpayers reduces effective progressivity, base broadening in the capital income area also promotes vertical equity. Excessively high marginal rates of tax, and associated tax avoidance problems and economic distortions, can therefore be reduced without sacrificing vertical equity if the tax base is broadened and applied more consistently.

In contrast to our benchmark analysis of work-leisure choice, where base-broadening strategies are ruled out, most of the gaps, loopholes and tax preferences under modern income tax systems are by no means technically or administratively inevitable or unavoidable. Much can therefore be done through tax reform to promote the achievement of basic tax policy objectives. In this regard base-broadening strategies clearly provide the key.

"Pure" Tax Avoidance

There is indeed a polar concept of "pure" tax avoidance, unalloyed with excess burden or horizontal inequity, which has recently achieved some prominence in the economics literature. Where, in particular, capital markets function perfectly — and information problems, transactions costs and institutional restrictions can therefore be ruled out — simple adjustments may be made in the asset portfolios of individual investors and/or in the financial policies of corporations which serve to exploit familiar loopholes in the capital income tax system at no cost to the individual investor or the company concerned or to society. In this limiting case tax avoidance is literally costless and entails neither excess burden nor horizontal inequity. Correspondingly, however, there is no revenue!

Personal Income Tax

This challenging concept of "pure" tax avoidance was first persuasively developed in two well known papers by Stiglitz[16] and illustrated by reference to gaps in the base of the U.S. personal income tax, notably the preferential treatment of capital gains. Stiglitz proceeds to show how, in perfect capital markets, purely paper transactions such as wash sales and commodity straddles (involving essentially the purchase and sale of the same asset or of perfect substitutes) can be employed to exploit tax loopholes without affecting the preferred risk-yield characteristics of the individual's asset portfolio. He recognises that some of the simpler and more blatant tax avoidance strategies can be blocked by general or specific anti-avoidance measures, such as wash sale provisions. He argues, however, that more complex strategies can readily be devised which it would be impossible in practice for the revenue authorities to control. He concludes that, if investors are rational and capital markets are perfect, no revenue whatever would be collected from capital income taxation — and the taxation of labour income could well be seriously threatened.

At the theoretical level this argument by Stiglitz appears to overlook the fundamental observation that, in perfect capital markets, tax avoidance though easier to arrange must also be much easier to control. With comprehensive information reporting and appropriate software, matching transactions and offsetting positions, no matter how complex, could readily be identified under routine computerised assessment procedures. Among the major tax avoidance strategies analysed by Stiglitz, commodity straddles — which had in fact already been outlawed in the US in 1981 — could therefore easily be controlled through anti-avoidance legislation. The same would clearly also be true for the complete range of more recent product innovations in the area of financial instruments which are seriously troubling the revenue authorities in industrialised countries.[17]

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[16] JE Stiglitz, Some Aspects of the Taxation of Capital Gains (1983) 21 *Journal of Public Economics* 257; The General Theory of Tax Avoidance (1985) 38 *National Tax Journal* 325. Essentially the same concept has also been discussed under the heading of pure tax arbitrage and pure tax shelters in, CE Steuerle, *Taxes, Loans and Inflation* (Washington, Brookings Institution, 1985) and Cordes & Galper, *supra* note 2, respectively.

[17] See, for example, AC Warren Jr, Financial Contract Innovation and Income Tax Policy (1993) 107 *Harvard Law Review* 460.

Even more importantly, there would no longer be any pretext, if capital markets were perfect, for those all-too-familiar gaps in the capital income tax base on which the Stiglitz analysis relies. Adoption of the realisation principle in preference to the ideal of accrual in the capital gains area, for example, is usually explained and justified in terms of valuation and liquidity problems which can only arise where the markets for important types of real or financial assets are imperfect. Where capital markets are perfect, however, comprehensive income taxation on the Haig-Simons accretion principle becomes feasible, and prevailing gaps in the capital income tax base could simply be closed!

Stiglitz himself concedes that capital markets are in fact not perfect; market outcomes and tax avoidance possibilities must generally be affected by problems of informational asymmetry, transactions costs and institutional restrictions (including anti-avoidance legislation). These "imperfections" are invoked by Stiglitz to explain the payment of substantial amounts of tax by significant numbers of investors — in apparent violation of his basic theorem. There is, however, strong evidence for industrialised countries that net revenue from capital income taxation is already in decline and in some cases may even be negative. And these problems are obviously increasing with the explosive growth of financial innovation.

It is therefore a very awkward combination of high — but less than perfect — substitutability between financial investments in an uncertain world with significant transactions costs which poses the immediate threat to the survival of income taxation. In the much simpler Stiglitz world of perfect capital markets — with perfect and costless substitutability — these problems, as we have seen, could easily be dealt with.

Corporate Income Tax

The possibility of "pure" tax avoidance in the area of corporate income tax has also been much discussed, notably in the literature stemming from pioneering contributions to financial theory by economics Nobel laureates Modigliani and Miller.[18] It has long been generally acknowledged that a classical system of company income tax — of the sort prevailing in

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[18] MH Miller & F Modigliani, Dividend Policy, Growth and the Valuation of Shares (1961) 34 *Journal of Business* 411; F Modigliani & MH Miller, The Cost of Capital, Corporation Finance and the Theory of Investment (1958) 48 *American Economic Review* 261; F Modigliani & MH Miller, Corporate Income Taxes and the Cost of Capital: A Correction (1963) 53 *American Economic Review* 433.

the United States, Australia and other countries throughout much of the postwar period — is highly non-neutral and inequitable.[19] In terms of the standard critique, distorting effects must generally be expected, both in the allocation of real investment and also in corporate financial policy, with debt favoured over new share issues and retention of earnings over distributions. In the M-M models, however, such adjustments in corporate financial policy, while serving to reduce or eliminate tax, need involve no efficiency cost or excess burden.

Since, in the M-M context of perfect capital markets, non-tax costs or benefits (for example, in terms of "signalling" or "agent control") from the payment of dividends or the issue of debt can safely be ruled out, changes in debt/equity ratios or in payout policies by companies can have no effect on the outstanding value of equity shares, as individual investors can make offsetting changes in their own asset portfolios. Corporate tax avoidance is therefore privately and socially costless. The same may be true of changes in organisational form away from more heavily taxed corporate structures to more tax-effective alternatives such as trusts or large limited partnerships.

Through behavioural adjustment in any or all of these three dimensions of business financial and organisational policy, it is clearly possible that the characteristic "double taxation" of dividends under the classical system of company tax could be completely avoided. The associated inequities and Harberger-style distortions in the allocation of real investment between sectors and industries, emphasised in the standard critique, do not therefore arise. This is therefore the precise counterpart, in the area of company tax, of the Stiglitz theorem on pure tax avoidance in the personal income tax area. If capital markets are perfect and corporate management pursues standard wealth maximisation objectives on behalf of shareholders, no revenue whatever would be generated by the "double taxation" feature of the classical system of company tax.

Once the assumption of perfect capital markets is relaxed, this proposition too requires substantial modification. In the case of debt/equity ratios, for example, there may well be a significant range over which the substitution of debt for equity may be a matter of little or no concern and

[19] This "traditional" analysis has been accepted in official studies from the Carter Report in 1966 to the US Treasury Report of 1992. See Canada Royal Commission on Taxation, *Report* (Ottawa, Queens Printer, 1966); US Treasury, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, 1992).

may even be privately beneficial to shareholders (in terms of agent control). Beyond a point, however, risk of bankruptcy becomes a major issue, and the high costs of financial distress and associated macroeconomic risks involved must be a matter of serious concern, both for shareholders and for society. Efficiency costs and excess burdens arise and must therefore be reckoned with.

Similarly in the case of payout policy, retention of earnings may, up to a point, be a matter of indifference. Dividend payout is nevertheless observed to perform a significant signalling function, as an indicator of changes in business prospects; and investment financed by retained earnings is not subject to the same market test as new share issues, raising social as well as private concerns regarding possible misallocation of investment. Beyond a point, at least, substitutability between new share issues and retentions as a method of finance may thus be far from perfect. Here too, then, one generally must account for efficiency costs and excess burdens.

It seems reasonable to conclude that, over a certain range, behavioural adjustment and tax avoidance in either of these two dimensions of business financial policy may be possible without associated costs in terms of efficiency or excess burden. The celebrated Modigliani-Miller propositions have to this extent some validity and may serve to distinguish these types of tax avoidance from the general run. Equally, however, these propositions are subject to very significant restrictions and limitations, and any distinction that may be drawn on this basis cannot be pushed very far.

A final candidate for special distinction in the area of business adjustment relates to the choice of business form. Income tax systems commonly apply in different ways to, and hence discriminate between, different business forms such as proprietorships, partnerships, private and public companies, business and trading trusts, and so on. Tax-motivated changes in business form may involve little cost or inconvenience and have been high on the list of types of tax avoidance causing public concern in Australia and other countries over recent decades. Professional consultancies provide an obvious Australian case in point, since there is little cost or inconvenience involved in organising as a private company as compared with the proprietorship or partnership alternatives, and there are clearly very substantial tax advantages.

As in our Modigliani-Miller examples, the essential issue here is the degree of substitutability between more and less heavily taxed alternatives.

Although there may indeed be cases in which the choice between alternative business forms is in itself a matter of indifference, this cannot be true more generally. The public company, for example, has obvious advantages as a vehicle for raising large amounts of capital. A smaller, more closely-held business has, however, compensating advantages in other respects such as flexibility, which may weigh heavily, say, in the early stages of venture-capital developments. As in our Modigliani-Miller examples, therefore, a limited distinction may be drawn in this dimension of behavioural adjustment. Excess burdens or efficiency costs may sometimes be quite small and tax avoidance in the narrow sense of revenue loss becomes the dominant policy issue, along with possible equity concerns. Here too, however, this distinction could easily be pressed too far.

Substitutability, whether between debt and equity, retention and distribution, or corporate and non-corporate business forms, is thus generally less than perfect. The standard critique of the classical system is therefore vindicated. Tax avoidance in the form of adjustments in corporate financial and organisational structure, serves to reduce excess burden but substantial inefficiency and inequity may nevertheless remain. For a satisfactory solution, much closer integration of the corporate tax with the personal income tax is in general required.[20]

Perfect, or Near-Perfect, Substitutability: A Technical Note

Even though, in the economic examples considered above, substitutability is clearly less than perfect — and the Stiglitz concept of "pure" tax avoidance is thus seen to be a very special polar case — the proposition, that in cases of high substitutability, efficiency costs or excess burdens may be quite small, or even zero, has strong intuitive appeal. This proposition, however, conflicts sharply with the fundamental theorem on excess burden derived in our previous analysis of work-leisure choice. In that analysis, ease of substitution of the untaxed for the taxed alternative, as reflected in the differing slopes of D^{I} and D^{II}, emerged as a major determinant of the magnitude of tax distortions. The higher the degree of substitutability, the flatter the demand slope and the greater the excess burden. Some geometrical clarification may therefore be in order, since conflicting intuitions are involved. Our previous Figure 1 is accordingly reproduced, with appropriate modifications, as Figure 3.

[20] See the sources quoted in note 19.

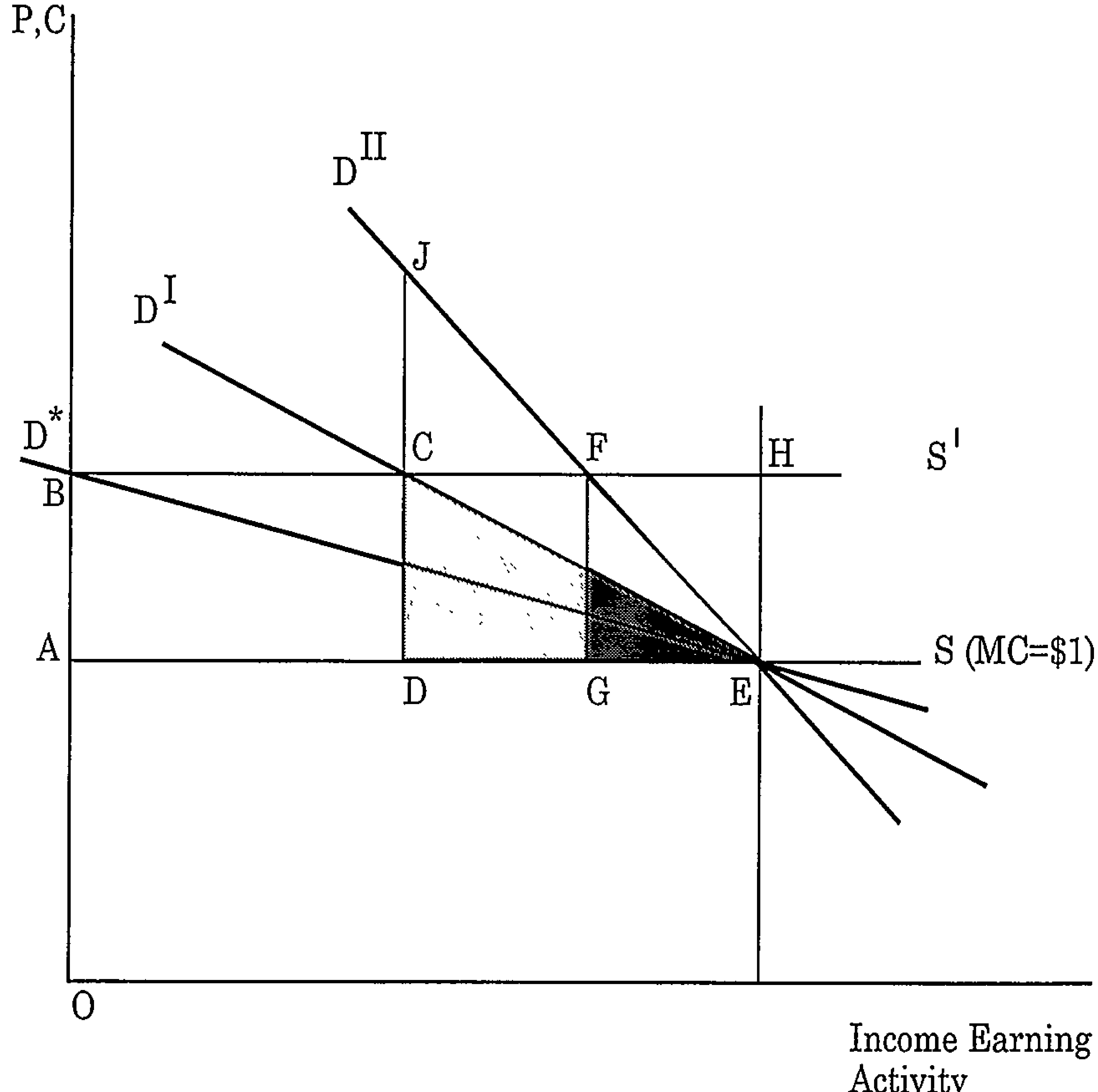

Figure 3

In Figure 3, the contrasting intuition that easy substitutability implies reduced welfare cost is easily seen to be valid for a given reduction in the taxed activity. For a reduction from E to D, for example, person I suffers a loss of CDE while person II's loss is a massive JDE. From a tax policy viewpoint, however, it is generally more relevant, as in Figure 1, to compare the effects of a given tax rate applied to both individuals or, alternatively, a given amount of revenue to be collected from each. In the more policy-relevant setting, therefore, the results of our previous analysis are generally valid. As, however, we increase substitutability further and consider demand schedules flatter than D^I, the amount of the taxed activity will ultimately be driven to zero, as for the demand schedule shown as D*, and revenue likewise falls to zero. Where all or most demand schedules are more elastic than D*, excess burden at the given tax rate or given (zero) revenue declines steadily and indeed disappears completely where substitutability is perfect for all market participants.

The contrasting intuition that welfare cost falls with increasing ease of substitution between taxed and untaxed alternatives achieves policy relevance therefore only in these special "corner cases" where the untaxed option has largely replaced the taxable activity.[21] In the area of capital income taxation, however, examples of perfect or near-perfect substitutability abound, as we have seen, both in the theory and practice of tax avoidance. Indeed this seems to be precisely the point at which the narrower legal concept of tax avoidance emerges from the broader concept that prevails in economic analysis.

The Legal Concept of Tax Avoidance

In legal discussions of tax avoidance, the primary focus is clearly on contrived and artificial schemes, which do not change the substantive character of an activity or transaction but may serve nevertheless to bring the activity within some tax-exempt or more tax-favoured legal category. Assuming a literal interpretation of the legislation by the courts, minor or essentially cosmetic changes may allow quite massive tax avoidance without significant cost to the taxpayer whether in legal fees or, in economic terms, from the adoption of inferior business forms or commercial practices. Substitutability between taxable and non-taxable alternatives may accordingly be almost perfect and, although revenue losses may be very large, the direct efficiency losses or excess burdens may be small. The lost revenue must, however, be made up by rate increases on a narrower base, thus increasing welfare cost, or public expenditure benefits must be reduced. The social costs of tax avoidance in this narrow legal sense may accordingly be very large and are not necessarily diminished by the absence of direct efficiency losses. In equity terms tax progressivity may be greatly reduced without offsetting effects from excess burden and, since certain types of artificial schemes may not be widely available, horizontal inequities may be considerable. Tax avoidance in the narrow legal sense remains therefore highly objectionable and must be dealt with if the tax system is to retain credibility and if tax compliance and social acceptance of the democratic budgetary system is to be preserved.

In accordance with the distinction we have proposed, a GAAR is directed at schemes or features of schemes that have no legitimate business

[21] JG Head & CS Shoup, Excess Burden: The Corner Case (1969) 59 *American Economic Review* 181.

purpose and/or are primarily intended to avoid tax. In the case of poorly drafted tax legislation subject to excessively literal interpretation by the courts, tax avoidance may, as we have already suggested, be quite inexpensive and require little or no departure from preferred business forms and commercial practices. Such cases should, however, be quite easy to handle by improved drafting, by requiring the courts to consider the intentions of the legislature or, if all else fails, through general or alternatively through specific anti-avoidance legislation.

Whereas a general anti-avoidance rule aims to cover a range of unspecified schemes where the dominant purpose is to avoid tax, more specific or targeted provisions may be employed to deal with particular tax avoidance practices. In the area of business forms, for example, any tax disadvantage suffered by companies in the "classical period" of company taxation in Australia could in many cases quite easily be avoided by operating instead as a business or a trading trust. Without attempting to address the underlying non-neutralities of the classical system through more basic structural reform (such as company tax imputation, integration or partnership treatment), tax avoidance through trusts was addressed through a specific anti-avoidance rule (SAAR) providing for the taxation of these alternative business forms as companies.

Reflecting the time value of money, effective tax rates are open to easy manipulation under a traditional realisation principle. Under income taxation much tax avoidance accordingly involves schemes or arrangements to defer the realisation of income or to advance the deduction of business expenses. The application of ideal or near-ideal accrual requirements has hitherto been relatively uncommon in Australia in spite of their familiarity in the area of financial accounting. Examples of specific anti-avoidance provisions under this general heading would include accrual-equivalent taxation of discount bonds and measures to control abuse in the area of pre-paid expenses.

There is, however, clearly a continuum of types of tax avoidance, which runs from these simpler and transparently contrived or artificial cases at one pole through a range of more elaborate and more expensive schemes involving in addition perhaps some more or less substantial sacrifice in terms of preferred business form and commercial practices. In a sense, of course, these latter schemes should be, if anything, more easily dealt with, since they must frequently exhibit features that may be highly dysfunctional in terms of preferred business practice and may involve therefore significant excess burdens in the economic sense. Such at least must be the case in simple comparative static models where firms and individuals are in market equilibrium to begin with, employing preferred business forms and commercial practices. Even so, it may be no easy matter for an outsider, or a court, to determine what constitutes a legitimate business purpose and what arrangements are clearly dysfunctional in the particular circumstances of a specific taxpayer.

In dynamic models, moreover, it cannot be assumed that firms and individuals are initially in equilibrium employing preferred business forms and commercial practices. Where tax avoidance occurs, there may well be efficiency gains, and hence a legitimate business purpose, involved. Anti-avoidance legislation, if it can be made effective, will in these situations prevent revenue loss but may well entail some partially offsetting efficiency loss. An interesting example of this type of legislation from the "classical period" is provided by the penalty tax on "excessive retentions" made by private companies out of active business income under the provisions of Division 7 of the *Income Tax Assessment Act*.[22] Since retained profits arguably serve as an essential source of finance for small, fast-growing firms with little or no access to the standard alternatives of debt or new share issues, a basic retention allowance was set beyond which, by implication, "unacceptable" tax avoidance was deemed to occur and a penalty tax of 50 percent applied. Up to this limit, however, considerations of efficiency or "legitimate business purpose" were held to outweigh the revenue losses from increased retention. Awkward tensions between these conflicting priorities are nicely reflected in the sharp rise of the allowable retention rate from 50 percent in the mid-1970s to 80 percent by the mid-1980s. By 1985, therefore, the penalty tax had become almost totally ineffective as a targeted anti-avoidance measure, and more fundamental restructuring of the company tax followed in 1987-88.

As we broaden the tax avoidance concept in this way, clearly what began as the narrow legal concept, based on perfect or near-perfect substitutability, merges with the broader economic concept previously discussed, and any meaningful distinction between the legal and economic concepts of tax avoidance threatens to disappear. It has sometimes been suggested that an independent legal concept can nevertheless be distinguished in these more elaborate cases on the basis of the large outlays required for expensive legal services. It is indeed an important insight from the analysis of rent-seeking in the modern public choice literature that taxpayers will be willing to spend on legal tax avoidance services up to

[22] *Income Tax Assessment Act* 1936 (Australia) Division 7.

the full amount of any potential tax saving. The economic waste involved in such cases should therefore not be underestimated.

Tax avoidance in standard cases of the type analysed by economists may, however, likewise be very costly and require substantial investments in retraining, psychological counselling or business consulting and legal services. To take a very simple example, the incentive provided by heavy tobacco taxes to break the habits of a lifetime may be very great, but tobacco consumption in most countries continues at high levels. Similarly the advantages of tax breaks for particular occupations may be largely confined for practical purposes to new entrants to the workforce because of major irreversibilities in human capital investments.

More importantly, however, in terms of policy implications, the issues raised under the broadened concept are less and less confined to the administrative and legal matters that understandably dominate the policy analysis of tax avoidance narrowly construed. The case for base broadening and substantive reform of the tax legislation becomes the dominant concern, and economic analysis of the sort that has long been familiar in the public finance and tax policy literature takes centre stage.

The Australian Experience: The Capital Gains Distinction

The distinctions drawn above can readily be illustrated from Australian experience of tax avoidance in the area of capital income taxation over the past 20 years. The tax treatment of capital gains in Australia long turned on a problematic profit-making purpose test somewhat analogous to the business purpose test described above. With a trend towards an increasingly literal interpretation of the tax legislation by the courts, it became a very easy matter to restructure or recharacterise relevant transactions without any essential change of substance in order to avoid the application of tax. As a result, by the second half of the 1970s, low-cost, mass-marketed schemes of tax avoidance exploiting these and related distinctions drawn in the legislation as interpreted by the courts were costing billions of dollars annually in lost tax revenue. This was no doubt the golden age of contrived and artificial schemes of tax avoidance. While the excess burdens involved were arguably of relatively small importance, vertical equity was nevertheless seriously affected, and rising rates of tax were required on an increasingly narrow base to compensate for revenue losses. Tax compliance was at a low ebb, and the democratic budgetary system had been seriously undermined.

Most of these schemes relied upon basic design deficiencies in, and lack of coordination between, the personal income tax and the company income tax. Under the prevailing system of company tax, tax reduction based on the capital gains distinction was easily accomplished for the average investor through retention of earnings by the company and a subsequent tax-free sale of the shares. With a company tax rate of 45 percent and a top personal tax rate of 65 percent, as in the mid-1970s, the company form provided a convenient vehicle for tax minimisation, and its attractions in this regard were greatly enhanced by the existence of major tax preferences. Since payout policy is at the discretion of management, this Modigliani-Miller adjustment was most readily exploitable within the closely-held company. A specific anti-avoidance provision in the form of a penalty tax on excessive retentions by private companies had long applied, as we have already noted, under Division 7 of the Act. The penalty tax provision was, however, subject to widespread avoidance. And the retention allowance was progressively increased and became less and less effective as an anti-avoidance measure. Schemes to strip corporate surplus based on the capital gains distinction and abuse of the s. 46 rebate had accordingly proliferated since the mid-1970s without significant restriction.

It should not in fact have been difficult, through anti-avoidance legislation, to stem the rising tide of contrived and artificial schemes. Some of the more arbitrary distinctions accepted by the High Court could likewise have been corrected by legislative amendment and by directing the courts to have more regard to the intentions of the legislature. Specific anti-avoidance measures had in fact been used repeatedly during the 1970s to close off particular practices. But no sooner was one loophole closed than others were opened exploiting the same basic design deficiency in the legislation. The general anti-avoidance provisions of s. 260 offered an obvious alternative solution, but the application of this section had been narrowed by High Court decisions to the point where it offered little if any assistance in the battle against tax avoidance during this crucial period. More comprehensive reform was, however, rather slow to appear but was ultimately sparked, as in the *Crimes (Taxation Offences) Act*,[23] by increasingly outrageous abuses that crossed the line into outright evasion, as in so-called "bottom-of-the-harbour schemes." New general anti-avoidance legislation to replace s. 260 followed in 1981, along with reform of the *Acts Interpretation Act* to address the problem of excessive literalism, and the era of the mass-marketed schemes was finally brought to a close.

[23] *Crimes (Taxation Offences) Act* 1980 (Australia).

Basic reform of the income tax legislation designed to remove, or at least greatly reduce, some of the more troublesome underlying distinctions and discrimination between the various types and sources of capital income was initiated by the Labor Government in its post-Summit tax reform program announced in September 1985, accompanied by corresponding measures in the labour income area, notably the fringe benefits tax (FBT). Major measures in the capital income category were the new tax on realised capital gains (CGT) and the full imputation system of company income tax under which the company tax rate was aligned with the top personal tax rate at 49 percent. As a result of these and related changes that followed in subsequent years, tax avoidance both in the broader economist's sense and in the narrower legal sense have been greatly reduced. Significant problems remain, however, and new problems keep emerging.

Thus, for example, it might reasonably have been expected that the newly integrated system of personal and company tax would remove, once and for all, the basis for tax avoidance schemes built on the capital gains distinction. And this distinction is in any case much reduced by the new CGT. The gap between the corporate tax rate and the personal tax rate was, however, almost immediately reopened with the reduction in the company tax rate to 39 percent in 1988 and subsequently to 33 percent in 1993, while the top personal tax rate was reduced only slightly to 47 percent. The limited protection against tax avoidance afforded by the Division 7 provisions had at the same time been abandoned as unnecessary with the introduction of the new imputation system in 1987, and it has not since been reintroduced. If more fundamental reform, such as partnership treatment for private companies, is not feasible, targeted anti-avoidance measures are now urgently required in order to control abuse.[24]

A fundamental problem has been that the CGT introduced in 1986 is at best a "practical compromise" measure which falls far short of the standard public finance ideal of an accrual tax and even of the comprehensive tax on realised capital gains originally proposed by the Government in the *Draft White Paper*.[25] The magnitude of the problems generated by the inconsistent treatment of capital gains, taxable (for post-1985 acquisitions)

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[24] JG Head, Imputation in the Context of Taxation Reform, in Bureau of Industry Economics, *Dividend Imputation Policy Forum* (Occasional Paper 17) (Canberra, AGPS, 1993).

[25] Commonwealth of Australia, *Reform of the Australian Tax System* (Draft White Paper) (Canberra, AGPS, 1985).

on realisation, and other forms of capital income can be illustrated by the difficulties that have arisen in the taxation of interest receipts.

The emergence in the early 1980s of the zero-coupon bond provides a classic example of contrived and artificial tax avoidance in this area. Since interest receipts were normally taxable as and when received, essentially on accrual, while capital gains were taxable either not at all or on realisation, income taxation clearly could be deferred or avoided by the simple device of issuing zero-coupon or deep-discount bonds offering the same yield to maturity. In Australia, as in other countries, this transparent device was soon dealt with by targeted anti-avoidance legislation providing for accrual-equivalent taxation.

The problem here is, however, more general, and threatens, with the rapid growth of financial innovation, to get entirely out of control. More comprehensive anti-avoidance legislation applying a system of accrual taxation to debt substitutes and to related financial arrangements was introduced as part of the extensive income tax reforms in New Zealand in 1987, and a similar system was proposed for Australia in the *Consultative Document on the Taxation of Financial Arrangements*[26] released by the Treasurer in December 1993. The amount of revenue at stake is very large and the case for such legislation seems compelling.

The difficulties are, however, considerable. Thus, for example, the debt substitutes involved are seldom perfect as in the simple case of the zero coupon bond. A range of more or less imperfect substitutability exists, and the risk characteristics of some alternatives based on put and call options resemble those of equity. As substitutability becomes less perfect, the efficiency costs of anti-avoidance rules increase. More fundamental reform to address the underlying inconsistency may therefore need to be considered. Although capital gains taxation is a difficult area and tends to be a political minefield, accrual taxation is administratively quite feasible for listed equity shares. In order to limit any resulting complications for individual investors, the accruals regime could be confined to companies and trusts, as under the proposals for debt substitutes in the *Consultative Document* of 1993.

There is accordingly a trade-off between anti-avoidance measures of the more traditional narrow variety and more fundamental measures to

[26] Treasurer, *Taxation of Financial Arrangements, A Consultative Document* (Canberra, ATO, 1993).

remove the underlying differences in tax treatment by reform of the tax base.

The Public Choice Concept of Tax Avoidance

A remarkable feature of developments in economics over the past half century has been the emergence of the new subdiscipline of *public choice* devoted to economic modelling of the political decision-making process.[27] Reflecting dissatisfaction with the somewhat simplistic normative orientation and heavily institutional emphasis of much traditional political science, the tools of modern economics have been applied with increasing sophistication and much apparent success to the positive analysis of democratic politics. This analysis has in turn served as the basis for important new insights and perspectives on policy. The achievements of the new subdiscipline were acknowledged at the highest level with the award of the Nobel Prize in Economics for 1986 to Professor James Buchanan, the distinguished founder of the modern public choice movement.

From the outset it has been a basic premise of public choice analysis that individuals and groups can and will seek to satisfy their desires or preferences through participation in political processes, just as they can and do express these same desires through their behaviour in markets. And it is a central proposition that they will allocate their time and resources between economic and political activity directed towards the achievement of their objectives in any given area of interest in accordance with their perceptions of the prospects for success in these alternative behavioural modes.

Tax avoidance, as we have analysed it thus far, is essentially a market, or more precisely a market-initiated, phenomenon — specifically a market response by the taxpayer to a tax structure that is non-neutral and discriminatory, but is taken as given or exogenously determined. Through behavioural adjustment in markets, under the given tax structure, taxpayers seek to reduce their tax liabilities and, in effect, shift part of their tax burdens to others. Whether these adjustments take the form of reducing the amount of work done or changing the pattern of investments — with or without the benefit of expert tax advice — the initiating behaviour is confined to the market setting.

Some political reaction to market adjustments by tax avoiders must, of course, be expected; and the ultimate distributional outcome or pattern of

[27] DC Mueller, *Public Choice II* (Cambridge, Cambridge University Press, 1989).

burden shifting will depend upon the precise nature of the government response. As we have already noted, this reaction may take the form of tax increases and/or expenditure reductions. The resulting chain of interrelated adjustments begins, however, with the market response by the tax avoider.

It is an obvious implication of modern public choice analysis that tax avoidance or burden shifting can also be initiated in other ways, notably through direct participation by taxpayers in the democratic political process. By devoting time, effort and financial resources to relevant political activity, such as lobbying, campaigning and voting, individual taxpayers can hope to exercise some direct influence on political decisions affecting the tax structure. Tax avoidance — and associated effects in terms of revenue loss, excess burden and inequity — are not therefore exclusively the result of market responses by taxpayers to a given revenue structure. They are also the outcome of efforts by taxpayers and their representatives to influence the tax structure itself through participation in political processes. A considerably broader and more dynamic concept of "tax avoidance in the public choice sense" thus emerges when the analytical framework is expanded to allow for behavioural adjustment by taxpayers in the political arena.

Recognition of the political dimension of tax avoidance allows us to identify a further category of welfare cost or deadweight loss to society, notably the time, effort and financial resources devoted to lobbying and other relevant political activity. The incentive to invest in political activity for the purpose of reducing tax burdens, and the likely magnitude of the associated deadweight losses, can readily be illustrated with the aid of our previous Figure 1, appropriately modified and reproduced as Figure 4 below. As before, we assume a two-person group of tax avoiders with identical incomes of amount AE.

Thus, for example, in the special case of tax avoidance in the narrow legal sense substitutability is perfect, and the demand schedule passing through the common equilibrium point E for each of our two persons becomes horizontal, as shown by AS. Measured against the benchmark of zero behavioural adjustment, the tax burden that can be avoided through exploitation of the relevant loophole or concession is represented, for each person, by the full amount of her or his original tax liability ABHE. In this case, creation or preservation of the tax-free status of the relevant substitute for taxable income-earning activity allows behavioural adjustment of a type that is completely painless or costless to the individuals concerned and requires no sacrifice in terms of organisational form or preferred commercial practices. After allowing for any initial market outlay for expert tax advice, taxpayers in this special legal category thus have an incentive *collectively* to invest in political tax avoidance activity up to the full amount of the potential tax saving ABLM (= 2ABHE).

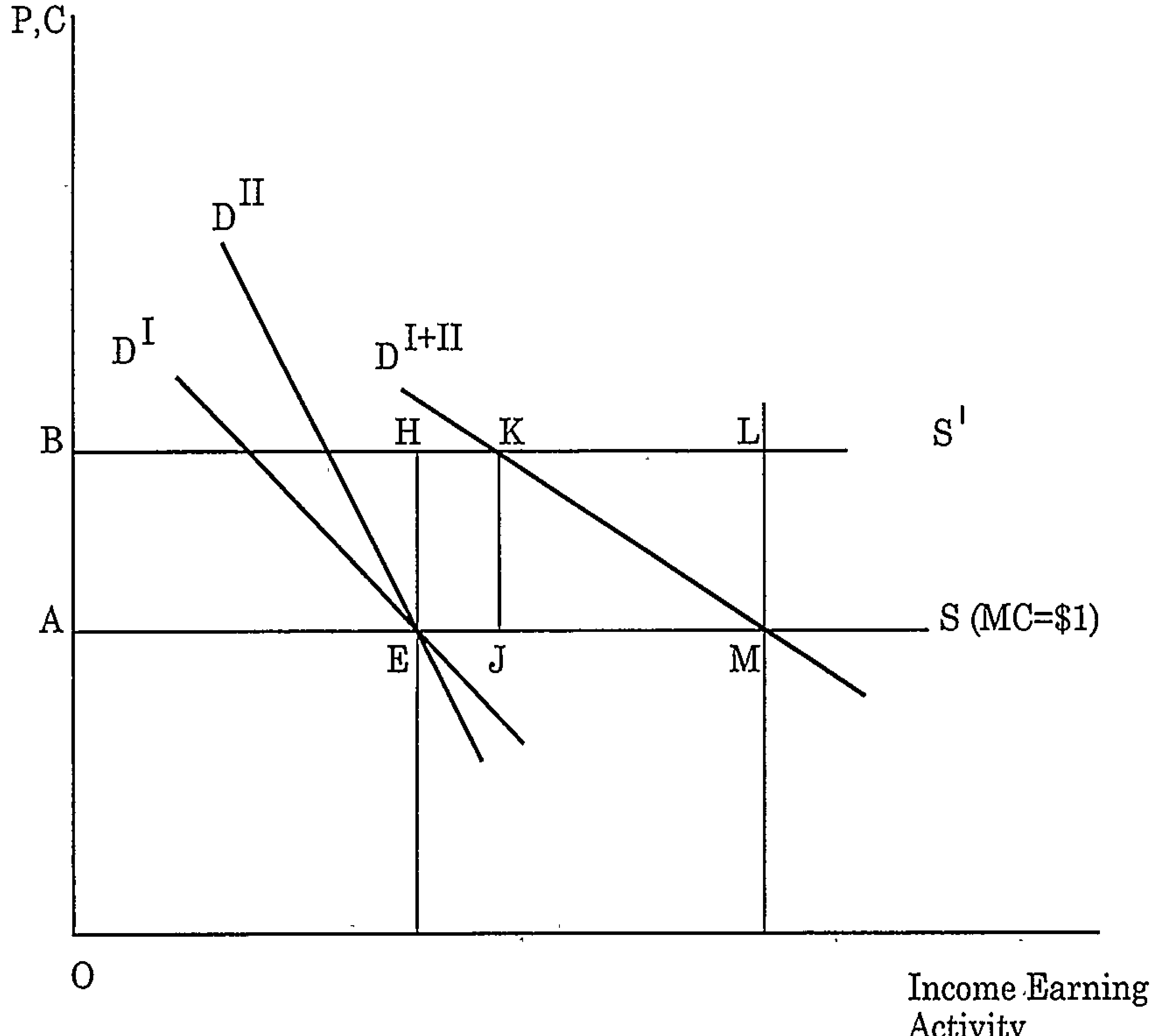

Figure 4

These political outlays would seem at best purely redistributive — and must generally increase excess burden, as increased rates must be applied to a narrower tax base if the lost revenues are to be recouped. Alternatively, government spending must be reduced, which may increase or reduce welfare losses according to whether public expenditure is initially under- or over-expanded. Setting aside the latter possibility, which will be explored further below, political tax avoidance outlays can impose deadweight losses up to, or more generally in excess of, the potential revenue loss. Even this may greatly understate the social damage, as those who stand to suffer from any resulting tax increase or expenditure cut have a corresponding — and generally somewhat greater — incentive, as a group, to lobby against the loophole. In the worst-case scenario, the total deadweight loss in the political dimension could amount to something in excess of double the revenue potentially at stake (i.e. 2ABLM).

More generally, of course, substitutability will not be perfect. Exploitation of a specific loophole, such as a tax-free fringe benefit or a tax-favoured income type or source, will seldom be painless or costless to any beneficiary group. Behavioural adjustment in the market is generally costly to individual tax avoiders and excess burdens arise. In these more general cases the incentive to invest in relevant political activity is reduced to the amount of the potential tax saving *less any associated excess burden*. In our simple setting of linear demand schedules, excess burden is half the amount of the revenue loss. For our two-person group consisting of persons I and II with demand schedules D^{I} and D^{II} as shown, the group demand schedule is represented by D^{I+II}, obtained by horizontal summation of the individual demands D^{I} and D^{II}. The collective incentive to invest in political tax avoidance activity is now represented in Figure 4 by the area of the triangle KLM, obtained by subtracting the relevant excess burden of amount JKM from the potential tax saving JKLM for the two-person group. Adding the costs of tax avoidance in the market, measured by the excess burden JKM, deadweight loss — as a result of behavioural adjustment in the market and in the political process — could amount to the area of the rectangle JKLM, the total amount of tax potentially avoidable. For other taxpayers (not represented in the diagram), the corresponding incentive to lobby against the loophole once again applies; and the total deadweight loss in the political dimension alone could exceed double the amount of the potential revenue loss (i.e. 2 JKLM), as in the case of perfect substitutability.

In a more ambitious variation on the example of political investment to create or preserve a specific loophole or concession, our two-person lobby group might alternatively seek to have the tax (of amount $\underline{t}$ = AB) on their income-earning activity completely abolished. For the general case of less-than-perfect substitutability, the potential tax saving is clearly increased as a result of this more radical strategy. The deadweight loss in this case could amount to as much as ABKJ + KLM, as compared to KLM for creation or preservation of the exploitable loophole. Total deadweight loss from tax avoidance activity — in the market *and* the political process — could amount to ABLM, and this amount is doubled, or more than doubled, when account is taken of the corresponding incentive for the rest of the community to oppose abolition of the tax.

It is, however, a basic observation that the benefits from tax avoidance tend to be clearly identifiable and concentrated on a relatively small group of potential beneficiaries, e.g. a specific industry group, that is easy to organise or may already be organised for other purposes. By comparison, the potential losses of those who stand to suffer from any resulting tax increase or expenditure cut are indirect, difficult to predict and widely dispersed across the whole community. Large numbers of small losers are accordingly involved. For the community at large, it is true that the collective incentive to oppose any loophole or targeted rate reduction must generally match — and could much exceed — the corresponding incentive for tax avoidance. At the individual level, however, the incentive to oppose avoidance tends to be relatively small, and such political opposition becomes in a technical sense a pure public good for those adversely affected. An effective response to tax avoidance through political processes must therefore pose substantial organisational problems and costs for adversely affected individuals and for the community at large.

This observation suggests that the total deadweight losses as a result of socially wasteful outlays directed towards — and more particularly *against* — tax avoidance in the public choice sense may fall well short of the maximum potential losses identified in the preceding analysis. This further category of deadweight losses remains, however, substantial and is clearly a matter of serious concern for any democratic society. These losses could well exceed the amount of any excess burden from tax avoidance in the standard economist's sense — though it is important to remember that the incentives for tax avoidance in this latter sense are much more fully, if not completely, individualised.

More importantly, the lack of financial incentive at the individual level to actively oppose tax avoidance in the political process serves to highlight problems that must be faced in the control of tax avoidance under democratic government.

Policy Implications

Policies to control tax avoidance must clearly be implemented by government, whether through the actions of the legislature, the bureaucracy or the judiciary. Political decision-making is accordingly of central importance. Even if it is accepted that standard tax policy objectives of equity, efficiency and control of tax avoidance can best be achieved in the income tax area by levying tax comprehensively and consistently on an economic income base, implementation cannot simply be taken for granted. The ups and downs of capital income tax reform, reviewed in a previous section — like the above analysis of political tax avoidance — serve to remind us that significant political obstacles must be overcome if tax avoidance is to be controlled effectively. The tax system prevailing at any time is typically the rather complex outcome of a long history of prior political activity and resultant decision-making within the relevant branches of government.

Economic modelling of political decision-making processes in modern public choice analysis strongly suggests the likelihood of inequities and inefficiencies in the tax system under democratic budgetary decision-making. The nature and extent of these "political failures", and the perspective on tax avoidance thus provided, varies quite dramatically, however, depending on the specific model under examination. Two main types of models can be distinguished in the relevant literature, demand-driven and supply-driven. In the demand-driven models political outcomes broadly reflect the expressed preferences of electors. In supply-driven models the behaviour of politicians and bureaucrats is much less constrained by voter preferences.

Demand-Driven Models

In the more "optimistic" tradition of demand-driven models, dating back to the pioneering analysis of *direct democracy* in the work of Arrow[28] and Black[29] — but, more specifically, in the analysis of *representative democracy* by Anthony Downs[30] — competition for votes is viewed as providing a significant constraint on institutional choice under majority voting systems. In the Downs model, for example, inefficiency in tax and/or spending programs is seen as exposing political parties to the risk of electoral defeat. If, as we have suggested above, the gains to tax avoiders are generally outweighed by the losses to society, policies to control tax avoidance should be election-winners.

However, information problems and organisational costs in the political process serve to blunt the impact of political competition; and majority coalitions can use the political process as an engine of redistribution to achieve sectional-interest benefits, whilst at the same time inflicting re-

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[28] KJ Arrow, *Social Choice and Individual Values* (Chicago, Wiley, 1951).
[29] D Black, *The Theory of Committees and Elections* (Cambridge, Cambridge University Press, 1958).
[30] A Downs, *An Economic Theory of Democracy* (New York, Harper & Row, 1957).

distributive externalities on minorities and on the community at large, as in the well known Tullock model.[31] Tax avoidance in the broad sense, as defined above, can therefore be pursued with some prospect of success through political processes, as sectional interest groups seek to create or preserve tax loopholes and attempt to shift the burden of taxation in their own favour. Even from the more "optimistic" perspective provided by demand-driven models of the majority-voting process, it is not therefore difficult to explain the loophole-ridden, distorting and inequitable tax systems which have prevailed over long periods in modern industrialised democracies.

If political competition under majority voting cannot be relied upon to control problems of inefficiency, inequity and tax avoidance satisfactorily, the obvious inference is that new and/or supplementary rules of a constitutional or quasi-constitutional character may be required. Since the majority voting rule serves to expose the budgetary decision-making process to distributional influences and distortions, measures calculated to limit such influences and reduce deadweight losses need to be considered. Voter-taxpayers must be encouraged to focus on long-term possibilities for achieving mutual gains rather than on short-term sectional interest or redistributional concerns.

It is a fundamental observation, stressed over decades in the public choice literature by James Buchanan,[32] that the tax system itself has a quasi-constitutional character in the sense that it remains in force, usually with only minor changes, over a sequence of budgetary decision-making periods. To the extent that this is generally understood and accepted by taxpayers and their representatives, the incentive to undertake large and socially wasteful investments in political activities for the purpose of promoting (and opposing) tax avoidance is clearly much reduced. In a well-functioning democracy major tax reform exercises are generally few and far between. Continuing and costly "rent-seeking" activities of the sort we have characterised as "tax avoidance in the public choice sense" would accordingly be perceived as largely futile and pointless by potential tax avoiders. The resulting social benefits from a stable revenue system provide an important justification for stability in the tax structure, over and above other significant advantages that are more commonly

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[31] G Tullock, Some Problems of Majority Voting (1959) 67 *Journal of Political Economy* 571.

[32] JM Buchanan, *Public Finance in Democratic Process* (Chapel Hill, University of North Carolina Press, 1967).

cited. These benefits could, however, arguably be increased by the formal adoption of a fiscal rule that major tax changes must remain in force for some minimum period of, say, ten to twenty years.

These advantages of a stable revenue structure in limiting the social costs of tax avoidance clearly apply regardless of the precise characteristics of the prevailing tax system. The analysis in earlier sections of this paper strongly suggests, however, that much can be done in the design of the income tax structure to reduce further the costs of tax avoidance. This is clearly true, as we have seen, for tax avoidance in the economic or legal sense, where the focus is on the revenue losses and associated excess burdens and inequities resulting from the market response to a given tax structure. It is, however, equally the case for tax avoidance activities in the political process.

As Buchanan[33] has once again emphasized, it is the possibilities for redistributive exploitation of minorities which positively encourage socially wasteful expenditures on lobbying and related political activity in the area of taxation, as in other areas of economic and social policy. As he suggests in a companion paper,[34] the obvious policy response to such problems in the tax area is a strong political commitment — ideally a constitutional commitment — to a tax structure of maximum uniformity in terms of base and rates. In Buchanan's view a comprehensive income tax of the Haig-Simons variety, but with a flat proportional rate structure, provides the best solution. Although there may be differences in relation to the vertical equity objective, clearly the policy requirements in terms of tax design for reducing the political costs of tax avoidance are remarkably similar to the more familiar design requirements for reducing the costs of tax avoidance in the economic sense identified above.

It is, however, one thing to identify the appropriate design characteristics of an income tax (or consumption tax) best calculated to minimise the costs of tax avoidance. It is unfortunately quite another to ensure that such a tax is actually introduced and successfully defended against tax avoidance, especially of the political or public choice variety. As we have seen, the incentives to engage in tax avoidance through the political process are rather clearly identifiable and tend to be concentrated, e.g. on a

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[33] JM Buchanan, How Can Constitutions Be Designed So That Politicians Who Seek to Serve 'Public Interests' Can Survive and Prosper? (1993) 4 *Constitutional Political Economy* 1.

[34] JM Buchanan, The Political Efficiency of General Taxation (1993) 46 *National Tax Journal* 401.

specific industry group which can easily organise for this purpose. The incentives to adopt policies to control such avoidance are, by comparison, diffused over the wider community and are rather unpredictable at the individual or interest-group level. To show that a tax structure of maximum uniformity is best calculated to reduce rent-seeking and related political costs — although it has some relevance in terms of vote-catching potential — is hardly sufficient therefore to guarantee the implementation and survival of such a tax in the practical setting of majority voting, interest-group politics and redistributive exploitation.

In an important early contribution to the public choice literature, Buchanan and Tullock[35] have explored the case for some modification of the simple majority-voting rule. Whilst remaining central to popular conceptions of political democracy, it is precisely the majority-voting rule which directly exposes the democratic budgetary process to distributional influences and distortions. As the noted Swedish economist Knut Wicksell[36] was the first to recognise, the replacement of majority voting by a unanimity requirement or minority veto could effectively prevent the redistributive exploitation of ordinary taxpayers by interest group coalitions seeking preferential treatment either on the tax or the expenditure side of the budget. In the tax area it seems clear that only a genuine efficiency-promoting tax reform could possibly satisfy this more demanding requirement.

Any significant change in an existing tax system will, however, have adverse consequences for taxpayers who have fully adjusted their affairs in response to the prevailing system. Extremely elaborate, complex, and informationally demanding compensation and grandfathering provisions will therefore be required if significant losses by important sections of the taxpaying population are to be avoided. These problems could, however, be reduced if the unanimity rule were also to be accompanied by a further fiscal rule that any major reform proposed can take effect only after a waiting period of, say, three to five years, allowing time for market adjustments on the part of affected taxpayers.[37] Complete unanimity remains, nevertheless, an extremely demanding requirement and is arguably

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[35] JM Buchanan & G Tullock, *The Calculus of Consent* (Ann Arbor, University of Michigan Press, 1962).

[36] K Wicksell, *Finanztheoretische Untersuchungen* (Jena: Gustav Fischer Verlag, 1896).

[37] M Feldstein, On the Theory of Tax Reform (1976) 6 *Journal of Public Economics* 77.

out of the question. A strong case could, however, be made for some tightening of the voting rule to require a more highly qualified majority of, say, two-thirds or three-quarters.

As it is clearly not feasible to require unanimous or near-unanimous agreement, consideration also needs to be given to other measures that could help promote more appropriate attitudes and perspectives among taxpayers, reducing the focus on redistributive exploitation and emphasising possibilities for mutual gain. It may, however, seem quite unrealistic to expect the average taxpayer or the representatives of major interest groups to behave impartially in the policy-making process. And it is certainly true that public choice models of majority-voting processes typically make no allowance whatever for the "romantic" possibility that voter-taxpayers may occasionally, or even consistently, take a more principled approach to matters of institutional reform. Such behaviour has nevertheless quite commonly been observed. And the need for a more impartial and principled approach in the tax area has been clearly recognised in the prominent role accorded to the familiar principles of equity, efficiency and simplicity, both in scholarly analysis and in public debate on tax reform issues. It has been recognised also in the prominent role commonly assigned, in major reviews of the tax system, to expert committees and Royal Commissions which can more confidently be expected to take the broader and more principled approach required.

The adoption of this more principled approach by most, if not all, of the major players in the tax reform process — demanding as it might appear — clearly provides the key to the effective implementation and survival of a tax system designed to minimise the incentives for tax avoidance in the public choice sense. And this would seem remotely possible only if measures and procedures can be identified that force taxpayers to focus on the longer-term possibilities for mutual gain rather than on the more obvious short-term considerations of sectional self-interest.

Determination of individual or sectional interest is, for example, more difficult in long-term decision-making. The requirement that a reformed tax structure must remain in force over an extended period can thus be used to encourage participants in the tax reform process to contemplate the consequences of alternative tax structures over an uncertain future in which self-interest is more difficult to determine accurately. It is indeed a basic observation that divisive matters of tax equity may be resolved by near-unanimous agreement if individuals can be persuaded to adopt the appropriate long-term or quasi-constitutional perspective.[38] It follows that understanding and acceptance of the quasi-constitutional character of the tax system — reinforced by specific budgetary rules of the type we have discussed — can help to reduce ongoing and costly rent-seeking investments in political lobbying between major tax reform exercises. More importantly in the present context, this understanding and acceptance must help to guarantee the implementation and survival of an income tax structure of maximum uniformity calculated to minimise political (and economic) tax avoidance costs over the long term.

With perhaps some modification of the simple majority-voting rule to require a more highly qualified majority — and with the introduction of budgetary rules providing that any major tax change can become effective only after a significant waiting period and must then remain in force for an extended period, say, of ten to twenty years — it seems clear that the more principled and impartial approach required for successful tax reform would be strongly encouraged. There is clearly also an important role for tax education and, relatedly, for the use of procedures such as expert tax review committees and Royal Commissions which help to highlight the quasi-constitutional character of the tax reform process and promote informed debate through the dissemination of relevant principles and objective analysis of the implications of proposed reforms.

It need not therefore be assumed, as in the hard-nosed majority-voting models of public choice analysis, that voter-taxpayers and their representatives must remain irremediably venal and incapable of behaving in a socially more productive and responsible fashion. It is indeed a fundamental observation that, without a strong measure of such "principled" behaviour, the political, fiscal and legal institutions of liberal democratic society must lack the stability necessary for their effective functioning and could not long survive. Strenuous efforts, informed by relevant education and understanding, are, however, clearly required if appropriate reforms are to be achieved in the face of the obvious incentives for redistributive exploitation.

Supply-Driven Models

The perspective on tax avoidance that emerges from public choice analysis of demand-driven models of representative democracy is thus unequivocally negative and serves to strongly reinforce the more traditional concerns and policy implications that emerge from standard eco-

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[38] Head, *supra* note 12.

nomic analysis of taxation policy. It is, however, an important characteristic of the demand-driven models that political outcomes tend to reflect, albeit imperfectly, the expressed preferences of the voters. Political tax avoidance represents in this context a pathological manifestation that must reduce social welfare and needs to be corrected by appropriate changes in political and budgetary rules and procedures.

Supply-driven models tend to be considerably more pessimistic, and the behaviour of politicians and bureaucrats is much less, if at all, constrained by voter preferences. Perhaps the best known of these models, at least in the tax literature, is the so-called Leviathan model of Brennan and Buchanan.[39] Whereas in the demand-driven models the level of public expenditure — although it is unlikely to be optimal — may be either too large or too small,[40] it is a central proposition of Leviathan models that government outlays tend to be grossly overexpanded. This argument draws some support from traditional public choice analysis of the Tullock model,[41] which over-emphasized the dangers of overexpansion; but its major thrust comes from the modelling of suppliers of public output, such as bureaucrats and public sector unions, who are assumed to favour high levels of government spending, in a setting where their behaviour is for practical purposes largely or even totally unconstrained by the forces of political competition.[42]

In the Leviathan model, the government is accordingly characterised as a revenue-maximising monopolist, and democratic governments are assumed to spend up to the limits of their revenue-raising capacity. In this setting, controlling public sector size and growth becomes a central issue in the analysis of public expenditure and taxation policy. Equal-revenue comparisons of alternative tax structures which provide the focus of modern tax policy discussion — including such matters as the excess burden issue from our previous analysis of tax avoidance in the economist's sense — are easily seen here to be of considerably less importance. And the dominant issue becomes the revenue-raising capacity of the various tax instruments, which will directly determine public sector size.

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[39] G Brennan & JM Buchanan, Towards a Tax Constitution for Leviathan (1977) 8 *Journal of Public Economics* 255; G Brennan & JM Buchanan, *The Power to Tax* (Cambridge, Cambridge University Press, 1980).

[40] RA Musgrave, Excess Bias and the Nature of Budget Growth (1985) 28 *Journal of Public Economics* 287.

[41] Tullock, *supra* note 31.

[42] See e.g., WA Niskanen, *Bureaucracy and Representative Government* (Chicago, Aldine-Atherton, 1971).

From this perspective the comprehensive income tax, which serves to minimise inequities, economic distortions and tax avoidance problems, is no longer necessarily ideal, as the maximum revenue derivable may be greatly excessive. Some appropriate narrowing of the tax base may therefore be desirable as a method of controlling excessive government spending — in spite of the resulting excess burdens, possible inequities and tax avoidance problems. The behavioural adjustments that provided the vehicle for tax avoidance and tax minimisation in our previous analysis are thus clearly to be welcomed, at least up to a point.

The perspective on tax avoidance provided by supply-driven models of democratic government is radically different from our previous analysis in the context of demand models. It should not, however, be inferred that Leviathan models can therefore be employed as an open-ended justification for tax avoidance in all its forms and manifestations. Thus, for example, in relation to the broad concept of tax avoidance in the economist's sense, it is true that some narrowing of the tax base may well be in order, but such a narrowing can only be justified if the resulting reduction in revenue-raising capacity is sufficiently predictable and leaves adequate revenues available to finance the levels of government spending which may reasonably be required. It is justified, moreover, only if less costly and inefficient methods of controlling government spending are unavailable.

The excess burdens, inequities and revenue losses resulting from tax avoidance in the economist's sense could, for example, be eliminated under the rather obvious alternative approach of imposing an upper limit on public sector size or tax revenues expressed, say, as a percentage of GDP — or a limit on the permissible rate or rates of tax.[43] With government spending controlled in this way, income taxation should clearly be designed in accordance with standard tax policy objectives to minimise inequities, excess burdens and tax avoidance problems. The case for the comprehensive income tax holds therefore without qualification. Alternatively, it might reasonably be argued that the adoption of appropriate supplementary rules and procedures in the budgetary process could provide a sufficient set of constraints. Obvious examples might include: a fiscal rule to prevent the collective provision of private goods; cost-benefit, project-evaluation and program-budgeting requirements; and the introduction of more competition on the supply or production side

[43] G Brennan, Tax Reform and Tax Limits: Political Process in Public Finance (1984) 1 *Australian Tax Forum* 83.

through more extensive use of contracting-out arrangements with private producers.

If, however, such alternative measures are not forthcoming, some narrowing of the tax base may need to be considered as a second-best approach to the Leviathan issue. Even here the basic requirement of stability in the tax structure for the control of tax avoidance in the public choice sense carries over from our analysis of demand-driven models. A strong long-term political commitment — ideally a constitutional commitment — to the appropriately modified tax base is accordingly required in order to discourage socially wasteful outlays on lobbying and related political activities. Specific concessions and gaps in the comprehensive income tax base — in familiar areas such as retirement saving, imputed rent, capital gains and non-cash fringe benefits — may be explicitly sanctioned, but these must be clearly identified and carefully circumscribed. In order to minimise resulting inequities, specific concessions and gaps in the income tax base should be chosen that are widely available and not confined to special interests and privileged groups.

There is, in conclusion, no justification in terms of the Leviathan approach for the adoption of a "relaxed attitude" to tax avoidance in any of the three senses we have identified. Clearly a loophole-ridden income tax base of the sort that prevailed in Australia during the 1970s notably fails to satisfy the relevant requirements in terms of stability and revenue predictability, since it exposes the income tax to the impact of mass-marketed paper schemes of tax avoidance with their quite unpredictable, open-ended and potentially quite devastating implications for taxation revenue. Carefully circumscribed base-narrowing measures with predictable revenue consequences, protected by well-drafted specific and general anti-avoidance provisions, represent therefore the appropriate (second-best) policy response from the Leviathan perspective. More generally, however, superior methods can surely be found to control public sector size. The flat-rate comprehensive income tax clearly dominates narrow-based and discriminatory income tax structures as an instrument for the control of tax avoidance in the public choice sense, as well as for the achievement of standard tax policy objectives of equity and neutrality, as Buchanan[44] has rightly emphasized.

[44] Buchanan, *supra* note 34.

CHAPTER 3

THE RESPONSIBILITY OF JUDGES IN INTERPRETING TAX LEGISLATION

Neil Brooks

Judges — Get Your Act Together!

Why Our Tax Laws Are Such a Mess

Our income tax laws are a mess. They are inequitable, overly complicated, avoided by the wealthy, relatively easy to evade, expensive to administer, and affect behaviour in perverse ways. Responsibility for this state of affairs is often pinned on policy analysts in government tax departments, who fail to appreciate the inexorable logic of the marketplace or the complexity of the real world; legislative drafters, who in arcane and jargon-riddled language obsessively try to cover every eventuality; special interest groups, who greedily lobby for every conceivable concession no matter how narrowly drawn; politicians, who are too ready to sacrifice tax principles for political expediency; tax lawyers, who in the single-minded pursuit of their client's self-interest assume no responsibility for the overall quality of tax legislation; and, ultimately, law and accounting professors — the shortcomings and lack of professionalism of those mentioned above is often alleged to be a testament to the poor education these hapless souls provide students of tax law. All these folks deserve some blame for the sorry state of our tax laws.

However, the people who are often not mentioned in the indictment of our tax laws, indeed who are often regarded as playing a somewhat heroic role in the tax law-making process, but in my view who are more blameworthy than any of the others for the mess we find ourselves in — even more so than tax professors — are judges. Generally, judges have simply done an abysmal job of interpreting tax legislation. Obviously, I am not referring to all judges; the craft and skill of some judges has been inspiring, however, generally, judges have not assumed their appropriate role or responsibility in the tax law-making process. And, because their role is so pivotal, the neglect of their responsibilities has made it almost impossible for the others involved in the process to compensate for it.

The Judges' Three Tasks in Tax Cases

The judges' role in interpreting tax legislation is examined in this essay. However, to place my comments in the larger context of judicial decision-making, and so that my comments might be more readily contrasted with those of other authors in this collection of essays, the judges' other tasks in tax cases will be briefly reviewed. At least heuristically, judges might be viewed as having three tasks in deciding tax cases: to give meaning to the words used in the legislation; to characterize the taxpayer's transaction for purposes of applying the tax statute; and to discourage tax avoidance by, for example, ignoring or recharacterizing a taxpayer's transaction in appropriate cases.

Giving Meaning to the Words in the Statute

A judge's first task in deciding a tax case is to give meaning to the words used in the relevant section of the legislation: there is no common law of tax. The thesis of this paper is that in discharging this responsibility judges should not attempt to determine what the legislative body meant, or intended, or what its purpose was when it enacted the legislation. Instead, their responsibility is to give a meaning to the statutory language that will lead to the most sensible tax policy result in the particular case, given the general structure of the legislation. In tax cases, judges should not act as single-minded originalist, attempting to divine the legislative meaning, intent or purpose, but instead should act as pragmatic tax analysts. The next three parts of the paper elaborate on this thesis.

Characterizing the Parties Transactions

Tax laws are not self-contained: they are applied to taxpayers' transactions based upon the legal rights and obligations the taxpayers have created in private law. Therefore, another important task of judges in tax cases is to examine the legal rights and obligations taxpayers have created and to characterize them for tax purposes. In characterizing taxpayers' transactions for tax purposes the judges' responsibility is to ensure that taxpayers are not permitted intentionally to exaggerate the divergence between taxable income as it would be determined by the measurement of economic income and taxable income as it is determined in an income tax system that must, for example, necessarily rely upon legal concepts as proxies for changes in economic income and in which income is measured only when realized. The types of situations that commonly give rise to difficulties in characterizing taxpayers' transactions might be divided into the following four broad categories.

Situations in which the legal rights and obligations taxpayers purport to have created have not in fact been created. "Shams" and "ineffectual transactions" are two concepts most courts use to describe situations in which taxpayers have not created the legal rights and obligations they purport to have created. The term sham is normally used to refer to a situation in which taxpayers have deliberately misrepresented the rights and obligations they have created; the term ineffectual transaction is used to describe a situation in which taxpayers have not created the legal rights and obligations they purport to have created due to negligence or an oversight.

The courts are unanimous that sham transactions should be ignored for tax purposes. However, they have taken somewhat divergent views with respect to ineffectual transactions. Although normally such transactions will be ignored for tax purposes, in some cases judges have been willing to give effect to taxpayers' obvious intentions with respect to a transaction even though they might not have been documented in a form that was legally enforceable.

Situations in which taxpayers have mischaracterized the legal rights and obligations they have created. A second relatively straightforward situation in terms of characterizing taxpayers' transactions is one in which they have simply mischaracterized the legal rights and obligations they have created. For example, if the parties refer to their relationship as being that of a payer and an independent contractor, but in fact they have created legal rights and obligations that might be more accurately characterized as that of an employee and employer, their legal relationship will be correctly characterized for tax purposes.

Situations in which taxpayers do not intend to enforce the legal rights and obligations they have created. This, of course, is the type of situation that arose in the classic English case, *IRC v. Duke of Westminister.*[1] In that case, the Duke was legally obliged to pay a sum to his gardener pursuant to a legal covenant (which under British tax law made it deductible), but the evidence suggested that in fact the gardener would not enforce the covenant, but would render personal services in return for the payment. The House of Lords held incorrectly that it was bound by the

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[1] [1936] A.C. 1.

form of the parties' transaction, consequently, the payments were deductible. Since in many cases, particularly if the parties have an ongoing economic relationship, the legal form of business transactions is a matter of indifference to the parties (as it was in the Duke's case), it would be impossible to administer a tax system fairly if the courts were bound by the legal form of the parties' transaction. If there is evidence that taxpayers do not intend to enforce the legal rights and obligations they have created, their economic position has not changed and neither should their tax liability.

Situations in which the legal form of the taxpayer's transaction is different than its economic substance. Parties often have a choice of legal forms to achieve the same economic consequences; for example, they can choose to fashion the conveyance of an asset for its useful life either as a sale or a lease, or they can raise capital and provide a promised rate of return and a defined degree of security using an instrument written as either a debt or an equity instrument in company law. Since tax policy distinguishes between taxpayers on the basis of their economic circumstances, courts should be free to assess them on the basis of the economic substance of their transactions.

Discouraging Tax Avoidance

If judges properly discharge their responsibility to give meaning to the statute and to characterize the taxpayer's transaction appropriately, there should be little room for tax avoidance. Nevertheless, since some tax avoidance transactions might still be possible, an additional responsibility of judges is to prevent income tax avoidance, when it is administratively feasible. In this context, a tax avoidance transaction is one that has three characteristics: (a) it results in a mismeasurement of taxpayers' economic income so that they pay less tax than they would have paid if they were taxed on their economic income (they derive a tax benefit); (b) it is engaged in by taxpayers for the sole or primary purpose of obtaining such a tax benefit; and, (c) it is not a mismeasurement of economic income that was contemplated for administrative or policy reasons by the structure of the tax legislation. There is no question that tax avoidance, as defined above, should be prevented: it leads to a misallocation of resources; it is a deadweight loss to the economy since no real activity that benefits someone is undertaken; it creates unfairness since some people are placed to take advantage of it while others are not or refuse to do so; it has adverse distributional consequences since the rich and the shrewd benefit most; and, it damages the social capital and fabric of the country. Since it is impossible to anticipate all tax avoidance opportunities when drafting legislation, judges have the ultimate responsibility of preventing tax avoidance.

Generally, judges have done an abysmal job of characterizing taxpayers' transactions and preventing tax avoidance in tax cases. Although somewhat speculative, I think the principal reason for this is that they have misperceived the fundamental nature of tax law. Judges have assumed that tax law is a form of government intervention in the more natural private ordering of our social and economic lives. Therefore, among other things, it should not override private law concepts and categories. Put another way, they have treated tax law as if it were an unjustified interference with private property, therefore, they have reasoned that it should be construed strictly (whatever that means), and tax avoidance should be tolerated since taxpayers are only acting to protect what is rightfully theirs. This is fundamentally and profoundly the wrong way to view tax law. Aside from any theory of distributive justice about what individuals ought to be entitled to, the fact is that in terms of defining entitlements tax laws are no different than rules of property and contract law.

Judges, perhaps misguided by economists, sometimes seem to operate on the assumption that there is such a thing as a self-regulating, free and neutral private marketplace and that any interference by government regulation or taxation with the property rights acquired in this marketplace is an unjustified interference with the natural order of things. In fact, of course, what is sometimes called the free market is comprised of commercial exchanges that are regulated by countless detailed and complex rules of property and contract law. None of these rules sprang from nature or were ordained by God. They are all the result of legislative outputs and were shaped by the political process. In other words, there should be nothing sacrosanct about pretax entitlements: they owe their origins not to nature but to law. Therefore, there is no reason why judges should privilege the policies that underlie the rules of property and contract law over the policies that underlie tax law. Indeed, the rules of property and contract law were often formulated in order to further highly contestable notions of public policy, and to the extent that their distributional consequences were considered they were often fashioned to favour the wealthy and powerful. Since tax laws are often formulated with the distributional consequences precisely in mind, it is reasonable to assume that the distribution of income and resources that result after-tax is widely regarded by the citizens of a democracy as presumptively more just than the pretax distribution of income.

I am not sure why the mistaken assumption that tax laws are somehow an alien intervention in the social ordering process appears to have retained such a firm grasp over the imagination of judges. Perhaps they are badly served by tax counsel. An able tax practitioner once confided that a steady diet of tax legislation does strange things to a person. In this respect, he observed, tax legislation has a lot in common with psychedelic drugs. (He was a product of the 1960s). Both tend to be habit forming. They also offer an escape from reality, and produce in people delusions of grandeur and power, followed by fits of depression and disorientation. Addicts, that is tax practitioners, he contended, get so they cannot distinguish illusion from reality.

The Paper's Outline

This paper is divided into three further parts and a conclusion. The next part briefly contrasts the approach conventionally taken by judges to statutory construction with my thesis that the judicial responsibility in interpreting an income tax statute is to elaborate on (or even adjust) the detailed provisions of the tax statute in order to ensure that, to the extent possible, they conform to a coherent model of how an income tax statute should be structured (given the broad outlines of the legislation being interpreted).

The third part traces the development, again briefly, of various theories of statutory interpretation. The point of this hop, skip and jump through legal scholarship on statutory interpretation is to clarify and support my thesis by showing how it differs from, or is similar to, past and prevailing theories of statutory interpretation. Naturally, the thesis that I propound here is not original to me. I have simply pillaged ideas that appealed to me from other more thoughtful authors. This survey will reveal where my most significant debts lie. Also, even if the reader remains unconvinced of my thesis, this survey will serve at least as an introduction to contemporary, competing theories of statutory interpretation that are having an influence in other areas of law and to the political theories that animate them. For some reason, tax law is often slow to assimilate contemporary currents of legal thought.

The final part of the paper briefly reviews a few Canadian tax cases to illustrate my thesis; namely, that the pragmatic tax analyst approach to statutory interpretation is more consistent than the approaches at present taken by the judges with democratic theory and the institutional competence of the courts and that it is more likely to further prudential goals such as certainty and rationality in the tax system.

Theoretical Soundness and Prudential Advantages of Judges Acting as Pragmatic Tax Analysts Instead of Single-minded Originalists

The mistake judges make in interpreting tax statutes is to assume that the only way to reconcile their role as unelected judges with the assumptions of majoritarian political theory is by attempting to apply an objective standard of interpretation that is anchored in statutory "plain meaning" or legislative "intent" or "purpose." They assume that when confronted with a problem in statutory interpretation they should begin (and end) by asking either: What is the plain meaning of this statutory language? What did the legislature intend when it passed this legislation? or, What is the purpose of this legislative enactment? Different judges emphasize different aspects of these approaches. In Canadian jurisprudence, there has been a general shift from plain meaning approaches to purposive approaches. However, whatever specific approach is taken, it is inevitably foundationalist: it is based on one central idea, namely, that the role of judges is to act as agents of the legislature and to resolve cases by reference to some aspect of the legislative record.

This approach to statutory interpretation is profoundly wrong. The role of judges in tax cases should be to decide what result would reflect the most sensible tax policy. Their role should be really no different than the role of tax analysts in a Treasury Department who have been asked by the Minister to clarify the meaning of the statute on an issue in dispute. Thus, the role of judges in tax cases should not involve parsing the words and phrases of the tax legislation, or attempting to decipher the legislature's true intent or purpose from the legislative debates or some other source, or, even less, trying to make sense out of some goofy old English case decided long before the development of modern tax policy analysis. Instead, it should involve the operation of the creative process inherent in tax policy analysis. It should involve three steps (1) the postulation of a range of plausible, alternative policy options for each interpretive issue; (2) a consideration of the consequences of each in terms of tax fairness, the neutrality of the tax system, administrative practicality, and other relevant evaluative criteria; and then (3) a choice among the alternatives based upon what makes the most sense in terms of tax principles (given the general structure of the tax legislation being interpreted).

This process necessarily entails an explication of the basic principles, theories and tools of analysis that are needed for a sensible, serious discussion of income tax policy. Basically, there should be no sharp distinction between tax policy and tax interpretation: between what treasury department tax analysts do in formulating tax statutes and what judges do in interpreting and applying them.

This is not to suggest that there are no differences between legislative bodies and courts. Clearly legislators and judges decide different questions. Legislators, for example, must determine, taking into account a range of political considerations, basic tax policy questions such as the appropriate tax base, the units to be taxed, the accounting period for taxation, and the rate structure to apply to the base. The tax policy analysts in the Treasury Department must then assume primary responsibility for developing the detailed rules needed to implement these basic political decisions. But once the basic structure of the legislation is in place, it is then the responsibility of judges to resolve ambiguities and fill gaps in the legislation as these ambiguities and gaps become apparent in the administration of the legislation. In doing this, to preserve the integrity of the basic political judgments made by the legislators, judges should engage in the same kind of analysis as would tax policy analysts.

