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INTERNATIONAL EXPERIENCE WITH GENERAL ANTI-AVOIDANCE RULES

Graeme S. Cooper*

VIEWED from the distance of the South-West Pacific, the current misgivings in the United States about the abuse of corporate tax shelters and the deficiencies of current laws to deal appropriately with them, are both mildly bemusing and reassuring. While other countries have felt compelled to wrestle with this problem over many years and in various ways, and their practitioners have railed against the obscure anti-avoidance statutes which have resulted, the U.S. has, to the casual observer at least, always seemed confident that the robustness of its jurisprudential doctrines, the comprehensiveness of the Code and regulations, and the creativity of the judiciary provided an adequate bulwark against abusive practices.¹ Yet, running in tandem, and slightly at odds with this confidence, is a unique and highly prescriptive style of drafting (often accompanied by targeted domestic anti-abuse provisions) employed both in the Code and regulations, and even inserted by the U.S.

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1. For example, Charles Gustafson writing in 1995 noted:

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.

Charles H. Gustafson, *The Politics and Practicalities of Checking Tax Avoidance in the United States*, in *TAX AVOIDANCE AND THE RULE OF LAW* 349, 350 (Graeme S. Cooper ed., 1997). Lee Sheppard asserted that this robustness made the U.S. experience different from that occurring elsewhere:

The British, who have far worse tax-avoidance problems than the Americans—the development of British tax law being about three decades behind the American law—have been wrestling with the idea of anti-avoidance rules lately. The British system exalts form and taxpayers get away with scams, like incorporated bank accounts, that would be laughable in the United States. The British system now depends on specific legislative fixes and on the courts to knock down particular tax-avoidance schemes on a case-by-case basis—which sometimes they do, and often they don't. There is no concept of substance over form in the British courts; the mother country of the common law has little taste for it when it comes to taxation.

Lee A. Sheppard, *Giving and Taking on Corporate Tax Shelters*, 18 *TAX NOTES INT'L* 1330, 1331 (1999).

into its double tax agreements.²

Whether the recent disquiet indicates that the original confidence was misplaced, or whether it is an excessive reaction to what was always a slumbering and systemic problem, is not important for present purposes. Instead, the object of this article is to examine why and where other countries have found it necessary to employ a statutory general anti-avoidance rule (GAAR) as their preferred strategy for dealing with corporate tax shelters, what form those rules have taken when countries have pursued this strategy, and how the approach taken in those countries differs from that currently proposed in the U.S. While GAARs feature in the tax systems of countries as diverse as Sweden, Hong Kong, and Germany,³ the focus of this article is on four common law jurisdictions—the United Kingdom, Canada, Australia, and New Zealand—which share a common law legal tradition with the United States. The contrast between the U.S. approach and the measures adopted elsewhere is striking and hopefully illustrative of where statutory responses might and might not be effective, as well as demonstrating the diverse forms that statutory responses can take. The discussion will proceed in these steps. Part I looks at the case that is usually made for a GAAR, some of the instances where that case has been found compelling, and the special example of the U.K. where a GAAR has recently been considered by the Government and then deferred, if not formally rejected. Part II considers the common design elements of GAARs that have been enacted or considered elsewhere, and contrasts those features with the proposals currently being examined in the U.S. Part III examines some of the curious outcomes that the foreign GAARs have generated. The purpose of all of this is to look at the new directions that the U.S. experience suggests for countries with a GAAR, and to indicate how the experience elsewhere might inform the current U.S. debate.

2. For example, the U.S. treaty policy is to insist on a detailed limitation of benefits provision in its double tax agreements to circumscribe the benefits that might otherwise flow to taxpayers from avoidance techniques relying on accessing treaty benefits. See, e.g., MODEL INCOME TAX CONVENTION art. 22 (1996), reprinted in THE 1996 UNITED STATES MODEL INCOME TAX CONVENTION: ANALYSIS, COMMENTARY AND COMPARISON (Richard L. Dorenberg & Kees van Raad eds., 1997). The Technical Commentary to article 22 notes that while the OECD Commentary asserts that a substance-over-form interpretation is required for treaty issues, "[t]he United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties . . ." *Id.* at 333.

3. Several countries from a civil law tradition have experimented with a statutory GAAR. See Leif Mutén, *The Swedish Experiment with a General Anti-Avoidance Rule*, in TAX AVOIDANCE AND THE RULE OF LAW 307 (Graeme S. Cooper ed., 1997); Frans Vanistendael, *Judicial Interpretation and the Role of Anti-Abuse Provisions in Tax Law*, in TAX AVOIDANCE AND THE RULE OF LAW 131 (Graeme S. Cooper ed., 1997); Eelco van der Stock, *General Anti-Avoidance Provisions: A Dutch Treat*, 1998 BRIT. TAX REV. 150. Surprising as it may seem, some continental European countries rely instead upon their own "common law" anti-avoidance measures—the *fraus legis* (fraud on the law) and *abus de droit* (abuse of the law) doctrines. See generally INSTITUTE FOR FISCAL STUDIES, TAX AVOIDANCE: A REPORT BY THE TAX LAW REVIEW COMMITTEE ch. 3 (1997); DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS ch. VI.B. (1997) [hereinafter *White Paper*].

The main argument of this article is that the experience of other jurisdictions shows a GAAR can play a useful part in the domestic legislative framework of a country without doing the damage that is often feared or asserted. The reason is that a GAAR will usually become just another part of the tax landscape which practitioners and the judiciary negotiate in much the same way they do any other area involving ambiguity and uncertainty. What is abundantly clear is that a GAAR does not suddenly embolden a reluctant judiciary to become highly interventionist. It neither unleashes a nuclear winter for advisors, nor serves as a panacea for tax authorities.

Rather, the effectiveness of a GAAR depends in large part on what the GAAR is meant to accomplish. A GAAR has its own limitations and difficulties, and will not address all of the matters currently thought to lie at the root of the U.S. problems. A GAAR is implausible as a solution to structural problems in the tax system, and it is inappropriate as a means of dealing with murky lines and fuzzy categories that are poorly drawn in the text of the law. As a revelatory mechanism and as a tool for manipulating the market for tax shelters, a GAAR is a poor implement. But as a means of addressing other aspects of artificial schemes, it is a plausible and feasible response, capable of encompassing both self-generated tax ploys and aggressively marketed externally-developed schemes.

I. THE DECISION TO EMPLOY A STATUTORY GAAR

There are many reasons to be surprised that a GAAR exists at all, especially in countries with a strong adherence to the Diceyan tradition of the rule of law. The predictably adverse reaction of tax advisors to a GAAR, and the damage that it might be thought to do to the notion of the rule of law, suggest that for countries with a strong adherence to the rule of law tradition, a strong case might be thought necessary in support of a GAAR before one would be enacted. What circumstances might be said to make a GAAR necessary? This Section examines some of the debates that have accompanied proposals to enact a GAAR. In three of the countries examined, these circumstances have been thought sufficiently parlous to justify the use of a GAAR.

A. A CASE OF FAILURE OF LAW?

When a GAAR is introduced into Parliament, the case for doing so is invariably made in political terms, trying to garner support from voters and their representatives for measures that will stop the wealthy (or sometimes more particularly, corporations) from avoiding their fair share of taxes⁴ or sometimes for reasons of revenue protection *simpliciter*. But

4. When the Australian Treasurer introduced the revised GAAR in 1981, he noted, "widespread abhorrence of blatant tax avoidance of the kind that we have recently experienced. It distorts in a most unacceptable way the relative burdens of tax that are borne by different sectors of the community." Second Reading Speech, *Income Tax Laws Amendment Bill (No 2) 1981 at the House of Representatives*, HANSARD, May 27, 1981, at 2684.

leaving the political rhetoric and the revenue need to one side, there is an underlying question that is more curious: why is it that the legal framework has proven to be, or has been perceived to be, inadequate to meet the challenge of tax avoidance? Why is there a failure of the usual legal process in the case of tax? It is a strange admission by legislators to introduce a law which says, in effect: Parliament is enacting a rule to reverse something which it does not otherwise prohibit and cannot foresee, and so must either prevent by deterring *ex ante* or else cure by *ex post* reversal. What are the sources of the failure that have led to this decision?

This article will do no more than sketch four of the possible underlying causes of the legal failure.⁵ One possible explanation is styles of judicial reasoning. It is said that in the U.K. at least, the judiciary adopts an antagonistic approach to dealing with tax issues that would affect the approach adopted to the resolution of tax matters. As Devlin put it, "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."⁶ It might be thought that this leads to an approach to the interpretation of tax statutes which treats them more literally than the statutes in other areas of law, and further, in cases of doubt, to a propensity to find against the government as a matter of principle in cases of modest ambiguity.

Lest it be thought that such a view is peculiar to the U.K., most countries, including the U.S., share a judicial presumption of immunity from tax unless it is clearly imposed, and a common lexicon of quotes about the freedom of taxpayers to arrange their tax affairs in such a way as to minimize tax. 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 have "a right" to try to minimize their tax, provided the means used are effective at law and they do not seek to conceal or misrepresent the true situation.⁷

The same case is currently made by the U.S. administration. The testimony of Assistant Treasury Secretary Donald Lubick before the House and Senate emphasized that corporate tax shelters breed disrespect for the tax system by others who "perce[ive] unfairness." *Hearing on Revenue Provision in President's Fiscal Year 2000 Budget Before the House Committee on Ways and Means*, 106th Cong. 11 (1999) [hereinafter *Hearings*]. Treasury Secretary Robert Rubin is quoted as saying that "[t]ax shelters not only erode the corporate tax base, they also breed disrespect for the tax system both by people who participate in the corporate tax shelter market and by others who perceive corporate tax shelter users as paying less than their fair share of tax." Ryan J. Donmoyer, *Forthcoming U.S. Treasury Regs May Define Tax Shelters More Narrowly*, 18 TAX NOTES INT'L 662 (1999).

5. Another cause that is usually cited is what might be termed the "tax culture:" the degree of aggressiveness shown by taxpayers and their advisors in the positions they are prepared to adopt in their dealings with revenue authorities. See, e.g., Brian J. Arnold, *The Canadian General Anti-Avoidance Rule*, in TAX AVOIDANCE AND THE RULE OF LAW 221, 222 n.3 (Graeme S. Cooper ed., 1997).

6. PATRICK DEVLIN, *THE JUDGE* 15 (1979); see also Ivor Richardson, *Appellate Court Responsibilities and Tax Avoidance*, 2 AUSTRAL. TAX F. 3 (1985).

7. There is certainly no shortage of statements by judges in tax cases, as seen in some of the favorite examples that follow. Lord Esher, in *Comm'r of Inland Revenue v. Angus*

Another plausible explanation is greater taxpayer creativity in the field of tax. Ash Wheatcroft put it nicely: “when dealing with other areas of law, citizens tend to stick to well-trodden paths; with tax law, they seek new ones.”⁸ A high degree of self-interested energy is likely to lead to great pressures on any part of a legal system, and the degree of pressure is likely to be extremely great in income tax: it is a mass system affecting almost the entire mature-age domestic population and often a significant segment of the foreign population. And not only are there many affected persons, but the amounts at stake individually and collectively can be very high.

A third explanation might arise from the idiosyncratic style of statutory drafting employed in writing tax laws. Because tax laws will often need to express sophisticated policy choices and political compromises, it is not surprising that tax laws are usually regarded as the most difficult laws to comprehend.⁹ Further, tax laws will always try to encompass the foreseeable abuse opportunities and protect against them. These demands on the drafters, combined with a unique style of judicial reasoning in tax, can lead to a high degree of apparent precision, with the use of highly technical and prescriptive terminology, compounding definitions, qualification upon qualification, and ultimately a large volume of material to express tax policy. The U.S. Internal Revenue Code is undoubtedly the apotheosis. In this environment, it is foolhardy not to expect omissions, lacunae, inconsistencies, and contradictions within the law. It is also unrealistic

& Co., 23 Q.B. 579, 593 (1889), said: “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.”

Lord Tomlin in *Comm’r of Inland Revenue v. Duke of Westminster*, A.C. 1 [1936], said: “Every man [sic] 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.”

Justice Sutherland in *Gregory v. Helvering*, 293 U.S. 465 (1935), stated “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.”

Justice Learned Hand in *Comm’r v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947), declared:

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 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.

Justice Starke in *Jaques v. Federal Comm’r of Taxation*, (1924) 34 C.L.R. 328, stated: “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.”

Justice Pratte in *Produits L.D.G. Prods. Inc. v. The Queen*, [1976] C.T.C. 591, declared: There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act, he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible.

8. GSA Wheatcroft, *The Interpretation of Taxation Laws With Special Reference to Form and Substance*, LA CAHIERS DE DROIT FISCAL 7 (1965).

9. Graeme S. Cooper, *Themes and Issues in Tax Simplification*, 11 AUSTL. TAX F. 417 (1994).

not to expect disagreements, errors, and subterfuges on the part of taxpayers and administrators.

A final explanation might be administrative paralysis. It is not an uncommon charge against tax administrators to assert that they do not do enough to challenge taxpayers' aggressive tax positions.¹⁰ In Australia, the non-taxation of employee fringe benefits, and the tax fraud usually known as the "bottom of the harbour" schemes, were both brought about by administrative inaction. In New Zealand, the "wine box" tax fraud, which involved a foreign tax credit fraud, apparently involved similar inaction.¹¹ If administrators believe they lack the legislated powers to act on an uncovered form of avoidance, or feel that they will not be given a suitable remedy by the judiciary, they will quite understandably not address the issue. If that belief is ill-founded, the failure lies not with the law but with their perception of it.

If the usual legal processes fail to prevent large-scale tax avoidance for these or other reasons, governments will seek remedies in unusual ways.¹² But not all of these examples of legal failure will be solved by a GAAR. Indeed, a GAAR can breed its own types of administrative paralysis. It is thought that the New Zealand GAAR lay untested for many years because of a fear that the "nuclear weapon" once detonated might be shown to be a toy.

B. HOW COMPELLING IS THE CASE?

No one can predict when and how a coalescence of these circumstances, combined no doubt with revenue and political pressures, will become compelling for a government: why, for example, Australia, New Zealand, and Canada acceded to the need for a GAAR as part of the solution to the failure of other mechanisms, while the recent U.K. and U.S. experience shows a reasoned reluctance to adopt it. And it is interesting to speculate why some countries employ a statutory GAAR when there are other alternative solutions to the problem. If one were searching for answers, one explanation for the decision in the U.K. seems to be

10. See, e.g., Brian J. Arnold, *The Canadian General Anti-Avoidance Rule*, BRIT. TAX REV. 541, 543 (1995) ("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.").

11. The particular fraud involved refunding to an associate of the taxpayer of an amount equivalent to the interest withholding tax it had suffered. It led eventually to the creation of a Commission of Inquiry headed by Sir Ronald Davison. The fraud is described in IAN WISHART, *THE PARADISE CONSPIRACY* (Howling At The Moon Productions Ltd. 1995) and IAN WISHART, *LAWYERS, GUNS AND MONEY* (Howling At The Moon Productions Ltd. 1997).

12. Arnold argues that the circumstances in Canada which necessitated the GAAR were: "taxpayers and tax advisors were becoming increasingly aggressive; second, for a variety of reasons, Revenue Canada was taking a very lenient attitude to tax avoidance transactions; and third, the Supreme Court of Canada had rejected any broad general judicial approach to combating tax avoidance." Brian J. Arnold, *The Canadian General Anti-Avoidance Rule*, in TAX AVOIDANCE AND THE RULE OF LAW 221, 226 (Graeme S. Cooper ed., 1997).

administrative fear; in the U.S. it seems to be a degree of confidence in other measures, combined with a particular set of political conditions.

The U.K. has only once had a GAAR in its income tax.¹³ The recent history of U.K. tax policymaking reveals an interesting dalliance with an idea that should provoke a mild sense of *déjà vu* for an American audience. In his Budget Speech in July 1997, the Chancellor for the Exchequer, Gordon Brown, commissioned a review to determine whether a GAAR should be enacted as part of U.K. income tax law.¹⁴ The announcement was greeted with some dismay among the profession¹⁵ and some initial apparent enthusiasm for the task by tax administrators.¹⁶ The Inland Revenue released its *Consultative Document* on anti-avoidance rules for direct taxes in October 1998.¹⁷ It outlined the case for a GAAR, the elements that such a rule might have, how it would differ from the existing judicial anti-avoidance doctrines, and some samples of the drafting that might be used. In many respects, the *Consultative Document* closely followed an earlier independent report issued by the respected Tax Law Review Committee of the highly influential Institute for Fiscal Studies (IFS).¹⁸ The Committee had undertaken its own assessment of what the Chancellor's proposal might involve which it published in November 1997, and subsequently issued a rejoinder to the *Consultative Document* in February 1999.¹⁹ The IFS had broadly supported a

13. Malcolm Gammie, *Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom*, in *TAX AVOIDANCE AND THE RULE OF LAW* 181, 192 (Graeme S. Cooper ed., 1997).

