

**ABUS DE DROIT AND THE GENERAL ANTI-
AVOIDANCE RULE OF INCOME TAX LAW: A
COMPARISON OF THE LAWS OF SEVEN
JURISDICTIONS AND THE EUROPEAN COMMUNITY**

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ABUS DE DROIT AND THE GENERAL ANTI-AVOIDANCE RULE OF INCOME TAX LAW: A COMPARISON OF THE LAWS OF SEVEN JURISDICTIONS AND THE EUROPEAN COMMUNITY¹

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with

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OVERVIEW: AVOIDANCE – A PROBLEM FOR ALL COUNTRIES¹⁶

Tax avoidance is a problem for every country. Avoidance is not evasion. Evasion means lying about one's income; for example, a cash business under-stating its takings. Avoidance is not mitigation. Mitigation means reducing one's tax in ways that the statute clearly encourages; for example, taking a deduction for a gift to charity. "Mitigation" is used in that sense in this article.

Avoidance is between the two. Avoidance means, approximately, contriving artificial transactions to reduce tax that is otherwise payable. This is a description rather than a definition. Terminology in the area is controversial. Some people deny that any meaningful distinction can be drawn between avoidance and mitigation. Some people deny that the word mitigation has any right to exist as a meaningful term in this context. However, such arguments are not the focus of this article. Rather, it deals with the core concept of avoidance. The concern is with transactions that most people would recognise as avoidance, and with how eight jurisdictions either frustrate avoidance or allow it.

A useful example to help to recognise avoidance is *Bowater Property Developments Ltd v Inland Revenue Commissioners*.¹⁷ The case involved development land tax, a kind of capital gains tax that applied to land sales if the development value component of the sale was more than £50,000. Bowater proposed to sell land for more than £250,000 to a company called Milton Pipes Ltd, and Bowater would have had to pay development land tax.

Instead, Bowater segmented the land into five undivided shares. It sold one share to each of five sibling companies in the Bowater group for £36,000 each. Land in undivided shares looks just like land: there was no subdivisional survey and no separate titles. The five Bowater companies owned the land in one title, just as a married couple owns their home in one title. The Bowater companies were a sort of modern marriage with five spouses. These five sales had no effect on the beneficial ownership of the land. Both before and after the sales the ultimate owners were the shareholders in the Bowater group. The effect was similar to a person moving his wallet from one pocket to another: it is still his wallet.

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¹⁶ With John Prebble.

¹⁷ *Bowater Property Developments Ltd v Inland Revenue Commissioners*, reported *sub nom Craven v White* [1989] AC 398; [1988] 3 All ER 495; [1988] 2 WLR 423; [1988] STC 476; 62 TC1, (HL).

The five companies then sold their undivided shares to Milton Pipes for £50,000 each. That is, each company bought for £36,000 and sold for £50,000, making a profit of £14,000, well under the threshold at which development land tax was payable. Legally, there were five separate sales from Bowater and five more sales to Milton Pipes. But, economically, there was one sale from Bowater to Milton Pipes. The two groups of five separate sales were largely a matter of making a template and photocopying – Bowater is one of the largest paper companies in the world and it had plenty of photocopier paper.

It seems likely that in the United States the courts would say that the Bowater sales were shams and tax would be charged. But jurisdictions that follow the House of Lords say that these transactions were not shams. The House of Lords held that the transactions were all sales that took place according to their documentation. Bowater escaped development land tax.

A third approach to the *Bowater* transactions would be to interpret tax legislation purposively. Upon initial consideration, it appears that tax would have been payable in the *Bowater* case – Parliament cannot have intended that people could avoid development land tax so long as they had good photocopiers. But this initial impression is misleading. In jurisdictions that follow the approach of United Kingdom courts, a purposive construction does not work well when applied to tax statutes. The general rule in such jurisdictions is that a tax provision has the purpose that can be seen in its text: there is no underlying spirit behind the statute. A purposive approach does not get us very far when applied in the context of this general rule. In the *Bowater* case, every company was a separate taxpayer. Legally, any person or persons can have as many companies as they like. The Common Law does not prohibit people from insisting on their strict legal rights, even if the result is to obtain benefits or to inflict detriments that a dispassionate view would suggest is contrary to the fundamental policy of the law in question; that is, the Common Law has no general doctrine of abuse of law.

The discussion that follows considers the approaches to tax avoidance of the European Court of Justice and of seven Common Law and Civil Law jurisdictions. The general Civil Law doctrine of abuse of law is an important concept in this context. It goes variously by the names *fraus legis*, *Rechtsmissbrauch*, and *abus de droit*. The article considers both general *fraus legis* doctrines and anti-avoidance rules in the context of tax law.

**SECTION 242 OF THE BURGERLICHES GESETZBUCH (THE GERMAN CIVIL CODE),
THE GENERAL ANTI-ABUSE RULE¹⁸**

The presence of the doctrine of *Rechtsmissbrauch* (abuse of law or abuse of rights) in the Civil Law is one of the most significant differences between Civil Law and Common Law jurisdictions. *Rechtsmissbrauch* is a general doctrine that pervades the whole of the Civil Law. Similar doctrines can be found in discrete pockets of the Common Law. For instance, courts give remedies for abuse of judicial process and apply the doctrine of promissory estoppel. Broadly speaking, the doctrine of promissory estoppel allows the courts to enforce a promise that is not contractual on the basis of good faith and fairness in bargaining. However, such examples are isolated pockets within the Common Law and fall far short of establishing any general doctrine of abuse of law or abuse of rights.

Generally speaking, the Common Law allows people to enforce their strict legal rights, even if the result may be unfair to others. In contrast, Civil Law systems have traditionally framed rights in a general and abstract manner. The German Civil Code never uses the word *Rechtsmissbrauch*, but the doctrine is clearly recognised in German law. The doctrine's effect is to limit the exercise of private rights in a general way, something that is not similarly seen in Common Law jurisdictions. The doctrine underlies paragraphs 226 and 242 of the German Civil Code in particular. Paragraph 226, the *Schikaneverbot*, prohibits vexatiousness. That is, it prohibits the exercise of a right if the sole purpose is to cause harm to another. This is a narrow test – an exercise of rights will not be prohibited if it has some other purpose in addition to causing harm. Paragraph 226, therefore, is seldom applied.

The more important abuse of rights provision is paragraph 242. This is a more general provision that requires rights to be exercised in good faith. If interpreted literally, the scope of the provision appears narrow. The paragraph is in the part of the Code that deals with the general law of obligations. This seems to imply that the good faith requirement of paragraph 242 applies only where a contract or other legal obligation already exists. However, the paragraph has been judicially interpreted to be much broader. In practice, paragraph 242 has been applied in a wide range of situations, for instance, where there is no binding contract, before a legal obligation comes into existence, after a contract has been performed, or where a contract was void from the beginning. In the light of this broad judicial interpretation, good faith

¹⁸ With Svenja Brandt.

now represents an underlying principle of German law. The legal consequences of applying paragraph 242 vary according to the circumstances of any particular case. At one end of the scale, paragraph 242 can simply allow for an alteration of an original contract; at the other end, it can allow for the complete invalidation of a contract.

The case law on paragraph 242 is grouped thematically. This is designed to clarify the concept of good faith and to make the application of the paragraph more predictable. Cases are grouped into the following categories: the prohibition of inconsistent behaviour; the prohibition against exercising rights that, though valid, were fraudulently acquired; the prohibition against making a claim where what is claimed would have to be given back immediately; and the suspension of rights that were not exercised within a reasonable time, even if those rights have not legally expired.

Rechtsmissbrauch is a fundamental legal principle underlying the German legal system. Paragraphs 226 and 242 of the German Civil Code apply to the entire German Civil Law, including family law, labour law, and corporation law. They also apply to procedural law, public law, and taxation law.

SECTION 42(1) OF THE ABGABENORDNUNG (GERMAN FEDERAL CODE OF TAX PROCEDURE) – ABUSE OF LAW IN TAX CASES¹⁹

Section 42 of the German Federal Code of Tax Procedure is the German general anti-avoidance rule. It restricts the principle that every taxpayer may order his affairs so that his tax liability is as low as possible. The section disallows the tax effects of any legal arrangements that constitute abuses of rights, or Rechtsmissbrauch. Taxpayers may not arrange their affairs to manipulate or distort a transaction's economic reality. Such manipulation or distortion is tax avoidance and is counteracted by the doctrine of Rechtsmissbrauch, or in the context of tax law, by the more specific concept of Gestaltungsmissbrauch (abuse of possible legal arrangements).

Section 42 is headed “Abuse of Possible Legal Arrangement”. It requires the taxpayer to be taxed according to the true economic substance of the transactions in question, rather than according to their artificial form. Section 42 reads:

- (1) The tax Act may not be circumvented by an abuse of possible legal arrangements. If there is such an abuse, the taxpayer shall be taxed as if he had chosen an adequate legal arrangement.

¹⁹ With Dennis Becher and Viktoria Preusker.

(2) Subsection 1 is applicable if its applicability is not excluded expressly by the law.

Section 42 does not specify exactly what will be an abuse of possible legal arrangements. German courts have interpreted the concept as comprising several elements. First, to be an abuse of possible legal arrangements or an abuse of rights, a taxpayer's chosen legal arrangement must be inadequate. The test of inadequacy is whether an objective third party, in the same circumstances and with the same economic purpose as the taxpayer, would have proceeded as the taxpayer did. If an objective third party would have proceeded differently, then that arrangement is inadequate. The more unusual or artificial an arrangement, the less likely it is to be adequate. However, the mere fact that a legal arrangement saves tax does not on its own make the arrangement inadequate. After all, an arrangement that saves tax is not necessarily tax avoidance – it could instead be tax mitigation if the tax savings are in the spirit of the legislation, or were contemplated or intended to be encouraged by the legislature.

Once it is established that a legal arrangement is inadequate, it must next be shown that the arrangement had the effect of reducing tax: that is, that an adequate legal arrangement would have led to higher tax than the chosen inadequate legal arrangement, which leads to the conclusion that there was an economic reason to choose the arrangement. Thirdly, section 42 can be applied only if there are no important reasons to suggest that the inadequate legal arrangement is reasonable and justified by non-economic or other important considerations.

Finally, abuse of possible legal arrangements has a subjective element. The arrangement must have been chosen with the actual intention or motive of reducing tax. The precise details of this subjective element have proved controversial – even the senates of the Federal Finance Court have expressed differing opinions. Notwithstanding this controversy, however, the prevailing opinion is that abuse of possible legal arrangements requires an intention to abuse. The court has to prove an intention to abuse in every case, but existence of the subjective intention is presumed where the first three objective requirements under section 42 are made out.

When these four elements are established, the court affirms that there has been an abuse of rights or abuse of possible legal arrangements according to section 42. As a consequence, tax is re-calculated and charged as if the taxpayer had chosen an adequate legal arrangement. In other words, section 42 allows tax to be calculated on

the basis of an economically adequate, but fictitious, possible legal arrangement rather than on the inadequate and abusive legal arrangement that the taxpayer actually used.

Application of Section 42 by the Courts

German courts have considered section 42 in a broad range of circumstances. It is useful to consider two examples to illustrate how the rule operates in practice. In the first example, the Federal Finance Court held that use of a reciprocal or “cross-over” renting arrangement was an abuse of rights in terms of section 42.²⁰ The taxpayer entered into a contract to purchase a three room freehold flat in city A on 4 February 1982. His colleague, C, purchased a matching freehold flat in the same housing estate. They entered into two bilateral leases. Under the first lease, the taxpayer let his freehold flat to C for four years. C paid monthly rent but did not live in the freehold flat – he lived in another city during the year in question. Under the second lease, the taxpayer rented two rooms in C’s freehold flat for an identical four year period. The third room was rented by another colleague, D. The taxpayer did not use the leased rooms, and instead lived in a freehold flat owned by D in another city.

German income tax law allows expenses to be deducted for tax purposes when they are incurred in order to realise a profit. The taxpayer tried to claim such a deduction. He said that his income-related expenses in relation to the second lease were 30,000 DM higher than the rent that he received under the first lease. That is, he had suffered an overall loss by virtue of the second lease. He wanted to set this loss off against his income from other sources.

The taxpayer was unsuccessful. The Federal Finance Court applied section 42(1) and refused to treat the expenses as income-related for tax purposes on the grounds that the transactions amounted to an abuse of possible legal arrangements. First, reciprocal renting is an unusual way to approach the leasing of property if one’s goal is to find somewhere to live or to derive income from property. An objective third party with the goal of securing a place to live and earning income would not lease his own flat while at the same time rent a similar flat from another person in the same housing estate and then fail to occupy the rented property. The arrangement was therefore inadequate.