Just to be clear about the import of my thesis — if a judge decides that the application of tax principles would lead to a particular conclusion in a case, the judge should reach that conclusion even though the words used in the disputed provision have not born the usage that must be imputed to them in any other context. And, this is the case not only when the words used are ambiguous or are used in a way that is over- or under-inclusive of a sensible interpretation of the section, but also when the words are specific. Indeed, the only circumstance in which judges should reach a result that they feel is not consistent with the tax policy principles underlying the structure of the legislation is in a case in which it is clear that the statute was designed to resolve the specific case in a way other than the judge thinks sensible in terms of tax policies and principles.

This suggested approach to statutory interpretation is not particularly radical.[2] No matter what one's theory about how judges should give meaning to words in a statute, in many tax cases judges have to engage in

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[2] Recently a leading Canadian international tax practitioner suggested that only by engaging in a type of pragmatic interpretive activism, similar to that advocated in this article, will courts be able to deal sensibly with such emerging issues as financial innovations in the international marketplace. See J Scott Wilkie, Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation (1995) 43 *Canadian Tax Journal* 1144.

the creative function of law making. For example, in spite of their detail, most tax statutes contain broad delegations of law-making power to a regulatory agency or the courts. By way of illustration, the Canadian income tax legislation provides that an employee has to pay tax on the value of all "benefits" received. The term benefits is undefined and there is no authority for the executive to pass regulations in order to resolve the difference between a taxable benefit and a nontaxable condition of employment. By using general language the legislature has specifically delegated law-making power to the courts to develop the detailed rules needed to fairly, neutrally, and simply define what amounts to a taxable benefit. No number of references to plain meanings or legislative intent or purposes can assist them in this task. Similarly, there is almost no guidance in the Canadian legislation for distinguishing between business and personal expenses, or between current and capital business expenses. It has been left entirely to the courts to develop the matrix of rules necessary to operationalize these distinctions. Furthermore, where there is a gap in the statute, or where the words are ambiguous or obviously over- and under- inclusive of any sensible interpretation, there is really no option but for the courts to engage in the creative process of law making. The only way, under any theory of interpretation, that they can sensibly discharge this function is by engaging in tax policy analysis. I am simply arguing that they should do so not only in these cases, but in every case.

This is not the place to review the basic principles of tax law, or the accounting, financial and economic logic that underlies it, and in terms of which judges should rationalize their decisions. However, one point bears emphasis. A conceptual distinction that is now commonplace in tax policy analysis, but has so far eluded judges almost entirely, is the distinction between technical tax provisions and tax expenditures. In interpreting a tax provision, one of the first things judges should do is resolve whether the statutory provision in issue is a technical tax provision, which should be designed as a measurement of ability to pay, or whether it is a tax expenditure, which should be designed as a programme of financial assistance for the activity involved. Suffice it to note here, to be illustrated in the discussion of a few cases in the last part of this paper, that by interpreting tax expenditure provisions as if they were technical tax provisions judges routinely make dreadful mistakes in interpretation. Technical tax provisions should be analysed using tax criteria; tax expenditures should be analysed using budgetary criteria.

A pragmatic and dynamic approach to statutory interpretation has five advantages over the conventional approach that judges apply: it is more consistent with democratic theory, it results in a more sensible specialization of functions between the legislature and the courts, it leads to more objective and determinate decisions, it allows for a system of implementation that accounts for changing circumstances, and it results in a better tax system.

More Consistent with Democratic Theory

Those who support theories of statutory interpretation that emphasize the original meaning of statutes, whether through attempting to discern their plain meaning or the intent or purpose of the legislation, frequently assert that these are the only approaches that could possibly have any legitimacy in a democracy in which the legislature is supreme. Legislative supremacy is taken to imply that statutory interpretation by unelected judges can be reconciled with representative democracy and majority rule only if judges make a good faith attempt to discern how the original legislator would have decided the case. However, aside from often simply being question begging, this argument for justifying these approaches to statutory interpretation rests upon a normatively indefensible theory of democracy.

The proponents of originalist approaches to statutory interpretation frequently commit the logical fallacy of begging the question: their conclusion simply repeats their implicit premise. They implicitly argue that in a democracy in which the majority rules, judges must necessarily attempt to determine the wishes of the majority in interpreting legislation therefore ... (essentially the same point). But why should we assume that the role of judges in a democracy is to discern the wishes of the majority by, for example, giving statutes a plain meaning. Certainly in most countries the legislature itself has never directed the courts on how they should interpret their statutes. The only reference in Canadian statutory law as to how the courts should interpret statutes is in the *Interpretation Act* which provides that "Every enactment shall be considered remedial, and shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects."[3] Now, of course, this section requires interpretation, but I would argue that it leaves the courts' role pretty well wide open for them to define as they see fit. Indeed, it would appear to direct the courts to take the very approach I am propounding, namely, that in resolving all cases they should take account of the principles underlying the legislation.

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[3] *An Act Respecting the Interpretation of Statutes*, R.S.C.1986, c. I-23, s. 11.

Although the legislature could dictate an interpretive methodology to the courts, in the absence of such a direction, except as given broadly in the *Interpretation Act*, what methodology should the courts adopt in order to further democratic values? Contrary to the assumptions underlying originalist theories of statutory interpretation, the legitimacy of democratic government does not rest, ultimately, on an unqualified majoritarianism. Instead, even in liberal theory, the moral legitimacy of government requires a commitment to the principle that government must always have public-regarding reasons for what it does.[4] Democratic governments should not act on the basis of pure power, whim or only on the self-interest of their supporters. Although they obviously have the constitutional authority to do so, they diminish their legitimacy when they do. To require the courts to carry forward the public purposes of statutes, to build upon legislative judgments in a reasoned and principled way, to justify their results in terms of public policy objectives and evaluative criteria that are widely accepted in the subject area of the statute, and to decide cases in a way that will promote a more deliberative democracy is entirely consistent with legitimate democratic government and appropriate majoritarianism.

My basic point is simply that, at the end of the day, the appropriate method of statutory interpretation is a normative question, to which even defenders of the conventional methods of statutory interpretation must respond. However, in my view, there is no question that a more pragmatic approach to statutory interpretation than at present taken by the courts would better reflect the best aspirations of our political system by, among other things, exemplifying the legitimacy of the coercive, collective power of the legislature and the judiciary, not as a brute act of a majority, but as an explicit balancing of principles that can be reasonably endorsed by all.

Parenthetically, it might be noted that the legislature frequently delegates broad policy-making powers to regulatory agencies and other arms of government and that the responsibilities that I suggest judges should assume in matters of statutory interpretation are modest by comparison. Moreover, the type of decision-making I am suggesting judges should engage in with respect to statutes is also more constrained than the kind of decision-making they exercise in common law cases. Yet no one has

[4] See generally J Rawls, *Political Liberalism* (New York, Columbia University Press, 1991).

ever suggested that judicial decision-making in common law cases is somehow undemocratic.

More Consistent with the Comparative Institutional Competence of Legislatures and Courts

Another flawed assumption underlying the conventional methods of statutory interpretation is that the doctrine of separation of powers, or some such similar doctrine, requires that the courts' function in interpreting statutes necessarily be different in kind than that of the legislature in enacting statutes. Instead of representing a separation of powers, it is more useful to view the roles of the legislature and the courts in formulating and implementing policy decisions as representing a specialization of functions Given their different institutional competencies, they simply play different roles in the policy-making process. The legislature is the dominant policy- making body, but it does not implement the policies that it formulates; that task belongs to the courts. It is now commonplace in the policy literature to acknowledge that successful implementation of policy involves a good deal of creativity, a thorough understanding of the underlying goals of the policy to be implemented, and is as important, if the objectives of the policy are to be achieved, as the formulation of policy.

Some argue that a policy-oriented approach to statutory interpretation would require the courts to formulate rules instead of simply disposing of individual cases and that the treasury department and the legislature are better able to write effective rules than the courts. This is true in some cases, but not dispositive. First, where there is a gap, ambiguity or over- or under-inclusive language in the legislation, or where the language is general, the courts must necessarily formulate rules if the case is to be resolved in a principled fashion. Second, judges are trained in problem-solving and usually have vast experience working with rules. There is reason to suppose that confronted with concrete problems that must be resolved, and unhindered by political considerations, judges often have a comparative advantage over legislatures and treasury departments in shaping coherent, efficacious and sensible rules for governing the type of situation described in the case with which they are confronted. Indeed, because of the difficulty treasury departments might have in anticipating the specific circumstances that a general rule will have to cover, it will often be desirable to leave the matrix of detailed rules needed to complement a general rule to be worked out by judges on a case-by-case basis. Third, as public choice theory underlines, there is great scope for arbitrary decision making in the legislature through agenda control and a preference for well organized and well financed special interests. Judges are sometimes in a better position to apply public values to the resolution of the cases before them because they are free from the usual political pressures and because their process of reflective thought and collegial dialogue gives them a unique opportunity to work out the implications of public values.

Another way to think about the responsibility of judges is to consider the relationship between the drafter and the interpreter of legislation. When we consider how legislation is drafted, at least three considerations would suggest that the judge, in giving the legislation meaning, should act as a pragmatic tax analyst instead of a single-minded originalist.

First, when drafters are drafting a tax provision they begin by considering the goals of the provision. They then try to formulate an approach that will achieve these goals in a way that is as equitable, neutral and simple as possible. That is, drafters begin with an overall understanding of both the problem they are dealing with and the evaluative criteria that need to be balanced. Only then do they attempt to write language that will implement these policies. In drafting the provision it is unlikely that, no matter how hard they try, they will be able to put out of their minds that larger tax policy context. Thus, in interpreting the drafted provision, judges, if they are to make sense out of it, and to be fair to the drafter, should take the same approach that the drafter did; namely, to determine the tax principles at stake and then look at the language.

Second, and a related point, any other approach makes it more difficult for the drafter to rely on the shared understandings that are critical to successful communication in any setting. All communication assumes a co-operative listener. Thus if judges do not consider the tax policy context in which tax provisions are drafted they are frustrating the tacit understanding underlying all forms of communication.

Third, originalist approaches encourage drafters to write statutes containing detailed provisions, each of which is attempted to be written in clear language that can be understood without much knowledge of the legal context. This is a silly way to write a statute. Tax statutes should be written to be communicated to tax practitioners and judges; that is, to the relevant "interpretative community" — to use a concept from modern linguistic theory. They should be written in a way that exposes the underlying principles. If the tax department wants to write to lay people it should prepare booklets for them, not attempt to educate them through legislation. Legislation is a different form of communication than textbooks or self-help pamphlets. It should be fashioned to reveal the public-regarding purposes that underlie it in order to encourage democratic deliberation. Furthermore it cannot be done effectively any other way. We have no experience that would suggest that detailed drafting gives rise to fewer interpretive problems than more general drafting.

Leads to Greater Certainty and Predictability

Which method of statutory interpretation will lead to the most certainty and predictability in applying statutes is, of course, an empirical question. However, as described above, the theories underlying originalist approaches would suggest that they are subject to a good deal of indeterminacy. Certainly, the kind of reasoning that judges often resort to in tax cases is on its face contradictory, manipulable and deductively incoherent.

Disputed cases almost always involve circumstances unanticipated by the legislature in targeting a particular problem. Therefore, the text of a statute itself will be incomplete and indeterminate. Moreover, the assumption that the majority, or even anyone, in the legislature, in the case of most tax statutes, has read the statute, let alone studied or understood its language is clearly a fiction. Tax statutes are usually so incomprehensible that even tax specialists cannot understand them without inordinate effort.

Similarly, the idea that the legislature had any intention or purpose with respect to the legislation as it applies to the kinds of cases that come before the courts is fanciful. In effect, originalist approaches are based on the assumption that legislatures are omniscient and that the purposes they had in mind anticipated all the problems that would arise and were embedded in the drafting. In fact, as public choice theorists have recently hypothesized, and as we have known forever as a matter of common sense and experience, even on issues that legislatures anticipate in passing statutes, compromises are endemic and there is frequently congeries of different and often conflicting purposes. By asserting that they can attribute intentions or purposes to legislative bodies that assist them in resolving most of the cases that come before them, judges are engaging in obvious make-believe.

Of course, no one should expect any theory of statutory interpretation to yield dispositive answers to controversial interpretive issues or to be able to completely neutralize the value and political judgments of judges. Tax policy analysis often leads to contestable conclusions even when filling the gaps in otherwise highly detailed areas of tax legislation. Nevertheless, the room for reasonable differences of opinion on the correct tax policy resolution of disputes is considerably narrower than the room for disputes over the correct determination of the plain meaning of the words in dispute, or the legislature's intention or purpose.

Allows for Changes in Values and Circumstances and Results in Greater Policy Coherence

Statutory schemes, like tax legislation, should be efficacious over time and across circumstances. The problem with all originalist approaches is that they do not permit statutes to evolve over time. A more sensible, pragmatic approach to statutory interpretation would allow judges to account for changing values and new circumstances in the application of the statute.

A final reason to prefer a pragmatic, dynamic approach to statutory interpretation, in which judges are encouraged to reach results based upon tax policy analysis, is that the very nature of tax legislation — a highly detailed and interrelated statute, enacted by different legislatures at different times and for different reasons, over a considerable period of time — means that it is inevitable that it will fail to coalesce into a coherent system. Tensions from unforeseen circumstances and unperceived conflicts are inevitable. Judges, as the final arbiters in the implementation process, should thus assume responsibility for ensuring that the legislation is as coherent as possible.

Of course, it might be argued that courts should simply allow the legislature to engage in a continuing process of reforming the legislation. However, this ignores the reality of the legislative process in which even amendments to legislation are subject to the political agenda. Moreover, if judges do not implement sensible rules, and justify their failure to do so on the grounds that the government can always default to the legislature and change the law, the attitude is fostered that tax laws and planning are largely a game in which the clever are entitled to win (witness the history of tax shelters in any jurisdiction).

Survey of Evolving Approaches to Statutory Interpretation[5]

The Rise and Fall of Originalist Approaches to Statutory Interpretation

Nineteenth Century Formalism and Conceptualism: Plain Meaning and Intentionalism

Most judges in the early twentieth century viewed statutory interpretation as a process involving the mechanical application of the plain meaning of the relevant statutory text to the interpretive problem at hand. This theory of interpretation was based on the premise that words had fixed meanings regardless of the context in which they were used and that courts could readily determine them. A slightly more sophisticated account of the role of judges in interpreting statutes that was prevalent throughout this same period was that judges were to determine how the legislature that passed the statute intended the issue before the court to be resolved. This theory allowed the court to look beyond the statutory text to other sources of original intent, such as legislative history.

The attraction of both the plain meaning and intentionalist approaches is obvious. If the legislature is the primary lawmaker and judges are its agent, then requiring courts to discover and follow the legislature's original intentions seems to further democracy by affirming the will of the elected representatives. Moreover, to the extent that judges are attempting solely to determine the intent of the legislature, they are absolved from any responsibility for the results of their decisions on their merits.

Both of these approaches were consistent with the formalism and conceptualism that characterized the judicial understanding of law in the late nineteenth century. Generally, law was perceived as being the subject of mutually exclusive and logically related categories that, when linked together into a system, comprehended the entire universe of human relations. The role of judges was to find the law, not make it.

The Demolition Job — The Legal Realists

Particularly during the 1930s, the legal realists — a group of scholars and judges who rejected the work of 19th-century judges and scholars, with their emphasis on legal logic and the purity of concepts — demolished the assumptions underlying both of these formalistic approaches to statutory interpretation. With respect to the plain meaning approach, they

[5] For an overview of these developments and citation to the extensive literature see PP Frickey, From the Big Sleep to the Big Heat: The Revival of Theory in Statutory Interpretation (1992) 77 *Minnesota Law Review* 241.

noted that statutory language is almost always ambiguous, vague, over- and under-inclusive, or so general that it cannot assist in resolving specific cases. To assert otherwise, they alleged, reflected a linguistic naïveté. All words have many usages and they take their specific meaning from their context. Thus the purported literal construction of a statute simply allowed judges to camouflage the real reasons for their decisions.

The realists launched equally withering attacks on the so-called intentionalist approach to statutory interpretation. In an influential 1930 *Harvard Law Review* article, Max Radin annihilated the foundations of intentionalism in arguing that the notion of "the lawmaker" is fictional, there is no such person; that it is entirely unrealistic to talk about the intention of a heterogeneous collectivity such as the legislature; that even if participating legislators had a common intent, there would be no reasonably verifiable means of knowing it; and, that even if something referred to as the legislative intent could be determined, it could hardly be helpful in specific cases that could not have been contemplated by the legislative body.[6]

In addition to averting to the plain meaning of the words in the statute, and the intention of the legislature, judges at the turn of the century were fond of disposing of cases involving the interpretation of statutes by relying upon one or more of the many linguistic canons of statutory construction that the courts had developed over the years. In a now classic article written in 1950, another well-known legal realist, Karl Llewellyn, inflicted irreparable damage on this approach to statutory construction.[7] He argued that it was manifest that the courts first decided how they would like to dispose of the case, for whatever reasons, and then searched among the canons for one that would justify the particular statutory interpretation their conclusion required. Among other reasons, he supported

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[6] M Radin, Statutory Interpretation (1930) 43 *Harvard Law Review* 863. The fact that legislative intent provides an incoherent anchor for a court's interpretative work has been the thesis of countless articles on statutory interpretation since Radin. For a recent example, see KA Shipsle, Congress is 'They' Not an 'It': Legislative Intent as Oxymoron (1992) 12 *International Review of Law and Economics* 359. Some have tried to rehabilitate the doctrine of legislative intent by shifting focus from the actual, supposed "subjective intent" of the legislature to a more objective concept of "manifest intent." See R Dickerson, *The Interpretation and Application of Statutes* (Boston, Little Brown, 1975) at 71-83.

[7] K Llewellyn, Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Constructed (1950) 3 *Vanderbilt Law Review* 395.

this argument by showing that for each canon there was a canon pointing in the opposite direction. In total, he found twenty-eight pairs of mutually contradictory canons of statutory construction that he culled from judges' "reasons" for their decisions. For example, the first contrasting pair was: "A statute cannot go beyond its text" and "To effect its purpose a statute may be implemented beyond its test."[8] The twelfth pair was: "If language is plain and unambiguous, it must be given effect," and "[n]ot when literal interpretation would lead to absurd or mischievous consequences or thwart manifest purpose."[9]

Although the legal realists ridiculed theories of statutory interpretation premised on formalist assumptions, they did not go on and elaborate a well thought-out alternative. Basically, they seemed to be in favour of a flexible "mischief" approach to statutory interpretation. The "mischief rule" is a form of interpretation that can be traced back to a formulation by Lord Coke in *Heydon's Case*,[10] which was decided in the sixteenth century. Basically, it suggests that judges should attempt to determine what mischief the legislature had targeted in passing the statute and then interpret the statute to attack that mischief as manifested under current circumstances.[11] In his article attacking the canons of statutory interpretation Karl Llewellyn, for example, went on to say that a statute "must be read in the light of some assumed purpose" if it is to make any sense.[12] He also claimed that decisions depended on "*the sense of the situation as seen by the court*"[13] and that "a court must strive to make sense *as a whole* out of our law *as a whole*."[14](emphasis in the original)

An Attempt at Rehabilitating Originalism — The Purposive Approach

Many American legal scholars were disturbed by the legal realist's annihilation of law, and yearned for less skepticism about judicial decision-making. Eventually, the most careful and elaborate response to their critiques emerged from a scholarly movement that become known as the le-

[8] *Id.* at 401.
[9] *Id.* at 403.
[10] *Heydon's Case* (1584) 3 Co. Rep. 72, 76 E.R. 637.
[11] See J Frank, Words and Music: Some Reflections on Statutory Interpretation (1947) 47 *Columbia Law Review* 1259.
[12] *Id.* at 400.
[13] *Id.* at 397.
[14] *Id.* at 399.

gal process school,[15] because of its emphasis on the importance of process in giving legitimacy to law. The legal process school saw law as instrumental: a form of social engineering designed to maximize human wants and solve the problems of social living. Within a liberal pluralist theory of democracy, they sought to assign functions to legal institutions based on a realistic assessment of their institutional capacities to further the social engineering of the law.

With respect to statutory interpretation, the most thorough attempt to resurrect the interpretive enterprise was undertaken by Henry Hart and Albert Sacks, both of Harvard Law School, in their brilliant teaching materials, *The Legal Process: Basic Problems in the Making and Application of Law*, first published in a tentative edition in 1958.[16] Basically, they attempted to expand on the realist's purposive theory of interpretation, but in a way that both remained faithful to the principle of legislative supremacy that underlaid intentionalism (but without the rigidity and definitional problems of intentionalism) and also that recognized the institutional advantages of the courts.

According to Hart and Sacks, "every statute must be conclusively presumed to be a purposive act." Therefore, "every statute and every document of written law developed by the decisional process has some kind of purpose or objective ... identifying that purpose and deducing the interpretation with which it is most consistent resolves interpretive ambiguities."[17] Thus their approach was based on the premises that law is a purposive activity, the legislature consists of reasonable persons pursuing purposes reasonably, meaning depends upon context, an essential part of context is purpose, and the technique of decision for a court is "a process of reasoned elaboration."

The "purposive" approach to statutory interpretation soon became the accepted theory. Judges presumably felt more comfortable with it than with the intentionalist approach since identifying broad legislative goals

[15] For an account of the relationship between realism and the legal process school, see MJ Horwitz, *The Transformation of American Law 1870-1960* (Oxford, Oxford University Press, 1992), at 169-268.

[16] HM Hart Jr. & AM Sacks, *The Legal Process: Basic Problems in the Making and Application in Law* (tent. ed.) (1958). This set of tentative teaching materials, which was used extensively in many American and even commonwealth law schools over the last 35 years, was never finished by the authors. Only in 1994, after both of the authors deaths, the tentative edition was published by Foundation Press with an introduction by William N. Eskridge Jr and Philip P. Frickey.

[17] *Id.* at 1200.

and purposes seemed less like a fiction than attempting to discover the specific intentions of legislators.

Hart and Sacks' approach reflected the optimism of the time. Their suggestion that courts should attempt to "make sense" out of regulatory statutes and treat legislators as "reasonable people acting reasonably" is a conspicuous outgrowth of the predominant political and social theories of the 1950s, which generally emphasized a growing consensus about the ends of the good life. Thus Hart and Sacks assumed that in most cases there would be some consensus about what decisions "makes sense" or were "reasonable." In this respect the "legal process" school of thought in jurisprudence, was similar to, for example, the "end-of-ideology" school of thought in political science[18] and the "consensus" school of American historiography.[19]

The Modern (and Postmodern) Attack on Originalist Approaches

Throughout the 1960s and 1970s little attention was paid to theories of statutory interpretation. The Hart and Sacks approach reigned almost unchallenged in the legal literature, and the judiciary in most common law countries slowly assimilated it.[20] Then, beginning in the early 1980s, there was a veritable explosion of writing about statutory interpretation, and although the various positions have by now been clearly staked out, the debate still rages in law journals.[21]

This current debate on statutory interpretation had its origins in the late 1960s in two sustained attacks on the legal process school, one from the right and one from the left. Although these attacks were on the legal process school more generally, eventually, they required new theories of statutory interpretation. In the 1980s, legal scholars interested in statutory interpretation responded to these challenges.

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[18] See generally D Bell, *The End of Ideology: On the Exhaustion of Political Ideas in the Fifties*, 2nd ed., (Cambridge, Harvard University Press, 1988).

[19] See P Novick, *That Noble Dream: The 'Objectivity' Question and the American Historical Association* (Cambridge, Cambridge University Press, 1988), at 281-360.

[20] In Canada, it took until 1984 for the Supreme court to endorse explicitly the purposive approach in tax cases. See *Stubart Investments Limited* v. *The Queen* (1984) 84 DTC 6305.

[21] For an exhaustive listing of the voluminous writings on statutory interpretation over the past decade, see WN Eskridge Jr. & PP Frickey, *Cases and Materials on Legislation: Statutes and the Creation of Public Policy* (St Paul, West, 1988 and 1992 supp.).

The Attack from the Right — Law and Economics

The attack on the legal process school from the right came from a group of scholars who in the late 1960s became known as the law and economics movement. As mentioned above, Hart and Sacks' theory of statutory interpretation rested upon the assumption that legislators are reasonable people who in formulating legislation reach reasonable, purposive results by following established procedures. This assumption rested firmly on pluralist democratic theory, which was dominant among political theorists in the 1950s. The mainstream political science view was that politics involved reaching compromises among competing interest groups and that this usually resulted in good policy because groups formed on all sides of important issues. One branch of the law and economics movement, public choice, directly challenged the assumption that legislatures acted in purposive ways in the furtherance of the public interest.

Public choice theorists apply economic methodology to the study of political institutions. Based upon their theories, they suggest that legislative enactments are not motivated by the public interest, but instead reflect arbitrary outcomes, private interest deals, and reelection posturing. Thus, as part of their larger attack on democratic institution, the right, by means of public choice theory, attempted to demonstrate that the democratic process was riven with parochialism, incoherence and unfairness. There are two distinct branches of public choice theory: decision theory and interest group theory.

The former indicts decision making by majority rule on the grounds that it frequently yields arbitrary and discriminatory results. It emphasizes the difficulties inherent in aggregating multiple points of view through legislation in a way that yields an intelligible preference of the collectivity. It draws inspiration from Arrow's theorem, a mathematical proof that in certain common situations majority rule cannot produce a definitive decision, and named after its Nobel Prize winning progenitor, economist Kenneth Arrow.

Public choice interest group theory sees politics not as an effort to carry out coherent or public-regarding purposes but as a battle for scarce resources among self-interested private groups in which powerful and well organized groups are likely to predominate regardless of the breadth of their constituencies. Thus it views legislative decision making as skewed toward private rent seeking and strategic voting behaviour and away from legislation enacted in the public interest.

If public choice theorists are correct, the problems with Hart and Sacks' suggestion that judges should assume that statutes result from the efforts of "reasonable persons pursuing reasonable purposes reasonably" are obvious. Indeed, to speak of a statute's purpose is incoherent, unless one means the deal struck between rent-seeking groups and reelection minded legislators.

The Attack from the Left — Critical Legal Studies

The attack on the legal process school from the left came from a group of scholars who in the early 1970s formed the critical legal studies movement. Their central claim was that the Hart and Sacks purposive approach made false claims about its neutrality. Although the purposive approach pretended to yield rules that permitted statutory interpretation to proceed in a neutral and predictable manner, in fact it simply masked liberalism's bias in favour of the market and private ordering and its incoherent oscillation between the pretense of neutrality and equal treatment and the desire to do justice in individual cases. They asserted that the process of interpreting statutes was just as political as the process of enacting them and that judicial decisions could only be justified in terms of the justness of their results. All law was politics.

The attack from the left drew its inspiration, in part, from the claims of textual and methodological indeterminacy in postmodern critical discourses including the new literary criticism, structuralism, post-structuralism, hermeneutics, and modern critical theory. Although there are subtle differences between these accounts, they all rest upon a pluralist epistemological. They all agree that everyone's perspective of the world is culturally and linguistically conditioned and that therefore meaning depends not only upon the culture and context that gave rise to the text but also upon the identity, experience and perspective of the interpreter.[22] Although similar to the critique offered by the legal realists against all forms of formalist legal thought, the critical legal studies assault on determinacy and transparency of meaning was more fundamental and sweeping.

[22] See AC Hutchinson, Identity Crises: The Politics of Interpretation (1992) 26 *New England Law Review* 1173.

Theories of the Right

As noted above, the right views statutes as the product of a deeply flawed process. What are the implications for statutory interpretation? Two prolific American legal scholars of the law and economics school — Richard Posner and Frank Easterbrook — both of whom are now respected federal court judges, each wrote a leading article in the same issue of the *Chicago Law Review* in 1983,[23] and each drew a different conclusion about the implications of public choice theory for statutory interpretation.

Richard Posner grounded his approach to statutory interpretation primarily in the lessons taught by the interest-group branch of public choice theory. While somewhat sympathetic to the Hart and Sacks approach, he felt that it gave judges too much leeway in attributing public-policy purposes to statutes. Judges, he asserted, should return to being the faithful agent of the enacting legislatures and thus enforce as closely as possible the deals struck by the legislatures. If the lines of the compromise were not clear, Posner asserted that judges should put themselves in the minds of the enacting legislatures and "imaginatively reconstruct" what the legislature would have done had it considered and resolved the issue.[24]

In his article, Frank Easterbrook drew inspiration for a new theory of statutory interpretation primarily from the "incoherent" wing of public choice. Because of factors such as strategic voting, agenda manipulation and cycling majorities, he argued that statutes will seldom if ever reflect the majority will. On this basis, Easterbrook specifically attacked Pos-

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[23] FH Easterbrook, Statutes' Domains (1983) 50 *University of Chicago Law Review* 533; RA Posner, Statutory Interpretation — in the Classroom and in the Court (1983) 50 *University of Chicago Law Review* 800. Both of these former scholars are now judges on the Court of Appeals for the Seventh Circuit, and their judicial exchanges, in which they frequently disagree with one another on matters of statutory interpretation represent some of the finest examples of the implications of competing models of statutory interpretation, particularly since Posner has adopted a more pragmatic approach.

[24] Posner, *supra* note 23, at 817-20. Posner has subsequently changed his views on statutory interpretation to reflect a more pragmatic approach. See RA Posner, *Problems of Jurisprudence* (Cambridge, Harvard University Press, 1990) at 276-78. In his recent writing, he makes a more explicit appeal to reasonableness. He argues that judges should blend appropriate use of conventional materials of judicial decision-making with an explicit focus on the consequences of adopting particular interpretations of a statute.

ner's imaginative reconstruction approach: legislatures can have no intention to reconstruct imaginatively, they have only outcomes. Based on this bleak vision of the legislative process, Easterbrook argued that the only approach a judge should take to statutory interpretation is a literal approach, basically, looking only at the plain meaning of the language itself. At the turn of the century, those who supported plain meaning approaches attempted to obscure their distrust of the legislature, and indeed, argued that this was the only method of interpretation that was consistent with the judges role as agents of the legislature. Now, those like Easterbrook who take this approach are frank in admitting their distrust of the legislative process.[25] Their public choice-influenced skepticism about how the legislative process works, and a corresponding preference for private ordering, justifies their highly literal interpretive approach.

The obvious effect of this method of interpretation is to impose a rigid requirement of specificity on legislatures. This reduces the sweep of statutory law, for it compels courts to construe narrowly laws that, for any number of reasons, do not address the particular questions of meaning that inevitably arise when statutes are applied. In effect it limits the reach of statutory law by imposing new costs and burdens on the enactment of legislation. Legislators must speak with collective clarity under this approach, for the courts will read laws no more expansively than their text unequivocally communicates. Easterbrook, for example, justifies his support for a literal approach primarily on the grounds that "a principle that statutes are inapplicable unless they either plainly supply a rule of decision or delegate the power to create such a rule is consistent with the liberal principles underlying our political order," namely, that "most social relations would be governed by private agreements, customs, and understandings, not resolved in the halls of government."[26] The approach taken by Easterbrook and others on the right is now fre-

[25] It has been suggested that another reason why the United Statues Supreme Court, for example, appears to have recently reverted to a literal approach is in order to reduce the amount of time and resources required in decision-making in complex cases and in order to encourage agreement on the Court. For example, Frederick Schauer has hypothesized that "members of a multi-member court, for cases they find less engaging, might use plain meaning as a second best coordinating device given their stipulated comparative lack of individual engagement in the outcomes and nuances of the cases, and given a stipulated desire to reach some agreement for the sake of agreement." F Schauer, The Practice and Problems of Plain Meaning: A Response to Aleinikoff and Shaw (1993) 45 *Vanderbilt Law Review* 715, at 723.

[26] *Id.* at 549.

quently referred to as the new textualism and has been taken up most energetically by Supreme Court Justice Antonin Scalia.[27]

Reclaiming the Centre

Those in the centre, who are generous in acknowledging their intellectual debt to Hart and Sacks, have attempted to rescue the foundationalist approach to statutory interpretation, in the light of criticism from the right and left, primarily by suggesting that courts ought to more explicitly acknowledge their law-making role. They argue that judges ought to more openly view themselves as engaged in a collaborative partnership with the legislature and view interpretation, while not quite politics in itself, as an important complement to politics. The court's role, based upon the relative institutional advantages that courts have over legislatures, should be to improve legislative outcomes. The structural advantages of courts that support such a role includes the ability to consider carefully the consequences of adopting competing interpretations, the effect of post-enactment developments, the ability to weigh unforeseen issues, and the ability to unearth important principles that might lie beneath a complex statutory instrument. Thus, by being more frank about their law-making role and complementing the legislature's role, given the institutional competencies of courts and the unique abilities of judges, judges can substantially improve the overall statutory product. On this view, then, the democratic legitimacy of the court is rooted in its ability to complement politics in a way that improves the functioning and quality of legislative lawmaking and so enhance democracy. Unlike that derived from public choice theory, the critique of pluralist democracy implicit in this theory of statutory interpretation is essentially a structural one.

Three authors bridge Hart and Sacks and more recent centrists: Reed Dickerson, Willard Hurst and Guido Calabresi. Reed Dickerson, a leading American draftsperson and academic, published a wonderful, but sadly underrated, book on statutory interpretation in 1975.[28] His central thesis is that in working with statutes there is an analytic dichotomy between the cognitive and the creative function that should be sharply drawn in practice. The cognitive function is the search for the statute's true meaning: "the meaning carried by [the] language when it is read in its proper context by a typical member of the audience to which it is ad-

[27] See A Scalia, The Rule of Law as a Law of Rules (1989) 56 *University Chicago Law Review* 1175.
[28] See Dickerson, *supra* note 6.

dressed."[29] When the search for meaning leads the court to conclude that a true meaning cannot be found, or, if found, does not resolve the issue, the court must engage in the creative function and judicially assign a meaning. The creative function is law making, not interpretation. Common situations in which judges have to engage in the creative function of law making, Dickerson asserts, include:[30] when the statutory rule is so general that sustaining the court's decision calls for a smaller-mesh network of legal concepts than the statute provides; when the statute remains ambiguous or vague even after the resources of meaning have been exhausted; when the situation in question falls outside the meaning of the statute and within its manifest purpose; and, when the statutes most plausible reading would lead to a result that is harsh, unfair, or otherwise undesirable.

In a book written in 1982, Willard Hurst, a well known American legal historian, justified loosening the reins of foundationalist theories based upon his appraisal of the comparative institutional characteristics of courts and legislators.[31] He emphasized structural qualities of the legislature that limit its ability unilaterally to create effective statutes and a coherent body of law, such as the fact that legislators typically react only to strong pressure and visit policy problems only piecemeal. Hurst, takes these problems to be "realities" for which the court can and should compensate in its interpretive methodology.

Guido Calabresi also published a book that dealt with statutory interpretation in 1982.[32] One of his main points was that a court should feel empowered to declare a law "obsolete" if it finds a statute "out of phase with the whole legal framework".[33] For Calabresi, this authority represents a sound allocation of the "burden of inertia" in relation to outdated statutes, which he argues have only a weak claim to contemporary majority support. Reviews of this kind would enable judges to increase the overall coherence of the "legal landscape."

The leading contemporary expositor of the centrist or complementarian view of statutory interpretation — the view that a partnership between

[29] *Id.* at 286.
[30] *Id.* at 238-39.
[31] W Hurst, *Dealing with Statutes* (New York, Columbia University Press, 1982) at 52.
[32] G Calabresi, *A Common Law for the Age of Statutes* (Cambridge, Harvard University Press, 1982).
[33] *Id.* at 164.

legislators and judges can make each statute the "best it can be" — is Ronald Dworkin.[34] Dworkin sees the judge's role as one of a collaborator with the legislature and one in which the judge continues to develop, in what the judge believes is the best way, the statutory scheme the legislature enacted.[35] Thus, the courts should interpret statutes in accordance with the best principle that can be brought forward in support of what the legislature has done. The judge should ask, "What coherent system of political convictions would best justify what [the legislature] has done?"[36] The judge then should find and apply to disputed issues of interpretation "the best justification...of a past legislative action."[37] He analogises the role of the legislature and courts to that of successive, institutional co-authors in a chain novel. Dworkin suggests that although 'textual integrity' requires judges to consider the clear import of words, the overriding judicial obligation is to ensure that statutes fit into coherent schemes of principle and meet the higher-order democratic principles of political integrity, fairness and procedural due process.[38]

Dworkin argues that in interpreting statutes judges must rely upon their own judgment not because he thinks their opinions are automatically right, but because "no one can properly answer any question except by relying at the deepest level on what he himself believes."[39] However, Dworkin is at pains to emphasize that judges in reading a statute are not to reach what they believe is the best substantive result, but rather must construct what they believe is the best justification for the legislative enactment. That is, he expressly disavows the kind of consequentialism that would permit judges to choose freely "the best substantive result" and instead argues that judges must "find the best justification he can of a past legislative event."[40]

Theories of the Left

It is difficult to draw a clear line between some of those who might be classified as on the left in issues of statutory interpretation and some of those in the centre, and to the extent it clarifies thinking about statutory interpretation to classify a group of commentators as being on the left,

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[34] R Dworkin, *Law's Empire* (Cambridge, Belknap, 1986) at 342.
[35] *Id.* at 313.
[36] *Id.* at 335.
[37] *Id.* at 338.
[38] *Id.* at 164-67.
[39] *Id.* at 313-14.
[40] *Id.* at 313.

there are clearly radically different camps on the left, as there are among those on the right. However, compared to those in the centre, those who might be classified as being on the left are more likely to be sceptical of any foundationalist account of statutory interpretation; more concerned about textual indeterminacy; more likely to see judges as free to reach decision based upon the correct substantive result; more distrustful of the democratic elitism that they see as implied in the centralist position, particularly that of Dworkin;[41] their politics are more likely to be rooted in politics other than liberal pluralism, whether civic republicanism, which stresses the value of deliberation in democracy, or more radical politics such as critical theories of feminism, critical race theory, and strains of postmodernism; and, they are more likely to view statutory interpretation as an instrument that should be used explicitly to correct the pathologies of the regulatory state, further democratic values, and assist in progressive social transformation by furthering political and cultural equality and inclusion.

In one notable camp on the left, William Eskridge, Daniel Farber, and Philip Frickey are leading exponents of what is commonly referred to as the new pragmatism in statutory interpretation. Over the last decade they have published a flood of articles expounding the virtues of "practical reasoning" in statutory interpretation. William Eskridge has consolidated much of this learning in a recent text, *Dynamic Statutory Interpretation*.[42] They argue against all foundational or grand theory approaches to statutory interpretation, that is, all approaches that purport to identify a single primary legitimate source of interpretation, for example, the statutory text or legislative intent. Instead, they urge judges to use practical reasoning in interpreting statutes.

While their approach has a good deal of subtleties, a quotation from an article by William Eskridge and Philip Frickey gives a sense of what a practical reasoning approach involves:

> The positive metaphors of our analysis — the web of beliefs idea, the cable-versus-chain contrast, and the hermeneutical circle — suggest the contours of a practical reasoning model of statutory interpretation that roughly captures the Court's practice. Our model holds that an inter-

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[41] See AC Hutchinson, Indiana Dworkin and Law's Empire (1986) 96 *Yale Law Review* 637, 659-53, 654-56, 660-62 (reviewing Ronald Dworkin's book, *Law's Empire*).

[42] WN Eskridge, *Dynamic Statutory Interpretation* (Cambridge, Harvard University Press, 1994).

> preter will look at a broad range of evidence — text, historical evidence, and the text's evolution — and thus form a preliminary view of the statute. The interpreter then develops that preliminary view by testing various possible interpretations against the multiple criteria of fidelity to text, historical accuracy, and conformity to contemporary circumstances and values. Each criterion is relevant, yet none necessarily trumps the other. Thus while an apparently clear text, for example, will create insuperable doubts for a contrary interpretation if other evidence reinforces it...an apparently clear test may yield if other considerations cut against it...[43]

A slightly different theory of statutory interpretation from what might be described as reflecting a left point of view has been expounded by Cass Sunstein.[44] Like the centrists, he has attempted to develop principles of statutory interpretation that will improve the performance of modern government, but instead of being based on a liberal model of government, the principles of statutory interpretation that he expounds are based upon a civic republicanism model of government. Thus he wants to formulate and defend principles that will serve the purposes of deliberative government and, in particular, will alleviate rather than aggravate the defects in modern regulatory programs. Like Eskridge and the pragmatists, he argues that statutory interpretation should not be limited to considerations of text and historical context, but should also incorporate evolving views of public policy. But unlike the pragmatists, who stress case-by- case analysis, and a sensitivity to a multiplicity of factors, he believes that "dynamic interpretation" should be systematic rather than ad hoc.

In order to realise his republican vision in statutory interpretation, he has developed an extensive, detailed and rank-ordered catalogue of interpretive principles that instead of being based upon linguistic concerns, as were the previous canons of statutory interpretation, are based on substantive constitutional and institutional concerns. Consequently, he links his canons to objectives like promoting public deliberation, protecting traditionally disadvantaged groups, and minimizing naked interest-group transfers. Prominent in his republican canon of canons are principles designed to vindicate under-enforced constitutional norms, to construe aggressively statutes that protect disadvantaged groups, to construe

[43] WN Eskridge Jr. & PP Frickey, Statutory Interpretation as Practical Reasoning (1990) 42 *Stanford Law Review* 321, at 352.

[44] CR Sunstein, Interpreting Statutes in the Regulatory State (1989) 103 *Harvard Law Review* 405.

narrowly statutes that benefit powerful interest groups, to promote welfare and hearing rights, and to self-consciously counteract statutory failure. His canons are basically aimed at the pathologies of regulation. Some are aimed at over-regulation, such as a canon favouring de minimis exceptions to regulations. Others seek to extend regulation further, such as the canon requiring broad interpretation of statutes protecting disadvantaged groups. Such canons, Sunstein believes, will promote uniformity and efficiency in statutory interpretation, and will also improve social welfare generally.

For those on the far left, the claim of textual indeterminacy, where all meaning is inextricably linked to identity, experience, and relationship to the interpreter, would appear to foreclose any systematic theory of statutory interpretation. Presumably, they would argue that judicial interpreters of statutes should self-consciously attempt to make laws available to more democratic appropriation, by infusing their enterprise with the perspectives of the oppressed, silenced and marginalized.

Cases Illustrating the Differences between Originalist and Pragmatic Approaches

The point of this brief review of a few randomly selected Canadian cases is simply to reveal the indeterminacy and irrationality of originalist approaches and the feasibility and coherence of a more pragmatic tax analytic approach. The few cases discussed in this part should not be taken as a comprehensive evaluation of the points in question or the kinds of arguments a pragmatic approach would endorse. However, they should be sufficient to illustrate the salient differences between originalist and pragmatic approaches.

The Fallacy of the Transplanted Category

In the Canadian income tax legislation, a number of provisions draw a distinction between a taxpayer earning income from employment and one earning income from business. In interpreting these provisions, like many other areas of tax law, the courts have committed what has been called the logical fallacy of the transplanted category. That is, what they have done in interpreting these provisions is looked to other areas of law where the concept of employee is used and simply transplanted the understanding of the concept from those areas into tax law.[45] This makes no

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[45] The cases are legion. For citations, see V Krishna, *The Fundamentals of Canadian Income Tax*, 5th ed, (Toronto, Carswell, 1995) at 187ff.

sense. In tort law, for example, the concept of employee has been used to limit the vicarious liability of payers. For this purpose, in the nineteenth century the courts developed what is commonly called the control test. In the context of limiting the vicarious liability of payers that test made some sense. If the payer controlled the work of the payee, both as a matter of fairness and as a matter of providing incentives for avoiding accidents, it made sense to limit the liability of payers to situations where they controlled the work of the employee. Then as notions of who should be liable for accidents caused by business changed, and as the notion of control as applied to the employees of large industrial undertakings clearly lost its original meaning, the courts in this area began expanding the test to include a specific result, an integrated part of the business, and an economic reality test. But who would have thought that any of these tests, which were developed to limit vicarious liability in tort law, would serve a useful tax policy purpose? Yet, in interpreting the concept of employee where it is used in tax law, the courts have simply relied upon these tests.

Four points might be made about this example of judicial tax interpretation. First, in tax law judges often seem to forget what we all know as a matter of common sense and experience, namely that one word can have countless usages. In tax law they routinely commit the one-word, one-meaning fallacy.

Second, in tort law, over the years the judges changed dramatically the concept of employee in order to account for changing values and circumstances. Why shouldn't we expect them to do the same thing when interpreting a statute? Indeed, somewhat ironically, in this particular area of tax law judges did interpret the concept of employee dynamically, but for reasons related to tort law considerations not tax law considerations. The concept of employee was used in the first income tax legislation in Canada in 1917. At that time, in tort law, the control test predominated. In tax law, this test was used exclusively by the courts until the early 1970s. Then some enterprising lawyer in the tax department must have noticed that the courts in tort law had adopted a battery of tests for determining who was an employee. These concepts of employee were consequently incorporated into the tax cases about this time. Thus, the courts were in fact construing the tax law dynamically, but based upon changing circumstances and values in the area of tort law!

Thirdly, there are numerous cases each year in Canada on the distinction between employees and independent contractors. Because of the application of these four tests the results are absolutely indeterminant. The judges can emphasize one test over the other, or apply them slightly differently and find everyone or no one to be an employee. The system only works because judges have an unarticulated sense about why they are making the distinction for tax purposes and therefore do not reach completely absurd results.

Fourth, instead of searching through tort law (or labour law) jurisprudence to discover the usage of the concept of employee in those areas, a judge deciding a tax case should attempt to give the concept a meaning that makes sense in terms of the tax principles that the legislature was attempting to further. For example, in Canadian tax law, employees are distinguished from self-employed taxpayers for four principal reasons: generally employees cannot deduct expenses incurred in earning their employment income; employees can report their income on a cash basis; employees have tax withheld at source; and, employees have to report their income on a calendar year basis, while (until recently) independent contractors have been able to report their income on a fiscal year basis. The courts could have easily developed tests for distinguishing between employees and independent contractors that would be anchored in the tax reasons for making the distinction.

Making Nonsense of the Tax Legislation

The facts of a relatively recent Supreme Court of Canada case[46] were that the taxpayer was employed by a life insurance company as a research assistant. She received the sum of $300 from her employer as an award for passing three life insurance courses that she had taken voluntarily on her own time. There were three issues in the case: (1) whether the employee had received this benefit "by virtue of her employment" and thus was taxable on it as employment income; (2) whether it was also taxable under a provision of the *Act* that taxed prizes "in fields of endeavour ordinarily carried on by the taxpayer," for which there was a $500 exemption and (3) if it was taxable under both charging sections, which took precedence? The Court got the first issue correct but by purporting to take a literal approach to the statute in resolving the latter two issues it made nonsense out of the structure of the legislation.

On the issue of whether the taxpayer had received the amount by virtue of her employment the Court carried on for pages and pages, citing a whole string of old English cases for and against the taxpayer, and even-

[46] *The Queen v. Savage* (1983) 83 DTC 5409.

tually correctly held for the Minister of National Revenue. The case should have been disposed of in a single paragraph. A tax policy analyst would have simply noted that there are two conceivable tests for determining whether or not an amount is received by virtue of employment: a test that asks whether or not the amount was received directly in return "for employment services" (this is the test propounded in numerous old English cases and which the Court of Appeal in this case applied in deciding in favour of the taxpayer); and a "but for" test, that is, a test that asks whether or not the taxpayer would have received the amount "but for" her employment. The only sensible way of choosing between these two tests is to ask which makes the most sense in terms of tax policy criteria. For reasons too obvious to even review, the "but for" test is more equitable, less likely to influence the compensation package offered employees, and simpler to administer.

On the second issue, the Court held that the amount was also received as a prize "in a field of endeavour ordinarily carried on by the taxpayer." Here the court purported to apply the plain meaning of this phrase. This is a good illustration of the indeterminacy of the plain meaning approach. I would have thought it was fairly obvious that it would be incorrect to say as a matter of ordinary usage that taking an insurance course was "a field of endeavour ordinarily carried on" by the taxpayer in this case. But more importantly, in terms of making sense of the structure of the legislation, what would be the sense of taxing some employment benefits under one section of the *Act,* but if the benefits could be characterized as a prize taxing them under another and providing a $500 exemption? The court seemed to think that if the section dealing with prizes did not cover this taxpayer it would be superfluous. But the obvious persons the prize section should be designed to catch is taxpayers carrying on businesses, like authors, who win a prize for, say, best novel for the year. The authors might argue that since they were not in the business of winning prizes the prize should not be taxed. The section is needed to cover this case. It was not needed to cover the case of employees winning prizes from their employers.

Then, in the silliest part of their judgment, the Court held that since the prize was potentially taxable under both sections, the more specific charging section, the prize section, should govern. Thus the taxpayer was entitled to claim the $500 exemption, making her prize not taxable. If a first year tax analyst in the treasury department made a mistake like this they would be fired. What this holding did, of course, was invite every employer to pay up to $500 of remuneration every year in the form of a prize. What was the Supreme Court thinking? Naturally, the department had to immediately amend the *Act*.

Distinguishing Tax from Tax Expenditure Provisions

Judges taking originalist approaches to statutory interpretation have often reached absurd results or have had to engage in tortuous reasoning to reach the correct result, because they have failed to distinguish between tax and tax expenditure provisions. In interpreting a tax provision, the first thing judges have to decide, or should decide, is whether they are interpreting a technical tax provision, the basic purpose of which is the accurate measurement of the taxpayer's income, or whether they are interpreting a tax expenditure provision, the basic purpose of which is to provide financial assistance to encourage taxpayers to engage in particular kinds of defined activity and thus further some social or economic goal of the government. Different criteria apply in making sense out of each type of provision.

Again, while any one of dozens of cases could be used to show how badly judges have mucked it up because they do not seem to understand the basic conceptual distinction between tax and spending provisions, a case from the Federal Court of Appeal and one from the Supreme Court will be used to show how comical judge's reasons can be because they fail to appreciate this basic distinction.

The Canadian tax legislation provides that when taxpayers die "amounts of which when realized or disposed of would have been included in computing (their) income" have to be included in their income. These amounts are commonly called "rights or things." This section has been taken to apply to, for example, amounts that are receivable but have not been received by the taxpayer in the year of death, and the inventory of a cash-basis taxpayer. This section is clearly part of the technical tax system. It is one of a number of provisions in the legislation the purpose of which is to equate cash-basis taxpayers with accrual-basis taxpayers in the taxpayer's year of death. Then, since these are amounts that if the taxpayer had lived might not have been included in income in that year, the legislation allows an election to reduce the bunching effect in the year of death. The taxpayer's legal representative can elect to rollover these rights or things to a beneficiary and that beneficiary will be taxed on them when they are received.

In *Lamash*,[47] the taxpayer's legal representative argued that in the year of taxpayer's death the proceeds in the taxpayer's Registered Retirement Savings Plan (RRSP) should be entitled to be treated as a "right or thing" and an election made to tax them in the hands of the beneficiary when received. In Canada, as part of a comprehensive, matching-grant scheme to encourage taxpayers to save privately for their own retirement, the government has provided for a tax vehicle (RRSPs) that if people contribute to, within limits, they can obtain a tax deduction. The investment income that is earned in the plan is not taxed. When the proceeds are withdrawn after the taxpayer retires they can be rolled into an annuity.

There is a provision in the legislation that provides that when taxpayers die they are deemed to have disposed of the assets in their RRSPs at their fair market value and the amount must be included in their income in the year of death. In this case, the taxpayer's legal representative argued that the proceeds in the taxpayer's RRSP should be treated as a "right or thing" and therefore qualify for the rollover to a beneficiary and be taxed in the beneficiary's hands. The Court held that the rollover was not available but they tied themselves in knots reaching that result because the definition of "rights or things" on its face seemed broad enough to include RRSP proceeds. I will not go through their tortuous reasoning, but the fact is that if the court had interpreted the provisions dealing with RRSPs as spending provisions, which they are, and applied a pragmatic approach in interpreting them, the resolution of the case would have been simple. The tax deduction for contributions to RRSPs is a subsidy to encourage people to save for their retirement. Given this purpose, when a taxpayer dies the subsidy should obviously come to an end. Period.

The need to interpret tax expenditure provisions using spending criteria instead of tax criteria can also be illustrated by reference to a Supreme Court of Canada case. In *Gagnon*[48] the taxpayer paid $660 per month to his former wife pursuant to a divorce decree. Of this amount, the wife was obliged under the agreement to pay $360 for mortgage payments and property taxes on her residence. Under the Canadian *Income Tax Act*, alimony payments are deductible by the payer and have to do be included in the income of the payee if, among other things, they are in the form of an "allowance." The tax department, and lower courts, had always held an "allowance" was a payment that was unconditional, that is, an amount the recipient could not be required to expend in a particular way.

[47] *Lamash (L.) Estate* v. *MNR* (1991) 91 DTC 9.
[48] *Gagnon v. The Queen* (1986) 86 DTC 6179.

In this case, the Supreme Court held that the concept of an "allowance," as used in this section, included any payment that was for the benefit of the recipient spouse and therefore the payer could deduct the $360 that the recipient spouse had to use as a mortgage payment and the payee had to include it in her income. The fundamental error the court made in interpreting this section is that they treated the section as an income measurement provision, instead of a tax expenditure. The Court referred to a number of cases which had held that an amount could be income to a taxpayer if the taxpayer benefitted from the amount, even though the taxpayer did not have complete control over how the amount was used. The Court concluded: "...for an amount to be an allowance ... the recipient must be able to do dispose of it completely for his own benefit, regardless of the restrictions imposed on him as to the way in which he disposes of it and benefits from it."

But, of course, in the context of this provision, to determine whether the payer should get a tax deduction and the payee an income inclusion by reference to whether the amount is income in terms of tax principles makes no sense. No one has ever argued (so far as I am aware) that the treatment of alimony in the Canadian tax system was fashioned because of a concern about tax justice. It was placed in the *Act* in the early 1940s in order to provide relieve for high income taxpayers who saw their marginal income tax rates raise dramatically during the War and who were having difficulty meeting previous alimony commitments out of after-tax income. More recently it has been justified on the ground that it encourages payers to meet their alimony obligations, or on the ground that it provides a subsidy for single custodial parents (on the assumption that the payer's tax bracket is greater than the payee's and that part of the overall tax savings are passed on to the payee). Thus it is almost laughable that the Supreme Court would spend about a dozen pages agonizing over the circumstances under which an alimony payment should be treated as income for tax purposes when they were interpreting a subsidy provision that has nothing to do with tax justice. (The legislature immediately amended the *Act* to overturn the result in this case.)

The Limits and Promise of Pragmatic Tax Analysis

The results reached by all forms of complex decision-making are contestable. They are inevitably laden with idiosyncratic conceptualizations, contestable value judgments, and disputable empirical assumptions. A more pragmatic and analytic approach to interpreting tax legislation will not replace the need for judgment. There is no sensible method of adjudication which is separable from political argument in general. However, such an approach will, first, lead to the furtherance of democratic values. In reaching decisions that affect us all, political actors, like judges, should not be permitted to obscure their empirical judgments or conceal their normative choices from public scrutiny. It is an abuse of their power for them to attempt to present their decisions as dictated by the ordinary usage of words or some obscure canon of statutory construction.

Second, such an approach will allow judges to more fully realize their institutional role in the legislative process. Courts were not established to be housed by critics, commentators, observers or audiences of the legislative body. The institutional role of judges requires them to be engaged in a cooperative law-making enterprise with legislatures. Particularly in modern administrative states, it is imperative that they accept their role as active participants in the implementation of statutory governance. Third, if judges took a more policy-oriented approach to statutory interpretation tax laws could be applied with greater certainty and more predictability. Finally, requiring judges to justify their decisions in terms of the tax policy goals and principles underlying the tax legislation will contribute to a fairer, simpler and more rational tax system.

CHAPTER 4

JUDICIAL INTERPRETATION AND THE ROLE OF ANTI-ABUSE PROVISIONS IN TAX LAW

Frans Vanistendael

Introduction: The Distinction Between Tax Avoidance and Tax Evsion

In practically all developed tax systems, a distinction is made between tax evasion and tax avoidance. Tax evasion or tax fraud[1] is an offence against the tax laws that is punishable by criminal sanctions. It consists of clear violations of the tax laws, such as fabricating false accounts or other false documents, keeping parallel accounts, not reporting income, or smuggling or dissimulating goods or assets. The tax consequences of these acts can of course be corrected by the tax administration, but in addition they are liable to criminal sanctions. The statutory measures taken to combat such violations of the tax law generally are not considered to be anti-avoidance measures.

Tax avoidance, on the other hand, comprises actions by a taxpayer to reduce a tax burden that do not constitute a criminal offence. The distinction between legal tax avoidance and illegal tax evasion is critical, because particularly non-lawyers are sometimes inclined to put both phenomena on the same footing. Such similar treatment may be justified in an economic or moral context, but is basically wrong in the legal context of administration and implementation of tax law. Usually a distinction is also made by tax lawyers between tax avoidance in the legal sense and tax reduction by behaviour modification such as reducing consumption of products subject to higher taxes such as tobacco products or alcohol (not smoking tobacco or not drinking alcoholic beverages) or not earning certain types of income. This factual avoidance of the tax burden

[1] In order to avoid any confusion in terminology, it should be noted that "tax evasion" is translated in France as *fraude fiscale* and in German as *Steuerhinterziehung*, whereas "tax avoidance" is respectively translated as *évasion fiscale* and *Steuerumgehung*.

is considered perfectly legal and is not subject to statutory anti-avoidance measures.[2] The tax avoidance that is considered problematic typically occurs when factual situations are moulded in legal forms that bear less tax than would alternative legal forms.

Such behaviour is perfectly legal, because most countries recognise the right of the taxpayer to arrange his affairs in such a way as to pay less tax.[3] A lesser tax burden may result from a legal construction or transaction that uses a gap or a loophole in the law to place the taxpayer outside the reach of a charging provision or within the scope of a statutory provision providing for a lesser tax burden, or from use of a legal construction or transaction to which the tax law attaches a lesser tax liability than it does to another legal construction or transaction with very similar factual results. It is clear that on the basis of considerations of economic efficiency and fiscal justice a taxpayer should not be able to use legal constructions or transactions to avoid similar situations being subjected to the same tax burden.

The question is whether ensuring this does not happen is a task for the courts or for the legislators. The arguments against the courts doing this job are largely based on the principle of legality and the role of the courts

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2 In German and Dutch, there exists specific terminology to define this behaviour as *Steuervermeidung* or *Belastingbesparing.*

3 For the United Kingdom, see *Commissioners of Inland Revenue v. Duke of Westminster* (1936) 1 AC 19 where Lord Tomlin said, "[e]very 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." For the United States, see *Gregory v. Helvering* (1934) 69 F.2d 809, at 810, where Learned Hand J. said, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." For Australia, see *Jaques v. Federal Commissioner of Taxation* (1924) 34 C.L.R. 328, at 362 where Starke J. wrote, "[t]here is nothing wrong in companies and shareholders entering, if they can, into transactions for the purpose of avoiding, or relieving them of taxation..." For Belgium, Judgment of June 6, 1961, Cour de Cassation, 1961 Pas. Bel. I 1082, at 1089, "[a]ttendu, d'autre part, qu'il n'y a ni simulation prohibée à l'égard du fisc, ni partant fraude fiscale, lorsque, en vue de bénéficier d'un régime fiscal plus favorable, les parties, usant de la liberté des conventions, sans toutefois violer aucune obligation légale, établissent des actes dont elles acceptent toutes les conséquences, même si la forme qu'elles leur donnent n'est pas la plus normale" (considering on the one hand that there is neither an illegal sham transaction, nor tax evasion, when the parties, making use of their freedom to contract, in order to benefit from a more favourable tax regime, engage in transactions of which they accept all the consequences, even when the form of the transactions is not the most common, and provided that they do not violate any legal obligation).

vis-à-vis the legislator.[4] The doctrine of the separation of powers holds that it is not for the judiciary to legislate. Therefore, when the clear wording of the tax law fails to tax certain situations, thereby leaving gaps and loopholes, the courts will shy away from imposing a tax when there is no formal legal basis for doing so even when reasonably and as a matter of tax policy these situations should be taxed. Strangely enough, the same courts will fill up the gaps and loopholes left by the legislator in other areas of the law. The explanation for this distinction is often an explicit or implicit constitutional provision or quasi-constitutional constraint that limits the state's authority to tax in a similar way as its authority to impose criminal penalties is limited: there is to be no tax imposed unless the government has the legal power to impose it. This constraint suggests effective implementation of the tax law is possible only with an all-knowing and infallible legislator, which does not exist in reality.

Courts in many jurisdictions will allow the tax administration to recharacterise a legal construction or transaction to extend the reach of the tax law to legal constructions and transactions having a factual effect similar to situations subject to a heavier tax, provided it can show that the legal elements for recharacterisation exist, but will refuse a recharacterisation for tax purposes when only a similarity in fact exists. This approach is based on the dichotomy between substance and form. The attitude of the courts again presupposes that the tax consequences attached to each legal construction or transaction are the intended tax results for the underlying factual situations covered by such constructions or transactions. In other words, their approach presupposes an infallible inner consistency of the law so that each legal form is always the adequate translation of the un-

[4] In Australia, Barwick, C.J., who is considered the principal architect of the Australian High Court's doctrine followed in the 1970s of applying a strict interpretation of tax laws, argued:

> It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax. The function of the court is to interpret and apply the language in which Parliament has specified those circumstances. The court is to do so by determining the meaning of the words employed by Parliament according to the intention of Parliament which is discoverable from the language used in Parliament. It is not for the court to mould or attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.

Federal Commissioner of Taxation v. Westraders Proprietary Ltd (1980) 144 C.L.R. 55, at 59.

derlying substance. That unique quality of the legal rule is of course absent in many cases.

Judicial Interpretation of Taxation Law

While the process of legal reasoning applied by courts in tax law is not fundamentally different from that applied in other areas of law, some approaches are specific to tax law due to the special features of tax law cases. One of these features is the fact that one of the parties involved is always a public authority, namely the tax administration. Another feature that is specific to tax litigation is that tax obligations in most cases can be established only by the tax law and cannot be drawn from doctrines or obligations based in other areas of the common law or codes such as contracts or torts. These specific circumstances have resulted in some specific standards for the interpretation of tax laws, which in some countries may be quite different from the general rules of interpretation.

Unlike in a contractual relationship, the tax administration and the taxpayer cannot determine the tax payer's liability by mutual consent. Moreover, because as a public authority the tax administration is obligated to treat all taxpayers equally, the solutions that are valid for one taxpayer should apply also to all other taxpayers in similar circumstances; that is, a conflict resolution applicable to one taxpayer must also be practicable for all other taxpayers. As a consequence, the court has less leeway in looking for possible solutions of a conflict between the taxpayer and the tax administration than in an ordinary suit based on the law of contracts or torts.

The interpretation of tax laws raises the basic questions: (1) should tax laws be interpreted strictly or more broadly through the teleological or analogical method; (2) should the legal form of a transaction take precedence over the substance of the transaction; and (3) should tax laws be subject to a kind of "economic" interpretation, which would not be applicable in other areas of law? These are partially overlapping questions that are answered differently by the case law of various countries. Following is a brief and selective overview of the judicial responses to these issues in several jurisdictions.

France

Historically, French law has been an influential example in many countries, particularly in continental Europe. As a general rule, in the French tradition tax laws are to be strictly interpreted. This is a consequence of the legality principle laid down in article 34 of the French Constitution — a clear text cannot be interpreted beyond the literal meaning intended by the legislator.[5] Yet, the Cour de Cassation and the Conseil d'Etat, the two highest courts that hear tax cases, do not entirely share the same position on strict interpretation. The Conseil d'Etat, which deals with the majority of the more modern taxes (personal and corporate income tax and value added tax), tends to have a more flexible attitude towards the interpretation of tax laws.[6] However, even under the traditional rule of strict interpretation of tax laws, since the middle of the last century the French courts have always recognised the authority of the tax administration to submit evidence about the real nature of the transaction, to show that it should be recharacterised for tax purposes.[7] At about the same time that this rule was established, French courts developed the theory of abuse of law in civil law.[8] This revolutionary theory would much later play an important role in tax cases in other countries.[9]

Belgium

Belgium has a long tradition of strict and literal interpretation of tax laws. This is based on the principle of legality which has been enshrined in the constitution: no tax is due unless imposed by a law, and the burden of proof for establishing that a tax is due lies with the tax administration. The tax law, like the criminal law, has always been considered as an exception to the natural state of affairs. The quintessence of the Belgian jurisprudence on income taxation was laid down in a decision of the Cour de Cassation[10] in which the court stated that a taxpayer is allowed to choose the *la voie la moins imposée*[11] (the lesser taxed way) and that for

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[5] See 1 *Demante, Principes de l'Enregistrement* no. 9 (1897) "Les lois d'impôts doivent recevoir une interprétation stricte, et le doute sur le sens de ces lois droit profiter au contribuable" (tax laws should be interpreted strictly, and any doubt about the meaning of these laws should be resolved in favor of the taxpayer).

[6] See, e.g., Judgment of July 8, 1992, Conseil d'Etat, 1992 Recueil des décisions [arrêts] du Conseil d'Etat [Lebon], No. 88734, at 284; see also older cases cited in J-J Bienvenu, *Droit Fiscal* nos. 52-54 (1987).

[7] This is the theory of simulation, or sham. See Judgment of February 15, 1854, Cour de Cassation (Civile), 1854 Recueil Dalloz Périodique et critique [D.P.] I 51; Judgment of December 11, 1860, Cour de Cassation (Civile), 1861 D.P. I 25; Judgment of August 20, 1867, Cour de Cassation (Civile), 1867 D.P. I 337.

[8] Judgment of May 2, 1855, Colmar, 56 D.P. II 9; Judgment of December 2, 1871, Paris, 1873 D.P. II 185; Judgment of November 22, 1889, Órleans, 91 D.P. II 120.

[9] See discussion under "Abus de droit" in *Encyclopédie Juridique*, 1 Répertoire de Droit Civil 28 (Dalloz 1951); see also the discussion above of the of interpretation of tax law in The Netherlands.

[10] Judgment of June 26, 1961, Cour de Cassation, 1961 Pasicrisie Belge [Pas. Bel.] I, 1082.

[11] See the book with the same title, T. Delahaye, *Le Choix de la Voie la Moins Imposéeé* (Bruylant, Brussels, 1977).

the application of the tax laws a legal construction engaged in by a taxpayer will stand, even if the form of the construction is unusual, provided the taxpayer subscribes to all legal consequences of his construction. The holding of the court was based on the view that the legal system as a whole is consistent, and that if the taxpayer took all the legal consequences of his acts, the tax administration also had to recognise the tax consequences. The court held specifically that in income tax law, there is no room for a principle of "economic reality."[12] Generally, it also has been held that there is no room for the application of abuse of law or "*fraus legis*" in the area of taxation. This jurisprudence stands for a high degree of legal security for the taxpayer. However, as tax planning became more aggressive, political pressure built up to introduce statutory anti-avoidance rules and in 1993, a general anti-avoidance provision was enacted in the Income Tax Code.[13]

While their approach to income tax is strict, the Belgian courts, like their French counterparts, applied the doctrine of "simulation" to some more traditional areas of taxation, such as gift and inheritance taxes. This doctrine is used when the legal act or instrument that is invoked by the parties against the tax administration does not correspond to the underlying legal relationship that the parties sought to establish. For example, a gift subject to substantial consideration to the benefit of the donor or a third party may be requalified as a sale.[14] Similarly, a transfer of immovable property to a newly established company in exchange for shares, immediately followed by the sale of the shares to a third party, has been requalified as a transfer of the real property itself to the third party.[15]

Germany

Germany presents an example of a country where the legislature and the courts have often jousted with each other about the interpretation of tax laws. The general tax law or *Reichsabgabenordnung*, introduced in

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[12] Judgment of February 27, 1987, Cour de Cassation, 1987 Pas. Bel. I, No. 387, at 777.

[13] See Code des Impôts sur les Revenus (Belgium) art. 344 permitting the tax administration to set aside any legal qualification of an act or a transaction by a taxpayer, when the purpose of such act or transaction was tax avoidance, unless the taxpayer can show a legitimate business purpose.

[14] Judgment of December 6, 1883, Leuven, Recueil Général de l'Enregistrement et du Notariat [Rec. Gén. Enr. Not.] 10.272; Judgment of January 4, 1900, Brussel, Rec. Gén. Enr. Not. 13.221; Judgment of March 3, 1912, Brussel, Rec. Gén. Enr. Not. 15.129.

[15] Judgment of December 19, 1962, Brussel, Rec. Gén. Enr. Not. 20.640; Judgment of March 26, 1905, Gent, Rec. Gén. Enr. Not. 20.895.

1919, provided that the tax laws should be subject to "economic interpretation."[16] Statutory guidance for the interpretation of tax laws reached its zenith in the *Steueranpassungsgesetz* of 1934, which mandated consideration of a range of non-legal factors when interpreting tax law.[17] The objective underlying the introduction of economic interpretation of tax law as a guiding principle was to overrule the excessively restrictive interpretation of the tax law that had developed on the basis of concepts and categories of civil law.[18] Particularly between the two world wars, the *Reichsfinanzhof* was very keen on furthering a wide interpretation of tax law. Economic interpretation became an instrument in extending the tax law to fill gaps and loopholes by interpretation based on analogy.[19]

The use of economic interpretation as a guiding principle in the interpretation of tax law has gradually been abandoned by the Federal Tax Court of Appeal and the pre-eminence of the use of civil law concepts in tax law interpretation has been re-established.[20] At the same time, the German Constitutional Court has been less clear in its approach to strict or expansive interpretation of tax law. Sometimes, it has spoken out in favour of strict interpretation and against the economic interpretation of tax law;[21] at other times, however, the same court has decided in favour of "judicial development of the law."[22] When the new general tax law was

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[16] See Reichsabgabenordnung of 1919 (Germany) para. 4.

[17] See Steueranpassungsgesetz (Germany) para 1/II. The provision provides that in interpreting the tax law, courts were to consider: "die Volksanschauung, der Zweck und die wirtschaftliche Bedeutung der Steuergesetze und die Entwicklung der Verhältnisse" (the social viewpoint, the purpose, and the economic significance of the tax laws and the development of the situation).

[18] In Germany, this narrow and literal interpretation was called *Begriffsjurisprudenz* (conceptual jurisprudence) and was subject to attack by the end of the 19th century. See K Larenz, *Methodenlehre der Rechtswissenschaft* (Berlin, Springer-Verlag, 1983).

[19] 4 Reichsfinanzhof Entscheidungen 243, 252; 6 Reichsfinanzhof Entscheidungen 292, 298.

[20] Bundesfinanzhof, 1969 Bundessteuerblatt II 736, 737; Bundesfinanzhof, 1976 Bundessteuerblatt II 246.

[21] See Judgment of January 24, 1962, Bundesverfassungsgericht [Federal Constitutional Court], 13 BVerfGE, No. 32, at 318, 328: "das Steuerrecht wird von der Idee der Primären Entscheidung des Gesetzgebers über die Steuerwürdigkeit bestimmter generell bezeichneter Sachverhalte," "getragen und lebt dementsprechend aus dem Diktum des Gesetzgebers" (tax law is based on the idea of the primary decision of the legislator concerning the tax treatment of specific generally defined circumstances and therefore draws breath from the statement of the legislator).

[22] Judgment of March 12, 1985, Bundesverfassungsgericht [Federal Constitutional Court], 69 BVerfGE, No. 12, at 188, 203: "Der finanzgerichtlichen Rechtsprechung ist es insbesondere nicht von vornherein verwehrt, im Wege der Rechtsfortbildung

adopted in 1977, the general "economic meaning" clause in the *Steueranpassungsgesetz* was not renewed.[23] At the same time, a few specific and one general anti-abuse clauses were introduced to give the courts more leeway in the interpretation of tax law, particularly in cases of abuse of legal construction.[24]

The Netherlands

As in other countries, the basic question in the Netherlands was whether the effective tax base had to be determined by the legal form of the facts as they emerged from the application of civil law, or whether the tax base was to be determined by the facts relevant to the tax law.

Like France and Germany, the Netherlands at an early stage adopted a general anti-avoidance provision.[25] However, for quite a long time, the courts did not rely on the statutory provision when interpreting tax law, because at about the same time the anti-avoidance provision was adopted, the Supreme Court introduced the *Fraus Legis* doctrine into tax law.[26] The doctrine applies when a taxpayer uses a legal form to achieve a factual situation that under another legal form would be is subject to tax different from that imposed on the legal form used by the taxpayer. Under the doctrine, the form adopted will be disregarded if the purpose of the tax legislation would be achieved by recharacterising the form of the factual situation to the form that would attract the greater tax burden. Originally, the legal form was only set aside under the *Fraus Legis* doctrine when tax minimisation was the exclusive reason for the use of the legal form.[27] Gradually, however, the case law modified the doctrine so it would apply when the tax motive was the dominant or decisive reason for

veränderten wirtschaftlichen Situationen Rechnung zu tragen..." (judicial decisions in fiscal law are not prohibited from giving significance to changed economic circumstances by way of development of the law).