14. Gordon Brown, *Speech at the House of Commons*, HANSARD, July 2, 1997. He said:

A government committed to the proper funding of public services will not tolerate the avoidance of taxation and we will be relentless in our war against tax avoidance. I have instructed the Inland Revenue to carry out a wide-ranging review of tax avoidance, with a view to further legislation in future Finance Bills. I have specifically asked the Revenue to consider a general anti-avoidance rule.

Id. The announcement was followed by a further explanation by the Finance Secretary. See Dawn Primarolo, *Playing With Fire*, *THE TAX J.*, Sept. 22, 1997, at 2.

15. See, e.g., Peter Wyman, *U.K. Proposed GAAR May Be Counterproductive*, 17 *TAX NOTES INT'L* 1160, 1161 (1998) ("Many U.K. tax advisors are concerned that the GAAR will create a tax climate that businesses will view as hostile."); Sarah J. Squires, *The U.K.'s General Antiavoidance Rule: The Consultative Document Arrives!*, 17 *TAX NOTES INT'L* 1226 (1998); David Goldberg, *Where to Now?*, *THE TAX J.*, Aug. 11, 1997, at 17; Maryanna Sharrock, *A Nine-Days Wonder?*, *THE TAX J.*, Oct. 6, 1997, at 7; Ian Barlow & Richard Hall, *A Targeted Approach*, *THE TAX J.*, Oct. 13, 1997, at 5; Francis Fitzpatrick, *Extreme Prejudice*, *THE TAX J.*, Oct. 13, 1997, at 7.

16. Officials from the Inland Revenue Department and Customs & Excise issued statements outlining their plans for developing the Chancellor's announcement into a workable proposal. See John Gribbon, *A Sterile Activity*, *THE TAX J.*, Sept. 22, 1997, at 3 (outlining the position of the Inland Revenue Department); Martin Brown, *All Measures Available*, *THE TAX J.*, Sept. 29, 1997, at 5 (outlining the position of Customs & Excise).

17. See INLAND REVENUE, *A GENERAL ANTI-AVOIDANCE RULE FOR DIRECT TAXES: CONSULTATIVE DOCUMENT* (1998) [hereinafter *UK Consultative Document*].

18. See INSTITUTE FOR FISCAL STUDIES, *TAX AVOIDANCE: A REPORT BY THE TAX LAW REVIEW COMMITTEE* (1997).

19. INSTITUTE FOR FISCAL STUDIES, *A GENERAL ANTI-AVOIDANCE RULE FOR DIRECT TAXES: A RESPONSE TO THE INLAND REVENUE'S CONSULTATIVE DOCUMENT* (1999).

GAAR for income. But by 1999, a significant level of opposition to the GAAR proposal came from the curious source of the U.K. Inland Revenue. The opposition arose from concerns about the administrative burden that the GAAR would place on the Revenue.²⁰ In March 1999, the Chancellor announced that there would be no GAAR for the U.K., although the option of proceeding with the proposal in the future was deliberately left open.

In the U.S., the immediate impetus for the recent Treasury proposals seems to have been borne of a few notorious tax shelter decisions.²¹ These cases were apparently viewed as significant not because the revenue authorities lost, nor for what the cases decided, but for what they revealed about corporate America and a new sub-current of tax avoidance schemes aggressively marketed to apparently willing buyers.²² At the same time there appeared to be a level of disquiet in the U.S. Treasury at the increasing disparity between the amount of income reported for financial accounting purposes and for tax purposes, with this book-tax gap said to be an important indicator of a problem of corporate tax shelters.²³ But it seems at present that the circumstances in the U.S. are not

20. See e.g., Peter Wyman, *U.K. Government Drops GAAR from Budget, Creating Winners and Losers*, 18 TAX NOTES INT'L 1222, 1222 (1999) ("Most commentators expected [Chancellor] Brown to brush aside the Revenue's objections, but clearly they underestimated the Revenue's ability to make its case and/or Brown's willingness to listen to the Revenue's views."); John Jay, *Shrinking the State, Not Meddling, is the American Way*, SUNDAY TIMES, Mar. 14, 1999, LEXIS, News/Times File ("The reason [that Treasury is in retreat] is Brown's team has had a reality check. A GAAR would pose huge administrative problems for companies and the Inland Revenue because such a rule would be politically unacceptable unless companies were allowed to have deals pre-screened.").

21. See *ACM P'ship v. Comm'r*, 157 F.3d 231 (3rd Cir. 1998), cert. denied 526 U.S. 1017 (1999) (which dealt with a capital loss generating scheme using the rules for recognizing income from sales where the price is partly contingent); *Saba P'ship v. Comm'r*, 78 T.C.M. (CCH) (1999) (dealing with a similar capital loss generating transaction); *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505 (D.C. Cir. 2000) (dealing with an installment sale tax shelter arrangement involving the financing bank as a putative partner); *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214 (1999) (scheme designed to secure foreign tax credits connected with dividend received from foreign company on shares held for a short term); *IES Indus., Inc. v. United States*, 84 A.F.T.R. 2d (N.D. Iowa Sept. 22, 1999) (scheme designed to secure foreign tax credits connected with dividend received from foreign company on shares held for a short term).

22. See e.g., Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, TAXES, Mar. 2000, at 63 ("a significant segment of corporate America has, in recent years, appeared to place a greater premium on tax savings . . ."); Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 231, 233, 233 (1999) ("It certainly is true that U.S. corporations are avid consumers of innovative tax-advantaged financing or transactional opportunities . . .").

23. *White Paper*, supra note 3, at 32 ("The data reported on Schedule M-1 of Form 1120, 'Reconciliation of Income Per Books with Income Per Return,' suggests that the difference between book income and taxable income has increased recently."). The *White Paper* finds that the ratio of book income to taxable income has increased from 1.25 during the period 1990-1994, to over 1.8 in 1995 and 1996. Kleinbard notes, however, that there is not a great deal of confidence in the accuracy and reliability of empirical measures, although most professionals are prepared to concede that a problem exists based on anecdotal evidence. Kleinbard, supra note 22, at 233. Compare Kenneth J. Kies, *A Critical Look at the Clinton Administration's 'Corporate Tax Shelter' Proposals*, 18 TAX NOTES INT'L 2465, 2465 (1999) (disputing the alleged size of the problem and insisting that "data on

such that the need for a GAAR is seen as pressing. Instead, there will likely be a series of targeted measures focusing largely on enhanced reporting requirements. Judged admittedly from quite some distance, this retreat from a GAAR seems to be driven by confidence that disclosure alone will suffice and by a degree of political opposition, driven surprisingly by tax advisors.²⁴ To foreign observers, the disquiet aroused by the proposals is surprising, given existing elements of the U.S. tax system: the current registration requirements in respect of individual tax shelter arrangements²⁵ and some corporate tax shelter arrangements,²⁶ the general partnership anti-avoidance rule,²⁷ and the veritable Pandora's Box of provisions in the U.S. Internal Revenue Code dealing with transactions the purpose of which is the avoidance of taxes.²⁸ Nevertheless, the case for a U.S. GAAR seems to be lost.

Whether and when a GAAR or some other measures might be an appropriate reaction to the pressures of legal failure is of course contingent and conjectural. And judging the proportionality of any response must pass a first hurdle: there is by definition usually little empirical evidence of the size of the problem. Nor is it clear what that empirical evidence should be testing: the size of the failure might be judged by the volume of suspect transactions discovered by the tax administration, the volume of cases litigated and lost, or the volume of revenue estimated to be "lost" from these activities. And then one would have to ponder how many transactions, or appeals, or revenue, is so much that "something must be done."

Moreover, one would need to be confident in two views: that the judges will too frequently reach the wrong conclusions when left to their own devices, and that they will be more likely to "get things right," or "get it right more often" if supported by a GAAR. There is some evidence to the contrary. The English judges, for example, have developed a form of judicial anti-avoidance rule in the form of a variant on the step-transactions doctrine.²⁹ And the criticism that the judiciary is too reluctant to delve into the "form v. substance" debate is not always borne out

corporate income tax revenues suggest that the house is not really on fire—corporate tax revenues as a percentage of GDP exceed any level reached since 1980").

24. See e.g., Kies *supra* note 23, at 2465 (describing the original proposals as "unnecessary, overreaching, and at odds with sound tax policy principles").

25. I.R.C. § 6111(a) (1986).

26. *Id.* § 6111(d).

27. Treas. Reg. § 1.701-2(b) (2000). Kleinbard, however, disputes the similarity between the Treasury proposals and the partnership rules. See Kleinbard, *supra* note 22, at 236-37.

28. See generally Gustafson, *supra* note 1, at 356-57.

29. W.T. Ramsay Ltd. v. Inland Revenue Comm'r, 54 T.C. 101, 185 (1981). Lord Wilberforce said:

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

by tentative steps in that direction in making characterization decisions. For example, when a partner assigns an interest in just the income of a partnership to another, an Australian court sees the sale of property (carrying with it the underlying income) while a New Zealand or U.K. court sees only the (ineffective) assignment of the partner's income.³⁰

And even if one were satisfied with the answers to these questions, there inevitably will be the allegation that introducing a GAAR will do serious damage to other democratic values. This is the standard claim that a GAAR is uncertain. It is a universal claim that "tax avoidance" cannot be defined in a sufficiently precise verbal formula for it to be used as the basis for the imposition of tax:³¹ that there will be too much

emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

Id. The doctrine was further developed in *Inland Revenue Comm'r v. Burmah Oil Co. Ltd.*, 54 T.C. 200 (1981), and *Furniss v. Dawson*, 55 T.C. 324 (1984), and came to be known as the principle of "fiscal nullity." The formulation of the principle in *Ramsay* that came to be accepted was articulated by Lord Brightman:

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 (i.e. business) 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'. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.

Furniss v. Dawson, 55 T.C. 324, 401 (1984). The principle was re-affirmed in *Craven v. White*, 3 W.L.R. 423 (H.L. 1988), *Ensign Tankers (Leasing) Ltd. v. Stokes*, B.T.C. 110 (H.L. 1992) and *Inland Revenue Comm'r v. McGuckian*, S.T.C. 908 (H.L. 1997).

30. The Australian decision is *Federal Comm'r of Taxation v. Everett*, (1980) 143 C.L.R. 440 (treating the assignment by declaration of trust of a sub-interest in a partner's interest in a partnership as an assignment of property carrying with it the right to the income it generates), and the New Zealand decision is *Hadlee v. Comm'r of Inland Revenue*, (1993) 25 A.T.R. 206 (treating the same assignment as the purported assignment of the right to income from the performance of services by the partner). This is a decision of the Privy Council and may be expected to bear upon future U.K. jurisprudence, as it principally interprets the property law effect of the transaction.

31. See, e.g., Colin Masters, *Is There a Need for General Anti-Avoidance Legislation in the United Kingdom?*, 1994 BRIT. TAX REV. 647, 671 (A GAAR "violates perhaps the most important and fundamental principle of tax law: that the tax 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."); Joel A. Nitikman, *Is GAAR Void for Vagueness?* 37 CANADIAN TAX J. 1409 (1989).

The animated debate sparked by the recent U.S. proposals put forward by the Clinton Administration and Treasury, and the outcry from U.S. practitioners might have been expected, but was interesting to foreign observers accustomed to seeing much more principled responses from U.S. tax practitioners. While tax advisors are notoriously prone to finding difficulties in statutory instruments, the vehemence of the responses to the reform proposals sits somewhat oddly apart from the conciliatory and supportive impression that the profession conveys in most matters of tax policy. See, e.g., Charles Davenport et al., *ABA Tax Section Convenes in Washington*, 18 TAX NOTES INT'L 1870, 1876 (1999) (describing the discussions at a meeting of the ABA Tax Section's Formation of Tax Policy Committee); Heidi Glenn, *Sen. Roth Cool to Clinton Administration's Tax Package*, 18 TAX NOTES INT'L 1917, 1917 (1999) (reporting on submissions made by practitioners to Senate hearings on the tax shelter measures that "the administration's proposals to curb abusive tax shelters would give far too much discretionary authority to the IRS"); Sheryl Stratton,

GAAR fallout creating havoc for unintended targets.³² This claim is rarely well developed; it is apparently thought sufficient merely to assert it and its truth becomes self-evident,³³ but how uncertain are GAARs?

One response is that in many ways, a GAAR is as certain as many other anti-avoidance tax rules. In his testimony before the Senate, Assistant Secretary Donald Lubick noted the range of rules of some antiquity already in the U.S. Code which applied to transactions which “d[id] not clearly reflect income”³⁴ or which involved a purpose of tax avoidance or evasion.³⁵

Another response is that a GAAR is probably clearer to state than many judicially-developed anti-avoidance doctrines, although any greater level of certainty may simply reflect the nature of the common law method. Judicial pronouncements tend to be restated over generations with variations and subtle differences introduced at each reformulation. Their scope is rarely defined; they are not consistently applied; they can be created almost at will.

The typical response by the government to these concerns then is to attempt to mollify critics and perhaps the wider voting populace with various forms of reassurance. The reassurance might be that the rule will rarely be used, that it will only be applied to transactions that are “blatant, artificial and contrived” or that it will not be applied to “ordinary family or commercial dealings.”³⁶ The experience with judges in Austra-

U.S. Administration Shelter Proposals Criticized Ad Nauseam, 18 TAX NOTES INT'L 2033 (1999) (reporting on the ABA Tax Section's meeting of May 1999).

32. Heidi Glenn, *Sen. Roth Cool to Clinton Administration's Tax Package*, 18 TAX NOTES INT'L 1917, 1918 (1999) (referring to the three experts giving testimony before the Senate who “complained that the administration's definition of corporate tax shelters casts too wide a net and would run the risk of catching legitimate transactions”).

This argument is well understood and not always challenged. Indeed, some degree of uncertainty may actually be an intended element in the overall anti-avoidance strategy. Assistant Secretary Lubick's testimony before the House noted that, “some amount of uncertainty may be useful in discouraging taxpayers from venturing too close to the edge . . . of established principles.” *Hearings, supra* note 4 (testimony of Donald Lubick).

33. Critics will always point to the fundamental problem of GAAR: it is a solution to a problem that is not a problem so far as the text of the law (strictly interpreted) is concerned. It is an *ex ante* solution to a problem that has yet to be recognized and so cannot be addressed. If it were possible to identify the failure, the drafter would undoubtedly do so and would proscribe it. If the target of the measure cannot be meaningfully defined, it will prove too imprecise to operate.

Indeed, the NYSBA submission adopts the interesting conceptual position that any verbal formula which tries to define “tax avoidance” will be too uncertain to admit its use in defining the tax base for the income tax, but will be sufficiently certain to be used in the imposition of penalties. N.Y. State Bar Ass'n Tax Section, *Report on the Treasury's Proposal to Codify Economic Substance Doctrine*, reprinted in, 2000 TAX NOTES TODAY 146-25 (July 28, 2000).

34. I.R.C. §§ 446, 482 (1986).

35. I.R.C. §§ 269, 357 (1986).

36. These assurances were offered by the Australian Treasurer when he introduced the revised GAAR into Australia's Parliament in May 1981. He said:

The proposed provisions—embodied in a new Part IVA of the Income Tax Assessment Act—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 le-

lia is that they have not treated such assurances as requiring a constraint upon their interpretation of the rule.³⁷

The last section of the article will suggest that, even though the international experience does not support the view that the GAAR will be applied to unintended targets, no one can have a high degree of confidence in how a GAAR will be applied in practice. But the point to be made at this stage is that there is no reason to believe judges will do a different, let

gitimately take advantage of opportunities available for the arrangement of their affairs. For example, a husband and wife who choose to run a business as partners will need have no fear of having their arrangements affected by Part IVA. There will be no question, either, of the new provisions impeding a parent who wishes to pass to a spouse or to children the use and enjoyment of some income-producing assets.

Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage. That description could be expected to cover the types of tax avoidance that, again using the language of social or political debate, are blatant, artificial or contrived, and which are indeed intended to be covered by this Bill. But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti-avoidance measures and ought, if need be, to be dealt with by specific measures.

In order to confine the scope of the proposed provisions to schemes of the blatant or paper variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and an objective examination, having regard to the scheme itself and to its surrounding circumstances and practical results, leads to the conclusion that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit. Certainly, different approaches might have been taken. The Government tried many of them in the course of developing this Bill. One possibility considered was to adopt the language of the Privy Council in the well-known decision in *Newton's case* and, positive tests of inclusion having been expressed, make the new provisions inapplicable to schemes entered into in the course of ordinary business or family dealing. It has been decided, however, that the better test of what is blatant, contrived or artificial is the positive one that has been adopted. That test seems best to capture the essence of the views expressed by the Privy Council which, in fact, characterised an ordinary business or family dealing as representing a situation other than one of which it can be predicated that it was implemented in the particular way so as to avoid tax.

House of Representatives, HANSARD, May 27, 1981, at 2684.

Similar assurances were given in Canada when the revision of their former limited rule was announced as part of the 1987 tax reform:

Proposed new § 245 is a broad general anti-avoidance rule which is intended to prevent artificial tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the rule proposed seeks to distinguish between legitimate tax planning and artificial tax avoidance so as to establish a reasonable balance between the protection of the tax base and the need of certainty for taxpayers in planning their affairs.

DEPARTMENT OF FINANCE, TAX REFORM: INCOME TAX REFORM 1987 214 (1987).

37. AAT Case 5219, (1988) 20 A.T.R. 3777, 3789 ("My basic task in approaching Part IVA is to ascertain the meaning of the words used in the relevant sections of the Act. If the meaning is plain then I must proceed to apply those words, using their plain ordinary meaning. . . . I am of the view that the primary source is the statute itself. The words of the statute are plain. I cannot use the Minister's words to displace the plain language of Parliament.").

alone a better, job in interpreting a written GAAR than they do in elucidating and applying existing judicially-developed doctrines.

C. ALTERNATIVE STRATEGIES

While a legislative GAAR is a possible response to insufficient robustness in a tax system, it is clearly not the only one.³⁸ Again, I will examine just a few of the options that are within the range available to a government.

It would, of course, be possible for the legislature to embark upon the rectification by further remedial legislation of the deficiencies exposed in the system. This is the traditional and most common method of solving perceived defects in tax laws. And if the impetus for a GAAR is to be found in a series of cases clustered around the same or similar transactions, it is a feasible strategy. But the problems with continual legislative rectification are said to be so great that it is not a feasible long-term solution. First, it is usually said that it will prove too slow; that is, that Parliament will not be able to act sufficiently quickly to stem the losses involved from large, well-marketed schemes. Second, the delay will invariably bring with it unacceptable levels of revenue loss. It is simply too costly to wait and see and then try to cure the problem. Further, continual design tinkering to surround individual provisions with further support will make the legislation too detailed and perhaps ultimately less secure.³⁹ The speed and cost arguments are especially cogent in a world of aggressively marketed schemes.

It would also be possible for the legislature to try to bring about a different form of judging in dealing with tax matters. This might involve more directive interpretational rules enacted to inspire "better" judging

38. The focus principally on legislative measures is quite deliberate: if the particular crisis or systemic failings in the tax system had been handled by the judiciary or the administration in other ways, there would be no need for rectification. But it is the implausibility and impracticability of expecting the judiciary to put its own house in order, or the intransigence or inertia of the administration often protected by some form of constitutional immunity from political interference, which usually means that a legislative solution is the only available response.

39. For example, Assistant Treasury Secretary Lawrence Summers is quoted as saying that a piecemeal approach to preventing tax avoidance is ultimately "counterproductive" and clogs up the Code, "putting the credibility of the common law at risk." Lee A. Shepard, *Giving and Taking on Corporate Tax Shelters*, 18 TAX NOTES INT'L 1330, 1330 (1999). Much earlier, the Carter Commission in Canada had noted that detailed remedial legislation will often create its own avoidance opportunities so that the specific rules become a roadmap for subsequent tax planning. See CANADA, 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 554-56 (1966); see also Gammie, *supra* note 13, at 195 ("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."); John Avery Jones, *Tax Law: Rules or Principles?*, 17(3) FISCAL STUDIES 63 (1996) (arguing that tax laws should be drafted to focus more on express underlying principles clearly, and less on legal detail). Cf. Kleinbard, *supra* note 22, at 231 (arguing that "Treasury Department's recent emphasis on overarching 'standards' that would supplement our system of operative 'rules' is ill-advised. There is no natural law of corporate income taxation.").

(as occurred in New Zealand and Australia).⁴⁰ The emphasis of such directives would be on giving judges more legislative support in the “substance v. form” debate common in many tax cases.

Administrative inertia or intransigence might be overcome by greater political interference. If political interference were possible and successful, it might then induce the issue of more aggressive administrative rulings or interpretations. The Revenue might be encouraged to state its position on various schemes so that taxpayers will know that, if discovered, they will be assured of a dispute. Some assurance of a dispute may well be a sufficient further cost to overcome the allure of artificial and marketed schemes.

Another partial “solution” to the problem might lie in structural change to the current tax systems. Of course, good tax design will always contain specific anti-avoidance rules to protect incentives or thwart anticipated forms of avoidance, but there are other tax law design approaches that might be employed: in other words, addressing tax avoidance through tax design principles. The replacement of vulnerable and poorly designed systems with more robust systems may hold promise,⁴¹ as may buttressing the existing taxes with other systems. A U.S. audience is familiar with the alternate minimum tax as one such buttress. Another example is the decision to operate a shareholder imputation system by tracking taxes actually paid by the company.⁴²

II. COMMON DESIGN ELEMENTS OF GAAR'S

Assume for the moment that the case for a GAAR has been made out. What are the important design elements that have been incorporated into a statutory GAAR elsewhere? The article will consider the Australian, New Zealand, and Canadian versions, and the unsuccessful U.K. proposal. The kinds of design questions that are considered here are: what is the importance of a taxpayer's purpose?; is purpose discovered from a consideration of objective facts and circumstances or is it subjective intent that matters?; which possible “benefits” that might be sought by a taxpayer are susceptible to challenge under the rule?; how does the rule delineate protected elections and choices from abusive transactions?;

40. Sections 15AA and 15AB of the Acts Interpretation Act, 1901 (Austl.) were amended in 1984 after the revision of the former GAAR to require courts to give effect to the purpose of an Act and to allow a court to take extrinsic materials into account in finding that purpose. Sections 6-6B of the New Zealand Tax Administration Act, 1994 (N.Z.) were also enacted in an attempt to impose an obligation on Ministers and the Commissioner to act to pursue “the integrity of the tax system” and §§ FC9 and FC10 of the Income Tax Act, 1994 (N.Z.) attempt to induce more purpose-oriented judging.

41. See Gammie, *supra* note 13, at 204 (arguing that the defects of the tax base of an income tax make it more susceptible to avoidance than more robust tax bases). See generally, INSTITUTE FOR FISCAL STUDIES, *supra* note 3, ch. 4.

42. Graeme S. Cooper, *The Effect of an Income Tax on Corporate Tax Compliance*, in COMPANY TAX SYSTEMS 341 (John G. Head & Richard E. Krever eds., 1997) (arguing for the benefits of an imputation system between the corporate and personal income taxes which gives credit only for corporate taxes actually paid).

what is the relation of the GAAR to existing specific statutory anti-avoidance rules or to existing judicial doctrines?; how extensive is the power to reconstruct the tax outcomes from an impugned transaction?; what is the interaction of the rule with the penalty regime?; is its operation automatic or must it be triggered by the triggering of some special administrative process?; and so on.

A GAAR differs from other forms of statutory judicial anti-avoidance rules in several important respects. All countries will have a range of general transaction-based rules which might be triggered to defeat tax outcomes that would otherwise occur. For example, the U.S. has a “necessary and reasonable” requirement in relation to business deductions and Australia and New Zealand have a test of “necessarily incurred” in relation to business expenses.⁴³ All countries will have some form of international arm’s length pricing rule to deal with transfer pricing,⁴⁴ and perhaps even a domestic arm’s length pricing rule. Some countries will have stop loss rules on transactions between related parties.⁴⁵ In addition to transaction-specific rules, there will often be a range of rules which express a general presumptive position. For example, the quarantining of losses from hobby-type activities⁴⁶ or from passive investments⁴⁷ is a common rule designed to thwart various deferral games or impede the access to deductions for consumption expenditures that taxpayers might seek. Similarly, thin capitalization⁴⁸ or profit-stripping rules⁴⁹ try to protect the tax domestic base by presuming that excessive levels of debt represent disguised equity instead. And there are inevitably incentive protection rules. Tax incentives will always be surrounded by rules circumscribing the target activities and benefits clearly, limiting benefits to amounts “at risk” and so on. None of these examples is a general rule in the sense of a GAAR. They either admit only a limited reconstruction, are specific to one form of transaction, or are triggered only for one tax regime.

A. STANDARD DESIGN FEATURES OF MODERN GAARS

The GAARs that currently operate in Australia, New Zealand, and Canada share a common approach and terminology, and the feature that they are reasonably fulsome and carefully drafted.⁵⁰ All have been re-

43. Income Tax Assessment Act, 1997, § 8-1 (Austl.) (allowing deductions for expenses “necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income”); Income Tax Act 1994 § BB7 (N.Z.) (requiring that any expenditure or loss be “necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income”).

44. Even where there is no domestic rule preventing transfer pricing between related companies, article 9 of their treaties will invariably create such an obligation.

45. See Income Tax Assessment Act, 1997, Div. 170-D (Austl.).

46. See I.R.C. § 183 (2000); Income Tax Assessment Act, 1997, Div. 35 (Austl.).

47. See I.R.C. § 469 (2000); Income Tax Assessment Act, 1997, § 82KZM (Austl.).

48. See Income Tax Assessment Act, 1936, Div. 16K (Austl.).

49. See *infra* text accompanying notes 139-45 (discussing surplus stripping).

50. Similarities should not be surprising. Professor Arnold notes that the Canadian rule was deliberately drafted with the experience of the operation of the Australian rule

cently revised, and display the common design elements needed by a GAAR.

1. *Defining Tax Avoidance*

The first and most obvious requirement is a provision that defines the trigger for activating the GAAR. This means addressing whether the target is a matter to be determined from the form of a transaction, the intent of a party, either, both, or something else entirely. In the 1950s, 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.”⁵¹ This formulation appears to rely only on purpose, not artificiality. In the 1960s, 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.”⁵² This formulation also relies upon intent. In the 1970s, 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.”⁵³ This variant relies on form. In Canada, the debate prior to the introduction of the new GAAR in the late 1980s saw this matter as a clear dichotomy: whether the rule would be made to apply to “artificial” transactions or to transactions entered into primarily for the purpose of avoiding tax.⁵⁴

Three subsidiary issues then need to be addressed. First, if tax avoidance is a matter of intent rather than form, how is intent to be determined? Purpose might be discovered by seeking the subjective intent of the player or determining objectively the intent of the person from the available non-direct evidence. If objective factors are to be examined, it is not uncommon to propose what they are and, sometimes, what they indicate. If tax avoidance is a matter of form, there is a derivative question about triggering the rule: if the rule is not activated by evidence of intent, is subjective intent a valid defense to the application of the rule?

The common answer to this question is that tax avoidance is a purpose-

(with which he was familiar from his work in Australia) in mind. See Arnold, *supra* note 5, at 231 n.23 (“The Australian experience was studied seriously by the Department of Finance during the development of the [Canadian] rule.”); see also J. Scott Wilkie & Heather Kerr, *Common Links Among Jurisdictions: Informing the GAAR Through Comparative Analysis*, in CANADIAN TAX FOUNDATION, 1997 CONFERENCE REPORT ch. 34 (1997).

51. UNITED KINGDOM, ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, FINAL REPORT para. 1024 (1955).

52. CANADA, 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 538 (1966).

53. TAXATION REVIEW COMMITTEE, FULL REPORT (1975).

54. The original draft version of the Canadian GAAR provided that the purpose of the rule was “to counter artificial tax avoidance.” DEPARTMENT OF FINANCE, *supra* note 36, at 214.

based notion.⁵⁵ The purpose that is to be found may be defined as an inappropriate one, as is the rule in Australia, New Zealand, and in the U.K. proposal, or it may be defined in reverse: any purpose except an acceptable one. So, section 245(3) of the Canadian Act defines an “avoidance transaction” as one:

- (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.⁵⁶

The Australian test appears to try to use both form and purpose. That is, the rule is triggered only where, “it would be concluded that the person . . . who . . . carried out the scheme . . . did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme”⁵⁷ But that judgment is apparently to be made “having regard to” an examination of eight listed factors:

- (i) the manner in which the scheme was entered into or carried out;
- (ii) the form and substance of the scheme;

55. Income Tax Act, 1994 § BB9 (NZ) (“every arrangement made or entered into . . . shall be absolutely void as against the Commissioner for income tax purposes if . . . its purpose or effect is tax avoidance”); INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 39 (“a tax driven transaction is a transaction that has as its sole purpose, or as its main purpose, or as one of its main purposes, the avoidance of tax”); *UK Consultative Document*, *supra* note 17, at para 6.6.4 (“This Rule applies to any transaction of which the sole or main purpose, or one of the main purposes, is tax avoidance by a company.”).

56. Income Tax Act, R.S.C., ch. 1, § 254(3) (1985) (Can.).

57. Income Tax Assessment Act, 1936 § 177D(b) (Austl.). The IFS proposal also included a list of objective indicators:

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

Its legal form including the legal rights and obligations created by the transaction; its economic and commercial substance; the expected duration of any step or any feature in the transaction; the change in the financial or other circumstances of the taxpayer or anyone connected with the taxpayer, as a result of the transaction; the expected tax consequences of the transaction on the assumption that this rule does not apply.

INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 39. The proposal in the *UK Consultative Document* mirrored this aspect of the IFS proposal. It proposes:

In determining the purpose of a transaction regard shall be had to the following considerations

- (a) its legal form, including the rights and obligations created by the transaction;
- (b) its economic and commercial substance;
- (c) the time at which any step was entered into and the length of the period during which the transaction was carried out;
- (d) any change in the financial or other circumstances of any person occurring, or which will or may reasonably be expected to occur, as a result of the transaction;
- (e) the tax consequences of the transaction if this Rule did not apply.

UK Consultative Document, *supra* note 17, at para 6.6.4.

- (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;
- (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result, or may reasonably be expected to result, from the scheme;
- (vii) any other consequence for the relevant taxpayer, or 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).⁵⁸

Whether listing purportedly objective factors adds anything to the analysis that a court would likely undertake is doubtful. But having the list does confirm that the investigation is to be based on an objective assessment of purpose, rather than a subjective one, and that purpose is to be found by examining the taxpayer's actions: that form reveals purpose.

The second matter that needs to be addressed is whether a purpose of making an after-tax profit from the transaction is adequate, or whether the taxpayer must also expect to make a pre-tax profit. In other words, how is the rule to deal with a taxpayer who makes a commercial loss or insignificant gain, but whose position is reversed or dwarfed by the tax benefits generated from the transaction?⁵⁹ Taxpayers will invariably argue that their actions are directed for sound commercial reasons to maximizing their total return (inclusive of tax benefits), and pursuing this goal ought to confer immunity from the GAAR, even though much or all of the commercial return emanates from the position. The Australian Courts have decided to reject this as a false dichotomy. In *Spotless Servs. Ltd.*,⁶⁰ the taxpayer deposited surplus funds in a tax haven in order to enjoy the then current foreign income exemption that Australian law afforded. The taxpayer argued that it was entitled to immunity from the GAAR because its commercial purpose was to maximize its overall return: to accept a lower, but lightly-taxed offshore return, in lieu of a higher, but more highly-taxed onshore return. The High Court disagreed:

58. Income Tax Assessment Act, 1936 § 177D(b) (Austl.). Some commentators suggest that the GAAR should also have ruled on what the list means: to which outcome are those items directed, how are they to be applied, and how is the omission of one to be viewed?