Secondly, the only purpose of the reciprocal renting arrangement was tax mitigation. If the taxpayer and C had chosen a less elaborate, but adequate, set of legal

²⁰ BFH [19.6.1991] IX R 134/86, BStBl II 1991, 904.

arrangements, they would have paid more tax. It was only by leasing the properties to each other that the expenses relating to their properties could qualify as income-related. Thirdly, there was no economic or other justification for the use of the inadequate arrangement aside from tax mitigation. Finally, with regard to the objective circumstances just discussed, the parties' subjective intention seems clearly to have been to avoid tax. The court was satisfied that their actions were an abuse of rights and applied section 42, with the result that the taxpayer owed tax at the rate that he would have been assessed at had he used adequate legal arrangements.

The second example is known as the *Dublin Docks* case.²¹ The case involved a German company that established a subsidiary in the International Finance and Services Centre in Dublin, where resident companies were subject to a reduced corporate income tax rate of 10 per cent. The sole purpose of the Irish subsidiary was to invest capital payments received from the German shareholder company. The subsidiary had no offices or employees, though it did have its own board of directors, which met in Ireland and determined investment strategy. However, the investments were managed by another Irish company, which did have offices and employees and which performed the same services for other investment companies.

The question was whether there was an abuse of possible legal arrangements, or Gestaltungsmissbrauch, under section 42. The German tax authorities considered that the establishment of the Irish subsidiary was an abuse under section 42. The effect was that all profits earned by the Irish subsidiary were directly attributed to the German parent company for tax purposes.

The company appealed against the tax assessment, and was partially successful at first instance. The court held that section 42 was applicable as there was an abuse of possible legal arrangements on the facts. But it also held that a deduction was allowable for the business expenses that were incurred in Ireland – only the establishment of the subsidiary company was disregarded under section 42, not the expenses that the parent company actually incurred in Ireland through the subsidiary or otherwise.

The Federal Finance Court later rejected the lower court's reasoning, holding that the establishment of the Irish subsidiary company was not an abuse of possible legal arrangements under section 42. Its reasoning was based on the relationship between

²¹ BFH [19.1.2000] I R 94/97, DStR 2000, 511 "the *Dublin Docks* case".

the German Controlled Foreign Corporation, or CFC, regime and section 42. The court said that the existence of the CFC regime, which is intended to be applied to such cases, precludes the additional application of general anti-avoidance rules. The German CFC regime was enacted to combat tax avoidance arrangements involving the establishment in low tax countries of passive corporations that do not actively trade or carry out business. The court concluded that, considering the purpose of the CFC regime, the mere fact of profit making by a passive subsidiary company in a low tax country is not enough to establish an abuse of possible legal arrangements under section 42. For section 42 to apply, it was not enough that the company was simply passive. It had to be no more than merely a letterbox company, with little activity at all, active or passive. The company in question was not a mere letterbox company because the board of directors made the major investment decisions; so, in this case, section 42 was not applicable.

ANTI-AVOIDANCE MEASURES IN AN EMERGING ECONOMY: THE SPECIAL CASE OF CROATIA²²

Among the seven countries discussed in this article, Croatia is a special case. It does not have a coherent approach to tax avoidance. While Croatia does have several specific anti-avoidance provisions, for instance, provisions regarding thin capitalisation and transfer pricing, it lacks a general anti-avoidance rule. This is a significant obstacle to combating tax avoidance. In addition, although Croatia is a Civil Law country, it does not have a strong *fraus legis* tradition. The concept is not codified in the way that it is in a number of other Civil Law jurisdictions, such as, Germany.

Croatia does, however, have an anti-sham doctrine in both the tax law and the general law.²³ In translation, the tax anti-sham doctrine provides that “if a sham transaction conceals some other transaction, then the tax liability shall be determined on the basis of the concealed transaction”.²⁴ This is a sham doctrine rather than a codification of the *fraus legis* concept. It is not founded on the notion of abuse of rights. Interestingly, the anti-sham doctrine in the tax law has never been used. As a result, it is somewhat uncertain what transactions the doctrine would apply to in practice. However, it is likely that the doctrine would apply in a similar manner to

²² With Rebecca Prebble.

²³ General Tax Act, Ch 11, Art 11 (Croatia); Obligations Act, Art 66 (Croatia).

²⁴ General Tax Act, Ch 11, Art 11 (Croatia).

sham doctrines in other Civil Law and Common Law jurisdictions. That is, if a transaction is not in reality what it purports to be, then it is a sham.

One way in which Croatia might more actively combat tax avoidance would be to follow the Hungarian example. Hungary is the only country in Central Eastern Europe to have enacted a general anti-avoidance rule.²⁵ The Hungarian general anti-avoidance rule is based on the *fraus legis* or abuse of rights doctrine, similar to the German model. The Hungarian general anti-avoidance rule provides that a transaction with the purpose of avoiding tax is not a proper use of rights, and provides for such transactions to be taxed according to their economic substance. The Hungarian anti-avoidance rule has not yet been used. However, it is likely that it would apply to the same sorts of transactions as the German abuse of rights rules. Furthermore, although the Hungarian general anti-avoidance rule has not been used, there is evidence to suggest that it is having a deterrent effect on potential avoiders of tax. Taxpayers are aware of the provision and on occasion write to the Ministry of Finance to ask whether their planned transactions are acceptable in terms of the rule.

The Croatian tax system is very young. Croatia has had a structured tax system, similar to the kind of system in the other jurisdictions discussed in this article, only since 1991. Even during that time, the Croatian tax system has been subject to frequent change. For instance, for six years, Croatia experimented with having only a consumption tax. This was replaced with other tax after a change of government. On the whole, tax evasion is currently a greater problem than tax avoidance in a developing economy such as Croatia. General anti-avoidance rules require a great deal of enforcement energy to apply. At present, this energy in Croatia is focused on tax evasion, rather than tax avoidance.

SECTION BG1 OF THE NEW ZEALAND INCOME TAX ACT 2004, THE GENERAL ANTI-AVOIDANCE RULE²⁶

New Zealand and Australia are both Common Law jurisdictions with general anti-avoidance rules. However, there have been interesting differences in the ways in which these rules have been interpreted and applied by the courts in each jurisdiction. The New Zealand general anti-avoidance rule is set out in section BG1 of the Income Tax Act 2004, which states that a tax avoidance arrangement is void as against the

²⁵ Tax Administration Act, s 1 (7) (Hungary).

²⁶ With Matthew Fountain.

Commissioner of Inland Revenue.²⁷ The provision allows the Commissioner to counteract the tax advantage that a taxpayer has obtained from a tax avoidance arrangement.²⁸ “Arrangement” is defined broadly by section OB1, as “an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect”.²⁹ Tax avoidance includes directly or indirectly altering the incidence of any income tax or relieving or reducing any income tax liability.³⁰ A tax avoidance arrangement is an arrangement that directly or indirectly has tax avoidance as its purpose or effect, or has tax avoidance as one of its purposes or effects and that purpose or effect is not merely incidental.³¹

Interpretation of Section BG1

A literal interpretation of the New Zealand legislation would suggest that an individual who, for instance, makes a rebate claim in respect of a charitable donation is avoiding tax. It is clear that Parliament cannot have intended the rebate claim to be avoidance. Rather, Parliament intended to encourage charitable donations. If interpreted literally, the general anti-avoidance rule does not distinguish between acceptable tax mitigation and unacceptable tax avoidance. In the light of this consideration, the courts have developed a range of methods for reading down the literal effects of the rule. Generally speaking, where there are two different ways to carry out a transaction and one of those involves the payment of less tax, if the lower taxed arrangement is chosen it will not be struck down for that reason alone.³²

Form and Substance: The Basis of Two Dichotomies

Formerly, the courts assessed whether an arrangement had a tax avoidance purpose on the basis of its legal form, that is, by looking chiefly at the legal rights and obligations established under the arrangement. For example, in the *Europa Oil (NZ) Limited* case, Lord Diplock, quoting an earlier decision, said that “[t]axation by end result, or by economic equivalence, is not what the [anti-avoidance] section achieves”.³³ He suggested that one must look to the legal rights and obligations that arise under the

²⁷ Income Tax Act 2004, s BG 1(1) (New Zealand).

²⁸ Income Tax Act 2004, s BG 1(2) (New Zealand); see also s GB 1.

²⁹ Income Tax Act 2004, s OB 1 (New Zealand).

³⁰ *Ibid.*

³¹ *Ibid.*

³² *Europa Oil (NZ) Limited v Commissioner of Inland Revenue (No 2)* [1976] 1 WLR 464, 475 Lord Diplock (PC).

³³ *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1.

arrangement, not to its economic consequences.³⁴ This has the effect of reading down the literal effect of section BG1, which interpreted literally, is more concerned with matters of substance than of form. Modern cases, however, generally treat section BG1 as, in large effect, a substance over form provision.³⁵

The concepts of form and substance give rise to two dichotomies. The first dichotomy is between legal form and legal substance. When analysing an arrangement, one could look at its legal form, that is, the legal label given to the arrangement. But alternatively, one could look at its legal substance, that is, the true legal rights and obligations created by the arrangement. Legal form and legal substance can diverge. For instance, the House of Lords held in one case that a non-recourse loan was, in legal substance, a partnership.³⁶

A second dichotomy exists between legal substance and economic substance. Legal substance is the element common to both dichotomies. The legal substance of an arrangement is its impact on the taxpayers' legal rights and obligations. Economic substance, on the other hand, concerns the economic effect of an arrangement. The case of *Commissioner of Inland Revenue v Wattie*,³⁷ although not an avoidance case, demonstrates this dichotomy. The issue was whether a lease inducement paid to the taxpayer was taxable. The legal substance of the payment was that it was a premium paid by the landlord to attract the tenant. Such a premium would not be taxable. The economic substance of the payment, on the other hand, was that it was a rent subsidy. A rent subsidy would be taxable. The Privy Council followed the legal substance and held that the payment was a premium and therefore not taxable.

The "Tax Avoidance Purpose" Test

A second method adopted by the New Zealand courts to read down the literal effect of the general anti-avoidance rule is to look at the purpose or effect of an arrangement. To constitute tax avoidance, an arrangement must have a tax avoidance purpose or effect that is more than merely incidental. The pursuit of a valid commercial objective that incidentally results in a reduction in tax liability is not tax avoidance. The tax

³⁴ Above, n 32.

³⁵ See, eg, *Commissioner of Inland Revenue v Challenge Corporation Limited* (1986) 8 NZTC 5,001 (CA); *Accent Management Ltd v Commissioner of Inland Revenue* [2007] BCL 728 (CA). But see, *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433 (PC).

³⁶ *Ensign Tankers (Leasing) Limited v Stokes (HM Inspector of Tax)* [1992] BTC 110 (HL).

³⁷ *Commissioner of Inland Revenue v Wattie* (1998) 18 NZTC 13,991 (PC).

avoidance purpose test is objective.³⁸ The test is whether the parties to the transaction would have entered into it even in the absence of a tax advantage. Similarly to the German objective test for the “adequacy” of a transaction, if the parties to the transaction would have entered into it even in the absence of the tax advantage, then it does not have a tax avoidance purpose.

The operation of the tax avoidance purpose test is illustrated by *Case V20* before the Taxation Review Authority.³⁹ There, a dentist left a partnership and established a trading trust structure whereby he was employed by the trust. There was a minor tax saving in the 1995 income year. Judge Barber held that there was no tax avoidance because the tax advantage was merely incidental to the transaction’s commercially valid chief objectives of asset protection and liability limitation. Nevertheless, the magnitude of the tax advantages attributable to a scheme has been held to be relevant to the purposes test. In *Case W33*, the Taxation Review Authority dealt with the same dentist in his 1996 income year, during which there was a larger tax saving.⁴⁰ The larger tax savings influenced Judge Barber to hold that the tax avoidance in that year was more than merely incidental. Although *Case V20* and *W33* concerned the same arrangement and the same taxpayer, the Judge held that the arrangement in the latter case had a tax avoidance purpose.

Scheme and Purpose of the Income Tax Act 2004

A third method used by the courts to read down the literal effects of section BG1 is to determine whether a transaction has a tax avoidance purpose by referring to the scheme and purpose of the Income Tax Act 2004. Arrangements that are within the scheme and purpose of the Act do not constitute tax avoidance. For instance, using a loss attributing qualifying company (that is, a company that is transparent for certain tax purposes) to attribute losses to shareholders is within the scheme of the Act and the intention of Parliament. However, conduct such as inserting a related entity into a transaction in order to create artificial deductions is outside of the scheme of the Act and would be tax avoidance.