[23] The Abgabenordnung of 1977 does contain a few specific anti-avoidance provisions (para 40 et seq.) some of which may be interpreted as the continuance of economic interpretation. These provisions have a clear and narrow legal meaning, however.

[24] See discussion of anti-abuse legislation below.

[25] See the discussion below.

[26] Judgment of May 26, 1926, Hoge Raad [Supreme Court], 1926 Nederlandse Jurisprudentie [N.J.] 723. The Swiss courts have applied an interpretation of tax law that is very similar to the Dutch theory of "*Fraus Legis.*" There is an abuse of law when the legal form of a transaction is unusual, it was entered into with the intent of obtaining a tax benefit, and the benefit must effectively have been realized. See J-M Rivier, *Droit Fiscal Suisse* (1972) 59; Ernst Höhn, *Steuerrecht* (1972) 17.

[27] Judgment of July 22, 1982, Hoge Raad [Supreme Court], 1982 Beslissingen Nederlandse Belastingrechtspraak [B.N.B.] 242.

the transaction.[28] Whether the tax motive is the dominant reason for the transaction is determined not by the subjective intent of the taxpayer, but by objective facts to be evaluated by the judge. If the taxpayer has objective non-tax reasons for the transaction, it will withstand the test of *Fraus Legis*. In this way, the Dutch courts maintain the right of the taxpayers to arrange their affairs in such a way as to minimize tax liability, provided that the validity of the legal form is well established.[29] The *Fraus Legis* doctrine has been considered as more than adequate to permit the courts to strike down artificial legal constructions, so that in 1987 the Minister of Finance decided to render the statutory anti-avoidance provision inoperative, although it is still on the statute books.

United Kingdom

Judicial interpretation of taxation law in the U.K. is reviewed more fully elsewhere in this volume. The U.K. tax system has no general statutory anti-avoidance provision. Interpretation of tax statutes used to be based on the principle enunciated by the case *IRC v. Duke of Westminster*.[30] In that case, it was stated that taxpayers are entitled to arrange their affairs so that the tax attaching under the appropriate Act is less than otherwise would be. If they succeed in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or other taxpayers may be, the taxpayers cannot be compelled to pay an increased tax.

This is generally considered to be the leading case for literal and strict interpretation, although the latter principle had already been formulated as follows in an earlier case: "in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."[31]

However, the judicial approach shifted following the 1981 decision of the House of Lords in *W.T. Ramsay Ltd. v. Internal Revenue Commissioner*.[32] In this case, the House of Lords struck down a tax planning device on the basis that it was entitled to look at the overall result of several transactions and need not give tax effect to every single transaction. A

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[28] Judgment of July 11, 1990, Hoge Raad [Supreme Court], 1990 B.N.B. 293.

[29] Judgment of December 19, 1990, Hoge Raad [Supreme Court], 1990 B.N.B. 121.

[30] *Commissioners of Inland Revenue v. Duke of Westminster* [1936] App. Cas. 1.

[31] *Cape Brandy Syndicate v. Inland Revenue Commisioners* [1921] 1 K.B. 64, at 71.

[32] *W.T. Ramsay Ltd. v. Internal Revenue Commissioner* [1981] 1 All E.R. 865.

later case, *Furniss v Dawson*, interpreted the principle of *Ramsay* as being that, "the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately."[33]

The new approach was further developed in that later case, which articulated the doctrinal bases for the approach. There are the "step transaction" doctrine and the "commercial purpose" doctrine were there explained in these terms: "the formulation, therefore, involves two findings of fact: first, whether there was a preordained series of transactions, i.e. a single composite transaction; second, whether that transaction contained steps which were inserted without any commercial or business purpose apart from a tax advantage."[34]

In more recent cases, the House of Lords has limited the scope of the commercial purpose doctrine and the step transaction doctrine.[35] In *Craven v White*, the Chancery Division decided that where two courses of action are open to the taxpayer and are actively considered by her or him, the Revenue could not deprive him of the tax benefit of one of the alternatives:

> It is one thing for the court to treat as a fiscal nullity a purely artificial step which will inexorably be followed by one or more others so as to achieve the desired end result. It is quite another for the court to treat as a fiscal nullity a step which had a commercial purpose in addition to tax avoidance and which in reality at the time it was taken might not have been followed by the other steps.[36]

This decision was confirmed by the House of Lords a few years later,[37] together with associated cases, and the position of the House of Lords on tax avoidance was stated succinctly by Lord Jauncey:

> I conclude my analysis of the three cases by emphasizing that the *Ramsay* principle is a principle of construction, that it does not entitle the court to legislate at large against specific acts of tax avoidance where Parliament has not done so, and that at the end of the day the question

[33] *Furniss v. Dawson* [1984] 1 All E.R. 530, at 532 (comments of Lord Fraser of Tullybelton on the *Ramsey* case).
[34] *Id.* at 543.
[35] *Craven v. White*, *IRC v. Bowater*, and *Baylis v. Gregory* [1988] 3 All E.R. 495; see *Craven v. White* [1985] 3 All E.R. 125.
[36] *Craven v. White* [1985] 3 All E.R. 125, at 155.
[37] *Craven v. White* [1988] 3 All E.R. 495.

will always be whether the event or continuation of events relied on amount to a chargeable transaction or give rise to allowable relief within the meaning of the relevant statutory provisions.[38]

The revised approach of the House of Lords has caused some observers to ask how long it will take before the Inland Revenue will decide that statutory anti-avoidance measures are in order, as has been decided already in Canada and Australia.[39]

Australia

In Australia, interpretation of the tax laws was for a long time dominated by literal and restrictive interpretation along the lines resulting from the *IRC v. Duke of Westminster* precedent in the United Kingdom. While the British courts have gradually taken a more flexible position on interpretation of tax law, the Australian courts persisted in their literal interpretation, thereby extending the doctrine of the *Duke of Westminster* to all kinds of modern and complicated tax planning schemes and implementing in fact a pro-taxpayer policy. In *Investment and Merchant Finance Corp. Ltd.*,[40] this literal and strict interpretation was based implicitly on the principle of legality:

> It is, of course, true that it is because company dividends are rebatable under s. 46 that dividend-stripping is so attractive, and, if it be thought that this is a practice which should be checked, it is to that section that Parliament may choose to direct some attention. It is not for the courts, however, to depart from the Parliament's clear statement.[41]

The 1976 decision of the Privy Council in *Europa Oil v Internal Revenue Commissioner*,[42] although based on a New Zealand provision, proved very influential in Australia. The Privy Council said:

> [I]t is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible

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[38] *Id.* at 542.

[39] See the discussion below.

[40] *Investment and Merchant Finance Corp. Ltd. v. Federal Commissioner of Taxation* (1971) 125 C.L.R. 249.

[41] *Investment and Merchant Finance Corp. Ltd. v. Federal Commissioner of Taxation* (1971) 125 C.L.R. 249, at 265. See also *Curran v. Federal Commissioner of Taxation* (1974) 131 C.L.R. 409; *South Australian Battery Makers Proprietary Ltd. v. Federal Commisioner of Taxation* (1978) 140 C.L.R. 645.

[42] *Europa Oil v. Internal Revenue Commissioner* [1976] 1 All E.R. 503.

or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.[43]

In spite of the fact that the Australian income tax law contained a wide general anti-avoidance provision,[44] the scope of the provision was gradually whittled away in a series of court cases by strict and literal interpretation of the tax law.[45] In 1981, the Court reversed its stand on literal interpretation and agreed to extend the scope of a statutory provision, although that wider scope was not within the literal meaning of the statute.[46] By that time, however, there had been a political reaction and Parliament had inserted into the *Income Tax Assessment Act* a range of general and specific anti-avoidance provisions, the most significant of which was a new general anti-avoidance rule adopted in 1981.[47]

United States

Although the Internal Revenue Code contains a limited provision allowing the Commissioner to deny tax benefits from an acquisition, the principal purpose of which is tax avoidance,[48] it does not contain a general provision on interpretation of tax law by the courts. Over time, the courts have developed a doctrine allowing them to set aside certain legal constructions when they do not have a "business purpose."[49] When a legal construction has as its clear purpose the avoidance of income tax and does not at the same time carry some economic substance, it can be set aside by the courts as having no effect for tax purposes and replaced by another construction that better reflects the underlying factual situation. Starting with the *Gregory v Helvering* case, the courts have developed

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[43] *Europa Oil v. Internal Revenue Commissioner* [1976] 1 All E.R. 503, at 508 (Lord Diplock).

[44] *Income Tax Assessment Act* 1936 (Australia) s. 260, which was replaced in 1981 by more comprehensive and at the same time more specific anti-abuse legislation. See discussion below. See also, J Waincymer, The Australian Tax Avoidance Experience and Responses: A Critical Review, in this volume.

[45] *W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation* (1956-57) 100 C.L.R. 66, at 92 et seq.; *Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation* (1962-64) 111 C.L.R. 430, at 441; *Mullens v. Federal Commissioner of Taxation* (1975-76) 135 C.L.R. 290, at 302.

[46] *Cooper Brooks (Wollongong) Proprietary Ltd. v. Federal Commissioner of Taxation* (1980-81) 147 C.L.R. 297.

[47] *Income Tax Assessment Act* 1936 (Australia) Part IVA, ss 177A-G ("Schemes to Reduce Income Tax").

[48] *Internal Revenue Code* 1986 (United States) s. 269.

[49] *Gregory v. Helvering* (1934)69 F2d 809 (2d Cir.), *aff'd,* (1935) 293 U.S. 465.

several judicial doctrines such as constructive income or ownership,[50] continuity of business enterprise,[51] and the "step transaction" doctrine, allowing them to decompose a transaction into several distinct steps, or to take several separate transactions together, in order to ascertain whether each of the individual steps, or the over-all complex transaction, meets the requirements to enjoy beneficial treatment under the tax law.[52] The precise methods of applying these doctrines are complex and continually evolving.[53]

The problems with, and the benefits of, the substance over form approach in U.S. tax case law have been summarized well by Bittker and Eustice:

> One of the persistent problems of income taxation, as in other branches of law, is the extent to which legal consequences should turn on the substance of a transaction rather than on the transaction's form. It is easy to say that substance should control, but, in practice, form usually has some substantive consequences. If two transactions differ in form, they probably are not identical as to substance. Even so, they may be sufficiently similar to warrant identical tax treatment...
>
> The foregoing judicial principles and statutory provisions, which often overlap in practice, are useful deterrents to tax-avoidance schemes of varying scope and ingenuity. Forcing transactions heavily freighted with tax motives to withstand judicial analysis in the context of these broad principles and provisions, vague and uncertain in application though they may be, is more salutary than uncompromising literalism in applying the statutory system for taxing corporations and shareholders.[54]

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[50] *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331; see discussion in BI Bittker & JS Eustice, *Federal Income Taxation of Corporations and Shareholders* 6th ed. (Boston, Warren, Gorham & Lamont, 1994) para 9.02.

[51] *Standard Realization Co. v. Commissioner* (1948) 10 T.C. 708; *Pridemark, Inc. v. Commissioner* (1965) 345 F.2d 35 (4th Cir.)

[52] *West Coast Marketing Corp. v. Commissioner*, (1966) 46 T.C. 32; *American Potash & Chemical Co. v. United States*, (1968) 399 F.2d 194 (U.S. Ct. Cl.), *motion denied,* (1968) 402 F.2d 1000 (Ct. Cl.); *King Enterprises, Inc. v. United States*, (1969) 418 F.2d 511 (U.S. Ct. Cl.), *later proceeding* (1970) 190 Ct. Cl. 947.

[53] For a discussion of tests for application of the step-transaction doctrine in reorganizations, see *McDonald's Restaurant of Illinois v. Commissioner* (1981) 688 F.2d 520 (7th Cir.).

[54] Bittker & Eustice, *supra* note 50, para 1.05[2][b] at 1-18 and para 1.05[3][d] at 1-22 (footnote omitted).

The broad interpretative approach often followed by U.S. tax courts contrasts with the style of legal drafting often found in U.S. tax law, which prima facie obliges the courts to make decisions based on very narrow rules. Notwithstanding the narrow focus of many provisions, U.S. courts continue to interpret constrained measures by reference to broader, purposive judicial doctrines. This probably has to do with the common law tradition of legal analysis in which common sense plays an important role in the interpretation of facts and rules.

General Anti-avoidance Provisions

In some countries, the legislature has judged it necessary to take legislative action in the form of general or specific anti-abuse provisions to remedy the failure of the courts to cut off abuse. General anti-abuse provisions require courts to apply a broad or economic interpretation of the tax law and to disregard legal constructions and transactions that have an artificial flavour. Specific anti-avoidance provisions, on the other hand are aimed at closing particular gaps and loopholes.

It should be noted that there is no clear relationship between the way courts interpret tax law (strictly versus broadly) and the presence or absence of general anti-avoidance provisions. Several Western countries operate their tax system without general anti-avoidance provisions: Belgium (until 1993), Italy, the United Kingdom, the United States, Sweden (from 1992 on), and Switzerland. Except for the United States, tax law is interpreted in a strict or literal way in each of these countries. The combination of case law and specific anti-avoidance provisions is apparently seen as adequate to cope with avoidance issues. A second group of countries does have general anti-avoidance clauses in their tax legislation with rather different results. The most prominent examples are Australia, France, Germany, the Netherlands, and Spain.[55] These five countries' general anti-avoidance provisions are discussed below.

Australia

The original Australian anti-avoidance rule provided that contracts are void [for tax purposes] if they were made in order to alter the incidence of the income tax, or to defeat, evade, or avoid any liability under the *In-*

[55] Code des Impôts sur les Revenus (Belgium) art. 344, as amended in 1993 and *Income Tax Act* (Canada) s. 245, introduced in 1988) also have general anti-abuse provisions, but they are too recent to be able to evaluate their impact on interpretation of tax laws by the courts. Sweden abolished the general anti-avoidance provision in 1992, but is now considering whether to reintroduce it. See also L. Mutén, The Sewdish Experiment With a General Anti-Avoidance Rule, in this volume.

come *Tax Assessment Act*.[56] Although the wording of this section was very broad, in the general climate of strict interpretation that dominated the interpretation of tax law by the Australian courts,[57] the scope of the section was systematically whittled down through the application of "freedom of choice" doctrines to a narrow rule that became very difficult to apply.[58]

By 1980,[59] it became clear that the existing Australian set-up of general and specific anti-avoidance clauses and literal or strict judicial interpretation was not working. In 1981, s. 260 was amended to apply only to schemes entered into prior to May 27, 1981, and a whole new set of anti-abuse rules applicable to arrangements entered into or after that date was introduced as Part IVA ("Schemes to Reduce Income Tax").[60] Basically, Part IVA provides that when there is a "scheme" as defined in the statute, the Commissioner has discretionary power to deny a tax benefit or disallow a deduction, that otherwise would be obtained through the scheme, when such scheme satisfies eight conditions laid down in s. 177D(b).[61]

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[56] ITAA s. 260. This provision is inoperative post-27 May, 1981, when the new anti-abuse provisions of ITAA Part IVA took effect.

[57] See the discussion above.

[58] *W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation* (1957) 100 C.L.R. 66, at 92 ("Whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny taxpayers any right of choice between alternatives which the Act itself lays open to them"); *Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation* (1964)111 C.L.R. 430, at 441 ("indeed, s. 260 does not authorize the Commissioner to do anything; it avoids as against the Commissioner arrangements, etc. as specified and so leaves him to assess taxable income and tax on the facts as they appear when the avoided arrangements, etc. are disregarded"); *Mullens v. Federal Commissioner of Taxation* (1976) 135 C.L.R. 290.

[59] *Federal Commissioner of Taxation v. Westraders Proprietary Ltd.* (1980) 144 C.L.R. 55.

[60] *Income Tax Assessment Act* 1936 (Australia) ss. 177A-177G.

[61] This section provides:

(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 this 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;

The crucial term "scheme" is defined in ss. 177A(3) and 177D as any unilateral scheme, plan, proposal, action, course of action or course of conduct entered into or carried out for the purpose of enabling the relevant taxpayer or other taxpayers to obtain a tax benefit in connection with that scheme. Unlike general anti-abuse provisions in Europe and even in Canada, the Australian provision follows a very complicated and technically difficult style of drafting.

The first case involving these provisions to reach the High Court of Australia was *Federal Commissioner of Taxation v. Peabody*.[62] The decision illustrates the complexity of the general anti-abuse provision. In deciding the case, the Court had to identify the "tax benefit," "the scheme," and "the relevant or other taxpayer." In this particular case, the taxpayer won on the basis that the Commissioner had allocated the revenue to the wrong taxpayer.

At the same time that the new general anti-abuse provisions were inserted in the *Income Tax Assessment Act*, Australia amended its *Acts Interpretation Act* to promote a purposive interpretation of legislation, particularly tax law. The new section reads:

> In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose

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> (vi) any change in 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 for any person referred to in subparagraph (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 subparagraph (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 who 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).

Income Tax Assessment Act 1936 (Australia) s. 177D(b).

[62] *Federal Commissioner of Taxation v. Peabody* (1994) 181 C.L.R. 359.

or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.[63]

The combined effect of the changes to the *Acts Interpretation Act*, the application of the general anti-abuse provision of the income tax law, and changes in the composition of the High Court have led to a shift over several years from literal to purposive interpretation of income tax legislation.[64]

France

French tax law contains two general instruments to combat tax avoidance: a procedural law on the *abus de droit*[65] (abuse of tax law) and the court doctrine of the *Acte de gestion anormale* (abnormal management act) which does not have a direct statutory basis in tax law.

The main principle of the abuse of law provision is that a transaction is only subject to sanction when a specific procedure is followed and when the transaction has been set up *exclusively* for tax avoidance purposes. This provision applies to sham transactions (the real legal transaction is hidden by an apparent legal transaction) only when the transaction is entered into exclusively to obtain a tax benefit.[66] Because the burden of proof is on the tax administration and the condition of the exclusive tax avoidance motive is very difficult to prove, this weapon is seldom used by the tax administration.[67] The French tax administration is now pushing for an amendment of the statute, so as to apply the abuse of law provision in cases where the tax avoidance motive is the dominant, but not necessarily the exclusive, reason for the transaction.

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[63] *Acts Interpretation Act* 1901 (Australia) s. 15AA(1). Section 15AB also contains rules with respect to the extrinsic materials that should be taken into consideration in interpreting of an Act.

[64] *Cooper Brooks (Wollongong) Proprietary Ltd. v. Commissioner on Taxation* (1981) 147 C.L.R. 297.

[65] See Livres des Procédures Fiscal (France) art. 64 (prohibiting "*abus de droit*"). This provision was introduced for indirect taxes by law of July 13, 1925 and for income taxes by law of January 13, 1941. The anti-abuse provision was enacted in the procedural law by Law No. 87-502 of July 8, 1987.

[66] Livres des Procédures Fiscal (France) art. 63, "les actes qui dissimulent la portée véritable d'un contrat ou d'une convention" (deeds which conceal the real content of a contract or covenant).

[67] Judgment of June 10, 1981, Conseil d'Etat, 1981 Lebon, No. 19.079, at 248 (1981); Judgment of June 27, 1984, Conseil d'Etat, 1984 Lebon, No. 35.030, at 248; see also for a more general discussion Cyrille David *et al.*, *Les Grands Arrêts de la Jurisprudence Fiscale*, Thème 8, Le "Réalisme" du Droit Fiscal: apparence, illicéité, anormalité et abus de droit, at 83 *et seq.* (1988).

The abnormal management act doctrine has been entirely developed by the courts and has no specific statutory basis.[68] It is based on the theory that a business taxpayer cannot engage in any activity that is contrary to her or his business interest, because the purpose of the business is to make a profit. This does not mean that the taxpayer has the obligation to maximize her or his business income under all circumstances, but it allows the tax administration to intervene in situations in which the taxpayer reduces her or his income, by acts against her or his business interests, in order to transfer income to another taxpayer who is exempt or who is taxed at a lower rate. The application of the abnormal management act doctrine is not subject to any special procedure. In most cases, it presents merely problems of fact and not of law, so that it is to be distinguished from the abuse of law provision of the code of tax procedure. However, the same transaction can reduce a taxpayer's income by an act against his business interests, and at the same time be entered into exclusively for tax avoidance purposes. In such a case, both anti-abuse instruments would be applicable. Because the burden of proof is less onerous than under the abuse of law provision and because there is no specific procedure that must be followed, the tax administration prefers this court doctrine to combat abuses of taxpayers.[69]

Germany

Germany introduced quite early[70] a provision in its general tax laws obliging courts to apply an economic interpretation of the tax law.[71] Gradually, however, the Court of Tax Appeals shifted its interpretation to a more traditional stance, giving predominance to concepts of civil law over tax concepts, so that the taxpayer came to be in a position of being able to make a choice between different legal forms of a transaction to minimize his tax burden.[72] When the new General Tax Law was intro-

[68] Judgment of April 14, 1976, Conseil d'Etat, 1976 Lebon, No. 97.260, at 202; Judgment of April 30, 1980, Conseil d'Etat, 1980 Lebon, No. 16.253, at 206.

[69] See commentary and cases cited in David et al., supra note 67, Thème 28, Le principe de la liberté de gestion des entreprises et la théorie des actes anormaux de gestion, and Thème 29, La théorie des erreurs et des décisions de gestion, at 279 *et seq.*

[70] Reichsabgabenordnung of 1919 (Germany) s. 4; Steueranpassungsgesetz of 1934 (Germany) s. I/II. Economic interpretation is not exclusively used in tax law in Germany, but rather is seen as a general form of statutory interpretation. K Tipke, *Die Steuerrechtsordnung* (1993) 1289.

[71] *Die wirtschaftliche Betrachtungsweise.* See discussion on court interpretation in Germany above.

[72] Bundesfinanzhof, 1967 Bundessteuerblatt II 781, 782.

duced in 1977, the mandatory economic interpretation method of tax laws was abandoned and replaced by several anti-abuse provisions.[73]

The most important general anti-abuse clause, s. 42, provides that tax cannot be avoided by *Steuerumgehung durch Missbrauch von rechtlichen Gestaltungsmöglichkeiten* (abuse of legal constructions.) When abuse of a legal construction is established, the taxpayer's liability will be based on the "legal form of the transaction that is appropriate to the legal factual situation."[74] An abuse exists under s. 42 when the legal form of the transaction or construction used by the taxpayer is not appropriate to the economic factual situation. Thus, the legal form of a transaction will be considered to be inappropriate when reasonable persons would not choose a particular legal form because they would consider it as inadequate to achieve a specific economic relationship, and in particular in view of achieving a specific economic goal.[75] The specific characteristic of the German law is that it requires some consistency between the legal form and the economic content of a transaction. In many other tax systems, it suffices to have a business purpose, even if the legal form in which this business purpose is achieved may not entirely be appropriate. If a transaction has no business purpose at all, it may be assumed that the legal form is inappropriate and that there is abuse of a legal construction. Generally speaking, in order for a legal transaction to be effective for tax purposes under Germany's general anti-avoidance provision, it will require a business purpose and an adequate legal form to achieve the business objectives of the taxpayer. It is clear that when there are several adequate legal forms to achieve these business objectives, the section will not be applicable, if the taxpayer chooses the legal form that minimizes his tax burden.

The Netherlands

In the Netherlands, a general anti-abuse provision was introduced in the general tax law in 1925. Since 1959, it has provided that a legal transac-

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[73] Austrian law still requires the true economic content of a transaction to be given effect in precedence to its outward appearance. See Bundesabeordnung (Austria) art. 21.

[74] *Eine den wirtschaftlichen Vorgängen angemessenen rechtlichen Gestaltung.*

[75] "Unangemessen ist eine rechtliche Gestaltung, die verständige Parteien in Anbetracht des wirtschaftlichen Sachverhalts, insbesondere des erstrebten wirtschaftlichen Ziels, als unpassend nicht wählen würden" (the legal form of a transaction is inadequate when reasonable parties with reference to the economic content of the transaction, and in particular with respect to its intended economic purpose, because of its inappropriateness would not choose such a form). 3 Tipke, *supra* note 47, at 1337.

tion that does not have as its purpose a significant change in the factual circumstances or that would not have occurred but for the fact that it eliminates or reduces the tax liability shall not be taken into account for tax purposes (i.e. when the exclusive purpose of a transaction is to minimize the tax burden, it is subject to correction for tax purposes).[76] In the Dutch tax literature, this provision is known as *Richtige heffing*[77] (correct taxation). To apply the procedure of correct taxation, the tax inspector must obtain specific advance approval from the Minister of Finance. Given the judicial development of the *Fraus Legis* doctrine, discussed above, the statutory provision has been of limited importance.

Spain

In Spain, article 6.4 of the Civil Code, which was adopted in 1974, codifies the "abuse of law" principle.[78] This civil law concept was also used in tax cases because, although the tax law referred in article 24, paragraph 2 to "abuse of law",[79] there was no clear definition of abuse of law in the tax code.[80]

In 1979, a decree established a special procedure for the application of the concept of abuse of law.[81] As in France, this special procedure is to be

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[76] Algemene Wet Rijksbelastingen (Netherlands) art. 31.

[77] See for a more ample report, A. Nooteboom, *Netherlands, in* LXVIIIa Cahiers de Droit Fiscal International 545, at 545 *et seq.* (1983).

[78] Codigo Civil (Spain) art. 6, para 4: "[l]os actos realizados al amparo del texto de una norma que persigan un resultado prohibido por el ordenamiento jurídico, o contrario a él, se considerarán ejecutados en fraude de ley y no impedirán la debida aplicación de la norma que se hubiere tratado de eludir" (acts concluded within the scope of the text of a rule which pursue a result prohibited by the legal regulation or contrary to it, shall be considered as executed as a fraud on the law and shall not thwart the proper application of the norm that was sought to be avoided).

[79] Ley General Tributaria (Spain) art. 24, para 2: "[p]ara evitar el fraude de Ley se entenderá, a los efectos del número anterior, que no existe extensión del hecho imponible cuando se graven hechos realizados con el propósito probado de eludir el impuesto, siempre que produzcan un resultado equivalente al derivado del hecho imponible" (to avoid fraud on the law it will be understood, for purposes of the previous paragraph, that there is not an extnesion of the taxable event in the case of taxation of actions realized for the proven purpose of evading the tax, as long as they produce a result equivalent to that derived from the taxable event).

[80] For a full discussion of the abuse of law provisions in Spain, see Escuela de Inspección Financiera y Tributaria, Ministerio de Economia y Hacienda, *Compendio de Derecho Tributario Español*, Tema 3-II, Analogía, Fraude de Ley y Economía de Opción, 79 *et seq.* (4th ed. 1984).

[81] Real Decreto [Royal Decree] 1.919/1979 of June 29, 1979, *por el que se regula el procedimiento especial de declaración de fraude de Ley en materia tributaria,* Boletin Oficial del Estado de 6 de agosto.

followed when a taxpayer is accused of abuse of law. The burden of proof is with the tax administration. In addition, article 25 of the Spanish tax code provides that taxes should be levied in accordance with the real legal or economic nature of the taxable event.[82] When the taxable event consists of a legal transaction, it will be qualified for tax purposes in accordance with its "true legal nature", regardless of the form of the transaction. When the taxable event is determined by economic concepts, it will be qualified in accordance with "effective economic relationships." Both provisions seem to indicate a strong bias in favour of economic interpretation of tax law and of substance over legal form.

However, article 24-1 of the General Tax Law contains an explicit prohibition of extensive interpretation of tax law and interpretation by analogy beyond the strict meaning of the words.[83] The resulting legal framework of the anti-abuse provisions in Spain is at least confusing, and there is great amount of debate about its exact meaning. These contradictory legal prescriptions have driven the High Court to very divergent applications of the tax laws.[84]

Specific Anti-abuse Provisions

With respect to specific anti-abuse provisions there is also a wide variety of statutory language. It is almost impossible to categorise these various provisions, but a rough distinction can be made between anti-abuse provisions in the domestic and in the international contexts. Generally speaking, most countries have domestic rules in one or more of the following areas:

- limitation of deductions for entertainment and travelling expenses;
- rules on taxation of accrued interest income;
- limitations on transfer of tax loss carry-overs from one taxpayer to another;
- limitations on loss deductions by partners or shareholders in partnerships or companies not subject to corporate income tax; and

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[82] Ley General Tributaria (Spain) art. 25, para: "[e]l impuesto se exigirá con arreglo a la verdadera naturaleza jurídica o económica del hecho imponible" (the tax is due in accordance with the real or economic nature of the taxable event).

[83] Ley General Tributaria (Spain) art. 24, para 1: "[n]o se admitirá la analogía para extender más allá de sus términos estrictos el ámbito del hecho imponible, o de las exenciones o bonificaciones" (analogy for the purpose of extending the scope of the taxable event, or of exemptions or benefits, beyond their strict limits, shall not be allowed).

[84] Judgments of May 3, 1988, March 5, 1988, April 5, 1982 and June 3, 1982.

• rules against dividend stripping.

The emphasis and the shape of these anti-abuse rules may vary substantially from one tax system to another.

Even in the international context anti abuse provisions may vary greatly between countries. With respect to international thin capitalisation rules, for example, a few countries do not have any specific provisions (Belgium,[85] France, Netherlands). Some countries do have a rule recharacterising dividends into interests (Germany, U.K.). However, the conditions for recharacterisation vary from one country to another.

With respect to transfer pricing, the situation is again not uniform. Practically all member states of the E.U. have specific transfer pricing provisions based on the arm's length principle (Belgium, France, Germany, Sweden, United Kingdom). The Netherlands, however, does not have a specific transfer pricing provision. Measures against transfer pricing are based on the general rules for the determination of taxable profits.

With respect to transfer of assets and corresponding transfer of income abroad, Belgium,[86] France,[87] and the U.K.[88] have specific anti-avoidance provisions in their tax codes. Germany has none, however, and the Netherlands has only a provision relating to the shifting of income from pension rights and insurance policies.[89]

Controlled foreign corporation legislation exists in Germany,[90] United Kingdom[91] and Sweden, which has provisions with a very wide scope. Spain has recently introduced new C.F.C. (controlled foreign corporation) legislation.[92] Conditions for application of the legislation are different in each member state. Belgium, France and the Netherlands have no controlled foreign corporation legislation. As a result, other EU member states are obliged to extend their CFC legislation to second and third tier subsidiaries, because otherwise their CFC provisions might be foiled by intermediary companies in member states having no CFC rules.

[85] Belgium does have a thin capitalization rule, but only for domestic application.
[86] Wetboek van den Inkomstenbelastigen, Code des Impôts sur les Revenus (Belgium) art. 344 bis.
[87] Code Général des Impôts (France) art. 238 bis.
[88] Income and Taxes Act (U.K.) ss. 739 and 740.
[89] Algemene Wet Rijksbelastingen (Netherlands) arts. 31/5 and 6 (B).
[90] Aussensteuergesetz (Germany).
[91] Income and Taxes Act (U.K.) s. 749.
[92] Decreto Real number 672 (Spain) dated 2 July 1992.

Conclusions

In a certain sense, the problem discussed in this paper is an eternal one: a "classic" about the argument of substance versus form. As long as law and legal rules exist these problems will arise. The question is, however, whether we can do better than just admit the inevitable. In tax law, perhaps we can, precisely because of the principle of legality adopted in many countries.

First, a distinction should be made between issues of substance versus against form in a given legal rule on the one hand and gaps in the tax statute on the other. When the legislator either out of negligence or because of political pressure leaves gaping holes in the statute that allow events that from an economic or social point of view ought to be taxed to occur tax-free, this is not a question of substance versus form. This is a basic constitutional question: whether courts can supplement to the legislator when the latter for whatever reasons fails to tax events that should be within the ambit of the statute.

In these cases, one's view of the appropriate outcome will be determined by one's opinion about the role of the courts vis-à-vis the legislator. Proponents of active political courts will argue that the courts should supplement the mistake made by the legislator and tax what has been left untaxed in the statute. Most people however see a more limited role for the courts. When there is clearly no legal basis for taxation in the text of the law, there is no reason for the courts to legislate judicially. This is a more prudent attitude, hedging against shifts in the political attitudes of the courts.

A different problem arises when there are no gaps in the statute, but merely a difference of opinion about how a statute should be applied. From a point of view of economic efficiency and social equity similar situations should be taxed equally. Therefore analogy and economic interpretation seem to be indicated. Because taxation is subject to the rule of law, however, legal concepts are always at the interface between economic and social events on the one hand and taxation on the other. Taxation on raw, unreconstructed economic or social facts does not work.

It is here that interpretation and the question of form against substance become issues. Legal concepts must fit reality, i.e. legal concepts and legal rules must contain an inner logic and consistency that matches the facts to which these concepts are applied. This means that the legal concept must not only show an abstract consistency between the various building blocks of the concept as such and the various rules that apply under the concept; it also must be capable of controlling and structuring facts and reality.

This is, in my opinion, the deeper sense of all attempts to subject legal constructions to conditions of commercial purpose in the application of tax laws. It is presumed that when there is a non-tax business purpose to a transaction, the legal form automatically also fits the facts of the transaction.

The commercial purpose rule looks different, however, from the point of view of legal consistency. The commercial purpose validates a legal construction with an external (economic) justification, even when the legal construction does not fit the facts of the case. If applied consistently this means that even when business considerations are present, the legal form of the transaction may not fit the facts and hence have different tax consequences than those prescribed by the legal form of the transaction.

This position has also a reverse side: when a legal construction does fit the facts, there always will be an important non-tax consideration to set up the transaction. So a predominant business purpose does not always justify a certain form of legal transaction, but a transaction that fits the facts will always contain a sufficient non-tax reason, justifying also the tax consequences from a legal and from a factual point of view.

In this analysis it is clear that general anti-abuse rules in the form of statutory provisions allowing recharacterisation of legal transactions for tax purposes on the basis of an absence of sufficient business purpose are not necessary. What is necessary is a consistent analysis by the courts of whether and how all the elements of the legal construction fit with all relevant facts from a point of view of logic and efficiency for the taxpayer. It is clear that in many cases the tax statute will leave the taxpayer with a choice between different legal instruments because the legislator has provided different forms that can reasonably be used in similar factual situations. In those instances the objectives of economic efficiency and social equity (i.e. taxing similar events equally) may not be achieved.

If this is so, so be it. It is indeed the role of the lawyer to make intelligent (legal) distinctions, where non lawyers like economists and sociologists from their point of view do not see any difference. These legal distinctions must always remain instrumental however in shaping the countless facets of the reality of every day life.

CHAPTER 5

TAX REFORM: A QUASI-CONSTITUTIONAL PERSPECTIVE

John G. Head

Introduction

The tax system has long been recognised as one of the most important economic and political institutions in a liberal democracy. Structural features of the tax system have, however, seldom, if ever, been comprehensively prescribed in a written constitution, even where such exists at all. Certain features may be laid down, or at least constrained, by explicit constitutional provision, such as the types of taxes which may be imposed by the various levels of government under a federal constitution. More fundamental, however, is the observation that the tax system, like other such institutions, has a quasi-constitutional character in the sense that it remains in force, usually with only minor changes, over a sequence of budgetary decision-making periods.[1]

There are some very good reasons why this should be the case. The prevailing tax structure establishes the way in which the cost of public services is to be shared and, in combination with the transfer system, it has a crucial impact on the shape of the income and wealth distribution. Extremely controversial and potentially divisive issues of justice, fairness or equity are thus intrinsically of central concern in tax policy. To embark upon a fundamental review of the taxation system, as in the context of a major tax reform exercise, is therefore to open up a veritable Pandora's Box of controversy, in the sense that it puts the existing and often hard-won compromise on cost-sharing and the income distribution up for grabs. Public discussion of far-reaching changes in the tax system generates great uncertainty, and the implementation of major reforms can be costly and extremely disruptive. Given the somewhat unpredictable func-

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[1] JM Buchanan, *The Demand and Supply of Public Goods* (Chicago, Rand McNally, 1968) ch 8.

tioning of the political process, we cannot be sure that the results will justify the risks involved.

Long-term stability in the revenue system is in any case of fundamental importance if the potential efficiency gains from tax reform are to be realised. Even if the focus is on static efficiency, the benefits (say) of a more neutral tax system build up gradually over a quite lengthy adjustment period as the allocation of investment responds slowly to changes in the net-of-tax return. In the case of intertemporal efficiency, the achievement of significant benefits may take decades as higher savings ratios gradually increase the stock of capital. There is accordingly little to be gained from a switch to a more efficient tax system unless it can be expected to apply without substantial variation over a considerable period of years. Stability in the tax structure is also of great importance in discouraging socially wasteful "rent-seeking" outlays on lobbying and related political activity aimed at influencing government decisions on the revenue system between major structural reforms.[2]

There is accordingly much to be said for the view that major tax reform exercises should be few and far between. The stability which is commonly observed in the basic structure of the revenue system, and even of individual components of that system, over periods of a decade and often much longer, is therefore readily explained and justified.

It follows from this basic observation that the attitudes and considerations which should be brought to bear in a major tax reform exercise are necessarily of a long-term or quasi-constitutional character. Redistributive or zero-sum elements are nevertheless almost inevitably very much to the fore in the tax reform process. Single-minded pursuit of short-term redistributive benefits or sectional interest under a system of majority voting will not, however, produce meaningful or durable reform. Primary emphasis needs rather to be placed on the positive-sum elements or possibilities for mutual gain.

A more principled approach is therefore required in which the familiar politics of sectional self-interest must give way to wider considerations. The prominent role in public finance and tax policy analysis of the familiar principles of equity, efficiency and simplicity clearly reflects this more general and more principled approach. It is likewise no accident that major reviews of the tax structure in modern democratic societies com-

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[2] M Brooks & JG Head, Tax Avoidance: in Economics, Law and Public Choice, in this volume.

monly assign an important role to an expert committee or Royal Commission which can be expected to take the broader and more principled approach required.

Equity and Efficiency Principles in Tax Reform Analysis

Although matters of justice, fairness or equity are thus easily seen to be of central concern in tax policy, it is much less easy to see how they could ever be satisfactorily handled either at the conceptual or at the practical level. Since the early 1930s it has indeed been generally accepted by economists that distributional issues are inherently controversial and require strong value judgments.[3] This was clearly recognised by Henry Simons in his classic reformulation of the ability to pay approach.[4] While insisting on the primacy of distributional or vertical equity objectives, Simons was quite explicit that this basic equity principle had to be founded on ethical or aesthetic judgments that might not be generally accepted.[5] The case for rate structure progressivity, although of central importance, remained therefore methodologically quite "uneasy."[6]

Most of his famous book, and much of the voluminous Haig-Simons literature published over the post-war decades, was in fact devoted instead to analysing the policy implications of the associated but much less controversial objective of horizontal equity. According to Simons, horizontal equity is best served if tax is imposed on a comprehensive income base, his famous net accretions concept.[7] The primary focus of analysis in the Haig-Simons tradition has accordingly been on issues related to the tax base rather than more controversial matters of rate structure progressivity.

Nor were these distributional matters more satisfactorily handled under the alternative benefit tax tradition which served instead to highlight quite different, though equally important, issues of commutative justice and efficiency in the supply of public services. Difficulties in the determination of individual benefit shares were anyway thought to rule out any

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3 G Myrdal, *The Political Element in the Development of Economy Theory* (Streeten trans.) (London, Routledge & Kegan Paul, 1930); L Robbins, *An Essay on the Nature and Significance of Economic Science* (London, Macmillan, 1932).

4 HC Simons, *Personal Income Taxation* (Chicago, University of Chicago Press, 1938).

5 *Id.* at 18-19.

6 WJ Blum & H Kalvern Jr, *The Uneasy Case for Progressive Taxation* (Chicago, University of Chicago Press, 1953).

7 *Id.* at 49-50.

general application of the benefit approach; and the more controversial issues of distributive justice were simply ignored or assumed somehow already to have been resolved.

The other major tax policy principle of efficiency or tax neutrality, though not ignored, was less strongly emphasized by Simons and his followers in the long dominant Haig-Simons tradition. To a significant degree the equity and efficiency objectives are indeed related, as Simons himself observed, since the comprehensive income tax required for purposes of horizontal equity will also achieve substantial neutrality in relation to business financial and investment decisions.[8] Any feasible system of broadly-based taxation may, however, have distorting effects on work-leisure choice and, in the case of income tax, on saving; and these effects could well be greater for progressive rate taxes thus raising the possibility of conflict between the requirements of vertical equity and efficiency. This possibility was clearly recognised by Simons but rejected in the case of work-leisure choice for lack of theoretical or empirical evidence.[9] The possible implications for saving were regarded as a more serious issue, but Simons argued in a rather modern way that budget surpluses could be used to offset any such negative effects. Where conflict could be demonstrated, the Haig-Simons tradition has been to assert the primacy of the vertical equity principle. Serious concern regarding the proper formulation and methodological standing of the distributional objective nevertheless remained.

The Quasi-Constitutional Alternative

Apparent problems at the conceptual level in achieving a satisfactory formulation of tax fairness objectives are, however, much reduced if the issue is reexamined in the methodologically appropriate quasi-constitutional setting. In this alternative view an essential feature of a proper approach to problems of institutional design or reform is the application of an appropriately impartial perspective. In the modern contractarianism of John Rawls,[10] or in the modern utilitarianism of John Harsanyi,[11] impartiality or fairness is achieved through a veil of ignorance device under which participants in the institutional reform process are denied, or must ignore, personal information bearing on their likely

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[8] Simons, *supra* note 4.
[9] *Id.* at 20-21.
[10] J Rawls, *A Theory of Justice* (Cambridge, Harvard University Press, 1971).
[11] JC Harsanyi, Cardinal Utility, Individualistic Ethics and Interpersonal Comparisons of Utility (1955) 63 *Journal of Political Economy* 309.

vested interest under alternative policy options. If participants must rely only on general information regarding the likely operation and effects of major policy alternatives, issues which must otherwise divide society may well be resolved by unanimous agreement.

In the controversial area of vertical equity it is a remarkable observation, due to Paul Samuelson,[12] that if all individuals are risk-averse — and if for simplicity we abstract from efficiency aspects — unanimous agreement could readily be achieved on an absolutely equal division of the national income. It follows therefore that quite radical distributional and tax equity objectives may be formulated which are nevertheless uncontroversial and should command general acceptance in the appropriate tax reform setting. Provided the appropriately impartial or quasi-constitutional perspective is consistently applied, equity-oriented reform of the tax system may therefore offer genuine prospects of mutual gain. For this purpose an assumption that individuals are generally risk-averse is sufficient; no problematic assumption of mutual altruism or utility interdependence is required.

It is, however, in the area of economic efficiency that the prospects for mutual gain are perhaps most obvious and most important. It is also self-evident that, beyond a certain range, equity and efficiency objectives will conflict. In any realistic policy setting we cannot for example abstract, in the manner suggested above, from the disastrous consequences for incentives and economic efficiency of an equal division of the national income. Some appropriate rule for determining the trade-off between equity and efficiency is accordingly required.

One intuitively appealing solution to this further problem, proposed by Rawls,[13] is that departures from equality in the interests of efficiency should be sanctioned if, and only if, the well-being of the least advantaged members of society is thereby promoted. This maximin criterion would, however, be unanimously accepted only if individuals were all extremely risk-averse. Some generalised utilitarian alternative may therefore be preferred. Whether Rawlsian or utilitarian, the quasi-constitutional approach to institutional reform is in any case strictly procedural in emphasis. Specific principles of equity and efficiency in taxation, and the appropriate trade-offs between them, should ideally be derived by an impartial process of political decision-making utilising what-

[12] PA Samuelson, AP Lerner at Sixty (1963-64) 31 *Review of Economic Studies* 169.

[13] Rawls, *supra* note 10.

ever general information may be available regarding the nature and operation of the particular economy and society. Excessive dogmatism and exaggerated claims for specific principles or trade-off criteria should accordingly be avoided.

Implementation Issues

Even if the logic of this quasi-constitutional approach is accepted, it still remains far from clear how it could ever be applied. In the case of the equity objective it may well be completely unrealistic to expect the average voter-taxpayer or the representatives of major interest groups to behave impartially in the policy-making process. Public choice models of budgetary decision-making under majority voting rules strongly suggest that the major players will pursue sectional interest and redistributive benefits rather than possibilities for mutual gain.[14] Idealised principles of distributional equity have no obvious role in these models. Even in the case of economic efficiency, the role of redistributive or zero-sum elements in a majority voting system must seriously threaten the achievement of mutually available efficiency gains. The interplay of vested interests pursuing redistributive gains under a majority voting rule could therefore clearly operate to produce and sustain the loophole-ridden, complex, inequitable and highly distorting tax systems familiar from 20th century budgetary experience in the industrialised democracies. How then might meaningful and durable reform of such a tax system be achieved?

Efficiency-Oriented Tax Reform

In the hard-nosed world of majority-voting models, efficiency-oriented reform of the tax system would appear to offer the best prospects for political success. If the prevailing tax structure is highly inefficient and distorting in the Paretian sense, all or at least most taxpayer-voters may benefit from standard base-broadening and rate-flattening measures either in the area of income tax or sales tax. In order to neutralise the highly divisive redistributive aspects, a requirement of vertical neutrality can be imposed. With appropriate packaging, including direct or indirect compensation measures and grandfathering provisions to minimise losses, a substantial measure of agreement may be possible on reforms offering mutual gains to most sections of the community.

[14] G Tullock, Some Problems of Majority Voting (1959) 67 *Journal of Political Economy* 571.

This general approach has arguably been used to good effect in some of the major tax reform exercises in industrial countries during the 1980s. Examples might include the US *Tax Reform Act* of 1986, the Australian income tax reform package of September 1985, and the extensive reforms of direct and indirect taxation in New Zealand in the second half of the 1980s. These and similar reforms have commonly been preceded by reports of an independent committee or government task force or even (in the case of Australia) by a National Taxation Summit, all designed to emphasize the quasi-constitutional character of the tax reform exercise and to help promote the application of the appropriately impartial perspective. A somewhat more sceptical assessment of these particular reforms is, however, to be found in Musgrave,[15] Head[16] and Stephens.[17]

There is, of course, no guarantee that tax reform proposals, however well designed, will always be successfully implemented. In a somewhat unusual variant of the quasi-constitutional approach, the Australian federal election of 1993 in Australia was turned by mutual consent into a referendum on the ambitious *Fightback!* package of tax reform measures proposed by the federal Opposition parties.[18] Although the quasi-constitutional character of the exercise was clear and unmistakable, the white heat of an election campaign was predictably less likely to encourage the more detached and principled approach which is ideally required. As a result, what had appeared to be an unlosable election for the Coalition parties was narrowly lost. Whatever the merits of the package, the election defeat has set back the cause of major tax reform in the sales tax area for a further decade. Such is, however, the inherent nature of a major tax reform exercise.

Although efficiency-oriented tax reform may well offer good prospects for political success, such initiatives remain no more likely under majority voting than distorting changes based on sectional interest and redistributive exploitation. Without institutional safeguards, moreover, there is clearly no guarantee that an efficiency-based reform package, once im-

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[15] RA Musgrave, Short of Euphoria (1987) 1 *Journal of Economic Perspectives* 59.

[16] JG Head, Australian Tax Reform: An Overview, in JG Head ed, *Australian Tax Reform in Retrospect and Prospect* (Sydney, Australian Tax Research Foundation, 1989).

[17] RJ Stephens, New Zealand's Tax Reform 1984-1992, in JG Head ed, *Fightback! An Economic Assessment* (Sydney, Australian Tax Research Foundation, 1993).

[18] JG Head, *Fightback! An Economic Assessment* (Sydney, Australian Tax Research Foundation, 1993).

plemented, will not soon unravel as a result of interest-group pressures and electoral competition.

Tax Reform and the Horizontal Equity Objective

We have already noted the attempt, under the Haig-Simons approach, to side-step the conceptual and implementation problems of the vertical equity or distributional objectives by focussing instead on horizontal equity. The reforms traditionally proposed on the basis of the horizontal equity criterion are essentially similar to those which follow from the neutrality principle. It might reasonably be inferred, therefore, that the prospect for political acceptance of efficiency-based reforms must be strengthened by horizontal equity considerations. Although "equal treatment of equals" sounds like a motherhood proposition, in the tax reform setting it has proved hardly less controversial than vertical equity. Even in a vertically-neutral framework, those who stand to lose from the implementation of reforms based on the comprehensive income principle are observed to resist tenaciously any erosion of their existing tax privileges.

In part, of course, this difficulty simply reflects the unwillingness of interest groups to adopt the appropriately impartial or quasi-constitutional perspective. It is however a basic observation, due to Feldstein,[19] that taxation based on the criterion of horizontal equity, which might command unanimous acceptance at the level of tax design, will inevitably generate windfall gains and losses for those in otherwise similar economic situations in the tax reform setting. In the absence of appropriate compensation or transitional measures, Haig-Simons based reforms will thus grossly violate horizontal equity! Apparent problems of horizontal inequity under an established tax system, however discriminatory it might appear to be, may by contrast by greatly reduced, if not completely eliminated, by capitalisation and resource flows. Feldstein's argument for retaining any existing tax structure has, to be sure, some obvious limitations.[20] But in the area of capital income at least, significant modification of the traditional Haig-Simons horizontal equity approach is clearly required.

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[19] M Feldstein, On the Theory of Tax Reform (1976) 6 *Journal of Public Economics* 77.

[20] JG Head, The Comprehensive Tax Base Revisited (1982) 40 *Finanzarchiv* 193, at section 3.

It has indeed been strongly argued by Kaplow[21] that the horizontal equity principle is in any case entirely problematical, even at the tax design level. If vertical inequity is conceived, following Simons, in terms of a degree and/or kind of inequality which is entirely arbitrary and lacks any moral justification, how can it follow that pre-tax equals should be treated equally? Their equal incomes could well reflect some type of economic injustice which could in principle be corrected by some appropriate degree or kind of horizontal discrimination in the tax system. In a practical tax design or tax reform setting, however, such information may well be unavailable. If arbitrary discrimination is to be avoided, those with equal pre-tax incomes should therefore be treated equally. Where particular types or sources of injustice can be identified, they should anyway generally be addressed, at the first best level, using other policy instruments such as labour market policies, incomes policy, and so on. Pollution taxes provide, however, an obvious and important exception.

The increasing emphasis on possible efficiency gains at the expense of horizontal equity from standard base-broadening tax reforms is already noticeable in the *Report* of the Carter Commission,[22] and, following Feldstein and Kaplow, the standing of horizontal equity is now seriously in question. As in the case of vertical equity, the horizontal equity principle is accordingly much less vigorously asserted in theoretical and practical tax reform analysis. Increasing agnosticism in the traditional area of tax fairness principles has at the same time been accompanied by a growing assertiveness, bordering on dogmatism, on the primacy of efficiency principles and efficiency-oriented reform.

Change in Voting Rules

Dating back to the pioneering insights of Knut Wicksell,[23] it has sometimes been suggested that the achievement of mutually available efficiency gains could be promoted by an appropriate change of voting rules. In principle it seems clear that the redistributive distortions likely under simple majority voting could be reduced by requiring a more highly qualified majority. In the limit a unanimity requirement or minority veto should completely prevent the redistributive exploitation of ordinary taxpayers by coalitions of interest groups seeking preferential treatment.

[21] L Kaplow, Horizontal Equity: Measures in Search of a Principle (1989) 42 *National Tax Journal* 139.

[22] Royal Commission on Taxation, *Report* (Carter Report) (Ottawa, Queens Printer, 1966) ch. 19.

[23] K Wicksell, *Finanztheoretische Untersuchungen* (Jena, Fischer, 1896).

Only a genuine efficiency-promoting reform with elaborate compensation and grandfathering provisions could satisfy this more demanding requirement.

It has, however, long been recognised that complete unanimity may never be achieved and high decision-making costs could be involved.[24] Full compensation is seldom, if ever, possible, and recalcitrant minorities may be encouraged to behave strategically, seeking to exploit the veto in an attempt to capture the lion's share of mutually available gains. The quasi-constitutional character of the tax system and of the tax reform process, properly conceived, does nevertheless suggest a case for requiring a more highly qualified majority in allocation branch decision-making. This would also help to reduce the well known dangers under simple majority voting of socially wasteful policy reversals or cycling phenomena.[25]

In relation to distributional objectives, however, Wicksell maintained that the conflicting interests of different socio-economic groups could only be satisfactorily resolved by simple majority vote. An operational separation of distribution and allocation branch taxes was therefore proposed which accords well with modern public finance theory as represented, say, by Musgrave's multi-branch budget approach.[26]

In interesting contrast to Wicksell, Buchanan[27] has argued strongly for the application of the Wicksellian unanimity criterion at the constitutional or quasi-constitutional level as the appropriate solution in the distribution branch. In their important early contribution to modern public choice analysis, Buchanan and Tullock were among the first to recognise the possibilities of agreement on even the most divisive issues of redistributive justice or tax equity under appropriate constitutional or quasi-constitutional procedures in which individuals lack personal or specific information which might bias their deliberations on matters of fairness.[28]

For practical purposes, however, this approach to distribution branch objectives does not really resolve, but merely serves to restate, the obvi-

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[24] JM Buchanan & G Tullock, *The Calculus of Consent* (Ann Arbor, University of Michigan Press, 1962).

[25] KJ Arrow, *Social Choice and Individual Values* (Chicago, Wiley, 1951).

[26] RA Musgrave, *The Theory of Public Finance* (New York, McGraw Hill, 1959) ch. 1.

[27] JM Buchanan, Taxation in Fiscal Exchange (1976) 6 *Journal of Public Economics* 17.

[28] Buchanan & Tullock, *supra* note 24, at ch. 13.

ous implementation problems. How can we ensure that the major players will lack the specific information required to determine their own sectional interest under alternative tax reform proposals? In response to this issue Buchanan emphasises the considerable uncertainty likely in multi-period decision-making, but how do we guarantee that individuals will in fact apply the multi-period perspective consistently in matters of institutional choice? And if uncertainty is not sufficient — after decades of relative stability and predictability in the modern welfare state — how can people be persuaded to abstract from distributionally sensitive but constitutionally irrelevant personal information?

These issues have not as yet been satisfactorily resolved, even where they have been explicitly recognised. Some possible answers have been suggested, and no doubt others could be explored. Decision-making on matters of institutional reform might, for example, be delegated to the relatively young or the relatively old on the not unreasonable presumption that vested interest may either be less obvious or may weigh less heavily. Alternatively, it might be stipulated that any reforms to be considered will be implemented only after a waiting period of some years and must then remain in effect for a lengthy minimum period. Without much further elaboration, however, traditional tax policy concerns about matters of equity and distribution are clearly destined to remain very much up in the air. These matters can in no sense be resolved by a change in voting rules. A change in attitudes and perspectives is clearly required. We shall return to these issues below.

Empirical Research and the Equity-Efficiency Trade-Off

The case for increased emphasis on the efficiency objective, suggested by our analysis of implementation issues, has been strongly reinforced during the 1980s by the results of empirical research. The pioneering contributions by Harberger,[29] and others to the quantification of the welfare cost or excess burden of taxation had already served notice on the post-war generation of tax economists working (mainly) in the Haig-Simons tradition, that the possible distorting and disincentive effects of taxation could no longer safely be ignored.

[29] AC Harberger, Taxation, Resource Allocation and Welfare, in JF Due ed, *The Role of Direct and Indirect Taxes in the Federal Revenue System* (Princeton, Princeton University Press, 1964); AC Harberger, Efficiency Effects of Taxes on Income from Capital, in M Krzyzaniak ed, *Effects of Corporation Income Tax* (Detroit, Wayne State University Press, 1966).

Since the results of theoretical analysis and early survey research studies had appeared largely inconclusive, most practitioners of the Haig-Simons school had hitherto felt comfortable with Simons' original view that "the effect of a higher degree of progression in taxation upon the distribution of income is certain; the effect upon production, problematical."[30] Possible disincentive effects on work-effort, and possibly also on saving, could therefore be heavily discounted. The Simons argument for primary emphasis on distributional objectives could not therefore be challenged convincingly with evidence of awkward and unfavourable trade-offs with efficiency objectives.

The welfare cost estimates in the early empirical studies were not, however, very large, and the neutrality characteristics of broad-based direct or indirect taxation implied, as we have seen, that major distortions of business and financial decision-making and in the allocation of real investment would in any case be corrected under appropriate applications of the Haig-Simons horizontal equity principle. In the crucial area of disincentive effects the empirical estimates of labour supply elasticities were mostly very low and savings appeared almost completely unresponsive to changes in the rate of interest. These early empirical studies therefore posed little real challenge to the primacy of distributional objectives.

This cosy picture changed dramatically during the early 1980s. Much larger labour supply elasticities began to emerge from the empirical studies, notably in the work of Hausman[31] and, somewhat earlier, by Heckman.[32] Similarly in the case of saving, much larger elasticities were claimed following upon the pioneering studies by Boskin[33] and Summers.[34] Estimates of the welfare cost of taxation and of redistribution were soon made incorporating higher elasticity assumptions, and these estimates by Stuart,[35] Browning,[36] Browning and Johnson[37] and others

[30] Simons, *supra* note 4, at 19.

[31] JA Hausman, Labour Supply, in HJ Aaron & J Pechman, eds, *How Taxes Affect Economic Behaviour* (Washington DC, Brookings Institution, 1981).

[32] J Heckman, Shadow Prices, Market Wages and Labour Supply (1974) 42 *Econometrica* 679.

[33] MJ Boskin, Taxation, Saving, and the Rate of Interest (1978) 83(2) *Journal of Political Economy* S3.

[34] LH Summers, Capital Taxation and Accumulation in a Life-Cycle Growth Model (1981) 71 *American Economic Review* 533.

[35] CE Stuart, Welfare Costs Per Dollar of Additional Tax Revenue in the United States (1984) 74 *American Economic Review* 352.

have led to a sea change in attitudes among tax economists towards priorities among the basic tax policy concerns of equity and efficiency. And this change has been strongly reinforced by continuing uncertainty regarding the conceptualisation and methodological standing of distributional objectives and also by growing doubts regarding the incidence of some of the major taxes. In a complete reversal of traditional Haig-Simons priorities, it has now come increasingly to be accepted that, whilst the distorting effects of taxation are certain, the distributional implications must forever remain highly problematical.

By the end of the 1980s, however, the pendulum had once again begun to swing, with much critical evaluation of the major studies which had suggested higher response elasticities. In the case of labour supply, serious doubts have been cast on the findings of Hausman by MaCurdy, Green and Paarsch[38] and by Triest.[39] And in the case of saving, the findings of Boskin and Summers must now be heavily discounted following further work by Howrey and Hymans,[40] Evans,[41] Blinder and Deaton,[42] Hall[43] and Starrett.[44] Estimates of the welfare cost of redistribution by

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[36] EK Browning, On the Marginal Welfare Cost of Taxation (1987) 77 *American Economic Review* 11.

[37] EK Browning & WR Johnson, The Trade-Off Between Equality and Efficiency (1984) 92 *Journal of Political Economy* 175.

[38] JD MaCurdy, JD Green & H Paarsch, Assessing Empirical Approaches for Analysing Taxes and Labour Supply (1990) 25 *Journal of Human Resources* 415.

[39] RK Triest, The Effect of Income Taxation on Labour Supply in the United States (1990) 25 *Journal of Human Resources* 491.

[40] EP Howrey & SH Hymans, The Measurement and Determination of Loanable Funds Saving, in JA Pechman, ed, *What Should Be Taxed: Income or Expenditure?* (Washington, Brookings Institution, 1980).

[41] OJ Evans, Tax Policy, the Interest Elasticity of Saving, and Capital Accumulation: Numerical Analysis of Theoretical Models (1983) 73 *American Economic Review* 398.

[42] AS Blinder & A Deaton, The Time Series Consumption Function Revisited (1985) 2 *Brookings Papers on Economic Activity* 465.

[43] RE Hall, Intertemporal Substitution in Consumption (1988) 96 *Journal of Political Economy* 339.

[44] DA Starrett, Effects of Taxes on Saving, in HJ Aaron, H Galper & JA Pechman, eds, *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, Brookings Institution, 1988).

Browning and Johnson[45] have likewise been found to be greatly exaggerated.[46]

As a result of these and related developments, some reevaluation of the heavy emphasis on the excess burden or distorting effects of taxation in tax reform debates of the 1980s would now seem to be required. On a considered reassessment of the general information now available, a rebalancing of equity and efficiency priorities is clearly called for.

Efficiency-Oriented Tax Reform: A Constitutional Critique

Serious concern regarding methodological standing and appropriate conceptualisation has not, however, been confined exclusively to distributional or tax equity principles. The relevance of the efficiency or neutrality objective as conventionally interpreted, and of the associated concept of the welfare cost or excess burden of the tax system, has also been seriously challenged in sharply contrasting applications of the constitutional or quasi-constitutional perspective by public choice exponents of Leviathan models and by a distinguished exponent of the Haig-Simons approach respectively.

A Leviathan Perspective

In contrast to the optimistic perspective on democratic budgetary decision-making implicit in the traditional Haig-Simons orthodoxy, it has commonly been argued by public choice theorists that a systematic bias towards over-expansion of public expenditure must generally be expected under democratic government. This argument draws support from simple majority voting models of the Tullock[47] variety and also from related public choice analysis of bureaucratic decision-making by Niskanen[48] and others. It is also strongly suggested by the experience of rapid public expenditure growth in the industrialised democracies over recent decades.[49]

On the basis of such considerations Brennan and Buchanan have argued that, in the relevant quasi-constitutional perspective, the model of a

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[45] EK Browning & WR Johnson, The Trade-Off Between Equality and Efficiency (1984) 92 *Journal of Political Economy* 175.

[46] CL Ballard, The Marginal Efficiency Cost of Redistribution (1988) 78 *American Economic Review* 1019.

[47] Tullock, *supra* note 14.

[48] WA Niskanen, *Bureaucracy and Representative Government* (Chicago, Aldine-Atherton, 1971).

[49] DC Mueller, *Public Choice II* (Cambridge, Cambridge University Press, 1989) ch. 17, table 17.2.

revenue-maximising Leviathan government has much to recommend it.[50] In the model, democratic governments are assumed to spend up to the limit of their revenue-raising capacity, and the problem of controlling public sector size and growth becomes a matter for serious concern. In this setting the equal-revenue comparisons of different tax alternatives, which form the basis of modern tax reform analysis, are easily seen to be irrelevant, since the maximum revenue derivable will vary systematically and predictably with specific characteristics of the particular tax instrument employed. Considerations of efficiency in public sector size may thus outweigh traditional concerns regarding possible tax disincentives and distortions in the private sector.

Thus, for example, it is easy to see that an ideally comprehensive income or consumption tax would maximise public sector inefficiency due to its enormous revenue potential, whilst at the same time minimising excess burden! Since leisure cannot generally be taxed, any feasible system of uniform-rate income or consumption taxes must distort work-leisure choice and will involve some excess burden. In the Leviathan model such behavioural adjustments are, however, clearly to be welcomed, since they reduce the maximum revenue derivable and serve to constrain budgetary over-expansion. From this perspective narrow-based taxes on elastic commodities and factor income sources, which generate large excess burdens, may well be strongly preferred by the rational taxpayer-voter in the appropriate quasi-constitutional perspective. From the Leviathan perspective, therefore, the heavy emphasis on minimising excess burden as the basis for efficiency-oriented tax reform in the orthodox tradition appears misplaced and inappropriate.

Indeed, in a remarkable reversal of prevailing priorities, vertical equity concerns receive surprising support in the Leviathan model, as progressive rate structures emerge as a possible instrument for controlling public sector size.[51] For a single individual the revenue-maximising rate structure unambiguously requires regressivity. Flat-rate taxation, by comparison, much reduces maximum yield, and revenue potential is further reduced if progressive rates are applied. In the many-person case the issue is more complex; but the point remains that, for any taxpayer other than the lowest, a rising marginal rate structure involves a form of discrimination

[50] G Brennan & JM Buchanan, Towards a Tax Constitution for Leviathan (1977) 8 *Journal of Public Economics* 255-73; G Brennan & JM Buchanan, *The Power to Tax* (Cambridge, Cambridge University Press, 1980).

[51] Brennan & Buchanan, Towards a Tax Constitution, *supra* note 50, at section 3.

precisely the opposite of that required to maximise revenue. For those concerned with controlling public expenditure growth, progressive rather than flat-rate or regressive income or consumption taxes may therefore be preferred. A somewhat surprising defence of progressivity thus emerges on grounds quite unrelated to, but clearly reinforcing, traditional vertical equity or redistributional concerns.

In the Leviathan perspective, efficiency or excess burden criteria can play their conventional role only in situations where there is a choice between alternative taxes with the same revenue potential. Where, for example, the same maximum revenue can be raised through income taxes with proportional, degressive or other progressive rate schedules applied to the same tax base, it is easy to show that these "other progressive" schedules would be rejected by voter-taxpayers at the constitutional level on account of the larger excess burdens necessarily involved.[52] For linear demand schedules excess burden is a fixed proportion of maximum revenue; and there is accordingly no choice in simple cases between broad-based and narrow-based taxes, or between taxes on elastic and inelastic income sources, yielding the same maximum revenue.

These Leviathan propositions clearly turn the standard excess burden arguments upside down, and the case for efficiency-oriented tax reform seems greatly weakened. But is the perspective offered by the Leviathan model appropriate or realistic as the basis for serious tax reform analysis? Much criticism of the model has emphasized its unreality as a description of budgetary decision-making in a parliamentary democracy; and it is clearly true that the picture provided is at best oversimplified and much exaggerated. Such criticism is, however, of limited relevance in the constitutional perspective where particular concern attaches to possible worst-case scenarios. Since a prima facie case for the existence of Leviathan tendencies has arguably been established, a model which highlights such unwholesome proclivities may well be relevant as the basis for tax design or tax reform. Similar tendencies towards possible under-expansion of the public sector may, however, also need to be addressed, possibly through the same or different policy instruments.

In their original presentation Brennan and Buchanan focus exclusively on tax design as the only possible instrument for the control of Leviathan tendencies.[53] More relevant criticism of their analysis might accordingly

[52] *Id.* at section 4.

[53] *Id.*

be focussed instead on the existence of alternative instruments for the control of excessive public expenditure growth. In a more complete analysis, incorporating multiple policy objectives and multiple policy instruments, it could, for example, be argued that setting maximum tax rates, or a limit to the government spending ratio, provides a more appropriate instrument for the control of public sector size. With Leviathan proclivities controlled in this way, the comprehensive tax base and associated welfare cost or excess burden criteria come back into their own as the basis for tax reform proposals designed to promote efficiency in private sector resource allocation and reduce disincentive effects.

A Possible Haig-Simons Perspective

The increasing dominance of efficiency or welfare cost considerations over the more traditional public finance concern with matters of horizontal and vertical equity has predictably been strongly resisted by the major standard-bearers of the Haig-Simons orthodoxy. Perhaps the most remarkable response has been the attempt by Richard Musgrave[54] to pull the rug from beneath the new orthodoxy with an argument which would seriously question the relevance of excess burden in the methodologically appropriate constitutional setting. Whether this appropriate framework is taken to be Rawlsian, utilitarian or Lockean, a strict application of the contractarian approach can, in Musgrave's view, be taken to imply acceptance of the tax burdens associated, on a formal or intended incidence analysis, with the relevant revenue-raising instrument. The familiar behavioural adjustments which underlie the excess burden concept are accordingly "in breach of contract" and, according to Musgrave, should arguably be ignored or at least to some degree discounted — or more accurately, I believe, eliminated or outlawed.

Ideally, of course, lump sum taxation might in principle be used to finance either the supply of public goods or redistribution of income, and no distinction is then required between the formal or intended incidence concept and the more sophisticated concept of effective incidence which allows for the further behavioural adjustments central to the excess burden concept. In this idealised setting allocation branch efficiency could, for example, be achieved as a Lindahl solution in which the marginal evaluation of public expenditure is equated with tax-price for each individual taxpayer. If decision-making costs are ignored, such a solution

[54] RA Musgrave, Social Contract, Taxation and the Standing of Deadweight Loss (1992) 49 *Journal of Public Economics* 369.

might be achieved politically by direct application of the full contractarian requirement of unanimous agreement, perhaps along the lines proposed by Vernon Smith.[55]

In practice, however, the information required to implement the Lindahl solution is not available, and it cannot be generated by costless bargaining under a rule of unanimity. Preference-revelation problems arise, and these must be resolved in a democracy by majority vote on public goods quantity with tax shares determined on the basis of some broad indicator of public goods preference, such as income or consumption. The resulting outcome is clearly not first best, since that is an unattainable benchmark. Rather it represents some sort of practical compromise reflecting the costs of information and of bargaining and the distorting effects of alternative decision rules.[56] Public goods quantity is thus hardly likely to be optimal in any standard sense. And the income or consumption tax employed will clearly have distorting effects on work-leisure choice and must therefore involve some excess burden.

In this more optimistic variant of the public choice tradition it is explicitly recognised therefore that voting rules and fiscal institutions are to some extent substitutes and should be chosen simultaneously. Tightening the voting rule, as under Wicksellian unanimity, may allow the consideration of projects involving the supply of services with reduced publicness characteristics, but will also require greater flexibility in the consideration of revenue-raising alternatives. If, however, majority voting seems clearly preferable in order to reduce decision-making costs, fixed tax-sharing arrangements involving broad tax bases will be required in order to limit majoritarian exploitation and promote allocation branch efficiency.[57]

These arrangements and the associated outcomes may, however, be taken in a free society as reflecting unanimous consent, not to be sure at the simple in-period level of annual budgetary decision-making, but at the constitutional level. The Wicksellian requirement of unanimity is applied therefore at one remove in the multi-period setting of institutional choice. In this setting, however, it is difficult to see how behavioural adjustments to freely-chosen tax institutions, such as an income tax or consumption tax, could possibly be regarded, following Musgrave, as somehow "in

[55] V Smith, The Principle of Unanimity and Voluntary Consent in Social Choice (1977) 85 *Journal of Political Economy* 1125.
[56] Buchanan & Tullock, *supra* note 24.
[57] Buchanan, *supra* note 1, at ch. 8.

breach of the social contract."[58] Efficiency, either in the supply of public goods or in the pursuit of distributional objectives, requires in any case that full account be taken of excess burdens which cannot rationally be ignored or even to some degree discounted.

Musgrave's suggestion to the contrary reflects perhaps an earlier tradition in public policy analysis in which majority voting is viewed as the central and defining institution of liberal democracy rather than a necessary evil (as in the public choice account). Instead of the elaborate and carefully articulated analysis of institutional choice with which we are now familiar, much emphasis was placed in this earlier literature on the concept of political obligation; and the textbooks of political science and of public finance presented themselves as handbooks of "moral guidance" for the major players (legislators, public servants, taxpayer-voters) in the democratic political process. It is, however, a familiar criticism of this approach that it is not operational in any relevant policy sense.

Recognising the dangers of inefficiency under a majority voting rule, it has for example been suggested by Buchanan that the proper role of the political economist or policy adviser is to propose only those policies which could satisfy the Pareto criterion and would command therefore near-unanimous agreement.[59] If a majority voting rule is to be preferred, however, one cannot argue logically for the application, under such a rule, of an implicit unanimity criterion. Nor is it in the least likely, without some explicit legislative requirements, that such a criterion would ever consistently be applied. Even in the early writings of Buchanan, therefore, we find a theory of political obligation for policy advisers which is clearly non-operational in any relevant policy sense.

In Musgrave's analysis essentially the same line of argument is applied to the distorting effects of the chosen tax institution which, he suggests, should simply be ignored, either wholly or in part. The policy logic of Musgrave's position is, however, that the behavioural adjustments which underlie the excess burden concept should, if possible, literally be outlawed, like tax avoidance under a GAAR. A GABAR (a general anti-behavioural-adjustment rule) would seem therefore to be required. But such a rule could clearly never be applied in practice.

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[58] Musgrave, *supra* note 54.

[59] JM Buchanan, Positive Economics, Welfare Economics and Political Economy (1959) 2 *Journal of Law and Economics* 124.

The related view that tax compliance is a moral duty and that tax avoidance breaches the spirit of social contract likewise clearly reflects this earlier policy tradition. This view still has, moreover, strong intuitive appeal, and it echoes down the decades in the public debate. Experience of tax avoidance in liberal democratic countries, including Australia, suggests indeed that a tradition of taxpayer compliance can become so firmly rooted that easy opportunities to avoid tax may be widely, if not universally, ignored. It would appear therefore that the Musgrave argument receives some support from liberal democratic experience with the closely-related norm of taxpayer compliance.