59. This is a perennial issue for a tax avoidance doctrine, whether developed judicially or by statute. See, e.g., Alvin C. Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981); David A. Ward et al., *The Business Purpose Test and Abuse of Rights*, 20 TAX'N IN AUSTR. 497 (1986).

60. *Comm'r of Taxation v. Spotless Servs. Ltd.* (1996) 186 C.L.R. 404.

The references in [lower court] on the one hand to a “rational commercial decision” and on the other to the obtaining of a tax benefit as “the dominant purpose of the taxpayers in making the investment” suggest the acceptance of a false dichotomy. . . . A person may enter into or carry out a scheme, within the meaning of [the GAAR], for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.⁶¹

This formulation suggests that the definition of tax avoidance is really: was there a significant non-tax purpose?⁶² That is, was the transaction undertaken principally for reasons other than obtaining a tax benefit? Viewed in this way, the *Spotless* transaction would be avoidance: the investment was made offshore principally for the tax-related reason of enjoying an exempt return.

Constructed in such a way, purpose will usually be an over-inclusive notion. That is, too many taxpayers do too many things in order to reduce their tax, not all of which can be put in jeopardy by a GAAR. So it is not uncommon to see a qualification that the rule is only to be triggered where the taxpayer’s actions also defeat policy goals underlying the provisions being avoided or perhaps the law as a whole.⁶³ For many of the same reasons, there is usually some need to afford safe harbours and provide protection against the unintended application of the rule. So it would be expected that the benefit of explicit elections and choices would generally be preserved.⁶⁴ But is it only explicit elections: for example, is incorporation to access the corporate tax rate an “election” for this purpose? It would also be expected that some forms of incentives might be given special treatment as they are designed to operate as a bribe, encouraging taxpayers to undertake the desired activity by the lure of re-

61. *Id.* at 415.

62. See Arnold *supra* note 5, at 231 (“The essence of the definition of an avoidance transaction is the non-tax purpose test. A transaction . . . is an avoidance transaction unless the transaction is undertaken primarily for purposes other than that of obtaining the tax benefit.”).

63. “The purpose of the rule is to deter or counteract transactions that are designed to avoid tax in a way that conflicts with or defeats the evident intention of Parliament. The rule shall be interpreted and applied in a manner consistent with that purpose.” INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 59.

The Canadian rule allows an overall assessment of avoidance to be made. Income Tax Act, R.S.C., ch 1., § 254(4) (1985) (Can.) provides:

For greater certainty, [the GAAR] 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.

64. Income Tax Assessment Act, 1936 § 177C(2) (Austl.) protects against the application of the GAAR where the taxpayer’s tax benefit “is attributable to the making of an agreement, choice, declaration, election or selection, the giving of a notice or the exercise of an option (expressly provided for by this Act . . .) by any person . . .” *Id.* There is an exclusion, however, if the scheme under challenge is one that was designed to put the taxpayer in the position where he would then be able to make the protected agreement, choice, election, and so on.

duced tax.⁶⁵

There would also be questions about who has the burden of proof to establish the preconditions to the rule's application in court proceedings: must the revenue authorities prove the case for its application, or must the taxpayer establish why it does not apply? The usual procedure seems to be that once the rule is triggered, the burden of disproving its applicability rests with the taxpayer.

2. Tax Benefit

A second element to the design of the GAAR will be a definition of the tax requirement which is avoided so as to give some rise to the unintended benefit. The Australian legislation, when first drafted, defined a "tax benefit" to focus exclusively on transactions which affect the tax base:

- (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 . . . 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 . . . if the scheme had not been entered into or carried out.⁶⁶

But the Canadian drafters were aware that tax benefits might come in a multitude of forms. The Australian rule expressed the obvious ones: that an amount is not included in assessable income, a deduction that should not be allowable is now allowed, or a tax credit is obtained.⁶⁷ But one could expect that taxpayers would also play timing games where income is deferred or deductions and credits advanced. And there are other less obvious options: tax arbitrage opportunities where amounts remain included in income, but now enjoy either a different character or a different source.⁶⁸ There might even be administrative advantages: for example, deferring the time at which tax installments might become payable, delaying the time at which a return is due, arranging to meet lesser compliance

65. The IFS proposal contained the notion of a "protected transaction." A "protected transaction" was defined as one that would satisfy any of these tests:

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

INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 60.

66. Income Tax Assessment Act, 1936, § 177C (Austl.).

67. See George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657 (1985) (arguing that most tax shelters and by inference tax avoidance schemes rely upon the combination of three elements: the deferral of gain by incurring large tax deductions in the early years of any scheme; any gain which must be taxed ought to be converted into capital gain rather than be taxed as income (arbitrage); and leverage).

68. This is explicitly dealt with in Canada. Income Tax Act, R.S.C., ch. 1, § 245(5)(c) (1985) (Can.) ("the nature of any payment or other amount may be recharacterized").

standards in relation to substantiation or verification procedures, arranging to file a return which requires less searching disclosures, or arranging so that whatever penalties might be applied would be low. More conjectural is how to deal with the territorial scope of the GAAR: whether it would be constructed to apply to schemes designed to avoid the tax of another country. There might be questions about the significance if any to be attached to differences between the formal and effective incidence of a tax: whether avoiding a withholding tax is avoidance only if it is done by the recipient of the payment, rather than say, by the payer.⁶⁹ The list of possible tax benefits is endless.⁷⁰ Consequently, the Canadian rule when drafted referred to any “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.”⁷¹

3. *Power of Reconstruction*

One of the most important parts of a standard GAAR is the provision permitting the revenue authority to reverse the tax outcome that has occurred, and substitute one of the possible tax outcomes that might have

69. For example, in Australia, the Income Tax Assessment Act, 1936, § 177CA (Austl.), now includes avoidance of a withholding tax liability.

70. The potential application of the rule to a wide variety of tax benefits was not addressed in the IFS proposal; it contained no definition of tax. INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 60. The *UK Consultative Document* was able to find a suitable definition. It suggested a definition looking both at the tax base and at compliance measures:

- (1) For the purposes of this Rule *tax avoidance*, in relation to a company, means—
 - (a) not paying tax, paying less tax or paying tax later than would otherwise be the case, or
 - (b) obtaining repayment or increased repayment of tax, or obtaining repayment earlier than would otherwise be the case, or
 - (c) obtaining payment or increased payment by way of tax credit, or obtaining such payment earlier than would otherwise be the case.
- (2) References in this Rule to tax avoidance include creating a loss or other amount with a view to tax avoidance in another accounting period or by another company.

UK Consultative Document, *supra* note 17, at para. 6.5.2.

71. Income Tax Act, R.S.C., ch 1, § 245(1) (1985) (Can.) (definition of “tax benefit”). The Australian rules followed suit and now refer to:

- (ba) a capital loss being incurred by the taxpayer during a year of income where the whole or a part of that capital loss would not have been, or might reasonably be expected not to have been, incurred by the taxpayer during the year of income if the scheme had not been entered into or carried out; or
- (bb) a foreign tax credit being allowable to the taxpayer where the whole or a part of that foreign tax credit would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer if the scheme had not been entered into or carried out.

Income Tax Assessment Act, 1936, § 177C (Austl.).

Indeed, there is a proposal in the current tax reform to widen the definition even further. Recommendation 6.3 of REVIEW OF BUSINESS TAXATION, A TAX SYSTEM REDESIGNED (1999) recommends, “that the definition of a tax benefit be expanded to cover any reduction or deferral of tax payable, including through tax rebates and credits or losses.” *Id.*

occurred.⁷² In Canada, this was expressed in quite general terms: "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"⁷³

This provision appears to focus only on denying tax benefits, and does not explicitly focus on reconstructing the tax outcomes of a transaction that did not take place. A subsequent provision confers an explicit power to re-allocate income and expenses, and to recharacterize amounts.⁷⁴ And there will usually be a further provision allowing second-order adjustments to reverse any positive tax outcome already reported by an-

72. Income Tax Act, 1994 § GB1 (N.Z.) ("Where an arrangement is void in accordance with section BB 9, the assessable income of any person affected by that arrangement shall be adjusted [in] such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement."). The Australian provision, prescribes explicit (and thus potentially limited) powers of reconstruction:

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

- (a) . . . determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or
- (b) . . . determine that the whole or a part of the deduction . . . shall not be allowable to the taxpayer in relation to that year of income; or
- (c) . . . determine that the whole or a part of the capital loss . . . was not incurred by the taxpayer during that year of income; or
- (d) . . . determine that the whole or a part of the foreign tax credit . . . is not to be allowable to the taxpayer . . .

Income Tax Assessment Act, 1936, § 177F (Austl.).

The IFS Proposal, which was followed in the *UK Consultative Document*, proposed a basic reconstruction rule:

where a person carries out a tax driven transaction, he shall be taxed as if he had carried out the normal transaction. . .

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

UK Consultative Document, *supra* note 17, at para. 6.8.1. The *UK Consultative Document* proposed:

6.8.2. Where a transaction is caught by the GAAR, the legislation would need to determine the tax implications of its being caught. The way to approach this may be to recharacterise it for tax purposes. There could be two alternative recharacterisations, depending on whether the tax-driven transaction also has a substantial legitimate commercial purpose (i.e. a genuine business purpose other than tax avoidance). If it does, then the recharacterisation is based on the "corresponding normal transaction. . .

6.8.3. The "corresponding normal transaction" is a hypothetical transaction which would have achieved the same or similar substantial commercial objectives as the actual (tax-driven) transaction, and which would have been carried out if tax avoidance had not been a consideration.

UK Consultative Document, *supra* note 17, at paras. 6.8.2 – 6.8.3.

73. Income Tax Act, R.S.C., ch. 1, § 245(2) (1985) (Can.).

74. See *id.* § 245(5).

other party to the scheme.⁷⁵

Exercising this power to reconstruct requires a judgment to be made by someone about the result that would have occurred without the avoidance, foreshadowing possible problems if that conjecture is flawed in some way.⁷⁶ For example, a general power to recreate the tax outcomes of a transaction that did not occur will presumably have to be exercised in some way that is reasonable and be subject to court scrutiny in the same way as the exercise of discretions exercised by any administrative agency. Moreover, it is always likely that there will be more than one plausible counter-factual hypothesis. What is the administrator to do in that case? There may be an explicit requirement that the transaction which is taxed is the one that is the most likely to have occurred, but for the scheme. Or there may be an explicit requirement that the transaction which is taxed is the one that would result in the next lowest tax payable.⁷⁷ There is also a potential problem with all counter-factual hypotheses: in the case of the most blatant marketed schemes, the most likely counter-factual is that there would not have been any transaction at all.⁷⁸ The common approach is to confer a wide-reaching power of reconstruction and hope that the exercise of the power can only be impugned on the usual administrative law grounds.

If a GAAR is to be articulated, there are issues about its interaction with the rest of the tax system and the rules already in existence which either deny tax benefits or confer powers to reconstruct transactions. What impact is the GAAR intended to have on existing judicial doctrines? It might be thought that the GAAR could be drafted in such a way that existing judicial doctrines could be immunized from any effect.

75. See Income Tax Assessment Act, 1936, § 177F (Austl.); Income Tax Act, R.S.C., ch. 1, § 245(6) (1985) (Can.).

76. This requirement lay at the heart of the defeat of Australia's first High Court appeal on the new GAAR. The counter-factual suggested by the Commissioner was viewed by the High Court as implausible and so the power was not properly exercised. See *Peabody v. Comm'r of Taxation* (1994) 181 C.L.R. 359.

77. The IFS proposal suggested the lower tax alternative: "if there are two or more alternative transactions that satisfy this description, then the transaction that would be least burdensome to the taxpayer in terms of tax shall be taken as the normal transaction." INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 60. The *UK Consultative Document* thought that this option "could lead to unnecessary argument and uncertainty, and the solution may therefore be to allow the taxpayer to choose between alternatives." *UK Consultative Document*, *supra* note 17, at para 6.8.7.

78. The Australian GAAR requires the construction of a (more highly taxed) counterfactual to the transaction actually undertaken, in order to trigger would-be operation of the GAAR. Although the legal architecture is different, the same argument could be made—there is no basis for triggering the rule because the most likely counterfactual is that nothing would have occurred. In order to eliminate this line of defense, the recent Review of Business Taxation recommended that it be explicitly removed as an argument. See REVIEW OF BUSINESS TAXATION, A TAX SYSTEM REDESIGNED 246 (1999) ("Currently, in order to demonstrate the existence of a tax avoidance scheme, the Commissioner of Taxation is required to construct a reasonable alternative transaction or counterfactual which does not give rise to the tax benefit. In some tax avoidance cases promoters of the scheme have argued that the reasonable alternative to the scheme may be that the taxpayer would not have done anything. The recommendation will confirm that this is not the case".).

And while that may be true, it might nevertheless lead to the stultification of any future judicial developments.⁷⁹ This dilemma was one part of the U.K.'s reluctance to proceed with a GAAR.

Secondly, some relationship would need to be established between the GAAR and other specific statutory anti-avoidance rules. One obvious interaction would be to construct the GAAR as the rule to be applied only when no specific rule existed. Where a specific rule existed, it would be a code for defining those circumstances where the transaction might be reconstructed. This would lead to the position that, if the taxpayer had passed the requirements of a specific rule, the GAAR should also be rendered powerless. But that is an implausible position to adopt. Consequently, it is not uncommon for a taxpayer to find itself in the position that it must meet both the specific anti-avoidance rule and the GAAR, before a tax outcome is won.⁸⁰

4. *Issues of Administration*

Another set of issues surrounds the process of administering the GAAR in a self-assessment tax environment. Clearly the rule will be applied to a taxpayer in retrospect by a decision of the revenue authorities, not self-applied. This may involve more formal procedures, or the allocation of decision-making powers to a more senior level in the bureaucracy, than would apply to the making of other administrative decisions.⁸¹ And if the power is only to be exercised in a special manner, should the decision to invoke it then be made susceptible to further challenge, or should only the merits of the underlying transaction be subject to judicial review?⁸² There is no common answer to these questions.

79. For example in *Oakey Abbattoir Pty. Ltd. v. Commissioner of Taxation*, the Full Federal Court found that it could not import into Australian law the doctrine of fiscal nullity developed in the U.K. in the presence of Australia's GAAR. 15 A.T.R. 1059 (1984) ("[I]n our opinion, the *Ramsay* and *Furniss* principles should be perceived as no more than rules governing the statutory interpretation of the United Kingdom legislation for the taxation of capital gains. As such, they have no immediate impact upon the Australian Act. Further, given the presence of [the GAAR] (a matter adverted to in argument and by Lord Wilberforce in *Ramsay*), and given the doctrine of economic equivalence underlying the approach of the House of Lords, we do not think that this approach affords any useful analogy in the present case, save to point to the possibility that [the GAAR] might well apply here.").

80. See generally Graeme S. Cooper, *Conflicts, Challenges and Choices — The Rule of Law and Anti-Avoidance Rules*, in *TAX AVOIDANCE AND THE RULE OF LAW* 13, 38-39 (Graeme S. Cooper ed., 1997).

81. The IFS proposed that the U.K. GAAR should be invoked only by the Commissioner of Inland Revenue, in order to ensure consistency of application. INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 61. The *UK Consultative Document* said, "[t]hat seems a reasonable suggestion, and could be incorporated into legislation. In that case the authority of the Board would be delegated to a section of the Inland Revenue's Head Office, which would have to approve any determination or assessment where the GAAR applied." *UK Consultative Document*, *supra* note 17, at para 7.1.

82. The IFS proposal had not only a centralized and high-level decision-making requirement, it also permitted to request the formal review of the decision by the Commissionerrrs, and further appeals against the decision to the standard quasi-administrative tax appeals body. The *UK Consultative Document* thought such procedural fairness was un-

Another administrative decision is whether the revenue authority will issue prospective guidance about the circumstances in which the GAAR will (and will not) be applied. If much of the force of a GAAR lies in its *in terrorem* effect, issuing detailed administrative reassurances about the circumstances when the rule will not be triggered is not likely to be attractive, but some form of assurance may be demanded as part of the price of securing a satisfactory level of political support. Consequently, it might be expected that taxpayers would be afforded some mechanism for seeking prior transaction-specific clearances. For example, in Australia it is possible for taxpayers to secure private rulings on transactions that will include a GAAR immunity.⁸³ Another measure which could be either an alternative or supplement to solicited rulings is a reporting requirement imposed on the revenue authority: that as the rule is applied, decisions about its application might be reported for the future guidance of taxpayers. The IFS proposals for the U.K. would have seen both the power to seek a prior clearance from the rule, and a subsequent reporting regime.⁸⁴ There is another side to this issue: is it possible for meaningful administrative decisions to be made *en masse* concerning the application of the GAAR? It is not uncommon in Australia for the revenue authority to issue Public Rulings purporting to trigger or preclude the application of the GAAR for classes of transactions.⁸⁵ The obvious difficulty

necessary, given that the original decision would only be made a senior level in the hierarchy. It suggested:

[A] review by the Board might be superfluous if application of a GAAR could only be done in the Inland Revenue's Head Office in the first place. . . . Since a GAAR would only have effect through one of the existing mechanisms for making a determination, assessment, etc., the existing appeals machinery can apply. It does not seem necessary, therefore, to have a special appeals procedure

UK Consultative Document, supra note 17, at para 7.3.