Uncertainty and General Anti-Avoidance Rules

The courts have developed methods to read down the literal effects of section BG1. In doing so, they have gone some way towards setting out the dividing line between

³⁸ *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 35.

³⁹ *Case V20* (2002) 20 NZTC 10,233 (TRA).

acceptable tax mitigation and unacceptable tax avoidance. However, in spite of these efforts, the scope of application of the New Zealand general anti-avoidance rule remains uncertain.⁴¹

This uncertainty is not necessarily a negative feature of the general anti-avoidance rule. A degree of uncertainty is necessary for any general anti-avoidance rule to operate as intended. If a general anti-avoidance rule tried to define tax avoidance with absolute certainty, tax avoiders would soon find new strategies that fell outside the definition. It is concrete rules that are most open to avoidance; so a general anti-avoidance rule must indeed be general if it is to catch tax avoidance arrangements and have deterrent value. With generality comes uncertainty.

PART 1VA OF THE AUSTRALIAN INCOME TAX ASSESSMENT ACT 1936: A GENERAL ANTI-AVOIDANCE RULE WITH CONCRETE ELEMENTS⁴²

The Australian anti-avoidance rules provide an interesting contrast with those in New Zealand. The difference in the approaches of the two countries illustrates the important role that the judiciary plays in determining the effectiveness of a general anti-avoidance rule. New Zealand provides an example of how a country's judiciary can adopt statutory interpretation techniques to make an anti-avoidance policy work. But it is also open to a country's judiciary to adopt a different set of interpretive techniques that render its general anti-avoidance rule inoperative. This was the experience in Australia with its previous regime. The current Australian regime was eventually enacted to overturn that line of judicial authority.

New Zealand and Australia started off with very similar anti-avoidance provisions – both rules were open-ended and contained very few internal and external reference points. The first Australian statutory anti-avoidance provision was section 260 of the Income Tax Assessment Act 1936. According to section 260, any arrangement that had the purpose or effect of altering the incidence of income tax was void for tax purposes.

The Australian courts developed two principles of interpretation that significantly reduced the scope of this seemingly limitless rule. The first interpretation technique was the “predication test”, which was formulated in *Newton v Federal Commissioner*

⁴⁰ *Case W33* (2004) 21 NZTC 11,321 (TRA).

⁴¹ *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350, 13,365 Tipping J (CA).

⁴² With David Dunbar.

of Taxation.⁴³ This first technique was followed in New Zealand, and did not cause a problem for the operation of the rule. The second technique was known as the “choice principle” and was developed by the High Court of Australia in *W.P. Keighery Pty Ltd v Federal Commissioner of Taxation*.⁴⁴ According to the choice principle, the Australian general anti-avoidance rule was designed to protect the general provisions of the Income Tax Assessment Act 1936, rather than to deny taxpayers any right of choice between the alternatives that the Act laid open to them.

Development of the Choice Principle

The *Keighery* case concerned a private company that sought to take advantage of tax benefits intended for public companies.⁴⁵ The taxpayer changed its tax status from a private to a public company by issuing a single share to each of a number of additional people who had little economic stake or influence in the company. The High Court held that section 260 offered private companies an implicit choice to change their status into public companies. That is, the general anti-avoidance rule did not frustrate or prevent taxpayers from exercising choices.

The high, or low, water mark of the application of the choice principle was *Cridland v Federal Commissioner of Taxation*.⁴⁶ That case involved a scheme that was designed to take advantage of income averaging rules that were intended to assist pastoral farmers. A unit trust was established, which carried on a modest pastoral farming business. The trust issued shares for one dollar to hundreds of university students in order to enable the students to enjoy the tax preferred status of primary producers. The High Court refused to apply section 260 on the basis that adoption of the arrangement was a choice open to the taxpayers under the Act.

Parliament’s Response to the Choice Principle: The Current Income Tax Regime

The eventual response of the Australian Parliament to the line of cases establishing the choice principle was the enactment in 1981 of the current regime, known as Part 1VA of the Income Tax Assessment Act 1936. That regime was designed to restore the law to what the position was thought to have been prior to the *Newton* and *Keighery* cases. It is interesting to compare how the New Zealand regime and the current Australian regime deal with the problem of choice. The current Australian

⁴³ *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1, 8 Lord Denning (PC).

⁴⁴ *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1956 1957) 100 CLR 66, 92 Dixon CJ, Kitto and Taylor JJ (HC).

⁴⁵ *Ibid.*

regime is broadly similar to New Zealand's. The Australian anti-avoidance rule has three components: the taxpayer must obtain a tax benefit; the benefit must be from a scheme; and the scheme must have been entered into by the taxpayer for the sole or dominant purpose of obtaining a tax benefit. This final element focuses on the dominant purpose of the taxpayer not of the scheme. These elements are similar to the New Zealand position, with the notable exception that the New Zealand test is objective, not subjective.

Another difference is that the Australian general anti-avoidance rule is not as general, open-ended, or uncertain as section BG1 of the New Zealand Income Tax Act 2004. Unlike the New Zealand provision, the Australian Act contains a number of criteria that the courts should use to determine whether the sole or dominant purpose of the scheme was to create a tax benefit. In the context of the present study, the two most important criteria are, first, a comparison between the form and substance of the scheme, and secondly, the question of whether there is a change in the financial position of the taxpayers involved in the scheme.

Difficulties with the Current Income Tax Regime

The Australian experience has demonstrated that the interaction of those three simple elements – a scheme, a tax benefit, and tax avoidance as the dominant purpose – has created a problem. The interaction between the first element, that is, identification of the scheme which conferred the tax benefit, and the third element, the dominant purpose test, is one of the most controversial aspects of Part 1VA of the Income Tax Assessment Act 1936. The fundamental problem has been to define the relevant scheme, since the general anti-avoidance rule itself defines the term widely. A scheme can cover a course of action, or as little as a single unilateral action. If the term is interpreted narrowly it is much easier to draw the inference that a scheme's predominant or sole purpose was tax avoidance.

Commercial and Tax Avoidance Purposes: A False Dichotomy

The ordinary interaction between the simultaneous pursuit of a commercial objective and the integration of tax considerations can, in the words of the High Court, create a "false dichotomy or fallacy". In *Federal Commissioner of Taxation v Spotless Services Limited* the High Court noted that:⁴⁷

⁴⁶ *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330 (HC).

⁴⁷ *Federal Commissioner of Taxation v Spotless Services Limited* (1996) 95 ATC 4775, 4805 (HC).

A particular course of action may be ... both “tax driven” and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a “scheme” for the “dominant purpose” of enabling the taxpayer to obtain a “tax benefit”.

This observation does not indicate how the court will differentiate between ordinary commercial transactions and transactions that are “blatant, artificial or contrived” tax avoidance.⁴⁸ The significance of this point is demonstrated by the facts of a number of decisions of the High Court.

Federal Commissioner of Taxation v Spotless Services Limited arose out of a transaction where a decision had been made to adopt a particular investment strategy to take advantage of the tax concessions specifically granted by the Income Tax Avoidance Act 1936.⁴⁹ The taxpayer had a significant amount of money available for a short-term investment and deposited the money with a financial institution in a tax haven. Interest paid by the tax haven borrower was less than interest available in Australia, but because the interest was ... exempt from tax in Australia, the after-tax receipts were higher than they would have been had the funds been invested in Australia and subject to tax there. The High Court held that the Part IVA applied and the transaction was struck down; it would not have been under the old section 260.

*Federal Commissioner of Taxation v Hart*⁵⁰ involved a successful attack by the Commissioner on a home loan product that had been widely marketed in Australia by financial institutions. The product was known as a “wealth optimiser” loan. It enabled a loan to be split into two parts. The main part was used by the taxpayer to purchase a new private residence. The second part was used to acquire the investment property. A special feature was that all payments of interest and principal were credited against the part of the loan that related to the taxpayer’s private residence until it was completely repaid. Meanwhile, interest on the investment property accrued at compound rates, which increased the principal amount due and accordingly the interest payable. After the loan in respect of the private residence was fully repaid, all of the remaining payments were credited towards the investment property. Overall, the taxpayer paid an amount of interest that was similar to what he would have paid had it been applied rateably to both parts of the loan, but the tax split between the two

⁴⁸ Income Tax Assessment Act 1936, Part IVA, Explanatory memorandum.

⁴⁹ Ibid.

⁵⁰ *Federal Commissioner of Taxation v Hart* (2004) 55 ATR 712 (HC).

components was skewed in favour of increasing the amount of deductible interest on the rental property. The High Court struck down the transactions.

Both cases illustrate a problem that has created considerable difficulty for the Australian judiciary: should Part IVA apply whenever a commercial transaction is structured to produce a tax advantage? The *Hart* case is an example of this dilemma. Despite the concrete elements of the Australian general anti-avoidance rule, uncertainty still exists, as it does in New Zealand, regarding its precise application and the distinction to be drawn between tax mitigation and tax avoidance.

ABUS DE DROIT IN FRANCE⁵¹

The *fraus legis* doctrine, that is, abuse or avoidance of law (sometimes called “abuse of rights”), is rooted in Civil Law principles. French law uses the term ‘*abus de droit*’⁵² when referring either to an abuse of private rights or to avoidance of the law. However, when referring to avoidance of the law, it may be more accurate to use the term ‘*fraude à la loi*’. Nevertheless, both the *fraus legis* doctrine and the French courts use ‘*abus de droit*’ to refer to either concept.

The doctrine of abuse of law is a legal concept that imposes sanctions upon the use of a right when that use exceeds the limits of its reasonable use and enforcement. Beginning with the *Clément Bayard* case in 1915,⁵³ during the Twentieth Century French case law gradually defined several criteria to determine when the use of a right is to be regarded as excessive.

The *Clément Bayard* case concerned a claim made against a landowner who had erected a 16 metre high fence surmounted by metal spikes around his boundary. The fence was of no use for the management of the land, but was erected to prevent hot-air balloons from a nearby airfield from flying over the property. Occasionally, people attempting to do so had their balloons punctured. When balloons became draped over the fence, the landowner sued the balloonists for the damages resulting from the mess. The balloonists counter-claimed on the basis of the danger created by the spikes on the fence. The French Court of Cassation ruled in favour of the balloonists: because the fence was erected purely to harm the property owner’s neighbour, the construction

⁵¹ With Yves-Louis Sage.

⁵² For further information on *abus de droit* see, L. Cadet, P. Le Tourneau, *Encyclopédie Dalloz* (2002), *Abus de droit*, especially n° 7 and seq.

⁵³ Req. 3 August 1915, *Clément Bayard*, D.P. 1917 I 79; S. 1920, I, 300.

was an abuse of the right of ownership. This abuse of right could give rise to damages under articles 544 and 1382 of the French Civil Code.

Generally, an abuse of law occurs when a person who has the right to choose between several legal paths aimed at providing a similar result exercises the right, but in doing so acts with malice or an otherwise improper motive.⁵⁴ Over the years, the criteria to determine whether there is an abuse of right have varied and compounded to form a set of general guidelines that deal with two main forms: (a) social abuse; and (b) intentional abuse aimed to harm a third party.

Social abuse encompasses deliberate actions that are carried out to divert the intended operation of a law in order to achieve a result that the legislature would not have intended. Intentional abuse aimed to harm a third party is what the name implies, that is, the use of a right (or rights) with the sole intention of harming a specific third party.

French case law may leave one under the impression that the intentional abuse concept has gradually supplanted the concept of social abuse. However, that is merely an appearance. The social abuse concept remains an important judicial implement, if not the most important, in this context: it is used to shape and develop the law by interpreting the objectives of legislative provisions according to the surrounding social circumstances. For example, at the end of the 19th century the French courts used the social abuse concept to formulate the principle of the right to be compensated for a breach of an employment contract. Thus, employees were entitled to receive compensation where their dismissals had been unjustifiable.

Under French law, the abuse of rights concept is an important judicial tool. First, it is used to limit the scope of rights that have been granted to an individual or legal entity, and secondly, the concept can be used by the courts to adjust the law to reflect the needs of society as it evolves.

ABUS DE DROIT IN FRENCH TAX LAW: BACKGROUND AND HISTORY⁵⁵

Under French tax law, there is a general presumption that contractual agreements, even between related parties, are genuine and binding, provided that they set out reciprocal obligations. Accordingly, taxpayers are free to organize their economic

⁵⁴ See Amos and Walton *Introduction to French Law* (3 ed, 1967) 219; David Ward et al “The Business Purpose Test and Abuse of Rights” [1985] *British Tax Review* 68; see also, Maurice Cozian *Les grands principes de la fiscalité des entreprises Litec*, 4^o édition.