The distortion of work-leisure choice under income or consumption tax which serves to exemplify the concept of excess burden in the Musgrave analysis, can in fact quite reasonably be characterised as tax minimisation and hence as tax avoidance in a very broad sense. Might not a similar norm extend by analogy to embrace a broadened tax compliance concept? Empirical evidence over the past half century, although as we have seen it is still the subject of considerable dispute, suggests moreover a very low response by most workers to tax rates. Indeed some leading tax law scholars, including Brooks and McIntyre, have been heard to argue that leisure is anyway not a good in the economist's sense. If these various arguments could be sustained, the concept of excess burden — in this regard at least — has little if any relevance and could properly be ignored.

Neither the evidence on norms of tax compliance nor the simplistic arguments of some legal scholars on work-leisure choice or the empirical evidence of low labour-supply elasticities is sufficient, however, to justify the sweeping dismissal of excess burden attempted by Musgrave. Familiar norms of tax compliance clearly proscribe only the more blatant and artificial forms of tax avoidance; and the disincentive and distorting effects of taxation analysed by economists under the excess burden rubric clearly lie well beyond the reach of such conventional norms.

The strong reaction, by Musgrave and others, against the excessive emphasis on excess burden in the tax reform debates of the 1980s no doubt reflects the exaggerated elasticity and welfare cost estimates to be found in some of the more prominent contributions to empirical research in the earlier part of this period. By the end of the 1980s, as we have seen, a more sober assessment of the likely distorting effects of taxation had come to prevail. No extreme argument, which would completely deny standing to the excess burden concept, is therefore required. Indeed such an argument must be very much a double-edged sword for the standard-bearers of the Haig-Simons tradition, since if standing is to be denied in the case of work-leisure choice, it must also be denied in the wider area of tax distortions generally. A traditional pillar of the case for broadly-based direct or indirect taxation on an income or consumption base is thereby threatened with immediate collapse.

Musgrave's apparent willingness to contemplate this further consequence of his constitutional destruction of the excess burden concept may be related to perceived white-anting of the neutrality argument by developments in the optimal taxation literature of the past 25 years. Any possible concern on this score can, however, be greatly eased by a more careful application of the quasi-constitutional perspective.

Like the Haig-Simons approach, the more technical optimal tax analysis of the past 25 years is virtually devoid of any appropriate institutional or quasi-constitutional framework. In the area of economic efficiency optimal tax analysis emphasizes the need for selectivity and unequal rate taxation, as against the comprehensiveness and uniformity of tax treatment called for in the Haig-Simons income tax or broad-based direct or indirect consumption tax tradition. In the pioneering work of Ramsey an optimal system of consumption taxes requires differentiated rates inversely proportional to own-price elasticities.[60] Or, as in the analysis of Corlett and Hague,[61] relatively higher rates of tax should be applied to leisure complements and lower rates to leisure substitutes. As the Meade Committee has observed, "almost every separate transaction should ideally be taxed at a special rate."[62]

This *reductio ad absurdum* of the optimal tax approach, though no doubt unfair to many of its more sensible practitioners, serves nevertheless to highlight very nicely a characteristic absence of careful institutional analysis in this tradition. Even if the relevant elasticities and cross-elasticities could be determined with sufficient certainty, a highly differentiated rate system is likely to be very costly to administer and comply with. Elasticity estimates are moreover highly variable and uncertain, inviting misrepresentation and heavy lobbying by interest groups seeking

[60] FP Ramsey, A Contribution to the Theory of Taxation (1927) 37 *Economic Journal* 47.

[61] WJ Corlett & DC Hague, Complementarity and the Excess Burden of Taxation (1953-54) 21 *Review of Economic Studies* 211.

[62] JE Meade, *The Structure and Reform of Direct Taxation* (London, Allen & Unwin, 1978) at 27.

the advantages of lower rates. Under majority voting there is clearly much to be said for a quasi-constitutional commitment to maximum possible comprehensiveness and rate uniformity under income or consumption taxation.[63]

The extent of the disagreement between the advocates of comprehensive, broadly-based income or consumption taxes and exponents of the optimal tax approach has, however, been much exaggerated. By the end of the 1980s the case for substantial comprehensiveness and uniformity at the practical policy level had generally been accepted by leading exponents of both traditions, with a limited role for selectivity confined to special cases nicely exemplified by the traditional excise taxes on liquor, tobacco and petrol, or, for the future, by pollution taxes. Protestations to the contrary notwithstanding, this is easily seen from a careful reading of Stern.[64]

Musgrave's attempt to conjure away the excessive emphasis on efficiency and excess burden thus clearly fails, but it can now be seen to have been unnecessary. With more modest elasticity findings emerging from more recent empirical research and with a more balanced assessment of the practical policy implications of the optimal tax approach, a strong case can be made both for broad-based direct or indirect taxation of income and consumption and for a rebalancing of priorities between the basic tax policy objectives of equity and efficiency.

What might otherwise be viewed as the somewhat old-fashioned emphasis in Musgrave's analysis, here and elsewhere, on the importance of social and moral norms suggests moreover an interesting possible direction for further and much needed development and enrichment of the quasi-constitutional approach and for the strengthening of tax equity objectives.

The Quasi-Constitutional Approach and Community Values

Economists have traditionally had little to say on the possible social or economic role of standards, norms or moral values, which have rather been the domain of sociologists and philosophers. A major reason for such neglect is that any adequate analysis of community values requires a theory of endogenous preferences which is entirely alien to the exogenous or given preference assumptions of economics. Although most di-

[63] Head, *supra* note 20. See also Brooks & Head in this volume.

[64] N Stern, Uniformity versus Selectivity in Indirect Taxation (1990) 2 *Economics and Politics* 82.

mensions of individual preference structures are clearly conditioned by history and the social environment, this is perhaps most obviously true of community values which emerge from the historical process of social interaction and are transmitted or reinforced informally within the family and through formal educational processes in the schools and in a variety of other types of community organisations.[65]

From the quasi-constitutional perspective, standards, norms and moral values are easily seen as having an institutional character, like the tax system itself. It is indeed a fundamental observation of modern public goods analysis that community values and ethical preferences emerge from the historical process of social interaction partly, if not largely, as a response to generalised free-rider problems.[66] Without a strong and complex supporting structure of standards, norms and moral values, the political, legal and fiscal institutions of liberal democratic society would lack the stability necessary for their effective functioning and could not long survive. These basic institutions and the associated value structures are properly to be regarded as public capital, as the social infrastructure of liberal democratic society.[67] In this enriched version of the quasi-constitutional approach to the design and reform of democratic institutions, standards, norms and moral values can clearly be seen as the "cement of society" without which instability and disintegration of our political, legal and fiscal institutions can be predicted.[68]

In this enriched formulation of the quasi-constitutional perspective, the apparent difficulties distinguished earlier in the conceptualisation and implementation of tax fairness or tax equity principles can, to some extent at least, be overcome. It need not, for example, be assumed, as in the hard-nosed majority-voting models of public choice analysis, that norms of tax fairness or tax equity have no real place in tax policy-making but can serve only as convenient rationalisations of sectional interest motives.[69] This is likely to be the case only in pathological social states, or in periods of institutional disintegration or major social upheaval. In more normal periods of reasonable stability, the institutions of democratic so-

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[65] RA Musgrave, Merit Goods, in J Eatwell, M Milgate & P Newman, eds, *The New Palgrave: A Dictionary of Economics* vol. 3 (London, Macmillan, 1987).

[66] A Schotter, *The Economic Theory of Social Institutions* (Cambridge, Cambridge University Press, 1981); R Sugden, *The Economics of Rights, Co-operation and Welfare* (Oxford, Blackwell, 1986).

[67] JG Head, On Merit Wants (1988) 46 *Finanzarchiv* 1, at 27.

[68] J Elster, *The Cement of Society* (Cambridge, Cambridge University Press, 1989).

[69] L Eisenstein, *The Ideologies of Taxation* (New York, Ronald Press, 1961).

ciety may be assumed to command broad acceptance in the quasi-constitutional sense. And these institutions will necessarily be strongly supported in well-functioning democratic systems by associated value structures.

The likelihood that tax fairness principles and related social norms can find effective expression, in competition with self-interest motives, in the democratic political process is further supported by recent analysis in the public choice literature of "expressive voting."[70] The point of departure in these discussions is the observation that individuals have little or no incentive to vote instrumentally in large number electorates under majority voting rules. Self-interest may therefore be suppressed in favour of ethical preferences reflecting social norms or community values as individuals choose to vote expressively rather than instrumentally in political processes.

In periods of reasonable stability, therefore, the tax system can be assumed to command general acceptance and will reflect prevailing principles of equity, efficiency and simplicity. Compliance with the tax laws should be more or less automatic and would be supported by a strong community norm of tax compliance. Problems of tax avoidance and evasion may well arise from time to time, but they would not be widespread and could normally be dealt with. It is certainly possible, under such a stable system, that easy opportunities to avoid or evade tax may be widely, if not universally, ignored.

Such a stable system should not, however, be confused with the highly unusual situation of voluntary compliance with a tax system violating all the prevailing principles of equity, efficiency and simplicity — a situation which, as we have suggested earlier, may well have prevailed in Australia during the 1950s and 1960s, held together only by a powerful tradition or norm of almost sheep-like taxpayer compliance. The analysis we have presented would suggest that such a system must generally be highly unstable and liable at any time to erode and break down in a cumulative cycle of avoidance, evasion and taxpayer revolt.[71]

As we have argued from the outset, a major reform of the tax system should not be undertaken lightly. And in special circumstances it may be

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[70] G Brennan & L Lomasky, Institutional Aspects of "Merit Goods" Analysis (1983) 41 *Finanzarchiv* 183; G Brennan & JM Buchanan, Voter Choice: Evaluating Political Alternatives (1984) 28 *The American Behavioural Scientist* 185.

[71] JG Head, Towards the Tax Summit (1985) 2 *Australian Tax Reform* 129.

possible for the conduct of fiscal affairs to proceed with tolerable efficiency even in the presence of a tax system which grossly violates prevailing norms of equity and efficiency. The quasi-constitutional approach strongly suggests, however, that a genuine need for reform of an outdated and ramshackle system of taxation cannot safely be ignored without seriously endangering a priceless public asset in the form of taxpayer compliance and community acceptance. As Australian experience of the 1970s and early 1980s clearly indicates, once compliance has irretrievably broken down, such an inequitable and inefficient tax system cannot be enforced even by the most Draconian anti-avoidance measures which at the same time may seriously threaten basic liberal democratic norms. The task for the tax administration becomes in this situation closely analogous to the prevention of behavioural adjustment under the Musgrave analysis of excess burden — like holding back the waves.

The normative and positive theory of tax reform suggested by the quasi-constitutional perspective presented in this paper can now be sketched out and briefly illustrated. A more fully articulated statement of this theory with extensive illustrations is contained in Head.[72] Even if we assume, to begin with, an equilibrium tax system consistent with the quasi-constitutional approach, exogenous factors and endogenous processes of economic and social change must eventually call for major structural reassessment of the tax system. Social values, including tax compliance norms, may undergo sea changes of the sort we have witnessed in most industrialised countries over recent decades.

Vertical equity norms may change, with (say) a reduced concern for inequality at the top of the income scale, as appeared to be the case, especially in the Anglophone countries, through the 1970s and 1980s. Heightened concern with matters of economic efficiency was at the same time sparked, as we have already seen, by the results of economic research, strongly reinforced by the priority given to microeconomic restructuring in the context of economic globalisation. The major tax reforms we have witnessed in the industrialised countries during the 1980s, with their base-broadening and rate-flattening features, arguably reflect these and related changes — though a more traditional Haig-Simons account is for some countries still reasonably convincing.[73]

[72] JG Head, Tax Fairness Principles: A Conceptual, Historical and Practical Review (1992) 9 *Australian Tax Forum* 65.

[73] Musgrave, *supra* note 15.

The decline in taxpayer morality and the collapse of traditional tax compliance norms in a number of countries over the past 20 years — whether the result of failure to address urgent needs for tax reform (as in Australia) or reflecting a more general weakening of community standards and moral values — would lead us to predict and recommend an increased emphasis on strong enforcement of the tax laws. This might take the form of a more extensive application of source-withholding, or strengthened systems of information reporting and/or tax audit. Although there have been some failures, clearly this has been a major thrust of tax reform in industrialised countries in the 1980s.

With a more modest assessment of potential efficiency gains and with increasing social concern about widening inequality and rising unemployment in the 1990s, further change in social norms, in the conceptualisation of equity and efficiency principles and in the assessment of equity-efficiency trade-offs can be predicted. Some strengthening of support for progressive income taxation might accordingly be expected. Other changes, however, clearly point in the opposite direction, as concern about low levels of national savings and enforcement problems of capital income taxation under globalisation of world capital markets further undermine support for and viability of the global income tax. Other countries may well decide to follow the Scandinavian example and uncouple the taxation of labour income at progressive rates from the taxation of capital income taxed at a flat rate.[74]

Over time therefore, changes in the conceptualisation and priority attaching to standard equity and efficiency principles of taxation must be expected. Such changes are perfectly consistent with a proper application of the quasi-constitutional perspective. These changes indeed provide on this view the basis for major tax reform initiatives which simply represent the normal constitutional recontracting required in all the major institutions of liberal democratic society in a dynamically changing world.

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[74] PB Sorensen, From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries (1994) 1 *International Tax and Public Finance* 57.

CHAPTER 6

TAX AVOIDANCE AND THE RULE OF LAW: A PERSPECTIVE FROM THE UNITED KINGDOM

Malcolm Gammie

Introduction

I imagine that the earliest methods of taxation involved no more than a demand for money, backed by the threat of force against prospective taxpayers or their property if they failed to pay. In a democratic society, governments legitimise their demands through legislation. In doing so, however, they confront two related problems. First, they must cast into legislative language what it is they want to tax. The words they use may prove inadequate for the task. Second, there are practical limitations on the amount that any government can cast in legislative form. This is not just a limitation on legislative time. If you placed no limit on the size of the tax code, it would still be impossible to write down how every aspect of human activity should be taxed. Even if the draftsman could think of everything today, there would be something new tomorrow to confound him.

Taxpayers rely on — or exploit — the boundaries that legislative words create and the absence of explicit provision to reduce their tax liabilities. In this, taxpayers have the advantage because governments must put their goods on show for all to see. You pay what the government demands. However, on that basis, the scope to avoid taxation depends significantly on who has the responsibility for saying where the boundaries are and which side of the boundary the taxpayer falls. As in the United Kingdom this is usually a matter of statutory interpretation, it falls first to the courts to deal with these issues. When the courts fail to draw the boundaries to the liking of the government, the government redraws the boundary. In case that fails, it reserves to itself (rather than to the courts) the right to say which side of the boundary the taxpayer falls. "You tell us what you have done and we will tell you what tax you must pay."

In the final resort, government reserves the right to say that although it has drawn the boundary in one place, it can redraw the boundary if it thinks that the taxpayer deserves to be taxed. "Well, that is what the legislation says but it is not what we meant in your case and you must pay tax anyway." And so far as it can, it removes the right of any independent tribunal to review its action in any of these things.

The progress of taxing powers down these paths raises high emotions. Professor Brian Arnold records that in Canada in 1987,

> ... there was enormous opposition among tax practitioners to the proposal to have a statutory general anti-avoidance provision. The quality of the arguments against the rule was pathetic. It was suggested that, if the rule were enacted, commercial life as we knew it would come to an end, it would be impossible to give a legal opinion on a proposed transaction, and that the provision was a violation of the rule of law.[1]

This paper addresses the problem of tax avoidance in two parts. In the first part, I consider how in the United Kingdom the courts and the government have responded to tax avoidance in recent years. I relate these responses to the concept of the rule of law in the United Kingdom. This places tax avoidance in its legal context. However, I have not gone on to examine the merits of these responses to tax avoidance. Commentators across the world have discussed in detail the different responses to tax avoidance, their merits and the issues they raise. I have not attempted to add to that debate. The literature is both voluminous and inconclusive.

In the second part of this paper, I explain why this is so and what are the origins of tax avoidance. This places tax avoidance in its economic context. Tax avoidance is a symptom of an affliction that affects all tax systems and a common failing of governments is to tackle the symptom rather than address the underlying cause. Tax avoidance does not reflect the inadequacy of legal language. Most tax avoidance stems from a failure in the underlying principles of what governments seek to tax. Forty years ago in the United Kingdom, the minority report to the Royal Commission on the Taxation of Profits and Income recognised this.[2] It is

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[1] BJ Arnold, Responses to Tax Avoidance, in M Gammie & A Shipwright eds, *Striking the Balance: Tax Administration, Enforcement and Compliance in the 1990s* (London, Institute for Fiscal Studies, 1996) at 205. In his view, practitioners' fears of the general anti-avoidance rule have not been realised. See also BJ Arnold, The Canadian General Anti-Avoidance Rule [1995] *British Tax Review* 541, at 553.

[2] The dissent to the *Final Report* observed,

ironic, therefore, that one of the minority's main recommendations — which the new Labour government adopted in 1965 with the introduction of capital gains tax — has been a major source of tax avoidance activity. It was the artificial schemes to avoid capital gains tax that led the courts in the United Kingdom to develop a new approach to tax avoidance schemes that I describe in the first part of my paper.

The Response to Tax Avoidance in the UK

The Power to Tax under the British Constitution[3]

The United Kingdom has no written constitution. In present day terms, its treaty arrangements with the other members of the European Community may be regarded as constitutional in nature. These treaty obligations limit a UK government's freedom to tax as it pleases. This is explicitly so in the case of indirect taxes.[4] In the case of direct taxes, it stems from the non-discrimination provisions of the Treaty of Rome and the fundamental freedoms that the Treaty establishes.[5] No government can ignore its EC treaty obligations in framing any taxation measure. However, the relationship between the taxing powers of the British Parliament and the European Community, is a separate topic which is peripheral to the main thrust of this paper.

By the reign of Edward III (1327–1377) the principle was established that taxation was illegal without the consent of the two Houses of Parlia-

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> Before turning to particular issues we feel impelled ... to record unequivocally our view that the existence of widespread tax avoidance is evidence that the system, not the taxpayer, stands in need of radical reform. We agree with the basic view ... that it would be wrong to assert that a man owes a duty to the community not to alter the disposition of his affairs so as to reduce his liability to taxation. It is up to the community, acting through Parliament, so to frame the tax laws that they do not leave wide loopholes or open broad avenues for tax avoidance.

Royal Commission on the Taxation of Profits and Income, *Final Report*, Cmnd 9474, (London, HMSO, 1955) Memorandum of Dissent, para. 33.

3 In considering the various constitutional issues that arise in this area, I have referred in particular to I Loveland, *Constitutional Law: A Critical Introduction* (London, Butterworths, 1996) and J Jowell & D Oliver eds, *The Changing Constitution* 3rd edition (Oxford, Oxford University Press, 1994).

4 See Articles 95–99 of the Treaty of Rome.

5 See, for example, Articles 6, 48, 52, 59, 73 and 100 of the Treaty of Rome; M Gammie & G Brannan, EC Law Strikes at the UK Corporation Tax — The Death Knell of UK Imputation? (1995) (No 8–9) *Intertax* 389.

ment.[6] Nevertheless, taxation was a major theme of the struggle for power in the seventeenth century between Parliament and the Monarchy. By that century, Parliament was reluctant to approve the raising of taxation by the Monarchy unless the Monarchy accepted some limitation on its powers. The ability of the Monarchy to resist such demands depended upon whether it could raise money from its own resources, without resort to Parliament. It is not surprising, therefore, that the *Declaration of Right* of 1688 accused King James II as having infringed the liberties of the English people, "by levying money for and to the use of the Crown by [pretence] of prerogative for other time and in other manner than ... grant by Parliament."

As a result, the *Bill of Rights* of 1688 declares that "the levying of money for or to the use of the Crown by pretence of prerogative without grant of Parliament ... is illegal."[7]

Parliament was clear that for the future it would control the purse strings and call the tune.[8] This explains the traditional judicial view that a tax can only be imposed by plain words.[9]

British Constitutional Principles

There are two principal elements to British constitutional theory that concern me: the sovereignty of Parliament and the rule of law.

The first of these implies that there is no limit to the powers of Parliament. An Act that passes the two Houses of Parliament and receives the Royal Assent is the ultimate statement of the law, unless and until Par-

6 JAG Griffith, M Ryle & MAJ Wheeler-Booth, *Parliament: Functions, Practice and Procedures* (London, Sweet & Maxwell, 1989) at 3. The first limitation on the Crown's sovereign ability to levy taxation dates from clause 12 of *Magna Carta* which provided that, "no scutage or aid shall be imposed in our Kingdom unless by the Common Council of our Realm." E Taylor, *Book of Rights* (1833) at 23.

7 1 Will. & Mary sess. 2 c. 2, s. 4 provides, "there can be no doubt that this statute declares the law that no money shall be levied for or to the use of the Crown except by grant of Parliament." See also *Attorney-General* v *Wilts United Dairies Ltd* (1921) 37 Times Law Reports 844, per Atkin LJ at 886. See also *Bowles* v *Bank of England* [1913] 1 Ch. 57 for an attempt to levy taxation prior to the passing of the annual Finance Bill. This lacuna in the government's taxing powers was corrected by the *Provisional Collection of Taxes Act* 1913 (UK).

8 Finance Bills are subject to a particular Parliamentary procedure. It is also the rule that only the government may propose a tax raising measure.

9 See, for example, *Coltness Iron Co* v *Black* (1881) 1 TC 287, at 311, 316, 317; *Ormond Investment Co* v *Betts* (1928) 13 TC 400, at 422, 434; *Russell* v *Scott* (1948) 30 TC 394, at 419.

liament chooses to modify it.[10] Furthermore, the courts have no power to call the legality of an Act into question or even question the procedure by which it became an Act.[11] The constraints on Parliamentary legislative action are political rather than legal in character.

As conceived by Dicey, the rule of law requires that, "no man is punishable or can be lawfully made to suffer in body or goods except for a distinct breach of the law established in the ordinary legal manner before the ordinary courts of the land."[12]

In part this reflects the phrase first used by Parliament in 1354, "that no man of what estate or condition that he be, shall be put out of land or tenement, nor taken nor imprisoned, nor disinherited, nor put to death, without being brought in answer by due process of law."[13]

In concept, this requires that government may only act within the law and that individuals are able to resort to the courts for the protection of their rights and liberties under the law. Government must act within the law but Parliament has an unfettered power to say what the law is. As such, the rule of law appears not to place any substantive constraint on the laws the government may introduce, provided the government can secure their passage in Parliament. On this basis, the rule of law amounts to no more than the right at law to see that government follows whatever processes the statute lays down.

However, Dicey envisaged more than this. Central to his thinking is the idea that governments should be bound by rules that were certain and that do not confer discretion. Goldberg summarises the position in the following terms,

> Because [in the United Kingdom] we have always believed that government action must be justified by law we have been loathed to confer upon our administrators too many discretions. It runs contrary to our notions of justification by law that an administrator should be given discretion effectively to decide what the law is.

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[10] However, unless the United Kingdom chooses to leave the European Community, Community law prevails over a British Act. *R* v *Secretary of State for Transport, ex parte Factortame Ltd (No.2)* [1991] 1 AC 603.

[11] The Parliamentary Roll is conclusive that a Bill has passed all its stages and received the Royal Assent to become an Act. *Edinburgh and Dalkeith Railway Co* v *Wauchope* (1842) 8 Cl & Fin 710; *British Railways Board* v *Pickin* [1974] AC 765.

[12] AV Dicey, *The Law of the Constitution* 10th ed. (London, Stevens, 1959) at 188.

[13] Statute of 28 Edward III ch. 3. See also Lord Denning, *The Due Process of Law* (London, Butterworths, 1980) at v.

> Thus, our constitution gives us a relatively simple model of government: we have law and we have administrators; the administrators are given power to implement the law but they are not in any way, at any rate under classic conceptions of our constitution, supposed to make law... Thus, we begin here with the principle that law should be as certain as it can be.[14]

You find this principle enunciated by Adam Smith in the eighteenth century, not as a constitutional principle but as a general principle of good taxation — as one of his canons of taxation.[15]

This desire for certainty has had a profound influence on the form of legislation and the approach of the courts to the interpretation of legislation. While Parliament's ability to legislate is unfettered by the rule of law, the courts retain the power to decide the precise meaning and effect of the laws that Parliament enacts. In this sense, and in their development of common law and equity, the courts act as lawmakers. How Parliament perceives the courts' approach to interpretation influences the forms of words that Parliament uses. Accordingly, I look first to the approach of the courts in interpreting tax legislation.

Judicial Approaches to Tax Avoidance[16]

Statutory Interpretation

Against this constitutional background, the courts' approach to the interpretation of taxing statutes has historically been seen as adopting a "literal" approach. This is embodied in Lord Cairns' statement in 1869 in *Partington* v *Attorney General* that,

> As I understand the principle of all fiscal legislation, it is this. If the person sought to be taxed comes within the letter of the law he must be taxed, however greater 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 apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what

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[14] D Goldberg, Between the Taxpayer and the Executive;·Law's Inadequacy; Democracy's Failure? [1996] *British Tax Review* 9, at 11.

[15] "The tax which each individual is bound to pay ought to be certain and not arbitrary." A Smith, *Inquiry into the Nature and Cause of the Wealth of Nations* (1776) book 5, chapter 2, part 2.

[16] See generally HH Monroe, *Intolerable Inquisition? Reflections on the Law of Tax* (The Hamlyn Lectures) (London, Stevens & Sons, 1981) ch 3, The Judge's Role.

> 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 the statute.[17]

If the words are clear that will end the matter. But clarity is often a matter of personal perception and, by definition, counsel for the Revenue and for the taxpayer will see that the court has two views of the legislative meaning. It is unlikely therefore that the courts have ever regarded themselves as truly constrained by a literal approach. In particular, where the court perceives that literal words produce a nonsensical result, it can be more imaginative in its construction.[18] Lord Wilberforce put the matter in the following terms in 1980,

> 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.[19]

And this was already well accepted where detailed tax avoidance provisions were in point. The problem in those cases usually lies in knowing where to draw the line in the literal meaning of the general words used. The courts have had to accept in such cases the need to identify the mischief at which the provision was aimed and to give effect to the words of the Act with that in mind — if only to ward off more drastic legislative remedies.[20] This does not mean that the courts attach the widest possible meaning to the words of an anti-avoidance measure. They merely seek

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[17] (1869) LR 4 HL 100, at 122. See also, for example, *Ormond Investment Co* v *Betts* (1928) 13 TC 400, per Lord Atkinson at 434; *St Aubyn* v *Attorney General* [1952] AC 15, per Viscount Simonds at 32; *Inland Revenue Commissioners* v *Trustees of Sir John Aird's Settlement* [1983] STC 700, per Oliver LJ at 707–08.

[18] See, for example, *Inland Revenue Commissioners* v *Luke* (1963) 40 TC 630.

[19] *Ramsay* v *Inland Revenue Commissioners* [1981] STC 174, at 179.

[20] Lord Reid said,

> ...if the Courts find it impossible to give very wide meanings to general phrases, the only alternative may be for Parliament to do as some other countries have done, and introduce legislation of a more sweeping character which will put the ordinary well-intentioned person at much greater risk than is created by a wide interpretation of such provisions as those which we are now considering.

Greenberg v *Inland Revenue Commissioners* (1972) 47 TC 240, at 272.

out the intended meaning having regard to the purpose of the provision, without giving the benefit of any ambiguity to either party.[21]

The advance of purposive construction techniques is apparent in a number of recent decisions[22] and it is an approach with which the courts should feel increasingly comfortable with the influence of European law.[23] Here, I need merely note that an essential aid to purposive construction is the ability to refer to any evidence that indicates what Parliament thought it was enacting. Accordingly, the House of Lord's decision in *Pepper* v *Hart*[24] — in which it disposed of the long-standing convention that the courts should not look at the Parliamentary record as an aid to interpretation — supports this trend.[25] In doing so, the House of Lords has reduced the risk that the courts commit a constitutional impropriety, by deciding that the law is contrary to what was represented to Parliament.[26] In this respect, criticism of the Revenue Department for actively

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[21] See *Inland Revenue Commissioners* v *Joiner* [1975] STC 657, per Lord Wilberforce at 662; *Inland Revenue Commissioners* v *Garvin* [1980] STC 295, per Buckley LJ at 301.

[22] In the High Court, Sir John Vinelott expressed the view that the Appeal Commissioners, "in applying the wording of the relevant provisions without regard to any equity or intendment or any supposed purpose or policy" adopted "an unduly narrow approach" to the construction of the *Oil Taxation Act* 1983 (UK). In deciding the issue he acknowledged the need "to discern the legislative purpose and to fit the particular provision under consideration into a reasonable and coherent scheme" and to rely less on "semantic delicacy." *Chevron UK Ltd* v *Inland Revenue Commissioners* [1995] STC 712, at 721. The Court of Appeal in considering an argument that the operation of one anti-avoidance provision impliedly negated the effect of another, expressed the view that "[it did] not believe that our processes of statutory construction are so wanting in technique and imagination as to allow such a state of affairs to ensue." See *de Rothschild* v *Lawrenson* [1995] STC 623, per Nourse LJ at 627.

[23] See J Avery Jones, Tax Law — Rules or Principles? (1996 Institute for Fiscal Studies Annual Lecture) (1996) 17 *Fiscal Studies* 63.

[24] [1992] STC 898.

[25] The House of Lords has subsequently acknowledged the value of the *Pepper* v *Hart* rule as an aid to the construction of particular taxing provisions. However, only clear statements by the Minister or other promoter of a Bill directed to the point in issue in the litigation may be used. Neither the Revenue nor taxpayers may introduce other Parliamentary materials purporting to show the meaning of a provision. See *Melluish* v *BMI (No.3) Ltd* [1995] STC 964, at 978–79.

[26] An outcome found to be so by the House of Lords in *Inland Revenue Commissioners* v *Congreve* (1948) 30 TC 163, contrary to assurances given by the Financial Secretary to the House of Commons in 1936 when the legislation in question was

seeking a different view of the law to that presented to Parliament seems fair.[27]

The New Approach to Tax Avoidance

Statutory interpretation is an essential aspect of the matter. But legislation operates on the arrangements a taxpayer enters into. Accordingly, does one regard what the taxpayer actually did or is it the substance of what he or she did? The classic statement is Lord Tomlin's in *Duke of Westminster v Inland Revenue Commissioners*, when he said, "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."[28]

The Duke had made payments to his household staff under deed of covenant on the understanding that they would not seek their full wage. By this stratagem the Duke substituted tax deductible payments for non-deductible wages. The House of Lords decided, however, that the covenanted payments could not be treated as wages merely because for the employees they had the same financial effect.

There is still no general principle requiring courts to look to the economic or financial substance of the matter in taxing transactions. The courts, however, have paid more regard to the legal substance of the arrangements that taxpayers enter into.[29] This "new realism," as Lord Oliver has called it,[30] gained acceptance in the House of Lords in *W T Ramsay* v *Inland Revenue Commissioners*.[31] Lord Wilberforce stated the doctrine in these terms,

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enacted. *Congreve* was subsequently reversed in *Vestey* v *Inland Revenue Commissioners* (1979) 54 TC 503.

[27] The taxpayer, Mr Hart, in an unpublished address to the Chartered Institute of Taxation in April 1994, reasonably asked how it was that the Inland Revenue sought to establish an interpretation of the law that it knew (or ought to have known) to be in contradiction to the intent expressed to Parliament by the Minister at the time the provision was enacted.

[28] *Duke of Westminster* v *IRC* (1936) 19 TC 490, per Lord Tomlin at 520.

[29] In doing so, Lord Diplock provided the riposte to Lord Tomlin's dictum when he said that it, "...tells us little or nothing as to what methods of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would attach to them if business transactions were conducted in a straight-forward way." *Inland Revenue Commissioners* v *Burmah Oil Co Ltd* [1982] STC 30, at 32.

[30] Lord Oliver of Aylemerton, Judicial Approaches to Revenue Law, in Gammie & Shipwright, *supra* note 1, at 178.

[31] *W T Ramsay* v *Inland Revenue Commissioners* (1981) 54 TC 101.

> Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance... This is a cardinal principle but it must not be overstated or overextended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as a part or nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.[32]

Ramsay was a circular scheme of a type prevalent in the 1970s. Transactions were entered into, documents were executed with legal effect and without being a mere sham. Money passed between the parties. However, except for the extraction of a fee for the purveyor of the scheme, everyone ended up where they started.[33]

The development of the new realism reached what is still its high water mark in *Furniss* v *Dawson*.[34] The taxpayer sold his shares in exchange for shares in a company he had set up for this purpose. The intermediate company then sold the shares it had acquired to an unconnected third party. In this way the taxpayer hoped to rely on the exception for share exchanges to avoid his liability to capital gains tax.[35] By redefining these arrangements as a direct sale by the taxpayer to the third party, the House

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[32] *W T Ramsay* v *Inland Revenue Commissioners* (1981) 54 TC 101, per Lord Wilberforce, at 185.

[33] Lord Templeman captured the essential absurdity of the whole process in the following description when he likened tax schemes to the performance of a play:

> nothing happens save that the Houdini taxpayer appears to escape from the manacles of tax... The object of the performance is to create the illusion that something did happen, that Hamlet has been killed and that Bottom did don the ass' head so that tax advantages can be claimed as if something had happened.

Id. at 128.

[34] *Furniss* v *Dawson* (1984) 55 TC 324.

[35] The scheme was counteracted by s. 40 of the *Finance Act* 1977 (UK). Since then the exception only applies if the Inland Revenue is satisfied that the transaction does not have tax avoidance as a main purpose. Taxpayers can obtain an advance clearance to that effect.

of Lords went further than they had in *Ramsay*. The creation of the intermediate company could not just be ignored as a fiscal nullity — as the whole arrangement in *Ramsay* had been ignored. The taxpayer owned shares in the intermediate company and the intermediate company held the cash generated by the sale. Nevertheless, the House of Lords decided that the arrangement failed because looked at in its entirety, the initial share exchange was not of a type contemplated by the exception.

Lord Brightman justified this approach in these terms,

> First, there must be a pre-ordained series of transactions; or if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial end... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax — not "no business effect."[36]

In this respect, the Judges have always been prepared to question the legal substance of an agreement. Thus, it is ineffective to describe a payment under a contract as a 'premium' when in reality it is interest.[37] Similarly, describing a payment as "interest" when there is no underlying indebtedness, is insufficient to secure a tax deduction.[38] The misconception of the *Duke of Westminster's* case was to believe that this approach was limited to an analysis of a single agreement; that where a series of agreements or transactions were involved, the courts were bound by a sterile concept of legal form — by the particular labels that the parties attached to the transactions or agreements that they entered into.[39] The

[36] *Furniss* v *Dawson* (1984) 55 TC 324, per Lord Brightman at 401.

[37] *Lomax* v *Peter Dixon & Son Ltd* (1945) 25 TC 353, per Lord Greene at 367.

[38] *Re Euro Hotel (Belgravia) Ltd* (1975) 51 TC 293.

[39] This is illustrated by a separate line of cases represented by *Ensign Tankers (Leasing) Ltd* v *Stokes* [1992] STC 226, where the arrangements were embodied in 17 documents, all executed together and drafted to achieve a particular tax effect. Essentially, the documents sought to characterise certain costs as a loan but a reading of all the documents showed that no loan was really involved. Accordingly, what was claimed as a loan was not to be given effect to for tax purposes as a loan. For an early example of the willingness of the House of Lords to ignore agreements entered into to avoid taxation, see *Magistrates and Town Council of the City of Glasgow* v *Messrs. Murdoch, Warren & Co*, 9 May 1783, described in I Ferrier, The Meaning of the Statute: Mansfield on Tax Avoidance [1981] *British Tax Review* 303.

new realism tells us that the courts will look at composite arrangements to give effect to the bargain the parties actually struck — the "real deal."[40]

An operational criterion for this approach, however, is a finding that tax avoidance lies behind some of or everything the parties did. I return to this in the conclusion to this part of the paper. However, the question upon which the courts have principally focused in later decisions is this: what degree of pre-ordination do you need for this doctrine to apply? Lord Oliver's answer in *Craven v White* is, "... 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."[41]

And in *FitzWilliam* v *Inland Revenue Commissioners*[42] Lord Keith said that, "the correct approach ... is to ask whether realistically [the series of transactions] 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."[43]

In essence, what the House of Lords has made clear since *Furniss* is that the new realism does not strike down any tax-saving arrangement merely because it is 'pre-planned,' rather than pre-ordained.

The Government's Response to Avoidance

No judicial doctrine is a complete answer to tax avoidance. No government can assume that the judges will consistently share its view of what amounts to tax avoidance. Why risk the outcome of litigation on the changing moods of the judiciary? Legislative measures accordingly remain pre-eminent.

Historically, the United Kingdom has eschewed a general anti-avoidance rule.[44] Nevertheless, a number of provisions have similar characteristics to a general anti-avoidance provision, the difference being their limitation to specific aspects of the tax code. The *Finance Act* 1996 provides two recent examples. The first is its code designed to prevent the manipulation of the VAT group rules so as to recover VAT (as input tax)

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[40] For another view of the constitutional issues of the new realism, see RT Bartlett, The Constitutionality of the *Ramsay* Principle [1985] *British Tax Review* 338.

[41] *Craven* v *White* (1988) 62 TC 1, at 199.

[42] [1993] STC 502.

[43] [1993] STC 502, at 513.

[44] There was a general anti-avoidance rule in the wartime excess profits tax.

in circumstances where this is not intended.[45] The second is the wide general anti-avoidance provision built into the new provisions for taxing and relieving corporate loans.[46]

The UK approach reflects a preference for tax avoidance provisions that are "tailor-made" to deal with a specific abuse or, more generally, for an abuse of a specific part of the tax code. Such provisions may, however, be general or specific in nature. Accordingly, the legislative treatment of tax avoidance in the United Kingdom defies general analysis and it is beyond the scope of this paper to attempt one. Criticism of specific anti-avoidance provisions is easy to find and the width and generality of some provisions have been likened to an "elephant gun"[47] or "scatter-gun"[48] technique. Detail, length or the generality of the words or some combination of them can obscure rather than to elucidate meaning.[49] But, as a general matter, is a "tailor-made" or "targeted" tax avoidance approach more consistent with constitutional principle and the rule of law than a general anti-avoidance rule of the type found in a number of other jurisdictions?

On the face of it, the UK tax code reflects the principle of legislative certainty. The detail of the legislation illustrates the desire of the draftsman and those who instruct the draftsman to anticipate any manoeuvres

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[45] See Budget Notice 129/95, para 1, 30 November 1995. The anti-avoidance provisions are contained in Schedule 4 to the *Finance Act* 1996 (UK). The provisions are activated through a direction by Her Majesty's Customs & Excise. No direction may be made if the main purpose of the offending arrangement has a "genuine commercial purpose" unconnected with the grouping and the recovery of input tax in question. Customs & Excise has supplemented its powers under the legislation with a 16-page Statement of Practice illustrating the type of arrangement at which the legislation is aimed.

[46] *Finance Act* 1996 (UK), sch. 9, para. 13. This denies a deduction for interest and other financing costs if the loan relationship includes a purpose other than a business or other commercial purpose of the company. This will be the case where the only or a main purpose of the loan is a tax avoidance purpose. A tax avoidance purpose covers the securing of a tax advantage which may include the deduction of financing costs.

[47] J Holroyd-Pearce, Gains from Property Transactions — The Attack on Tax Avoidance [1980] *British Tax Review* 382, at 383,

> ...the point of the description is that the Revenue appear to be uncertain what precisely the target is, and so they fire off an enormous gun in the general direction of where they suppose the target to be in the hope that they will hit something worthwhile.

[48] Lord Oliver, *supra* note 30, at 184.

[49] *Yuill* v *Wilson* [1979] STC 486, at 489.

by taxpayers to take advantage of the legislation in unintended ways. The draftsman explains when and where the legislation is to apply and who or what falls within — or outside — its scope. What the draftsman seeks is precision. The legislation should achieve what the government intends — no more, no less. Anyone who needs to know his or her position can do so by studying the legislation, which may not be easy but which will ultimately yield the correct answer.

In another context, this process has been described as "tax rule madness."[50] On the face of it, however, it is the epitome of the rule of law as described by Lord Oliver,

> Law is all about the rules which society imposes upon its members for the regulation of their conduct. Elementary fairness dictates that if rules are to be imposed in an area in which there is no universal moral imperative to aid understanding, they shall be clear and unequivocal, so that the subject may know with certainty what he or she may or may not do and what are the legal consequences of any projected course of action.[51]

The reference to a moral imperative recalls the frequently stated judicial view, expressed by Learned Hand J in Commissioner of *Internal Revenue v Newman* that,

> Over and over again the courts have said that there is nothing sinister in so arranging one's affairs so as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right; for nobody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[52]

The consequence of this, in Lord Oliver's words, is that,

> ... the judge's initial perception of his function is that of standing between the citizen and the state to ensure that the former is not prejudiced by rules which are unclear, uncertain or unpromulgated and, par-

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[50] RJ Vann, Improving Tax Law Improvement: an International Perspective (1995) 12 *Australian Tax Forum* 193, at 222.

[51] Lord Oliver, *supra* note 30, at 174.

[52] (1947) 159 F. 2d 848. The same sentiment was expressed by Lord Tomlin in the *Duke of Westminster's* case and agreed to in 1955 by the Royal Commission on the Taxation of Profits and Income.

ticularly by administrative activity which makes up its own rules as it goes along.[53]

Is this, however, what the explosive growth in tax rules achieves? The simple answer, I believe, is that it does not. There is a tension between the use of purposive construction techniques by the courts and the resort to increasing detail by the draftsman that may merely obscure whatever principles underlie the legislation.[54] The development of legislative detail, so that users of the legislation find it more difficult to pick their way through the maze, is not an objection in itself. The reality, however, is that the detail merely obscures the effective practical discretion that the uncertainty of meaning confers on the administrator.

I will take a single example to illustrate my point. Over time, Parliament has enacted detailed rules designed to identify when companies are within a sufficiently close economic relationship to claim a variety of tax benefits. You can contrast the detailed UK rules with the more general expression of the concept of a corporate group that is used in Dutch tax legislation. Goldberg notes that the brevity and generality of the Dutch rule give very considerable latitude to the Revenue authority.[55] But do the several pages of the UK rules preclude such administrative discretion?

The detail of the UK rules is largely a response to previous manipulation of the rules by taxpayers. Over time, taxpayers have devised arrangements that satisfied the current rules but without producing the type of on-going economic relationship that meets the government's conception of what the rules ought to allow. The most recent change to the rules countered one such arrangement.[56] However, even while amending legis-

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[53] Lord Oliver, *supra* note 30, at 174.

[54] Lord Diplock, Presidential Address to the Holdsworth Club, University of Birmingham, 1965.

> When an Act attempts ... to deal specifically with every class of transaction which the draftsman can foresee, it becomes difficult indeed to extract from the mass of detail any principle which the Courts can say with confidence Parliament intended to be applicable to any class of transaction which the draftsman did not foresee. This is what drives the Court to adopt the narrow semantic approach. We cease to ask ourselves: "What did the users of the words intend?" and ask ourselves: "What, as a matter of semantics, do the words they used mean?" These are different questions and may result in different answers.

See also Avery Jones, *supra* note 23. Avery Jones' main thesis is that the draftsman should seek a clearer expression of principle (in the European tradition) rather than the elaboration of detailed rules.

[55] See Goldberg, *supra* note 14, at 13.

[56] *J Sainsbury plc* v *O'Connor* [1991] STC 318.

lation was before Parliament, the government was consulting on the terms of a concession that would allow the Revenue to ignore the amended law in cases within the concession.[57]

Extra-statutory concessions contain their own general anti-avoidance rule because a taxpayer cannot rely on a concession for any tax avoidance purpose. A taxpayer cannot seek to enforce a concession in ordinary appeal proceedings because, by definition, a concession reflects a derogation from the law.[58] The taxpayer's only remedy if a concession is denied is to ask the courts to review the reasonableness of the Revenue's decision, which they will not do in any case involving tax avoidance.[59]

The nature of this response to avoidance was candidly described in Parliament in the context of another broadly drawn provision,

> I sought to comment on the way in which the new clause would be interpreted by the Revenue in practice. It would be easier if we could define precisely not merely the circumstances dreamt up to benefit that arrangement but those that will be in the future. The need for a flexible basis in law is underlined by the fact that the hon. Gentleman began by saying that we discussed the point two years ago in the context of equity notes. We should try to avoid entertaining the Committee with this debate on an annual basis.[60]

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[57] Extra-statutory Concession C10. The terms of the amending legislation were circulated for consultation in January 1992 at which time many consulting bodies drew attention to its perceived deficiencies. The Finance Bill Committee debated and passed the amendments (which the government had modified in only minor ways) on 23 June 1992. The terms of the Concession and a Revenue Statement of Practice, addressing some of the earlier concerns of the consulting bodies, were already in existence by then. See *House of Commons Official Report*, Standing Committee B, 23 June 1992, cols. 239–241.

[58] Concessions are of questionable constitutional validity in the light of the Bill of Rights of 1688 which abolished the Crown's ability to dispense with the law.

[59] *R* v *Inland Revenue Commissioners ex parte Fulford-Dobson* [1987] STC 344 is a case where the taxpayer sought this remedy but failed. It is well established that the Courts may review an attempt by the Revenue to resile from a stated interpretation of the law. See *R* v *Inland Revenue Commissioners ex parte MFK Underwriting Agencies Ltd* [1989] STC 873; *R* v *Inland Revenue Commissioners ex parte Matrix-Securities Ltd* [1994] STC 272. However, there is no authority to show that a court would force the Inland Revenue to apply a concession, that is, to depart from the law rather than merely apply a particular interpretation of tax law.

[60] *House of Commons Official Report*, Standing Committee B, 30 June 1992, col. 446. The equity notes legislation to which this refers was subsequently subject to an exchange of correspondence between the Inland Revenue and the Law Society

An Interim Conclusion on the Legal Issues

I do not propose to argue the merits of different approaches to tax avoidance based on this brief survey of the judicial and legislative responses to tax avoidance in the UK. Arnold has argued, correctly in my view, that a response that is appropriate in one jurisdiction may not translate successfully into another jurisdiction.[61] But this conclusion should not disguise the fact that tax avoidance raises the same issue in every jurisdiction, even though the legal answers to the issue may differ from jurisdiction to jurisdiction.

The objection to a general anti-avoidance rule in the United Kingdom is most often stated in these terms,

> [A general anti-avoidance provision] violates perhaps the most important and fundamental principle of tax law: that the legislation must impose tax in clear and unambiguous terms and that a person must not be taxed unless he comes within the letter of the law. What is more, to the extent that such a provision vests any sort of discretionary taxing power in the Executive, it is nothing less than a departure from the rule of law..."[62]

However, once you reach the stage at which legal definition is neither possible nor (for the government) advisable, resort to discretion is inevitable. However it is approached, the issue to address is always how best to balance the interests of the taxpayer and the State — for taxpayers to know what tax they must pay other than through an unfettered demand and for government to be assured that it can raise the revenue it requires. Adherence to the fiction of legislative certainty in areas for which government must ultimately claim a discretion may merely inhibit the development of satisfactory mechanisms to balance the various interests involved. Ultimately, such mechanisms may function more satisfactorily to preserve the rights of the general body of taxpayers and to uphold the rule of law than the illusory appearance of a certain tax code.

The legal issues of avoidance arise when satisfactory legal definition is no longer possible and the resort to discretion becomes inevitable. The question is how in those circumstances to control administrative discre-

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in which the Inland Revenue "explained" its view of the broad terms used by the legislation. See [1993] *Simon's Tax Intelligence* 306.

[61] See Arnold, The Canadian Rule, *supra* note 1, and the other authorities cited there.

[62] C Masters, Is There Need for Anti-Avoidance Legislation in the UK? [1994] *British Tax Review* 647, at 671.

tion. In this respect, the absence of evidence to show that administrators currently abuse their discretion is irrelevant. The required protection is against what administrators might do if uncontrolled, rather than against what they are currently shown to do.[63]

However, is it possible to identify a satisfactory criterion for reviewing the exercise of administrative discretion in those areas where the legislator has been unable to define what it is he objects to? Is there an operational definition of tax avoidance? This is the common thread that links the debate on judicial approaches to tax avoidance, on many specific and general anti-avoidance provisions and on the ability to review satisfactorily the exercise of administrative discretion in this area. It is to this that I turn first in the second part of this paper.

The Origins of Tax Avoidance

Defining Tax Avoidance

The Behavioural Effects of Taxation

In 1955, the Royal Commission on the Taxation of Profits and Income noted that "by tax avoidance ... is understood some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement."[64] People who neither smoke nor drink alcohol will pay less tax than if their personal preferences were different. This is, however, a matter of personal choice rather than an arrangement to avoid tobacco or alcohol duties. This perception does not change if someone smokes or drinks less as a result of those duties, or switches from cigarette to pipe tobacco where the latter attracts a lower duty. Taxation affects individual behaviour and these are merely examples of the behavioural effects of the duty.

On the other hand, to cross the river Thames, you may use the Blackwall Tunnel which charges no toll or the Dartford River Crossing which

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[63] However, the absence of current abuse may be evidence that existing review procedures are effective to control discretion. Alternatively, administrators may understand that their current discretions — which may be extensive — and their relative freedom from review depend upon their not being seen to abuse that discretion. Goldberg argues in a similar context that the British constitutional tradition has inhibited the growth in administrative law and that the judges have as yet proved unequal to the task of controlling administrative discretion. See Goldberg, *supra* note 14.

[64] Royal Commission on the Taxation of Profits and Income, *supra* note 2, at para. 1016.

does. Accordingly, you do avoid taxation if you choose the Blackwall Tunnel instead of the Dartford River Crossing when the latter would otherwise be the more direct route. This is an arrangement to avoid the toll but it is not one that people normally label tax avoidance in its pejorative sense. Your choice of route across the Thames should be related to your travel costs. You may object to the toll but if you are a rational person, you will pay it if the additional cost of a longer journey through the Blackwall Tunnel exceeds the toll.[65]

Artificiality as a Criterion for Tax Avoidance

Accordingly, it is not every behavioural effect of taxation that amounts to avoidance. Nor is it every arrangement that reduces a person's tax liabilities tax avoidance that must be countered — what I shall occasionally refer to as "abusive tax avoidance." Abusive tax avoidance is usually represented by those cases where taxation has an extreme effect on individual behaviour. Let us assume that the toll at the Dartford River Crossing applies only to mechanically propelled private vehicles. This leads some drivers to disable their car on one side of the river by removing some vital engine component, push the car across and replace the component on the other side. Most people would recognise such conduct as out of the ordinary. It is not just that the toll has affected people's behaviour. Their behaviour has become extremely artificial.[66]

Nevertheless, neither complexity nor artificiality provides a satisfactory criterion for identifying tax avoidance.[67] Many commercial arrangements are highly complex and are affected by taxes. Any behavioural effect of taxation is in one sense artificial, namely that without taxation taxpayers would have arranged their affairs differently. However many commercial or private transactions go further than this and are carried out in artificial

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[65] In this respect, the toll charged at the Dartford Crossing should be related to the additional expense that the average traveller would be expected to incur by going the longer route through the Blackwall Tunnel. See P Willoughby, Taxation: The Dream And The Reality, University of Hong Kong, vol. XXIV (No. 4) *Supplement to the Gazette* (25 March 1977) at 2.

[66] You can observe equally bizarre and artificial arrangements in a number of cases that have come before the courts. See for example *Ransome* v *Higgs* (1973) 50 TC 1; *Black Nominees Ltd* v *Nicol* (1975) 50 TC 229; *W T Ramsay* v *Inland Revenue Commissioners* (1981) 54 TC 101.

[67] Nor does the existence of "fat fees for clever tax advice and ... wads of documentation" indicate tax avoidance, despite such a claim by the Minister in the debates on the 1996 Finance Bill. See *House of Commons Official Report*, 28 March 1996, cols. 1192–1193.

ways to secure particular tax results without meeting official or public disapproval.[68] The Revenue authorities themselves may encourage the adoption of artificial transactions that secure a particular tax result. In that way they can defuse the pressure that would otherwise exist to change the law to allow that end to be achieved in a more straight-forward manner.[69]

The Purpose of the Arrangement

As a result, most tax systems do not attempt an objective definition of artificiality but ask why people behave in the way they do. In my example, their car may have broken down but in most cases their only response can be that they were seeking to avoid the toll. However, the answer is not always so straight forward. Let us suppose that "a mechanically propelled private vehicle" is any vehicle other than a commercial vehicle. A commercial vehicle is either a vehicle suitable to carry commercial goods or one in use for a commercial purpose. The behavioural response you observe is that people make some small modification that increases their car's carrying capacity. They then arrange with a local business to carry a small quantity of its goods on each trip across the river. The toll is the reason for the modification but each trip across the river now has an independent commercial justification.

People who do not resort to such measures may face a choice each time they use the River Crossing. They can tell the toll keeper that they are travelling on business and claim to pay no toll or they can admit to a private journey and pay. The law normally punishes dishonesty, but in this case honesty is rewarded by a tax bill.[70] The individual who lies is merely evading the toll, even if this may be difficult to prove. However, what of the individual who, when his business is done, intends to visit his parents before returning home? Or who is visiting his parents and will take the opportunity to visit a customer? And is his journey home in any of these

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[68] For similar reasons "artificiality" was rejected as a suitable criterion for the Canadian general anti-avoidance rule. See Arnold, The Canadian Rule, *supra* note 1, at 545–46.

[69] The Revenue may prefer not to introduce a specific relief from the tax charge in question because they cannot guarantee that it will not be abused. By sanctioning a more artificial way of achieving relief, deserving cases are not denied the relief but without opening up the risk of abuse. Alternatively, the legislation needed may be long and complex and difficult to persuade Ministers there is a need, especially if those affected have other means to circumvent the problem.

[70] While the same is true for those who are honest with Customs and declare the goods they are importing, the dishonesty of smugglers can be verified objectively by searching their luggage rather than merely their mind.

cases a private or a business journey? The toll that he pays may eventually depend upon how easily he can reconcile the different reasons for his journey, and how good he is at presenting his story to the toll keeper.

A more complex illustration of this point is that of an employer who establishes a trust for his employees. Such trusts have been used to reduce liability to the UK's social security tax — national insurance contributions. Once the prospective tax justified the costs involved, any well advised employer would use this device to pay bonuses. However, no anti-avoidance rule can deal successfully with such arrangements based on why the trust came into being. There are many reasons why employers set up trusts for the benefit of their employees. With such a rule, those other reasons would become an important justification for the trust's existence. Accordingly, there will be a premium on the professional advice that can suggest what those reasons might be, and present them persuasively to the Revenue authorities.

These examples illustrate an area of uncertainty between tax avoidance and tax evasion that commentators do not always acknowledge. It arises where the taxation treatment of a transaction — a journey or the establishment of a trust — depends upon the reason for undertaking the transaction. A substantial part of the literature on tax avoidance is devoted to analysing the concepts of motive, purpose and intention, and this reflects that taxation based on these concepts is less satisfactory than taxation based upon objective and verifiable fact.[71]

Enquiry into states of mind blurs the distinction between avoidance and evasion.[72] Taxation that depends upon why someone did something presents significant policing problems and allows taxpayers the opportunity to represent their activities in ways that can shade from tax avoidance into tax evasion. Once questions arise as what and how the Revenue authority is told of a person's state of mind the boundaries between legitimate

[71] J Kay, The Economics of Tax Avoidance [1979] *British Tax Review* 354, at 354–55.

[72] A similar issue arises for tax avoidance schemes that rely for their success on each step being looked at individually. The taxpayer has an incentive to report the scheme as if it is outside the *Ramsay* or *Dawson* doctrines, and is therefore effective. If the taxpayer admits that the scheme is pre-ordained and that certain steps were inserted only to achieve a tax advantage, he invites the Inland Revenue to say that the scheme is ineffective.

avoidance and concealment amounting to evasion become increasingly difficulty to detect.[73]

The Purpose or Spirit of the Legislation

The existence of some tax benefit that the taxpayer derives from the arrangement is taken as granted. However, does any feature of the tax advantage help to identify the arrangement as abusive tax avoidance? Recent UK cases have sought to articulate such a feature. Lord Goff in *Ensign Tankers* thought that, "unacceptable tax avoidance typically involves the creation of complex artificial structures by which ... the taxpayer conjures out of the air a loss, or a gain, or expenditure, or whatever it may be, which otherwise would never have existed."[74]

But many things only occur or come into existence because of taxation and there is no universal rule that they therefore be characterised as abusive tax avoidance. Lord Templeman has referred instead to the "trick" or "pretence" that every tax avoidance scheme involves.[75] By this, however, he does not mean that the scheme is a sham.[76] However, as I explained earlier, it involves your being able to identify which real transactions and agreements confer the tax advantage and which do not. Lord Templeman has proposed that you can identify abusive arrangements,

> ... when a 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

[73] For example, in the United Kingdom, a number of the tax avoidance schemes in the 1970s depended upon transactions that occurred off-shore. Taxpayers who acquired and relied upon those schemes to avoid taxation usually had to take on trust that the offshore transactions were duly executed as described. The issue of disclosure in tax avoidance cases was examined by the Committee on Enforcement Powers of the Revenue Departments. See *Report of the Committee on Enforcement Powers of the Revenue Departments*, Cmnd 8822, (London, HMSO, 1983) vol. 1, ch. 7.

[74] *Ensign Tankers (Leasing) Ltd* v *Stokes* [1992] STC 226, at 244.

[75] *Matrix-Securities Ltd* v *Inland Revenue Commissioners* [1994] STC 272, at 282.

[76] "I apprehend that, if ["sham"] has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the Court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create." *Snook* v *London & West Riding Investments Ltd* [1967] 2 QB 786, per Diplock LJ at 802.

loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.[77]

This involves ascertaining the Parliamentary intention and Lord Templeman implicitly recognises that in his speech in the *Challenge Corporation* case, when he says,

> In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.[78]

Everyone can form a view whether, in the cases that have come before the courts, Lord Templeman's formulation has been satisfied. However, it offers no guiding principle that you can apply with any degree of certainty in other cases because it involves an assessment of the purpose that underlies the tax exemption, relief or advantage in question.

The Canadian general anti-avoidance rule explicitly recognises that a general anti-avoidance rule still has to distinguish those transactions entered into principally to obtain a tax advantage where that advantage is intended by Parliament. It does so by providing an exemption from the rule for transactions which have as their principal purpose the obtaining of a tax advantage but which do not "result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole."[79]

However, if you can readily identify the purpose of the legislation you may ask why the draftsman is not prepared to state that purpose in preference to detailed rules that obscure rather than clarify the purpose.

The simple answer to this question, is that the most serious problems of tax avoidance arise where there is no clear principle underlying the legislation. The formulation of any test to identify whether at the boundaries of the legislation an arrangement satisfies the Parliamentary intention or

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[77] *Commissioner of Inland Revenue* v *Challenge Corporation Ltd* [1986] STC 548, at 554–555. This case concerned the New Zealand general anti-avoidance rule. See also the similar remarks made by Lord Templeman in *Matrix-Securities Ltd* v *Inland Revenue Commissioners* [1994] STC 272, at 282.

[78] [1986] STC 548, at 555.

[79] *Income Tax Act* 1985 (Canada) s. 245(4).

not will always be an expression of personal view rather than verifiable fact. The House of Lords has told us that the sale of shares in exchange for shares is, in the circumstances of *Furniss* v *Dawson,* a transaction that does not benefit from the capital gains tax exemption for share exchanges. However, there is no taxation principle to explain why the tax consequences should differ depending upon whether a taxpayer exchanges his shares in a public take-over, exchanges them in a *Furniss* v *Dawson* transaction or sells his shares for cash and invests in new shares.

In *Furniss* v *Dawson* the House of Lords distinguished one share exchange from another. Lord Oliver has described its test as "a general doctrine of fiscal nullity dependent upon motive."[80] As such, his objection is that,

> ... the Courts ... [have created] ... two categories of tax avoidance; permissible tax avoidance and impermissible tax avoidance ... without at the same time establishing any reliable criteria for distinguishing between the two. Pre-ordination is no sort of criterion because no commercial transaction is undertaken without a measure of pre ordination. 'Business purpose' is no sort of criterion, because the saving of money from tax mitigation in order to have it available for a business must itself be a 'business purpose'. So the citizen and the Courts themselves are left without any readily intelligible reference points.[81]

It is part of the judicial function to interpret tax legislation in a way that recognises the Parliamentary intention and I outlined earlier the current trend towards the more purposive construction of tax legislation. However, a court will not be able to develop a clear principle where none underpins the legislation. Differences in judicial views and outcome, and inevitable uncertainty, are the only result.

Tax Avoidance and the Tax Base

The Importance of Perceptions of the Tax Base

Does this mean, therefore, that tax avoidance is and must remain an elephant: you recognise it when you see it (although it is easily confused with a hippopotamus or a rhinoceros)? This would seem to be so from the Ministerial "guidance" (*sic*) on the subject,

> Companies that enter into schemes with the primary aim of avoiding tax will inevitably be aware of that. The transactions we are aiming at

[80] Lord Oliver, *supra* note 30, at 181.
[81] *Id.* at 186.

are not ones which companies stumble into inadvertently ... companies will know when they are into serious tax avoidance; apart from anything else, they are likely to be paying fat fees for clever tax advice and there will commonly be wads of documentation.

The last thing I want to do, however, is set out a list of so-called acceptable or unacceptable activities. Borrowing for commercial purposes can be structured in a highly artificial way in order to avoid tax. If we said that borrowing for certain types of activity would always be okay, tax advisers would quickly take advantage and devise artificial financial arrangements simply to avoid tax. Provided that companies are funding commercial activities or investments in a commercial way, they should have nothing to fear. If they opt for artificial, tax driven arrangements, they may find themselves caught.[82]

The conventional line that people draw is between tax avoidance and tax evasion. The boundary between the two is not always clear where taxation depends upon motive but the essential difference is that tax evasion is illegal while tax avoidance is not. Evasion is a function of the assessment and collection mechanisms that are available to governments to secure compliance with the taxes they impose. The practical manifestation of those mechanisms is the powers conferred upon the Revenue authority to control and monitor taxpayers and their activities. By comparison, tax avoidance is a function of the tax base.

The labels that people use to describe the effects of taxation on individual behaviour, such as "abusive" or "unacceptable" tax avoidance, "proper" tax mitigation or "sensible" tax planning, are legitimate expressions of opinion. They are no different from the many other judgements that people make everyday. However, you cannot divorce the labels from the personal perceptions of the sense and suitability of a particular tax base, and whether it is "fair." With no consensus as to what is the correct tax base, it is futile to search for some objective principle or standard by reference to which you can say which label applies in specific circumstances.

A simple example serves to illustrate how the tax base may affect attitudes to tax avoidance. Let us assume that a bridge toll varies according to the number of people being carried in a car but that there is no toll for crossing the bridge on foot. Is it avoidance if a driver lets his passengers out as he approaches the bridge and picks them up on the other side? Or

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[82] *House of Commons Official Report*, 28 March 1996, cols. 1192–1193.

is such action no more than sensible tax mitigation?[83] Your attitude may depend upon whether you believe in a social obligation to pay tax. Whatever their initial reaction, however, most people will see that avoidance or mitigation is not the issue. The tax base is in a muddle. The toll should be related either to the use of the bridge by vehicles — in which case it does not matter how many passengers there are — or to its use by individuals — in which case everyone should pay the toll whether they cross by foot, by car or by any other means. In the face of an irrational tax base, views on whom we should criticise will differ: the people who take steps to pay less tax or those who are responsible for devising an irrational tax base?

Successful Taxes

We should therefore look beyond labels and examine more fundamentally why it is, in my illustrations, different forms of toll induce different behavioural responses and different views of that behaviour. An attractive objective of tax design is to minimise the behavioural effects of taxation. In this respect, the scope for avoidance under any given tax structure is of particular interest. Tax avoidance provides an indication of the distortions inherent in the structure and is a good guide to the deficiencies of that structure. A measure of the success of a tax system lies in the lack of opportunities that it offers for tax avoidance (and tax evasion).

In addition, opportunities for tax avoidance are not shared equally by taxpayers. The ability to disable a car and push it over the bridge is limited to those with large and particularly fit and mechanically minded families or those who can afford the necessary technical assistance. A toll on individuals who cross by car but not on those who walk allows the burden to fall disproportionately on those elderly or disabled persons who cannot walk the distance and therefore avoid or mitigate their liability. Accordingly, tax avoidance is essentially inequitable.

Most literature approaches tax avoidance as an issue of legal definition. How successful has Parliament been in converting what government wants to tax — the tax base — into legal language? But the better question is how well defined and sustainable is the economic concept that forms the tax base? Without a clear economic concept, the legislators will have as much difficulty in giving legal coherence to the concept as the judges will in understanding their legislation. Both the behavioural response to taxation and the difficulty with legal language are related to the clarity of the economic concept that underlies the tax base.

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[83] The cost of shoe leather would be a relevant consideration in any decision to walk.

Successful taxes are those that reflect two factors — a well-defined and sustainable economic concept that recognise a person's ability to pay, and the ability of government to administer, collect and enforce the tax. The absence of both factors lay behind the disastrous failure of the Thatcher Government's 1988 poll tax. The tax did not recognise in any satisfactory way a person's ability to pay and the mobility of the population in inner city areas defeated the administrative resources available to local government to collect the tax.[84] This failure was dramatic because it came about through widespread tax evasion — including public disorder. Tax avoidance may be more subtle and its effects less easily observed but its impact on an unsatisfactory tax base may be equally severe.

Income as the Basis for Taxation

The most commonly recognised tax base is consumption. Taxation based on a person's consumption invariably recognises their ability to pay tax. People do not always recognise that consumption lies at the heart of income as a tax base. Economists' definitions of income, however, are cast almost exclusively in terms of what people can consume. Bradford explains the point in these terms,

> ... the concept of income generally used in discussion of tax reform has been called an accretion concept. It is supposed to measure the command over resources acquired by the taxpayer during the accounting period, that command having been either exercised in the form of consumption or held as potential for future consumption in the form of an addition to the taxpayer's wealth. Hence, the apparently paradoxical practice of defining "income" by an "outlay" or "uses" concept — consumption plus change in net worth.[85]

It is the Haig-Simons' definition that is the foundation of the accretion concept of income. This defines income as consumption and the opportunities for consumption in the form of a change in the person's net worth. However, identifying the opportunities for consumption raises considerable issues. First, the measure of any person's income in this sense will vary according to the period over which income is measured.[86]

[84] See D Butler, A Adonis & T Travers, *Failure in British Government: The Politics of the Poll Tax* (Oxford, Oxford University Press, 1994).

[85] D Bradford & US Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform* 2nd ed. rev (Arlington Virginia, Tax Analysts, 1984) at 26.

[86] What is important in this respect is the period of measurement not the fiscal period. Thus, capital gains are normally measured over the period between the acquisition

Second, to measure income you must be able to *value* current opportunities for consumption, even though they have not been reflected in any cash receipt.

Many people regard wealth as an appropriate measure of a person's taxable capacity. However, there is an inherent practical difficulty in basing tax on a measure that requires the annual valuation of a person's total assets. This is a problem also for a tax on income in the sense of a tax on the opportunities for consumption. How do you measure opportunities? Some assets cannot be valued easily. Furthermore, valuation merely reflects one current expectation of several possible outcomes by whoever is doing the valuing — whether that be the market, an accountant in respect of business profits or some other specialist valuer. And are you interested merely in taxing the opportunity to consume, or do you want to know that that opportunity was actually realised? And in what sense realised — as actual consumption or something else?

You can easily identify from those problems those areas of the tax system that are prone to abusive tax avoidance. First, there is the basic idea of deferring income and accelerating expenses. And to get round the difficulty of annual valuation, the system relies on cash receipts. However, frequently taxpayers can control the timing of receipts and in many cases the form of the receipt. Most obviously, the system cannot allow taxpayers to lock up their savings in institutions and only pay tax when they withdraw them to spend. This converts an income tax into a tax on consumption. An income tax accordingly requires effective measures to tax intermediaries or to allocate the returns they earn to individual savers. And if you tax what people earn and save, you must be able to distinguish capital — their savings — from income when taxing the return on their savings. Making income look like capital has been a fruitful source of avoidance opportunities.

Kaldor, one of the minority members of the 1955 Royal Commission, was of the view that "[the] problem of *defining* individual income, quite apart from any problem of practical measurement, appears in principle insoluble."[87] Kay summed the matter up when he noted that,

> ... income is, in the last analysis, a subjective concept whose size depends on the judgement of the accountants who compile it and the par-

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of an asset and its disposal, even when that spans several tax years. The effective rate of tax on capital gains varies according to the period of measurement.

[87] N Kaldor, *An Expenditure Tax* (London, Allen & Unwin, 1955) at 70.

ticular purposes for which the measure will be used. This doesn't mean that the income concept doesn't have substantial practical value: it does ... [W]ithout an income concept as a guide to practical action individuals and companies are likely to make serious mistakes; ... Income ... is a necessary concept but one which cannot be given the precision or objectivity that some of its uses might require. Foremost among these is its use as a tax base, and the principal source of the bulk of the extensive statutory provisions is successive, not very successful, attempts to give that precision to a concept which intrinsically lacks it.[88]

Consumption as the Tax Base

Implicitly, I acknowledge in this paper that taxes on consumption — in my illustration, the use of a river crossing — are not immune from avoidance activity. Whenever taxation seeks to differentiate in some way between people or products, the question arises as to how easy the line will be to draw. And this will depend upon how robust is the underlying concept on which the distinction is drawn. The more numerous and diverse the characteristics and attributes of particular goods and services, the easier it is to distinguish them and the smaller the incentive for taxpayers to substitute one product for another. A persistent difficulty of taxing savings is that the relevant characteristics of financial assets are limited — typically the rate of return, risk and liquidity. One form of saving is therefore a very close substitute for another and the difficulty and distortions of savings taxation — which is associated with so much avoidance activity — should not surprise us.

The problems of savings taxation are the problems of an accrual income tax. Defining consumption has its problems. However, because income is defined as consumption plus new opportunities for consumption, it should be apparent that income shares whatever problems consumption has as a tax base. You can see this if you consider whether a person who crosses the bridge for mixed business and private reasons can deduct the toll in calculating his income, or whether the VAT input tax attributable to his use of the company car ought to be allowed. However, a consumption base avoids many of the problems of the income base because it taxes outcome not opportunity. As Kay points out,

For every problem which arises under VAT there is an analogous difficulty for an income tax, but the converse is not true ... [and a]s with

[88] J Kay, *Is Complexity in Taxation Inevitable*? (Institute for Fiscal Studies' Working Paper 57) (London, Institute for Fiscal Studies, 1985) at 10.

VAT, the avoidance problems faced by a direct personal expenditure tax are a strict subset of those arising for a personal income tax... But the central reason why avoidance opportunities are much reduced is that an expenditure tax is a tax on net receipts... The description of the tax base is therefore substantially easier to handle under a personal expenditure tax than under a person income tax.[89]

Conclusion

Rules and the Underlying Principles

Taxes are no part of any unwritten code that governs society. A tax system must therefore be rule-based. The legal system then faces a choice. Does it favour legal rules underpinned by judicial interpretation and application — a legalistic approach? Or does it rely on administrators to formulate rules to govern their action, subject only to review — an administrative approach? The practical impossibility of legislating for every situation means that legal systems contain a mixture of both approaches.

The constitutional and legal tradition in the United Kingdom has preferred a legalistic approach and this remains at the heart of the UK's tax system. In recent years, however, UK tax administrators have been more willing to publish guidance on how they interpret and apply the legal rules. While legal rules still prevail, the administrative view and judicial review techniques have taken on an important status. In practical terms most people prefer to accept the administrator's view of a legal rule than to challenge that view in the courts.

By itself an administrative approach should not concern us, provided the administration is open and unbiased and the courts have satisfactory powers of review. The administrative response to a changing social and economic environment may be quicker, more flexible and more effective than Parliamentary action. However, the balance between legal and administrative rules is not the central issue.[90] The soundness of the eco-

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[89] Kay, *supra* note 71, at 363–64.

[90] People often use the expression "purposive drafting" to describe the movement of the legislative detail of the rules from the formal and relatively inflexible status of primary legislation into more flexible forms of secondary legislation or Revenue practice statements. A case can be made for this movement but it has nothing to do with purposive drafting in the sense of expressing a clear principle that you can apply to a variety of circumstances as a guide to the correct answer in those circumstances.

nomic principle that underlies the rules is. Tax rules, whether legal or administrative, are more easily formulated and applied when they are drawn up to put flesh on sound economic principle.