83. The Commissioner will routinely issue private rulings that the GAAR does not apply to a proposed transaction. Some of the difficulties of this practice were remarked upon by the Full Federal Court in *Bellinz v. Commissioner of Taxation*. It said:

While there is nothing to suggest that in an appropriate case a ruling could not issue on [the GAAR], both the Commissioner and the taxpayer must be aware of the difficulty which a private ruling on a [GAAR] issue will create. Section 177D(b) sets out the various matters to which the Commissioner shall have regard in reaching the conclusion that a person or more than one person entered into or carried out the scheme or any part of the scheme for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with it. One of those matters is 'the manner in which the scheme was entered into or carried out.' Where the arrangement in respect of which a private ruling is sought has not yet been carried out, it is difficult to see how there could be adequate facts upon which to base a private ruling. Even where the scheme has been carried out, there may in many cases be difficulty in obtaining all relevant facts, particularly those relating to the manner in which the scheme was entered into or carried out. In the present circumstances there is no need to consider these difficulties.

39 A.T.R. 198 (1998). The practice continues.

84. See INSTITUTE FOR FISCAL STUDIES, *supra* note 3, at 62-63.

85. See, e.g., Taxation Ruling IT 2635 (in relation to syndicated R&D schemes); Taxation Ruling IT 2643 (wash sales of shares in companies in liquidation in order to triggering losses earlier).

with such a proclamation is that if tax avoidance is a matter based on the taxpayer's purpose, that matter can presumably only be found on a case by case basis.

Finally, what will be the interaction between the rule, once triggered, and the level of under-statement penalty? Does attracting the GAAR have the effect of exacerbating the level of penalty? It might be argued that a transaction which is impugned only at the last hurdle might deserve more lenient rather than harsher treatment, when compared to a transaction for which there is less support. But, except in Canada, triggering the GAAR increases a taxpayer's culpability.⁸⁶

This catalogue of design issues shows a high degree of convergence and similarity to the design features of the GAAR in the four countries examined: a series of common issues, addressed using a similar approach, and with a common legal lexicon.

B. THE U.S. CORPORATE TAX SHELTER PROPOSALS

To a commentator familiar with these design features for GAAR measures, the current U.S. Treasury proposals seem at first glance an idiosyncratic approach to a shared problem. Of course, a plausible explanation for the divergence may be that the proponents of the U.S. measures take the view that they have different problems from the ones that a GAAR is usually enacted to address.⁸⁷ The U.S. Treasury's assessment of the U.S. position seems to be that the problem in the U.S. is not tax avoidance *per se*, but rather the marketing of tax avoidance and its concealment.⁸⁸ This may be an accurate assessment of the U.S. problem, but marketed tax schemes are simply a subset of the transactions against which a GAAR is usually employed. Be that as it may, my purpose here is to contrast the design elements just examined with the U.S. proposals.

86. See INSTITUTE FOR FISCAL STUDIES, *supra* note 3, ch. 6; Income Tax Assessment Act, 1936, § 224 (Austl.); s. BG1(2) ITA (NZ). The IFS considered but made no recommendation about the relationship between the GAAR and the level of penalty. The *UK Consultative Document* was completely silent on the issue.

87. For example, Bankman says that the target of the U.S. proposals—the corporate tax shelter—is defined by reference to six characteristics: “the shelter provides a certain tax loss for an investment with little or no [commercial] risk,” the parties to the transaction are a domestic corporation and another person facing a zero or minimal marginal tax rate; the transaction will usually be constructed to draw upon a rule which generates and allocates an amount of tax income which exceeds economic income; the transaction might instead rely upon a “structural flaw” in the allocation of income from partnerships, companies or countries; the transaction is a generic transaction intended to be marketed to companies; and when discovered, the transaction will “be shut down by [appropriate] legislative or administrative” measures. Joseph Bankman, *The New Market in U.S. Corporate Tax Shelters*, 18 TAX NOTES INT'L 2681, 2682 (1999). Trier argues that corporate tax shelters consist principally of four main types of transactions: loss-generating transactions, loss-accelerating transactions, tax-driven corporate financing instruments, and gain-offsetting transactions. See Trier, *supra* note 22, at 66. Similarly, Kleinbard suggests that insofar as the current examples of corporate tax shelters are driven by tax base problems, they are idiosyncratic problems depending on deficiencies in particular provisions of the Code (and thus not well addressed by generic approaches). See Kleinbard, *supra* note 22.

88. See Kleinbard, *supra* note 22 (arguing that the 2000 Budget Proposals mix the problems of corporate tax shelters with corporate tax collections).

I will focus on the five main proposals that are being considered in the U.S. during the protracted process currently underway to try to bring these measures to a conclusion. They are the proposals (a) to codify the economic substance doctrine, (b) to increase the disclosure to the IRS of certain targeted transactions, (c) to increase the substantial understatement penalty for users of corporate tax shelters, (d) to impose a penal excise tax on fees received by promoters from the marketing of corporate tax shelters, and (e) to impose tax on the income of tax-exempt and foreign taxpayers (referred to as “tax-indifferent parties”) who are involved as participants in corporate tax shelters.

These proposals are no doubt the visible manifestation of a larger flurry of activity that has been in progress since at least early 1999. There are four milestones in the visible part of the current battle against corporate tax shelters. The first was the announcement of the Clinton Administration’s Budget proposals for the 2000 fiscal year released on February 1, 1999.⁸⁹ It was followed by a White Paper on *The Problem of Corporate Tax Shelters* in July 1999,⁹⁰ another set of Budget proposals for the 2001 fiscal year released on February 7, 2000,⁹¹ and the release of Proposed and Temporary Regulations providing for the disclosure of various transactions considered likely to involve tax shelter elements.⁹²

The five proposals were modified after their release in 1999, so I will focus on the current version. While the details have changed, the common themes have remained largely unchanged: a serious attempt to find an objective way to define a corporate tax shelter, premised upon quantifiable “tax avoidance,” and then empowering the IRS to attack the tax outcomes of the arrangement—to penalize the corporation involved, to penalize the advisers who put it together, and to penalize other participants in the shelter.⁹³ The changes to detail are principally in the latter three elements.

89. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S REVENUE PROPOSALS (1999) [hereinafter *2000 Budget Proposals*].

90. *White Paper*, *supra* note 3.

91. The government’s 1999 proposals were reformulated in the 2000 “Green Book.” See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2001 REVENUE PROPOSALS 122-38 (2000) [hereinafter *2001 Budget Proposals*].

92. See Temp. Treas. Reg. § 1.6011-4T (2000) (requiring taxpayer reporting and record-keeping); Treas. Reg. § 301.6111-2T (2000) (registration of confidential corporate tax shelters); Treas. Reg. § 301.6112-1T (2000) (lists of investors in potentially abusive tax shelters). The proposed regulations are in identical form. See Tax Shelter Disclosure Statements, 65 Fed. Reg. 11,269 (proposed Mar. 2, 2000) (to be codified at 26 C.F.R. pt. 1); Corporate Tax Shelter Registration, 65 Fed. Reg. 11,272 (proposed Mar. 2, 2000) (to be codified at 26 C.F.R. pt. 301); Requirement to Maintain List of Investors in Potentially Abusive Tax Shelters, 65 Fed. Reg. 11,271 (proposed Mar. 2, 2000) (to be codified at 26 C.F.R. pt. 301).

93. It was apparently an important part of the proposal to impose costs on all the players in the tax shelter, not just on the taxpayer. See Lee A. Sheppard, *Giving and Taking on Corporate Tax Shelters*, 18 TAX NOTES INT’L 1330 (1999) (referring to comments of the then Deputy Secretary of the Treasury Lawrence Summers).

1. *Defining Tax Avoidance*

The measures in the 2000 Budget Proposals began from a definition of what would constitute a corporate tax shelter: "any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction."⁹⁴ A "tax-avoidance transaction" would be defined as any transaction in which the reasonably expected pre-tax profit arising from a transaction would be insignificant when compared to the reasonably expected net tax benefits resulting from that transaction. This computation would be undertaken by calculating economic benefits on a net present-value basis, and treating foreign taxes and transaction costs as expenses. A tax avoidance transaction also would include certain transactions involving the "improper elimination or significant reduction of tax on economic income."⁹⁵

This formulation has remained largely intact throughout the ensuing debate. In the 2001 Budget Proposals, the intermediate step of defining a tax shelter was abandoned but the quantitative test remained.⁹⁶ The test though was now expressed to be the codification of the economic substance doctrine (a proposition which some have doubted), rather than a definition of tax avoidance, thus trying neatly to sidestep the perennially-asserted problem that no verbal formula can adequately and accurately encapsulate the idea of tax avoidance.⁹⁷ The proposal would attack,

[A]ny transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the taxpayer from the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of the taxpayer from such transaction.⁹⁸

This definition of a suspect transaction is interesting because it is a quantitative test. It operates by comparing the reasonably expected pre-tax profit from a transaction with the reasonably expected net tax benefits. It is not a test based on form, nor on intent. Instead, it looks only for what in other countries would be viewed as the tax benefit arising from tax avoidance and imposes the various consequences where the benefit is found.

This quantitative approach provides an interesting contrast to the approach taken in other jurisdictions. Yet it does have some resonance with the Australian High Court's view that the pursuit of an overall profit,

94. 2000 Budget Proposals, *supra* note 89, para 364.

95. *Id.*

96. In the *White Paper*, Treasury abandoned the decision to commence its proposals from the definition of "corporate tax shelter." Instead, Treasury decided to codify the "economic substance" test. Earlier proposals denying deductions for promoters' fees and imposing an excise tax on rescission agreements were also abandoned.

97. N.Y. State Bar Ass'n Tax Section, *supra* note 33.

98. 2001 Budget Proposals, *supra* note 91, para. 622.

where it is the tax component that drives the profit, can still be avoidance. Elsewhere, as was noted above, tax avoidance is usually constructed as a matter that depends upon finding evidence of conscious planning: tax avoidance requires a *mens rea*.⁹⁹ If a taxpayer's purpose is not relevant in finding avoidance, the potential scope for the application of the rule is expanded quite substantially. It might potentially apply to deny the tax benefits of transactions that are not tax-motivated. And the nature of the court's inquiry in any dispute involving the rule is commensurately narrowed. Courts would not need to become embroiled in long evidentiary inquiries to find the taxpayer's intent before the rule is triggered. Moreover, it appears that the presence or absence of a "business purpose" would not be relevant even in attempting to save a transaction from the application of the rule where the taxpayer had encountered an unintended tax benefit.

But this idea that tax avoidance is a purposive notion is not an easy one to eradicate.¹⁰⁰ It is interesting, therefore, to see in the Regulations requiring the registration of corporate tax shelters by promoters, that one group of transactions which must be registered is that where a significant purpose of the structure of the transaction "is the avoidance or evasion of Federal income tax" for a direct or indirect corporate participant."¹⁰¹ It is odd to see a purpose test reappear in setting the obligations of the promoters, rather than the participants.

The formula requires comparing the pre-tax commercial profit to the reasonably expected tax saving. If the former is small and the latter large, avoidance would exist. The archetypal case would presumably be a taxpayer who invests \$40 million (of which he recovers \$39 million immediately) but remains entitled to tax deductions based on the full \$40 million spent. Assuming a marginal tax rate of 35%, this equates to a tax saving of \$14 million for an outlay of \$1 million, and one might conclude the rule is triggered. But the kind of numerical comparison which the formula suggests may lead to some odd outcomes. Applying the formula could lead to the conclusion that expensive tax shelters might be acceptable while cheap ones are not. So, if the taxpayer invests \$40 million (of which it recovers only \$27 million) and it secures tax deductions based on \$40 million spent, this equates to a tax saving of \$14 million for an outlay of \$13 million. Can it now be said that the pre-tax profit is insignificant relative to the reasonably expected net tax benefits? It cannot be the intention of the proponents that such a transaction would fail.

99. Tax advisors will often distinguish between motive, purpose, and intention. The point is to try to distinguish what might be thought of as the objective outcomes that resulted from an action, from the desired outcomes. John F. Avery Jones, *Nothing Either Good or Bad, But Thinking Makes It So—The Mental Element in Anti-Avoidance Legislation*, 1983 BRIT. TAX REV. 9, 113.

100. Indeed, some suggest that it is not even desirable to try to eradicate it. See N.Y. State Bar Ass'n Tax Section, *supra* note 33.

101. Temp. Treas. Reg. § 301.6112-1T (2000).

One unquantified term in the definition is “insignificant,” but that is unlikely to prove difficult for a court to assess, or for taxpayers and their advisors to predict. A similar issue would arise in identifying the range and value to be ascribed to the likely benefits that are “expected” to arise from a transaction.¹⁰² Again, it is by no means heroic to believe that a court would be able to distinguish the boundaries of this term.

A quantitative test also means that defining the scope of the relevant “transaction” is crucial.¹⁰³ In performing such a computation, one needs to know how many of a planned series of steps might need (or be able) to be examined, and over how long. This has been a common question of the statutory GAARs elsewhere, but it is not one that has troubled courts significantly.

2. *Disclosure Measures*

The next element of the current proposals, the disclosure measures, is again an interesting departure from the international approach to dealing with avoidance. The proposal currently contains two sets of measures: one requiring taxpayers to report various targeted transactions, and the other requiring the registration of various products by promoters and the identification of them by the clients to whom they have sold these products.

The disclosure of transactions has gradually assumed greater importance in the measures directed against tax shelters. In the 2000 Budget Proposals, disclosure formed one aspect of the proposed changes to the penalty rules. The penalty for the substantial understatement of tax was to be increased, but the penalty would then be reduced if the taxpayer disclosed the transaction to the IRS, noted this disclosure in his return and annotated his return to show the differences between financial and tax income resulting from the shelter. But with the release in July 1999 of the White Paper, a policy of ensuring the disclosure of transactions which bore certain features was given greater prominence. The 2001 Budget Proposals elevated increased disclosure to the first of the measures needed as the solution to the problem, still enforcing the disclosure through increased penalties for non-disclosure. Before the month was over, Temporary and Proposed Regulations were released to impose three reporting obligations: requiring taxpayers to report tax avoidance transactions and potential shelter transactions, requiring the promoters of confidential corporate tax shelters to register them with the IRS, and requiring the promoters to keep lists of investors involved in potentially abusive tax shelters.¹⁰⁴

The reporting requirement is to be driven by a set of “objective characteristics identified by the Treasury Department and others as common in

102. See N.Y. State Bar Ass'n Tax Section, *supra* note 33.

103. Alan Shapiro et al., *Clinton's Budget: Tax Increases for the New Millennium*, 18 TAX NOTES INT'L 691, 695-96 (1999).

104. See *supra*, Treasury Regulations in note 92.

many corporate tax shelters.”¹⁰⁵ In the 2001 Budget Proposals, taxpayers would be required to disclose transactions which possess:

[A] book/tax difference in excess of a certain amount; a rescission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits (other than customary representations and warranties found in non-shelter transactions); involvement with a tax-indifferent party; contingent advisor fees or fees in excess of a certain amount; a confidentiality agreement; the offering of the transaction to multiple taxpayers (if known or the taxpayer has reason to know); a difference between the form of the transaction and how it is reported (with exceptions for certain specified common transactions where the form and the reporting differ, such as repurchase agreements). . . .¹⁰⁶

The Regulations give effect to this idea by defining two groups of “reportable transactions” in much the same terms as the Budget announcement.¹⁰⁷ Interestingly, the Regulations allow an exemption from reporting based at least in part on the taxpayer’s purpose. One exemption arises where the taxpayer has entered the transaction in the ordinary course of its business and in the usual commercial form, and the taxpayer decides that it would have done exactly the same deal “irrespective of the expected Federal income tax benefits.”¹⁰⁸ Other exceptions arise when the taxpayer reasonably believes that there is “a long-standing and generally accepted understanding that the expected . . . tax benefits . . . are allowable under the Internal Revenue Code for substantially similar transactions” or “that there is no reasonable basis under Federal tax law for denial of any . . . of the expected . . . tax benefits.”¹⁰⁹

The underlying idea has now become that if taxpayers are obligated to disclose their tax positions to the authorities, the authorities will be able to counter what they see using current law. This was an interesting *volte face* because of the view expressed earlier in the debate that disclosure alone proved inadequate to deal with shelters and so substantive rule changes were needed.¹¹⁰ It is specifically asserted in the Regulations that

105. *White Paper*, *supra* note 3, para. 606.