⁵⁵ With Séverine Baranger, John Prebble, and Lisa Tat.

activities as they wish. However, even though this presumption is generally applicable, the French tax administration is empowered to set aside transactions that are intended only to provide a tax benefit. In this situation, the tax administration may recharacterize a transaction even if the formal elements are effective in law. This authority arises both under the general abuse of law principle and under article L 64 of the *Livre de Procédure Fiscale*, that is, the French Code of Tax Procedure, known as the “LPF”.

Until the mid-nineteenth century, by virtue of favoring the principle of freedom of contract, the French Court of Cassation considered that it was perfectly lawful for taxpayers to choose the less expensive option, in terms of tax liability, to carry out a transaction. It followed that the tax administration could not challenge the taxpayer’s choice of arrangement.⁵⁶ However, a few years later the same court came to almost the opposite conclusion. It recognised a *sui generis* right in the French tax authority to examine transactions in order to discover the true substantive nature of contractual agreements. This right was said to arise in the case of “fraud”, which in this context included what a Common Law court would call avoidance, as well as the more obvious evasion.⁵⁷

Following this decision, the French tax authority began to challenge the validity of what it considered to be “fictitious schemes” set up for evading tax. Today, pursuant to article L 64,⁵⁸ transactions will be deemed to be an “abuse of law” when taxpayers attempt to reduce their liability by relying on documents that misrepresent or simulate the substantive economic nature of the transaction.⁵⁹

Article L 64 originated from a statute passed on 13 January 1941,⁶⁰ which authorized the tax administration (i) to disregard a legal act that had aimed to dissimulate income or profit, and (ii) to recharacterize the transaction according to its

⁵⁶ Cass. Civ, 24, April 1854 (Broyard/ Enregistrement), Dalloz Sirey, 1854, 157. Robbez-Masson cites a similar decision in 1849, Ch. Robbez-Masson, *La notion d’évasion fiscale en droit interne français*, LGDJ, 1990, p. 196. This approach is similar to that of the House of Lords in *IRC v Duke of Westminster* [1936] AC 1. For a comparative discussion see, J Voyame, B Cottier and B Roches, *L’Abus de Droit en Droit Comparé*, in Conseil de l’Europe, *L’Abus de Droit et les Concepts Equivalents*, 1990, Strasbourg, 24 and seq. The authors gratefully acknowledge the work of Olivier Fouquet, whose article “Fraude à la loi et abus de droit”, Dr. Fisc. No 47, 23 November 2006, 1999, led them to a number of the sources mentioned in this and other footnotes to this section of the article.

⁵⁷ Cass. Civ. 20 August, 1867, Dalloz Sirey 1867.

⁵⁸ The rule was previously part of article 244-1 of the French Tax Code, which later became article L 64 in 1981.

⁵⁹ Waal, Allard “Abuse of Right: the CCRAD and the Contribution-transfer: Information or Intox?”, *Revenue Duty*, n° 46, 12/11/2003, 1426-1428T. (See, for example, Cass. Crim, 8 February 2006, n° 05-83493).

genuine character. Cases involving this *fraus legis* principle could be submitted by the tax authority to a pre-litigation Consultative Committee. The burden of proof fell on the taxpayer if the Consultative Committee was in support of the tax administration. If the Consultative Committee found the existence of a fraudulent intention, there was a 100 per cent increase in the tax liability.

A statute passed on 27 December 1963⁶¹ modified this procedure. First, a special penalty of 200 per cent was introduced. Secondly, the procedure was limited to avoidance achieved by contractual agreements, rather than applying to all “legal acts”. Thirdly, the statute extended the procedure to registration tax and to most turnover tax. Lastly, the 1963 statute altered the powers of the Consultative Committee in respect of cases referred by the tax administration. The Committee could no longer disqualify the taxpayer from defending the impugned arrangement, but could only order that the burden of proof should be reversed in any resulting litigation, and should lie on the taxpayer.⁶²

Law No 87-502 of 8 July 1987⁶³ introduced articles L 64 and L 64 B of the LPF, which allowed taxpayers, as well as the tax administration, to submit their cases to the Consultative Committee. If it was found that the tax administration had failed to follow the procedure set out in article L 64, the reassessment would not be valid. The burden of proof in any subsequent litigation fell on the party that received a negative opinion from the Committee or, where the case had not been referred to the Committee, from the tax authority.

Scope and Procedure under Article L 64

Under article L 64, the tax authority is empowered to disregard artificial or fictitious dealings that have a sole purpose of evading or lowering the tax liability that would otherwise have attached to the transaction in question. This principle has been expressed as being, in essence, the equivalent of the “substance over form” principle

⁶⁰ JO, 3 February 1941, rectified in JO 15 February 1941, p. 746. The provisions of this law were incorporated into Art. 115 of Decree No 48-1948, which introduced the former Art. 244 in the French Tax Code.

⁶¹ Law No 63-1316 of 27 December 1963 introducing Art. 1649 quinquies B and Art. 1732 CGI.

⁶² Consultative Committee for the repression of abuses rights (CCRAD). In 2005, 38 requests were submitted to the Committee (14 in the taxpayers’ favour) against 41 in 2004 (11 in the taxpayers’ favour), 39 in 2003 (4 in the taxpayers’ favour), and 34 in 2002. For the whole 2005 CCRAD report, see Bulletin Fiscal Lefebvre, 6 / 2006, 679.

⁶³ Art. 2, III of Law No 87-502 of 8 July 1987, which introduced a penalty of 80 per cent on the tax due by the taxpayer, by virtue of Art. 1729 CGI, in case of abuse of law within the meaning of article L 64.

that is embodied in various pieces of tax legislation.⁶⁴ The tax administration may reassess the taxpayer under article L 64 whether the transaction is fictitious or genuine, but it must be proven that the transaction was motivated partly or wholly by reasons of avoidance. However, the abuse of law principle within article L 64 does not prevent the taxpayer from choosing the legal framework most favourable to his transactions.⁶⁵ There is a subtle equilibrium in this respect between what is simply the freedom of taxpayers to organise their affairs and what amounts to an abuse of law. Essentially, for there to be an abuse of law, it must be demonstrated that the legal form of the transaction does not equate to the substance of the transaction.

A fundamental gloss that the courts have put on the doctrine of abuse of law as applied in the context of article L 64 is known as the doctrine of simulation. In essence, this doctrine denies legal effect to transactions that are artificial or “simulated”. The courts have gradually incorporated the doctrine into the abuse of law concept both generally and, in particular, in tax cases, though in the latter cases with certain restrictions.⁶⁶

Within the parameters of this approach, the French Supreme Administrative Court (Conseil d'Etat) has ruled consistently since 1981⁶⁷ that a seeming abuse of law that appears on its face to amount to simulation only⁶⁸ does not amount to an abuse except where:

- a) the documents produced by the taxpayer are fictitious;⁶⁹ or,

⁶⁴ Bruno Gouthière “France: French anti-abuse international tax legislation: recent developments” (November 2006) 46 IBFD, European Taxation, 154.

⁶⁵ Ibid, 159.

⁶⁶ Repression of abuses rights: Main tendencies of the year 2003 (Report/ratio of the Consultative Committee for the repression of abuses rights), Léraillé, Celine, the News Tax, n° 912, 15/04/2004, 22-25.

⁶⁷ 12 June 1981, n° 19079, RJF 9/81 n° 787. For another example see, Maurice Cozian “To disguise a transfer of goodwill under cover of a concession of user licence: this is an abuse right” Revue Revenue duty, 2004, n° 44-45, 1594.

⁶⁸ See for example, CE, 10 June 1981, req. 19 079: Droit fiscal, 48-49 / 1981, comm. 2187 ; RJF 9 / 1981, n° 787; Cass. Com. 19 Avril 1988, n° 86-19079: RJF 2 / 1989, n° 250 ; Avis CE 8 Avril 1998, n° 192539, Ass., Sté de distribution de chaleur de Meudon et Orléans (SDMO) : RJF, 5 /1998, n° 593, Chr. Verclytte, p. 359, Conclusions Goulard, p. 378; Cass., Ch. com, 2004-11-16, 02-17147, CA of Lyon, 2003-10-02, 2002/01586, published by the Service de Documentation et d'Etudes de la Cour de Cassation. Article L 64 of the *Livre de Procédure Fiscale* does not apply to a forgiveness of debt if the creditor, acting with a donative intention, does not receive any value in exchange, CA Poitiers, 2nd Ch. civ, June 15, 2004, n°03-1872, Epx Briand.

⁶⁹ CE 8° et 9° s-s, 11 October 1978, n° 06744, Sieur X c/ Ministre de l'Economie, des Finances et de l'Industrie ; CE 9° et 8° s- s, 17 January 1979, n° 05118, Sieur X c/ Ministre de l'Economie, des Finances et de l'Industrie. TA Rouen, 3e ch., 20 June 2002, req. n° 97 809, Cordier; see also, Mme x / Ministre de l'Economie, des Finances et de l'Industrie CE Contentieux, 21 Décembre 1983, n° 31934.

b) if the documents are not fictitious, where they cannot be explained or justified by any reason⁷⁰ other than the exclusive and intentional⁷¹ purpose of reducing or avoiding tax.⁷²

The penalties under the abuse of law principle are severe. The income subject to reassessment is added back to the taxable income and the total tax burden is then increased by 80 per cent as a penalty for the adjustment. Parties to the abusive transaction are jointly liable to pay the penalty. Late payments incur a monthly interest penalty of 0.4 per cent.

Relationship between Article L 64 and the General Abuse of Law Principle

Before the decision of the French Supreme Administrative Court in *Sté Janfin*,⁷³ it was unclear whether the general abuse of law principle as applied in Civil Law cases could apply also to tax cases. Some authors took the view that the tax administration was entitled to apply the abuse of law doctrine only within the framework of the procedure of article L 64. The jurisprudence on article L 64 can be summarized as follows: article L 64 does not cover all tax matters, but where the reassessment falls within the scope of the article, the special procedure set out in article L 64 must be followed strictly; otherwise the reassessment is not valid. The tax administration thus took the view that the general abuse of law principle could be used within the framework of article L 64.⁷⁴ The issue was whether the position taken by the tax administration was correct.

The French Supreme Administrative Court resolved this issue in the *Janfin* case. Although the court denied the application of article L 64 to the facts of that case, it held that, in general, the tax administration could disregard an action with legal consequences on the basis of the general abuse of law principle in situations where the specific provision of article L 64 could not be applied. That is, the general principle, which is based on case law, could be applied if the sole purpose of the transaction was to benefit from the literal application of legal provisions in order to avoid or diminish

⁷⁰ Only schemes aimed at avoiding the payment of tax could be validly challenged by the tax authorities, Administrative Court of Appeal Nancy, 14 March 1996, n° 93-729, 2e ch., SARL Inter Selection.: RJF 11 / 96, n° 1329: conclusions Commenville, BDCF 6 / 96, 45.

⁷¹ CE 17 January 1994, n° 120157, 8e et 9e s.-s., Chollet : RJF 3 / 1994, n° 304.

⁷² CE Contentieux, 10 June 1981, n° 19079, *Ministre du Budget c/ x*; CE Contentieux, 10 May 1993, n° 95128, *SARL Elite Model Management c/ Ministre de l'Economie, des Finances et de l'Industrie*; cf. "Transfers de bénéficiaires, prise en charge de pertes par une société en participation: abus de droit ou acte anormal de gestion?" Lexbase Hebdo n° 38 du 11 Septembre 2002 - Edition Fiscale.

⁷³ CE, 27 September 2006, No 260050, *Sté Janfin*:

a tax burden. To invoke this general principle, the tax administration must establish that the transaction or act has a fictitious character.

The scope of the general abuse of law principle in tax cases is limited as it does not apply to situations covered under article L 64; for example, tax credits, real estate tax (taxes foncières), dwelling tax, and payroll tax. In general, the burden of proof, which rests with the tax administration, will be difficult to discharge in applying the general abuse of law principle outside the framework of article L 64.

The court concluded in the *Janfin* case that the tax administration had not invoked the general abuse of law principle. Consequently, as article L 64 did not apply to the case in question, the court decided the case in favour of the taxpayer.

Examples of the Application of Article L 64

French tax authorities usually apply the substance over form doctrine to foreign investment structures that appear to be contrived to avoid tax. Typically, such structures employ foreign holding companies.⁷⁵ In two recent decisions, the Supreme Administrative Court dealt with the application of article L 64 in respect of the use of Luxembourg 1929 holding companies⁷⁶ by French resident companies.