The rules for determining and taxing employment incomes illustrate my points. The legislation that imposes tax on employment incomes ranks among the shortest and most straight-forward pieces of the tax code. Predictably, the difficulties arise in such areas as non-cash benefits — where valuation is an issue — and expenses — where personal consumption choices are in point. Significantly, the rules for taxing employment incomes are largely administrative rules. This has not, however, been a particular concern. The unavoidable difficulties of benefits and expenses are peripheral issues. They cannot disguise that a person's salary is an easily identified and sound economic base for taxation.[91]

A more controversial aspect of current employment income rules, however, is the exemption from tax of "profit related pay." Detailed and complex legal rules are needed to define what pay is "profit related." It is a matter of considerable controversy and concern whether legal or administrative rules should supply the answer. There is no consensus at any time that the rules — whether legal or administrative — are wholly correct. It does not take long for allegations to emerge that some directors or employees have undeservedly obtained exemption through tax schemes and the refinement of the rules is on-going.[92]

The simple answer is that neither legal nor administrative rules can satisfactorily say what pay is profit related. There is no clear principle on which to base such rules. Employees contribute to the success of an enterprise in a variety of ways that rules cannot readily identify and value separately from the employee's basic salary. Accordingly, people object to administrative rules because they perceive that there is no clear principle to guide the administrators and they fear that administrative decisions may be arbitrary and unfair.

But legal rules are equally incapable to producing a satisfactory answer to the problem. As a result, the legal rules offer opportunities for manipulation. The outcome is equally arbitrary and unfair in allowing clever and

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[91] See M Gammie, Tax Simplification — Right Path or Dead End? in *Report of the Proceedings of the 47th Conference, 1995 Conference Report* (Toronto, Canadian Tax Foundation, 1996) at 2:1.

[92] See, for example, the Budget Statement and Inland Revenue Press Release of 30 November 1993.

well advised people to obtain the benefit of the relief where others cannot. Purposive legislation offers no escape because there is no satisfactory principle to express as a legislative purpose.

The Response to Tax Avoidance

A Piecemeal Response

A major failing of UK fiscal policy has been for government too often to target the symptom of the problem — specific tax avoidance schemes — rather than the underlying cause.[93] Consequently, as one scheme is countered another emerges. The invariable outcome is the continuing refinement of legal rules in a vain attempt to define the problem out of existence. Kay describes very well the result,

> The final exasperated outcome is the buttress of a rather vague and general provision which leaves doubt in the mind of honest and dishonest taxpayer alike; and which may well create difficulties for those who have no thought of tax avoidance. The sum of the resulting legislation is complex in appearance and uncertain in effect.[94]

A recent illustration is the UK's approach to the taxation and relief of corporate debt. For a dozen years or so, Parliament has legislated on an annual basis to deal with the tax advantages of varieties of financial instrument. In doing so it has merely demonstrated the market's ability to out-think the draftsman. The government has finally been driven to a more fundamental reform of the rules, coupled with a general anti-avoidance rule to limit abuse of the new rules.[95]

A Judicial Response

I have argued that a resort to discretion is inevitable where there is no satisfactory principle to underpin particular tax rules. The only alternative is policy reform. However, with no satisfactory principle, judicial responses to avoidance are unlikely to offer a solution. First, with no clear rationale for the tax base you should not expect the judges to find a satisfactory test to distinguish abusive tax avoidance and ordinary tax mitiga-

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[93] As a result you can only fully understand a number of complex and detailed tax avoidance provisions if you are familiar with the schemes at which they were aimed. Such provisions add to the overall complexity of the taxing Acts.

[94] Kay, *supra* note 71, at 358.

[95] *Finance Act* 1996 (UK) sch. 9, para. 13. An extract from the government's guidance on this provision was reproduced above. The problems that lie at the heart of taxing corporate loans are those of taxing accrual income and of enforcing satisfactorily the tax in an international environment.

tion. Nor will the legislation that Parliament produces adopt a purposive rather than a rule-based approach. Second, in the end it is the government that will want to decide what is abusive tax avoidance. It will not leave it to the variable judicial attitudes and perceptions. Finally, a judicial solution can only serve the government's purposes adequately if it is creates sufficient uncertainty regarding its application. However, as Lord Oliver points out,

> A general doctrine of fiscal nullity dependent upon the motive for which a transaction is undertaken leads inevitably to great uncertainty. It leads, perhaps even more importantly to taxation by Revenue discretion — as indeed Furniss did. The Revenue ... are not slow to take advantage of an opportunity to undertake the taxing role of Parliament...[96]

Thus, the judiciary may confer on the administrator what traditional British constitutional and legal doctrine is supposed to deny — discretion.[97] And this is without necessarily vesting taxpayers with adequate rights to balance their interests with those of government.

A Legislative Response

A general anti-avoidance rule — whether in the context of a specific regime, such as that for corporate debt, or across the tax system as a whole — offers no clearer principle where none exists.[98] However in the face of unanswerable difficulties, are such rules a better course? In one sense they are. Tax avoidance is essentially the problem of giving legal expression to the government's chosen tax base. As such, the problem is political rather than legal. If the government wishes to exempt profit re-

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[96] Kay, *supra* note 71, at 358.

[97] I believe that the position in the USA ought to be considered with the different constitutional and judicial framework in mind. The division of legislative powers between the Congress and the President and the place of the Judiciary within the constitution provides a different background to considering the function and relative merits of judicial and statutory general anti-avoidance rules. See generally J Tiley, Judicial Anti-Avoidance Doctrines: The US Alternatives, Part I [1987] *British Tax Review* 180; J Tiley, Judicial Anti-Avoidance Doctrines: The US Alternatives, Part II [1987] *British Tax Review* 220; WD Popkin, Judicial Anti-Tax Avoidance Doctrine in England: A United States Perspective [1991] *British Tax Review* 283.

[98] Similar avoidance problems should emerge for a tax base in a country that adopts an administrative approach. However, as the use of administrative discretion is a part of the system, I assume that avoidance is more readily addressed. This is perhaps why the debate on avoidance and general anti-avoidance rules seems to be a matter for countries that have adopted English legal traditions.

lated pay, or to exempt some share exchanges but not others, the government may claim the final word on what qualifies.

Lord Oliver thought a legislative approach was to be preferred. He said,

> ... I have to say that I marginally prefer a statutory anti-avoidance framework, at any rate if it is accompanied by an efficient and easily intelligible clearance procedure. I think that I would prefer it even if it is taken out of the province of the High Court and committed to a special tribunal subject only to judicial review.[99]

However, would that framework, as some have claimed, confer unacceptable discretion for administrators, contrary to the rule of law? The answer, as Lord Oliver perceives, lies in establishing the appropriate legal and political controls. A general anti-avoidance provision places in the hands of administrators the power to say what is or is not acceptable. In its traditional British expression, the only control that the rule of law offers is for government to impose tax in clear and unambiguous terms — the letter of the law — in areas where no such certainty (and therefore no such control) can exist.

I have argued that discretion is inevitable in those areas most affected by tax avoidance and I have illustrated the variety of ways, in the United Kingdom, that discretion is conferred even with no general anti-avoidance rule. The immaturity and perceived inadequacy of UK administrative law remedies are central to the objections by taxpayers and practitioners to the introduction to the United Kingdom of a general anti-avoidance rule. The Revenue Departments advise Ministers on the policy of the legislation, instruct the draftsman on the form of the legislation and administer the legislation once enacted. This concentration of functions creates concern that the operation of a general anti-avoidance discretion in the Departments' hands cannot practically be controlled. A devotion to legislative certainty is seen as taxpayers' best refuge. The outcome, however, is an effective discretion without the development of the legal and political controls that ought to accompany it.

Controlling the Discretion

It is beyond the scope of this paper to consider the adequacy of current UK administrative law remedies.[100] Here, I will address three particular

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[99] Lord Oliver, *supra* note 30, at 185–86.

[100] This forms part of the work currently being undertaken by the Institute for Fiscal Studies' Tax Law Review Committee on the reform of the UK tax appeals system.

concerns in relation to the discretion a general rule confers: the rule allows administrators an unfettered discretion to decide after the event how much tax to demand — it creates unacceptable uncertainty; the discretion may be arbitrarily, unfairly or inappropriately exercised and unnecessarily extended; and the discretion allows administrators to alter the scope of taxation without proper legislative control.

Unacceptable uncertainty. An understandable fear of general anti-avoidance rules is that they allow an administrator to decide after the event what tax should be paid, while refusing to say in advance. There is a view that creating legislative uncertainty is an essential weapon for controlling tax avoidance. However, discretion and uncertainty are not necessary companions. Indeed, the exercise of discretion is how you offer certainty where legal definition cannot. Discretion may be inevitable in those areas where avoidance is a problem but uncertainty is not. Uncertainty has no merit whatsoever. A discretion that allows taxpayers to ask administrators how they will be taxed recognises the interests of both taxpayers and government.[101]

Arbitrary taxation. Existing procedures allow the courts to review action by the Revenue departments. Arguably, however, in the case of tax avoidance judicial review is not enough. The proper control of discretion requires that administrators must exercise their discretion openly. An open process is therefore essential. However, the courts can only say whether the administrators have applied a rule fairly. They cannot say whether the rule is being applied *appropriately*. An arbitrary rule may be applied fairly and consistently against all taxpayers.

Ultimately, the resolution of arbitrary taxation lies in the political process, as the fate of the poll tax demonstrates. However, it is no part of the judicial function to say whether the rule was appropriately applied in the case in question. This is a political rather than a judicial question. It points, however, to the establishment of special review procedures, as Lord Oliver suggests, that can satisfactorily reflect the political aspects of the matter.

A legislative power. Would the discretion be unnecessarily extended beyond tax avoidance? I have already drawn attention to the growth of administrative material within the tax system, and to the reliance on ad-

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[101] The apparent belief of the current government that any formal pre-transaction rulings system should explicit deny a ruling for a tax avoidance transaction seems completely misconceived.

ministrative materials for the taxation of employment incomes. There is no reason to think that a general anti-avoidance rule would affect the developing balance between legal and administrative rules.[102]

In this respect, however, existing anti-avoidance procedures in the United Kingdom afford inadequate protection to taxpayers. In particular, the use of concessions offers the Revenue the opportunity to alter taxation liabilities with no guarantee of legislative scrutiny.[103] An anti-avoidance rule should be able to develop to counter new strategies to avoid taxation. This should not, however, allow administrators to alter the accepted taxation of existing arrangements, circumventing legislative procedures in the process.

A Policy Response

My purpose in this paper is not to argue for a particular tax base but to make clear the relationship between legislation, avoidance and the tax base. The difficulties of legislation and avoidance are a function of the chosen tax base and are more severe when the tax base fails to reflect a coherent and sustainable economic concept. Within any tax system, an analysis of the tax base should reveal the areas that are prone to avoidance activity. In this respect, a policy response is usually a better response to avoidance than the resort to broadly drawn anti-avoidance rules that address symptoms but not causes.

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[102] Beighton suggests that a shift to more purposive approach to legislation coupled with a general anti-avoidance rule offers the option of dispensing with complex specific tax avoidance rules and simplifying existing legislative language. See L Beighton, The Finance Bill Process: Scope for Reform? [1995] *British Tax Review* 33, at 43. I cannot examine such claims in this paper but I believe the benefits are probably overstated. The outcome is more likely to be the substitution of detailed administrative guidelines for detailed legal rules.

[103] The withdrawal of extra-concession C10, for example, would deny taxpayers the benefit of assurances they received in 1992 when the group rules were amended which were discussed above. As another illustration, many taxpayers considered that the Inland Revenue changed its interpretation and application of extra-statutory concession A5 for employee removal expenses. In the end the matter was resolved when the concession was replaced by legislation in 1993. Mr Hart criticised the Revenue for seeking an interpretation of the law in his case that was contrary to Ministerial assurances to Parliament and departed from the Revenue's practice of many years. In consultations prior to its defeat in the House of Lords, the Inland Revenue denied that its arguments in *Pepper* v *Hart* contradicted the practice and interpretation it had previously adopted. I merely record that this did not accord with the views and experience of any practitioner involved in the consultation process.

In the United Kingdom, abusive tax avoidance has historically been associated with income taxation and the nineteenth-century Schedular structure of the income tax. Economists have been unable to produce a precise definition of income. It should not surprise us, therefore, that draftsmen and judges have been equally unsuccessful in explaining the concept. A general anti-avoidance rule takes us no closer to understanding the concept of income. It may, however, be a better way to guarantee the rule of law while giving effect to the chosen tax base. An inadequately controlled discretion is contrary to the rule of law, but this is not a necessary consequence of a general anti-avoidance rule.

Avoidance or Evasion?

The poll tax demonstrates that an attempt to impose an unsustainable tax can itself be subversive of the rule of law. The income tax faces a similar dilemma: is accrual income a sustainable tax base? So far as economists can explain this concept, it is one that does not command popular support and cannot practically be implemented as a tax base. The obvious illustration of this point is people's resistance to the idea of paying tax on gains as they accrue. But the compromise of taxing gains when they are realised becomes a source of tax avoidance activity, as *Furniss* v *Dawson* illustrates. A general anti-avoidance rule can counter this and other avoidance techniques. However, the central issue of the income tax is no longer avoidance but that of evasion and therefore survival. In a world in which capital can move freely abroad, the practical ability of the Revenue to control and monitor savings and investment and the income they generate is significantly reduced.

This is not specifically a UK problem but one that affects all jurisdictions that aspire to tax accrual income. It explains the general movement towards taxes on earnings and taxes on general consumption and the reduction of taxes on savings and investment in recent years. [104] Taxes on earnings and consumption are as vulnerable as any to avoidance where, for example, they incorporate exemptions and reliefs that do not reflect any clear principle. Similarly, they encounter problems if they do not adopt objectively verifiable distinctions when they tax people or products at different or multiple rates. My previous examples illustrate these points.

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[104] See Kay, *supra* note 88; J Kay, Tax Reform: A Perspective Longer Than The Life Of One Parliament, in *The Irish Dilemma: How to Achieve Fiscal Reform* (Proceedings of the Ninth Annual Conference of the Foundation for Fiscal Studies) (London, Foundation for Fiscal Studies, 1994); Gammie, *supra* note 91.

However, taxes on earnings and general consumption share three characteristics: they arise from everyday cash transactions, which makes it easy for people to recognise when tax arises, what is the basis of the tax and how much tax is due; their tax base corresponds to a well defined economic concept — earnings and consumption; and their tax bases are relatively immobile.

It is easier to see where people earn their living and spend their money than it is to see where income arises from savings and investment. And because people are less mobile than their capital, collection and enforcement of tax on their earnings and consumption is more a domestic than an international concern. Thus, by accident or design, tax systems are moving towards a tax base that is more robust to abusive tax avoidance and where evasion may be easier to control.[105]

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[105]John Prebble reached similar conclusions on the relevance of the tax base to the issues of avoidance and the rule of law. See Ectopia, Formalism and Anti-avoidance Rules in Income Tax Law, in W Krawietz, N MacCormick & G H von Wright (eds), *Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S Summers* (Duncker & Humboldt, Berlin, 1994) at 367. See also J Prebble, Philosophical and Design Problems That Arise From the Ectopic Nature of Income Tax Law and Their Impact on the Taxation of International Trade and Investment (1995) 13 *Chinese Year Book of International Law and Affairs* 111.

PART II

THE OPERATION OF ANTI-AVOIDANCE RULES

CHAPTER 7

THE CANADIAN GENERAL ANTI-AVOIDANCE RULE

Brian J. Arnold

Introduction

In 1988, the Canadian government introduced a new general anti-avoidance rule into the *Income Tax Act* (the "Act").[1] According to a White Paper on tax reform issued in June, 1987, a general anti-avoidance rule was necessary to prevent taxpayers from engaging in aggressive tax planning that undermined the integrity of the Canadian self-assessment system and the stability of tax revenues. Existing provisions of the Act and judicial anti-avoidance doctrines were perceived to be inadequate to discourage or prevent offensive transactions. As expected, tax practitioners were virtually unanimous in their opposition to the rule on the grounds that no general anti-avoidance rule was necessary and, even if one were necessary, it should not take the form of the rule proposed by the government. After approximately a year of consultation and several modifications to the proposed rule, the rule was enacted as s. 245 of the Act and became effective generally for transactions occurring after September 13, 1988.[2]

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[1] S.C. 1970-71-72, c. 63, as amended.

[2] For a detailed analysis of the rule see BJ Arnold & JR Wilson, The General Anti-Avoidance Rule - Part 1 (1988) 36 *Canadian Tax Journal* 829; BJ Arnold & JR Wilson, The General Anti-Avoidance Rule - Part 2 (1988) 36 *Canadian Tax Journal* 1123; BJ Arnold & JR Wilson, The General Anti-Avoidance Rule - Part 3 (1988) 36 *Canadian Tax Journal* 1369; HJ Kellough, A Review and Analysis of the Redrafted General Anti-Avoidance Rule (1988) 36 *Canadian Tax Journal* 230; J Sasseville, Implementation of the General Anti-Avoidance Rule, in *Income Tax Enforcement, Compliance, and Administration, 1988 Corporate Management Tax Conference* (Toronto, Canadian Tax Foundation, 1989) 4:1; DA Dodge, Tax Reform and the Anti-Avoidance Proposals, in *1987 British Columbia Tax Conference* (Toronto, Canadian Tax Foundation, 1987) tab 4.

Under the new rule, a transaction resulting in the reduction, avoidance or deferral of tax is disregarded for tax purposes unless the transaction is carried out primarily for non-tax purposes or does not constitute a misuse or abuse of the provisions of the Act. If the general anti-avoidance rule applies, the tax consequences must be determined as is reasonable in the circumstances to deny the tax saving that would otherwise have resulted from the transaction.

This article examines the Canadian general anti-avoidance rule with a view to providing readers with an understanding of the Canadian experience. The article commences with a brief description of the background to the introduction of the Canadian rule. It sets out the major policy choices that were made by the Canadian government in the design of the rule, since the same choices confront any country considering the adoption of a statutory general anti-avoidance rule. The article then provides a brief general analysis of the rule itself. This analysis attempts to avoid the technical details of the rule which are peculiar to the Canadian tax system. The article concludes with some personal comments about the effects of the general anti-avoidance rule on tax planning, the application of the rule by Revenue Canada, and the possible attitude of Canadian courts to the rule. As of August, 1996, no cases involving GAAR have been decided by the courts, although several cases are currently before the courts.

At the outset I want to acknowledge expressly the limitations of comparative tax analysis. A country's tax provisions are the product of its own experience. Consequently, great caution must be exercised in adopting features of another country's tax system. This caution is especially necessary with respect to anti-avoidance legislation, which is often a sensitive barometer of the relationship between the rights of taxpayers and the needs of the state.[3] However, it would be foolish for a country to ignore the experience of other countries in dealing with the same problem. Such experience should be studied even if it is rejected or adapted. Often a study of other countries' rules will illustrate the range of policy

[3] Many factors influence a country's attitude and response to tax avoidance, including: the type of tax legislation (detailed technical rules or broad general principles); the extent of tax avoidance and taxpayers' attitudes to tax avoidance; the effectiveness of the tax authorities in dealing with tax avoidance; the attitude of the courts to tax avoidance, their approach to statutory interpretation, and their view of the role of the judiciary vis-à-vis the legislature; and the availability of advance rulings and the publication of detailed guidelines concerning the administrative practices of the tax authorities.

options available to deal with a problem, especially when the countries share common legal and tax traditions, as is the case with, say, Canada and Australia. The experience of other countries is especially valuable in helping to identify mistakes made in the past that can be avoided in the future.

Background

Prior to 1984 Canadian courts had flirted with the adoption of a judicial business purpose test despite fundamental adherence to the principle of the *Duke of Westminster* case,[4] that a person has a right to arrange his or her affairs so as to pay the minimum amount of tax. In a 1984 case, *Stubart v. The Queen,*[5] the Supreme Court of Canada expressly rejected the business purpose test, primarily because such a test was inconsistent with what the court characterized as a general statutory anti-avoidance rule in former s. 245(1). In other words, since Parliament had spoken on the matter, it was inappropriate for the courts to usurp the role of Parliament in dealing with tax avoidance by adopting a general anti-avoidance rule judicially. In this regard, the Supreme Court made a fundamental error. Former s. 245(1) was clearly a provision of narrow application;[6] it was not a general anti-avoidance rule. Even on a superficial examination, it did not apply to deductions in computing taxable income, deductions in computing tax payable, or transactions that artificially reduced income but did not involve deductions.

Although the Supreme Court's decision in the *Stubart* case is flawed, it did recognize the important relationship between statutory interpretation and the control of tax avoidance. The Court rejected strict or literal interpretation of statutes in favour of a "modern approach":

> To-day there is only one principle or approach, namely, the words of an Act are to be read in their entire context in their grammatical and ordi-

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[4] *CIR v. Duke of Westminster* [1936] AC 1.

[5] *Stubart Investments Ltd. v. The Queen* [1984] CTC 294; 84 DTC 6305 (SCC).

[6] Former s. 245(1) read as follows:

> (1) **Artificial transactions.** In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.

nary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament.[7]

Although the modern approach to statutory interpretation is rooted in the ordinary meaning of the text of the statute, the purpose or "object and spirit" of the statute cannot be disregarded as it was under the strict or literal approach. The modern approach gives courts considerable latitude to scrutinize transactions with a view to determining whether they are within the object and spirit of a particular statutory provision. As discussed subsequently, Canadian courts have recently indicated a willingness to control tax avoidance in this way. However, in a 1995 case, the Supreme Court restricted purposive interpretation to situations where the plain meaning of the statutory language is not clear.[8]

Despite the Supreme Court's endorsement of a purposive approach to statutory interpretation in the *Stubart* case, Revenue Canada maintained an excessively literal approach, largely for political reasons. After the *Stubart* case, Revenue Canada announced that it would issue advance tax rulings on transactions that lacked any business purpose. It also issued a Declaration of Taxpayer Rights, which informed taxpayers that "[you] have a right to arrange your affairs in order to pay the minimum tax required by law."

In response to Revenue Canada's new approach and to the Supreme Court's rejection of the business purpose test, taxpayers and their professional advisers became increasingly aggressive. Transactions were carried out that would not have been seriously contemplated 10 years earlier; in fact, advance tax rulings were requested and received in respect of some of these transactions. Many of the transactions involved the utilization of accumulated losses. These transactions became so prevalent that in the period 1985-87 the government experienced a serious shortfall in corporate tax revenues. The government responded by adopting the practice of issuing press releases announcing specific amendments to stop the offensive transactions. Thus, the tax avoidance activity that the Supreme Court thought its new interpretative approach would mitigate had instead intensified by the time the government embarked on its tax reform exercise in 1987.

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7 *Stubart*, at 316, quoting from EA Driedger, *Construction of Statutes*, 2d ed (Toronto, Butterworths, 1983).

8 *Friesen v. The Queen* [1995] 95 DTC 5551, [1995] 2 CTC 369 (SCC).

Major Policy Options

This section of the paper deals with three questions: is some type of general anti-avoidance rule necessary; if some type of rule is necessary, should the rule be judicial or statutory; if a statutory general anti-avoidance rule is considered to be appropriate, what are the most important issues in the design of the rule? Each of these questions could be, and has been, the subject of a separate article.[9]

My intention here is to deal with the first two questions summarily. These questions have been debated at length in the Canadian literature. Moreover, the analysis of these two questions is peculiar to each country; therefore, the Canadian experience is unlikely to be of much significance in another context. However, I think it is important that readers understand what the author's general attitude is toward these questions.

It is impossible to prove whether or not a general anti-avoidance rule is necessary in the Canadian tax system.[10] It is unclear whether there is too much unacceptable tax avoidance, partly because there is no generally accepted definition of unacceptable tax avoidance. Also, the courts have struck down some tax avoidance schemes without the need for any general anti-avoidance rule. In Canada, strong disagreements over the need for a rule were expressed in 1987; it is to be expected that they would continue to be advanced today.

In my view, any tax system requires some general anti-avoidance rule to ensure that taxpayers cannot avoid the obligations that the tax law seeks to impose by engaging in transactions that are designed primarily to avoid those obligations.[11] Furthermore, a survey of the income tax sys-

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[9] See, for example, DC Nathanson, The Proposed General Anti-Avoidance Rule, in *Report of Proceedings of the Thirty-Ninth Tax Conference, 1987 Conference Report* (Toronto, Canadian Tax Foundation, 1988) at 9:1; J Tiley, Judicial Anti-Avoidance Doctrines: The U.S. Alternatives — Part I [1987] *British Tax Review* 180; J Tiley, Judicial Anti-Avoidance Doctrines: The U.S. Alternatives — Part II [1987] *British Tax Review* 220.

[10] BJ Arnold, In Praise of the Business Purpose Test, in *Report of Proceedings of the Thirty-Ninth Tax Conference, 1987 Conference Report* (Toronto, Canadian Tax Foundation, 1988) 10:1, at 10:4.

[11] See Judge Learned Hand's statement to this effect in *Gilbert v. Commissioner of Internal Revenue* (1957) 248 F. 2d. 399, at 411 (2d Cir):

> The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disre-

tems of several European and common law countries indicates that all countries have a rule of this type.[12]

In my view, in 1987 a statutory general anti-avoidance rule was necessary in Canada for several reasons. First, taxpayers and tax advisers were becoming increasingly aggressive; second, for a variety of reasons, Revenue Canada was taking a very lenient attitude towards tax avoidance transactions; and third, the Supreme Court of Canada had rejected any broad general judicial approach to combating tax avoidance.

Once a decision is made that a general anti-avoidance rule is necessary, the next question is whether the rule should be statutory or judicial.[13] A general anti-avoidance rule may be created either by the courts, as it has been in the United Kingdom and the United States, or by the legislature, as it has been in several other countries, including Australia and New Zealand. The adoption of a statutory rule is more acceptable than a judicial rule to those persons who consider that it is the legislature's exclusive responsibility to develop the tax laws. The introduction of a statutory rule is subject to all of the safeguards of the legislative process, including the consultative process. The limits of a statutory rule can be established with more specificity than the limits of a judicial rule, even if only by way of explanatory notes and administrative guidelines which help to reduce uncertainty. Conversely, a judicial rule is inherently more flexible than a statutory rule; it can develop gradually and "cannot be undermined by microscopic examination in the search for loopholes."[14] The benefits of both approaches can perhaps be obtained where the general anti-avoidance rule is introduced by the legislature in a statutory form that is sufficiently flexible to permit the courts to develop the rule gradually. Since the *Stubart* case effectively prohibited the development of a broad judicial business purpose test, the only realistic alternative for Canada was the adoption of a statutory general anti-avoidance rule.

Once it has been determined that a statutory approach to tax avoidance is more appropriate than a judicial approach, the next issue is the design of the statutory rule. Three general legislative approaches are possible.

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gard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities it sought to impose.

[12] Arnold & Wilson, *supra* note 2, Part I, at 872.

[13] See generally, Revenue Law Committee of the Law Society, *Tax Law in the Melting Pot* (London, The Law Society of England and Wales, 1985) at 40-41.

[14] P Millett, Artificial Tax Avoidance: The English and American Approach [1986] *British Tax Review* 327, at 338.

First, Parliament can enact specific anti-avoidance legislation to deal with particular tax avoidance schemes or transactions. Every developed tax system is full of such provisions. Such specific legislation can never be an adequate response to controlling tax avoidance.[15] Second, the tax authorities can be given administrative discretion to deal with tax avoidance. This type of broad administrative discretion is clearly unacceptable in the Canadian tax system because it is perceived to be contrary, at least in spirit, to the rule of law. It must be noted, however, that such administrative discretion is a prominent part of several countries' tax systems. Third, a broad general statutory rule can be introduced to counteract abusive tax avoidance arrangements. This approach was adopted in Canada because specific anti-avoidance rules were thought to be inadequate and administrative discretion to be unacceptable.

In a previous article co-authored with James Wilson, we attempted to identify the principles that should be used in formulating a statutory general anti-avoidance rule for Canada.[16] In my opinion, these principles are equally applicable to the adoption of a statutory general anti-avoidance rule in other countries. Of course, translating these principles into statutory language that represents a balanced, practical, and effective tool for dealing with abusive tax avoidance arrangements, but that does not interfere with legitimate tax planning, is an enormously difficult task.

A comprehensive discussion of the principles to be followed in designing a general anti-avoidance rule is beyond the scope of this article. However, it is appropriate to discuss two of the more important principles.

First, any general anti-avoidance rule must distinguish between acceptable and unacceptable tax avoidance transactions. This distinction is central to any general anti-avoidance rule. Not all tax avoidance is offensive, but no tax system can tolerate or permit unrestricted tax avoidance. The difficulty, of course, is to identify the basis on which the distinction should be made. It seems clear that the distinction should not just be made by way of ad hoc judgments in particular cases; it should be

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[15] See Canada, *Report of the Royal Commission on Taxation*, volume 3 (Ottawa, Queen's Printer, 1966) at 554-56. The Commission identified the following deficiencies — drafters cannot foresee all the possible avoidance transactions, detailed legislation often creates new avoidance opportunities, specific anti-avoidance rules are often overly broad and therefore discourage some legitimate transactions, specific rules often create roadmaps for planners, and specific rules lead to complexity.

[16] See Arnold & Wilson, *supra* note 2, Part II, at 442-53.

made on the basis of predetermined objective criteria that are capable of application by taxpayers, tax authorities, and the courts. In Canada, two main approaches were debated, namely, the rule could apply to "artificial" transactions[17] or to transactions entered into primarily for the purpose of avoiding tax.

Ideally, tax consequences should be determined on the basis of the legal and commercial results of a transaction and not on the taxpayer's purpose in carrying out the transaction. The use of "artificiality" as the test has one significant advantage in that it avoids the necessity of determining tax consequences on the basis of the purpose of a transaction. Nevertheless, this advantage is outweighed by several disadvantages. The meaning of "artificial" is ambiguous; it can mean both "unnatural" and "fictitious." The latter meaning is similar to "sham," which adds nothing to the existing law and which is clearly too narrow for a meaningful general anti-avoidance rule. Also, in Canada and in most countries, artificiality is not inherently offensive; many artificial or unnatural transactions are specifically permitted, either by statute or by administrative concession.[18] Most important, an artificiality test by itself does not provide any criteria to resolve whether a transaction is normal or artificial.[19]

A purpose test, on the other hand, provides a reasonable basis for distinguishing between acceptable and unacceptable tax avoidance. If the primary purpose of a transaction, determined objectively, is something other than tax avoidance, the transaction represents acceptable tax planning. On the other hand, if the primary purpose is to obtain tax benefits and the transaction would not have been carried out in the absence of those benefits, the transaction is unacceptable tax avoidance. Admittedly, there will be some uncertainty concerning the characterization of transactions that have both tax and non-tax elements.

In Canada, it was concluded that a purpose test by itself was not sufficient to exclude all inoffensive transactions. Some transactions that have

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[17] The original draft version of the general anti-avoidance rule provided that the purpose of the rule was "to counter artificial tax avoidance."

[18] For example, consolidation of the profits and losses of corporations in a related group is not expressly permitted by statute. Nevertheless, "informal" consolidation by means of various intra-group transactions is accepted by Revenue Canada.

[19] United Kingdom, Royal Commission on the Taxation of Profits and Income, *Final Report*, Cmd 9474 (London, HMSO, June 1955) para. 1024:

> [A] transaction is not well described as "artificial" if it has valid legal consequences, unless some standard can be set up to establish what is "natural" for the same purpose. Such standards are not readily discernible.

tax avoidance as their primary purpose are authorized expressly by statute or by administrative concession. For example, in Canada estate freezing and transfers of property within a related group of companies are viewed as acceptable in policy terms even though they are not expressly authorized by the tax legislation.

There are several ways to exclude these transactions from the application of a general anti-avoidance rule. One approach favoured by tax practitioners would be to narrow the scope of the rule to transactions that are specifically identified as offensive. This approach would convert the general anti-avoidance rule into a specific rule and make it ineffective. The converse approach would be to create specific exceptions for specific transactions that are not considered to be offensive. The difficulty with this approach is that it is impossible to identify in advance all the transactions that are inoffensive; some transactions that are not excluded from the rule may be as inoffensive as transactions that are expressly excluded. Moreover, it is inappropriate to provide that a particular type of transaction is invariably exempt from the rule.

As a result of these difficulties, the Canadian general anti-avoidance rule provides a general exception from the rule for transactions that do not involve a misuse or an abuse of the provisions of the Act. This approach places enormous responsibility on the courts to interpret and apply the rule and the exception to the rule in order to strike an appropriate balance between legitimate and illegitimate tax avoidance transactions. The general exception to the rule, s. 245(4), is discussed in more detail subsequently.

The original draft version of the Canadian general anti-avoidance rule took a different approach. It contained a clause indicating that the purpose of the rule was to counter artificial tax avoidance. This purpose clause was intended to be a signal to Revenue Canada and the courts that not all transactions lacking a non-tax purpose should be caught by the rule. The idea was that Revenue Canada and the courts would develop the rule on a case-by-case basis, applying the non-tax purpose test to control offensive tax avoidance. Tax practitioners argued strongly that the purpose clause did not provide sufficient protection for inoffensive transactions; it was replaced by the general exception in s. 245(4).

The second issue, which is closely related to the first, involves the relationship between the general anti-avoidance rule and other statutory provisions. In some cases, the general anti-avoidance rule should override specific provisions because otherwise tax planners will be able to manipulate the technical provisions to achieve unintended tax benefits.[20] However, the general rule should not take precedence over specific provisions in all cases. For example, it would be perverse to apply the general anti-avoidance rule to cases where a taxpayer is simply obtaining a tax incentive specifically provided by the statute. Therefore, the courts must decide in each particular case whether the general anti-avoidance rule or another provision should prevail. Although this places enormous responsibility on the courts, any other approach would be arbitrary and inappropriate, at least in some cases. In Canada the legislative drafters have attempted to provide some guidance to the courts in the explanatory notes to the general anti-avoidance rule. Specific examples are given in the notes of situations where specific provisions are intended to prevail over the general anti-avoidance rule and vice-versa.

Description and Analysis of Section 245

The purpose of s. 245,[21] the general anti-avoidance rule, is set out explicitly in the explanatory notes to the section issued by the Department of Finance:

> New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.[22]

Subsection 245(2) provides that, if a transaction is an "avoidance transaction," the "tax consequences" are to be determined as is reasonable in the circumstances to deny the "tax benefit" that would otherwise result from the transaction.

A "tax benefit" is defined very broadly in s. 245(1) to be a reduction, avoidance, or deferral of tax or other amount payable (such as interest and estimated tax instalments) or an increase in a refund of tax or other

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[20] See for example, *IRC v. Challenge Corporation Ltd.* [1986] STC 548 (Privy Council) in which the New Zealand general anti-avoidance rule was held to apply to an intra-group loss the deduction of which was expressly permitted by other provisions of the New Zealand tax legislation.

[21] The full text of s. 245 is reproduced in the Appendix.

[22] Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa, Department of Finance, June 1988) s. 245.

amount payable under the Act.[23] This broad definition ensures that the general anti-avoidance rule applies not only to transactions that avoid tax, but also to transactions that result in any type of tax advantage, including the deferral of tax. The definition of a tax benefit assumes that there is some notional proper amount of tax payable against which to judge whether there has been a reduction, avoidance, or deferral of tax. Although it may be difficult to determine the quantum of the tax benefit, it is ordinarily easy to determine that there is a tax benefit.

An avoidance transaction is defined in s. 245(3) to be any transaction or part of a series of transactions that, in the absence of s. 245, would result, directly or indirectly, in a tax benefit. A transaction is not considered to be an avoidance transaction, however, if the transaction "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."

The term "transaction" is defined in s. 245(1) to include an arrangement or event. Also, the concept of a series of transactions is deemed to include any related transactions completed in contemplation of the series.[24]

The essence of the definition of an avoidance transaction is the non-tax purpose test. A transaction that results in a tax benefit is an avoidance transaction unless the transaction is undertaken primarily for purposes other than that of obtaining the tax benefit. This non-tax purpose test is really an expanded version of the business purpose test. The use of the term "business purpose" was rejected because of a concern that the courts would interpret it narrowly to exclude family and investment transactions (for example, intra-family transfers of property that do not have any business purpose but that are inoffensive because they do not have any tax avoidance purpose).[25] Therefore, if a transaction is carried out for bona fide purposes, other than tax avoidance, the transaction will not be disregarded pursuant to s. 245.

The use of the words "may reasonably be considered" suggests that the test is objective. Also, the section refers to the purpose of the transaction, not the taxpayer's purpose. These aspects of the rule suggest that the test should be what a reasonable taxpayer would have considered the purpose

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[23] The term and the concept were borrowed from the Australian general anti-avoidance rule. The Australian experience was studied seriously by the Department of Finance during the development of the rule.

[24] Subsection 248(10) of the Act.

[25] The term "business" has a well-established meaning for Canadian tax purposes.

of the transaction to be, not what the particular taxpayer's motive or subjective intention for the transaction was.[26] The purpose of a transaction must be determined by reference to what the taxpayer did and the legal, commercial, and tax results of what the taxpayer did, rather than his or her motives and intentions. However, several commentators have criticized the rule as subjective and requiring a determination of the taxpayer's intention at the time of the transaction.[27] Even if this is the case, however, a taxpayer's subjective intention must be verified by reference to objective facts.[28]

Thus, the distinction between abusive and acceptable tax avoidance under s. 245 depends on the primary purpose of a transaction. The determination of the primary purpose of a transaction is likely to require difficult judgments where the transaction is carried out for a combination of tax and non-tax purposes. This determination is essentially factual. However, Revenue Canada and the courts are accustomed to making similar determinations under other statutory provisions that require the determination of the purpose of a transaction.[29]

Under paragraph 245(3)(b), if a transaction is part of a series of transactions and the series results in a tax benefit, each transaction in the series must be tested to determine whether it was carried out primarily for

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[26] With respect to the difference between motive and purpose, see JF Avery Jones, "Nothing Either Good or Bad, But Thinking Makes It So" — The Mental Element in Anti-Avoidance Legislation [1983] *British Tax Review* 9.

[27] For the argument that the purpose test is subjective, see Nathanson, *supra* note 9, at 9:15 - 9:16; Kellough, *supra* note 2, at 47-50.

[28] In a recent case involving the use of a "temporary" partnership to obtain tax benefits, the Federal Court of Appeal held that no partnership existed because the parties did not intend to carry on business in common with a view to profit despite the existence of several objective indicia of partnership. See *The Queen v. Continental Bank Leasing Corporation* [1996] FCJ no. 710 (FCA).

[29] There have been at least 36 cases involving business purpose since 1967. Although these cases are dependent on their facts and the relevant statutory provisions involved, the following tentative propositions may be suggested:

- In certain circumstances, the use of a company to earn or receive income that would otherwise have been earned or received by an individual shareholder may be considered to lack a business purpose.
- Where there are two or more ways of carrying out a transaction that has a business purpose, the taxpayer is not obliged to select the way that maximizes the amount of tax payable.
- Saving for retirement, estate freezing, establishing a captive foreign insurance company, supplying working capital to a subsidiary on an interest-free basis, and securing limited liability have all been found to be bona fide purposes.

non-tax purposes. The series of transactions as a whole need not be justified by a non-tax purpose, and there is no attempt to reorder the series or to determine its true character.

The meaning of the term "series of transactions" has not been the subject of any judicial interpretation in Canada.[30] Subsection 248(10) of the Act provides that a "series of transactions" is deemed to include "any related transactions or events completed in contemplation of the series." The precise meaning of this extension of the meaning of a series of transactions is unclear. Potentially, however, it makes the concept of a series very broad. At a minimum, it includes a transaction planned in advance as part of a series. It may also include an alternative transaction carried out pursuant to a contingency plan on the failure of the original plan. A transaction carried out in contemplation of a series will likely be included as part of the series without the necessity of satisfying any additional requirement concerning the relationship between the transaction and the series.

Subsection 245(4) provides an exception to the charging provision in s. 245(2) for transactions that do not "result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole." To put it positively, s. 245(2) applies only to transactions that lack a bona fide business or non-tax purpose and that result, directly or indirectly, in a misuse or an abuse of the provisions of the Act.[31]

The major difficulty with s. 245(4) is that it does not disclose what criteria the tax authorities or the courts are to apply in deciding whether a transaction results in a misuse or an abuse of the provisions of the Act. The explanatory notes indicate that "[s]ubsection 245(4) draws on the doctrine of 'abuse of rights' which applies in some jurisdictions to defeat schemes intended to abuse the tax legislation."[32] But the notes also state that "[t]ransactions that comply with the object and spirit of other provisions of the Act read as a whole will not be affected by the application of

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[30] It was, however, explored in a trilogy of U.K. cases that may be persuasive in Canada. According to the House of Lords, although it is not necessary that there be a contractual obligation to take the subsequent steps in the series, there must be no practical likelihood that such subsequent steps will not be taken. *Craven v. White*; *IRC v. Bowater Property Developments Limited*; *Baylis v. Gregory* [1988] STC 476 (House of Lords).

[31] Paragraph 76(3)(b) of the Irish general anti-avoidance rule is strikingly similar.

[32] See Department of Finance, *supra* note 22.

this general anti-avoidance rule" and that "[i]t is not intended that section 245 will apply to deny the tax benefits that result from these transactions as long as they are carried out within the object and spirit of the provisions of the Act read as a whole."[33] The reference to the civil law concept of abuse of rights is unfortunate since that concept is not a part of Canadian legal traditions.

According to the explanatory notes, s. 245 is intended to apply as a provision of last resort; accordingly, a transaction must satisfy the other provisions of the Act before any question concerning the application of s. 245 arises. Under the modern rule of interpretation espoused in the *Stubart* case, the provisions of the Act must be interpreted and applied in accordance with their object and spirit. Therefore, if a transaction is not in accordance with the object and spirit of the other provisions of the Act, it is unnecessary for the general anti-avoidance rule to be applied to invalidate the transaction for income tax purposes. On the other hand, if a transaction is within the object and spirit of the other provisions of the Act, s. 245(2) potentially applies if the transaction is an avoidance transaction. It must then be determined whether the transaction constitutes a misuse or an abuse of the Act under s. 245(4). If s. 245(4) is nothing more than an object and spirit test (as the explanatory notes of the Department of Finance suggest), it is difficult to see how a transaction that is in accordance with the object and spirit of the other provisions of the Act could be considered to be a misuse or abuse of those provisions. This interpretation makes s. 245 meaningless. If the courts are persuaded to avoid this result, there appear to be two possibilities.

First, the courts might treat s. 245(4) as a rule of construction rather than an exception to the general anti-avoidance rule. The Department of Finance has argued this position on the grounds of the words "for greater certainty"[34] and the fact that s. 245(4) is an exception to the charging provision in s. 245(2) rather than an exception to the definition of "avoidance transaction" in s. 245(3).[35] If s. 245(4) is a rule of construction, it will operate primarily to assist in resolving situations where a

[33] *Id.*

[34] The expression "for greater certainty" is used by drafters to exclude the operation of the principle *expressio unius est exclusio alterius*. In the context of s. 245, the intended effect of the words is to exclude any implication that transactions covered by s. 245(4) are necessarily caught by s. 245(2). In my view, the expression is used inappropriately.

[35] See DA Dodge, A New And More Coherent Approach To Tax Avoidance (1988) 36 *Canadian Tax Journal* 1, at 21.

transaction is subject to both s. 245 and other provisions of the Act. Thus, it would be possible for s. 245 to override the specific provisions of the Act in appropriate circumstances. However, it seems clear that s. 245(4) is an exception to the general anti-avoidance rule and not a rule of construction; it represents another test that must be met before a transaction can be disregarded pursuant to the rule.

Second, the courts might interpret s. 245(4) as an exemption for transactions that are not abusive. Such an approach could be workable as long as it is supplementary to the fundamental non-tax purpose test. There is a real danger, however, that this approach will degenerate into an unprincipled, conclusory approach based on judges' views of the substance or economic reality of transactions.

Subsection 245(4) refers to "a misuse of the provisions of this Act" and "an abuse having regard to the provisions of this Act, other than this section, read as a whole."[36] The concept of a misuse of the provisions of the Act is relatively straightforward. It would presumably apply to transactions that, although complying technically with the provisions of the Act, are not within the policy, purpose, or object and spirit of those provisions. A provision of the Act that applies to a transaction may apply improperly or be misused; a provision that does not apply cannot be misused. A transaction that avoids certain provisions might, however, be found to be an abuse of the Act as a whole.

The serious difficulties concerning the interpretation of s. 245(4) raise the question whether the provision is necessary. The purpose of s. 245(4) is to exclude from the application of the rule transactions that are carried out primarily for tax purposes but are nevertheless in accordance with the policy of the Act. It has been suggested that, under the modern approach to statutory interpretation, s. 245 would not apply to such transactions even in the absence of s. 245(4).

There are two types of transactions that must be examined in this regard: avoidance transactions that are specifically authorized by the pro-

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[36] The Explanatory Notes explain the meaning of these two concepts as follows:

> For instance, a transaction structured to take advantage of technical provisions of the Act but which would be inconsistent with the overall purpose of these provisions would be seen as a misuse of these provisions. On the other hand, a transaction may be abusive having regard to the Act read as a whole even where it might be argued, on a narrow interpretation, that it does not constitute a misuse of a specific provision.

Department of Finance, *supra* note 22.

visions of the Act and avoidance transactions that are not so authorized but may be regarded as inoffensive or acceptable in tax policy terms. With respect to the first type of transaction, the issue of statutory interpretation is whether s. 245 overrides the specific provisions of the Act. Since s. 245 does not provide explicitly that it overrides, the courts are entitled to decide in any particular case whether or not s. 245 should override. In each case, the courts must exercise judgment by reference to the purposes of the general anti-avoidance rule and the specific statutory provisions involved and to the nature of the particular transaction.[37]

The second type of transaction is more difficult to analyze. Subsection 245(4) excludes such transactions on the ground that they do not constitute an abuse of the provisions of the Act read as a whole. In the absence of s. 245(4), it would be difficult for a court to justify the conclusion that an avoidance transaction is not subject to s. 245; there would be no obvious basis for the court to limit the application of the section. Therefore, in such situations, a court might attempt to avoid applying the general anti-avoidance rule by finding that the transaction is not an avoidance transaction.

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[37] A recent tax avoidance case decided by the Federal Court of Appeal (*The Queen v. Fording Coal Limited* (1995) 95 DTC 5672, [1996] 1 CTC 230) may provide some clues as to how the courts might approach the general anti-avoidance rule with respect to these situations. The case involved a conflict between a detailed technical rule and former s. 245(1), which denied the deduction of expenses that artificially or unduly reduced income. All three judges found that the expenses in question were deductible in accordance with the plain meaning of the specific provision. Two judges held that the deductions artificially reduced income because there was no "rational legislative purpose" to justify them. Therefore, the deductions were "contrary to the object and spirit of the sections which nevertheless permit them" and may be considered to artificially reduce income. The dissenting judge, on the other hand, found the deductions to be in accordance with both the plain meaning and the object and spirit of the specific provisions. Having reached this conclusion, the transaction could not, in his view, be considered artificial under former s. 245(1):

> If a section creates a complex means by which a taxpayer can receive a specific benefit, and if the taxpayer's actions in so doing have been found to be in keeping with both the plain meaning and the object and spirit of the relevant sections, then subsection 245(1) cannot operate to disallow the deductions which arose.

In effect, the dissenting judge's interpretation renders former s. 245(1) largely meaningless. It applies only to transactions that are not within the object and spirit of the other provisions of the *Income Tax Act*. However, such transactions would not be effective under the specific provisions and there would not be any need to resort to former s. 245(1).

Unlike judicial anti-avoidance doctrines, s. 245 specifies how the tax consequences are to be determined where a transaction is subject to the general anti-avoidance rule.[38] Section 245 requires only that the tax consequences must be determined on a basis that is reasonable in the circumstances and in a manner that denies the tax benefit that would otherwise result from the transaction. As the explanatory notes indicate, this approach was adopted because "it is not possible to prescribe exhaustively the appropriate tax consequences for the range of avoidance transactions to which the rule might apply."[39]

Subsection 245(5) supplements the reasonable basis approach without restricting its generality. Thus, in determining the tax consequences to a taxpayer that are "reasonable in the circumstances," Revenue Canada is authorized to:

1. allow or disallow any deductions or tax credits;

2. allocate any deduction, income, loss, or other amount;

3. recharacterize any payment or other amount; and

4. ignore the tax effects that would otherwise result from the application of other provisions of the Act.

The scope of these potential adjustments is extremely broad. There seem to be no restrictions on the aspects of the computation of a taxpayer's current and future tax liability that may be adjusted under the reasonable basis approach. Further, the reasonable basis approach applies to any taxpayer, including one who is an indirect or even marginal participant in the avoidance arrangement.

The impact of s. 245 on future, and perhaps indeterminate, taxation years of a taxpayer, or on taxpayers other than the one whose tax benefit is to be denied, is dealt with under special provisions of the rule. The thrust of these provisions is to facilitate relieving adjustments with respect to persons other than the taxpayer assessed under s. 245(2) and thereby to prevent double taxation in the broadest sense.[40]

Where an avoidance transaction results in an increase in an amount that is relevant in computing a taxpayer's income in a subsequent taxation year, such as a loss carryover, the Minister is entitled to make, or obliged

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[38] Subsections 245(2) and 245(5) - (8).

[39] Department of Finance, *supra* note 22.

[40] For a detailed description of the administrative aspects of the general anti-avoidance rule, see Arnold & Wilson, *supra* note 2, Part II, at 1170-76.

to make if a taxpayer so requests, a determination of the amount.[41] Any determination may be appealed by the taxpayer under the normal objection and appeal rules. The apparent intention of the determination procedure is to allow the Minister to determine the tax consequences immediately rather than wait until the issue arises in a subsequent year.

Finally, it should be noted that all aspects of s. 245, the application of the section, the determination of the tax consequences, and any adjustments made by the tax authorities can be contested by a taxpayer pursuant to the ordinary objection and appeal process.

Practical Experience with the Canadian General Anti-Avoidance Rule

Shortly after the adoption of s. 245, Revenue Canada issued an information circular that provided guidance concerning its approach to the application of the general anti-avoidance rule in specific circumstances.[42] The circular confirmed that the rule was intended to apply only to abusive tax avoidance. To ensure consistency in the application of the rule, the information circular indicated that any assessments involving the application of the rule would be reviewed by the head office of Revenue Canada. A "GAAR" committee was established, composed of senior officials of the Department of Justice, the Department of Finance, and the various departments of Revenue Canada, to review all ruling requests and proposed assessments involving the general anti-avoidance rule.[43] The information circular sets out 12 examples in which Revenue Canada considered s. 245 to apply and 11 examples in which it was considered not to apply. A supplement to the information circular was issued by Revenue Canada on July 13, 1990.[44] In this supplement, an additional 7 examples were discussed, 6 of which were considered by Revenue Canada not to be offensive.

The information circular and supplement are of limited usefulness to tax planners, since the examples used in the circular are stark in their

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[41] Subsection 152(1.11).

[42] Revenue Canada, Taxation, Information Circular 88-2, October 21, 1988.

[43] Until recently, the membership and operation of the GAAR Committee were carefully guarded secrets. In 1995 Revenue Canada became more open. See W Adams, The General Anti-Avoidance Rule (GAAR) Committee, in *Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report* (Toronto, Canadian Tax Foundation, 1996) 54:1.

[44] Revenue Canada, Taxation, Information Circular 88-2, Supplement 1, July 13, 1990.

simplicity. Indeed, the circular assumes that all of the transactions in the examples are avoidance transactions (i.e., the transaction has been carried out primarily for tax reasons) and therefore the only issue is whether the transaction constitutes a misuse or an abuse. However, Revenue Canada has an accessible advance income tax rulings process whereby taxpayers can request a binding opinion from Revenue Canada concerning the tax consequences, including the possible application of the general anti-avoidance rule, of a proposed transaction. This rulings process enables taxpayers to determine with certainty whether s. 245 will apply to a transaction in advance of carrying out the transaction. Therefore, Revenue Canada has taken several actions to minimize the uncertainty caused by the introduction of the general anti-avoidance rule.

As of October 31, 1995, the GAAR Committee had considered 156 cases where the application of s. 245 was a serious issue.[45] In 98 cases, the Committee recommended that s. 245 be applied to the transaction. In 12 cases, the Committee recommended against applying the general anti-avoidance rule but suggested an alternative basis of assessment. The remaining 46 cases were abandoned.

As of the end of 1995, Revenue Canada had issued assessments under s. 245 in over 25 cases. Many more assessments are likely in the near future in light of the number of cases in which the GAAR Committee has recommended the application of the rule. The length of time (8 years) between the introduction of the general anti-avoidance rule and the first assessments is not surprising, since Revenue Canada began to audit the taxation years for which the general anti-avoidance rule first became effective only in 1993. In addition, Revenue Canada has taken a very cautious approach, at least initially, to the application of the general anti-avoidance rule.

As of October, 1995, there were six cases involving the general anti-avoidance rule before the courts.[46] The only decision rendered to date is one by the Canadian International Trade Tribunal in a case involving the Goods and Services Tax, which also contains a similar general anti-avoidance rule.[47] The transactions involved in the cases currently

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[45] *Id*, at 54:3.

[46] R Taylor, Current Tax Avoidance Cases, in *Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report* (Toronto, Canadian Tax Foundation, 1996) 12:1, at 12:12.

[47] *Michelin Tyres (Canada) Ltd. v. The Queen* (1995) CITT No. 20, on appeal to the Federal Court — Trial Division.

before the courts are quite varied, and include surplus stripping, loss creation, income splitting, and weak currency borrowing.

In at least two of the cases currently before the courts,[48] the general anti-avoidance rule is being challenged as unconstitutional. This constitutional argument is that the rule is so vague that the courts must declare it to be unconstitutional.[49] Canadian courts have indicated that a statute may be considered void under s. 7 of the *Charter of Rights and Freedoms,* which guarantees life, liberty, and security of the person, if the provision does not give "sufficient guidance for legal debate."[50] However, the general anti-avoidance rule, and tax issues in general, normally do not involve life, liberty, or personal security. Consequently, in tax cases, the constitutional argument is that the rule is so vague that it contravenes the rule of law. In a paper in this volume, Malcolm Gammie concludes that in the United Kingdom, "Parliament's ability to legislate is unfettered by the Rule of Law." The rule of law means that government must itself act in accordance with the law; therefore, the rule of law is directed at administrative actions of officials rather than at legislative actions.[51]

I suspect that the same analysis is applicable in Canada. The courts should not usurp Parliament's power to frame legislation in general terms because such legislation is often more appropriate than precise detailed rules in dealing with certain problems. Canadian tax legislation is replete with vague general provisions that, for example, prohibit the deduction of expenses unless they are "reasonable" or are incurred for the purpose of earning income.[52] These provisions have been interpreted and applied by the courts over many years without any suggestion that they were unacceptably vague. Although courts have complained on several occasions about the complexity of tax legislation and the incomprehensibility of the statutory language, they have never declared a tax provision to be void for vagueness. Consequently, in my opinion, Canadian courts are likely to dismiss rather easily the void-for-vagueness argument concerning the general anti-avoidance rule and to get on with the difficult task of applying the rule to control abusive tax avoidance.

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[48] *Blair v. The Queen*; *Owen Holdings Ltd. v. The Queen* (on appeal).

[49] See J Nitikman, Is GAAR Void for Vagueness? (1989) 37 *Canadian Tax Journal* 1409.

[50] *The Queen v. Pharmaceutical Society (Nova Scotia)* [1992] 2 SCR 606 (SCC).

[51] M Gammie, Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom, in this volume.

[52] See, for example, para. 18(1)(a) and s. 67.

For taxpayers and their advisers, the general anti-avoidance rule has not been as disastrous as tax practitioners predicted it would be in 1987. When the rule was initially proposed in the 1987 white paper on tax reform, tax practitioners made claims that the rule would bring commercial activity to a standstill; that taxpayers would not be able to carry out even simple, straightforward transactions without advance rulings; and that tax lawyers would be unable to give unqualified legal opinions on simple, straightforward transactions.[53] Although tax advisers now routinely consider the application of the general anti-avoidance rule to proposed transactions, in my opinion, very few transactions that would have been carried out before the introduction of the rule have not been carried out since its introduction. If the rule had any *in terrorem* effect, it was very short-lived as a result of the comfort given to taxpayers and their advisers by the explanatory notes of the Department of Finance and by Revenue Canada's position with respect to the application of the rule. Moreover, there is no penalty even if the general anti-avoidance rule applies to a transaction. In other words, if a tax avoidance transaction fails, the taxpayer will simply have to pay the tax that would otherwise have been payable, plus interest (which is non-deductible) plus any transaction costs. In my opinion, a general anti-avoidance rule that applies only to clearly abusive tax avoidance schemes should be subject to a penalty.[54] 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 recognize, however, that the imposition of a penalty is a very controversial subject.[55]

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[53] See the sources quoted in Arnold, *supra* note 10, at 10:22. See similarly outrageous comments about the Canadian rule in C Masters, Is There a Need for General Anti-Avoidance Legislation in the United Kingdom? [1994] *British Tax Review* 647, at 670:

> Such legislation as this is little short of a disgrace. Where is the certainty that a taxpayer is entitled to expect? How can taxpayers and their advisers legitimately and properly plan genuine business transactions not knowing how such woolly and imprecise legislation will be construed by judges brought up on common law concepts, rather than the alien principles imported into this section?

[54] For a more detailed discussion of the propriety of a penalty, see Arnold & Wilson, *supra* note 2, Part II, at 1152-53.

[55] See for example, Nathanson, *supra* note 9, at 9:27.

Conclusion

Revenue Canada's application of the general anti-avoidance rule has been cautious and responsible. It is difficult to predict how the Canadian courts will deal with the general anti-avoidance rule. It is certainly possible for them to render the rule virtually meaningless, as the Australian courts did with respect to the original Australian general anti-avoidance rule. At the other extreme, the courts could make the rule into an overly broad weapon that discourages legitimate commercial activity. It is likely to be several more years before there is any significant jurisprudence on which to base an assessment of the attitude of Canadian courts to the general anti-avoidance rule.

In the meantime, however, the courts have not been powerless to deal with abusive tax avoidance arrangements. In several recent cases, the courts have struck down tax avoidance transactions on the basis of judicial anti-avoidance doctrines, the new purposive approach to statutory interpretation, and in other ways.[56] However, in another recent case, the Federal Court of Appeal refused to strike down a tax avoidance arrangement and took a very formalistic approach:

> In tax law, form matters. A mere subjective intention, here as elsewhere in the tax field, is not by itself sufficient to alter the characterization of a transaction for tax purposes. If a taxpayer arranges his affairs in certain formal ways, enormous tax advantages can be obtained, even though the main reason for these arrangements may be to save tax ...[57]

Therefore, the attitude of the lower courts to tax avoidance is inconsistent. Despite a couple of opportunities,[58] the Supreme Court of Canada

[56] See *The Queen v. Fording Coal Limited* (1995) 95 DTC 5672, [1996] 1 CTC 230 (FCA); *The Queen v. Continental Bank Leasing Corporation* (1996) 96 DTC 6355, [1996] FCJ no. 710; *Canwest Broadcasting Ltd. v. The Queen* (1996) 96 DTC 1375, [1995] 2 CTC 2780 (TCC). See generally P Barsalou, Review of Judicial Anti-Avoidance doctrines in Selected Foreign Jurisdictions and Supreme Court of Canada Decisions on Tax Avoidance and Statutory Interpretation, in *Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report* (Toronto, Canadian Tax Foundation, 1996) 11:1.

[57] *The Queen v. Friedberg* [1992] 1 CTC 1 (FCA), affirmed [1993] 2 CTC 306 (SCC).

[58] In *The Queen v. Bronfman Trust* [1987] 1 CTC 117, the Supreme Court endorsed, without any analysis the "movement away from tests based on the form of transactions and towards test based on . . . a common sense appreciation of all the guiding

has not dealt with tax avoidance seriously since the *Stubart* case in 1984. The composition of the court has changed significantly since that time and Parliament has added a general anti-avoidance rule to the Income Tax Act. Therefore, it is impossible to predict whether the Supreme Court would be willing to decide a tax avoidance case, although it seems unlikely that the Court would refuse to speak on such an important issue, and whether it would interpret the rule broadly or narrowly.

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. Does each taxpayer have the right to arrange his or her affairs to minimize tax, which is the conventional wisdom based on the *Duke of Westminster* case, or does each taxpayer have an obligation to pay his or her fair share of the total tax burden? Therefore, 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.

Appendix — Section 245 Income Tax Act (Canada)

Section 245. **Definitions.**

(1) In this section and in subsection 152(1.11),

"**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

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features of the events in question." Revenue Canada has become fond of referring to the following excerpt from the reasons for judgment:

> Assessment of taxpayers' transactions with an eye to commercial and economic realities, rather than juristic classification of form, may help to avoid the inequity of tax liability being dependent upon a taxpayer's sophistication at manipulating a sequence of events to achieve a patina of compliance with the apparent prerequisites for a tax deduction.

In contrast, in *Friedberg v. The Queen,* [1993] 2 CTC 306, the Court endorsed the Federal Court of Appeal's statement that "[I]n tax law, form matters."

Act, or any other amount that is relevant for the purposes of computing that amount;

"**transaction**". A "transaction" includes an arrangement or event.

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

(3) **Avoidance transaction.** 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.

(4) **Provision not applicable.** 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 this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

(5) **Determination of tax consequences.** 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 in 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 recharacterized, 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.

(6) **Request for adjustments.** 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 the transaction

any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the day of 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.

(7) **Exception.** Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment or determination pursuant to subsection 152(1.11) involving the application of this section.

(8) **Duties of Minister.** Upon receipt of a request by a person under subsection (6), the Minister shall, with all due dispatch, consider the request and notwithstanding subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection (6).

CHAPTER 8

THE AUSTRALIAN TAX AVOIDANCE EXPERIENCE AND RESPONSES: A CRITICAL REVIEW

Jeffrey Waincymer

Introduction

The nature, scope and responses to tax avoidance are important issues for research and analysis yet they are often overlooked by tax scholars. They are important because the efficacy of any system of taxation laws, is a product of the substantive policy content of the rules, the design and drafting of those rules and ultimately, the attitudes to and implementation of the rules by taxpayers, administrators and adjudicators. Liberal democracies tend to allow scope for a significant degree of tax planning and minimisation by taxpayers. Community and governmental attitudes will commonly call for anti-avoidance activities. These can comprise legislative, administrative or judicial responses, either of a general nature or of a specific nature pertaining to the substantive activity in issue.

A comprehensive study of tax avoidance would consider the nature and extent of the problem and evaluate the various responses from both a philosophical and economic perspective. For example, such a study would inevitably highlight the central jurisprudential aspects of the judicial function in the tax arena, the proper approach to legislative design and drafting, the administrative responsibilities of the Commissioner in seeking to maximise compliance levels and the ethical responsibilities of the profession in the way it deals with its clients. In this way, such a study would sit alongside an examination of public finance theory as a key theoretical foundation upon which to analyse substantive tax provisions and tax reform issues.

The importance of avoidance in the history of Australian taxation law cannot be over estimated. More than any other western democratic jurisdiction, Australia has placed the greatest reliance on general anti-avoidance provisions contained within the taxation legislation. Again, more than any other western democratic jurisdiction, Australian courts have seen the development of judicial doctrines and precedents which have at times encouraged tremendous resources to be devoted to avoidance exercises. Basic design issues such as the failure to tax capital gains until 1985, and at best equivocal provisions dealing with income splitting, encouraged a significant degree of avoidance activity. Furthermore, the Bottom of the Harbour scandal in the 1970's was unique in its degree and impact and led a significant group in society to believe that paying tax was only for the foolish.

These developments and the responses to them make the Australian experience a particularly valuable case study for the purposes of analysis. While many would argue that the Australian approach has been one which placed undue reliance on general anti-avoidance rules (GAARs), which in turn was to the detriment of more fundamental taxation reform, it is none the less true that all taxation systems must have mechanisms to deal with unacceptable tax practices. Regardless of the social desirability or otherwise of any deviation from economic norms, such deviations induce others to arrange their affairs so as to utilise the provisions for their own ends. Progressive rates of taxation encourage income-splitting techniques; tax expenditures in favour of activities deemed worthy of encouragement, lead to the creation of tax-inspired shelters; preferential or tax-free status to capital gains, encourages commercial gains to be described as such; administrative necessities such as limiting the taxing exercise to a particular period, encourages manipulations of the timing of deductions and receipts of income streams; those jurisdictions which prefer to tax beneficiaries rather than controllers of income streams, encourage the use of discretionary trusts and other partial alienations. Notwithstanding the recent major reform exercises in Australia, all of these are still "live" issues.

This paper identifies and evaluates some of the key Australian developments including the short history of the revised general anti-avoidance provision, but seeks to do so in the context of the key conceptual issues that are common to the field regardless of jurisdiction.

What is "Tax Avoidance?"

We should begin in this fashion by addressing a definitional question. Before identifying and evaluating the history of anti avoidance responses by government, the bureaucracy and the judiciary in Australia, it is first necessary to consider just what we mean by tax avoidance. The first reason is because the debate can easily be confused through using the term to cover different phenomena. For example, many public finance scholars either use the term interchangeably with tax evasion, on the basis that a dollar of lost revenue through evasion is the same as a dollar of lost revenue through avoidance, or use it to describe the mere utilisation of tax shelters, on the basis that deviations from a comprehensive tax base are an "avoidance" of the proper amount of tax from the perspective of horizontal equity. A more fundamental reason to analyse the concept is that it would be difficult if not impossible to devise or critically evaluate anti-avoidance responses without having an understanding of the phenomenon that we are concerned with and some articulated philosophy why anti avoidance responses are desirable.

The process of seeking to devise a definition may also tell us much about the validity of the concept. If a workable, efficient and equitable definition can be devised, this can help direct the form of legislative drafting and perhaps judicial responses. On the other hand if no workable definition seems possible, we must at least consider the hypothesis that the concept has no certainty of meaning and therefore GAARs may be either misguided in their focus or inherently indeterminate. The indeterminacy thesis has been articulated by a number of scholars and judges.[1] The latter view needs particular attention in jurisdictions that rely on, or are considering implementing GAARs.

One way to attempt some definition is to consider the phrase in contradistinction to other expressions relevant to the field of tax practice. Minimisation activities can be given labels ranging from those connoting opprobrium to ones which almost suggest positive prescriptions of familial duty. The labels chosen often depend upon one's role and perspective in the tax arena. We speak of tax evasion, tax avoidance, tax minimisation, tax planning or alternatively, commercial decision-making exercises. Exact meanings of these terms are elusive.

When speaking of tax evasion, all seem to agree that we are speaking of an inherently illegal activity. Either the transaction which gives rise to the tax being unpaid is inherently illegal, for example, smuggling money offshore, or illegality simply arises through the failure to properly declare the appropriate amount of assessable income derived in a legal transaction. At times, both forms of illegality co-exist.

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[1] The leading academic proponent of this view is A Gunn, Tax Avoidance (1978) 76 *Michigan Law Review* 733. An illustrative judicial approach is that of Barwick CJ in *FCT v Westraders Pty Ltd* (1979) 11 ATR 24.

Tax avoidance, on the other hand, is seen as involving a legal activity but not necessarily one which is effective for tax purposes. The main difference with tax evasion, however, is that the underlying transaction is not illegal and there is no suggestion of fraudulent misdescription or fraudulent failure to declare. Whether a tax avoidance transaction will be effective for tax purposes or not will depend on the particular statutory provisions in issue and the way the Commissioner and the courts choose to interpret both the facts and the law.

It is more difficult to distinguish tax avoidance from tax planning, although the ordinary implications of the two terms suggest some difference between acceptable and non-acceptable practices either from a moral, legal, ethical and/or political perspective. A number of factors have been considered relevant in distinguishing between these two concepts. Academic writers and statutory provisions look at factors such as motive, intent, purpose, artificiality, commerciality and commercial effects to try and make those distinctions. The first point to note is that there is no common meaning of either expression adopted by all or most commentators.

The Asprey Committee in Australia considered that tax avoidance generally referred to acts within the law not based on bona fide and adequate consideration. The Committee acknowledged that there is a fine line between acceptable and non-acceptable transactions.[2] The Carter Commission report from Canada has a lengthy appendix entitled *Problems of Tax Avoidance* which describes various supposed techniques. It defined the term as follows:

> For our purposes... the expression "tax avoidance" will be used to describe every attempt by legal means to prevent or reduce tax liability which would be otherwise incurred, by taking advantage of some provision or lack of provision in the law... It presupposes the existence of alternatives, one of which would result in less tax than the other. Moreover, motive would seem to be an essential element of tax avoidance. A person who adopts one of several possible courses because that one will save him the most tax must be distinguished from a taxpayer who adopts the same course for business or personal reasons.[3]

[2] Taxation Review Committee, *Full Report* (KW Asprey, Chairman) (AGPS, Canberra, 1975) paras 11.1 and 11.6.

[3] Canada, *Report of the Royal Commission on Taxation* (KL Carter, Chairman) (Queens Printer, Ottawa, 1966) Volume 3, Appendix A, 538

The OECD Committee on Fiscal Affairs in its paper on *International Tax Avoidance and Evasion*[4] considered that while a distinction was frequently made between evasion and avoidance, it could not be made consistently as between countries. This is particularly so because in some countries, to seek to frustrate the intention of the law is already a breach of an express legal principle.

The Committee considered, however, that it was possible to identify the kind of avoidance schemes that should be combated. Thus rather than defining tax avoidance broadly and drafting legislation consistent with that definition, another approach is to identify those practices that are of concern and either write specific legislation to deal with them or inductively develop a general provision that would cover each without at the same time, covering other unintended transactions. Nevertheless the Committee went on and attempted an indirect definition by saying that the particular schemes that should be combated are those where the "main feature is that there is an attempt to reduce tax liability to a level below that which the legislature intended should apply to that particular income in those particular circumstances..."[5]

Some scholars have also concentrated on legislative intent as the key to the concept. Rosenberg has stated that, "there can be tax avoidance only when (1) some Code provision mismeasures economic income: (2) that mismeasurement accompanies behavior that fails to implement the congressional purpose underlying that Code provision."[6]

The latter should be the preferred view from a conceptual basis. A careful examination of each of the factors considered relevant to a definition, supports a conclusion that the essential feature of tax avoidance involves a transaction which somehow avoids parliament's intended tax incidence for a particular taxpayer. A transaction which would save tax in a way contemplated and supported by parliament should never be described as avoidance of tax in the context of a legal perspective or in the context of the mischief to be addressed by a GAAR, although it may well be of concern from an efficiency perspective and may even be a linguistically accurate statement. Thus in Australia we have a parliamentary mandated deduction for capital investments in the Australian film industry. The fact

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[4] Publication of the International Bureau of Fiscal Documentation, No 31, Colloquy of 5-7 March 1980.

[5] *Id.*

[6] J.D. Rosenberg, Tax Avoidance and Income Measurement (1988) 87 *Michigan Law Review* 365, at 445.

that a particular taxpayer is motivated by the desire to minimise his or her tax in making such an investment, should not be relevant in determining the tax treatment, because the Government must have contemplated appealing to such motives in enacting the specific tax expenditure. Tax analysts may criticise the policy but not the legal entitlement of individual taxpayers.

On the other hand many such shelters are abused. For example, under an earlier and less regulated version of the Australian film deduction provisions, a number of schemes developed whereby film promoters lent taxpayers extra funds to invest back into the film to multiply the level of deduction. The obligation to repay the loan was swapped for some other right, for example, a percentage of profits from the film. Such behaviour can already be described as tax avoidance on this definition as parliament would have intended new equity to be invested in Australian films but would not have intended promoters existing funds to be loaned in a circle over and over again with tax deductions being created at each turn of the loop. Either parliament or the judiciary could respond by requiring independence of funds or some "at risk element" before allowing a deduction. Australian courts adopted mixed responses to such transactions, although the dominant preliminary finding was generally that a "round robin" should be treated as two independent and legitimate payments.[7]

While it is possible to criticise some of the definitions for going beyond an analysis of Parliament's purpose and including taxpayer motives and purposes, the proponents of those definitions were not necessarily advocating that the legislation should use those factors as determinative control mechanisms. For example, the fact that the Carter Commission says that motive would seem to be an essential element of tax avoidance, could merely be identifying one necessary element in any conscious tax avoidance activity. Where a taxpayer inadvertently avoids paying tax by misunderstanding the law, this is quite a different situation calling for different responses. We have the development of self assessment systems throughout much of the developed world with significant penalties for even innocent error, to encourage greater concern by taxpayers with correctly identifying the true tax position and encouraging them, where necessary, to consult professionals in the field.

[7] In rare cases, such events have been described as shams e.g. Case V160 (1998) 88 ATC 1058.