106. *Id.*

107. The first group consists of transactions substantially similar to transactions that are currently reportable under I.R.C. § 6011. The second is a transaction that involves any two of these features: a confidentiality agreement, a form of contractual protection against loss, promoter fees in excess of \$100,000, a difference between accounting and tax income of more than \$5 million, the likely involvement of a tax indifferent party, and cross-border differences in reporting the transaction. Temp. Treas. Reg. § 1.6011-4T(b)(3)(I)(A)-(F) (2000).

108. Temp. Treas. Reg. § 1.6011-4T(b)(3)(ii) (2000).

109. *Id.*

110. *Id.* See, for example, the comments attributed to Assistant Treasury Secretary Donald Lubick: “Our proposals target transactions that make use of these common indicia in an effort to deter tax shelter transactions. This, we hope, will provide an ex ante solution to the corporate tax shelter problem.” Amy Hamilton, *Shelter Debate Is About Rules vs. Standards*, Lubick Says, 18 TAX NOTES INT’L 1247 (1999). Similar sentiments are attributed to Assistant Secretary Lawrence Summers, “The administration further recognizes that existing disclosure rules are ineffectual, and wants attention-getting sanctions for

reporting does not indicate acquiescence nor does it offer a safe harbour: reporting "shall not affect the legal determination whether the tax benefits claimed with respect to the transaction are allowable."¹¹¹ This is, with respect, a very "American" approach and shows a very robust view about the curative powers of disclosure. And it may be that the victories of the IRS in the recent tax avoidance cases vindicate this view that knowledge of transactions is all that is needed. Other countries lack this level of confidence, so an important part of the function of a GAAR in the legal system is the denial and reconstruction powers it confers.

But, there is one important respect in which the U.S. approach is less robust than that sought by those countries which use a GAAR. One of the common complaints about the ability of tax authorities to deal with tax shelters is the invariable U.S. practice of protecting from any remedial rules those transactions which have already commenced.¹¹² The obvious policy is one against retrospective taxation. But those countries which employ a GAAR do so principally because they wish to put taxpayers on notice that such protection is not to be afforded to them: there is to be no protection for the first ones into a scheme. The adequacy of the warning and the degree of prospectivity that a GAAR establishes is of course rather meagre, but it is a deliberate part of the choice to use one.

3. *Changing the Costs and Benefits for Participants*

The third leg of the attack on corporate shelters is the decision to increase costs and remove safe harbours for participants in them, beginning with the taxpayer purchasing the shelter. Doing so, of course, changes the expected cost-benefit calculus for participants, in the hope that it will discourage some taxpayers at the margin from purchasing the offered shelter.

Increasing the "cost" part of the cost-benefit equation might have involved changes to either the tax base or the penalty regime. Three possible lines of attack expanding the tax base were originally advanced; none survived. First, the 2000 Budget Proposal contained a proposal that section 269 of the Code would be amended to create a discretionary power to disallow a deduction, tax credit, or income exclusion obtained in the tax-avoidance transaction. This proposal was examined in the White Paper, the degree of opposition to it noted, and by the time of the 2001 Budget Proposals had disappeared. This decision was consistent with the change of emphasis from substantive remedial powers to disclosure as a sufficient measure to address the problem. Another line of attack suggested in the 2000 Budget Proposals was that fees paid to promoters for advice regarding corporate tax shelters not be deductible as business ex-

failure to disclose." Lee Sheppard, *Giving and Taking on Corporate Tax Shelters*, 18 TAX NOTES INT'L 1330, 1331 (1999).

111. Temp. Treas. Reg. § 1.6011-4T(a) (2000).

112. See Bankman, *supra* note 87, at 2697. The 2000 Budget Proposals and 2001 Budget Proposals reflect this approach, making them applicable only to acts occurring after the proposals take effect.

penses. Again, this measure evaporated into the ether. Another line of attack suggested in the 2000 Budget Proposals was that corporations which purchased shelters from promoters would be subject to a 25% tax on any payments that might be made under a tax guarantee clause or other arrangement designed to protect the taxpayer from losses due to unsuccessful shelters. The tax would be imposed on the maximum amount the taxpayer could collect if the tax benefit alleged under the shelter were denied. Again, this measure disappeared.

Instead, what has survived are the measures designed to increase costs for taxpayers using the penalties imposed elsewhere for the substantial understatement of income likely to result from using a shelter. These measures form part of the disclosure strategy: taxpayers would be liable to pay a 40% penalty where they participated in a corporate tax shelter and as a result substantially underpaid tax. The 40% penalty would be reduced to 20% where the taxpayer had filed the necessary reports under the reporting rules.

Moreover, the 2001 Budget Proposal would also change the value of the “insurance” against penalties offered by the legal opinions accompanying marketed tax shelters. Section 6664(c) allowed a so-called “reasonable cause exception” to any penalty:

No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

Regulations attempted to elaborate this test in the case of tax shelter items, allowing the exception to be triggered where:

a corporation reasonably relies in good faith on the opinion of a professional tax advisor, . . . the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.¹¹³

Although the regulations carefully spelled out that an opinion would not of itself be sufficient to confer immunity, in practice there was apparently a widespread view that protection against penalty would be available where the promoter was able to offer the buyer a bona fide legal opinion from a qualified advisor that the position alleged to follow from the shelter was “more likely than not” correct.¹¹⁴

The 2001 Budget Proposal was somewhat short on detail about when a bona fide opinion would in future confer immunity from the substantial understatement penalty. It said that the taxpayer would be able to avoid a penalty only where he “had a strong chance of sustaining his position and acted in good faith.”¹¹⁵ This was said to be a “modification” and

113. I.R.C. § 1.6664-4(e)(2)(i)(B)(2) (2000).

114. The process is described in Bankman, *supra* note 87, at 2681.

115. 2001 Budget Proposals, *supra* note 91.

“strengthening” of the existing rule.

There are two points which emerge from this proposal. First, the status afforded to the opinions of tax advisors in the imposition of penalties is clearly a matter on which tax systems can have different views. Australia, for example, gives them no credence *per se*,¹¹⁶ and even U.S. commentators have admitted their unreliability when rendered in connection with a shelter.¹¹⁷ There is no ineluctable link between tax avoidance or its absence, and opinions of professional advisors. Second, there is another and separate policy judgment to be made about the interaction between participation in defined shelters and the imposition of penalties. In Australia, for example, the imposition of tax using the GAAR automatically triggers a 25% penalty.

4. *Penalties on the Promoters*

The next line of attack is directed against the promoters of shelters. The attack on the promoters is in the form of a 25% tax imposed on the gross fee income derived from promoting shelters and the provision of advice in relation to them.

Under current law, the promoter of a shelter presumably incurs deductible items as its principal costs (salaries, legal fees, office overheads, and so on) and pays tax on its net “sales” income after allowing these expenses. So, if its expenses were, say, \$10 million and it was able to sell the product to 20 corporations for \$1 million each, it would pay income tax, assuming a 35% tax rate, of \$3.5 million. Applying a 25% excise tax to its \$20 million gross fee income and denying deductions for the expenses against fee income and all other income, would raise the tax cost to \$5 million, and the effective tax rate from 35% to 50%.¹¹⁸

This is an interesting approach because it addresses the supply side of the tax shelter market. Whether this will prove as effective as the measures against buyers is debatable; it seems much less likely to be a serious deterrent when the seller’s gains are potentially so large. It would still be preferable to develop and market shelters if the seller made a lower after-tax return at ordinary tax rates from its next most profitable activities.

None of the other countries examined above uses the tax base as the principal means of dealing with promoters. Instead, the more usual ap-

116. See Income Tax Assessment Act, 1936, § 222C(4) (Austl.), which limits the “relevant authorities” for the purpose of deciding whether a taxpayer held a reasonably arguable position to only the text of the income tax law, material forming part of the legislative history, decisions of Australian and foreign courts, and formally issued public rulings.

117. Kleinbard, in a more far-reaching suggestion, proposes that a taxpayer should only be allowed an opinion from a tax advisor if the opinion was not proffered by the promoter, is made on the basis of a statement of all the facts, and the advisor is not remunerated by a percentage of purported tax saving. Kleinbard, *supra* note 22.

118. The proposal does not state what changes if any are proposed for the treatment of the expenses incurred by promoters of the products. It says simply that sales revenue will be taxed at a flat rate of 25% under an excise tax. This presumably means all expenses are denied against any income. Of course, if the \$10 million expenses remain deductible against other income, the tax cost reverts to \$3.5 million.

proach is to impose penalties on them if and only if they are participants in the scheme.

5. *Taxing Other Players*

The final attack against corporate tax shelters is against the counter-parties involved in the shelters. This line of attack has revolved around the proposals for taxing the income of so-called "tax-indifferent" parties: non-residents enjoying treaty relief, tax exempt persons, and taxpayers in tax loss. The proposal is that they would be taxable on the income from a corporate tax shelter without being entitled to enjoy any statutory exclusions, including treaty relief, and would be jointly and severally liable. Again, this proposal was included in the 2000 Budget Proposals and has survived into the 2001 Budget Proposals, with only minor changes.

This measure also addresses the supply side of the market: in this case, the sellers of tax attributes such as their domestic tax exempt status or their treaty protection. It recognizes that much tax probity depends on the conflicting interests of buyer and seller to a transaction, and where that contrariety of interests is missing, dangers exist. So, insofar as tax shelters depend on the existence of a seller with an exemption from the tax consequences that would otherwise occur, those tax consequences are then resurrected.

The contrast between these five pillars and the GAAR approach is striking. The last part of the article will draw out the significance of some of the differences.

III. THE GAAR EXPERIENCE

This part of this article recounts and analyzes some of the experiences of countries that have moved from reliance on jurisprudential doctrines to a statutory GAAR. The history tells a curious story. There are, as tax advisors always asserted there would be, the unexpected hits on targets that were never envisaged. More interestingly, there are the expected hits that did not eventuate. In other words, a GAAR can be a "loose canon" on the tax ship of State, injuring friend and foe alike. But the history shows that on balance the experience with a GAAR does not support the worst fears of tax advisors, just as it has not proved to be the panacea of revenue authorities.

A. A FAILURE OF GAAR?

The tax legislation in Australia, New Zealand, and Canada had "first generation" rules of some longevity.¹¹⁹ The experience with these first generation GAARs shows that a statutory GAAR can prove no more

119. The former Income Tax Act, R.S.C., ch. 148, § 245(1) (1952) (Can.) 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." *Id.*

robust in dealing with tax avoidance than the judicial doctrines which it is intended to shore up.

Until 1981 in Australia, the residual anti-avoidance power for the tax Commissioner to overcome the effects of a tax avoidance scheme was contained in a provision which asserted that any arrangement that had the purpose or effect of altering the incidence of income tax was "absolutely void as against the Commissioner."¹²⁰ The terms of the section, had it been liberally construed, might have proved to be more than equal to the task asked of it, but the courts read into the section a series of limitations which rendered it almost useless.¹²¹ Some of these limitations were limitations to annihilations: the section was construed as permitting only the destruction of a transaction, not its reconstruction to disclose some amount of income.¹²² A second requirement was a purpose (or predication) test. According to Lord Denning in *Newton's* case, section 260 applies only when the court can "predicate—by looking at the overt acts by which it was implemented—that [a transaction] was implemented in that particular way so as to avoid tax . . . [and is not explicable as] ordinary business or family dealing."¹²³ If the taxpayer's purpose was something other than avoiding tax, the section did not apply. A third limitation was the so-called "choice doctrine": the section would not be applied where the Act gave a taxpayer a choice on how to structure a

120. Income Tax Assessment Act, 1936, § 260 (Austl.). It stated:

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.

Id.

121. See generally, ICF SPRY, SECTION 260 OF THE INCOME TAX ASSESSMENT ACT (1978); Jeff Waincymer, *The Australian Avoidance Experience and Responses: A Critical Review*, in TAX AVOIDANCE AND THE RULE OF LAW ch. 8 (Graeme S. Cooper ed., 1997). One of the ironies of tax law in Australia is that section 260 seems to have acquired after its repeal a vigour and potency which the courts denied to it during its currency. Australian courts dealing with the tail of undecided cases re-interpreted the section and doubted the validity of those limitations.

122. See for example, *Cecil Brothers Pty. Ltd. v. Commissioner of Taxation* (1964) 111 C.L.R. 430 (Austl.), in which the High Court held that section 260 could not replace the price actually paid to a related company for inventory with some other price. It is interesting to note that the same limitation appears to be implicit in the "economic substance" doctrine applied by U.S. courts—that is, that the economic substance doctrine serves only to deny tax benefits to taxpayers who might otherwise enjoy them. See N.Y. State Bar Ass'n Tax Section, *supra* note 33.

123. *Newton v. Comm'r of Taxation* (1958) 98 C.L.R. 1.

transaction.¹²⁴ A fourth limitation was the antecedent transaction doctrine, a construction which asserted the section was postulated upon the re-arrangement of a prior set of circumstances so that if the tax effective structure was set up correctly from the outset, the section did not apply.¹²⁵

The original New Zealand general anti-avoidance provision¹²⁶ bore a strong similarity to its Australian counterpart. The former section 108 *Land and Income Tax Act 1954* (NZ) provided:

every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person, from his liability to pay income tax.¹²⁷

The judiciary found this Act to also suffer from some of the same deficiencies that had been found in the Australian provision.¹²⁸ The Privy

124. This proposition was applied in *W.P. Keighery Pty. Ltd. v. Commissioner of Taxation*, (1957) 100 C.L.R. 66, to allow a company's controllers to manufacture the status of a public company for tax purposes so that the company would not have to pay additional tax on its undistributed profits. The controllers generated the status by issuing one redeemable preference share to each of 22 individuals immediately prior to June 30. The court said:

the very purpose or policy of [the relevant provision] is to present the choice to a company between incurring the liability it provides and taking measures to enlarge the number capable of controlling its affairs. To choose the latter course cannot be to defeat[,] evade or avoid a liability imposed on any person. . . .

Id. at 93-94.

125. Barwick, C.J. said in *Mullens v. Commissioner of Taxation*, (1976) 135 C.L.R. 290, and in *Brambles Holdings Ltd. v. Commissioner of Taxation*, (1977) 77 A.T.C. 4481, that the section was postulated upon the re-arrangement of a prior set of circumstances so that if the tax effective structure was set up correctly from the outset, the section had no application.

126. A GAAR, derived from the then existing land tax law, had existed in New Zealand income tax since the tax was introduced in 1891. The history of the provision is recounted by the Privy Council in *Mangin v. Commissioner of Inland Revenue*, [1971] N.Z.L.R. 591.

127. Section 108, *Income Tax Act, 1954*, § 108 (N.Z.).

128. The judgment of Lord Wilberforce notes four major difficulties with the provision. Upon comparison to more recent legislation, several deficiencies appear:

(a) It fails to define the nature of the liability to tax, avoidance of which is attacked. Is this an accrued liability, a future but probable liability, or a future hypothetical liability? Is it one which must have arisen but for the arrangement, or which might have arisen but for the arrangement, and if "might," probably might or ordinarily might or conceivably might?

(b) It fails to specify any circumstances in which arrangements, etc. which in fact have fiscal consequence may be outside the section, and, if such exist, to specify on whom the onus lies, and to the satisfaction of whom, to establish the existence of such circumstances. The taxpayer is left to work his way through a jungle of words, "purpose," "or," "effect," "purported purpose," "purported effect," which existing decisions have glossed but only dimly illuminated.