The first judgment was delivered on 18 February 2004.⁷⁷ In that case, the taxpayer, a French company, established a Luxembourg 1929 holding company as a subsidiary. The Luxembourg subsidiary then invested in a sub-subsidiary in the Cayman Islands. The taxpayer argued that the use of the Luxembourg 1929 holding company was motivated by legitimate business considerations. The Supreme Administrative Court rejected this argument. The court found that the 1929 holding company had no economic substance, as investment activities were fully controlled by its Cayman Islands subsidiary and a Luxembourg bank. Further, the 1929 holding company benefited from the Luxembourg participation exemption for dividends and capital gains. That is, when the holding company's investment income was repaid to the French company in the form of dividends, the dividends were eligible for the participation exemption in France, which resulted in substantial tax savings. The lack

⁷⁴ For an excellent analysis of the abuse of law principle under French tax law, see, Olivier Fouquet, "Fraude à la loi et abus de droit", Dr. Fisc. No 47, 23 November 2006, 1999.

⁷⁵ For an example of the most recent decisions, see Administrative Tribunal of Versailles 13/12/2005 5e ch., n° 0404909, RJF 6/06 n° 750, see Droit et Patrimoine, May 2006 & RJF 6/06 n° 750.

⁷⁶ In 1929, the Grand Duchy of Luxembourg legislated to establish holding companies that, essentially, are ignored by the Luxembourg tax system as long as their initiatives and business activities are outside Luxembourg.

⁷⁷ CE, 18 February 2004, No 247729, min. c/ Sté Pléiade : Dr. fisc. 2004, No 47; RJF 5/04, No 510.

of economic substance in the 1929 holding company and the substantial tax savings suggested that the company was set up purely to avoid tax. The Supreme Administrative Court held that the Luxembourg structure was an abuse of law falling within article L 64.

In the second case,⁷⁸ the taxpayer argued that article L 64 was incompatible with European Union law, in particular with the right to freedom of establishment as set out in article 43 of the European Community Treaty. Freedom of establishment confers the right on individuals to take up and pursue activities as self-employed persons, companies, or firms. Restrictions on the freedom of establishment are prohibited, including restrictions on setting up agencies, branches, or subsidiary companies in other Member States. The case involved a French resident company using a Luxembourg 1929 holding company that again had no economic substance. The Supreme Administrative Court stated that the application of article L 64 is restricted to situations where the tax authority can prove that the structure of a company is either fictitious or simulated, or is motivated solely by tax reasons. The court added that article L 64 is intended to exclude purely artificial structures that have the sole purpose of avoiding French tax by employing transactions or investment structures that are contrived to take advantage of provisions of the tax law that offer benefits to the taxpayer. The Supreme Administrative Court thus held that the abuse of law doctrine in article L 64 was compatible with article 43 of the EC Treaty.

Article L 64 in a Tax Treaty Context

The case of *Bank of Scotland*⁷⁹ concerned the application of article L 64 in the context of the issue of beneficial ownership under the France-United Kingdom tax treaty. The case involved a usufruct structure that was later rendered inoperative for the taxpayers by a legislative amendment introduced by the Finance Amendment Law 1993.⁸⁰

On 5 November 1992, an American parent company concluded a usufruct agreement with the Bank of Scotland, under which the bank acquired dividend coupons attached to the shares of the French subsidiary of the American parent company for three years. On 30 September 1993, the French company distributed dividends to the bank in an approximate gross amount of FRF 90 million, which was

⁷⁸ CE, 18 May 2005, No 267087, SA Sagal: Dr. fisc. 2005, No 44-45, comm.726.

⁷⁹ CE 29 December 2006, no. 283314 : *Bank of Scotland* – RJF 3/07, no. 321, 322; 248-251.

⁸⁰ Art. 45 of Finance Amendment law for 1993, no 93-1353 of 30 December 1993, published in Official Journal n° 303 of 31 December 1993, p 18,521 amending Art. 158 ter (I) of the French Tax Code.

subject to a 25 per cent withholding tax. On 15 December 1993, the bank requested a refund of the French withholding tax levied in excess of the maximum rate of 15 per cent under article 9(6) of the France-United Kingdom tax treaty, and also asked for the transfer of the *avoir fiscal* tax credit under article 9(7) of the treaty.

The French tax administration rejected the claim of the Bank of Scotland, arguing that the beneficial owner of the dividend distribution was not the bank but the American parent company. According to the tax administration, the price paid by the bank to the American company to acquire the dividend coupons corresponded to the amount of the net dividends before withholding tax. Consequently, the tax administration characterised the transaction as a loan that was granted by the bank to the American parent company for three years, which was repaid as to principal by the dividends from the subsidiary, and as to interest by the *avoir fiscal* tax.

The issue was whether the Bank of Scotland, having acquired dividend coupons under a usufruct agreement with the American parent company, was the beneficial owner of the dividends distributed by the French subsidiary within the meaning of article 9(6) of the France-United Kingdom tax treaty. The bank brought the case to the Lower Court of Paris, which rejected its claim on 4 July 2001.⁸¹ The bank then appealed to the Court of Appeals of Paris, which ruled in its favour.⁸²

The case then came before the Supreme Administrative Court. The court examined the usufruct agreement and concluded that the transaction in reality concealed a loan agreement between the bank and the American company, with repayment by the French subsidiary. The court stated that the advantages of the France-United Kingdom tax treaty, namely, reduced withholding tax and transfer of the *avoir fiscal*, could be granted only to the effective beneficial owner of the dividends. The court then stated that the usufruct agreement was motivated solely by tax reasons, with the aim of benefiting from the transfer of the *avoir fiscal* tax credit, which was available under the France-United Kingdom tax treaty,⁸³ but not under the France-United States tax treaty.⁸⁴ The court held that, on analysis, the agreement

⁸¹ To our knowledge, this decision has not been published.

⁸² Court of Appeals of Paris (CAA Paris), 23 May 2005, n° 01-4068, 5e ch. B, *Sté Bank of Scotland-RJF* 5/06, no 569.

⁸³ Income tax treaty between France and the United Kingdom of 22 May 1968, as amended by four Protocols signed on 10 February 1971, 14 May 1973, 12 June 1986, and 15 October 1987.

⁸⁴ Income and capital tax treaty between France and the United States of America of 28 July 1967, as amended by four Protocols signed on 12 October 1970, 24 November 1978, 17 January 1984, and 16 June 1988.

revealed that the beneficial owner of the dividends was the American parent company, which delegated the repayment of the loan to its French subsidiary.

The Supreme Administrative Court also denied the claim of the bank that it had been deprived of the right to request advice from the Consultative Committee for the Prevention of Abuse of Law, available under the provisions of article L 64. The court considered that the case in question did not arise from a tax reassessment procedure, but merely from the denial of a claim for a withholding tax refund and the transfer of *avoir fiscal* tax credits. Accordingly, the tax administration was entitled to scrutinize the agreement and to reclassify the transaction as a loan agreement without applying the procedure set out in article L 64.

Ultimately, the Supreme Administrative Court concluded that the Bank of Scotland was not the effective beneficial owner of the dividends distributed by the French company within the meaning of article 9(6) of the France-United Kingdom treaty.⁸⁵ Therefore, the bank was not entitled to a refund of the excess withholding tax or the transfer of the *avoir fiscal* tax credit.

There are two conclusions to be drawn from the *Bank of Scotland* case. First, article L 64 applies only when there has been a reassessment and when the procedures set out in article L 64 have been followed. Secondly, where it is simply a matter of denying treaty benefits there is, strictly, no reassessment. In such cases, therefore, the tax administration may invoke the general principle of abuse of law, as set out in the *Janfin*⁸⁶ case. To invoke the doctrine, the tax administration must establish: (i) that there was a planned arrangement; and (ii) that the exclusive aim of putting the plan into effect was to obtain a tax advantage that the taxpayer could not normally have received. Where relevant treaty clauses apply, the beneficial ownership principle⁸⁷ reinforces the general principle of abuse of law.

ALLOWABLE SCOPE OF ANTI-AVOIDANCE RULES FOR EUROPEAN COMMUNITY MEMBERS⁸⁸

⁸⁵ Art. 9 (6) of the income tax treaty between France and the United Kingdom, see footnote 83: "Dividends paid by a company which is a resident of France to a resident of the United Kingdom may be taxed in the United Kingdom. Such dividends may also be taxed in France, but where such dividends are beneficially owned by a resident of the United Kingdom the tax so charged shall not exceed: (a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which controls the company paying those dividends; (b) in all other cases 15 per cent of the gross amount of the dividends."

⁸⁶ See footnote 73.

⁸⁷ See text following footnote 79.

⁸⁸ With Franca Frenzel.

Many European Union jurisdictions have their own anti-avoidance rules. However, in practice, these rules do not wholly determine the scope of states' tax-avoidance provisions. All European Union member states must ensure that their national laws are consistent with the fundamental freedoms guaranteed under the European Community Treaty. This includes member states' anti-avoidance rules, which must not undermine or infringe any of the freedoms guaranteed under the Treaty.

The guaranteed freedom of establishment is particularly pertinent in the context of anti-avoidance rules. The aims of freedom of establishment are to ensure free market principles while also promoting market equality. It requires foreigners and nationals to be treated equally and to be subject to the same rules and conditions. Anti-avoidance rules often deal with cross-border situations, for instance, the use of tax havens. An anti-avoidance provision designed to restrict the use of tax havens is likely to do so at the cost of freedom of establishment.

Rights guaranteed by the Treaty take precedence over the aims of national laws. When a domestic law limits a guaranteed freedom, it can be challenged before the European Court of Justice. The court then determines whether those limitations are nonetheless justified. In the context of anti-tax-avoidance provisions that are challenged on the basis that they limit freedom of establishment, the court decides whether the provisions are justified and so compatible with European Community law, in spite of their effect on freedom of establishment.

For European Community members, there is thus an extra dimension that has to be considered in designing and enacting anti-avoidance provisions. An anti-avoidance provision needs to work in a domestic context, but it also has to be consistent with the country's European Community membership obligations.

Decisions of the European Court of Justice

The decisions of the European Court of Justice provide guidelines for national legislators regarding how they should design national anti-avoidance provisions. The court's approach has been to view national anti-avoidance rules as justified provided that they restrict freedom of establishment only with respect to wholly artificial arrangements. If an anti-avoidance provision restricts freedom of establishment with respect to some arrangements that are not wholly artificial, then it is inconsistent with European Community law.

From the late 1990s, the European Court of Justice considered a number of anti-avoidance rules to see whether they complied with the freedom of establishment principle.⁸⁹ The rules considered include the United Kingdom's group relief provisions and the German CFC regime. In each instance, the court held that the rules were unjustified restrictions on freedom of establishment. The anti-avoidance legislation did not have the specific purpose of preventing wholly artificial arrangements that were set up to circumvent national tax legislation; rather, the anti-avoidance provisions applied generally. In these earlier cases, neither the court nor the Advocate-General defined what constitutes a wholly artificial arrangement. Eventually, in the *Cadbury Schweppes* case of 2006⁹⁰ the Advocate-General proposed a definition, which the court in due course adopted.⁹¹

The Cadbury Schweppes Case

The *Cadbury Schweppes* case involved a British company that, like the German company in the *Dublin Docks* case already discussed,⁹² established subsidiary companies in Ireland because of the low corporate income tax rate of 10 per cent. This was found to be a tax avoidance arrangement. The United Kingdom CFC provision meant that the arrangement had no effect against the Revenue – the profits of these subsidiaries were treated as belonging to the United Kingdom parent company and were taxed according to the higher United Kingdom tax rate. The taxpayer took the case to the European Court of Justice. It objected to paying the higher, United Kingdom, tax rate on the grounds that this was a restriction of its freedom of establishment.

The Advocate-General considered whether the prevention of tax avoidance was sufficient to justify the United Kingdom's CFC rules. He advanced the view that national anti-avoidance rules should not be drafted to deal with cross-border situations in general terms. They must be worded to enable the national courts to refuse the

⁸⁹ Case C-264/96; *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Tax)* [1998] ECR I-4695; Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779; and Case C-9/02 *De Lasteyrie du Saillant v Ministere de l'Economie, des Finances et de l'Industrie* [2004] ECR I-2409; see also the general abuse of rights case, Case C-110/99 *Emsland-Staerke GmbH v Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569.

⁹⁰ Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] Opinion of Advocate General Léger (ECJ). The opinion of the Advocate-General was confirmed by the European Court of Justice: Case C-196/04; *Cadbury Schweppes pls and another v Inland Revenue Commissioners* [2007] Ch 30.