While it is right to say, as many have suggested, that taxpayer motives cannot of themselves be a ground for negating a tax effective transaction, this is complicated by the fact that Parliament and the courts do make a taxpayer's purpose relevant as a distinguishing feature in many key instances. For example, because capital gains provisions in Australia have a residual operation compared to the general income provisions and because the current approach of the courts is to see a profit as giving rise to ordinary assessable income where transactions occur with a dominant profit-making purpose, purpose remains a key basis for distinguishing between income and capital gains. Purpose is also utilised to distinguish between private and business expenses where s. 51 is concerned. It is also used in specific and general anti-avoidance provisions and some judicial doctrines. Where this occurs, many more questions need to be answered. Unfortunately, in Australian tax history, the norm has been to ignore many of these issues and leave the resolution to judicial invention. For example, under the earlier general anti avoidance provision in Australia, s. 260, no indication was given whether the relevant purpose needed to be a dominant or sole purpose or some lesser purpose.

Other questions include whether we are solely concerned with the purpose of the legislation or the taxpayer or both? How are the administration and the courts to determine the purpose of legislation? How do we determine the purpose of the taxpayer, subjectively or objectively? Are we interested in a taxpayer's indirect or direct purposes? If a taxpayer has a number of purposes, are we concerned at looking at dominant purpose, significant purpose or any purpose? Some scholars have attempted to distinguish between purpose, intent and motive in identifying taxpayer behaviour, which may also complicate matters. Finally and most importantly, is a purpose based test likely to be equitable and efficient? A purpose test for identifying tax avoidance might simply be bad policy and a misallocation of legislative resources.

A number of problems become apparent once we analyse the likely efficiency of a purpose based test. A predication or purposive test can either look at the features of the transaction or the purpose of the transaction as the ultimate test for distinguishing between ordinary transactions and tax motivated transactions. This is not to say that both of these features may be relevant in all circumstances. A purposive test is better able to ignore transactions where some commercial features are merely thrown in for camouflage purposes. On the other hand it is far more difficult to employ with any certainty or consistency. It is a test which must either rely primarily on subjective considerations, or alternatively look at objective features as a means to deduce what the subjective purpose was likely to be. In the latter event, one is again considering the features themselves. Concepts such as an "ordinary business or family dealing" tend to be made central to the practical application of GAARs. Questions of form versus substance also arise if taxpayers design their schemes to have the appearance of ordinary dealings.

At this stage we need to acknowledge that if we are utilising terms such as form, substance, purpose and Parliament's intent we are using very grey concepts which can lead to quite diverse views among administrators, practitioners and judges. Consequently, regardless of any possible agreement on a definition, what one person would describe as tax avoidance under any particular definition would not necessarily be so described by others. This might then add weight to the hypothesis that a general anti avoidance provision would offend against the rule of law by delegating significant political choices to judges in making decisions in these contentious areas.

The next point is the most conceptually challenging hypothesis that flows from the assertion that tax avoidance means avoiding parliament's intent and that purposive interpretation is at times mandated. To the extent that the spirit or purpose of the legislation becomes relevant in its interpretation and application, this definition of tax avoidance is to some degree tautologous or even self defeating. If legislation is only to be interpreted in the context of its purpose, then transactions which offend that purpose should not succeed in gaining the tax advantages sought. Thus the greater the purposive analysis by the courts, the lesser the number of transactions which will be held to have succeeded in satisfying the substantive law but in a way which is contrary to its spirit. The hypothesis might then be that a provision such as s. 15AA of the *Acts Interpretation Act* is the only appropriate general anti-avoidance provision. The Australian experience is simply that these issues are rarely if ever debated.

What are the Main Forms of Tax Avoidance?

It would be wrong to consider the concept of tax avoidance in a vacuum, particularly as one of the strongest critiques of anti avoidance activities is the thesis that offensive transactions should be considered individually and specific responses adopted for each. In the Australian context this was articulated most strongly by Sir Garfield Barwick, both as an advocate and as Chief Justice of the High Court. For example, if policy analysts see the ability to divest receipt of income without divesting control of its disposition as a problem, an appropriate response could merely be to adopt a control test for derivation of income. It is not the purpose of this paper to examine individual substantive situations and identify an appropriate policy response. This would involve a separate and significant debate. For example, where control versus benefit is concerned, there is no consensus among scholars as to which is most appropriate under a Henry Simons-style income tax system. Nevertheless, to give some framework to the debate, it is important to be aware of the broad forms that tax avoidance techniques take.

The main types of tax avoidance techniques are the conversion of taxable gains to non taxable gains, the deferral of taxable gains, the utilisation of tax shelters, the prepayment of expenses, the use of intermediary entities that are taxed at differential rates, income splitting and offshore transactions. These could be further reduced to three broad categories as identified by Stiglitz, namely income shifting, postponement of taxes and arbitrage among the different rates at which the returns to capital are taxed.[8]

Is Tax Avoidance a Problem?

Before elaborate anti-avoidance principles and practices should be employed, it is also necessary to demonstrate that avoidance is a significant problem. In analysing that significance, one can utilise both equity and efficiency perspectives. These two criteria will often suggest contrary responses. For example, a system that catches the majority of schemes but allows the most sophisticated to escape is arguably inequitable because it favours the rich or strong. It may however be relatively efficient in that the absolute level of avoidance is low. It may also be that the level that remains may be the necessary price to encourage the rich or strong not to evade the system completely. This paper does not assert that this is so or that it is desirable but merely desirable seeks to use it as an analytical example.

A preliminary point to again note is that a number of economists lump avoidance and evasion together when analysing the problem.[9] They argue that there is no economic difference between evasion and avoidance because in each case Parliament's intended revenue is interfered with. This

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[8] JE Stiglitz, A Student's Guide to Tax Avoidance, in JE Stiglitz, *Economics of the Public Sector* (2nd ed) (New York, WW Norton, 1988) at 592.

[9] *Id.* See also PD Groenewegen, Distributional and Allocational Effects of Tax Avoidance, paper presented at NSW branch of the Economic Society of Australia Conference, *Tax Avoidance and Economy*, 4 March 1983.

is perhaps an unduly static way of looking at the situation. It is true that in the immediate sense, one dollar of tax evaded equals one dollar of tax avoided in terms of Government spending power. On the other hand, the potential nature of the problem and the appropriate responses to each on both cost benefit and equity bases may well differ.

One intuitive lesson to learn from the Australian experience is that when tax avoidance became virtually sanctioned by the High Court in the 1970's, supermarket style off-the-shelf tax avoidance packages reached epidemic proportions. Having the Chief Justice of the High Court propound taxpayer rights would surely be a powerful rationalising factor for taxpayers and advisers. The same is never likely to be true for tax evasion where quite different moral choices are made and the tax profession is far less involved. More rigorous microeconomic analysis of both phenomena is also undertaken by some scholars but builds on challengeable psychological assumptions about risk aversion as a guiding decision making factor.

Tax avoidance can be a problem for a number of reasons. The most immediate is the amount of intended revenue that is not obtained by the Government. Because a budget adopts a particular spending program based on anticipated revenue raising, an unintended shortfall will arise if tax avoidance is significant. Other economic consequences of tax avoidance are the reallocation of resources to the tax preferred activities and the costs of engaging in those activities. The administration must also allocate resources to combat the activities. Because tax avoidance opportunities are not equally available to those on different levels of income or even to those with different sources of income, there are obvious adverse distributional results from avoidance activities.[10] Given that governments spend much of their revenue providing public goods, tax avoidance is a particular aspect of the free rider problem.

Stiglitz also points out that the economic effects of an anti-avoidance activity may be different to what is intended, a reminder of the economic theory of second best. An example is leveraged leasing whereby a low income taxpayer who needs equipment but has no benefit from depreciation and investment allowances might be teamed up with a high income taxpayer who will purchase the equipment, claim the allowances and lease it to the first taxpayer. A tax law that makes this less advantageous might not necessarily hurt the high income taxpayer. If the tax law leads

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[10] *Id.*

to a lesser number of persons willing to engage in those transactions, the low income taxpayer may have to pay a higher rent to induce the deal. This of course is not an argument against the closing of such tax expenditures as the ultimate tax question is the proper relative contributions to government revenue and not the appropriate after tax returns to individuals. The latter should balance out by normal market forces in any event.

Tax avoidance also has equity concerns given that different persons will contribute to different degrees regardless of their respective abilities to pay. When tax avoidance reaches significant ongoing proportions, it can also perversely be used to encourage political changes in basic tax structure which can also have equity effects. For example, an analysis of tax incidence over the years tends to show that regardless of the basic political choice of progressivity in most tax systems, wealthier individuals simply do not tend to pay the expected high marginal rates. After initially attempting to fix the law to overcome this, some commentators ultimately assert that on a cost benefit basis it would be better to move to a flatter rate tax system, in part to accept the inevitable outcome at a lower transaction cost.

Other results of tax avoidance suggested in the Australian context include discouraging governments from making desirable tax reforms. Lehmann suggests that the government delayed indexing tax brackets in the progressive system because of the revenue shortfall from avoidance. Legislative responses to avoidance also increase the complexity of the Act. He also asserted that the tax avoidance boom led to a lowering of standards of commercial morality.[11]

The Causes of Tax Avoidance

In considering what ought to be the appropriate responses to tax avoidance activities, we may benefit by considering what causes this phenomenon. Causes suggest possible solutions. No simple solution is apparent in the tax avoidance area, hence we need to evaluate competing solutions on a cost benefit basis. This section merely seeks to identify potential causes without attempting any conclusive analysis.

There are a number of ways that we can look at causes. At a simple level we may wish to identify those features of the law that allow for differential tax treatment of similar economic transactions. An example in

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[11] G Lehmann, The Income Tax Judgements of Sir Garfield Barwick: A Study in the Failure of the New Legalism (1983) 9 *Monash University Law Review* 115.

Australia is the lower tax rate on corporations and the consequent inducement for people to make investments through a corporate form. Because trusts are also an acceptable method of income splitting in Australia, taxpayers have ensured that private family companies are potential family trust beneficiaries as a "parking space" for income that would otherwise be taxed at a higher marginal rate. After having introduced a comprehensive imputation system of company tax and then undermining it with a lower company tax rate, we now hear calls for the reintroduction of undistributed profits tax.

At a more fundamental level we might look at psychological factors to determine causes of tax avoidance. What motivates people to behave in this way? Here the work of compliance theorists, whether in the psychology or criminology area, asks us to consider factors such as the respect that the taxpayer has for the law and the level of taxation, the individual morality of the taxpayer and the general likelihood of detection.

Judicial responses are also important. It is easy to say, as some do, that it is only when the Act is drafted in a careful and comprehensive fashion that tax avoidance can be appropriately dealt with. In this regard there is a somewhat loose alliance between Sir Garfield Barwick and certain public finance scholars. While one can readily acknowledge that it would be easier for judges if the Act was simple and comprehensive, the fact remains that the role of judges is always to give effect to whatever piece of legislation is before them. Because legislation is built on language, with all its vagaries and ambiguities, there are fundamental questions of judicial interpretation that need to be addressed no matter how strongly one supports principles of separation of powers.

Other possible causes are the style of statutory drafting and the organisation and approach of the administration. For example, in Australia, the very detailed style of statutory drafting may invite judges to adopt interpretive presumptions to the effect that matters not specifically mentioned were not intended to be covered. In turn, this may encourage resources to shift to those overlooked areas. Limited bureaucratic resources or inefficient resource allocation within bureaucracies may also be a problem.

Each of these issues is addressed separately below.

The Judicial Function and Tax Avoidance

Where judicial roles are concerned, the Australian experience is worthy of particular attention given the markedly different attitudes of the courts to s. 260, the previous GAAR, over a number of years. In addition, tax was one area where High Court judges were found to debate philosophical positions openly in judgments, albeit rarely.

As indicated above, some judicial role is unavoidable. If the form of tax avoidance is typically to exploit a loophole or drafting ambiguity in the legislation or utilise a provision in an unintended manner, the success or otherwise of the transaction will depend on the judges approaches to statutory interpretation. While broadly different approaches can be discerned in various jurisdictions, the fact remains that within each, cases can be found where some judges have adopted a purposive approach to interpretation to attack schemes while others have adopted a more strict and libertarian approach to their task. We all have our political preferences and tend to like one broad group of decision makers over the other, but we should all acknowledge the negative aspects of the very presence of such choices.

This is not to say that judges should not make such choices. The inherent choices available in the judicial process require all judges to have some legal philosophy about their role and processes. Most would also acknowledge that there are some inevitable limits in which judges can validly make law. We are used to judges seeking to balance conflicting values and goals in contentious areas such as constitutional law, criminal law and administrative law. An important hypothesis might then be whether tax avoidance can only be adequately combated by requiring or accepting that judges adopt a purposive approach to interpretation.

Parliament may seek to limit such choices by directing a particular approach to statutory interpretation. As indicated above, this has occurred in Australia through s. 15AA of the *Acts Interpretation Act* which calls for a purposive approach to interpretation when there is an ambiguity and s. 15AB of the same Act which directs attention to extrinsic aids to interpretation to support that process. Experience shows that the old choices inevitably surface, however. Some judges find the necessary ambiguity to justify a purposive analysis, others do not. A directive such as s. 15AA does not clearly resolve how one is to discern the purpose of a Tax Act. Practitioners have even pointed to the fact that s. 15AA refers to the purpose of the Act itself as opposed to the provision in issue. This is of course a tenable but casuistic distinction. The purpose of the entire Act can be made up of the various purposes of each of the provisions and it must surely be open for a judge to consider the purpose of the particular provision before him or her. Nevertheless, there is still the common argument that the only purpose of a Tax Act is to take such tax as the statute imposes.[12]

It is submitted that the proper approach to a purposive analysis of the *Income Tax Assessment Act* is to consider the purpose of the particular provision under examination. To do so will ordinarily require a consideration of the purpose of the generic type of provision as opposed to the purpose of the Act as a whole. It is certainly meaningless to talk about a particular purpose of a piece of legislation of the size and complexity and history of the *Income Tax Assessment Act.* On the other hand it is fair to say that the core provisions have discernible purposes. For example s. 51 has the purpose of denying deductions to private expenses, domestic expenses and capital expenses. Other expenses in an earning setting should be deductible. Section 25, the general assessability provision, seeks to bring into taxable income, gross receipts in an earning setting that are not of a capital nature. Capital receipts are to be taxed under the capital gains provisions.

Against this backdrop there is the realisation that many tax avoidance schemes result from the manipulation of a principle from a reported decision. This is not to say that the manipulation is unfair but merely that the precedent has been stretched to cover a different situation. It is the role of the courts to determine whether the precedent adequately protects the newly constructed situation. In most instances the central question is *factual.* Here we may need to acknowledge that there can not be any objective principle that limits the way judges can determine the facts in a particular case, thus choices are inevitably made.

Whatever the choices made, we ought to concede that there is no simple, incontrovertible or tax specific principle that we could promote in order to maximise the equity and efficiency of judicial decision-making. Different people will have different philosophical views about the proper role of judges in the legal system. Some assert that under the principle of separation of powers, it is for Parliament to make law and for judges to merely interpret that law. Thus, judges should take a restrained role in the interpretative function and be apolitical. The suggested corollary is the adoption of the literal approach to statutory interpretation.[13] Others assert

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[12] Lord Halsbury in *Tennant v Smith* [1892] AC 150, 154. This narrow argument was accepted by Turner J in *Commissioner of Inland Revenue v. International Importing Ltd* [1972] NZLR 1095.

[13] Higgins J in *Amalgamated Society of Engineers v Adelaide Steamship Co. Ltd.* (1920) 28 CLR 129, at 161 considered that the intent of Parliament is found by ex-

that any realistic assessment of the way the legal system develops must acknowledge that judges make law whatever approach to interpretation they take. Those in this camp would assert that a "conservative" approach to interpretation is just as much an example of judges using their own views and philosophies to decide the law, as is suggested by a so called more activist approach.

Whichever view is preferred, the argument that a literal approach to interpretation is an apolitical stance, can easily be criticised. Given that all judges have the power to adopt either a literal or a purposive approach to interpretation, or to find that a general interpretative provision applies or not, they all make choices. Whichever way the choices are made, judges are activist to that extent at least. Furthermore, if a judge can clearly discern a difference between the likely purpose of the legislation and its ordinary meaning, to select the latter is a conscious decision not to uphold the statute's purpose. On this scenario it is at least arguable that the literal judge is particularly political. It is only when a judge can say that he or she can discern no purpose other than the ordinary meaning of the words used, that a literal approach is both restrained and appropriate. Even here, however, if a judge is faced with a purposive argument by one of the litigants and concludes that there is not sufficient evidence to discern that purpose, a conscious and active decision has nonetheless been made. Furthermore, the judge can make choices by looking at the ordinary meaning of words within a particular sub-section, words in the context of the entire section, or words in the context of the entire legislation.

Thus choices are made and politics and philosophy are hard to keep at bay. This does not mean that judges simply pander to their own political prejudices. A judge's preferences as a judge are not necessarily the same as the personal political preferences that he or she would choose. The judicial political philosophy can be quite different to a personal one. An example in the Australian context would be Deane J who commonly advocated anti-tax avoidance perspectives on the Federal Court but has held the other way in at least one case in the High Court where he felt bound by past High Court precedent on the basis that he thought it more impor-

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amining "the language used in the statute as a whole" which should be examined "in its ordinary and natural sense" even if the result seems "inconvenient, impolitic or improbable." Rowlatt J, a highly respected English tax judge said in *Cape Brandy Syndicate v. Inland Revenue Commissioner* [1921] 1 K.B. 64, at 71 "there is no presumption as to a tax. Nothing is to be read in. Nothing is to be implied. One can only look fairly at the language used."

tant that a clear line of authority be maintained.[14] The judges' preferences might thus more commonly be the necessary corollary of a thoughtful and consistent approach to the judicial function.

We also need to distinguish between plain meaning and literalism. The difference between these terms is that the latter may allow a word to be taken out of context by looking at its dictionary meaning while the former is a more contextual process.[15] The difference between a contextual and a literal approach is suggested by Sir Ivor Richardson to be that the former is discerned from "the twin pillars" of "scheme" and "purpose" and is thus to be preferred on the basis of giving effect to parliament's intent.[16]

If literalism is allowed to flourish this may also have an undesirable effect on statutory drafting. In *FCT v Westraders Pty Ltd*, Murphy J said "the nature of language is such that it is impossible to express without bewildering complexity provisions which preclude the abuse of a strict literalistic approach."[17] The irony is that if drafters respond with ever more detailed and complex provisions, such complexity may perversely then encourage greater literalism under the principle of *expressio unius est exclusio alterius.*

Regardless of how many agree that proper parliamentary attention to policy and drafting should be the dominant response to avoidance, some realities of tax law must be accepted which in turn place great pressures on the judiciary. We need to remember that there is a great conceptual difference between the economic concept of income and the approach taken in virtually all income tax statutes. Because we choose for political and other reasons not to adopt an accruals basis of taxation, we adopt a transactional approach. Income is that which flows from certain concrete events. In jurisdictions such as the United Kingdom and Australia it must also flow from certain forms of activity. Often some description of the relevant types of transactions is adopted, either by parliament or the courts. In Australia, income has been seen as that which flows from an earning activity. In the commercial field, it must be a business or trading transaction. Where judicial decisions are concerned, there is an obvious difficulty in coming up with a yes/no answer to such a question where

[14] *FCT v Gulland; Watson v FCT* (1985) 17 ATR 1, at 23.

[15] ED Popkin, The Collaborative Model of Statutory Interpretation (1988) 61 *Southern California Law Review* 541.

[16] Sir Ivor Richardson, Appellate Court Responsibilities and Tax Avoidance (1985) 2 *Australian Tax Forum* 3, at 8.

[17] *FCT v Westraders Ltd* (1980) 80 ATC 4357, at 4370.

there are a whole group of relevant factors that themselves do not readily support such an all or nothing decision.[18] Furthermore, taxpayers are encouraged to manipulate those criteria to maximise their after tax profit. This makes fact finding a particularly important element of the process of tax decision making. The following section looks at this issue in the context of the judicial function.

Fact Finding and the Judicial Function

University law courses tend to underplay the importance of facts. Students are usually encouraged to concentrate on appellate court decisions and discern principles from them. However the nature of legal practice in general and the tax avoidance area in particular show how fundamental fact finding is to the judicial function. Practitioners commonly examine leading decisions and seek to devise commercial strategies which maximise a client's chances of fitting within favourable precedents whilst minimising chances of being caught by unfavourable ones. A key element of many of the so called leading authorities in Australia and the United Kingdom can be related back to a key factual determination, which because of the nature of the appellate process, was invariably determined at the first instance stage.. An example was *Phillips* case,[19] which dealt with deductions by an accounting firm for payments to a related service entity that led to the splitting of income. The trial judge held that the marked up expenditure was commercially reasonable. The Commissioner's appeal was unsuccessful. After such a finding at first instance the end result is not surprising. The judge had compared the payments to commercial rates and found them to be reasonable. Whilst that comparison is a reasonable way to elicit relevant evidence, it was surely even more relevant that the arrangement had deliberately ensured that there was a mark up over the historical costs paid for independent services. In this context it would be easy to argue that the whole of the payment could not be explained as an ordinary commercial dealing. Factual issues such as this pervade the leading cases. If the Australian courts in cases such as *Esquire Nominees Ltd v FCT*[20] had taken a similar approach to *Unit Construction Co Ltd v Bullock*[21] on the question of the central management and control and hence statutory residence of offshore companies, off-shore tax avoidance and anti-avoidance provisions in Australia might not be at the healthy

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[18] Rosenberg, *supra* note 6, at 367.
[19] *FCT v Phillips* (1978) 78 ATC 4361.
[20] (1973) 129 CLR 177.
[21] [1959] 3 All ER 831.

levels that they are currently at. A controlled foreign corporation regime would be largely unnecessary unless there were problems in extracting the tax from offshore subsidiaries. Even here a practical solution could have been introduced in a somewhat simple form.

In order to highlight the fact that judges have a real role to play in this regard, it is useful to contrast the New Zealand courts response to a number of key substantive questions. Thus one might contrast *Phillips* case with the contrary decision in *Wisheart v CIR*[22] This is just one of a number of examples where New Zealand courts adopted a more policy oriented approach. The *Acts Interpretation Act* in New Zealand has long required a purposive approach to interpretation and while New Zealand common law developments have often shown significant deference to English and Australian authorities, in the tax area at least, some key decisions saw a very different approach taken which presumably provided a strong disincentive to tax avoidance.

One particular fault in the Australian experience has been the undue deference to non-tax principles in deciding tax cases. Many taxation disputes depend upon the application of tax laws to complex commercial and interpersonal transactions. The ultimate conclusion in the taxation dispute may depend upon legal conclusions about those areas of law. For example, the nature of property transactions depends upon property law. Gains from employment may depend upon employer/employee law. Trust law, company law, contract law and the like all become relevant in many taxation disputes. At times, tax schemes will be developed which depend upon those non tax law principles being determinative of the tax question.

An example of the utilisation of non-tax principles to decide tax cases, was *FCT v Everett.*[23] While the court acknowledged the general rule that personal exertion income was not assignable, *Everett's* case was distinguished because it was a legal partnership and the view was adopted that partnership profits arise from the proprietary right rather than personal exertion. This result is merely a preference for one relevant fact over another. One might wonder what Mr Everett's partners would have said if he asserted that he did not need to come to work to earn his partnership share.

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[22] (1971) 71 ATC 6001.
[23] (1980) 143 CLR 440.

Another particular problem in the area of tax avoidance is that judicial statements made in key cases are looked at very carefully to see if they allow some opening for construction of favourable schemes. Invariably, the judges in the leading cases were not considering the potential schemes when articulating their reasons for decision. The question then becomes how a later court will modify or adapt the earlier statement or alternatively, whether the later court will see that statement as binding precedent in most if not all cases.

A simple example is thrown up in the area of income from employment and fringe benefits. In *Tennant v Smith*,[24] the court said that to be income, a receipt must be money or money's worth. A non-monetary receipt would have to be convertible into money to be money's worth. In *Dawson v CIR (NZ)*,[25] the tax scheme manipulated that statement by intentionally making the benefit non-transferable. The court in *Dawson* could have qualified the earlier comments and asserted that they only apply to receipts that were independently non transferable and not receipts that the taxpayers themselves made non-transferable for tax purposes. This is not to say that the judge should hold in that way, but merely that the approach to judicial interpretation and refinement of key concepts in the tax arena has much to do with the development of avoidance activities. This in turn led to a massive fringe benefits industry in Australia and ultimately a costly and complex fringe benefits tax that still provides undue preferences, a result readily explicable if a public choice analysis is applied to the motor vehicle industry and the political process.

General Approaches to Interpretation by Judges

It is fair to conclude therefore that there have been major ramifications from the more literal style of interpretation adopted in Australia and the United Kingdom from time to time, although by no means uniformly so adopted. A wider question is why that style was as influential as it was for many years. Popkin utilises the general analysis of Atiyah and Summers to suggest the following differences in approach between US and English judges. While it would be simplistic and insulting to broadly categorise all judges into a singular national approach, it is still arguable that many Australian judges, particularly at the time of the Barwick High Court, could be accurately described as coming closer to following the English model in tax cases at least. The suggested differences are:

[24] [1892] AC 150.
[25] (1978) 78 ATC 6012.

- The presence of a written constitution in the US (which is the same for Australia).
- The greater detail in English statutes, which Popkin asserts has the tendency to "dampen any judicial tendency to look for the underlying purpose of the document."
- The British Parliament has the power to correct statutes because the party in power controls legislation. This is true in Australia but is not the case with the complete separation of powers in the US and the resultant difficulty of having Congress make necessary changes.
- The unequivocal parliamentary sovereignty in England. (Again Australia here is like the US with constitutional based judicial authority).
- English judges have not tended to look for legislative history. (Australian judges are now entitled to do so through ss 15AA and 15AB of the *Acts Interpretation Act*).
- Legal certainty is considered more important in the English tradition and is argued to be promoted by a literal interpretation.
- Academics who tend to advocate a more principle based interpretation, have less influence in England than in the US.

Such comments are best seen as identifying issues and influences rather than being predictors of individual behaviour. Exceptions to the model would be easily found. English judges have often commented about the role that they perform and have at times made it clear that a purposive approach to interpretation is appropriate. English approaches to statutory interpretation may also have recently been influenced by Britain's entry into the European Community. The civil law tradition of a more purposive interpretation is thought to have had clear influence as has the central European Court of Justice.

The modern approach to statutory interpretation in Australia is probably best reflected in the case of *Cooper Brooks (Wollongong) Pty Ltd v FCT*.[26] The case concerned a complicated tax scheme based on a loophole in the legislation. The loophole only arose because Parliament, in specifically modifying legislation to catch the scheme, forgot that a particular definition also needed to be amended to make it work. The court looked at the history of the provisions and noted the inadvertent failure to make the necessary amendment. The court found for the Commissioner. Two

[26] (1981) 147 CLR 297.

High Court Justices commented that the literal rule of construction had been applied too rigidly in the past. In their view, 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." A literal interpretation is to be departed from whenever the "operation of the statute on a literal reading does not conform to the legislative intent as ascertained from the provisions of the statute, including the policy which may be discerned from those provisions..." The Court also criticised the historical presumption that revenue statutes were to be interpreted strictly in favour of the taxpayer.

In the tax arena, judges are not only forced to think about the approach to interpretation in general, but must also think about the way tax avoidance and tax planning activities affect their own obligations. The next question is what role, if any, should judges employ, in seeking to ensure that tax avoidance activities do not proliferate. Most would concede that judicial approaches to interpretation will have a considerable effect on the amount of tax avoidance activity.. If tax schemes are accepted by the courts, they are more likely to be promoted.

To say that judicial responses have an impact upon tax avoidance is not the same as saying that judges *ought* to be concerned about this. Once again, the fundamental issue in any legal system is what is the proper role of the judiciary in relation to the legislature. Nevertheless, while all judges would wish to approach the task of statutory interpretation without being coloured by their sympathy or lack of sympathy with a particular litigant, it is almost impossible to decide on the merits of a purposive approach to interpretation, without having a view about the role of tax legislation in combating avoidance. For example, a judge who sees the role of tax legislation in some areas as stopping avoidance activities, might be more likely to adopt a broad purposive approach to interpretation to make sure that a technical scheme that arguably found a loophole, would not succeed. On the other hand, a judge who believes that Parliament must be very specific in indicating who should pay tax and in what circumstances, might adopt a more restrained approach.

There is certainly no shortage of political statements by judges in tax cases. Whatever the final view about the application of a particular provision to a particular scheme, the almost uniform approach of judges in western democratic societies has been that taxpayers clearly have a right to try and minimise their tax as long as they use legal means and do not seek to conceal or misrepresent the true situation.

> The Crown .... must make out its right to the duty and if there be a means of evading the duty, so much the better for those who can evade it. It is no fraud upon the Crown, it is a thing which they are perfectly entitled to do.[27]

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Act is less than otherwise would be.[28]

> The legal right of the taxpayer to decrease the amount of what ever otherwise would be his taxes, or all together avoid them, by means which the law permits, cannot be doubted.[29]

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any duty to pay more than law demands. Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[30]

> There is nothing wrong in companies and shareholders entering, if they can, into transactions for the purpose of avoiding, or relieving them of taxation .... and it depends wholly upon the construction of the taxing Act whether they have succeeded.[31]

Many judges then went a further step and asserted that the logical corollary of this right was for them to adopt a literal approach to interpretation and at times raise a presumption against the Crown in unclear cases. One of the most commonly cited authorities in Australia is the *Duke of Westminster* case.[32] To many observers, the libertarian philosophy espoused in that case is unassailable. It is correct to say in England and Australia that every person does have that right to read legislation and to cast their transactions in the most favourable way in the light of what they have read. This point was also reiterated in the United States in *Gregory v Helvering*.[33] The misreading of the *Duke of Westminster* case by some subsequent judges was to allow themselves to become preoccupied with that statement of the rights of the individual taxpayer and ignore the sepa-

[27] Lord Esher in *Commissioner of Inland Revenue v Angus and Co.* (1889) 23 QB 579, at 593.
[28] Lord Tomlin in *IRC v Duke of Westminster* [1936] AC 1.
[29] Sutherland J in *Gregory v Helvering* (1935) 293 US 465.
[30] Hand J in *Commissioner v Newman* 1947 159 F. 2d 848, at 850-851.
[31] Starke J in *Jaques v FCT* (1923-24) 34 CLR 328.
[32] *IRC v Duke of Westminster* [1936] AC 1.
[33] (1935) 293 US 465.

rate question as to the obligations imposed on a judge. In the Australian context it was disappointing that the *Duke of Westminster* principle is continually cited as the original source of that philosophy. The earlier formulation by Starke J in *Jacques* both pre-empted the comment in *Duke of Westminster* by some 12 years and more importantly placed it in its proper perspective by adding the rider that while the taxpayer has such an inalienable right, it depends on the particular legislation whether the taxpayer has succeeded or not.

A number of judges in the tax arena have more directly addressed the social role of the courts in relation to tax avoidance. Dixon CJ was not as confident in the ability of Parliament to develop a simple and unassailable tax system when in *Hancock v FCT*,[34] he said that "the resource of ingenious minds to avoid revenue laws has always proved inexhaustible ..."

In *Leary v FCT*,[35] Bowen CJ pointed to the likely revenue loss if the scheme was successful and acknowledged that this short-fall would "be made good by the general body of taxpayers." Brennan J cautioned lawyers and accountants who "donned the mantle of entrepreneurs." Mason J (as he then was) made a significant comment in *FCT v Students World (Aust) Pty Ltd* when he said:

> Although the traditional rule has been that clear words are required to impose a tax, so that the taxpayer has the benefit of any doubts or ambiguities, a provision introduced by way of an attack on tax avoidance should be given the wide meaning evidently intended, it should not be cut down in the interests of precision.[36]

Some judges have been prepared to speak on these issues or write about them outside of the court environment. The Honourable Sir Anthony Mason, the recently retired Chief Justice of the High Court has said:

> the recent judicial decisions in those countries which have general anti avoidance provisions, along with the adoption of the fiscal nullity doctrine in the United Kingdom, clearly indicate that the courts are conscious and take account, of the object and purpose of revenue legislation. If the courts fail to do this, there is a risk that wide ranging discretion will be conferred upon the revenue authorities simply be-

[34] (1962) 108 CLR 258, at 281.
[35] (1980) 80 ATC 4438.
[36] (1978) 138 CLR 251, at 265.

cause it would be impractical to enact fail-safe specific and detailed anti-avoidance provisions that would cover all possible eventualities.[37]

The following conclusions are therefore apposite. An Act of Parliament that makes such policy choices as the *Income Tax Assessment Act*, must be given effect to in terms of the discernible intent of Parliament. Given that the government has made certain redistributive commitments through its choice of tax provisions, and given that in most of those cases the government does not intend the provision to found illusory tax avoidance schemes, there remains a vital role for the judiciary to interpret and apply the legislation in terms of that intent.

If this is an inevitable corollary of the basic structure of our income tax legislation, then we need some anti avoidance responses at the judicial stage. The complexities and ambiguities of language ensure that there are often competing views as to the meaning of legislation. Complexities of life and the various ways that transactions can occur also imply that there are a number of ways of analysing facts. A court in each case is trying to identify the essential facts of a case and identify what they truly are. Because tax planning is commonly about characterising transactions in one way while the Commissioner would seek to characterise them in another way, the judicial process is quite an active one. This raises both the importance and the key problem with the judicial role. If there is no clear way to interpret statutes or to determine essential facts, there is also little guarantee of consistency between different judges. Without a unifying judicial philosophy and methodology, therefore, complete reliance on judges on the one hand or a broad critique of judges on the other is not sustainable.

A Philosophical Digression

If the previous assertion is accepted, we might then explore whether some unifying judicial philosophy can be propounded. Here we should acknowledge the failure of tax analysts to fully address this challenge. Tax policy has been dominated by public finance theorists for many years and for good reason. Lawyers are simply not trained to evaluate the very rules and processes we work with. Such evaluation requires attention to be given to other disciplines such as economics, philosophy and sociology. What is surprising is the relative paucity of attention by legal philosophers to the issues arising in the tax arena. Certainly the rationale for

[37] Sir Anthony Mason, Taxation Policy and the Courts [1990] *CCH Journal of Australian Taxation* 40, at 43.

government and distributional goals are considered by philosophers such as Rawls[38] and Nozick.[39] But little attention is given to the equity issues in the behaviour of the various participants in the process. An example of just one potential field for philosophical debate would be the possible use of retrospective legislation where tax avoidance is concerned. Most have strong views on this question and the professions are particularly scathing but are each of us aware of a philosophical justification for our position and is it consistent with our general jurisprudential perspective? For example, a legal positivist would not be concerned about the moral perspective. A utilitarian might support such legislation on social utility grounds. Rawls would adopt a maximin principle and advocate proper tax collection from the wealthy. Natural lawyers and deontologists might support such approaches on the grounds of moral laws and duties respectively. It might only be a libertarian such as Nozick who would hold such laws to be illegitimate confiscation of property without just compensation, although to some libertarians, the negative externalities of tax avoidance are themselves an invasion of the liberty of others. These comments are not presented as an argument in favour of such laws, but rather, a plea for the philosophers to stop lagging so far behind the economists in the tax field.

This is particularly important when considering the judicial function. For example, how much difference is there between judges who develop doctrines such as fiscal nullity because they believe in promoting equitable tax contributions, and judges who uphold a libertarian right to avoid tax in the face of a voracious Leviathan? Are we aware that the consistent assertion by judges that taxpayers have a right to organise their affairs to pay the minimum amount of tax merely supports a libertarian philosophy? Some moral philosophers would assert a different proposition, arguing that we owe a duty to fellow members of our society to try and pay the amount that the society intended us to pay. The two views may not be inconsistent, as the duty of the judge and taxpayer may be very different, but there is little excuse for making ill considered philosophical assertions.

If we wish to pursue these issues we might ask what are judges doing when they develop doctrines such as the business purpose test, fiscal nullity or the principle that personal exertion income cannot be assigned for tax purposes? But these questions are merely subsets of the general

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[38] J Rawls, *A Theory of Justice* (Oxford, Oxford University Press, 1972).
[39] R Nozick, *Anarchy, State and Utopia* (Oxford, Basil Blackwell, 1974).

question of what judges do and should do when deciding cases. Here there are some quite diverse schools of thought. Legal positivists assert that judicial decision making can be based on logical analysis rather than considerations of policy. Modern positivists have accepted that there are hard cases where there is no obvious result. HLA Hart has said: "the open texture of law means that there are, indeed, areas of conduct where much must be left to be developed by courts or officials striking a balance, in the light of circumstances, between competing interests which vary in weight from case to case."[40]

Dworkin has challenged Hart's assertion of a discretionary law making function in the hard cases by asserting that there is a distinction between principles and policies and even that in the hardest cases, there are enough principles available in our system of law to determine which party has a right to win. Dworkin's views have received much criticism and have been the centre of recent jurisprudential debates.[41]

Another school of thought emanates from the field of sociology. Under this theory judges are involved in balancing competing social interests. Judges themselves will at time acknowledge this. A present member of the Australian High Court, the Hon Mr Justice M McHugh in his survey of legal theory argued that sociological jurisprudence had important lessons for the Australian judiciary in so far as judges are properly called upon to resolve competing social interests.[42]

Perhaps an example that a little bit of philosophical knowledge is a dangerous thing is the statement by a number of judges that an increased judicial function is appropriate based on the lessons of political science, namely, that the so-called democratic process is not truly democratic. Thus judges, so the argument goes, must shoulder the responsibility of protecting fundamental common law democratic values. Yet those judges rarely address the proper place of judge made law in the context of the essential nature of democracy. Why the judges do not advocate political reform along the lines suggested by Buchanan, Tullock and others rather than increased judicial powers is not articulated.

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[40] HLA Hart, *The Concept of Law* (Oxford, Clarendon Press, 1961) at 132.

[41] Useful expositions and critiques of his theories include, A Hutchison & J Wakefield, A Hard Look at Hard Cases: The Nightmare of a Noble Dreamer (1982) 2 *Oxford Journal of Legal Studies* 86; J Raz, Professor Dworkin's Theory of Rights (1978) 26 *Political Studies* 123.

[42] M McHugh, The Law Making Function of the Judicial Process (1988) 62 *Australian Law Journal* 15, at 28.

Questions such as these permeate the areas of jurisprudence and constitutional theory and law. There is no easy resolution of these issues and certainly none could be sought within the confines of this paper. Nevertheless, the issues are of central importance to the fundamental thesis we are currently examining, namely, whether judges have responded appropriately to tax avoidance activities.

Judicial Anti-avoidance Doctrines

An examination of the various doctrines developed throughout the world could be looked at to identify core criteria by which judges have attacked certain tax avoidance activities. While most if not all relate to the central concept of purpose, most were also unclear and ill defined in not addressing questions such as how purpose is to be determined and what level of purpose is required. In one respect, the Australian Parliament has entered the debate through s. 15AA of the *Acts Interpretation Act* which directs that judges look for the purpose behind legislation, at least where there is an ambiguity, although again there is no stated methodology for doing so other than the related right to look at extrinsic aides to interpretation contained in s. 15AB.

The next point that can be made about the various judicial doctrines is that they are too often used in quite inconsistent ways, and too often used without supporting reasoning. This heightens the political nature of the process of utilising such criteria. Furthermore, if they can mean different things to different judges, enshrining them in legislative form will not necessarily lead to a more objective result.

Some authors would assert that tax avoidance is an indeterminate concept and cannot be adequately dealt with through judicially developed anti-avoidance doctrines. For example Gunn[43] suggests that there is no logical justification for deciding tax cases by reference to a taxpayer's state of mind or by invoking some need to prevent tax avoidance as a justification for a particular rule. He asserts that there is no consistency in cases dealing with these issues and that cases where it is thought that the taxpayer should not be entitled to succeed can be justified on more logical grounds.

For example, Gunn would say that rather than ask whether a person who assigns income for tax avoidance purposes should be allowed to do so, the primary policy question is whether the *controller* of an income

[43] A Gunn, Tax Avoidance (1978) 76 *Michigan Law Review* 733.

stream should be taxed or whether the *beneficiary* should be taxed. Gunn seeks to argue that judges who deny being influenced by taxpayer motives, are inherently contradicting themselves when they apply a business purpose test. Those judges can only hold that there is no business purpose when they find that the sole purpose was tax reduction, in which case they are deciding against the taxpayer because of the latter's purpose.

Gunn never addresses the central question directly, however, namely, are judges able to adopt a business purpose test by justifiably holding that the section being interpreted was only intended for taxpayers who utilise it for a specific business purpose? For example, where a tax expenditure such as a shelter is concerned, the investment itself constitutes a business activity, albeit one which could be motivated solely by tax considerations. Thus a normal investment in a legitimate shelter should satisfy the test and be granted deductibility. If however a tax shelter scheme was arranged whereby the shelter was merely a conduit for a paper investment to ultimately be effectively returned to the taxpayer, then it ought to be proper to say that either the sham transaction doctrine, the business test or a purposive interpretation applies to deny deductibility to that part of the initial investment which was never intended to remain within the shelter.

One particular problem is that it is difficult if not impossible to have all judges follow an identical approach to statutory interpretation no matter what legislative guidance is given. Each judge makes his or her own findings of fact. Different judges can view the same situation in different ways. They may see different levels of ambiguity and shades of meaning in statutory provisions. They are also likely to have different views about the role of judges and the degree to which judges should develop doctrines to minimise tax avoidance activities. Consequently, we would not expect a uniform, coherent and consistent approach from judges in relation to this issue. Because some of the criteria by which we would test the merits of any anti-avoidance activity would be uniformity and consistency, this suggests that undue reliance should not be placed upon judges. On the other hand, many disputes end up before the courts and tax planning endeavours are usually going to lead to disputes. Thus judges will always have an important role.

An important related hypothesis is whether each and every one of these doctrines is an inherent part of the judicial process in any event. For example, in its most limited form, the *sham doctrine* merely says that judges will make decisions based on the real facts, not on any camouflage. The *substance versus form* doctrine asks a judge to look at both aspects of what the taxpayer has done. The *step transaction doctrine* asks the judge to look at the facts in their wider context. The *business purpose test* asks a judge to consider what was the purpose of a particular tax expenditure and how widely it was intended to apply. The *fiscal nullity doctrine* is less certain, but might best be described as a limited subset of the narrow version of the business purpose test. Most commentators agree that the majority in *Craven v White*[44] have stepped back from the potentially open ended judicial doctrine in *Furniss v Dawson*[45] and returned to the ambit of *Ramsay's* case. In so doing they have arguably denied that there is in fact a distinct principle, whether that of fiscal nullity or otherwise. *Ramsay's* case,[46] being the first of the trilogy, can simply be seen as a case which sets out what should always have been the proper approach of the courts to the facts, namely that the entire circumstances can be examined to determine what has really occurred in a particular situation. That the "loss" was not seen as such in that case, is arguably the same as the Federal Court saying the gift was no gift in *Leary*. In addition, *Ramsay* put the *Duke of Westminster* doctrine in its perspective in saying that whilst the individual taxpayer can as always seek to minimise his or her tax, it is for the courts to determine whether in a particular situation the taxpayer has been successful or not.

Legislative Responses

Because of the inherent problems in the judicial function, it is common to hear some commentators and judges call for the legislature to take the primary role in preventing tax schemes. Legislative provisions can deal with tax avoidance in a number of ways. Specific provisions could be developed to attack particular schemes as and when they become prevalent. Secondly, a general anti-avoidance provision could be incorporated which sets out broad and more general criteria that would operate in a prospective fashion in relation to future schemes that may never have been contemplated by the draftsperson. Thirdly, the legislature could seek to give broad powers and discretions to the administrators to help identify tax schemes and impose penalties as a deterrence to such activity. Finally, the legislature could address the particular policy choices that led to avoidance in the first place, such as different tax rates for different entities or various tax shelters.

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[44] (1988) 3 WLR 423.
[45] [1984] AC 473.
[46] *Ramsay v IRC* [1982] AC 300.

A number of arguments can be identified in relation to the use of specific anti-avoidance provisions. First, many of the specific anti-avoidance provisions were only introduced because of particular judicial decisions. If those decisions had gone the other way, the specific provision would not have been necessary. This is not to say that the case should have been decided differently but this may be so in some circumstances. Secondly, many of the specific provisions would not be needed if the Act addressed a key policy issue in a more direct manner. A more direct draft of a specific provision should always be preferred to anti-avoidance provisions.

Some argue that these are an important tool because in each case, they are targeted at the particular mischief that Parliament sought to redress and are thus fairer and require less intervention by the judiciary. On the other hand, such provisions, being essentially reactive, tend to be ineffective in many instances. It will often take the Commissioner a number of years to find out about a new scheme. There will often be a need for litigation to determine whether the scheme is successful under existing legislation. If the Commissioner is ultimately unsuccessful, he must then seek to convince the Government to make an appropriate specific amendment. By the time that process is completed, tax planners are looking for other schemes. If specific provisions are made retrospective in order to overcome these problems, they are more effective but are seen by most as particularly unfair.

Such provisions also tend to add much cumbersome detail to the legislation and can even adversely affect the extent to which judges adopt a purposive approach to interpretation. For example, the complex style of legislative drafting generally adopted in Australia has been described by Sir Ivor Richardson as leading to a reversal of roles between Parliament and the Courts, with Parliament preoccupied with detail and the courts trying to sift purposes and principles from out of the legislative fog.[47] That is a consistent and accurate criticism of the Australian and obviously New Zealand drafting style but it should be remembered that Australia's judges dealing with very simple phraseology such as "source," or "central management and control" also used very narrow and literalistic reasoning.

[47] Sir Ivor Richardson, Reducing Tax Avoidance by Changing Structures, Processes and Drafting in this volume.

General Anti-avoidance Provisions

Because of the above criticisms, some countries have resorted to the use of general anti-avoidance provisions that incorporate some broad criteria by which to make distinctions between acceptable and non-acceptable tax planning and avoidance. Because of their generality, they aim to be fully prospective and able to be applied to any scheme whether known or unknown at the time of the drafting of the provision.

General anti-avoidance provisions raise their own difficult policy and design issues. From a policy perspective, some argue that they are too uncertain in their operation. Some assert that they rely too heavily on the judiciary to give them an expansive meaning to make them effective. Others argue that the criteria selected are inappropriate and either allow too much avoidance or interfere unduly with ordinary commercial dealings.

Here it is worth making brief comments about the experience in Australia with the previous and troubled general anti-avoidance provision, s. 260, and then address the makeup and experience under the present regime contained in Part IVA of the legislation.

Section 260 operated on transactions entered into prior to 27 May 1981. Before looking at its specific requirements, we should acknowledge that any general anti-avoidance provision must aim to set out clear and identifiable criteria by which to distinguish between acceptable and non-acceptable tax minimisation transactions. In addition, the provision must indicate what the ramifications are to be where particular schemes are undermined by the provisions.

Section 260 provided that arrangements that have the purpose or effect of in any way altering the incidence of any income tax shall be absolutely void as against the Commissioner. Most judges saw this terminology as unclear and potentially unduly wide. Three tests were developed by the Courts. These have been described by leading commentators as the *predication test*, the *choice principle* and the *antecedent transaction doctrine*. While the Courts did not always use those terms in the judgments, various cases can be allocated to these three alternative approaches.

These tests also have relevance for the new GAAR, Part IVA. First, the stated aim behind Part IVA is to encapsulate the predication test. Secondly, the choice principle and the antecedent transaction doctrine effectively undermined s. 260 and rendered it unable to deal with all but the most blatant and poorly constructed schemes. While those principles can be criticised from a political perspective for that reason alone, they were based on tenable propositions which were particularly influential in the 1970s. These included libertarianism, the proper relationship between general and specific provisions and the proper role of judges vis-à-vis the legislature. Those same propositions will inevitably be raised in the context of Part IVA and it is important to consider how Part IVA itself has been drafted to respond to these attacks and furthermore, how judges would be likely to deal with them to the extent that Part IVA does not fully resolve the issue. In addition, these questions are inherently relevant to any GAAR.

The predication test was developed by Lord Denning in *Newton v FCT*.[48] In his view, s. 260:

> is not concerned with [the taxpayers] 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 is was implemented in that 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.[49]

The courts did not stay with this formulation although they did not reject it for all cases. Instead they developed the choice principle which changed significantly over time. Initially it merely stated that if the Act gives two express choices to taxpayers, then if they exercise such a choice even for tax purposes, their actions cannot fall foul of s. 260. For example, if the Act allows a taxpayer to choose either a trust or corporate form under which to run a business, then s. 260 should have no application to such a choice.

At the other extreme, some judges used the notion of choice to indicate that taxpayers have a fundamental choice to avoid the Act entirely as long as they do so by legal means. By *Slutzkin's* case,[50] Barwick CJ brought

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[48] (1958) 98 CLR 2.
[49] (1958) 98 CLR 2, at 8.
[50] (1978) 7 ATR 166.

the politics and policy issues right out into the open. The taxpayer sold a company which had large accumulated profits in return for a non taxable gain. If the company had been liquidated, the profits would have been deemed a taxable dividend. Barwick CJ refused to apply s. 260 and held that the taxpayer had a fundamental right to make the choice to sell the company rather than liquidate it. There is certainly a lot of merit in the argument that a taxpayer who has a company with accumulated profits who legitimately does not wish to have the company any more and who knows he or she is offered a better after tax deal for selling the company than for liquidating it, ought to be able to exercise that choice without fear of s. 260. Certainly the taxpayer is offered a higher price than normal because the purchaser feels confident that he or she can somehow avoid the full tax liability which would otherwise be imposed if the company profits were sought to be distributed. Any departure from tax policy, however, occurs at the time the purchaser avoids tax liability and not when Mr Slutzkin sells his unwanted company. There is thus a highly tenable argument that in the *Slutzkin* case itself s. 260 should not have applied. Barwick CJ's judgment however is relatively short on analysis in this regard and concentrates instead, on references to the *Duke of Westminster*[51] and the *Europa Oil*[52] decisions so as to present the twin propositions that taxpayers are entitled to try and minimise tax and secondly that it is the legal arrangements they enter into that must be looked at for tax purposes and not any alternative methods they may have chosen.

Remarkably, Barwick CJ did not refer to any of the previous s. 260 cases relating to dividend stripping in which the Commissioner was often successful.[53] At the very least, he should have sought to distinguish those precedents in relation to the case before him. Aickin J, who had been a leader of the tax bar before accepting an appointment to the High Court, also failed to refer to these cases. He stated that the "choice principle" applies equally to receipts with which the Act does not deal. In his view s. 260 was not aimed at catching a transaction which avoids the scope of the Act entirely even where it was done "with a conscious intention that the proceeds should not fall within the operation of the Act."[54]

[51] *Duke of Westminster v IRC* (1936) 19 TC 490.
[52] *Europa Oil (NZ) Ltd (No 2) v IRC (NZ)* (1976) 5 ATR 744.
[53] *See e.g., Bell v FCT* (1953) 5 AITR 462 and *Newton v FCT* (1958) 98 CLR 2.
[54] (1978) 7 ATR 166, at 174.

The next key case was *Cridland v Commissioner of Taxation*[55] which held that s. 260 did not apply to a scheme aimed at allowing persons to average their income as primary producers where they were beneficiaries in a primary production trust. Because of fluctuations in farm incomes and the progressive nature of the Australian tax system, averaging of incomes was allowed. In a poor piece of drafting, the then operative provision allowed for an argument that a beneficiary in a trust was to be deemed a primary producer over all their income. In response, the promoters of the scheme in *Cridland's case* set up a unit trust and sold units for one dollar each, primarily to university students. They were then able to average their next four years income. Mason J acknowledged that the acquisition by the students of income units in the trust fund could not be considered ordinary family or business dealings but were instead protected by the choice principle as it extended to the choice whether the Act is to apply or not.

There would be nothing wrong with this comment if it is seen simply as being a re-iteration of the libertarian philosophy of the *Duke of Westminster* and is solely related to the rights of the individual taxpayer. The problem with Mason J's judgment was that he made the comment in relation to the choice principle. This improperly mixes the two separate issues of taxpayer rights and judges' interpretative responsibilities. Deciding a case on the basis of choice should only follow from a finding that parliament's intent was to offer that choice.

The choice principle raises another particular difficulty where general anti-avoidance provisions are concerned. If a taxpayer's transaction falls foul of a specific provision, there is no need for a general anti-avoidance provision. If on the other hand their transaction is perfectly legal and acceptable under the specific provisions of the Act, why should a general anti-avoidance provision be allowed to interfere?

Once the choice principle had got to the level it had in *Cridland's* case and *Slutzkin's* case, it left little room for the operation of s. 260. The Court obviously had to find some ambit of operation for the provisions otherwise it would be accused of defining the section to be wholly inoperative. At about this time, the Court developed what became known as the antecedent transaction doctrine. Based on the words "alter the incidence of tax," Barwick CJ argued that these words are only satisfied

[55] (1977) 140 CLR 330.

where there is an antecedent transaction that is then changed for tax purposes.[56]

In his view the section would apply to a taxpayer who had already embarked on a particular transaction which would have given rise to a particular tax liability but then changed his or her method of effecting the result where that change was obviously motivated by tax considerations and not commercial ones.

Finding some scope for its operation, however, does not of itself justify the reasoning employed to this end. A number of criticisms can be made of the antecedent transaction doctrine. First it would mean that s. 260 does not apply generally to support the policy behind the substantive provisions. It only imposes a penalty on those foolish enough not to think about tax issues before embarking upon transactions. Furthermore, over time some judges took as restrictive an attitude to the factual question of when something actually had an antecedent transaction as they had done to the legal principles themselves. Whilst they could have held that sole practitioners or business persons entering partnerships to split income were merely changing the transaction for tax purposes, they held instead that the new legal arrangement was also to be described as a new business venture. Again one cannot say that they are clearly wrong in having done so, as in most cases, there would be other objective changes beyond mere tax benefits which could justify the argument that there is in fact a new commercial arrangement. Such decisions did, however, reduce the scope of s. 260 even further.

Barwick CJ's argument is based on a superficially literal reading of the words "alter the incidence of tax." Yet in reality, it is not a consistently literal approach to interpretation. If there is no tax liability as yet but merely a change of what was anticipated to be the tax liability, it could be argued to be altering the anticipated incidence of tax rather than the incidence itself. This is not to suggest that the section should have such a literal interpretation, but merely that, as was at times the case, decisions by Barwick CJ that purported to be based on conservative approaches to interpretation did in fact have elements of reasoning that were quite different. Furthermore, given that Barwick CJ thought the wording of s. 260 was too wide and needed to be read down, that view is not entirely consistent with a literal approach to the actual provisions themselves.

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[56] *Mullens v FCT* (1976) 6 ATR 504.

The importance of the role of judges in the interpretation of a GAAR is best shown by the change in attitude to s. 260 some time after Part IVA was introduced. At the time the High Court handed down the decisions in *Gulland, Watson and Pincus,*[57] leading practitioners were heard to criticise the decision on the basis that it went wholly against the pre-existing authorities on s. 260. That view was of course not only held by practitioners. Deane J based his dissent on that very proposition. In a practical sense it is obvious that these cases constituted a major shift in the nature and effect of s. 260. It is wrong however to see those cases as going against a clearly definable and consistent line of authority applicable to s. 260. It is simply not possible to reconcile with any logical consistency, the decisions made under s. 260. It was therefore quite proper for the High Court as late as 1985, to seek to determine once and for all the ambit of the section and the relative positions of the choice principle and the predication test. That their conclusion reversed a discernible trend as to the applicability of s. 260 throughout the 1970's can surely be no more disturbing than that such trend reversed the earlier position where s. 260 was successfully applied against many "middle of the road" transactions.

In *Gulland, Watson and Pincus* the Court considered the relationship between general and specific provisions and the implications this has for the choice principle. It is sensible to respect a prima facie rule that a general provision is not intended to interfere with the operation of a specific provision. This cannot be said of a general anti-avoidance provision such as s. 260. If it cannot have any effect at all over and above the specific provisions of the Act, it must surely be otiose. On the other hand it is correct to say that it should not be inflated in importance to deny a particular tax treatment to transactions which are clearly intended to be covered by specific provisions of the Act. The difficult question, which cannot be avoided by simply referring to one maxim over another, is to determine when and to what extent s. 260 or any GAAR ought to apply to situations which at first sight seem to gain the benefit of the express wording in some specific provision. This was what Lord Denning correctly identified as the real question when he developed the predication test in *Newton's* case. Some may disagree that the test chosen by him is an appropriate one or even that it was proper for the legislature to leave s. 260 so general as to require the judiciary to attempt such an exercise. It does not alter the fact that Lord Denning correctly identified the central issues.

[57] (1984) 15 ATR 422.

Where Part IVA is concerned, the lesson has at least been learnt in that *generalia specialibus* and *expressio unius* have been specifically over-ruled and an approximation of the predication test has been included in the statutory language.

Gibbs CJ's reasoning in these cases addresses a purpose he discerns (or more correctly a lack of such purpose) in that in his view "it is simply not right to say that the Act allows a taxpayer the opportunity to have his own income from personal exertion taxed as though it were income derived by a trust and held for the benefit of a number of beneficiary's." This reminds us of the problems with a GAAR. In cases such as *Everett*, the principle that personal exertion income cannot be assigned was not tied to s. 260. It was seen as being a general principle of tax interpretation although the basis and justification was never made clear. If however it is a general principle of the common meaning of "income" and "derivation," then the reason for denying the transactions in these cases, would be found within s. 25, the main income provision of the Act rather than s. 260. In the practical and political sense, it probably matters little whether the sanctity of the Act is protected through the operation of s. 25, s. 260 or some indefinable combination of the two. But from both the academic and judicial perspective, perhaps the conclusion that could be drawn from this inability to divide and distinguish the reasoning appropriate to s. 260 from the reasoning appropriate to the substantive provisions of the Act is that the central tautology of a general anti-avoidance provision is at work. Something which was otherwise legally valid was tainted by a particular purpose. The presence of such purpose could in turn ground the argument that for tax purposes the transaction should not even be seen as tax effective in the substantive area of the Act. The conclusion might therefore be that it is impossible to make a logical distinction between a purposive approach to the interpretation of the substantive provisions and the proper application of a general anti-avoidance provision itself.

This does not necessarily mean however that a general anti-avoidance provision should not be included in the Act as a safety precaution or as a direction for the judges to apply a purposive analysis at each stage.

In late 1987 the full Federal Court (Fisher, Lockhart and Spender JJ) handed down a most important decision *Gregrhon Investments Pty. Ltd. & Others v. FCT*,[58] which showed clearly the extent to which the courts are now prepared to go to make anti-avoidance operable. The great fault

[58] (1987) 87 ATC 4988.

in the professional response to *Slutzkin's* case was to ignore the trite legal observation that slight changes in facts between the reported judgment and one's clients position need to be addressed to determine whether they constitute grounds for a new decision. The great fault on the part of the Commissioner was that until *Gregrhon* he did not ask the courts to make such a finding. The most obvious distinction that may or may not have given rise to a different decision is that Mr. Slutzkin happened to have a company with nothing but accumulated profits which he no longer required and for which he was able to find a purchaser. This is to be distinguished from the bulk of the so called "bottom of the harbour" transactions as evidenced by *Gregrhon*. Most commonly, persons who had an existing company with assets comprising real estate and a business, incorporated a new company, and then transferred the business and the assets from the old company to the new company so that they *intentionally* created a *Slutzkin* type company. They then disposed of this 'shell' within a very short space of time. The Federal Court found in favour of the Commissioner and saw these additional factors as leading to an integrated interdependent series of transactions, the intent of which was to keep the existing business but derive a tax benefit as well. This could not be described as a mere sale of shares as was the case with Mr Slutzkin and had sufficient objective features to bring s. 260 into play.

We have stated at the outset that the two main reasons to examine s. 260 are first, to identify the nature of the predication test which was intended to be encapsulated in the new Part IVA and secondly to see what drafting problems or interpretation problems arose and which should be prevented in any well drafted general anti-avoidance provision.

Where drafting was concerned, one of the main problems with s. 260 was its use of the word "avoidance" without giving any particular criteria for determining where this occurs. The second major drafting problem was the failure to allow any reconstruction power for the Commissioner. Prior to its "resurrection", many judges saw it as inadequate as it merely treated the relevant transaction as void, but did not allow the Commissioner to reconstruct or tax any hypothetical alternatives. Thus if a tax scheme inappropriately moved income through various trust vehicles and eventually into a tax haven country, to void the entire transaction still arguably left the real money sitting somewhere offshore. In many cases, this lead to him losing even though the Court considered that the relevant transaction should be struck down. In other cases, judges were prepared to reconstruct even though the section did not give them any direct power to do so.

Attention then needs to be given to the criteria by which acceptable and non-acceptable transactions will be delineated. If the core test is a purpose test, then direction needs to be given as to whose or what purpose is relevant, whether this is sole purpose, dominant purpose or any purpose, whether purpose is found by subjective or objective evidence or both, and whether indirect purposes are relevant along with direct purposes.

Judge-made problems arose from the establishment of a choice principle and antecedent transaction doctrine. The lesson here is the need to determine how the general provision will interrelate with specific provisions.

Part IVA

Prior to the "resurrection" of s 260, a new GAAR was incorporated in Part IVA of the Act in 1981.[59] The Australian High Court has recently considered Part IVA. This legislation requires that there be a "tax benefit" in relation to a scheme to which the Part applies. Such a scheme is one where any person who entered into the scheme or any part of it would be said, based on an examination of all relevant factors, to have done so for the dominant purpose of giving the relevant taxpayer a benefit. Where this is so, the Federal Commissioner of Taxation has the power to amend assessments and reconstruct the tax position of any parties involved.

The High Court considered these provisions in the case of *FCT v Peabody*.[60] The case is examined in detail as a case study in the operation of the new provisions. While international readers would not be concerned with the fine detail of Australian cases, it remains the fact that this case is one of the few superior court decisions on a current GAAR. It squarely raises some of the most difficult design issues where GAARs are concerned, most of which would be key issues in any other countries legislation and litigation.

The facts were as follows. Stated simply, it involved a value shifting exercise from a high taxed asset to a non-taxed asset, although the entire arrangement was somewhat more complicated and combined tax planning and commercial considerations. In 1963 Mr Peabody with his father and another partner established a fly ash business. This was a by product of the burning of coal which was blended with cement to improve the

[59] *Income Tax Assessment Act* 1936 (Australia) ss. 177A - 177G.
[60] *FCT v Peabody* (1994) 94 ATC 4663.

properties of the concrete. In 1985 the Peabody interests owned 62% of the business. 38% were owned by a Mr Kleinschmidt or his associated interests. The business comprised four main companies. The shares in the group which were owned by Peabody interests were held in the name of a corporate trustee, TEP Holdings Pty Ltd ("TEP") That company held the shares as trustee of a discretionary trust. Discretionary trusts are accepted tax planning vehicles in the Australian system. They can be used to split income, particularly with family members, although there are now prohibitive tax rates when under-aged children are allocated more than a modest amount. Mrs Peabody and her two children were beneficiaries under the trust. Mr and Mrs Peabody were the directors of TEP.

In 1985 Mr Peabody decided to have TEP acquire Mr Kleinschmidt's interest in the group and publicly float it. He wished to float 50% and retain control of the remainder. An agreement was reached between Mr Peabody and Mr Kleinschmidt that the latter would sell his interest to the Peabody interests. Neither Mr Kleinschmidt nor Mr Peabody wanted the price of the shares to be disclosed publicly. Mr Peabody believed that the public float would be capitalised at a figure well in excess of the value agreed upon as the basis of the purchase from Mr Kleinschmidt. He considered that difficulties might arise if it was necessary to disclose in the prospectus that the shares had been acquired from Mr Kleinschmidt beforehand at a substantially lower price than that at which they would be offered to the public. A senior barrister gave advice that disclosure was not required but this advice was qualified.

Mr Peabody then had discussions with his advisers where it was suggested that the Kleinschmidt shares could be converted to a different class with restricted rights that would render them worthless. This would then have the effect that the other shares held by TEP Holdings would effectively be the sole valuable shares and would hence have increased in value. From a tax point of view this would have benefited the Peabody interests because a then operative provision, s. 26AAA, indicated that if property was acquired and disposed of within a 12 month period the profit would be deemed to be assessable income. If instead, the Kleinschmidt shares were devalued, the TEP shares which had been held for much longer than 12 months would have given rise to a capital gain only. (Taxation of capital gains as ordinary income was only introduced into Australia on 20 September 1985. Before that time they escaped the tax net if they avoided s 26 AAA.)

Discussions were then held about methods of financing the purchase of the Kleinschmidt shares. A decision was made to use redeemable preference shares for finance rather than a direct borrowing. Australian tax law has allowed this device to create a substantive debt in an equity form. Under the then existing Australian provisions, a financier receiving dividends on such shares would have received a rebate of 100% of the tax in respect of the dividends under s. 46. In turn this meant that the financier could offer the funds for an agreed dividend rate that was lower than the then current interest rate. After the dividends had been declared, the preference shares could be redeemed so that the financier would have effectively received the amount that was equivalent to a loan principle.

A decision was made for TEP to acquire a shelf company, Loftway Pty Ltd. The latter company would purchase the Kleinschmidt shares using redeemable preference share financing obtained from an independent bank. Once the Kleinschmidt shares were acquired, the companies and the group declared dividends in favour of Loftway which in turn declared dividends in favour of the banker. The companies in the group then passed special resolutions converting the shares which Loftway had acquired in them into Z class preference shares which carried restricted rights. This reduced their value from approximately $8.6 million to less than $500. TEP then agreed to sell all of the ordinary shares in the group to a company, which was the float vehicle and eventually became Pozzolanic Industries Ltd, for $30 million. This was paid partly in cash and partly in shares so that TEP eventually held 50% of the shares in Pozzolanic Industries. The remainder was floated to the public. The prospectus did not disclose the price paid for the Kleinschmidt shares.

TEP then used the sale proceeds to loan money to Loftway to enable it to redeem the preference shares from the banker. Loftway eventually transferred the Z class shares to TEP which then transferred them to Pozzolanic Industries. TEP then forgave the debt owed to it from Loftway. Thus the potential profit on the acquisition and disposition of the Kleinschmidt shares was replaced with an identical profit on the disposal of the long held shares by TEP.

The Commissioner assessed the profit made by the trust in the hands of the beneficiaries on the basis that the trustee had already resolved to split the income of the trust equally between Mrs Peabody and her two children. The Commissioner asserted that the devaluation of the shares and related transactions constituted a scheme to give Mrs Peabody a tax benefit and that Mr Peabody's dominant purpose in entering into the scheme or any part of it was to give her that benefit.

In reviewing the High Court decision in *Peabody,* we need to consider how the court treated the three key elements of Part IVA, namely what is a scheme, what is a tax benefit and when the relevant dominant purpose can be said to have been found.

These are not three separate elements. They are identified from the core provision namely s. 177D. That section indicates that a scheme is subject to Part IVA if it is one where a taxpayer receives a tax benefit and in the circumstances it would be concluded that a person who entered the scheme or any part of it did so for the relevant dominant purpose. A "scheme" is defined in a broad way in s. 177A(1) to mean:

> any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceeding;
>
> (a) any scheme, plan, proposal, action, course of action or course of conduct.

Section 177A(3) indicates that the scheme may be unilateral.

Section 177C(1)(a) defines a "tax benefit" to include:

> 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.[61]

Section 177D indicates that a taxpayer has obtained a tax benefit in connection with the scheme if, having regard to eight stipulated matters, which are essentially the objective features of the arrangement, "it would be concluded 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 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 is one of the taxpayers.

[61] There is a corresponding part dealing with deductions that was not relevant for the case.

Where a tax benefit has been obtained in connection with such a scheme, the Commissioner may make an assessment and relevant adjustments to other returns under s. 177F.

The notion of *tax benefit* is merely the idea of avoidance of tax in a strict numerical sense, regardless of the motivation for that to be so. However given the way the legislation is drafted it involves some comparison of the actual tax position with a likely tax position if the scheme had not been entered into. All tax planning involves some likelihood of a tax benefit. For example the decision to lease a company car rather than buy it outright leads to higher allowable deductions through the lease payments than would likely be the case under the depreciation provisions. A general anti-avoidance provision is not seeking to attack every transaction whereby some lower tax is obtained. Instead such provisions seek to have a triggering test to differentiate between acceptable and non-acceptable tax benefits. In the Australian legislation it is the dominant purpose test that performs this function.

The notion of a scheme is merely there to provide the framework within which to consider the presence of a tax benefit and relevant purpose. Hence the definition is a wide one and does not itself seek to distinguish between tax motivated schemes and general commercial schemes. It includes all forms of conduct whether legal or otherwise and regardless of the number of parties involved. Each element will now be addressed using the facts and judgment in *Peabody* as illustrations.

Scheme

In spite of its width, important questions need to be asked about the nature of the concept of scheme for Part IVA purposes which were discussed in *Peabody*. Because the relevant dominant purpose must relate to the person entering the scheme, consideration must be given as to why they entered that scheme rather than engaged in any other conduct. Similarly when determining the likely presence of a tax benefit, a comparison is made between the tax position under the scheme and the tax position that would reasonably be expected to have occurred in the absence of that scheme. Thus the mental processes needed for determining tax benefit and dominant purpose cannot ensue without a consideration of what the scheme is.

This raises two conceptual issues. First, are there any limitations on the Commissioner's power to identify the scheme or is the definition so wide that he has an entirely free hand? Secondly, what are the ramifications if the Commissioner wrongly identifies the scheme in the eyes of the court?

Can the court rectify the situation, can the Commissioner seek an amendment or is the provision discretionary so that the discretion is vitiated if the Commissioner wrongly identifies the scheme? The High Court addressed both of these issues in *Peabody* giving a clear answer as to the first and a somewhat more ambiguous response to the second.

The High Court rejected the Full Federal Court's view that it is for the Commissioner to identify the scheme and if he is wrong then the rest of his decision is fatally flawed. The case became complex because in the Federal Court proceedings the Commissioner particularised the scheme as being 10 steps. The drafting of some of those steps was less than fully clear and did not readily indicate what ambit the Commissioner had intended. These particulars were ambiguous because expressions were used which might have been taken to imply that the acquisition from Mr Kleinschmidt and the ultimate float were all included in the scheme. Because those features were clearly commercial in nature and were not motivated by tax avoidance, it would decrease the Commissioner's chances of success to include all of these in the scheme given that there is a dominant purpose test applied to the scheme.

The court considered that the scheme as originally identified by the Commissioner extended "to the conversion of [Kleinschmidt shares] to Z class shares, with the result being that same were not subsequently sold to the newly formed public company Pozzolanic Industries Ltd."

The court pointed out that the existence of the discretion is not dependent upon the Commissioner's opinion or satisfaction of any facts. The presence of a tax benefit and the question of whether it was obtained in connection with a Part IVA scheme are posited as objective facts. Under the Australian legislation the onus on any appeal is on the taxpayer. The taxpayer must show that the assessment was excessive. In a case like Part IVA where it is not fundamentally a discretionary provision, the taxpayer must address those objective features and not merely attack the methodology of the Commissioner.

This conclusion by the court is certainly right as a matter of interpretation although from a policy point of view there is still room for debate as to how strong an onus there ought to be on a taxpayer in responding to a Part IVA assessment. Where Part IVA is concerned, the Commissioner has made a determination based on his presumed analysis of the situation. This raises more difficult questions as to whether there should be some stronger obligation on the Commissioner to get his analysis right at the outset or whether he is instead entitled to render Part IVA assessments under a particular line of reasoning knowing that he is entitled to amend his reasoning at any stage and justify a flawed process as long as the end result was proper.

The Court went on to hold that if the Commissioner erred in identifying the scheme, that would only be fatal if that led to a fundamental error such as one where he identified the wrong taxpayer. The Commissioner could be asked to particularise the scheme as had occurred in *Peabody* but may put his case in alternative ways. If within a wider scheme identified he seeks also to rely on a narrower scheme then he should be permitted to do so subject to the possibility that there may need to be an amendment or other limitation on this power to serve the interests of justice. The court then indicated that the Commissioner sought to rely upon the narrower scheme before the High Court and was entitled to do so. It is not clear from this statement whether the court is saying that the Commissioner was entitled to attempt to narrowly define the scheme or whether the court is going further and saying the narrow identification did itself constitute a scheme. The court noted that the Full Federal Court saw the only scheme being the whole scheme embraced by the particulars. Once again, because of the ambiguous way in which they were drafted it is not clear whether this was seen by either the Full Federal Court or the High Court as including the acquisition from Mr Kleinschmidt and ultimate floating of the company. Looking at the wider scheme, the Full Federal Court considered that Mr Peabody's dominant purpose was a commercial one.

The court did not indicate whether the converse was also true. If the Commissioner had originally identified a narrower scheme which turned out to be unduly narrow could he argue in the alternative that a broader set of transactions constituted the scheme? While the court did not give a specific answer to this question it is more likely than not that the court would answer this in the affirmative. It is consistent with the court's view that the presence of a scheme is not a set of features identified by the Commissioner which form the foundation of some discretion on his part. Instead they are objective facts that either do or do not support the tax benefit which he has sought to cancel. The court's comments that in most circumstances any surprise could be cured by amendment would be similarly apposite. It is true to say, however, that the judgment implies that in an extreme case at least the court might consider that it would be so unjust to a particular taxpayer to allow the Commissioner to change the nature of his argument that he might be prevented from doing so.