(c) It fails to specify the relation between the section and other provisions in the *Income Tax* legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there a distinction between

Council in *Mangin v. CIR*¹²⁹ went to some length to insist that section 108, like its Australian counterpart, contained no power to reconstruct a potential transaction and to impose tax based on it, instead of the one that did happen.¹³⁰ The Privy Council further limited the rule in *Challenge Corp.*¹³¹ by claiming that the GAAR could not be triggered where a specific anti-avoidance rule existed which might have applied, but in fact had not been triggered.

Unlike Australia and New Zealand, the source of the second generation Canadian GAAR does not lie in difficulties with the operation of the first anti-avoidance rule.¹³² On the contrary, it seems that the section was largely left to languish as a dead letter, through either administrative oversight or inertia. In this case, introducing a formal and detailed GAAR seems to have been a reaction to the perception that judicial doctrines were unlikely to evolve into a sufficiently robust rule.

The difficulties of implementing these provisions led Australia, Canada, and New Zealand to attempt to refine their rules. Australia enacted its Part IVA in 1981, New Zealand its section 99 in 1976,¹³³ and

"proper" tax avoidance and "improper" tax avoidance? By what sense is this distinction to be perceived?

(d) It gives rise to a number of extremely difficult problems as to what hypothetical state of affairs is to be assumed to exist after the section has annihilated the tax avoidance element in the arrangement (*cf.* (in Australia) Peate v. Federal Commissioner of Taxation 1967 AC 308.

These difficulties are referred to in the majority opinion. I return to them later.

Many of these matters are dealt with in the English and Canadian legislation. See Finance Act 1951 section 32, Finance Act 1960 section 20. Canadian Income Tax Act section 138—summarised in an Appendix hereto. No doubt these raise their own difficulties, but the New Zealand section, precisely because it was one of the first in the field, leaves the emergent problems largely unassaulted.

Mangin v. Comm'r of Inland Revenue [1971] N.Z.L.R. 591, 602.

129. *Mangin*, [1971] N.Z.L.R. 591.

130. Their Lordships said:

This contention throws into relief the difficulties caused by leaving a section such as s. 108 completely silent as to what is to happen once the contract, agreement or arrangement has been declared absolutely void so far as its tax relieving purpose or effect is concerned. Is a vacuum left or is the taxpayer to be deemed to go on deriving the income? What is to happen if, simply in order to avoid tax, he has parted with the source of the income? Or receives money which is capital and not income? Section 108 gives no guidance at all on these points

Id. at 602.

131. *Inland Revenue Comm'r v. Challenge Corp.* [1987] 2 W.L.R. 24.

132. See Arnold, *supra* note 10, at 542-47.

133. Section 108 was rewritten in Section 99, Income Tax Act, 1976, § 99 (N.Z.). It provided:

(1) For the purposes of this section —

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

"Liability" includes a potential or prospective liability in respect of future income:

"Tax avoidance" includes

(a) directly or indirectly altering the incidence of any income tax:

(b) directly or indirectly relieving any person from liability to pay income tax:

(c) directly or indirectly avoiding, reducing, or postponing any liability to income tax.

(2) Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,

—
(a) its purpose or effect is tax avoidance; or

(b) where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, whether or not any person affected by that arrangement is a party thereto.

(3) Where an arrangement is void in accordance with subsection (2) of this section, the assessable income of any person affected by that arrangement shall be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of the foregoing provisions of this subsection, the Commissioner may have regard to such income as, in his opinion, either —

(a) that person would have, or might be expected to have, or would in all likelihood have, derived if that arrangement had not been made or entered into; or

(b) that person would have derived if he had been entitled to the benefit of all income, or of such part thereof as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

(4) Where any income is included in the assessable income of any person pursuant to subsection (3) of this section, then, for the purposes of this Act, that income shall be deemed to have been derived by that person and shall be deemed not to have been derived by any other person.

(5) Without limiting the generality of the foregoing provisions of this section, where, in any income year, any person sells or otherwise disposes of any shares in any company under an arrangement (being an arrangement of the kind referred to in subsection (2) of this section) under which that person receives, or is credited with, or there is dealt with on his behalf, any consideration (whether in money or money's worth) for that sale or other disposal, being consideration the whole or, as the case may be, a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would derive, as income by way of dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or otherwise howsoever, an amount equal to the value of that consideration or, as the case may be, of that part of that consideration shall be deemed to be a dividend derived by that person in that first-mentioned income year.

(6) Where any arrangement has been made or entered into before the 1st day of October 1974 and the Commissioner is satisfied, in respect of that arrangement or, as the case may be, in respect of a part of that arrangement, that the terms or conditions of that arrangement or, as the case may be, of that part (being legally binding terms or conditions which were agreed upon in writing before that date) prevent the discontinuance of that arrangement or, as the case may be, of that part —

(a) subsections (2) to (5) of this section shall not be applied with respect to that arrangement or, as the case may be, with respect to that part so long as that arrangement or, as the case may be, that part is so prevented from being discontinued and is continued strictly in accordance with the requirements of the aforementioned terms or conditions thereof; and

Canada redrafted its rule in 1988. Not surprisingly, when the GAARs were rewritten, they were often accompanied by revisions to the various Interpretation Acts to try to avoid the fate that had befallen their predecessors.¹³⁴ Thus, the shared experience is that a GAAR can be, through policy or neglect, a largely forgotten byway of little concern to tax advisors or administrators, as well as a force rendered powerless by adverse judicial interpretations.

B. UNEXPECTED TARGETS

One main argument habitually advanced against a proposed GAAR is that it will be inadvertently triggered to strike down innocuous transactions. The experience of countries with them is more subtle.

In Australia, the GAAR has been successfully and consistently applied to counter the practice of employees turning themselves into contractors or using an intermediary to conduct a business that consists predominantly of providing the services of the former employee.¹³⁵ For a North

(b) so long as the said subsections (2) to (5) of this section are not applied with respect to that arrangement or, as the case may be, with respect to that part in accordance with paragraph (a) of this subsection, the section for which section 108 of the Land and Income Tax Act 1954 was substituted by section 9 of the Land and Income Tax Amendment Act (No. 2) 1974 shall, notwithstanding the repeal thereof by the said section 9, be deemed to remain in full force and effect in relation to that arrangement or, as the case may be, in relation to that part.

Income Tax Act, 1976, § 99 (N.Z.).

Interestingly, when the entire N.Z. income tax law was rewritten in 1994, section 99 was substantially revised, reverting to something more like the former section 108. Section BB9 Income Tax Act 1994 provided:

Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,

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

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

Income Tax Act, 1994, § BB9 (N.Z.)

134. See, e.g., Acts Interpretation Act, 1901, §§ 15AA, 15AB (Austl.); Income Tax Act. 1994 §§ FC9, FC10 (N.Z.).

135. See, e.g., *Peate v. Comm'r of Taxation* (1964) 111 C.L.R. 443 (decision of the High Court); (1966) 116 C.L.R. 38 (decision of the Privy Council) (striking out the incorporation of a medical practice); *Hollyock v. Comm'r of Taxation* (1971) 125 C.L.R. 647 (striking down assignment of half-share in income from a pharmacy); *Comm'r of Taxation v. Gulland, Watson v. Comm'r of Taxation, Pincus v. Comm'r of Taxation* (1985) 160 C.L.R. 55 (striking out the incorporation of a medical practice); *Millard v. Comm'r of Taxation* (1962) 108 C.L.R. 336 (striking out the incorporation of a bookmaker's business); *Watson v. Comm'r of Taxation* (1983) 14 A.T.R. 316 (striking out the operation of a medical practice through a unit trust); *Tupicoff v. Comm'r of Taxation* (1984) 15 A.T.R. 655 (striking out the incorporation of an insurance salesman's business); AAT Case 59 (1987) 18 A.T.R. 3396 (permitting the operation of an accounting practice through a unit trust); AAT Case 4110 (1987) 19 A.T.R. 3215 (striking out the attempt of a real estate agent to operate as a contractor); *Daniels v. Comm'r of Taxation* (1989) 20 A.T.R. 1120 (striking out the incorporation of a draftsman's business); AAT Case 5219 (1989) 20 A.T.R. 3777 (striking out the incorporation of a computer consultancy); *Bunting v. Comm'r of Taxation* (1989) 20

American audience, one would suspect there is little odd in seeing a court strike down the re-arrangement of employment into independent contracting. What might be considered odd, however, is that such re-arrangement is territory for the use of a GAAR, rather than more traditional judicially-developed doctrines. When the GAAR was enacted in Australia, it was important for political acceptance that the rule not be applied to “ordinary family or commercial dealings.” In applying the GAAR to contractors, the judiciary is making a judgment but it is not clear whether that judgment is a decision that such arrangements are not “ordinary family or commercial dealings” or whether, instead, that such political assurances cease to have any ongoing relevance in interpreting the GAAR once enacted. That is, these cases may be plausibly interpreted as reflecting a degree of disregard for the legislative history where the terms used in the rule are capable of interpretation without recourse to the legislative history.¹³⁶

A.T.R. 1579 (striking out the incorporation of a computer consultancy); AAT Case 6412 (1990) 21 A.T.R. 3801 (striking out the incorporation of a draftsman’s business); Deputy Federal Comm’r of Taxation v. Blackman (1991) 22 A.T.R. 895 (striking down the incorporation of a radio and TV presenter); AAT Case 6560 (1991) 22 A.T.R. 3001 (striking out the incorporation of a medical practice); AAT Case 6523 (1991) 22 A.T.R. 3054 (striking out the incorporation of a mechanical engineer); AAT Case 6584 (1991) 22 A.T.R. 3028 (striking out the incorporation of a computer consultancy); AAT Case 6861 (1991) 22 A.T.R. 3201 (striking out the incorporation of a mechanical engineer); AAT Case 6864 (1990) 22 A.T.R. 3144 (striking out the incorporation of a computer programmer); AAT Case 6866 (1991) 22 A.T.R. 3207 (striking out the incorporation of a computer programmer). *Compare* Liedig v. Comm’r of Taxation (1994) 28 A.T.R. 141 (permitting the operation of a real estate agency by a trustee); Rippon v. Federal Comm’r of Taxation (1992) 23 A.T.R. 209 (permitting the incorporation of a chartered engineer); Osborne v. Comm’r of Taxation (1995) 30 A.T.R. 464 (permitting the incorporation of a valuer’s business).

136. See, for example, the comments of Justice Hartigan in AAT Case 5219 (1988) 20 A.T.R. 3777:

My basic task in approaching Part IVA is to ascertain the meaning of the words used in the relevant sections of the Act. If the meaning is plain, then I must proceed to apply those words, using their plain, ordinary meaning. At the hearing the applicant’s counsel tendered as Exhibit 2 the Treasurer’s Second Reading speech and the Explanatory Memorandum relating to the Bill which was subsequently enacted as an amendment of the ITAA and which introduced Part IVA into the legislation. Mr. Brown has submitted that I should refer to the extrinsic material forming Exhibit 2 in order to interpret the words of ss. 177C(2)(a)(1), s 177A(5) and the various matters to which regard must be had under s 177D. Mr. Brown, on this question, relied upon s. 15AB of the *Acts Interpretation Act* 1901 (Cth).

Mr. Black QC submitted that s. 15AB had no operation so far as the legislation before the tribunal was concerned. The first basis of the submission was that the material upon which Mr. Brown sought to rely did not bear upon the question of whether the meaning of the provisions is the ordinary meaning conveyed by the text of the provisions. He submitted that the ordinary meaning was plain enough. The second basis for his submission was that there was nothing ambiguous or obscure about the meaning of the provisions. Further, he submitted, it cannot be said that the ordinary meaning of the words of the provisions led to a result that is manifestly absurd or unreasonable.

I am of the view that the primary source is the statute itself. The words of the statute are plain. I cannot use the Minister’s words to displace the plain language of parliament. I refer to the words of Mason CJ, Wilson and Dawson JJ in *Re Bolton: Ex parte Bean* (1987) 162 C.L.R. 514, at 518: “The words

Second, the use of the GAAR has proved less successful in Australia when the company or other intermediary was used principally to secure greater access to retirement income tax incentives, rather than to retain income to be taxed only at the corporate rate or to divert income to low rate related taxpayers.¹³⁷ Such an exception expresses a view about the appropriateness of applying a GAAR to an incentive regime and confirms the obvious proposition that, as incentives are designed to encourage behavior which reduce the taxpayer's tax liability by arranging to come within the scope of the incentive, such a behavioral response ought not be avoidance.¹³⁸

A second important area for the operation of the rule has been in the so-called dividend stripping or surplus stripping cases. For example, in Canada in *McNichol*¹³⁹ and in *RMM Canadian Enterprises Inc. & Equilease Corp.*¹⁴⁰ the court held that the GAAR can apply to surplus stripping arrangements, apparently to the surprise of some tax advisors. The surprise arose because the Canadian Income Tax Act already contains provisions that recharacterize dividends paid in connection with a share sale (which would otherwise enjoy tax relief) as a taxable capital gain,¹⁴¹ and that treat the appropriation of corporate assets potentially as divi-

of a Minister must not be substituted for the text of the law." Mr. Black went on in his submissions to demonstrate, convincingly in my view, that in any event the words used in the sections that go to make up Part IVA are not at odds with the text of the second reading speech and the explanatory memorandum. In the result, Exhibit 2 confirms that the meaning of the provisions in question is the ordinary meaning conveyed by the text of the provision, taking into account its context in the Act and the purpose or object underlying the Act.

AAT Case 5219 (1988) 20 A.T.R. 3777, at 3789-90.

137. See, e.g., *Osborne v. Comm'r of Taxation* (1995) 30 A.T.R. 464 (permitting the incorporation of a valuer's business because there was no income splitting).

138. See *Comm'r of Taxation v. Gulland, Watson v. Comm'r of Taxation, Pincus v. Comm'r of Taxation* (1985) 160 C.L.R. 55, 71. Gibbs CJ said:

In my opinion the arrangements made by Mr. Watson . . . bear on their face an indication of a purpose to avoid tax. It is true that the arrangement revealed other purposes as well, namely the desire to make adequate provision for the [retirement] of Mr. Watson and to benefit the members of his family. I do not think that the attempt to obtain deductions for contributions to the [retirement] fund should be treated as merely another attempt at tax avoidance. It would have been possible, theoretically at least, for Mr. Watson to provide for himself a [retirement] scheme while he remained self-employed, but unless he were an employee, contributions to the . . . scheme would not have been tax deductible. As at present advised I do not consider that [the GAAR] would have frustrated an arrangement made by Mr. Watson to become an employee for the purpose of enabling his employer to have the benefit of the deductions [from employer contributions], even if the employer were a company or trust which he himself controlled. However, the arrangements in fact made, went far beyond what was necessary to take advantage of the tax benefit provided [to employer contributions] . . .

Id.

139. *McNichol v. The Queen* [1997] D.T.C. 111.

140. *RMM Canadian Enters. Inc. & Equilease Corp. v. The Queen* [1997] D.T.C. 302.

141. *Income Tax Act, R.S.C., ch. 148, § 55(2)* (1952) (Can.). For a discussion of the Canadian surplus stripping rules, see H. Heyward Stikeman & Robert Couzin, *Surplus Stripping*, 43 *CANADIAN TAX J.* 1844 (1995).

dends.¹⁴² Dividend stripping has been an ongoing concern for tax administrators in the U.K.¹⁴³ and Australia¹⁴⁴ and, while there are several conceptual ways to address the problem (by focusing either on the seller or the buyer, by re-characterizing either the dividends or the prices paid and received, or by denying tax relief for the dividends received), the choices are difficult and involve structural matters for the income tax that require a considered and explicit position. Australia has both pursued structural reforms¹⁴⁵ and applied the GAAR as a secondary (and now largely redundant) means of dealing with these cases, a trend that Canada appears ready to follow.