⁹¹ *Ibid*, para 111 (Advocate General), para 65 (Court).

⁹² *BFH* [19.1.2000] I R 94/97, DStR 2000, 511 ("the *Dublin Docks* case"). See text accompanying footnote 21, above.

freedom of establishment only to companies that have made use of wholly artificial arrangements for the purpose of avoiding tax. The Advocate-General stated that:⁹³

[A]ccording to a phrase habitually used in the case law, a hindrance to a freedom guaranteed by the Treaty can only be justified on the ground of counteraction of tax avoidance if the legislation in question is specifically designed to exclude from a tax advantage wholly artificial arrangements aimed at circumventing national law.

The Advocate-General considered that the courts were obliged to decide objectively, on a case-by-case basis, whether national anti-avoidance provisions were worded sufficiently narrowly to constitute a justified limitation on the guaranteed freedom of establishment. As explained under the next heading, the court adopted the Advocate-General's proposals.⁹⁴

The Cadbury Schweppes Case: "Wholly Artificial Arrangements" Defined

The Advocate-General went on to define what is meant by wholly artificial arrangements. He said that the existence of a tax reduction motive is too subjective a criterion for the artificiality of chosen arrangements. The level of taxation, like labour costs or infrastructure, is a factor that a company can take into account in choosing its host state. The Advocate-General developed a negative definition of what arrangements are wholly artificial, presenting three objective criteria for arrangements that are not wholly artificial. Arrangements satisfying the criteria cannot be said to be wholly artificial.

The first criterion is that the subsidiary company must be genuinely established in the host state, and must have the substance and capability to perform the services that have resulted in the reduction of the tax burden. Otherwise, it is wholly artificial. Secondly, the services performed by the subsidiary must be of a genuine nature. The subsidiary cannot be a mere tool of execution. Its staff must have the competence to provide the service and to make decisions, and must actually make those decisions. Finally, the subsidiary's services must have some economic value from the perspective of the parent company. If the subsidiary's services have no economic value, then payment for them by the parent cannot be regarded as consideration and the payment is merely a sham. If any one of these criteria is not fulfilled, the arrangement is wholly artificial.

⁹³ *Cadbury Schweppes pls and another v Inland Revenue Commissioners* [2007] Ch 30, para 87.

⁹⁴ *Ibid*, paras 55 and 65.

The European Court of Justice confirmed the decision of the Advocate-General. First, the court agreed that an intention to obtain tax relief by incorporating a company that is a controlled foreign company is not in itself sufficient to demonstrate that there is a wholly artificial arrangement; other objective circumstances must be satisfied.⁹⁵ Secondly, the court, in essence, adopted the definition of wholly artificial arrangements as set out in the three criteria developed by the Advocate-General. Essentially, the “incorporation of the CFC must correspond with an actual establishment intended to carry on genuine economic activities in the host member state.”⁹⁶ If that cannot be demonstrated, then the creation of the CFC must be regarded as a wholly artificial arrangement. The court concluded that:⁹⁷

[A]rticles 43 and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a member state of profits made by a CFC in another member state, where those profits are subject in that state to a lower level of taxation than that applicable in the first state, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that, despite the existence of tax motives, that CFC is actually established in the host member state and carries on genuine economic activities there.

Anti-Avoidance Provisions in European Community Member States: A Difficult Balancing Act

States that are members of the European Community are restricted in the drafting of national anti-avoidance provisions. These rules cannot be drafted too broadly, or they are likely to be incompatible with the European Community Treaty’s freedom of establishment. These provisions must instead be drafted narrowly so that they only combat arrangements that are wholly artificial and made with the sole purpose of avoiding tax. However, as has been discussed earlier, the generality of an anti-avoidance rule is its best weapon against tax avoidance. The European Court of Justice’s definition of wholly artificial arrangements in terms of the three negative criteria is intended to be exhaustive.

Concrete, definite rules are the easiest to avoid and have the clearest loopholes. This means that legislators in European Community states are faced with a difficult balancing act. An anti-avoidance provision will be effective against tax avoidance arrangements and have a deterrent effect only if it is not going to be struck

⁹⁵ Ibid, paras 63 and 64.

⁹⁶ Ibid, para 66.

down by the European Court of Justice on the grounds that it is an unjustified limitation of the state's Treaty obligations. Thus, legislators need to draft these provisions narrowly so that only wholly artificial arrangements are caught. However, in drafting anti-avoidance rules so narrowly, legislators face other risks. An anti-avoidance provision that is narrowly drafted may be avoided. If this occurs, it is likely to provide little or no protection or deterrence.

THE JUDICIAL SHAM DOCTRINE IN THE UNITED STATES OF AMERICA⁹⁸

The United States of America is the first of two jurisdictions discussed in this article that manages to combat tax avoidance without having an anti-avoidance rule or an abuse of law doctrine.⁹⁹

Like any jurisdiction with a tax system, the United States faces the issue of how to distinguish acceptable tax mitigation from unacceptable tax avoidance. Ideally, a tax system provides guidance on this issue, whether by judicial interpretation, administrative pronouncement, or legislative enactment. The United States, with its three equal branches of government (the judiciary, the executive, and the legislature) employing a system of checks and balances, has witnessed the participation of each of these branches in the enforcement and interpretation of the tax laws on such issues.

History of the Judicial Formulation and Application of the Sham Doctrine in the United States

From the earliest days of its income tax law, American courts have felt free to scrutinize a transaction, regardless of its literal compliance with the taxing statute, in order to ensure that it was one of substance, compliant not only with the language of the tax law, but with its spirit as well. The ease with which this was done by the courts during the infancy of the federal tax law was remarkable.

The Sixteenth Amendment authorizing an income tax was ratified by the states in 1916. As early as 1935,¹⁰⁰ with regard to a transaction complying with the literal text of the 1924 Revenue Act, the Supreme Court in its landmark decision of *Gregory v*

⁹⁷ Ibid, para 75.

⁹⁸ With Philip Postlewaite.

⁹⁹ The other jurisdiction is the United Kingdom. Croatia, although it also lacks a general anti-avoidance rule and does not have a strong abuse of law tradition, nonetheless falls into a separate category from the United States and United Kingdom. Croatia has an anti-sham doctrine, but this is never used in practice to combat tax avoidance. There is no coherent approach in Croatia to tax avoidance.

¹⁰⁰ Earlier tax decisions had already shown the judiciary's willingness to intervene where necessary.

*Helvering*¹⁰¹ applied a judicial sham or business purpose doctrine to a transaction for which the taxpayer sought tax-free treatment. Emphasizing the legislative purpose for the statute, the transaction was invalidated for tax purposes notwithstanding compliance with the literal text of the statute.

Thus, early on, without delay, the courts felt that it was their duty to ensure that the application of the taxing statute required the transaction's substance, not its form, to be followed. In doing this, they attempted to ascertain the legislative purpose in enacting the statute and to ensure that the transaction complied not only with its text, but with its purpose as well. The courts invoked various judicially-created doctrines, all emanating from the same concern, but employing different verbiage in their description and application, to safeguard against transactions elevating form over substance.

As the courts confronted more avoidance cases they refined and developed further doctrines and sub-doctrines. The sham doctrine originally meant all things to all people; it now comprises a shorthand phraseology for any number of judicial safeguards – the doctrine of substance over form, the step transaction doctrine, the economic substance doctrine, or the business purpose doctrine.¹⁰²

These judicial safeguards were soon recognized by most tax practitioners as something that they should consider in structuring transactions. The Common Law surrounding tax law was something that taxpayers and their counsel learned to integrate into their tax planning, lest their efforts be undercut and thwarted by the application of these judicial safeguards.¹⁰³ After fully signaling the availability of these doctrines and their potential application, the courts experienced a period of relative tranquility with regard to the interpretation and application of these judicial

¹⁰¹ *Gregory v Helvering* (1934) 69 F 2d 809 (2d Cir); aff'd (1935) 293 US 465. As stated by the court, "Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business purpose or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner ... the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

¹⁰² A District Court recently revealed its own exasperation at attempting to define and apply these different safeguards. See *Long Term Capital Holdings v United States* (2004) 330 F Supp 2d 122 (D Conn) where the court asserted that "[t]he terminology used, whether sham, profit motivation, or economic substance is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance... ."

¹⁰³ See generally, Harris, "The Economic Substance Doctrine in the Federal Tax Law: Understanding When and How It Should Apply" (2006) 64 NYU Tax Institute 27-1 to 27-60.

doctrines. Practitioners tended to shy away from transactions that might test the boundaries between acceptable tax mitigation and unacceptable tax avoidance.

Tax Products and Increasing Invocation of the Safeguard Doctrines by the Service

The landscape changed dramatically in the United States in the 1990s – tax practitioners became less hesitant to “push the envelope”. The period was marked by the rise of tax products. These were prepared generically for any wealthy taxpayer with a need for tax benefits and were designed and peddled by accounting firms, investment bankers, and some law firms. This rise led to a new round of scrutiny and interpretation of the definition and application of the sham doctrine. Many of the tax product transactions of the period appeared reminiscent of the excessive efforts of the early days of the tax law that led to the creation and application of the judicial safeguard doctrines. Surprisingly, the courts have struggled more than one would have expected given their prior judicial activism, with far more decisions favouring the taxpayer than most would have imagined.

The Rise of the Judicial Safeguard of Economic Substance

This wave of tax products led to substantial litigation and the rise of the latest judicial safeguard through which to safeguard against abuse - “economic substance.”¹⁰⁴ The test for a transaction’s economic substance has two prongs. First, the court must find that the taxpayer subjectively had a non-tax purpose for the transaction. Second, there must be an objective showing of a realistic possibility of pre-tax profit. However, the application and interpretation of this standard is uncertain. The economic substance test has been increasingly endorsed by the lower courts; however, this recent formulation of economic substance has not been considered by the Supreme Court. As a consequence, it has not been defined on a uniform basis. It is uncertain whether the test is exclusive or to be combined with other factors, and also whether it is disjunctive or conjunctive. The courts have varied with their answers.¹⁰⁵ The confusion continues, with differences appearing among the Circuit Courts of Appeal in the test’s formulation and application.

¹⁰⁴ Harris, *Ibid* 27-5 that traces the origins of the doctrine to *Gregory v Helvering* above, n 101.

¹⁰⁵ See *Transcapital Leasing Assocs 1990-II LP v. United States* (2006) 97 AFTR 2d 2006-1916 (WD Tex) in which the court noted the different approaches of three Circuit Courts of Appeal in applying the economic substance doctrine.

The first case on whether anti-avoidance judicial safeguards apply to tax products was *ACM Partnership v Commissioner*,¹⁰⁶ where the government prevailed. While acknowledging its tax-motivated structuring, the taxpayer attempted to justify the tax consequences by reference to other considerations. The efforts were unsuccessful in large measure because the court concluded that the structures were shams, lacked business purpose, and lacked sufficient economic substance.

Notwithstanding the government's success in *ACM*-type cases, in the great majority of other tax products cases, taxpayers' successes have been dramatic, both in number and in the extreme nature of the products' design. Taxpayer victories include *IES Industries, Inc v United States*,¹⁰⁷ *United Parcel Service of America Inc v Commissioner*,¹⁰⁸ *Black & Decker Corporation v United States*,¹⁰⁹ *Compaq Computer Corp v Commissioner*,¹¹⁰ *TIFD III-E v United States*,¹¹¹ and *Coltec Industries Inc v United States*.¹¹² The string of victories by taxpayers is unprecedented and suggests a change in the judicial climate when such issues present themselves.

The Compaq Decision

Most indicative of the eradication or shrinkage of the former judicial safeguards is the Fifth Circuit's decision in the *Compaq* case.¹¹³ The significance of *Compaq* is that, on its facts, it is one of the most extreme settings of the cases producing taxpayer victories. If there were ever a case which would have been classified before the turn of the century as virtually certain to fall prey to the application of judicial safeguard doctrines, it was *Compaq*. The duration of the transaction was less than 24 hours; it had little or no relevance or connection to the taxpayer's business; the transaction costs were significant; the economic profit was virtually non-existent; and the tax

¹⁰⁶ TC Memo 1997-115, aff'd in part and rev'd in part, (1998) 157 F 3d 231 (3rd Cir). The *ACM* progeny were similarly invalidated as unacceptable tax-driven structures. See *ASA Investering Partnership v Commissioner* (2000) 201 F 3d 505 (DC Cir); *Saba Partnership v Commissioner* (2001) 273 F 3d 1135 (DC Cir); and *Boca Investering Partnership v United States* (2003) 314 F 3d 625 (DC Cir). See also Harris, above n 103, 27-18. While this might appear to be a significant streak of victories by the government, they all involved the same issue, the same tax product, and the same Court of Appeals. Accordingly, the impact of this precedent upon other controversial transactions was not as great as one might otherwise expect.