What is less clear is the basis upon which the court would be entitled to do so.

The court did however indicate that the wide definition of scheme does not mean that scheme includes parts of a scheme. The Commissioner had sought to argue before the High Court that s. 177D, where it refers either to a person who entered into the scheme or part of scheme, allowed him to analyse Mr Peabody's dominant purpose in relation to that part only which related to the devaluation of the shares. The High Court rejected this argument and stated that Part IVA does not provide that the "scheme" as defined includes part of a scheme. Despite the very wide definition of scheme, a set of circumstances may constitute only part of a scheme and not a scheme in itself "where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning' The court indicated however that "if part of the scheme may be identified as a scheme in itself the Commissioner is allowed to rely upon it as well as the wider scheme."[62] Once again, no direct comment was made as to whether the Commissioner had correctly identified it in this case.

These words will form the basis of an important test to be applied at the outset in any Part IVA analysis. Has the Commissioner identified a scheme or only part of one? It is submitted that another way to state the High Court's test is to say that a scheme is something which is capable of having a practical meaning standing on its own. This does not fully resolve the ambiguity. There are two possible meanings of this. First it could merely mean that anything which has some objective purpose in and of itself can be treated as a separate scheme no matter how interrelated with other commercial transactions. A second possibility is to assert that a particular transaction, that is preordained to be interrelated with other transactions and which would not have occurred without the latter cannot be seen as a separate scheme. Each of these interpretations will have fundamentally different consequences for Part IVA. In the *Peabody* example, the devaluation of the Kleinschmidt shares can be said to have a discrete objective, either being the avoidance of s. 26AAA, the prevention of disclosure of the acquisition price in the prospectus or both. On this view the Commissioner was quite proper to identify this as a scheme before the High Court. The alternate view is to say that in and of itself devaluation of shares has no meaning without looking at the rest of the transaction where the value shifted to the TEP shares and was realised in the public float. On this basis the mere devaluation of the Kleinschmidt

[62] *FCT v Peabody* (1994) 94 ATC 4663, at 4670.

shares could not constitute a scheme. The scheme would have to be the wider set of circumstances which in turn would make it much more likely that the taxpayer would succeed, as the dominant purpose in the entire arrangement was certainly more commercial than tax saving.

Unfortunately the High Court has simply not given any clear guidance as to which approach it prefers. By implication it seems more reasonable to conclude that the court preferred the first approach which would give a wider ambit to Part IVA. When the court said the Commissioner relied upon 'the narrower scheme identified by the judge at first instance', using the word scheme in that context and saying he was entitled to do so implies that they agree that that was a scheme. Secondly they referred to the 'scheme for cheaper finance' which itself was less than the entire transaction. Thirdly, when they looked for the tax benefit, they looked at what Loftway might have been expected to have done if it made a profit, which presumes that the narrower Loftway transactions could properly constitute a scheme. This is not an unassailable proposition because the High Court dealt with the difference between scheme and part of a scheme after criticising the Commissioner's argument that if Mr Peabody's dominant purpose in carrying out part only of the scheme being a devaluation of Kleinschmidt shares was to obtain a tax benefit then the tax benefit obtained as a consequence could be said to have been obtained in connection with a scheme within the meaning of Part IVA. Certainly there is no way to support an argument that s. 177D somehow makes something less than a scheme into a scheme. All it could arguably do in Mr Peabody's case is to allow the dominant purpose to be analysed in the context of only part of the total scheme that he entered into. Thus the assertion would be that, even if the scheme was the wider one it might be possible because s. 177D speaks in the alternative of a person "who entered into or carried out the scheme *or any part of the scheme*" (emphasis added), one could look at Mr Peabody's purpose for the entire scheme (which would be commercial) or look at his purpose for entering the part that relates to the devaluation of the shares (which O'Loughlin J, thought was for the purposes of avoiding s. 26AAA). While this argument is open on the plain meaning of the words, the better reading and the more sensible one from a policy point of view is to see the alternative in s. 177D contemplating two distinct types of people, the first category being those who entered into the entire scheme and the second category being those who merely entered part of it. If one entered the entire scheme then the dominant purpose must be found in relation to that entire arrangement. Conversely if a person entered only part of a scheme, the alternative allows them still to be considered for Part IVA purposes and the dominant purpose test would be applied to that part which they entered into. Any other reading would allow the Commissioner to take perfectly commercial transactions comprising a complete scheme, albeit with some tax minimisation involved, identify the entirety as the scheme but look at the dominant purpose in relation to the tax minimisation step in isolation. This would effectively mean that no tax planning is ever allowable except where it arises from an express choice offered by the legislation and which is sanctioned by s. 177C(2).

The ambiguity remains because the High Court could have disposed of this point by reading the latter words of s. 177D in this way and did not need to make any comments at all about schemes incorporating parts of schemes. If the High Court thought the narrower transaction was a scheme, then there is no question of a part being seen as a scheme. If the High Court felt the wider arrangement was the scheme, it is still possible to run the dominant purpose argument as outlined above without needing to say that part of the scheme consequently becomes a scheme.

One way of arguing about the High Court by implication accepting the narrowest scheme of the Commissioner is to look at its suggestion that Loftway almost certainly received a tax benefit. To determine that a particular person has received a tax benefit involves looking at what did happen and comparing that to what would be excepted to have happened "but for the scheme." If the scheme was the wider the one as identified by the Federal Court, but for the scheme, Loftway simply would not have existed and would not have derived any income whatever. But for the entire scheme, the shares would have remained in Mr Kleinschmidt's hands and he would have received assessable income by way of dividends. He would have a tax benefit as part of that wider scheme but no one would have entered it for the dominant purpose of giving him that benefit. To say that Loftway would have made the profit but for the scheme therefore implies that the scheme is those steps that devalue the shares so that Loftway never made a s. 26AAA profit.

The High Court's quote about the difference between a scheme and a part of a scheme was from *Brebner's* case.[63] Unfortunately the quote is slightly out of context. The English legislation had a provision which indicated that if in consequence of a transaction in securities or the combined effect of two or more such transactions a person obtains a tax

[63] *IRC v Brebner* [1967] 2 AC 18, at 27.

benefit then unless he or she shows that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments and that none of them had as their main object or one of the main objects to enable tax advantages to be obtained, then the section applies to cancel the tax benefit. The English Commissioner attacked a particular transaction that was part of an interrelated series of events. The court held in the circumstances that he could not do so. The case involved six shareholders bidding for a company to protect it from a takeover which would have adversely affected their commercial interests. They obviously had commercial reasons to bid for the company and borrowed in order to do so. After successfully taking over the company, they arranged for the company's capital to be reduced to give them the funds to repay the bank. That repayment of capital was non-taxable under the substantive provisions and the issue was whether this anti-avoidance provision applied. Lord Pearce indicated that the first part of the transaction committed them to the latter part unless they abandoned it. He indicated that the sub-section would be robbed of all practical meaning if the Commissioner was entitled to break up the transaction in this way. Thus Lord Pearce's comment was in the guise of interpretation of the English provision. In and of itself it has nothing to say about the way to interpret Part IVA although it is conceded that there are good reasons for holding that there may still be transactions that are less than schemes.

The reference to *Brebner* further complicates the matter as Lord Pearce considered the transactions should be treated as one. He saw the elements attacked by the Commissioner as being one part of a whole dominated by other considerations. The section obliged the Commissioner to look at the object of each interrelated transaction in its actual context and not in isolation. These statements allow for competing arguments about the ambit of scheme in Part IVA. Taking the first part which sees the transaction as one part of the whole, dominated by other considerations, could be cited in favour of the Peabodys to say that the devaluation was part of the wider commercial aim. The second part of the statement indicating that the object of each interrelated transaction must be looked at in its actual context can allow for competing views. It does not say that the object of an interrelated transaction must be seen as the object of the entire transaction, merely that it needs to be looked at in context. This could lead to competing conclusions in the *Peabody* facts.

Tax Benefit

While comments about the nature of scheme in *Peabody* were equivocal, the court was very clear in holding that there was no tax benefit to Mrs Peabody in that year and largely adopted the reasoning of the Full Federal Court. The Commissioner had contended that there was a tax benefit to Mrs Peabody on the basis that but for the scheme, the money would have ended up in the TEP trust one way or another. Either it would have acquired the shares itself or if Loftway had acquired the shares and made a profit it would have distributed dividends to TEP. In turn, because the trustees had determined to divide the income equally between Mrs Peabody and her two children, the Commissioner assessed her as to one-third of the tax which would otherwise have been payable under s. 26AAA.

As indicated above, the notion of a tax benefit is merely a reference to the core fact of tax avoidance having occurred. There can be no basis for an anti-avoidance provision if there has been no avoidance. Section 260, the precursor to Part IVA, spoke about altering the incidence of taxation. The High Court in a number of cases had been favourably disposed to an argument that a taxpayer could not be said to have altered the incidence of taxation if there was not an impending liability clearly discernible that was avoided through a transaction that could not be explained on any other basis. This became known as the antecedent transaction doctrine, best identified in *Mullens*.[64] It is clear from the Explanatory Memorandum and the Second Reading Speech that the intention of Parliament was to provide an easier test to satisfy and prevent such a doctrine from undermining Part IVA. It was presumably for this reason that s. 177C defines a tax benefit to mean more of an allowable deduction or less assessable income as the case may be than would have been included if the scheme had not been entered into or carried out "or might reasonably be expected to have been included" or "not have been allowable" as the case may be if the scheme had not been entered into or carried out. The intent was to allow the Commissioner to make a reasonable assessment of what would have been likely but for the scheme.

A number of issues arise in this context. First the Australian provision speaks of a tax benefit being obtained "by a taxpayer." Thus there is the need to identify the tax benefit for the particular taxpayer being assessed. This is to be contrasted with overseas models. This does raise one policy

[64] (1976) 6 ATR 504.

question which was of the essence in *Peabody's* case, namely if in a group of related entities there is a clear tax benefit to someone or other but it is not clear exactly who, what limitations does this place on the Commissioner's powers?

The second key issue is the basis upon which the Commissioner makes the reasonable hypothesis. The expression used is "might reasonably be expected to have been included." This forces the judges to consider how likely the expectation must be before the Commissioner has properly identified a tax benefit. The phrase is an awkward form of drafting because it uses two different words that suggest quite different levels of likelihood. The use of the word "might" is a word implying less than a strong possibility. On the other hand, the use of the word "expected" implies that it must be more than a mere statistical possibility. In *Peabody*, the High Court emphatically expressed the latter view.

> A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.[65]

The court pointed to the difficulty of having TEP itself finance the acquisition. Being a trustee rather than a company operating in its own right, there are strong arguments that it would not have been able to issue redeemable preference shares or be entitled to a rebate for any dividends paid. Any uncertainty as to TEP's ability to operate in this way would have made it unlikely that it would have been chosen as purchaser of the shares. Thus the High Court felt that the Full Court was correct in concluding that there was no reasonable expectation that TEP would have acquired the Kleinschmidt shares as part of the overall exercise. If TEP had acquired the shares in its own right and not as trustee, there would have been no present entitlement on Mrs Peabody's part to any portion of the profit. The court concluded that it necessarily followed that any profit obtained from the sale of the shares if a devaluation had not taken place would have been obtained by Loftway so that any tax benefit would have been obtained by that company.

The Commissioner also sought to argue that if Loftway had made the profit it would have been likely to declare a dividend to TEP which would have in turn made the distribution to Mrs Peabody so that ultimately the persons who did derive the money would have derived the

[65] *FCT v Peabody* (1994) 94 ATC 4663, at 4671.

same amount of money under the alternate arrangement. The High Court did not address this issue in detail but merely said that "there is no reason to suppose and the Commissioner was unable to demonstrate that had the devaluation not taken place and had that profit been made by Loftway it would have flowed or could reasonably be expected to have flowed to TEP Holdings and hence to Mrs Peabody in the year ended 30 June 1986."[66] The court considered that there was no reasonable expectation that Loftway would have declared dividends.

Importantly, under the imputation system operating in Australia, there is no tax penalty for withholding profits. Such a penalty should not be imposed in any well designed imputation system but Australia's company tax system saw the company tax rate reduced significantly below the top personal rate and hence it was already a legitimate tax minimisation devise to hold profits in investment company vehicles.

In considering the Commissioner's various reasonable hypotheses, the court said that the method adopted by Loftway "apart from the devaluation of the Kleinschmidt shares" was found below to be entirely explicable upon a commercial basis. The examples advanced by the Commissioner even if commercially possible were not shown as ones which "would have been adopted in the absence of the devaluation as a matter of reasonable expectation."[67]

Again there are a number of difficulties in the High Court's comments. First, in the latter quote they used the word "would" rather than the word "might" as appears in the legislation. To this extent they may arguably have made the test a stronger one than that intended by Parliament.

It is submitted that the High Court was right to determine that a reasonable expectation must be more than a mere possibility. What is not clear is how likely a particular event must be before it could reasonably be said to be a reasonable expectation or prediction. For example if there are three possible outcomes, (a) with 30% likelihood, (b) with 30% likelihood and (c) with 40% likelihood, is (c) albeit less than 50% a reasonable expectation? Could (a) or (b) be a reasonable expectation given that they have quite a significant likelihood of arising? What if there are ten possibilities each with a likelihood of 10% thus none being more likely than any other and all with relatively low possibility? If this could not be a

[66] *FCT v Peabody* (1994) 94 ATC 4663, at 4671-2.
[67] *FCT v Peabody* (1994) 94 ATC 4663, at 4672

reasonable expectation does this mean that in any scenario where a taxpayer has many alternatives, Part IVA will have no application?

It would depend upon the circumstances as to whether this will be a serious issue in Part IVA cases. Where *Peabody* was concerned, the court clearly implied that Loftway itself obtained a tax benefit by avoiding s. 26AAA profit through the devaluation of the shares. It was only at the next level where the Commissioner sought to assert that the money would have been obtained by Mrs Peabody in various other ways that the court thought he was raising many possibilities, none of which was a reasonable expectation. One issue is how one determines what a reasonable expectation could be or what methodology the Commissioner must utilise in making the determination. In *Peabody* the Commissioner could have asserted that it is reasonable to expect that the person who obtained the monetary benefit within the actual scheme would have been intended to obtain the monetary benefit but for the scheme. Thus because the money ended up in TEP and was allocated to Mrs Peabody, it would be a reasonable expectation that the same would have occurred under the hypothetical alternative. Thus the Commissioner would assert that it is reasonable to expect that if Loftway made the profit it would distribute this profit to TEP who would in turn distribute the income to the three beneficiaries in the same proportions. The only reason for arguing that this would not be a reasonable expectation would be because this would lead to more tax being paid in the relevant year. Because there is no obligation to distribute profits and because the company tax rate is lower than the top personal rate, Loftway could easily have held on to the money in the short term at least. Low interest loans from Loftway to the family members would have been attacked under s. 108 but it may even have been advantageous to borrow the money at commercial rates. This raises a fundamental issue in relation to the notion of tax benefit. In determining the reasonable alternative course of conduct, is that hypothesis to be undertaken excluding tax considerations or can it include these as a matter of course?

From a policy point of view there are difficulties either way. If tax considerations are excluded, the so-called "reasonable expectation" becomes somewhat unreasonable given that all sensible people consider the tax implications of various commercial endeavours. On the other hand if tax considerations are allowed for, significant problems may arise where taxpayers have two or more clever ways of avoiding tax. If a taxpayer has three ways of escaping tax under s. 26AAA in a case like *Peabody* and one way of achieving the commercial end paying full tax, can the taxpayer argue that there is no tax benefit because the scheme was method 1 and but for the scheme, the taxpayer would merely have adopted scheme 2? There are two ways in which the Commissioner could attack such an assertion. The first is to argue that the hypothetical alternative cannot utilise tax considerations and therefore the fourth alternative is the reasonable expectation but for tax, assuming it is the most simple and straightforward methodology. Another approach would be to argue that if the taxpayer has contemplated methods 1, 2 or 3 at the outset, even though he or she has chosen one, the scheme could be broadened to encompass 1, 2 or 3 as alternatives and that the hypothetical alternative should exclude all three for this reason. Such an argument stretches the meaning of scheme and includes alternatives considered but not intended to be undertaken as part of an actual scheme. From a practical point of view, the greater efforts a taxpayer makes to provide objective evidence that he or she would have undertaken alternatives 2 or 3 only to prove that scenario 4 was never contemplated, the more evidence the Commissioner has to say that they therefore become part of the overall scheme.

If this argument was able to be applied, would it effectively destroy Part IVA? For example, what if the taxpayer in *Peabody's* case argued that but for the scheme, Loftway would have invested money in Australian films to gain a tax deduction to remove the taxable income? This would not be a good argument as it only asserts that a deduction would have been sought and does not prove that more assessable income would not have been made. Thus even if the taxpayer was believed, there is still the argument that there is less assessable income than otherwise would have been the case. Section 177C does not look at taxable income but rather assessable income and allowable deductions separately. If the hypothetical alternative was on the same side of the tax ledger as the actual benefit, a taxpayer would lose this argument if he or she was not believed. The onus would be on the taxpayer to show that he or she really would have been expected to adopt the alternate form of generating that higher deduction or lower assessable income.

If it can be shown that distributing the money to TEP and thence to Mrs Peabody would lead to higher amounts of tax, this in turn can be used to show that redeemable preference share financing was not the cheapest methodology if the ultimate intention was to have the money in Mrs Peabody's hands. If the latter was the case it would have been cheaper for TEP to merely borrow money directly to acquire the Kleinschmidt shares.

There needs to be some balancing in the requirement for the making of the hypothesis for the purposes of s. 177C. If the Commissioner has to show with some degree of certainty that in complex transactions a particular taxpayer would have obtained the money, then this will only be an inducement to make transactions more complex in the hope that he picks the wrong person. While this was a concern in *Peabody* itself, it is unlikely to be as serious a problem for the Commissioner as some might assert. First, *Peabody* does not mandate that people can insert $2 companies to pass tax liability and get out of a Part IVA assessment. Such a company would only be accepted as still existing but for the scheme if there is a commercial reason for its use. The court accepted that Loftway or a company like it was necessary to take advantage of the preference share financing. If there had been no commercial basis for the introduction of the company its existence would be disregarded under the s. 177C hypothesis. Furthermore, if a liability is passed through a company like Loftway, we will expect that in the future the Commissioner will render assessments against such companies.

Where an assessment is raised against a $2 company, even if the company has no funds to pay, anyone who chose not to organise payment of such an assessment would need to carefully consider the *Crimes Taxation Offences Act*, s. 222AOB of the *Companies Code* and the reparation powers under s. 21B of the *Crimes Act*. Each of these provisions raises legal arguments as to whether they could apply if the Peabodys refused to put funds in Loftway to pay any assessment on it although it would be a brave taxpayer who sought to face such a prosecution.

A second potential concern with the notion of tax benefit has long been asserted in relation to discretionary trusts. Many practitioners have argued that in a fully discretionary trust where there is no pattern of consistent distributions in the past, the Commissioner can never make the reasonable expectation that a particular beneficiary would have received the money. While *Peabody's* case did involve a discretionary trust, it does not answer this question because the court held that the trustee itself would not have received any assessable income. There was no need for the further argument as to whether a particular beneficiary would have received any such income. Importantly in *Peabody* the trustee had made a general determination to divide assessable income equally. This occurs in many instances either in a general sense to catch anything overlooked or indirectly through residuary provisions in the deed itself. Where there is no direction either way as to the way discretionary income is to be distributed, taxpayers who interpose discretionary trusts in all tax planning activities to try and avail themselves of this argument will force the court to expand on the nature of the concept if it is to give any meaningful effect to Part IVA. There are a number of things the court could say. The court could treat the trust as part of a scheme if it was separately included. If it is a long-standing trust as in *Peabody's* case, the court could accept the Commissioner's argument that it is a reasonable expectation that but for the scheme the trust would have been used to split income in the most tax beneficial way as the parties can be presumed to have tax minimisation as a key objective given the nature of the scheme itself. This would be an example of allowing the Commissioner to take the end result of the actual scheme as a relevant factor on which to build the reasonable expectation. While this is the preferred view it did not seem to impress the High Court in *Peabody* itself so to that extent the court's attitude is unclear. Another question not raised in *Peabody* itself is what if he gets the right taxpayer but misjudges the amount of the tax benefit? It is more likely that s. 177F would be interpreted to allow the court to overturn that part of the Commissioner's determination that wrongly included a particular amount.

It is also not clear what rights the Commissioner has to render more than one assessment under Part IVA to different people in relation to the same arguable benefit. That raises questions of administrative law and whether two conflicting assessments can both be said to be valid.

Another way to consider the High Court's comment about the reasonable expectation is to contrast it with the judgment in the Full Federal Court. In that decision the court said reasonable is used in contradistinction to that which is "irrational, absurd or ridiculous." The word "expectation" requires that the hypothesis be one which proceeds beyond the level of a mere possibility to become that which is the expected outcome. If it were necessary to substitute one ordinary English phrase for another, it might be said that it requires consideration of the question whether the hypothesised outcome "is a reasonable probability." The word "probability" invites us to think of percentages close to 50% if not higher. The question can then be asked as to what inferences can be drawn from the failure of the High Court to adopt this phrase in its own judgment.

Dominant Purpose

The *Peabody* decision said little about the notion of dominant purpose and the way it is to be determined. Because the Full Federal Court considered that the wider scheme was involved, it was easy for them to say that Mr Peabody's dominant purpose was commercial. The High Court merely made the point that looking at Mr Peabody's involvement in part only of the scheme does not itself render a scheme for Part IVA purposes. As indicated above, that is justifiable on policy grounds. Many questions still remain to be considered in this context. For example, what would the purpose of the professional advisers have been if they were considered in *Peabody*? Was their dominant purpose to merely obtain professional fees? Can one look at indirect purposes as well as direct purposes? What was the purpose of the advisor who as director of Loftway agreed to vote to devalue the shares?

Another question is whether the Commissioner could look at a number of people as alternatives in considering the dominant purpose test. Again by implication because the court considered that the Commissioner could look at a number of schemes in the alternative the same reasoning should apply.

Another important question thrown up by implication is the relevance of subjective purpose. When Part IVA was drafted, early commentators asserted that the eight criteria in s. 177D are strongly objective in nature, albeit most conceded that some subjective elements may still be considered. On the other hand, when looking at the litigation in *Peabody*, given the evidence of the particular parties and their assertions as to what they really intended at various stages, we can see how subjective and objective evidence can blur at the margins. When a person gives evidence about advice that was given at a particular time, they are stating the objective facts about a particular conversation. On the other hand they are giving subjective evidence about their particular views.

Peabody did not consider the overall effect of s. 177D in the context of Parliament's intent. There are two aspects to this question. First, Parliament has indicated that the overall aim of Part IVA was to incorporate in different words the predication test as adopted in *Newton's* case. Secondly, the Treasurer indicated that Part IVA would not apply to "ordinary family or commercial" dealings but would apply instead to "blatant artificial or contrived transactions."

There are a number of problems with this. First, it is not easy to compartmentalise the facts in *Peabody* in this way. Are the categories of ordinary dealing or blatant and contrived meant to cover the entire array or is there a grey area in the middle? If these are the only two categories, competing arguments can be raised in *Peabody's* case.

Secondly, if the predication test is to be adopted, there were ambiguities in the language used by Lord Denning that do not make it clear how strong a purpose was originally intended. Certainly Part IVA speaks of a dominant purpose but s. 177D uses the words "it would be concluded" rather than it might be concluded or might reasonably be concluded. This is stronger language and it at least allows an argument that a taxpayer should be safe wherever there is any possible commercial explanation of a particular transaction. This is almost certainly what was intended by the legislature as it did not want to be involved in an actual subjective determination for each individual taxpayer.

Tax Administration and GAARs

Another major problem with general anti-avoidance provisions is the ability to build an efficient and consistent administrative structure around them. Whilst overly specific legislation encourages avoidance activities through loophole spotting, provisions that are too general pose greatest problems in ensuring that bureaucratic decision makers consider only relevant criteria when making determinations and also that bureaucrats in different parts of the country should reach similar decisions. Where administrators are concerned, they can flesh out this detail through the ruling system. On the other hand, undue reliance on this approach offends against the separation of powers doctrine and the requirement that laws be made by parliament not bureaucrats. There is also no guarantee that the administrator will be impartial, fair or would appropriately balance the interests of taxpayers against the interests of revenue collection.

On the other hand, compliance theory has motivated many governments to move to self assessment regimes in revenue areas whereby taxpayers are primarily obligated to indicate the amount of taxable income, have record keeping requirements and the administration is encouraged to use audit powers to verify the accuracy of the information. Strict liability penalty provisions are incorporated to provide a potential cost for taxpayers who are inaccurate in their assessment.

One difficulty in combating tax avoidance, particularly through this approach, is that while avoidance is defined somehow through the notion of purpose, the strict liability penalty provisions are not. A purposive penalty provision has the difficulty of all criminal or quasi criminal provisions in terms of problems of proof. The way out in the Australian tax system is to provide an automatic penalty that flows from the operation of Part IVA itself.

Ultimately, the use of administrative design changes as a means to combat tax avoidance is subsumed into the wider debate about the role of the bureaucracy in our society and the checks , balances, powers and duties that are appropriate in that debate. For this reason it is difficult to form final conclusions from a study of avoidance alone.

Conclusions

This paper has sought to raise some conceptual issues about judicial behaviour, legislative design and administrative structure, all in an area where the central concepts, tax avoidance and tax planning, are difficult if not impossible to clearly define and identify. It would be equally difficult to attempt to assert with any degree of certainty the relative causes of excessive tax avoidance in Australia's history. It is simply not possible to prove the cause or connection to any clear degree. Nevertheless, any analysis of tax avoidance and its likely causes helps us identify various possible solutions. Because an avoidance activity offends against the underlying policy of the Act, a first step should always be to critically evaluate that policy. If the policy itself is flawed, that may well explain the avoidance activity.

In litigation, purpose is determined by judges. It is easy to discern the purpose of legislation when the Act displays pure horizontal equity. Under such a system any departure from that concept would therefore subvert the purpose of the Act. If however the Act applies different treatments to different forms of achieving the identical economic result, can an anti-avoidance provision operate or must a court accept that one purpose of the legislation is to provide the very choice that the tax avoider has made? It is true that there are certain design features of the legislation that create such inequities without any justifiable policy basis. The absence of a capital gains tax till 1985 was the most glaring defect. The difference in treatment between capital expenses and revenue expenses remains just such a problem. Whilst one can readily acknowledge that it would be easier for judges if the Act was simple and comprehensive, the fact remains that the role of judges is always to give effect to whatever piece of legislation is before them. An Act of Parliament that makes such policy choices as the *Income Tax Assessment Act*, must be given effect to in terms of the discernible intent of Parliament.

Finally the limited experience with Part IVA shows that once again, in spite of a fair amount of drafting effort, too many key policy questions have been left for judges to answer. If we are concerned about the philosophical questions as to the rule of law in a complex society and not just about revenue collection, we should as a result have concerns about the present GAAR operative in Australia.

CHAPTER 9

THE SWEDISH EXPERIMENT WITH A GENERAL ANTI-AVOIDANCE RULE

Leif Mutén

Introduction

This paper is an overview of the Swedish experience with a general anti-avoidance rule (GAAR). There are many facets to this development. For a long time, from the early 1950's when tax avoidance started gaining the attention of the public as a problem, the courts, in the first place, were trusted to look through the transactions and identify what were "sham transactions." Moreover, what in Sweden is called "stop legislation," specifically directed against tax avoidance schemes, was seen as a remedy. Gradually, in some cases, this type of legislation was given a virtually prohibitive character. Yet, the prohibition against retroactive legislation sometimes caused a feeling of frustration at the barn-door being closed behind the horse.

In 1980, opinion was ripe for a GAAR. Experience of the GAAR is difficult to analyze. The paucity of cases where the GAAR has successfully been referred to by the tax authorities may look disappointing to those who hoped that the GAAR would solve the problem. The fact that most cases in which the GAAR has been applied have later given rise to stop legislation, has tended to diminish the perceived importance of the GAAR. Nevertheless, the very existence of the GAAR may be seen as a deterrent.

The GAAR was taken off the statute book by the non-socialist government, effective January 1, 1993. After a social-democratic government took over, after the September 1994 elections, it hastened to reinstate the GAAR, effective July 1, 1995. A committee has been given the task of reviewing the text with the objective of rendering the GAAR more effective than before. Meanwhile, in a doctoral dissertation presented in 1995 by Anders Hultqvist, the issue has been raised whether the GAAR is constitutional.[1] The argument against is that the GAAR in its present form authorizes interpretation of the tax law by analogy, something that might violate the constitutional provision, under which taxation can be imposed by law only.

In the following, these developments will be dealt with in more detail, with a view to illuminate the basic features of the legal, technical, and constitutional problems raised by the efforts to control tax avoidance.

The Background

The Swedish experience of tax avoidance turning into a problem may be said to emanate from the drastic increase in the tax burden during and, in particular, just after World War II. The attitude on the side of the legislators remained for a long time relatively calm. It was felt that the more egregious abuses could be stopped by legislative measures, and the courts were trusted to look through tax schemes constituting what was usually but imprecisely called "sham transactions" (in Swedish *skentransaktioner*).

It might be added that there was at the time a certain discipline even on the side of the professional tax consultants. It was regarded as a part of the work ethics not to set up schemes that might help one client at the cost of many more being hit by the legislative measures the scheme might provoke. This type of inhibition is rarely observed these days.

One might add, although there is not much written evidence to confirm the impression, that the Swedish tax legislation already at an early stage had tended to encourage what was called "tax planning." Already in 1938, the investment reserve system was introduced as a device to influence the timing of corporate investment. Obviously, a government that used tax policy measures to encourage certain economic behavior, had no standing to criticize taxpayers who, of course within the bounds of the law, tried to minimize their taxes. As a matter of fact, tax incentives would be fruitless, if taxpayers disregarded the tax factor in their business decisions. In Sweden, tax interventionism went rather far, particularly in the first post-World War II period.[2] It was stated, not without a certain

[1] A Hultqvist, *Legalitetsprincipen vid inkomstbeskattningen* (The Legality Principle in Income Tax Law) (Juristförlaget, Stockholm, 1995).

[2] Illustrative for the times, although perhaps already a bit less enthusiastic than earlier writings, is the report on Sweden by Karl-Olof Faxén and myself in the Brookings/NBER conference volume. See EG Keith ed, *Foreign Tax Policies and Economic Growth* (NBER, New York, 1966).

pride on the side of the Swedes, that Swedish enterprises took tax advice before investing, whereas it was felt that in the UK, the tax advisor was called in only after the act, thus rendering incentives offered by the government less effective than they would have been with more attention given to tax planning.

One might regard the *Nordbäck* case as a dividing line.[3] The Supreme Administrative Court had to take position in a dividend-stripping case, where the taxpayer had used the well advertised services of one chartered accountant (Mr. Lundin), who promised his clients to arrange tax exempt liquidation of closely-held companies with reserves they could in theory not get rid of without either income tax on dividends or liquidation tax on liquidation proceeds. Lundin had let a company buy the shares, cashed in the profits as a tax-exempt intercorporate dividend, and then liquidated the moribund company. The Court (*in pleno*) found that it could not set aside this series of transactions.[4]

Needless to say, there is now not only a capital gains tax to make this kind of operation less profitable. There are also strict limits on what will constitute a tax exempt inter-corporate dividend, and a *Lundin* transaction, at least in the old, simple form, doesn't work any more.

Yet, with this case shaking up the legislators, the discussion got lively whether Sweden might need an anti-avoidance provision or not. Opinion was split.

One line, eloquently taken by Dag Helmers in his 1956 dissertation,[5] was opposed to the GAAR, stating that normal principles for the interpretation of laws, including tax laws, in combination with effective tax legislation could deal with the problem. Helmers did much to clear up the terminology, stating that "sham transaction" is a perfectly accepted legal expression for a transaction intended not to be undertaken in reality but just on paper. He saw no need for establishing some new tax law concept under that name, although his study brought a good deal of information on how different doctrines had emerged in countries like the United States (the "business purpose" doctrine), in Germany (the *wirtschaftliche*

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[3] RÅ 1953 ref 10.

[4] This decision differed from an earlier decision in a similar case that seemingly had meant a "piercing of the corporate veil." See RÅ 1951 ref 8. Of course, the description above is simplified.

[5] D Helmers, *Kringgående av skattelag* (Tax Avoidance) (Almqvist & Wiksell, Uppsala, 1956).

Betrachtungsweise), in the UK (substance versus form) and in several countries the *fraus legis* doctrine.

Against this stood a more politically inspired indignation against those avoiding their fair tax burden. In the opinion of these critics, trusting legislation alone would be a losing proposition — like the tortoise running against the hare, the tax avoiders would always keep one step ahead of the legislators, as long as there was no general clause constituting a decisive and victorious jump of the hare.

Certainly, the Supreme Administrative Court of Sweden was not always as prudent as in the *Nordbäck* case. In another case it ventured into private law, establishing that interest paid by a mother to her minor child on a promissory note the mother had given the child was not interest, after all, and hence not deductible, since even the interest payment was a part of the gift.[6] The discussion of that case illustrates the relationship between tax law and private law. Critics of the decision tended to maintain that the Court had deviated from private law, categorizing the interest payments as part of the gift transaction for the purpose of stopping a tax avoidance scheme. Others, including at least one prominent member of the Court, felt that the decision rested firmly on the private law concept, hence giving no basis for the assumption that tax law concepts were developed independently from private law.

In a series of cases from the same period, the court set aside partnerships formed by parents with their minor children, either altogether declaring the partnership void, since they did not emanate out of contributions from all the partners, or declaring the distribution of the profits to be a gift, to the extent that it exceeded more than a normal interest for the capital contributed by the children. Again, this was done with expressions in the judgment that clearly showed the learned judges to form their opinions on the firm foundation of private law.

According to the legal doctrine of the time, the Court was not ready to pronounce an interpretation principle that would take on the general function of a GAAR. The court at the time never quoted the *ratio legis* — *lagstiftningens grunder* (the legislative purpose), as the Swedish expression goes — unless it was done in the taxpayer's favor.[7]

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[6] RÅ 1956 ref 11.

[7] Helmers, *supra* note 5, at 223, shows this to hold for all cases from 1930 to 1949. With the GAAR, times have, of course, changed. In this context, there is room for doubt whether the distinction between "intent" and "purpose" has been clear to the

It is illustrative for the attitude of the Supreme Administrative Court that even as late as in 1987, in a case on which the GAAR could have been applied, the Court, rather than resorting to that rule, chose to rest on a private law concept. One such case concerned prepaid interest on long-term loans (the debtor using up virtually the whole sum borrowed to make a deductible-once-and-for-all interest payment). It was only in the most egregious case of the interest payment amounting to 99 percent of the loan that the Court was ready to declare that the alleged interest payment was not "a consideration for a credit received."[8] In other cases of large interest payments the tax authorities followed the letter of the law, so that legislation was needed to stop the abuse. More examples could be quoted.

Anti-abuse Legislation

While, in spite of much discussion and several committee studies, it was difficult to find a convincing form of a GAAR, the legislative ambition to prevent avoidance took specific form in several law provisions. Some have already been mentioned. One other, introduced in 1976, aimed at closely held companies. Among other provisions, it made taxable as income of the shareholder the full amount spent by his company on assets acquired for the purpose of accommodating his personal needs. In other words, to prevent abuse it made certain transactions prohibitively expensive, rather than just establishing a system under which the tax avoidance measure would be neutralized.

Meanwhile, the idea of a GAAR was kept on the back-burner. A public study in 1963 took a kind of middle-ground position.[9] The committee felt that careful legislative wording could in most cases do the trick. However, the committee admitted that there were special areas of the tax law where a general formula would have to be resorted to.

The GAAR

After numerous studies, a successful one was presented by the committee on business taxation (*Företagsskatteberedningen*),[10] followed up by a

legislators or the courts. Obviously, the former expression opens more room for subjective interpretation than the latter usually does.

[8] RÅ 1987 ref 78.

[9] The Tax Avoidance Committee (SOU 1963:52), referred to in the national report by Bertil Wennergren to the 1965 IFA congress in *Cahiers de Droit Fiscal International* Vol. La, at 240.

[10] SOU 1975:77.

ministerial memo with a proposed legal draft.[11] The time was finally felt to be ripe for legislation, oddly enough in 1980, during a short interregnum of the non-socialist parties in government.[12] The original version of the GAAR, an act called the *Tax Avoidance Act,*[13] unusual in as much as it could be applied at the appeals stage only, set out four criteria:

1. The taxpayer must have performed a legal act which was *part of a tax avoidance procedure.*
2. The tax avoidance procedure must constitute a *roundabout way* in relation to a normal and in economic terms essentially equivalent alternative course of action.
3. The transactions must result in a *substantial tax benefit* which can be assumed to have been the *decisive reason* for the choice of the course of action taken.
4. The procedure must, finally, be in clear violation of the *purpose of the legislation.*

After a change in government in 1982 the law was strengthened in the following year. The present criteria are three:

1. The legal act to be disregarded, taken for itself or in conjunction with another action to which the taxpayer (or the entity, on the income of which the taxpayer is assessed) is directly or indirectly a party, is *part of a procedure implying a not unimportant tax advantage* to the taxpayer.
2. Such tax advantage according to the circumstances can be *assumed to have been the main reason for the action being taken.*
3. An assessment on the basis of the action would be *in violation of the purpose of the legislation.*

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[11] Ds.B 1978:6.

[12] See the national report by Sture Bergström to the 1983 IFA congress in *Cahiers de Droit Fiscal International*, Vol. LXVIIIa, at 601, from whom the summary of the 1980 law is quoted. Readers of Swedish are referred to Hultqvist, *supra* note 1, who explains at length why, in his view, the 1980 act was unconstitutional.

[13] In Swedish, *Skatteflyktslagen*, SFS 1980:865. The translation of the name of the act is not self-evident. The literal translation is "Tax Escape Act," a word that certainly includes tax avoidance but is normally seen as also including tax evasion, both terms having well established Swedish counterparts. Bergström uses "Tax Avoidance Act," and given the purpose of the statute, that translation should be adequate.

The main differences between the two versions are, first, that the action need no longer be a "roundabout" arrangement, second, that the tax advantage need not be the decisive reason but just the main reason for the action, and, third, that the violation of the purpose of the legislation need no longer be a clear violation.

A third revision of the law was proposed by a committee on tax evasion and avoidance reporting in 1989.[14] It had just two criteria, one, that a substantial reason for the action can be assumed to be that the action causes the tax or social security contributions to be lower than would otherwise have been the case), and, second, that the action can be deemed to be in conflict with the purpose of the legislation under which the tax base is assessed. The committee, interestingly, took an exception to the remedy established in the 1980 law, i.e. the setting aside of the action, alternatively an assessment as if the taxpayer had used a straightforward action rather than a roundabout one, or, if either method would lead to an unreasonable result, an assessment based on a reasonable estimate. Instead, it recommended an assessment based on the disputed action, accompanied by a supplementary tax aimed at eliminating the improper tax advantage. This proposal did not lead to legislative action.

The 1980 law had a sunset rule, first to apply after five years, end 1985, then, in the course of the 1983 revision, extended to end 1993. In 1992, once again with a non-socialist government in power, the law was abolished, effective from 1993, but with the law still being applicable to actions taken up to December 31, 1992. Following the social-democratic takeover in the fall of 1994, a bill, adopted by parliament, reinstated the law effective July 1, 1995. Also, a new committee study was initiated with a view to proposing a new wording of the law. The committee would also deal with methods to fight avoidance, evasion, and fraud.[15]

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[14] *Skatteflyktsutredningen*, SOU 1989:81.

[15] There is a curious twist to this procedure in the dealings with the EC merger directive (90/434/EEC). In Art. 11 (1) (a) the directive gives a member state the right to refuse to apply benefits under the directive if the merger etc. "has as its principal objective or as one of its principal objectives tax evasion or tax avoidance" and mentions the absence of "valid commercial reasons" as constituting a presumption that the operation falls under this description. The non-socialist government that removed the GAAR surprised the public by including a version of this provision in the merger law proposed (enacted as SFS 1994:1854, s. 25). In translation, the Swedish text says about this:

> If a procedure indicated in ss. 3-6, alone or in connection with other transactions, by the application of ss. 7-24 would imply an undue tax benefit for the taxpayer,

It is of interest to notice that the bill proposing the reinstatement of the GAAR did not mention the argument by Anders Hultqvist that the law in its proposed wording should be regarded as unconstitutional.[16] The "Law Council," three Supreme Court justices normally responsible for pronouncing on the compatibility of new legislation with the constitution, were not asked for their opinion.[17] The official reason was that the law had already once passed the scrutiny of the Council. Another feature that might or might not have been intentional was that the bill was named for some other, innocuous proposals (concerning certain information returns), with the controversial GAAR mentioned just as "inter alia."

Case law

The Use of the Advance Ruling Procedure

The number of cases in which the GAAR has been tested is rather limited. Some of them are of the advance ruling kind, although it is most certainly not the intention of the legislators to make the advance-ruling institute a means of risk-free testing of tax avoidance schemes. The authority issuing advance rulings in the first instance is entitled to dismiss an application without appeal, and according to preparatory works expected to do so if it feels that the question raised is one of intended tax avoidance. In other words, the advance ruling system should not be abused by taxpayers presenting ingenious tax avoidance schemes for safe testing.

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and this is not insignificant, and can it be assumed that the tax benefit was a major reason for the procedure, the latter sections shall not be applied to such procedure.

In the bill, signed by the new government, it is stated that the criteria proposed are somewhat less restrictive than those of the GAAR. The provision can be applied at the assessment stage already, and it may also be applied by reopening the case, without the regular criterion allowing this only if the taxpayer has given wrong or insufficient information. The reason why this seemed acceptable was that the section at issue was to be applied in the context of a law with limited application, conceived as conveying an advantage to the taxpayers concerned.

[16] See Hultqvist, *supra* note 1.

[17] As mentioned below, the Swedish constitutional tradition leaves little if any room for courts testing the compatibility of a law with the constitution. An explicit such right for the courts was not introduced until, in 1979, it was included in the new, 1974 constitution. With respect to measures taken by the government or parliament, in other words all legislation in the narrow sense, the criterion for a court throwing out the law is that it is "obviously" violating the constitution. Normally, the very fact that the Law Council has not objected should be sufficient to confirm that the violation of the constitution, if any, was at least not obvious.

Yet, in a number of cases advance rulings have been given and after appeal confirmed by the Supreme Administrative Court, although the fiscal side has maintained that they should be thrown out on the basis of the GAAR. And what is more remarkable in this context: to save taxpayers from potential surprises, advance rulings, otherwise issued only if "of particular importance" to the applicant, need only be "of importance" for a ruling to be issued, if the matter concerns the GAAR. The intention behind this liberalization of the criteria for advance rulings to be given seems to be that taxpayers with other intentions than avoiding tax, particularly those whose actions would not render them liable to tax under the GAAR, should be given reassurance in this respect.

Hultqvist's case studies

In this section, use will be made of the study presented by Anders Hultqvist in his 1995 dissertation on *The Legality Principle in Income Tax Law*. Hultqvist has analyzed some 20 cases resolved by the Supreme Administrative Court from 1985 and on, in which the Court has referred to the GAAR.[18] Far from all these cases were won by the tax authorities, but in several cases, anti-avoidance legislation was later resorted to with a view to stop the abuse.

Some of the cases were resolved in the negative because of the *decisive reason* test. In one of these,[19] a capital loss was recognized on a father's sale of real property (below the cost price but above the assessed value of the property) to his children, reference being made to the purpose the father could have had to enrich his offspring. The law has meanwhile been clarified to tighten this loophole.

Others were lost by the revenue authority because there was no *tax advantage* identified (for example, where real property was sold in two steps, first cheaply to a closely held corporation owned mainly by the seller, then onward at the market price to an unrelated buyer).[20]

The *legislative purpose* test was not filled in some cases of partner leasing, where in one case a corporation, in another a partnership had acquired from a finance company assets already under (operational) lease to third persons, and used the assets as a basis for depreciation, thus reducing otherwise uncomfortably large taxable profits.[21] The court found that

[18] Hultqvist, *supra* note 1, at 399 et seq.
[19] RÅ 1985 1:69.
[20] RÅ 1990 ref 11.
[21] RÅ 1992 ref 21 I and II.

the tax advantage was considerable and obviously a main motive for the action. Yet, given the many other opportunities of consolidation by setting off tax-free reserves, letting the depreciation allowances on leased property reduce the taxable profits in these cases could not be seen as violating any legislative purpose. The tax authority even tried, in vain, to make the Court quash the traditional twelve-months convention, allowing the purchaser of machinery and plant to take a full year's depreciation allowance, as if the asset had been kept throughout the year of acquisition, rather than reducing the first year's depreciation *pro rata temporis*.

In another case, the tax authority failed the *legislative purpose* test in an operation, the nature of which as a tax avoidance scheme was quite obvious. The scheme was set up in connection with the coming into force of the law limiting deduction for advance interest payments to one year. A partnership — in fact, 240 of them — was set up with the intention of taking a substantial interest deduction for an interest payment made on the last day before the coming into force of the new law. The shares in the partnerships were later on to be sold at a loss. The Court found that there was no basis for applying the GAAR to the use of the long-established rule that a partnership loss, deductible to the partner, does not reduce his basis for purposes of capital gains tax when selling the share.[22] (The rule has now been changed by legislation.) With respect to the advance interest, however, the Court found that the alleged interest payment could not be accepted as such until such day when the debt had been established. At that time, the new law limiting advance interest payments had gone into force, and the deduction could be reduced accordingly.[23] Hence, there was no need for applying the GAAR.[24]

[22] RÅ 1994 ref 52 I and II.

[23] SFS 1987:1203.

[24] It should be added here that on June 30, 1995, the Supreme Administrative Court delivered judgment in a whole series of pilot cases of the partnership kind. It was a common line in all these cases that the Court saw fit to deal with them without applying the GAAR. Instead, the schemes of the taxpayers were largely quashed on other grounds. For instance, the Court applied as a test for interest to be deductible, that a real debt relation must first have been established. Thus, a huge anticipatory interest payment was not seen as having this character until such day, when there was a clear debt (not just a loan relent by the borrower to the lender), a day that fell after the stop legislation limiting interest deductions to interest for the current year only. Also, the Court saw fit to set aside as irrelevant a totally uneven and unjustified distribution of the results of a partnership in favor of a pro rata sharing. The whole series of cases indicated that the Court saw the GAAR as a last resort and the

The GAAR was not quite toothless, however. In one case the combination of a tax exempt capital injection in a newly acquired subsidiary and the use of that capital to finance a tax deductible contribution from the subsidiary to the parent was regarded as violating the purpose of the legal rules governing contribution payments within corporate groups.[25] The loss carry-forward rules have now been tightened to prevent this.

In another case the issue was one of the rules intended to stop dividend stripping.[26] The taxpayers tried to clean out a real estate gain from a closely-held company they planned to sell. They would first sell the property at book value to a subsidiary and then let the subsidiary sell the property at market value to the owners of the parent, who would then sell their shares in the parent corporation before the gain had been taxed in the subsidiary. Thus, there would be no gain accruing to the parent corporation, just in the subsidiary, and hence, the dividend-stripping rule in the form it then had would not apply. According to that rule, the full amount of the sales proceeds at the sale of the shares was taxable as a capital gain of the shareholder, if, at the time of the sale, there were untaxed profits in the corporation sold, following from the alienation of the whole or the main part of the corporation's assets. The Supreme Administrative Court disapproved, referring to the legislative purpose of the dividend stripping provisions.

With this, we enter an area where the interpretation of the law is still under dispute. At issue is the question whether the GAAR could or should be used to supplement incomplete drafting of anti-avoidance rules, so-called "stop legislation." The issue came to the fore in 1990 and 1994. In the first case,[27] the issue was a clear-cut tax avoidance scheme, aiming at establishing on the one hand an interest item, on the other a capital loss. This was needed since a law of 1982 had limited the deduction for a net deficit under (current) income from capital to the regular income tax (at a maximum rate of 50 percent), disallowing such deductions for the purpose of the progressive surtax. A taxpayer, who had realized a capital gain, in contrast, could use a capital loss in full against such a gain, and if he received an interest income to make up for the capital loss, the net result was likely to give him a tax advantage. In 1986, legislative action

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regular instruments of the law as clearly adequate to deal with the schemes at issue. See RÅ 1995 ref 32-35.

[25] RÅ 1989 ref 31.

[26] RÅ 1989 ref 83.

[27] RÅ 1990 ref 101 I and II.

was taken against the use of so-called yield-funds, used to achieve this desirable combination of interest income and capital loss. Holders of fund certificates would not be allowed to book as capital loss the loss they incurred by buying certificates just before the yearly interest was paid and selling them just after. In the 1990 cases, instead of the yield-funds, specifically defined in the 1986 law, certificates in so-called dividend funds had been used. The Court, nevertheless, found that the cases were in fact identical with the yield-fund cases envisaged in the stop legislation, and applied the GAAR.

In a more recent case,[28] a similar operation had been undertaken with the help of a corporation that had sold its assets and had been restructured to facilitate a massive distribution of profits preceding a loss sale of the shares. The Court found that this type of transaction was different from the type it had rejected in 1990. Apart from the 1986 stop legislation, the legislator, while certainly knowing that transactions in shares often took place around dividend day to arrange capital losses, had not acted. Hence, there was no violation of the legislative purpose, and the GAAR did not apply. One member of the Court dissented, stating that the share transaction was, if not identical, so in substantial respects at least similar to the yield-fund scheme.[29]

The cases raised the issue, whether, once stop legislation has been enacted, the GAAR can be applied to supplement it. In the 1990 case, it can be argued that the Court was rather tolerant towards a sloppy job of legal drafting. The 1994 case is not formally a reversal of the former case, but those of us who criticized the 1990 case rightly or wrongly feel encouraged by the 1994 case.[30]

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[28] RÅ 1994 ref 56.

[29] There are those who feel that both these transactions could have been quashed by a more restrictive interpretation of what constituted interest and dividends, respectively. Having resorted to the GAAR in the 1990 case, however, the Court could hardly change its approach and redefine the dividend payment in the 1994 case. Yet, the dissimilarity was sufficiently important to make the GAAR inapplicable. In other words, according to this theory, if there had been no GAAR, it is conceivable that both cases had been decided against the taxpayer.

[30] In L Mutén, Lagstiftningens Grunder (The Legislative Purpose) (1992) *Svensk Skattetidning* 279, I criticized not only the avoidance scheme that I felt could not stand the good old "smell test," but also the tendency of the Court to show too much understanding with respect to errors and omissions committed by the legal draftsmen. After all, specific anti-abuse laws should not be read as if their legal definitions of forbidden transactions ended by an "and the like."

The difference between the two cases is hardly striking, and there is at least some reason to believe that the Court will be reluctant to extend by analogy legal provisions having the character of stop legislation. Obviously, however, there is no legal prohibition against applying the GAAR with reference to the legislative purpose of such a law, and in the 1983 reformulation of the rule, there were statements in the preparatory works rendering support to such use of the GAAR. Time will show whether the idea will prevail that the GAAR may be used to patch up omissions in stop legislation, or whether the situation is such that the tax legislator has to choose which horse to ride.

The answer to the question will, ultimately, depend on subjective values. Those of us who regard the rule of law, in the sense of the individual's safety against unlawful deprivation of rights and property, as a value that overrides the fiscal interest in efficient taxation, will tend to feel that stop legislation is a better instrument than a GAAR, and that stop legislation, once used, should be exclusively used rather than be used in combination with a GAAR.

In Sweden, this attitude has certainly not been uncontested. Indeed, the very word *rättssäkerhet* (the same as the German *Rechtssicherheit*, implying the safety of the individual against intrusion on his legal rights, commonly translated into English as "the rule of law") is used differently by different people. It is an old and commonly used argument from the political left that, in the tax context, it should be understood to include not just the safety of the individual against unlawful actions of the fiscal authorities, but also the assurance of the loyal taxpayer that he is not abused and taken for a ride, whereas smarter people get away with tax avoidance schemes.

It should not be interpreted as negligence vis-à-vis the problems raised by tax avoidance and evasion, when this mixed-up use of the word is opposed. It is most certainly possible to defend taxpayers' rights while at the same time urging firm measures against tax avoidance and evasion.

Since the case studies seem to show, however, that most cases will eventually be dealt with through stop legislation, and that other cases can be satisfactorily resolved by using normal rules for interpretation of the law and the facts, it is difficult to see the necessity of the GAAR. There is no clear indication that the existence of the GAAR has turned the generally applied interpretation rules more restrictive; at least it seems obvious that the Supreme Administrative Court prefers solving cases without resorting to the GAAR. The GAAR may have a positive value in making taxpayers a bit less audacious in their scheming, and in stopping some transactions more quickly than stop legislation could. Against this stand two big negatives: one that the GAAR violates the principle of *nullum tributum sine lege*, the other that the GAAR by its very existence threatens to lower the standards of precision applied by the legal draftsmen.[31] In other words, the GAAR may not just raise the issue of the rule of law, but it may be counterproductive as well.

The Constitutional Issue

In his recent dissertation, Anders Hultqvist analyzes the constitutional provisions under which the government's right to tax is exercised. He comes to the conclusion that the constitution requires written law to be the basis for taxation. An interpretation by analogy will bring the tax outside the realm of constitutional legitimacy.

The interpretation Hultqvist gives to the GAAR is that the legislative purpose criterion implies a mandate to interpret tax laws by analogy. Thus, the legality principle is violated and the GAAR is unconstitutional.

Sweden has no long tradition of courts testing the constitutionality of laws. There was for a long time up to the adoption of the 1974 constitution an ongoing discussion among law scholars, whether the courts had such a right or not under the 1809 constitution. All the proponents of a US style constitutional review had to show, at least as far as taxes were concerned, was a case where the Supreme Court had taken up a taxpayer's claim that the 1947 estate duty (introduced over and above the inheritance and gift tax and soon abolished) was a confiscation and not a tax. The taxpayer lost, leaving little room for the constitutionality test theory.

In 1979, however, an amendment to the new constitution opened the door for such a test. Certainly, the door is not wide open: when it comes to legal provisions issued by the national government or the parliament, they can be set aside only if found "obviously" in violation of the constitution. While the Supreme Administrative Court has, indeed, been ready to throw out regulations issued by the central tax administration as

[31] The principle, in English "no taxation without legislation," was formulated by the Swedish tax law professor Seve Ljungman in his *Skattefordran och skatterestitution* (Tax Claim and Tax Refund) (Almqvist & Wiksell, Uppsala, 1947). While never officially made a tenet of the courts, it has played a major part in the writings of Helmers, Hultqvist, and others, where the problem of how to deal with avoidance and evasion has been dealt with. Most certainly, the same idea has been of importance in other countries as well.

usurping the parliament's prerogatives, it has been less than adventurous in dealing with duly enacted laws.[32] It is therefore a bet against extremely high odds that the Court would be ready to dismiss a reenacted GAAR as being unconstitutional.

Malpractice

The existence of a GAAR raises the issue of responsibility on the side of those, who advise the taxpayers and invent the avoidance schemes. There has been a good deal of mass fabrication of this kind of schemes, and advisors have not always taken care to get in writing from the taxpayers that they have been duly warned against the risks and will never ever make the tax advisor responsible.

The dividend fund case described above gave rise to a couple of such malpractice suits.[33] In the first one publicly known, the Bank was able to impress on the lower court that the investor had been fully aware of the vagaries of the GAAR, and the court accordingly found him — more or less having the status of a consenting adult — to have no recourse to the bank to cover his costs of the ill-fated operation.[34]

In another case, the client had more luck in the appeals court, but much to the relief of the banking and consulting community, the Supreme Court

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[32] The clearest case in point is RÅ 1992 ref 10, where the Court had to deal with a "temporary wealth tax" levied in 1986 on life and pension insurance institutions. The background to the law was that government economists felt that the yield on insurance capital had been excessive in 1986, and that, to cool down the market, government should seize some of the excess. The constitutional prohibition against retroactive taxation precluded the use of an income tax for the purpose. Instead, the tax law, hastily decided and enacted at Christmas time, got the form of a "wealth tax" albeit differentiated so as to make it lower on the capital life insurance funds (the yield of which was subject to some income tax) than on pension insurance funds (on the yield of which the tax was nil). A very large amount in tax was at stake. The Court had three choices, one, to declare the law unconstitutional on retroactivity grounds and order the tax refunded, another, to declare the law unconstitutional, but not "obviously" so, thus escaping the awkward refund order, and, third, to accept the description of the tax as a wealth tax, the due date of which fell after Christmas and thus implied no retroactivity. That the Court chose the third line has been seen by some observers (such as myself) as accepting an avoidance trick on the side of the legislators that, if practiced by a taxpayer, would have provoked the use of the GAAR. As Holberg, the Danish playwright, put it: "When Daddy is drinking, it is right!"

[33] RÅ 1990 ref 101.

[34] NJA 1994 p. 598. *Linköpings tingsrätt* (a local court), verdict June 23, 1993, DT 397.

took up the case and took the bank off the hook, mainly because it had been shown that the taxpayer in another context had been organizing a meeting with an entrepreneurial club, at which of all people a representative of the bank he now was suing had had an opportunity of talking about the anti-avoidance rule and the risks it involved for any ingenious scheme to be thrown out.[35]

An Evaluation

It would be an ostrich-like attitude to deny the existence of tax avoidance as a problem. There have been those who have described tax avoidance as a necessary safety valve preventing excessive tax laws from taking their full, detrimental effect.[36] Yet, trusting tax avoidance to improve on the tax system is trusting the fox to keep up good order in the chicken-pen.

There is greater room for differences of opinion when it comes to methods to deal with the problem.

Ideally, tax laws should be consistent, clear, and unequivocal, so as not to open any loopholes. If, exceptionally, a loophole should be found, swift legislative action should be taken with a view to closing the loophole while at the same time guarding the consistency, transparency, and simplicity of the tax law.

Regrettably, not all tax legislation lives up to these standards. In Sweden, however, one can at least note a considerable improvement through the great tax reform in 1991 and its follow-up. Virtually all the cases so far resolved by the Supreme Administrative Court with application of the GAAR would not need a GAAR any more to be properly dealt with.

Ideally, the courts should be sources of wisdom and good judgment. In the exercise of these characteristics, the courts should do two things. With respect to the laws, they should interpret them with a clear understanding for the legislative purpose, tampered by an equally clear respect for the legality principle. With respect to the facts, they should disregard sham transactions, set aside empty constructions with no other purpose than tax

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[35] This and other related cases are dealt with by A Baekkevold, Skadestånd på grund av rakstam skattenådgiming (Damages for Negligent Tax Advice) (1994) *Svensk Skattetidning* 662. Compare also L Mutén, Sweden's Supreme Court Frees Bank in Malpractice Suit (1994) 9 *Tax Notes International* 1677.

[36] The discussion of the issue at the 1983 IFA congress gave ample room to this point of view — one that is certainly not shared by this author.

avoidance,[37] and yet show due respect for the taxpayers' claim to predictability and respect for the words of the laws.

Most court systems will be found wanting, when tested on this basis. The world has seen examples of courts, sabotaging the tax system by making unrealistic claims on legal draftsmen and tax officials. Some of them have been shunted out of the system altogether, thus illustrating the veracity of the old saying *summum ius, summa iniuria.* Other courts have bent in the direction of the fiscal authorities, dutifully assisting in clarifying obscure laws and supplementing incomplete ones, at the risk of violating the civil rights of the taxpayers, who have the right to expect respect for the rule of law.

Finally, the tax administration should pay due respect to the rule of law, both in safeguarding the revenue interest of the authorities and in assuring the taxpayers fair and objective treatment. If the tax administration takes too relaxed a view of the evasion and avoidance going on, the result will be that only those stupid enough or idealistic enough will pay, whereas the rest will cheat. If the tax administration treats every taxpayer as a potential cheater, it runs the risk of making this preconceived idea come true.

No tax administration is flawless, either.

There are shortcomings among each one of these three pillars of the tax system, the law, the judiciary, and the administration. Countries tend to make up for the failures of one by putting more weight on another.[38] To take the case in point: if the law is deficient and the courts apply it as if it were a pattern of perfection, there is a temptation to let a GAAR make up for the shortcomings of the law, and turn the responsibility to the courts and the administration. If the administration is weak and auditors gullible, tax laws might have to be Draconian, whereas, if applied by a more com-

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[37] Note the word "empty." A taxpayer's sole purpose of avoiding tax does not by itself make his action void for tax purposes, if there are consequences (other than tax saving) from his actions. A taxpayer abstaining from making an income out of reluctance to pay tax, is not taxed on the income he could have made. A dog-lover, leaving the pet shop with a cat rather than a dog, because he hates taxpaying even more than he hates cats, is not made to pay dog tax because his sole purpose in acquiring the cat is avoiding the dog tax. After all, once the cat scratches him, he has suffered other consequences from his action than just avoiding tax.

[38] This summarizes L Mutén, Tax Law, Tax Administration, and Courts: the Need for Harmonization, in *Festskrift till Per Olof Ekelöf* (Norstedts, Stockholm, 1972) at 519-526.

petent audit service, the law can leave more room for administrative judgment.

There is no general rule spelling out for all countries at all times whether a GAAR is needed or not. If the three pillars function reasonably well, a GAAR could be dispensed with. If there are serious malfunctions, a GAAR will not do the trick either, and it might, indeed, aggravate the situation. General principles for the interpretation of tax laws — or, to be precise in the common law context, for the analysis of facts as well as the interpretation of statutes — may with benefit play the role intended for a GAAR. Yet, if these principles jeopardize the rule of law by being carried too far, a properly worded GAAR may be better.

Hence, there is no common prescription at the end of this paper, just a statement of the simple fact that there are many ways of skinning a cat, and ample room for criticism, whichever one is chosen.

PART III

ALTERNATIVES TO ANTI-AVOIDANCE RULES

CHAPTER 10

REDUCING TAX AVOIDANCE BY CHANGING STRUCTURES, PROCESSES AND DRAFTING

Rt Hon Sir Ivor Richardson

Background

My inaugural lecture in 1967 following appointment as a tax professional to a chair in the law school at Victoria University of Wellington was on attitudes to income tax avoidance. At that time I was fairly confident of the ability of the legislature, the revenue and the judiciary to strike the right balance between acceptable and unacceptable tax planning. The legislature traditionally exerts control of tax avoidance through special and general anti-avoidance provisions; the revenue administration contributes in administering those provisions and exercising discretions; and the judiciary is expected to strike the right balance between acceptable and unacceptable tax planning through its interpretation and application of tax legislation. Thirty years on I am not so confident about the use of anti-avoidance provisions as a governing mechanism and am inclined to favour greater reliance on other means of identifying and controlling tax avoidance.

In recent years the economic, social and political landscape in New Zealand and Australia has changed markedly. This has been particularly true in the last 10 years. There have been massive institutional changes, changes in processes, and changes in the nature and degree of government involvement in the economy. Above all are changes in attitudes, in the way of looking at the economy, at the functioning of government and at society. Throughout the world, capitalist and former communist, there has been concern over the effectiveness of public sector bureaucracies, over the level of taxation and the effects of income taxes on effort, savings, and economic growth and behaviour, and over the suspected effects of the welfare state on individual initiative and self reliance. The reform processes have already had a marked impact on the administration of government. Inevitably they have led to a questioning of the traditional reliance on the exercise of state power through the administration of the tax system coupled with dispute resolution through the courts as the means of striking the balance between citizen and the state in protecting the tax base and controlling tax avoidance. Inevitably tax administration and the decision making of courts are influenced by the changed public policies which have so affected other institutions of society.

Acceptable Planning or Unacceptable Avoidance?

Whether the effective rate of income tax is 30%, 40% or 50%, some taxpayers will utilise the advantages of the system so as to minimise the total tax paid in respect of their productive efforts. In turn, drafters of tax legislation recognise that, to an extent not met with in other areas, entry into commercial transactions and the shaping of commercial transactions will be influenced by the detail of tax legislation. Given that the legislation cannot anticipate and provide for every situation that may arise and that there are obvious limits to the length and complexity of any statute that has to be applied day in day out, a modified approach has been adopted in Australia in large areas of tax law, as it has in a great many other countries. It is to draft in some detail so as to reflect the policy underlying the provision in the treatment of obviously distinct situations calling for separate recognition; to repose discretions in or otherwise leave the application of the provision in other situations to an officer of the revenue; and to add specific and general anti-avoidance provisions designed to protect the tax base against unacceptable depredations of tax planners.

Legislators, judges and other mortals have found great difficulty in drawing the line between acceptable tax planning and unacceptable tax avoidance. Put broadly, tax avoidance refers to arrangements and transactions designed to achieve tax benefits other than those specifically allowed for in the legislation. The object of general anti-avoidance provisions is to protect the tax base and the general body of taxpayers from what are considered to be tax avoidance devices. The legislation recognises that the Commissioner cannot rely on market forces to provide adequate protection for the public interest. In intra-family transactions and self-dealing transactions that is clearly so. And in some apparently arm's length transactions the steps employed to achieve the commercial result may represent an accommodation by one party to assist the other's tax position. Tax is a highly significant factor in business decision-making and family property planning, and specific anti-avoidance provisions necessarily have limited impact. Against that background it is not surprising that the legislature should raise a general yardstick by which the line between legitimate tax planning and improper tax avoidance is to be drawn.

The original Australian and New Zealand general anti-avoidance provisions had major interpretation deficiencies. Some of those deficiencies were noted by the Privy Council in *Mangin v Commissioner of Inland Revenue*[1] and *Challenge Corporation v Commissioner of Inland Revenue*.[2] Even in Part IVA of the Australian legislation and s. 99 of the 1976 New Zealand statute (now s. BB9 of the 1994 Act), formidable uncertainties remain. The function of these sections is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that s. 99 should over-ride all other provisions of the Act so as to deprive the tax-paying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all the specific provisions of the tax legislation. It, too, is specific in the sense of being specifically directed against tax avoidance; and it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation.

The general anti-avoidance section thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and the general anti-avoidance provision and of the relationship between them. That is a matter of statutory construction; the twin pillars on which the approach to statutes mandated by s. 5(j) of the New Zealand *Acts Interpretation Act* 1924 rests are the scheme of the legislation and the relevant objectives of the legislation.

There are two obvious limitations to the scheme and purpose approach. First, it is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. There is force in the thesis that in many respects the tax base is so inconsistent and contains so many structural inequities that a single general anti-avoidance provision

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[1] [1971] NZLR 591.

[2] [1986] 2 NZLR 513.

such as s. 99 cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences.[3]

The second is the uncertainty arising from differing judicial perspectives and differing administrative approaches. They reflect differing perceptions of morality and reality. On one view taxes are enforced exactions and everyone does right in so arranging one's affairs as to get them as low as possible.[4] Another view is that tax arrangements are often sterile or unproductive in themselves (except perhaps in respect of their tax advantages for the taxpayer concerned) and also have social consequences that are contrary to the general public interest.[5] There is a vast literature concerned with the morality and fairness of taxation and tax avoidance. Perceptions differ. But, if there is agreement on nothing else, there is at least a widespread recognition that the New Zealand tax system rests very substantially on voluntary compliance which in turn depends on widespread agreement that the system operates fairly and efficiently over the whole community.

Judicial Approaches

Arguing tax cases in the different climates of the New Zealand courts and the Privy Council brought home to me years ago how much judges are affected by their particular environment. So did preparing new tax codes for other countries. Even within the same environment, traditional attitudes and hence judicial approaches may change over time. Witness the sea changes in the approach of the High Court of Australia to s. 260 in the pre-*Barwick*, *Barwick* and post-*Barwick* years. The interpretation approach taken inevitably depends on judicial attitudes and the perceptions judges have of community values, as well as on any statutory directives.

Even with those limitations, trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between general anti-avoidance provisions and other provisions of the Act that best reflects the intention of Parliament as expressed in the statute. It may also allow for the countering of what is perceived to be tax avoidance without any resort to the general anti-avoidance provision. *Hadlee v*

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[3] See GJ Harley, Structural Inequities and Concepts of Tax Avoidance (1983) 13 *Victoria University of Wellington Law Review* 38.

[4] Judge Learned Hand in *Commissioner of Internal Revenue v Newman* (1947) 159 F.2d 848.

[5] *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683, at 686.

Commissioner of Inland Revenue[6] is a striking example. Like the noted Australian case of *Federal Commissioner of Taxation v Everett*[7] it concerned dealings in interests in an accountancy partnership. In a narrow sense it hinged on the meaning to be given the word "derived." The legal answer involved a wider approach which assessed the scheme and policy of the legislation. The resulting conclusion was that income from personal services was derived by the person who performed the services even though he had assigned the future income so that in property law terms he never owned it.

In other jurisdictions courts have relied on other approaches in determining whether to recognise transactions as tax effective. In terms of the business purpose requirement, well established in American jurisprudence, the absence of any legitimate commercial purpose for incorporation of the entity or for a particular transaction by an existing entity requires refusal of recognition for income tax purposes. This concept is not without its difficulties and the literature on the subject is enormous. As Surrey explains:

> Thus, in some areas the Code provisions themselves are understood to establish new business norms though those norms are motivated by the tax result. But other provisions, such as the interest deduction or the provisions turning on the presence of 'debt' as opposed to 'equity' . . . must be understood as written only for those transactions whose business or economic norm or motivation is not derived from the tax law. This combination of the existence of a rule permitting transactions to be disregarded but uncertainty as to when the rule will be applied has an *in terrorem* effect that dampens the enthusiasm of some would-be manipulators but prompts others to take a chance where little is at risk if the scheme fails.[8]

The business purpose test reflects an attitude towards the rights of individuals that in civil law jurisdictions finds its expression in the doctrine of abuse of rights. That doctrine limits an individual's rights over property in order to protect the interests of his or her neighbour. In taxation law the same principle provides a technique that may be used to subordinate to the interest of the State as a tax collector the liberty of the individ-

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[6] [1991] 3 NZLR 517; [1993] 2 NZLR 385.

[7] (1980) 143 CLR 440.

[8] S Surrey, *Federal Income Taxation — Cases and Materials*, 2nd ed. vol. II (1980) at 675-76.

ual to choose otherwise effective legal forms through which to channel income-earning activities.

In *Stubart Investments Ltd v The Queen*[9] the Supreme Court of Canada refused to follow that path. It firmly rejected the proposition that any transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent bona fide purpose. The Court considered it more appropriate to turn to an interpretation test that would provide a means of applying the Act so as to affect only that conduct of the taxpayer which has the designed effect of defeating the expressed intention of Parliament.[10] And the rise and partial decline of the fiscal nullity principle in England demonstrates the problems of varying judicial perceptions of tax avoidance and approaches to avoidance arrangements.

Which legislative and judicial approaches are appropriate in defining tax avoidance and then countering it must depend on the perceptions that legislators and judges have of community values and attitudes in their own society. It is not for me to express any views about that. But, based on my own experience, I have become less sanguine about the capacity of the New Zealand tax system to control economic behaviour. As a result I have come to the view that there should be less emphasis on the invoking of anti-avoidance provisions and on essentially discretionary judgments by tax officials and the courts as a control mechanism, and that there should be more emphasis on reducing incentives for tax planning, on changing the drafting approach, on restructuring the tax agency and on reorganising the tax collecting system to recognise and reflect central features of tax collecting.

Features of Tax Collecting

The starting point, at least from a New Zealand perspective, is to identify the special features of modern tax collecting that affect tax avoidance. The recent Organisational Review of the Inland Revenue Department, whose recommendations are currently being implemented in New Zealand, identified seven features having major implications for tax administration generally. Rephrased to reflect the focus on tax avoidance, they are set out below:

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[9] (1984) 10 DLR 4th 1.

[10] See Felesky & Jack, Is There Substance to "Substance Over Form" in Canada, in *Report of Proceedings of the Forty-Fourth Tax Conference, 1992 Conference Report* (Toronto, Canadian Tax Foundation, 1993) at 50:1.

1. Taxes are imposed by Parliament. The tax administrator quantifies the statutory liability and constitutionally neither the tax administrator nor the Government can simply suspend the operation of all or part of those laws.

2. The resources available to the tax administrator for the determination of the taxes of all taxpayers, and the collection of those taxes, are limited. The tax administrator must make decisions as to the management of those resources.

The New Zealand Report saw the primary objective for the tax administration as being to collect over time the highest net revenue that is practicable within the law having regard to the resources available to the Department, the importance of promoting compliance by all taxpayers with the tax acts and, in that connection, the compliance costs incurred by taxpayers. "Over time" indicates the obvious need for the tax administration to balance short term and long term implications of possible management strategies and "highest net revenue" means actual revenue less administration (collection) costs.