Nevertheless, these two areas are uncontroversial for a North American audience where statutory provisions unadorned by a GAAR could reach such results.¹⁴⁶ The other side to the GAAR coin is the area in which the GAAR has failed to hit an intended target. Consider, for ex-

142. See Income Tax Act, R.S.C., ch. 148, § 84 (1952) (Can.). More recently, in *RMM Canadian Enters.* [1997] D.T.C. 302, the Tax Court of Canada applied section 84 without recourse to the GAAR to a surplus strip transaction. In *RMM*, the transaction was a cross-border surplus strip. The subject company was an unwanted subsidiary of a U.S. Corporation acquired as part of a larger acquisition, and, rather than wind it up and remove the retained profits as a dividend, the parent sold the subsidiary to a Canadian company formed in order to buy it. The revenue authority assessed the U.S. seller on the basis that the proceeds of sale of the shares were a dividend in part (excluding the return of paid up capital) assessable in Canada; the seller (and the buyer who was vicariously liable for withholding tax if the revenue authority was correct) argued instead that the transaction was a sale which gave rise only to a capital gain not taxable in Canada. The judge did, however, go on to hold that section 245 would also have applied to the transaction: "A form of transaction that is otherwise devoid of any commercial objective, and that has as its real purpose the extraction of corporate surplus and the avoidance of the ordinary consequences of such a distribution, is an abuse of the Act as a whole." *Id.* at 313.

143. See *Lupton v. FA & AB Ltd.* [1969] 3 All E.R. 1034; *Griffiths v. J P Harrison (Watford) Ltd.* [1963] A.C. 1; *Inland Revenue Comm'r v. F S Sec. Ltd.* [1965] A.C. 631; *Bishop v. Finsbury Sec. Ltd.* [1966] 3 All E.R. 105; *Thomson (Inspector of Taxes) v. Gurneville Sec. Ltd.* [1972] A.C. 661.

144. *Newton v. Comm'r of Taxation* (1958) A.C. 450; *Inv. & Merchant Fin. Corp. v. Comm'r of Taxation* (1971) 125 C.L.R. 249; *Rowdell Pty. Ltd. v. Comm'r of Taxation* (1963) 111 C.L.R. 106; *Bell v. Comm'r of Taxation* (1953) 87 C.L.R. 548; *Hancock v. Comm'r of Taxation* (1963) 108 C.L.R. 258; *Mayfield v. Comm'r of Taxation* (1961) 108 C.L.R. 323; *Ellers Motor Sales v. Comm'r of Taxation* (1972) 46 A.L.J.R. 181; *Patcorp Inv. Ltd. v. Comm'r of Taxation* (1976) 140 C.L.R. 247; *KM Hennessey v. Comm'r of Taxation* (1974) 5 A.T.R. 179; *Curran v. Comm'r of Taxation* (1974) 131 C.L.R. 409; *Harrison v. Comm'r of Taxation* (1976) 7 A.T.R. 359; *Brookton Co-operative Soc'y Ltd. v. Comm'r of Taxation* (1981) 147 C.L.R. 441; *Westraders Pty. Ltd. v. Comm'r of Taxation* (1980) 144 C.L.R. 55; *Werchon v. Comm'r of Taxation* (1982) 13 A.T.R. 256; *McLean v. Comm'r of Taxation* (1986) 17 A.T.R. 583; *Gregrhon Invs. Pty. Ltd. v. Comm'r of Taxation* (1987) 19 A.T.R. 457; *Slutzkin v. Comm'r of Taxation* (1977) 140 C.L.R. 314; *John v. Comm'r of Taxation* (1989) 166 C.L.R. 417; *Comm'r of Taxation v. C.P.H. Prop.* (1999) 42 A.T.R. 575.

145. The position of the shareholder can be adjusted by denying the tax relief on the receipt of the stripped surplus. See Income Tax Assessment Act, 1936, § 46A (Austl.) (disallowing the loss made on a sale of shares); Income Tax Assessment Act, 1936, § 177E (Austl.) (requiring a step-down in the tax cost of shares purchased with retained profits); Income Tax Assessment Act, 1997, § 110-55(7) (Austl.).

146. In the case of surplus stripping, I.R.C. § 306(a)(1) and (2) rewrite the position of the seller of the shares. The exclusion from § 306(a) provided in I.R.C. § 306(b)(4) for transactions that do not have a "principal purpose" of tax avoidance shows a similar concern with deciding based on the merits when the tax consequences for seller of the shares should be reconstructed. In the case of the buyer, I.R.C. § 246(c) limits the availability of

ample, the Australian decision in *W.D. & H.O. Wills*.¹⁴⁷ This was the first occasion that an Australian court was asked to rule on the treatment of a captive insurance company. In a lengthy judgment, the court set aside the Commissioner's assessments that denied deductions for premiums paid to the offshore insurance company. One can only wonder at the fearsome reputation that a GAAR has engendered if its application to such a transparent transaction can be defeated.¹⁴⁸

The failure of the GAAR in *W.D. & H.O. Wills* results from the GAAR's requirement of purpose. The evidence showing the taxpayer's documents setting out the captive insurance proposal had been very well prepared. The taxpayer sought to justify the arrangement on commercial grounds—self-insuring currently uninsured and uninsurable risks, obtaining this insurance at lower cost, and obtaining direct access to the wholesale market for other risks. This proposal was said to have advantages over an “internal fund” (i.e., domestic self-insurance) because an offshore insurer would deal directly with claims by the public and would not cause “increased difficulty with public relations.” The part of the report that canvassed Singapore's advantages briefly noted that it possessed concessional tax rates, but was not regarded as a tax haven by Australian authorities. Based on the evidence, the judge found that the series of events identified by the Commissioner as constituting the scheme were undertaken for two commercial purposes: to enable the taxpayer to obtain cover against risks that it could not otherwise insure, and to enable the group to secure the other advantages identified in the consultant's report. Although, as the judge noted, one of these advantages was the low tax rate in Singapore, “any taxation advantage was incidental to the principal objectives. Taxation issues were not at the forefront of the parties' consideration. Without taxation benefits, the proposal still made commercial sense.”¹⁴⁹

the tax relief associated with the receipt of the dividend and I.R.C. § 1059 requires that an adjustment be made to the shareholder's cost in its shares.

147. *W.D. & H.O. Wills (Australia) Pty. Ltd. v. Comm'r of Taxation* (1996) 32 A.T.R. 168. For a more general discussion of the case, see Graeme S. Cooper, *Australian Courts Consider Captive Insurance Company Case*, 13 TAX NOTES INT'L 233 (1996).

148. The Commissioner had denied deductions to the taxpayer for the payments on three related, but different grounds. First, he argued that the payments were not deductible because they were not necessarily incurred by the taxpayer in carrying on its business. Rather, they were voluntary contributions to set up an in-house fund to meet future claims. The Commissioner argued that evidence for this position could be found in the voluntary nature of the payments, their size relative to the size of the risk assumed, and the group relationship between the taxpayer and the insurer. Second, he argued that the payments were not deductible because they were not true insurance premiums. Instead, the payments were simply inter-group payments that served to create a capital fund to meet any future claims made by consumers and, as such, were not deductible. Evidence for this could be found in the fact that the risk could not be realistically insured on the open market, and most importantly, the fact that the risk remained within the group since it was not reinsured by the captive. Finally, the Commissioner argued that the transaction amounted to a scheme entered into predominantly to secure a tax benefit, and thus could be set aside under Australia's general anti-avoidance rule. The judge rejected all of these arguments and allowed the deductions. See *Wills*, 32 A.T.R. 168.

149. *Id.* at 201-02.

Apart from the two areas noted above, it is difficult to find a consistent pattern in the few GAAR cases that have been decided in Canada, Australia, and New Zealand. It is also hard to be concerned about either the frequency or the circumstances under which the rule has been invoked. In Australia, only about 25 cases have been decided on the basis of applying the revised GAAR in the 20 years of its operation (although it has been argued in many more cases), and the income splitting cases account for all but six of these. The GAAR has been applied to a marketed scheme involving changing the source of income,¹⁵⁰ but other cases involving marketed schemes have been struck down using traditional judicial doctrines, without the need for the GAAR.¹⁵¹ Indeed, this tension between transactions that do not achieve their intended outcome under ordinary doctrines and those which fail at the last hurdle, as it were, remains obvious; many of the more egregious transactions are found to fail for other reasons.¹⁵² In Canada, Revenue Canada officials have indicated that between 1988 and October 1998, only 300 cases had been referred to consider the potential application of the GAAR, and only 15 cases had proceeded to the litigation stage, with only three proceeding to judgment.¹⁵³ Admittedly, these figures do not account for the transactions that were never undertaken or were abandoned because of the "chilling effect" that an unexpected application of the rule might have engendered.¹⁵⁴

IV. CONCLUSION

This Article has examined how GAARs have been structured elsewhere, in contrast to U.S. proposals, and the experiences of the countries that have utilized them. That experience is mixed; it is neither startling nor terrifying. While several lessons can be drawn from the international GAAR experience, the overall impression remains that the success of a

150. See *Comm'r of Taxation v. Spotless Serv. Ltd.* (1996) 186 C.L.R. 404.

151. See, e.g., *Fletcher v. Comm'r of Taxation* (1991) 173 C.L.R. 1 (marketed scheme involving prepayment for annuities not allowable under general interest deductibility rules); *The Queen v. Shell Canada Ltd.*, [1999] Can F.C. 57 (interest accruing on a weak foreign currency loan was not deductible under the ordinary interest deduction provisions); *Bastion Mgmt. Ltd. v. The Queen* [1995] 3 Can F.C. 994 (transaction not undertaken in ordinary course of taxpayer's business, so not deductible); *Backman v. The Queen* [2000] 178 D.L.R. 4th 126 (taxpayer never became partner in tax loss partnership).

152. In Australia, there have been three cases involving tax shelters marketed by merchant banks that depend upon the purchase of accelerated depreciation benefits from either tax exempt or tax loss projects. In one case, the court held that depreciation benefits were not allowable to the buyer under existing rules. See *Bellinz Pty. Ltd. v. Comm'r of Taxation*, (1998) 155 A.L.R. 220. In another case, that the GAAR did not apply because the taxpayer's dominant purpose was securing short term finance. See *Metal Mfrs. Ltd. v. Comm'r of Taxation*, (1999) 43 A.T.R. 375. In another case that the GAAR did apply. See *Eastern Nitrogen Ltd. v. Comm'r of Taxation*, (1999) 43 A.T.R. 112.

153. CANADIAN TAX FOUNDATION, 1998 CONFERENCE REPORT 52:21 (1998).

154. See Howard J. Kellough, *Tax Avoidance: 1945 - 1995*, 43 CANADIAN TAX J. 1819, 1833 (1995) (describing the deliberate inducement of fear as a tool in discouraging tax avoidance).

GAAR depends in large part on what the GAAR is being sought to accomplish.

A first lesson is that a GAAR is implausible as a solution to structural problems in a country's tax system. A tax system with structural failings will find those failings exploited, and the GAAR will be a poor tool if invoked as a last line of defense. The failure of a tax system to be able to dissect a dual purpose outgoing into its constituent elements should be solved directly, not through a GAAR.¹⁵⁵ The failure of the substantive rules to account correctly for a dividend stripping transaction will not be well or consistently solved by a GAAR. Nor will a GAAR serve as an adequate substitute for a comprehensive CFC regime.¹⁵⁶

Nor will a GAAR be an appropriate tool for dealing with the difficult line-drawing and categorization issues that tax law always presents. A distinction between line-walking behavior and loophole-seeking behavior is commonly drawn in this area. The point is that a GAAR can help protect against loophole-seeking, but will rarely solve line-walking in a principled way. It may be called in to help arbitrate such issues, but the line between employees and contractors is best drawn explicitly and formally. Nor is a GAAR appropriate as a back-up rule to cure technical defects in the drafting of other regimes.¹⁵⁷ It will not reverse the predictable incentives created where a foreign income exemption is used as the means for dealing with relief of double tax, for example.¹⁵⁸

But as a means of addressing artificial schemes, a GAAR is both a plausible and feasible response. A GAAR usually will be capable of encompassing self-generated tax ploys. There is little evidence that the application of the rule to such transactions is done in a way that shocks the sensibilities of careful advisors. That is because the degree of artificiality required to access a tax benefit usually will be a significant indicator of the existence of avoidance.

A GAAR likewise can constitute a powerful tool for dealing with the aggressive marketing of externally-developed schemes that are sold to taxpayers, at least so far as the taxpayers are concerned. It was noted above that U.S. Treasury's assessment of its position is that tax avoidance is not the problem in the U.S., but rather the marketing of schemes and the revenue authority's ignorance of their purchase. If that is correct, a GAAR is not as well targeted as the U.S. proposals. But usually a

155. *Inland Revenue Comm'r v. Europa Oil (NZ) Ltd.* [1971] A.C. 760.

156. The subsequently-enacted Australian CFC rules would have rendered the transaction in *W.D. & H.O. Wills (Australia) Pty. Ltd. v. Commissioner of Taxation* (1996) 32 A.T.R. 168, largely ineffective for tax purposes.

157. *Inland Revenue Comm'r v. Challenge Corp. Ltd.* [1986] S.T.C. 548.

158. This was the problem underlying the scheme to which the Australian GAAR was applied in *Commissioner of Taxation v. Spotless Services Ltd.*, (1996) 186 C.L.R. 404. The High Court applied the GAAR to a scheme involving the foreign source income exemption provisions. The provision had been held not to apply by both the judge at first instance in the Federal Court in *Commissioner of Taxation v. Spotless Services Ltd.* (1993) 25 A.T.R. 344, and by the members of the Full Federal Court in *Federal Commissioner of Taxation v. Spotless Services Ltd.* (1995) 32 A.T.R. 309.

GAAR will be triggered by marketed schemes because of the degree of artificiality that the scheme will display.

One of the most vital parts of a GAAR is its power of reconstruction: empowering the revenue authorities to tax a transaction as if a different tax outcome had occurred. This power is premised on the assumption that knowledge is not enough. But it is also in recognition of the fact that judicial doctrines and the common law method usually will allow only one consequence: denying the benefit sought by the scheme. In some cases, this will be an adequate remedy, but not always. In so far as current judicial doctrines do not allow the reconstruction of an alternative transaction, the GAAR may be a worthwhile endeavor.

It is not being argued that a GAAR does not bring its own problems. Drafting needs to be carefully undertaken while the design elements examined above must be carefully considered and explicitly provided. A GAAR can inhibit whatever creativity the judges might otherwise have pursued,¹⁵⁹ and once set in place, the rule can become a road map to avoidance.

The U.S. experience shows a new direction for countries with a GAAR. The GAARs that have been developed so far are clearly focused on dealing with the players, both consumers and counter-parties, but not the promoters. So, a standard GAAR can restore the contrariety of interests upon which the tax system depends for so much of its integrity and which, when missing, provides the opportunities upon which corporate tax shelters thrive. But the U.S. proposals go further than simply reversing the position for the players. They take seriously the incentives of the sellers (though it is an open question whether discouraging external sellers from supplying to customers will simply drive them in-house to “sell” to their owners).¹⁶⁰ So, while a GAAR in the standard form can deal with the other players to a scheme, it typically does not do what the U.S. proposals envisage, and discourage supply.

And a GAAR is clearly not a revelatory mechanism. It does not bring sunshine to the dark corners of a taxpayer’s affairs in the ways that the U.S. proposals will. This oversight is curious—the U.S. approach clearly recognizes that the detection of transactions is necessary and may, even at the margin, be sufficient to discourage some from occurring. Perhaps the

159. Arnold has argued that the 1984 Canadian case, *Stuart Investments Ltd. v. The Queen*, [1984] C.T.C. 294, shows the Supreme Court of Canada expressly rejecting a common law business purpose doctrine because the test would have been inconsistent with the existing rule. Arnold says, “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.” Arnold, *supra* note 5, at 223. In Australia, this was also the case. See also the discussion of the Australian decision in *Oakey Abbattoir*, *supra* note 79.

160. See Kleinbard, *supra* note 22, at 234 (“If selling corporate tax shelters is made a felony, but corporations are still committed to managing their tax liabilities . . . then those who structure corporate tax-advantaged transactions simply will migrate inhouse (as, in many cases they already have) and Tax Executives Institute meetings will become a Casbah for the exchange of tax-savings strategies by all these inhouse gurus.”).

typical GAAR ignores mechanisms for the detection of tax avoidance because of an awareness that elsewhere the most profound problems are in the lack of powers for substantive reconstruction: detection without remedy breeds only the contempt of taxpayers and the frustration of administrators. But having secured a remedy, the U.S. lesson is that detection becomes paramount.

Finally, a GAAR will rarely deal well with unintended tax benefits, because of the purposive elements of the rule. Whether this is an important target is open to doubt. What is more interesting is whether the deliberate decision in the U.S. proposals to eschew any reliance upon subjective or objective purpose can be sustained and incorporated into a GAAR to make it a more reliable and predictive measure of abusive transactions.