¹⁰⁷ *IES Industries, Inc v United States* (2001) 253 F. 3d 350 (8th Cir).

¹⁰⁸ *United Parcel Service of America Inc v Commissioner* (2001) 254 F 3d 1014 (11th Cir).

¹⁰⁹ *Black & Decker Corporation v United States* (2006) 436 F 3d 431 (4th Cir) involving a grant of a motion for summary judgment with a remand for a further determination of whether the sham transaction doctrine is applicable.

¹¹⁰ *Compaq Computer Corp v Commissioner* (2001) 277 F 3d 778 (5th Cir).

¹¹¹ *TIFD III-E v United States* (2004) 342 F Supp 2d 94 (D Conn).

¹¹² *Coltec Industries, Inc v United States* (2004) 62 Fed Cl 716.

¹¹³ Above, n 110. The same issue was presented in *IES Industries, Inc v United States* above, n 107, which also held in favor of the taxpayer.

savings were extraordinary. If confronted with the facts of the case as a proposed transaction to be entered by their client, most tax practitioners in the 1990s would have had grave difficulties in endorsing the transaction. Nevertheless, reflective of a new era of broad judicial latitude and deference given to tax transactions, excessive interpretive literalism, and increasing judicial restraint, the transaction and its dramatic tax savings were upheld.

The facts of the *Compaq* case, in brief, involved the taxpayer's purchase of stock of a Dutch corporation on which a dividend had been declared. The stock was sold almost immediately, that is, within one hour, back to the original seller, after Compaq had become the owner of record. As characterized by a leading commentator, "the strategy was designed to essentially provide for the risk-free purchase of foreign tax credits".¹¹⁴ As noted by the court, the purchase price was approximately \$888,000,000, reflecting a net dividend of approximately \$19,000,000.¹¹⁵ The sale price an hour later was approximately \$868,000,000: the purchase price less the amount of the net dividend payable to Compaq. Transaction costs, the net out of pocket costs of participating in the tax-saving device, totalled \$1,500,000.

The transaction produced an overall loss, of which most rational taxpayers would stay clear. However, the motivation for Compaq's participation was the foreign tax credit generated by the 15 per cent withholding tax. The near \$22,000,000 dividend was taxable by the United States, the approximately \$19,000,000 loss on the sale sheltered related gains from other transactions entered by Compaq, and the transaction costs were deducted, resulting in additional tax to the United States of about \$500,000 given Compaq's tax rate of 33 per cent.¹¹⁶ The overall cost before taking the foreign tax credit into account was more than \$2,000,000.¹¹⁷ Nevertheless, as the transaction generated an additional foreign tax credit of over \$3,000,000, it produced an overall benefit of approximately \$1,000,000. The investment of pre-tax \$1,500,000 resulted in a post-tax gain of \$1,000,000 which "was accomplished in an hour and possessed minimal market risk."¹¹⁸

¹¹⁴ See Harris, *supra* n 103, 27-32.

¹¹⁵ That is, the actual dividend of approximately \$22,000,000 less the 15 per cent withholding tax payable to the Netherlands.

¹¹⁶ See Harris, above, n 103, 27-34.

¹¹⁷ That is, the transaction costs plus increased tax liability.

¹¹⁸ See Harris, above, n 103, 27-34.

The Tax Court concluded that the transaction lacked both a business purpose and pre-tax profit potential.¹¹⁹ Nevertheless, the Fifth Circuit faulted the analysis of the lower court on the basis that it has focused on the net, rather than the gross, dividend. Instead, the Fifth Circuit concluded that there was a pre-tax profit of approximately \$1,500,000. It further emphasized the taxpayer's lack of control over the market, the possibility, although not a probability, of price fluctuations, and the risk that the dividend might not actually be paid. Accordingly, the Fifth Circuit upheld the transaction.

Textualism in the Application of the Tax Law

It is important to note the great uncertainty that remains about the application of the judicial safeguard doctrines to income tax cases in the United States. None of the recent cases challenged on the basis of such doctrines has yet been considered by the Supreme Court. Nevertheless, such taxpayer efforts have drawn the attention of Congress, which increasingly proposes to legislate the standard for the judicial determination of economic substance. Some commentators attribute this possible shift from one branch of the government to another to the rise of textualism as the interpretive standard employed by the courts when addressing tax legislation. The fear of usurping the role of the legislative branch has increasingly led the courts to apply the "plain language of the statute" in their judicial scrutiny of the transaction and to look no further. This plain language approach does not allow courts to search for the purpose of the legislation or attempt to predict how Congress would have reacted if it had actually considered the precise situation presented to the court.¹²⁰

This tendency appears attributable to the Supreme Court's pronouncements in its first tax case of the new millennium. The Supreme Court in *Gitlitz v Commissioner*¹²¹ allowed a transaction that had produced a tax loss without the taxpayer incurring an accompanying economic loss. In responding to the concern of the Service that without judicial intervention the transaction would produce a "double windfall," the court dismissed the concern summarily by stating that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this

¹¹⁹ Above, n 110.

¹²⁰ See Harris, *supra* n 103, 27-47. In *TIFD III-E v United States* (2004) 342 F Supp 2d 94 (D Conn) the court expressly indicated its view that such safeguard efforts are exclusively within the province of the legislature by stating that "[t]he government is understandably concerned that the Castle Harbour transaction deprived the public fisc of some \$62 million in tax revenue Under such circumstances, the IRS should address its concerns to those who write the tax laws."

¹²¹ *Gitlitz v Commissioner* (2001) 531 US 206.

policy concern”.¹²² A similar attitude appears to have enveloped the judiciary of the United States regarding the application of the historic safeguard regimes, moving the issue of which branch of government should address these types of issues sideways to another branch.

A Shift to the Legislative Branch of the Responsibility to Provide Appropriate Safeguards by Statute

In many ways, the *Compaq* case evidences the shift for the responsibility of preventing excessive taxpayer behaviour to the legislative branch. The courts are becoming increasingly tolerant of taxpayer efforts and concluding that, if safeguards are needed, it is job of Congress to provide them. For instance, legislation correcting the results obtained in the *Compaq* case followed through the enactment by Congress of § 901(k), which provides that: “In no event shall a credit be allowed ... for any withholding tax on a dividend ... if - (i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend...”.¹²³ Thus, Congress, rather than the courts, closed the opportunity to produce these tax-driven results.

Interestingly, even with regard to the heart of the judicially created and contoured safeguard doctrines, there have been repeated proposals to legislate the meaning of “economic substance.” While unaddressed by the House of Representatives, the Senate amended a tax bill in May of 2006 in order to provide for the “[c]larification of the economic substance doctrine”, given the lack of uniformity in its application.¹²⁴ The amendment was dropped in the Conference Agreement. This effort reflects a growing Congressional concern with these problems and a willingness to intervene in such matters. Judicial safeguards are moving sideways to the legislature and receiving greater attention, not only in the definition of such safeguards but increasingly in legislation preventing future taxpayer victories on transactions previously allowed by the courts.¹²⁵ Simultaneously, the judiciary has become more

¹²² *Ibid.*, 218.

¹²³ 26 USC 901(k)(1)(A).

¹²⁴ Section 411 of the Senate Amendment to the Tax Increase Prevention and Reconciliation Act of 2006 (PL 109-222). The Senate amendment would have strengthened the judicial safeguard by mandating the application of a conjunctive test in which a transaction would be respected only if the taxpayer could meet both prongs of the economic substance test.

¹²⁵ To reference but a few statutory overrides of judicial decisions, see ss 26 USC, 358(h), 734(d), and 743(d).

restrained in its application of such safeguards, viewing such matters as no longer within its province.

THE UNITED KINGDOM: A JURISDICTION WITH NO GENERAL STATUTORY RULE¹²⁶

Like the United States, the United Kingdom lacks a general anti-avoidance rule. Both have relied to a large extent on their respective judiciaries to interpret statutory provisions in question and to determine whether transactions constitute tax avoidance. However, the lack of a general anti-avoidance rule does not mean that matters relating to avoidance are left solely to the judicial branch of the government.

Her Majesty's Revenue and Customs and the Anti-Avoidance Group

In the United Kingdom, the collection of tax is administered by Her Majesty's Revenue and Customs, or HMRC, a non-ministerial department of the British Government. HMRC was formed by a merger of the Inland Revenue and Her Majesty's Customs and Excise and came into formal existence on 18 April 2005. A key target for HMRC in the United Kingdom is to reduce the tax gap, that is, the difference between the amount of tax that is actually collected, and the amount that should have been collected. A significant part of that tax gap arises from tax avoidance, and accordingly HMRC takes an active interest in its prevention.

Shortly after HMRC was established, it set up the Anti-Avoidance Group. The Group's objective is to reduce the tax gap attributable to avoidance in a systematic manner. It has responsibility for policy advice on preventing and tackling avoidance, as well as for working with operational colleagues to identify and investigate avoidance activity more effectively. Its approach is based around three generic problems that are believed to provide the conditions for avoidance. The first is the opportunities for avoidance that are currently provided by United Kingdom tax legislation. The second stems from the insufficiency of disincentives or deterrents to prevent taxpayers from entering into avoidance schemes. The third is the practical difficulty of quickly identifying avoidance transactions.

In relation to the first of these problems, the Anti-Avoidance Group recognises that minimising the tax gap that arises from avoidance begins with the legislative process. If there are loopholes in the legislation, then there is a risk that some taxpayers will exploit these loopholes and avoid tax. It is important to design tax legislation carefully so that it is avoidance-proof, or as close to avoidance-proof as

¹²⁶ With David Pickup.

possible, from the outset. On the second theme, HMRC aims to make the risks to taxpayers of engaging in tax avoidance outweigh the benefits. These risks already include investigation and litigation, but the aim is to ensure that avoiders face increased financial risks and risks to their reputations. In relation to the third problem, that is, identifying avoidance, a key development has been the introduction of advance disclosure regimes for direct and indirect tax, which put disclosure obligations on those who use and promote certain tax schemes and arrangements. Disclosure increases transparency, allowing earlier detection of avoidance activity and more effective targeting of HMRC's response.

Currently two main legislative techniques are employed in the United Kingdom to combat and control tax avoidance. The first technique is to enact specific legislation; the second is to enact targeted anti-avoidance provisions, also known as "mini general anti-avoidance rules", aimed at deterring and countering avoidance in a specific area of the tax system.

The Sham Doctrine

The United Kingdom does not have a general anti-avoidance rule. However, the courts have developed their own approach to tax avoidance, namely, the sham doctrine. According to this doctrine, the courts will not recognise a transaction that is a sham and instead will impose tax according to the transaction's economic substance. A sham transaction is one in which the parties to the transaction had intended to create different rights and obligations from those appearing in the relevant documents, and to give a false impression of those rights and obligations to third parties.

The fact that a transaction is uncommercial or artificial does not necessarily mean that it is a sham. The approach of the United Kingdom courts to taxing uncommercial or artificial tax arrangements has evolved over time. For many years, the approach of the courts was permissive of any arrangement that fitted within the language, even if not within the spirit, of the legislation. The prevailing doctrine was that laid down by Lord Tomlin in the *Duke of Westminster* case in 1936, where he said that:¹²⁷

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

¹²⁷ *Duke of Westminster v CIR* [1936] AC 1, 19 Lord Tomlin (HL).

That permissive approach, sometimes expressed as being one of form over substance, survived until the 1980s, when the courts, confronted by new and sophisticated tax avoidance devices, developed a new approach that was more restrictive of tax avoidance. They did not do so in a particularly logical or structured way, however. The cases exhibited marked variations in judicial attitudes on issues such as the correct approach to composite transactions, and on whether transactions or elements of transactions with no commercial or business purpose were to be disregarded by the court. More radical approaches were sometimes initially adopted but were then modified or limited by later cases.

The current purposive approach is far removed from the approach of *Duke of Westminster* case. It is set out by the House of Lords in *Barclays Mercantile Business Finance Limited*.¹²⁸ Under this approach, judges engage in a statutory construction exercise and determine whether the legal form of a transaction matches its economic substance. Judges are to:¹²⁹

... give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description.

The current purposive approach is less permissive of tax avoidance. However, as John Tiley, a leading United Kingdom scholar, has noted, the current position is well summarised by the old newspaper headline “Less chaos, more uncertainty!” That position is compounded by the incorporation, following the *Halifax* case,¹³⁰ of the European principle of abuse into the United Kingdom’s value added tax, or VAT, law. That decision effectively introduced the concept of “abusive practice” into European Union VAT law. However, the judgment was not an outright victory for HMRC, and contained comments that support taxpayers’ right to arrange their affairs to pay less tax if they so choose.