3. The principle of voluntary compliance, coupled with appropriate enforcement action, is central to efficient and effective tax collecting.

There are two aspects of particular importance. First, taxpayer perceptions of the integrity of the tax system are crucial to maintaining voluntary compliance. Taxpayers want assurance that the application of the tax law to individuals is free from political influence. Taxpayers have to feel that their own affairs receive impartial treatment, that the affairs of others are treated impartially and that the rights of the individual are upheld.

Second, tax administration structures and processes and the culture of the organisation should focus on the taxpayer as a customer. So too should tax legislation. Policy development and legislative drafting should promote the central strategy of voluntary compliance by taxpayers and efficient and effective performance by the tax administration.

4. Ultimately, the Minister is responsible to Parliament for the tax administration. Accordingly the Minister must have the power to direct the Chief Executive/Commissioner on any matter relating to the operation of the tax administration in accordance with, and subject to, the relevant statutes.

The New Zealand Organisational Review and the Report of the Commonwealth Parliament Joint Committee of Public Accounts, *An Assessment of Tax*[11] both emphasised the Minister's accountability requirements and the need to protect the integrity of the tax system against improper use of the powers of direction. To protect the integrity of the tax system the Commissioner must exercise totally independent judgment on the tax affairs of individual taxpayers and on the interpretation of tax law; and any Ministerial directions should be confined to the administration of the tax legislation consistently with public finance, human rights and any other relevant statutes.

Reflecting the recommendations in the New Zealand Report, the new section 6 of the *Tax Administration Act* 1994 as enacted by amending legislation in April 1995 spells out the duty of Ministers and officials to use their best endeavours to protect the integrity of the tax system as that expression is expansively defined; s. 6A confers care and management authority on the Commissioner in meeting the goal of collecting over time the highest net revenue that is practicable within the law; and s. 6B provides for and limits Ministerial directions to the Commissioner. The new sections appear in Attachment 1.

5. In the discharge of tax collecting functions the tax administrator has responsibilities to Parliament, to the Government/Minister and to the taxpayers.

6. Modern technology enables the great bulk of taxes to be collected using a data processing operation, supported by the judgment of tax officials, that reconciles any tax collected at source with the self-assessed returns of taxpayers and identifies non-compliers.

Modern tax collecting involves three different but related functions. In the first place it is a massive, largely automated data processing operation, akin to that of a bank or insurance company. Most taxpayers have less personal contact with the tax department than with their local petrol station.

To run that side successfully requires a different focus and different skills than under the second function, adjudication and enforcement, and the third function, policy development and review. The conclusion reached in the New Zealand Report was that these three functions of tax

[11] Australia, *An Assessment of Tax* (AGPS, Canberra, 1993) Report No 326.

collecting, which are fundamentally different and require different skills and processes, should be the subject of separate structural focus.

7. The tax enforcement function ensures, so far as possible, that taxpayers comply with their obligations. Within this function the tax administration exercises an independent judgment in investigating and quantifying obligations of particular taxpayers and collecting their taxes. It embraces adjudication, rulings and technical interpretation. The role is different and high level technical skill is particularly important.

Drawing on these features of modern tax collecting, it is not difficult to identify steps that may significantly reduce problems in countering tax avoidance. These steps may be grouped under the headings of policy development and implementation, structures and processes.

Policy Development and Implementation

The New Zealand Organisational Review identified five main concerns in relation to tax policy development. First, the complexity of the subject matter and its potentially significant social and economic impacts necessitate close consideration of issues of strategy and detail. Second, at both ministerial and departmental level the roles and accountabilities at each stage of the policy development process should be clearly defined. Third, the tax policy development process should ensure that strategic issues and issues of detail are dealt with in an appropriate sequence, at appropriate levels and in appropriate forums. The process should give sufficient weight to the development of clear strategic direction and links between macro-economic, fiscal and revenue objectives as a pre-requisite to the development of a policy work program. The process should also allow for adequate and timely contestability. That requires effective external inputs in a developmental role and full attention to compliance considerations, administrative feasibility and costs, and broader economic impacts. Fourth, there are always concerns as to the quality of policy formation. Fifth, the basic structure of tax legislation does not reflect the realities of contemporary tax collecting and the traditional legislative drafting approach is unsatisfactory.

The New Zealand Government has adopted the Generic Tax Policy Process (GTPP) recommended by the Organisational Review. Protocols apply between the ministers and between the chief executives of the two policy departments, Treasury and Inland Revenue. The GTPP is a 16 step process divided into what are termed strategic phases, tactical phases, operational phases, legislative phases and implementation and review phases. An outline of the GTPP is annexed as Appendix 2.

It has three main objectives: to encourage earlier, explicit consideration of key policy elements and trade-offs; to allow for substantial external input in order to increase transparency and to provide for greater contestability and quality of policy advice; and to clarify the responsibilities and accountabilities of participants in the process. The description "generic" recognises that it may not be appropriate in all cases to follow right through the process. It is a yardstick and a discipline on all concerned, and anyone seeking a shortcut should do so aware of the risks involved.

For present purposes it is sufficient to note four features of the GTPP. The first is the focus on strategic planning in tax policy development and in maintaining linkages with the strategy in subsequent phases of the process. Strategic consideration relevant to tax policy begins at the overall economic level. Having set that overall strategy, the Government can then adopt a fiscal strategy that is supportive of those goals. Next, the revenue strategy focuses on determining and working through the Government's preferred way of meeting the need for tax revenue as expressed in the fiscal strategy. And those three strategic phases also require reconciliation with the Government's social and other objectives.

The tactical phases of the GTPP are intended to set the ground rules for subsequent development of policy, giving effect to the Government's major strategies. The operational phases include detailed policy design. While the legislative phases follow the conventional pattern, the sequencing of policy development and the emphasis on external contributions throughout the process, and particularly at the early stages, should facilitate the legislative process. And the implementation phase obviously should include implementation of computer and people-based systems, staff training, taxpayer/practitioner communication and education and enforcement strategy.

The second feature for present purposes is the systematic review of legislation and the identification of remedial measures. It is budgeted for and carried out as part of the work program.

The third feature noted a moment ago, is the external input and consultation throughout the process. That is contemplated at the green paper stage where policy options acceptable to Government are being developed and considered, at the white paper stage where detailed design issues are considered, during the legislative drafting phase, during the select committee stage, and in the post-implementation review.

The fourth feature is the emphasis on cost benefit analyses during the various phases. The starting point is always the calculation of total economic costs. The three types of costs are conventionally referred to as administration costs incurred by the tax agency, compliance costs incurred by taxpayers, and economic or deadweight costs that affect the overall efficiency of the economy. Cost benefit analyses should explicitly address those costs, the contribution of the particular policy to the achievement of strategic objectives and also the impact on social objectives, considerations of simplicity and certainty (for taxpayers) and implementation constraints.

The tax policy choice itself effectively determines the levels of theoretical revenue and deadweight losses and has a strong influence over the levels of compliance and administration costs. That makes it all the more important to address compliance costs, along with other costs, at every stage of the tax policy development process.

There are two reasons why the cost of compliance is a critical issue for tax policy and tax administration. High compliance costs can have serious effects on the economy when they influence decisions on employment and economic growth. They are also important because of their potentially detrimental effect on voluntary compliance. Those considerations are relevant both in the policy development process and in the design and development by the tax administration of operational procedures.

Clearly policy development and the design of business and management processes, relationships, strategies and culture within the Tax Department should include as a matter of course an assessment of tax avoidance implications. What scope is left for tax reduction or tax shifting? How much room need be left? What is the potential loss to the revenue both in immediate economic cost terms and indirectly through likely impacts in the long run on the central strategy of voluntary compliance? Are there any better policy or management options?

Policy Implementation: Legislative Drafting

There are two major problems with New Zealand's present income tax legislation. I suspect similar problems exist in many other jurisdictions. One is its design defects. Its design does not meet modern requirements of tax collecting; it is deficient in two major respects. The basic New

Zealand legislation dates back to 1916. At that time the tax liabilities of the limited number of taxpayers were individually and manually assessed in a rudimentary way. In the world of the 1990s the great bulk of taxpayer supplied information and the receipt of tax payments are processed in purpose built largely automated centres.

Because the basic legislation was designed in the horse and buggy age it does not adequately reflect in its central provisions two critical features of modern tax collecting noted earlier. One is the central strategy of voluntary compliance coupled with appropriate enforcement. The other is that the Commissioner must determine how best to deploy the limited resources available for tax collecting purposes. Thus the New Zealand legislation does not differentiate between semi-automatic acceptance by the department of taxpayer returns falling within particular parameters on the one hand and decisions following investigations on the other. Both are called assessments. In addition, in tax legislation designed for the current era, adjustments made to taxpayer assessments following receipt of further or correcting material should not be treated as the allowance of objections. In short, the operation of the data processing system is quite different from an individual adjudication system. Yet the present legislation assumes there is no difference. Again, the legislation has never dealt coherently with taxpayer services. The same is true of taxpayer audit. Legislative deficiencies in these important areas of tax administration have caused particular problems for the courts in various judicial review cases involving challenges to departmental investigating techniques.

Various specific additions over the years to the machinery provisions of the legislation have been no substitute for the lack of a cohesive set of provisions reflecting modern tax philosophy and practice.

The other design deficiency is that layers and layers of major changes and new regimes have been added on over the years without any attempt until recently to re-order and re-write the legislation in a coherent form. The 1916 statute ran to 43 pages and covered both land tax and income tax. The 1993 income tax reprint occupied 2038 pages and the new 1994 Acts total over 1700 pages. In Australia the legislation grew from 126 pages in 1936 to over 5000 in 1993.

The second major problem in interpreting the present income tax legislation is the traditional drafting approach. Certainty and precision are sought through the detailed expression of policies in the variety of complex circumstances in which they will operate. Too often the intent is lost or blurred in a legislative fog. As between Parliament and the courts there is in effect a reversal of roles. Parliament is pre-occupied with detail. Then, when problems reach the courts, the judges may take a big picture approach and try to establish the purposes and principles that were intended to apply.

The Commonwealth Parliament Joint Committee of Public Accounts found that there were similar problems in Australia. It concluded:

> As possibly the most important piece of economic legislation in Australia, the Committee found the Act was in desperate need of a comprehensive overhaul. Not only has the Act developed into a complex and incomprehensible mass of convoluted, legalistic and pedantic provisions but, most importantly, the uncertainty of its meaning acts as a positive detriment to the welfare of Australia.[12]

It recommended what it described as a priority simplification redraft within two years and the full simplification of the Act within five years.[13]

The first step taken on the New Zealand side of the Tasman was the re-organisation of the legislation to follow a coherent pattern, but without any substantive amendments. The *Income Tax Act* 1994 replaces the 1976 statute. It begins with a statement of the core provisions and continues in successive parts with income further defined, deductions further defined, timing of income and deductions, apportionment and recharacterised transactions, avoidance and non-market transactions, treatment of net income of certain entities, assessment of income and treatment of losses, surcharges, rebates, credits, tax payments, withholding taxes and taxes on income of others, and definitions. There are subtitles within each part and the individual sections follow a logical sequence. The alpha-numeric numbering system locates each section in its appropriate part and subpart and is designed to facilitate incorporating major and minor amendments in logical sequence.

Alongside the *Income Tax Act* 1994 are the *Tax Administration Act* 1994 and the *Taxation Review Authorities Act* 1994.

The re-ordering of the legislation will provide the base from which the re-writing of the legislation can be carried through. In that process the adjudication and administration provisions will also be reviewed and updated. The New Zealand re-write is expected to be completed in five years.

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[12] *Id.* at xviii.

[13] *Id.* at para 5.38

The drafting approach to be followed in both the re-write and in amending and new tax legislation is intended to seek greater simplification and clearer expression of the intent of the legislation.

The literature on tax simplification is becoming a cottage industry. But it demonstrates that the drafting problems are quite complex. A tax system has to be sufficiently robust to function effectively and fairly in the sophisticated international economy. All the elements cannot be expressed in a few short sentences. And the framers of the legislation need to know the user groups involved. Large specialised areas of the tax system are important to special groups of taxpayers, their advisers and the administrators involved, but are largely irrelevant to the great bulk of taxpayers. Thus some areas, such as accruals and international regimes, require the development of fairly detailed rules. No one suggests simply providing a purpose statement and a set of principles.

The design of the tax system is very important. Governments here and overseas have struggled with design problems. Simplicity of expression is recognised as one of the criteria of a good tax system. And sentence length is an indicator of readability and comprehension. An empirical study of the readability of New Zealand income tax and goods and services tax legislation was recently carried out by Tan and Tower.[14] The study revealed that the average sentence length of the survey sample was 135 words.

I would prefer to see much greater reliance on statements of intent and principles and governing rules. The amount of detail must depend on the complexity of the subject matter and the degree of sophistication of policy development. But, whether the design features are simple or complex, the drafting should, I suggest, prefer plain words, short sentences, use of the active voice and the present tense. Let me mention two striking New Zealand examples of what can be done. One is the redrafting by the Working Party on the Re-organisation of the *Income Tax Act* 1976 of the core provisions. That was done in 14 simply expressed sections and five pages of legislative text. The other is the recently enacted legislation on binding rulings. Both are models of what can be done with a plain English approach.

There will always be difficulties in applying tax legislation in marginal cases however the statute is drafted. In borderline cases clear language

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[14] Tan & Tower, The Readability of Tax Laws: An Empirical Study in New Zealand (1992) 9 *Australian Tax Forum* 355.

and structures and clear statements of intent will facilitate understanding and resolution of the problem. Thinking back over the years in the Court of Appeal, I am sure that in many cases the interpretation process would have been much easier had a different drafting approach been adopted. And I do not accept the argument that it is necessary to try to cover every situation so as to promote immediate certainty. Immediate, the argument goes, because it takes too long to have problems that may emerge dealt with by the courts. Unfortunately that drafting approach tends to be destructive of the very certainty it favours.

What is even more important than drafting for marginal cases is this. Tax legislation ought to be easy to administer and to comply with in the great mass of cases not near the borderline. Comprehension problems must have a direct bearing on the difficulties of applying the legislation, and so on compliance and administration costs. There the key is the clarity of the intent and of the style of drafting.

The New Zealand project team is developing drafting guidelines for the task ahead. They face two further problems. One is the tendency of past law drafters to express functions of the Commissioner and rules relating to the calculation of tax in the language of discretion. Currently there are many hundreds of references to the Commissioner "may", "in the discretion of the Commissioner", "as the Commissioner shall think fit", "if the Commissioner is satisfied" and so on. On analysis a large number of the provisions are not true powers at all. They require the objective ascertainment of facts from which particular conclusions follow. They do not repose any discretion in the tax administrator. That reflects the first special feature of modern tax collecting noted earlier, namely that taxes are imposed by Parliament and the tax administration quantifies the statutory liability. Such provisions should not be expressed in the language of powers. A change of that kind in the drafting approach would also better reflect taxpayers' sense of entitlements and enhance voluntary compliance.

The second special problem in developing drafting guidelines is that the present drafting approach and terminology do not distinguish adjudication from management. With a view to emphasising that difference and to allowing for the clear separation of the commissioner and chief executive roles, so far as practicable, the Organisational Review recommended that the distinctive functions and powers of adjudication should be identified and reflected in the drafting. Progress down that path of providing the clearest and most practical expression of the adjudication function and powers for tax collecting purposes may facilitate eventually splitting data processing covering the great bulk of tax collection and the application of independent judgment to the quantification of the tax of limited groups of taxpayers, if that proves desirable and feasible.

Structural Focus for Adjudication

The effectiveness of tax administration both in terms of revenue collecting and for voluntary compliance across the board requires that the affairs of all taxpayers, including those minded to minimise their tax payments, be dealt with competently, efficiently and fairly. To achieve that objective there must be an adequate focus on the correct and impartial application of tax law to the affairs of individual taxpayers and the development of the necessary skills to ensure that this takes place; adequate quality control procedures in the determination of liability of individual taxpayers, particularly where that determination is likely to be contentious or occurs in an adversarial context; and the ability to target resources at those high profile areas in a transparent way.

The role of adjudication is thus to provide that focus; and the restructuring of the New Zealand Inland Revenue Department will reflect that, subject to some qualifications. The adjudication group (less than 100 persons) will have responsibility for producing taxpayer-specific and general rulings and for that final judgmental function primarily in contentious cases where taxpayers have been audited.

Concentration on technical expertise at the point of assessment and rulings should promote a right first time philosophy and facilitate the efficient and effective discharge of the Commissioner's tax collecting responsibilities.

Structural Focus for Operations

Tax operations may be organised on a revenue type, operational function or customer segmentation basis or, as is common in many tax administrations, a mixture of all three. Many organisations in both the public and private sector increasingly accept that the critical and strategic issue they face is identifying the needs of their customer base and managing relationships with their customers. A tax department crucially dependent on a central strategy of voluntary compliance must have a customer focus. It must have adequate understanding of the businesses and other income earning activities in which its taxpayers are engaged. Just as the Australian Tax Office is moving to increase its customer focus, so too the operations unit of the New Zealand department will have a particular focus on meeting customer needs.

The department's activities can be broadly grouped into two types. "Front room" activities are those in direct contact with external customers. These are the activities where a segmentation based structure will be most useful. "Back room" activities are those operational functions and processes — including the work of the processing centres — that support the front room. These functions will mainly be organised around work flows rather than segmentation (i.e. as work is organised in processing centres now).

Recognising the differences between front room and back room activities and organising around those differences support two of the key principles. A segmented front room structure supports the principle of customer focus. A back room concentrating on high volume information and revenue processing supports the principle of efficiency.

One example of the successful use of a segmentation basis of organisation is the Inland Revenue Department's corporates group, which combines design and delivery functions for large corporates. Each corporate now has its own Inland Revenue Department account manager. Instead of simply providing some taxpayer services and carrying out audit functions and investigations in respect of previous years, the corporates group is able to confer with taxpayers on a regular basis in regard to current year activities and tax returns. That facilitates facing and averting or resolving disputes at a working level rather than simply storing them up and disputing post-year returns years later.

Segmentation of other taxpayers is intended to foster greater focus on customer needs through the provision of differently tailored services and the effective provision of generic services by specifically trained staff with greater industry and segment awareness and knowledge. It is proposed that the segments in addition to corporates around which the operations will be structurally organised will be business and individual (represented by a tax practitioner), business (not represented by a tax practitioner), individual (not represented by a tax practitioner) and child support.

The Significance of Processes

A crucial issue at the heart of tax collecting — and of the timely identification of tax liability and tax avoidance — is what is expected by and from taxpayers and the tax administration. Increased understanding by the revenue of the taxpayer's business and other income earning activities should both enhance voluntary compliance and facilitate any necessary enforcement action.

Much depends on the design and delivery of assessment and dispute resolution processes buttressed by other processes designed to encourage voluntary compliance. They should encourage the Commissioner to apply appropriate resources to getting assessments right in the first place; encourage the taxpayer to disclose all relevant information to make that achievable; and encourage both the Commissioner and the taxpayer to resolve any disputes that remain fairly, efficiently and expeditiously. The "all cards on the table" approach at the pre-assessment stage supported by appropriate evidence exclusion provisions for withheld material, with a separate adjudication of liability in potentially contentious cases, and with direct access to the High Court and the Taxation Review Authority to challenge assessments (thereby treating tax as commercial litigation), are designed to deal with what are in New Zealand deep seated problems. This system is designed to change the conventional approach to tax litigation, which has produced far too many unsatisfactory results and results destructive of the very voluntary compliance on which the system depends.

I suggested without explanation that the assessment and dispute resolution process should be buttressed by other processes designed to encourage voluntary compliance. Binding rulings are part of the package. They enable taxpayers to obtain confirmation of their tax positions. Disclosure rules are another part of the package. A third element is the setting of standards required of taxpayers and sanctions for various grades of tax avoidance. To avoid penalties it is proposed that taxpayers generally should be required to have a reasonably arguable position when self-assessing their tax liabilities. Establishing a reasonably arguable position will be based on an objective application of the law to the relevant facts. Finally, a comprehensive interest regime should provide an incentive to both taxpayers and the revenue to ensure any disputes are resolved as quickly as possible.

The development of close working relationships between taxpayer and tax officer, the ability to obtain rulings on transactions, proper disclosure rules and defined taxpayer standards should together reduce the need and desire of taxpayers to commit themselves to what might later be labelled as tax avoidance.

Conclusion

Tax administrators and professionals have customarily placed great reliance on three means of countering tax avoidance: general and specific anti-avoidance provisions; discretions reposed in the revenue; and judicially developed doctrines designed to identify and counter avoidance. The thrust of this paper is that there should be less emphasis on those elements as a control mechanism. The major focus should be on the design of tax legislation and the design of the tax collection system. By reducing incentives for uncontrolled tax planning, by developing a clear customer focus, by changing structures and processes of tax administration and the culture of the organisation so as to recognise and reflect central features of tax collecting, and by balancing incentives and sanctions for both taxpayers and tax administrators, we are likely to improve tax collecting overall.

Attachment 1: Tax Administration Act 1994, ss. 6, 6A and 6B

6. Responsibility on Ministers and officials to protect integrity of tax system

(1) Every Minister and every officer of any government agency having responsibilities under this Act or any other Act in relation to the collection of taxes and other functions under the Inland Revenue Acts are at all times to use their best endeavours to protect the integrity of the tax system

(2) Without limiting its meaning, 'the integrity of the tax system' includes-

(a) Taxpayer perceptions of that integrity; and

(b) The rights of taxpayers to have their liability determined fairly, impartially, and according to law; and

(c) The rights of taxpayers to have their individual affairs kept confidential and treated with no greater or lesser favour than the tax affairs of other taxpayers; and

(d) The responsibilities of taxpayers to comply with the law; and

(e) The responsibilities of those administering the law to maintain the confidentiality of the affairs of taxpayers; and

(f) The responsibilities of those administering the law to do so fairly, impartially, and according to law.

6A. **Commissioner of Inland Revenue**

(1) The person appointed as chief executive of the Department under the *State Sector Act* 1988 is designated the Commissioner of Inland Revenue.

(2) The Commissioner is charged with the care and management of the taxes covered by the Inland Revenue Acts and with such other functions as may be conferred on the Commissioner.

(3) In collecting the taxes committed to the Commissioner's charge, and notwithstanding anything in the Inland Revenue Acts, it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law having regard to-

(a) The resources available to the Commissioner; and

(b) The importance of promoting compliance, especially voluntary compliance, by all taxpayers with the Inland Revenue Acts; and

(c) The compliance costs incurred by taxpayers.

6B. **Directions to Commissioner**

(1) The Governor-General may by Order in Council, and with due regard to sections 6 and 6A of this Act and the provisions of the *State Sector Act* 1988 and the *Public Finance Act* 1989, issue directions to the Commissioner in relation to the administration of the Inland Revenue Acts.

(2) Subsection (1) does not authorise the giving of directions concerning the tax affairs of individual taxpayers or the interpretation of tax law.

(3) Every order made under subsection (1) shall as soon as practicable after it is made-

(a) Be published in the *Gazette*; and

(b) Be laid before the House of Representatives together with any accompanying statement of the reasons for the order and any advice of the Commissioner in relation to it.

(4) An order made under subsection (1) becomes binding on the Commissioner on the 7th day after the date on which it is made.

Attachment 2 - Generic Tax Policy Process

Strategic Phases 1-3	**1. Economic Strategy**[a,b]	*Reconcile 1-3 with government objectives*
	2. Fiscal Strategy[a,b]	
	3. 3-Year Tax Revenue Strategy[a,b,c]	
Tactical Phases 4-5	**4. Rolling 3-Year Work Program**[a,c]	*Issues encountered at later stages (7-16) of the process, and decisions taken to change policy, may lead to reconsideration of earlier phases (3-6)*
	5. Annual Work and Resource Plan[a,c]	
Operational Phases 6-8	**6. Detailed Policy Design**[a]	
	7. Formal Detailed Consultation and Communication	
	8. Ministerial and Cabinet Sign-off of Detailed Policy[a]	
Legislative Phases 9-13	**9. Legislative Drafting (phases 6-12)**	
	10. Ministerial and Cabinet Sign-off of Legislative Drafting[a]	
	11. Introduction of Bill	
	12. Select Committee Phase	
	13. Passage of Legislation	
Implementation and Review Phases 14-16	**14. Implementation of Legislation**	
	15. Post-Implementation Review	
	16. Identification of Remedial Issues	

External Input
External input as appropriate through Green Paper (ideas) stage and/or through White Paper (detail) stage by either:
1. Secondment of personnel from private sector
2. A permanent advisory panel
3. Issues-based consultative committees
4. Submissions based on consultative document

Consultative committee may be required to explain the intent of their recommendations to Select Committee

Notes

[a] Cabinet decision.

[b] Output from phases 1-3 widely publicised by Government through Budget Documentation.

[c] Phases 3-5 are linked with the Budget process and have a high degree of simultaneity.

CHAPTER 11

THE POLITICS AND PRACTICALITIES OF CHECKING TAX AVOIDANCE IN THE UNITED STATES

Charles H. Gustafson

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them by means which the law permits, cannot be doubted." *Helvering v. Gregory* 293 US 465 (1935)
>
> "The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation ..." *Helvering v. Gregory* 293 US 465 (1935)
>
> "A foolish consistency is the hobgoblin of little minds." Ralph Waldo Emerson

Introduction — The Several Faces of Tax Avoidance

Media reports each year in the United States describe people who have made voluntary contributions to the federal government to aid in paying off the national debt. The media also continue to report various forms of "man bites dog" stories. Both are newsworthy because they represent unusual events. Dog bites [of man] and efforts to avoid making payments to the government are not newsworthy. Stories from this perspective are more likely to appear on the self-help pages: how to avoid dog bites and taxes.

Every tax administrator in every country must operate with the assumption that the subjects of his or her art will engage in tax avoidance.[1]

[1] Even tax administrators engage in tax avoidance. A 1992 change in the income tax laws of the United States requires that a portion of the value of subsidized parking provided by employers to employees be included in the gross income of the employee. The amount to be taxed is determined by the value of the parking privilege. The Commissioner of Internal Revenue and other high level administrators of the Internal Revenue Service had been assigned individually designated parking spaces,

The successful implementation of chosen tax policies in fact often depends upon that assumption. Incentives to engage in particular economic and financial activities created by the adoption of special exemptions, deductions and credits will fail if taxpayers are not moved by the incentive.

At the same time, concerns with revenue collection often lead legislators and tax administrators to conclude that too much tax avoidance activity is unacceptable and that legal and procedural defenses must be established to protect revenues. Thus, in the United States the same Congress that has adopted sometimes very generous tax incentives has also risen up periodically to smite "tax avoiders."[2] Moreover, United States tax administrators and courts have created other checks against tax avoidance not specifically reflected in legislative language. Such checks, regardless of their source, are often applied most vigorously to the very taxpayers who were motivated by the creation of the tax incentives.

The result of these efforts is manifest in the form of a series of statutory prescriptions, judicial doctrines and detailed regulations that combine to establish a very complex array of defenses to unacceptable degrees of tax avoidance or abuse. This structure appears to have satisfied lawmakers and tax administrators. The United States Congress has never seriously considered and no administration has proposed the adoption of a general anti-avoidance or anti-abuse rule that would apply to all situations. The purpose of this exercise is to examine the array of legal and administrative checks against tax avoidance that have been evolved in the United States by the Congress, the courts and the Internal Revenue Service; to endeavor to find a conceptual basis in United States tax law and practice for distinguishing between the forms of tax avoidance behavior that have been targeted for enrichment as appropriate responses to tax incentive devices and those forms of tax avoidance behavior that have been targeted for special sanction by tax authorities; and to reflect on the likely future course of anti-avoidance efforts in the United States.

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the value of which in the center of any large city would be considerable. After the change in the tax law, it was reported that the individually designated parking places had been replaced by a more general designation for the privilege, presumably bearing a lesser fair market value. See Note, *Tax Notes*, March 14, 1994, at 1343.

[2] The language used to describe such situations has been changing in recent years from "avoidance" to "abuse." See P Olson, Some Thoughts on Anti-Abuse Rules (1995) 48 *The Tax Lawyer* 817.

The analysis is divided among a number of rather distinct forms of legal and administrative defenses deriving from different sources of United States income tax law and directed at rather different issues of tax avoidance. The first is the creation by judges of special tests for determining a taxpayer's entitlement to exploit advantages created by the Congress. The second is the development of statutory defenses to the excessive exploitation of tax-savings possibilities created by the rules of general applicability that depend upon the existence of tax avoidance motivations. The third is a situation in which judicially created defenses have been followed by more specific legislative and administrative checks. Fourth, the paper examines the establishment of procedural devices for distinguishing between income-seeking (deductible) activities and personal (nondeductible) activities. Fifth, the paper exams several situations in which limitations based upon the existence of an excessive degree of tax-avoidance motivation has been replaced in practical effect by a statutory conclusion that the degree of tax-avoidance motivation must be too high. The paper then examines the idea of establishing a new formula for taxing certain taxpayers believed to have been excessively blessed by the usual taxing rules despite their full compliance with those rules. After reporting briefly on some recent initiatives to confront areas of international tax avoidance that have been the object of extensive discussion and debate, the paper offers some reflections about the tax-avoidance jurisprudence of the United States and the likely course of future anti-avoidance efforts there.

Judicially Created Checks — Divinations of Legislative Intention

At an early point in the modern version of United States income tax law, the Supreme Court concluded that the constitutional authorization for the income tax extended only to "realized income." In *Eisner v. Macomber*,[3] the Supreme Court concluded that stock dividends that had been paid by a company in its own stock to the taxpayer and to every other shareholder did not constitute realized gain because the taxpayer's equity interest was unchanged by the distribution. The Court held, therefore, that the statutory provision purporting to tax the stock dividends exceeded the authority ceded to the Congress by the United States Constitution to lay "taxes on incomes, from whatever source derived."[4]

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3 (1920) 252 US 189.

4 The modern version of the federal income tax in the United States was authorized by the XVIth Amendment to the United States Constitution, which was adopted in 1913. An income tax adopted in the 19th century primarily to finance the Civil War

Despite the fundamental importance of the rule of realization articulated in *Eisner v. Macomber*, there are many transactions in which taxpayers realize gain which Congress has chosen to except from the rule of realization. For example, the basic corporate income tax regime of the United States has been marked virtually since its inception with many opportunities to modify the substance of a taxpayer's investment without the imposition of an income tax liability by engaging in different forms of "corporate reorganization." The result in such situations generally is that taxpayers may realize income, but need pay no tax at the time of the realization.

The rationale for the corporate reorganization provisions is, to oversimplify just a bit, that the operating assets are still being held by a corporation and that, therefore, the individual investor has not in a sense realized gain that should be taxed. It is, of course, a dubious proposition in many cases. If General Motors and Boeing Aircraft were to merge, the resulting investment of their respective shareholders would obviously differ from what had been owned prior to the merger. In fact, the merger may be effectively illegal under the applicable antitrust laws. Nevertheless, the transaction would be classified as a "reorganisation"[5] and neither the companies nor their shareholders would in general be taxed on the transaction.

It is safe to say that such mergers would occur much less frequently if shareholders were taxed on the gain realized by the conversion of their former shares in the previously separate companies for shares in the merged company. In fact, directors approving such a transaction, if fully taxable, might better choose to switch from business to academic vocations where potential liabilities for misfeasance are more modest.

The corporate reorganization is a classic example of a form of transaction that Congress has chosen to bless by the adoption of a special provision that virtually reverses a general principle of United States taxation — the rule of realization. It obviously establishes an incentive to pursue transactions that would otherwise be deemed less desirable. In due course, however, the Internal Revenue Service began to believe that this legislative manna was being consumed at an excessive rate. It argued in effect that the reorganization provisions should not apply when there is

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had been held by the Supreme Court to be unconstitutional. *Pollock v. Farmers' Loan & Trust Co.* (1895) 157 US 429.

[5] See *Internal Revenue Code* 1986 (USA) (hereinafter referred to as the "Code") s. 386.

no purpose for the transaction other than the avoidance of tax. The normal rule of realization would then apply, and tax liabilities would accrue.

In the celebrated case of *Gregory v. Helvering,*[6] the Supreme Court effectively embraced that position. The taxpayer had sought to use the reorganization provisions to extract shares of stock held in turn by her wholly-owned company so that she could sell them and avoid a double tax.

The form of the transaction clearly satisfied the technical and specific statutory definition of a "reorganization" which would bear no income tax. The motivation of the taxpayer was also clear. She wanted to reduce her taxes on the disposition of the company shares originally owned by her corporation. The Court concluded that her motivation for the transaction placed it outside of the intention of the legislature:

> Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the [taxpayer]. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.
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> ...The whole undertaking, though conducted according to the terms of [the Code], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[7]

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[6] (1935) 293 US 465.
[7] (1935) 293 US 465, at 470.

The creation of the "business purpose doctrine" derives from a perception of legislative will. The Court's powers of perception are obviously very keen for no legislative history was cited to support its interpretation.

The introduction of avoidance tests as reflections of usually unstated legislative intent punctuate United States tax jurisprudence. Several cases illustrate the approach.

From the earliest years of the modern version of the United States income tax, almost all interest payments, regardless of the purpose of the debt, were fully deductible. Over time, however, a series of statutory limitations were adopted to defend against some of the more obvious means of exploiting the deduction. For example, no deduction was permitted for interest paid on loans taken to finance the acquisition of tax-exempt bonds (debt instruments issued by state and local governments the interest from which is exempt for federal income tax purposes).[8] Similar limits applied to other specific transactions.

During this period, the Supreme Court was asked by the Internal Revenue Service to support the denial of a deduction of interest payments that were not affected by the specific statutory restrictions. In *Knetsch v. United States*,[9] the Service argued that certain loan transactions had been established in connection with related annuity arrangements solely for the purpose of generating interest deductions. They were. The taxpayer-borrower in effect increased his debt annually by the approximate amount of the interest owed. While very little cash flowed, large interest deductions were created. The Service was, moreover, skeptical about the eventual repayment of the loan because the creditor had no personal recourse to the borrower. In the event of default, the lender's rights were limited to certain pledged property, the value of which approximated the amount of cash that the lender had put into the transaction.

The taxpayer argued simply that interest was deductible unless Congress has adopted a restriction. Moreover, he argued, the presence of a series of specific restrictions on deductibility (none of which here applied) demonstrated that the legislature had considered and identified forms of abuse that it believed to be unacceptable. This was not one of them. Finally, Congress had adopted a provision aimed against the form

[8] Code s. 103 establishes the exemption for such interest income. Code s. 265(a)(2) denies a deduction for "interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from [tax]."

[9] (1960) 364 US 361.

of transaction that had been implemented by the taxpayer, but it was only applicable to taxable years following the ones in question in the case itself.[10]

The Supreme Court held that the transaction was a "sham." The payments of interest were not, therefore, deductible even though the statutory restrictions did not apply. The Court cited the language of *Gregory v. Helvering.*

Not all of the Court agreed. Justice Douglas, joined by two others, dissented. He concluded:

> Tax avoidance is a dominating motive behind scores of transactions.... To disallow the 'interest' deduction because the [transaction] was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative.[11]

Scholarships and fellowships have traditionally been excluded from United States income tax.[12] In *Bingler v. Johnston,*[13] however, the Internal Revenue Service argued that the taxpayer's scholarship was not excluded. The taxpayer had received the scholarship from his employer. His academic work was related to his work for the company. He reported to the company on his academic progress and was expected to return to it when he earned his doctoral degree. The Service argued that this was not the kind of arrangement which Congress had sought to bless by the exemption. Again, there was a series of statutory limitations that did not apply to the situation. The taxpayer again argued that Congress had already explicitly determined when a "scholarship" was not excludible, and that this was not one of them. The Supreme Court, however, agreed with the Internal Revenue Service and reversed the decision of the Court of Appeals favoring the taxpayer.

While the Court did not invoke a generally characterized defense against tax avoidance, such as the business purposes test or the sham transaction doctrine, the decision in *Bingler v. Johnson* was again based upon an inference that the legislative will should not interpreted to sanction an escape from taxation. Except for some passages of legislative

[10] Code s. 264(a)(2).
[11] 364 US 361, at 371.
[12] Code s. 117.
[13] (1969) 394 US 741.

history explaining limitations that did not apply to the specific case (but which indicated that in at least certain situations the continuation of salary payments by an employer to an employee should not be covered by the exclusion), there was no clear support for the Court's inference of legislative intent other than the assumed concern of the Congress with revenue collection.

The willingness of federal courts to establish eligibility tests on the basis of inferred legislative intention, whether reflected in an identified test or doctrine or simply as a device for protecting federal revenues, is now a widely accepted element of United States income tax jurisprudence. Although the Internal Revenue Service does not always succeed in persuading a court of the validity of such an interpretation, the general awareness of the practice serves as a brake on the use of transactions to exploit particular tax advantages. There is no data indicating the extent to which this practice affects taxpayer behavior and revenue collection. But the practice is certainly one of the reasons why a general anti-avoidance provision has never been used in the United States.[14]

Statutory Checks — Questions of Intent

Justice Douglas, writing in dissent in the *Knetch* case, would effectively consign to the Congress the task of erecting barriers to the unacceptable exploitation of Congressional favors. This is, of course, an extension of a jurisprudential issue that arises in many contexts. Justice Douglas, moreover, had a well-earned reputation as a "taxpayer's friend" when it came to deciding income tax cases. Whether moved by such observations or a greater interest in addressing particular transactions, Congress has punctuated the *Internal Revenue Code* with many provisions that explicitly depend for their application upon the existence of tax avoidance motivation.

The following examples illustrate the breadth of circumstances in which such a formulation has been used:

- Section 269 of the Code denies deductions, credits, or other allowances in certain corporate acquisitions in which "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax."
- Section 269A allows for the reallocation of income, deductions, credits, exclusions and other allowances where "the principal purpose for

[14] See generally, Compendium on Anti-Abuse Rules (1995) 48 *The Tax Lawyer* 799.

forming, or availing of, [a] personal service corporation is the avoidance or evasion of Federal income tax."

- Section 302 eliminates certain taxes in respect of stock distributions if the "distributee did not have as one of its principal purposes the avoidance of Federal income tax."
- Section 306, which treats gains on certain stock sales as ordinary income rather than capital gain taxable at preferential rates, does not apply if the transaction "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."
- Section 355, which permits the distribution of stock and securities of a controlled corporation without tax, will not apply in certain circumstances unless it is established that the transaction was "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."
- Section 357, which permits the assumption of certain liabilities in a corporate reorganization without being taxed, will not apply if "the principal purpose of the taxpayer .... was a purpose to avoid Federal income tax ... or, if not such purpose, was not a bona fide business purpose."
- Section 367 conditions the application of corporate reorganization provisions to foreign corporations upon compliance with "regulations prescribed by the [IRS] which are necessary or appropriate to prevent the avoidance of Federal income taxes."
- Section 453, which allows taxpayers to report gains on long-term contracts under the installment method, will not apply if the transaction had "as one of its principal purposes the avoidance of Federal income tax."
- Section 467, which permits the accrual of certain deductions, will not apply to "certain tax avoidance transactions." Another portion of the provision will not apply if the "principal purpose ... is the avoidance of tax."

As these examples illustrate, the statutory formulation generally takes one of two forms. The special advantage is denied in some cases if tax avoidance is "*the* principal purpose" of the transaction. In other circumstances the special advantage is denied if tax avoidance is "*a* principal purpose of the transaction."

The practical effect of these provisions is obvious. They are intended to and in fact deter some taxpayers from entering into transactions in which special tax advantages would otherwise be attainable. They thus provide tax administrators with a legal weapon for raising additional taxes. The impact on revenue collection resulting from the use of such formulations is, however, virtually impossible to estimate with any degree of accuracy.

One might hope to identify some conceptual basis for distinguishing between those circumstances in which tax avoidance will be a disqualifying factor if it is the sole purpose and those circumstances in which the presence of a "principal purpose" to avoid tax will disqualify. However, this search, at least thus far, has produced no such insight.

There is, moreover, an interesting issue of statutory construction that rises from the widespread use of such language. It obviously invites the conclusion that Congress has considered and decided when tax advantages are going to be denied because of the taxpayer's intentions. The inference of such a conclusion is that intention in other circumstances should not be a disqualifying consideration. The Internal Revenue Service has not, however, accepted that conclusion.

Refining a Statutory Test — The Case of Partnership Allocations

Partnerships are not taxpayers in the United States. The results of partnership activities are generally allocated to the respective partners who, in turn, must include them in the determination of the partner's own income tax liability for the relevant time period.[15] Moreover, the special allocation of particular items of income or deductibility was explicitly sanctioned.[16] This simple formulation of the basic regime lead to many circumstances in which partners could effect arrangements to transfer gains and losses between or among them.

Congress has for some time been concerned about such opportunities. Its initial response was the application of one of the general formulations about tax avoidance. Section 704(b) provided that the special allocation of an item would be disregarded if its "principal purpose [was] the avoidance or evasion of ... tax." In such event, the Code provides for the allocation of the particular item "in accordance with [the partner's] distributive share of partnership income or loss" under the generally applicable terms of the partnership agreement.

A series of judicial decisions invoked the disqualifying language in situations in which the allocation of tax items was not accompanied by a

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[15] Code s. 701.
[16] Code s. 704.

collateral impact on the rights of the partners to receive eventual partnership distributions. Such tax allocations were held to be without "substantial economic effect" and were disregarded.[17] As part of the *Tax Reform Act* of 1976, Congress amended s. 704(b). The language making the reservation dependent upon a principal purpose to avoid or evade tax was deleted. It was replaced by language imposing the restriction — that the partnership agreement will not determine allocations — when there is an allocation that "does not have substantial economic effect."

The regulations promulgated under the new language provide that an allocation has a substantial economic effect if it is reflected in the capital accounts of the partners, if liquidating distributions are made according to the capital accounts and if partners are required to restore the amount of any deficit in their capital accounts upon the liquidation of the partnership.

Despite some success in dealing with certain instances of perceived abuse in the exploitation of the partnership provisions, continued exploitation has been a major source of concern for the Internal Revenue Service. At the end of 1994, the Service issued in final form "anti-abuse rules" in the form of special regulations that would apply for the entire partnership tax regime.[18] After describing the general objectives of the partnership taxing regime ("to permit taxpayers to conduct joint business ... activities through a flexible economic arrangement without incurring an entity-level tax"), the regulations give broad powers to the Service to "recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of [the partnership rules]." The powers may be invoked "if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of [the partnership tax rules]."

The specific powers include:

- The purported partnership can be disregarded in whole or in part.
- One or more of the purported partners may not be treated as a partner.
- The methods of accounting used by the partnership or the partner may be adjusted to reflect clearly income.

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[17] See e.g., *Orrisch v. Commissioner* (1970) 55 TIC 395.
[18] Treasury Regulation s. 1.701-2.

- The partnership's income, gain, loss, deductions or credits may be reallocated.

The new regulations are lengthy, complex and controversial. The text of the new regulations occupies 13½ pages in the *CCH Standard Federal Tax Reporter*. They have been criticized by practitioners who fear that they place inordinate power in the hands of a tax auditor. Nevertheless, many believe that the use of generalized anti-abuse regulations, such as those issued in respect of partnerships, is likely to be expanded into other areas.[19]

Procedural Checks — Switching the Burden of Proof

The Congress and the Internal Revenue Service have wrestled with the difficult question of determining when an activity motivated by both economic gain and personal enjoyment should justify trade or business or investment deductions. For many years the question was whether the "primary purpose" of the activity was to seek income. Courts would base determinations upon a comparative enumeration of economic and personal factors. Did the working farm — or luxurious family estate — produce income? How was it managed? What part was devoted to income productivity? The conceptual game for the taxpayer was to try to demonstrate that more than half the motivation was economic rather than personal. The burden of proof, as usual, was on the shoulders of the taxpayer. Because the cases were so dependent upon the presentation of specific facts, there was a sense that consistency and uniformity were lacking in the results.

In the 1950's Congress sought to increase consistency with respect to the treatment of the issue by adopting a provision severely limiting trade or business loss deductions to individuals who had lost more than $50,000 in each of five consecutive years. Although referred to as the "hobby loss" provision, it applied to all trades and businesses. Moreover, the Internal Revenue Service continued to contend in litigation that various hobbies were not really businesses even though the statutory restriction did not apply.

As part of the *Tax Reform Act* of 1969, Congress adopted s. 183 to deal with "hobby loss" situations. Section 183 is a procedural device. When its requirements are satisfied, it establishes a presumption for the taxpayer that an activity has been pursued for profit. In that event, deductions may

[19] Compendium on Anti-Abuse Rules, *supra* note 14.

exceed revenues produced by the activity. The presumption is not determinative. Its effect is to shift the burden of proof to the Internal Revenue Service, who must then rebut the presumption in order to deny deductions.

The current version of s. 183 establishes the presumption that an activity has been conducted for profit when the activity has produced income in excess of deductions for three out of five consecutive years ending with the tax year in question. Demonstrating either Congressional sensitivity to the risks of equine activities or very effective lobbying, the presumption is established if the taxpayer has net income in two out of seven consecutive years if the activity "consists in major part of the breeding, training, showing, or racing of horses."

The provision has been used generally in two types of situations. Its most obvious application is to "hobby loss" situations. Dog-loving taxpayers who seek to deduct the cost of attending shows, enthusiastic but unsuccessful sportsmen, gentleman farmers on large estates and enthusiastic sailors have all been targeted successfully by s. 183 to deny federal assistance in the financing of the recreational activity.[20] Moreover, the IRS has overcome the presumption in many other such cases.

Section 183 has also been applied to "tax shelter" situations in which the Internal Revenue Service seeks to demonstrate, not only that no profits were generated, but that there was never a reasonable prospect for the production of profit. Cases have included book manuscripts, art objects, film syndications, livestock deals and various sale-leaseback transactions.[21] The use of s. 183 in such cases is sometimes criticized because the court is operating with the benefit of hindsight. After all, some argue, there are many foolish investors who lose money while seeking massive gain.

There is some resemblance in these cases to an approach suggested in *Welch v. Helvering*,[22] an early Supreme Court decision holding that the payment of a bankrupt corporation's debt by an officer who sought to reestablish his own business with the same creditors was not deductible because only "ordinary and necessary" expenses could be deducted and this payment was not "ordinary" (a statutory term). Critics of modern business ethics might be amused by the Court's rationale:

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[20] See e.g., *Burger v. Commissioner* (1985) 50 TCM 1266.
[21] See e.g., *Cherin v. Commissioner* (1987) 89 TIC 986.
[22] (1933) 290 US 111.

> Men do at times pay the debts of other without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to read in its natural and common meaning, ... we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary.[23]

Critics of this formulation observed that it placed an impossible task on judges who would have to determine what businessmen normally did. Moreover, such an approach might deny business deductions to the most forward-looking businessmen who were willing to make extraordinary expenditures in search of profit. The purportedly "objective" approach to the definition of ordinariness by the Supreme Court was eventually discarded, *Welch v. Helvering* was eventually read as a decision that the expenditures were not deductible because they were more appropriate characterized as capital expenditures that should not be immediately deductible.

The Internal Revenue Service does not always win these cases. In *Jacobson v. Commissioner*,[24] the Court of Appeals reversed a Tax Court determination that a movie venture had not been pursued for profit. The Tax Court opinion relied heavily upon the conclusion that the film could not possibly have been profitable:

> The film is a slow-paced melodrama, and the screen play is full of trivial conversation and shallow commentary. The subplots (the doctor's relationship with a male radiologist and patient's relationships with her parents and boyfriend) are pedestrian, and the supporting characters are flat.... Considering the film's trivial and shallow screen-play, its depressing and downbeat theme without offsetting character development, and its slow pace, *Promises* was discernibly not going to be a "blockbuster." We concur with [the Internal Revenue Service] expert that it was manifestly impossible for the film to generate gross receipts [sufficient to make a profit].[25]

The Court of Appeals rejected the Tax Court approach, which it characterized as a "judicial version of the Siskel and Ebert — two well-known film reviewers — 'thumbs up, thumbs down' approach to film evalua-

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[23] (1933) 290 US 111, at 114.
[24] (1990) 915 F. 2d 832 (2d Cir.).
[25] 55 TCM 1437, at 1443.

tion," and noted that: "A film's depressing theme does not preclude such success, as numerous epics, including *Camille*, attest."[26]

Section 183 is a peculiar form of check because its application creates an advantage for the taxpayer. In practical terms, however, at least in dealing with revenue agents, the failure to benefit from the presumption may be interpreted as a presumption that the activity does not qualify.

Statutory Imputation of Excessive Tax Avoidance — Subpart F and the Passive Activity Loss Limitations

Another technique that has been used to check unacceptable degrees of tax avoidance has been to withdraw tax benefits otherwise available where statutory tests reflecting a high probability of tax avoidance motivation have been failed. International practitioners are well aware that the United States purports to apply a rule of worldwide taxability for its citizens, residents and domestic corporations. Investments made by such taxpayers through foreign corporations do not, however, normally result in a United States income tax until profits are repatriated to the United States.

In the late 1930s Congress was persuaded that the opportunities for the deferral of income taxes arising from this arrangement were excessively generous. It adopted first the foreign personal holding company provisions[27] and then Subpart F of the Code.[28] The effect of these provisions is to attribute to United States shareholders their allocable share of the earnings of certain foreign corporations controlled by United States investors even though such earnings have not in fact been distributed by the corporation to the United States shareholder. The provisions are based upon the legislative conclusion that the circumstances in which they apply are likely to be based upon tax avoidance aspirations, but they apply regardless of whether tax avoidance was in fact a motivating factor in structuring the investment and resulting transactions.

An important element of the political process leading to the adoption of the *Tax Reform Act* of 1986 provides another dramatic example of a legislative check against tax avoidance that does not depend upon the finding of specific intention by the taxpayer to avoid tax. The driving political force for the 1986 legislation was simplification and reduced rates without revenue loss. The justification for removing special tax advantages

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[26] 915 F. 2d 832, at 839.
[27] Code ss. 551-558.
[28] Code ss. 951-964.

was that the enlarged tax base would permit a substantial reduction of marginal rates.

The process worked. Maximum marginal rates of individual tax were reduced by the 1986 Act from 50 percent to a nominal rate of 28 percent. Maximum corporate rates were reduced from 46 percent to a nominal rate of 34 percent.[29] To achieve these rate reductions without losing revenues, the tax writing committees of Congress strove to find ways to increase the tax base.

One of the most ingenious devices was the creation of the Passive Activity Loss Limitations, which effectively deny deductions and credits to taxpayers involved in certain forms of business activities even though such losses are determined and are deductible under general rules otherwise applicable.[30]

The development of the proposal derived from the widespread recognition that many successful tax shelters had been based on limited partnership interests. In effect limited partners could enjoy the allocation of partnership losses without being exposed to personal liability in excess of the contributions or commitments to contribute. But earlier legislation had been adopted to deny most losses where a taxpayer's assets were not really "at risk."[31]

The 1986 legislation identified situations in which Congress was again persuaded that the exploitation of tax benefits was so likely to be a primary motivation that a denial of the normally allocable losses was deemed appropriate. There is no reference in the legislation to the presence of a tax avoidance objective. The limitations apply regardless of the motives of the taxpayer. It is in effect a statutory finding that tax avoidance is likely to have been the primary purpose of the activity and that, therefore, deductions otherwise available should be denied.

The rationale for the provision was in part that certain participants in trades and businesses are for all practical purposes passive investors. Losses from investments are normally deductible only when the investment is sold or exchange. Therefore, it is inappropriate to allocate deductions to this category of non-participant-investor when the result is to

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[29] Tax rates for individuals and corporations have been increased since the 1986 Act. The maximum nominal rate for individuals is currently 39.6 percent. Code s. 1. The maximum nominal rate for corporations is currently 35 per cent. Code s. 11.

[30] Code s. 469.

[31] Code s. 465.

reduce taxes on other categories of income, such as earned and portfolio income.

Those engaged in "passive activities," assuming it is possible to do so, are defined in management, rather than psychiatric, terms. A passive activity in general is "any activity ... which involves the conduct of any trade or business, and ... in which the taxpayer does not materially participate." Material participation is defined to be involvement in the operations of the activity on a basis which is regular, continuous and substantial. Certain activities are defined to be passive, including rental activities, unless the taxpayer is in the trade or business of real estate management, working interests in oil and gas properties and most limited partnership interests.

The effect of the provision is to limit the ability of taxpayers to deduct losses arising from such "passive activities" to the income from other such passive activities. Losses not deducted during the course of the passive activity are finally reflected in the determination of net gain or loss which is then recognized in the year that the investment is liquidated.

Checking Tax Avoiders Who Play by the All of the Rules

During the waning hours of the Johnson Administration in January, 1969, the Acting Secretary of the Treasury made a speech asserting that many wealthy taxpayers who earned substantial amounts of gross income had paid little or no income taxes in the preceding tax year. This observation, of course, is unsurprising to tax specialists who understand that the degree of progressivity reflected in the simple tax rates of the *Internal Revenue Code* has been substantially less than meets the eye because of the effect of exemptions, exclusions, deductions and credits. However, the Acting Secretary predicted that a "taxpayer revolt" would ensue from the dissemination of these facts to the general public.

He overstated the case. There was no revolt. But Congress was persuaded to reach out and tax a few taxpayers, individual and corporate, more vigorously than would be the case under the general rules of United States income taxation. The basic proposition is that "everyone ought to pay something" — even if the application of the general provisions results in little or no tax and even though taxpayers are not engaging in transactions that can be attacked under specific transactional doctrines developed by the Congress, courts or Internal Revenue Service.

This proposition is currently reflected in the Alternative Minimum Tax.[32] The approach is simple. Determine taxable income under the generally applicable rules and apply the usual rates to it. Then, determine taxable income under a formula in which certain tax preferences have been removed. Apply a somewhat lesser rate to the result. If the result is higher than the "normal" net tax, the alternative minimum tax must paid.

Under present law, adjustments include: accelerated depreciation, percentage depletion allowances in excess of basis in mineral properties, certain state and local bond interest otherwise exempt, certain itemized personal deductions, taxes not related to business activities, certain personal interest and personal exemptions.[33] The individual rate applied to the result is 26 percent up to $175,000 and 28 percent in excess thereof (compared to a maximum marginal rate of 39.6 percent). The corporate rate applied to the result is about 20 percent (compared to a maximum marginal rate of 35 per cent).[34]

If the formula for the Alternative Minimum Tax is relatively simple, the rationale from a tax policy perspective may seem somewhat obscure. After all, the Congress created the rules which produced the imposition now deemed to be too small. The Alternative Minimum Tax seems to imply that a taxpayer may have been too responsive to the incentives established by that same Congress. Alternatively, it may reflect a nascent feeling that the tax preferences may not be wholly justified.

Many would make the obvious suggestion that the basic provisions be reviewed and corrected. The problem is that each tax preference is defended by interest groups willing to swear that the "American way of life will be risked if the [fill in the blank] exemption, deduction or credit is removed." The Alternative Minimum Tax allows the political leadership to evade to a degree the sharp focus of potentially wounded oxen.

Transfer Pricing — Checking the Tax Avoidance Monster

Transfer pricing concerns weigh heavily on the hearts and minds of tax administrators around the world. Officials of governments of developing countries have for years been certain that transfer pricing practices have cheated their countries of many of the fruits of foreign investment and that their governments are ill-equipped to deal effectively with the prob-

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[32] Code ss. 55-59.
[33] Code s. 56.
[34] Code s. 55.

lem. Wealthier countries have been as concerned, but have been somewhat more successful in addressing the problem.

Section 482 of the United States *Internal Revenue Code* has been a prototype for confronting the potential abuse of transfer pricing. In recent years, although the statuary formulation has been modified only slightly, there has been a shift in some of targets and in the methods employed to deal with transfer pricing in the United States.

The language of s. 482 is well known by tax specialists:

> in any case of two or more organizations, trades, or businesses ... owned or controlled directly or indirectly by the same interests, the [Internal Revenue Service] may distribute, apportion, or allocate gross income, deductions, credits, or allowances, between or among [them], if [it] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any [of them].[35]

The regulations explain that the purpose of the provision "is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining ... the true taxable income" of the controlled taxpayer.[36] The appropriate standard is, of course, usually characterized as fair market value of "arm's length" pricing.

Section 482 is available only to the Internal Revenue Service. It affords no rights to taxpayers to recalculate the tax consequences of transactions that have been implemented. Moreover, taxpayers may not compel the Internal Revenue Service to invoke s. 482.[37] A determination by the Service to effect an adjustment under s. 482 is presumptively correct. A taxpayer seeking to challenge the adjustment bears the burden of proving that it is arbitrary, capricious or unreasonable.[38]

The task of overcoming a proposed adjustment under s. 482 may be formidable. Successfully demonstrating that the Internal Revenue Service's analysis is inappropriate or inaccurate may not suffice. In one well-known decision, for example, the court sustained the proposed Internal Revenue Service adjustment and offered some telling observations about the nature of the burden confronting taxpayers:

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[35] Code s. 482.
[36] Treasury Regulation s. 1.482-1(a)(6).
[37] Treasury Regulation s. 1.482-1(b)(3).
[38] See e.g., *American Terazzo Strip Co. v. Commissioner* (1971) 56 TIC 961 (Acq.).

> In reviewing the [IRS] allocation of income under s. 482, we focus on the reasonableness of the result, not the details of the examining agent's methodology....
>
> The amount of reallocation would not be easy for us to calculate if we were called upon to do it ourselves, but s. 482 gives that power to the [IRS] and we are content that his amount (totaling some $18 million) was within the zone of reasonableness. The language of the statute and the holdings of the courts recognize that the Service has broad discretion in reallocating income... A 'broad brush' approach to this inexact field seems necessary.[39]

The Internal Revenue Service may even change its theory during the course of litigation.[40]

Taxpayers may seek to avoid an adjustment by showing that prices were not established to avoid taxes. For example, the presence of minority shareholders of a corporation who have rights that can be asserted against unfair transfer pricing arrangement might be offered as proof that prices were not intentionally skewed away from market values. In other situations, it might be shown that the managers of different corporations, even within a closely integrated operating group, were competing vigorously to produced high profits for the entities for which they were responsible.

Such circumstances will not themselves be a defense to an adjustment under s. 482. The authority of the Internal Revenue Service to make adjustments does not necessarily depend on any tax-motivated behavior by the taxpayers involved. It arises not only in the case of the conscious activities of "evasion" and "avoidance," but also in any circumstances where adjustments are necessary "clearly to reflect ... income." An appropriate adjustment cannot be avoided on the ground that the taxpayer did not consider tax consequences or that the total taxes paid by all of the related entities in all nations was higher than the tax that would obtain in the United States. As a practical matter, of course, the discovery by Internal Revenue Service agents of evidence that pricing arrangements were established purposefully to avoid United States tax is likely to increase the probability of an adjustment under s. 482.[41]

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[39] *E.I. DuPont de Nemours & Co. v. United States* (1979) 608 F. 2d 445 (cert den.).
[40] See e.g., *Sundstrand Corp. v. Commissioner* (1991) 96 TIC 226.
[41] Treasury Regulation s. 1.482-1(b).

In the past decade, several events have focused attention on transfer pricing issues and have produced some identifiable shifts in the focus on targets of transfer pricing abuses and in the methodologies of addressing transfer pricing questions. Moreover, legislation has been adopted to provide more weapons for the arsenal of the Internal Revenue Service in confronting transfer pricing issues. At the same time, the Service has lead the way among tax administrators in its willingness to consider offering advance rulings on pricing issues, manifesting a fundamental change in its longstanding refusal to offer advance rulings on issues that are essentially factual.

There has been a noted increase in the number of "big cases" involving transfer pricing issues. A report issued several years ago indicated that $9.9 billion in transfer allocations were at the time being litigated in various courts. Very large amounts were in dispute in many of these cases. Even though such cases represented only .002 percent of the cases before the Tax Court, they accounted for approximately one-third of the amounts being contested in that forum.[42]

Historically, the Internal Revenue Service has been concerned primarily with transfer pricing arrangements by United States companies intended to move income offshore. During the 1980's, however, there was a dramatic shift in the comparisons between investment abroad and foreign investment in the United States. As foreign investment in the United States increased, attention was turned more sharply upon the application of United States income tax laws to foreign taxpayers. One of the manifestations of the new focus was on issues of transfer pricing between foreign investors and their United States subsidiaries.

The issue has become one of political moment. A series of congressional hearings during 1990 elicited data suggesting that the profitability of domestic corporations owned by United States investors seemed to be substantially higher than that of those controlled by foreign interests. The possibility that such results were attributable to the brilliance of United States international competitiveness was not seriously considered. During the presidential campaign of 1992, then candidate Clinton alleged that the Bush Administration had failed to collect $45 billion in taxes owed by foreign companies. While the figure was not supported by any reasonable data and substantially exceeded estimates by most experts in the international tax community, it was a charge that stuck in part because it seemed

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[42] B.N.A, 204 *Daily Tax Reporter*, at 6-7 (October 25, 1993).

to support the contention that the Bush Administration was more concerned with foreign interests than with domestic problems.

One of the principal targets for s. 482 adjustments had been transactions involving intangibles. The *Tax Reform Act* of 1986, which was a major recodification of the *Internal Revenue Code*, added some rather mystical language to s. 482: "In the case of any transfer (or license) of intangible property ..., the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

This provision, which has come to be called the "super-royalty" provision, was also added to s. 367(d), which deals with transfers of manufacturing and marketing intangibles to foreign corporations.

The meaning of the amendment is not necessarily obvious. The House of Representatives Committee Report stated that, "the [Ways and Means] committee intends to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles transfers. Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms."

In practice, many interpret this language as moving in the direction of a profit-splitting technique. In fact, a number of recent decisions by the Tax Court seem to be best understood as profit splits. This development may be viewed as somewhat ironic in light of the substantial criticism that has been directed against the use of certain formulary approaches to profit allocation certain state income tax regimes within the United States.

The power of s. 482 has been buttressed by a number of additional requirements. Sections 6038A and 6038C authorize the Internal Revenue Service to impose special reporting requirements for domestic corporations that are 25 percent foreign-owned and foreign corporations engaged in a United States trade or business.

Special penalties, in addition to those that would otherwise obtain, have been crafted for some transfer pricing cases. The Code imposes an "accuracy-related penalty" of 20 percent for a substantial valuation misstatement.[43] This penalty applies in situations where the price adjustment is either twice as much or half as much as that actually charged or 10 percent of gross receipts or where the price adjustment exceeds $5 million.

[43] Code s. 6662(b).

The taxpayer may be able to defend against the penalty, however, if it proves:

- that it established prices under a specific pricing method approved by the regulations in a reasonable way;
- that it has documentation extant at the time of filing the return which sets forth the determination of such price in accordance with such method and establishes that the use was reasonable;
- and provides such documentation to the Internal Revenue Service within 30 days of a request therefor.

The tax is doubled to 40 percent if the price is adjusted to an amount that is four times or one quarter of the amount actually charged or if the price adjustment exceeds $20 million.[44] The defenses described above are not available in respect of such "gross valuation misstatements."

Finally, acting under a mandate contained in the *Tax Reform Act* of 1986, the Treasury Department undertook a study of the substance of transfer pricing techniques.[45] The study generated wide debate in the tax community. After several proposals were withdrawn in the wake of public criticism, the Treasury Department promulgated new regulations in 1994 for the implementation of s. 482.

The new regulations are too detailed for analysis in this paper. They differ from their predecessors in a number of dramatic ways. The old regulations prescribed a series of techniques in order of preference. The new regulations call for the use of the best method for determining appropriate prices. The new regulations also contemplate the use of industry comparative data for determining prices by a particular group of related entities.

The jurisprudential re-engineering of s. 482 is quite obvious and dramatic:

- Increase record-keeping requirements.
- Increase penalties, thereby automatically increasing the stakes between the IRS and the taxpayer.

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[44] Code s. 6662(h).

[45] A Study of Intercompany Pricing under s. 482 of the Code, Notice 88-123, 1988-2 *Cumulative Bulletin* 458.

- Move away from a transaction-by-transaction analysis in the direction of arrangements that effectively divide the profits after their magnitude is determined.

There is also an important administrative development that reflects a dramatic change in policy for the Internal Revenue Service. Although willing to issue advance rulings on questions of law in many instances, the Service has steadfastly refused to issue advance rulings with respect to questions of facts. The most obvious reason is the quite reasonable suspicion that the Service will not have all relevant facts.

Several years ago, however, the Internal Revenue Service announced its willingness to enter into "advance pricing agreements" that will bless transfer pricing arrangements in advance.[46] Tax administrators in a number of other countries have followed suit. The long-term impact of the practice of concluding advance pricing agreements is not presently ascertainable. The Service is relying strongly upon its ability to renounce the applicability of advance pricing agreements if factual representations proffered by the taxpayer turn out to be untrue.

There is an irony in at least one important change that has been wrought by developments in the strategy for checking transfer pricing issues. In earlier times, the participation of tax experts in the establishment of prices might have been regarded as evidence of tax avoidance. The requirement of contemporaneous documentation and the invitation to seek advance pricing agreements necessarily involves the participation of tax counsel and accountants.

A Current Debate — Legislating Another Tax Avoidance Intent?

Public attention in the United States has been directed recently to a proposal by the Clinton Administration that would convert a provision currently dependent upon the presence of tax avoidance motives in effect to a statutory prescription of the existence of such motives.

United States citizens and resident aliens are generally subject to United States tax on worldwide income. Nonresident aliens are generally subject to United States income tax only upon income from United States sources. The source of income from the sale of non-inventory property is generally the residence of the taxpayer. A United States citizen with appreciated investments might be tempted to avoid United States taxes by moving to a tax haven jurisdiction and expatriating himself.

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[46] Revenue Procedure 91-22, 1991-11 IRB. 11.

Section 877 of the Code was adopted years ago to defend against this form of tax avoidance. It provides that a former United States citizen will continue to be subject to United States income taxes on certain income for ten years following expatriation "unless [the expatriation] ... did not have for one of its principal purposes the avoidance of taxes."

There have been very few cases testing the meaning of this language in the context of an expatriation. The only major taxpayer victory occurred in a case in which the former United States citizen renounced her citizenship to marry "a titled Austrian aristocrat."[47] She did so "cognizant of the fact that it was general European custom for a wife to adopt the nationality of her husband." She married him to "bear his name, his title, and his nationality" — this may be the last case of its kind. The Tax Court noted importantly that she had formed her intention before consulting her tax counsel and that there were some tax-savings steps available to her that she did not take. The court's conclusion was perhaps a caution against those too fully informed about taxes:

> Finally, although it is true that [she] is a wealthy and intelligent woman, she has no more than a layman's knowledge of the tax law; indeed, she admitted that she did not read or understand her tax returns ..., she merely signed what was presented to her by her accountants. Thus, we cannot infer a tax-avoidance motive merely by virtue of her wealth and intelligence.[48]

President Clinton's Budget Proposal, announced late in 1994, included an important change in the premises of s. 877. Any United States citizen who chooses expatriation would be required to recognize gains and losses on the basis of fair market values at the time of the expatriation. No tax avoidance test would be applied.

The proposal attracted a surprisingly high degree of media interest. Newspapers and television commentators described the luxurious [and tax-free] life styles of former United States citizens living on Caribbean islands. Most thought that this was a class that would find few champions in the Congress. However, opponents emerged who criticized the proposal on the ground that it was inconsistent with the fundamental rule of realization. These tax policy arguments were buttressed by the rather remarkable suggestion by one group of lawyers that the tax would resemble exit charges imposed upon Soviet émigrés during the Cold War and might

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[47] *Furstenberg v. Commissioner* (1984) 83 TIC 755.

[48] *Furstenberg v. Commissioner* (1984) 83 TIC 755, at 781.

constitute a violation of fundamental human rights. When the proposal was rejected by the Republican majority in the House of Representatives, one Democratic wag observed that "the wealthy expatriate has become the Republican poster child." Although legislation enacted in August 1996 somewhat tightened the provisions of s. 877, the Clinton proposal was rejected.

Some Reflections on the Once and Future Treatment of Tax Avoidance in the United States

The propensity of courts to create barriers to tax avoidance by the imposition of tests not articulated in the taxing statute has sometimes been characterized as the "common law" approach to tax avoidance. While occupying an unquestionably important posture in the topography of United States tax jurisprudence, the frequency of the use of the technique seems to be diminishing. There are several apparent reasons for this tendency. As the decades pass and experience with the taxing mechanism accumulates, the most obvious instances of tax avoidance through loophole exploitation are likely to have been addressed directly. Sensitive to situations where tax avoidance motives may control too much of a transaction, Congress seems increasingly inclined to include some form of tax avoidance brake in the legislation itself.

There is, moreover, a discernible trend in the direction of generalized conclusions about tax avoidance instead of or in addition to specific transactional analyses. The hobby loss provisions, Subpart F, the Passive Activity Loss Limitations, the Alternative Minimum Tax, and the attempt to change the tax consequences of expatriation all reflect such a tendency. The new departures in confronting transfer pricing may be the leading edge of the systematic enlargement of administrative force through the creation of additional record-keeping requirements, establishing special and steep penalties, and inviting scrutiny by the Internal Revenue Service before transactions are implemented. The new anti-abuse regulations intended to blanket the partnership taxing regime might be seen as an attempt to use some of the transfer pricing methodology of s. 482 to govern a broad area of potential avoidance activity.

It must be recalled that the effectiveness of all techniques for addressing unacceptable degrees of tax avoidance are infected by the continued propensity of the Congress to enact tax advantages for particular industries and particular transactions. The *Economic Recovery Tax Act* of 1981, adopted in the first year of the Reagan Administration, provides an interesting foil to any discussion of the evils of tax avoidance in the

United States. Especially through the adoption of very short depreciation lives and very generous investment and research and development credits, many large corporations had virtually no income tax liability. This meant that additional tax incentives (Congress declined to approve refundable credits) would not work once the company's tax liability was reduced to zero. The answer was found in the idea of the free market. Companies unable to use more tax breaks were authorized in effect to market those breaks to other companies who still had tax liabilities. The idea of "tax leasing" was born. It allowed such arrangements through paper transactions. The two companies effectively divided the taxes saved.[49]

The public response to tax leasing, except for those companies engaging in it, was generally negative. Congress repealed the arrangement within two years.[50] The experience, however, reflect the somewhat schizophrenic attitude of Congress to the question of tax avoidance and underscores the conceptual difficulty of checking it.

One lesson that seems to be affirmed by many judicial decisions is that substance, rather than form, will determine income tax consequences. There are, however, many provisions in the Code that invite taxpayers to choose the form of transaction that guarantees the best tax result. Section 1031, for example, provides for the nonrecognition of gain on the "exchange" of "like-kind property." Under this provision, a farmer might exchange his appreciated farm for another without being taxed on the gain realized in the trade. If, however, the farm's value has fallen, the well advised farmer will choose to sell the farm and use the proceeds of the sale to purchase the other. The new farm still qualifies as "like-kind property; but since there was no "exchange" of properties, the loss realized on the sale of the first farm is recognized.

The choice of transaction, as in the case of the corporate reorganizations, is virtually determined by tax motives. Courts and the Internal Revenue Service have in fact approved the use of "triangular transactions" in which the owner of appreciated property effects the necessary "exchange" with a person who has purchased from a third party "like-kind property" designated by the taxpayer.[51] The rather exasperating

[49] Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81) at 102.

[50] The provisions allowing "tax leasing" were substantially eliminated by the *Tax Equity and Fiscal Responsibility Act* of 1982. See Sen. Rep. 97-494, at 130.

[51] See e.g., *Coupe v. Commissioner* (1969) 52 TIC 394 (Acq.).

conclusion that one reaches from these stories is that substance prevails over form ... unless it doesn't.

This paper began by inquiring whether there is a conceptual basis for identifying unacceptable degrees of tax avoidance. The circumstances attending the adoption of the Passive Activities Loss Limitations, the Alternative Minimum Tax, the changing focus and increasing attention to transfer pricing and the, thus far, failed attempt to change the expatriation rules suggest that in the United States the question of what forms of tax avoidance should be checked is firmly planted on the agenda of the United States political landscape. The evolution of jurisprudential techniques may also lead to another interesting and important conclusion. The language found in many of the early "common law" cases and many of the statutory provisions refers to the intention of the taxpayer. The generalized approach to broad categories of transactions or taxpayers seems to reflect an adjustment away from questions of taxpayer intent and in the direction of identifying areas of perceived abuse which can permissibly be addressed even if there is no actual tax-avoidance motivation on the part of the particular taxpayer affected.[52] In light of the observation which began this paper — that one must assume the existence of tax avoidance as a constant and perpetual motivation for every taxpayer — such a trend would seem to advance the objective of rational tax administration.

[52] Such an approach has been supported by academic as well as professional tax specialists. See e.g., WJ Blum, Motivation, Intent and Purpose in Federal Income Taxation (1967) 34 *University of Chicago Law Review* 485.

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