It will be fascinating to see how the concept is developed in future cases, whether the principle of abuse can be applied beyond VAT, and how the principle will influence the judicial approach to the interpretation of direct tax issues that have been referred to here.

¹²⁸ *Barclays Mercantile Business Finance Limited v Mawson (Inspector of Tax)* [2004] UKHL 51

¹²⁹ *Ibid.*

ENVOI

The speakers at the colloquium from which the papers that make up this article were drawn covered a range of jurisdictions. Although there are differences between the jurisdictions' approaches to tax avoidance, a number of common themes emerge. The first is that, in relation to tax avoidance, all jurisdictions share the same basic aim – that is, to combat it. Tax avoidance is a problem for all countries and it is in all countries' interest to attempt to curtail it to the greatest degree possible. The jurisdictions discussed in the colloquium differ not in their aim to combat tax avoidance, but in the methods that they employ. Most of the jurisdictions use statutory general anti-avoidance rules. Some, notably the United Kingdom and United States of America, do not have a general anti-avoidance statute. In those jurisdictions the courts have stepped in to play a greater role in developing anti-avoidance approaches, such as creating rules like the sham doctrine, though the courts in the United States have drawn back from judicially-created anti-avoidance rules since the late 1990s. Civil Law jurisdictions, such as France and Germany, have available the doctrine of abuse of law, but even in Civil Law countries there is a tendency to enact general anti-avoidance rules that apply in tax cases in addition.

Formulating the aim of combating tax avoidance is straight-forward. Developing an approach that will successfully address the problem is a more nuanced matter, whether for a Civil Law or Common Law jurisdiction. A number of interests must be balanced against a jurisdiction's aim to minimise tax avoidance. There is a fine line between tax mitigation and tax avoidance. The prevention of the latter must be addressed in a way that is consistent, predictable, and fair, so that taxpayers can manage their affairs intelligently, confidently, and in good faith.

This balancing act is more complex still for European Union member states. In these jurisdictions, domestic laws must be consistent with the fundamental freedoms guaranteed under the European Community Treaty, in particular, the freedom of establishment. The European Court of Justice recognises the abuse of law concept in principle and acknowledges the existence of the United Kingdom sham doctrine. However, the court has proved to have a very formalist approach. As a result, it is very permissive of tax avoidance – tax avoidance thrives on formalism.

¹³⁰ *Halifax Plc v European Court of Justice* (2006) C-255/02.

Only one jurisdiction among those studied in this article does not appear actively to pursue the aim of combating tax avoidance, namely Croatia. In fact, Croatia altogether lacks a coherent approach to tax avoidance. Unlike other Civil Law jurisdictions discussed in the colloquium, Croatia lacks a strong abuse of law doctrine. Although it has a codified anti-sham doctrine, that rule has never been used. However, in the context of the colloquium, Croatia is a special case. Its tax system is young, and its economy developing. At present, evasion is a more pressing problem for Croatian authorities than avoidance and so enforcement efforts are generally on evasion.

A second theme that emerged in the course of the colloquium is that the concepts of form and substance play different roles in income tax cases from their roles in other areas of the law. One author discussed the view that an income tax is more likely to need a general anti-avoidance rule than other sorts of tax.¹³¹ Income tax law necessarily taxes the results of legal transactions, rather than their underlying economic effect. The target of the tax, that is, economic profits, is not legally able to be taxed directly. Instead, a legal description of these economic profits is the subject of the tax. However, that legal description is never anything more than a simulacrum of the profits. There is always a gap between what the legal description of a set of transactions is and the underlying economic reality. This means that income tax law is fundamentally defective. As a fundamentally defective law, income tax turns out to need a rather unusual kind of law to enable it to operate effectively. It is almost a question of needing to have two evils in order to get a good – assuming of course that income tax is a good. John Rawls held that sometimes a law will need two evils to operate in practice, saying that “[t]wo wrongs can make a right in the sense that the best available arrangement may contain a balance of imperfections, an adjustment of compensating injustices.”¹³² The need for general anti-avoidance rules does not arise with the same urgency in respect of other kinds of taxation where tax applies to something that is more readily identifiable, such as in a customs duty on imported goods, or in a wealth tax, or in an estate duty where the actual wealth of the deceased is in question. There will still be rough edges, but income tax is notable in having a fundamental flaw at its core.

¹³¹ See John Prebble “Fictions of Income Tax” (Australasian Tax Teachers Association 14th Annual Conference, Manukau Institute of Technology, January 2002).

¹³² John Rawls “Background Institutions for Distributive Justice” from *A Theory of Justice* (The Belknap Press of Harvard University Press, Cambridge, Massachusetts, 1971) 279, also published in JC Smith and David N Weisstub (eds) *The Western Idea of Law* (Butterworth & Co Ltd, Canada, 1983) 479 – 490.

A third theme of the colloquium was the role of the court in interpreting tax statutes. From the early days of United States income tax law, the American courts have felt free to scrutinise not only the legal form of transactions, but also their economic substance. This means looking beyond whether a transaction fits within the literal meaning of a tax statute to whether the transaction accords with its spirit as well. Historically, United States courts have approached the task of interpreting tax statutes purposively rather than literally. Nevertheless, courts have not felt so free to adopt a purposive approach to tax matters in all Common Law jurisdictions.

To understand why, perhaps, the United States appear to have resiled from this position since the turn of the twenty-first century, consider the example of New Zealand. The Income Tax Act 2004 contains a statement that the Act's purpose is to raise tax.¹³³ But even in the absence of such a provision, it would be fairly clear to any reader of the statute that the collection of revenue was a key purpose. In fact, it should not be controversial to state that most, if not all, tax legislation shares such a purpose. The New Zealand Interpretation Act 1999, section 5(1) says that all legislation should be interpreted purposively.¹³⁴ This rule replaced a similar provision in the earlier Acts Interpretation Act 1924.¹³⁵ On its face and on its words the Acts Interpretation Act 1924 applied to all legislation.¹³⁶ However, in the *International Importing* case,¹³⁷ Turner P refused to apply section 5(j) of the Acts Interpretation Act 1924 to interpret tax legislation purposively, saying that section 5(j) was "normally of little material assistance in the construction of revenue statutes".¹³⁸ His Honour's reason was that if the court adopted a purposive approach to interpret tax statutes, it would always have to decide tax cases in favour of the Commissioner.¹³⁹

¹³³ **AA1 Purpose of Act**

The main purposes of this Act are—

- (a) to define, and impose tax on, net income[:]
- (b) to impose obligations concerning tax[:]
- (c) to set out rules for calculating tax and for satisfying the obligations imposed.

¹³⁴ **5 Ascertaining meaning of legislation**

- (1) The meaning of an enactment must be ascertained from its text and in the light of its purpose.

¹³⁵ **5 General rules of construction**

... (j) Every Act, and every provision or enactment thereof, shall be deemed remedial, whether its immediate purport is to direct the doing of anything Parliament deems to be for the public good, or to prevent or punish the doing of anything it deems contrary to the public good, and shall accordingly receive such fair, large, and liberal construction and interpretation as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true intent, meaning, and spirit.

¹³⁶ This was also true of the Acts Interpretation Act 1924.

¹³⁷ *Commissioner of Inland Revenue v International Importing Co Ltd* [1972] NZLR 1095 (CA).

¹³⁸ *Ibid*, 1096, lines 33-34 Turner P.

¹³⁹ *Ibid*, lines 32 – 42 Turner P.

The difficulty with adopting a purposive approach to tax legislation is that the purpose of raising tax is too broad to be decisive in respect of the finely balanced issues of interpretation that arise in the context of transactions that may or may not constitute tax avoidance. Adopting a purposive approach to interpretation when a tax statute's broad purpose is to generate revenue would always lead to decisions in favour of the Commissioner. The purposive test is circular when applied to tax avoidance. A transaction that is potentially tax avoidance is one that, at least, results in a taxpayer suffering less tax than would have been attracted by another arrangement. If the test for whether a transaction amounts to avoidance is simply whether it is inconsistent with the Act's purpose of raising tax for the state, then the general anti-avoidance rule will always catch the suspected arrangement.

As a consequence, historically a purposive approach to statutory interpretation in tax cases was not favoured in a range of Common Law countries. Yet, before the present century that approach was well-established in the United States of America, clearly underpinning America's sham doctrine.

A fourth theme that emerged was whether there are features of a tax system itself, aside from targeted anti-avoidance measures, that can encourage or discourage tax avoidance activity. The colloquium considered whether there is a correlation between the prevalence of tax avoidance activity and the levels of tax rates. A hypothesis that is often advanced, and perhaps assumed by many to be true, is that the lower the tax rates and the broader the tax base, the less the propensity of taxpayers to attempt to avoid tax. Inherent in such a hypothesis is the assumption that taxpayers are to some extent provoked to engage in tax avoidance by tax rates that are unduly high.

There is no data to prove or disprove such a hypothesis in New Zealand. One has the impression that in the United States there is no link between tax rates and rates of tax avoidance. Income tax rates have oscillated widely in the United States since the 1950s. At the end of the Second World War, the highest tax rate was 70 per cent, and before that it was upwards of 90 per cent. Following the war, the top rate went down to 50 per cent. Under Ronald Reagan's administration from 1981 to 1989, the top rate dropped to 28 per cent. Since then, the top rate has crept back up to the rate in 2006 of around 35 per cent.

However, the hypothesis that higher tax rates lead to more tax avoidance activity has not been borne out by the United States experience. The post-War years were not

marked by rampant tax avoidance even though tax rates were high during that time. On the other hand, the tax rates of the 1990s were much lower. Yet that period was characterised by the rise of tax products that were prepared generically for wealthy taxpaying clients of accounting firms, investment bankers and law firms. The aim was to avoid tax, but taxpayers were not driven to this by tax rates that were particularly high compared to previous levels in the United States, or to tax rates in other jurisdictions. From a United States perspective, the lowering of the rates does not seem to have had any dramatic minimisation of taxpayers' efforts to avoid tax.

Similarly, in the United Kingdom there does not appear to have been a causal link between tax rates and the incidence of tax avoidance. Many of the problems with tax avoidance that have been experienced in the United Kingdom appear to have been caused not by tax rates themselves but by the degree of complexity of the tax system as a whole. The greater the number of exemptions, exclusions, special cases, and different rates that are present in a tax system, the more complex it becomes. The more complex the tax system, the greater the incentive there is for people to try to play on those differences.

While minimisation of tax avoidance is a goal for the designers of tax legislation, it is only one among many considerations. Legislation must operate in the real world, which includes the real political world. The political process dictates the aims of the taxation system. A tax system designed with the primary purpose of minimising tax avoidance would no doubt be very different from the tax systems considered in this article. Such a system might be much less complex, and it might succeed in minimising tax avoidance, but this achievement would be at the expense of a number of other factors. One view is that the biggest problem in terms of encouraging, or failing to discourage, tax avoidance is the scale of tax legislation. This is a problem that is common to most jurisdictions. In 1941, the relevant Australian federal tax legislation covered 81 pages. As at 2004, that had exploded to 8,500 pages, or 13,500 pages including fringe benefits, capital gains, and superannuation tax. In the United Kingdom, approximately 400-500 pages of primary tax legislation are added every year. The position in the United States is similar.

The greater the complexity and sheer volume of tax law, the more scope there is for inventive taxpayers and their lawyers to find ways to engage in tax avoidance. The United States' experience indicates that this impulse is not connected, or not strongly connected, with the tax rates themselves. If it is correct that tax rates are not decisive,

then reducing avoidance is not a simple matter of lowering, or of flattening, rates. Complexity is more likely to influence rates of tax avoidance, but prevention of avoidance by itself is not a sufficient reason to simplify taxation regimes in any complex, real world political environment. Thus, jurisdictions must work within their more or less complex tax systems to find other ways of addressing tax avoidance.

The final theme of the colloquium was the relative effectiveness of the various approaches to tax avoidance employed by the jurisdictions that were discussed. The effectiveness of any jurisdiction's approach to tax avoidance prevention can be assessed in either pragmatic or principled terms. It is sensible to apply the tests in that order. The first question should be pragmatic: how well does a jurisdiction's approach work in practice to address tax avoidance? If a number of jurisdictions' approaches to tax avoidance are similarly effective in pragmatic terms, then a principled comparison becomes highly relevant: what is the most appropriate method, in principle, to address tax avoidance? This principled question is really a separation of powers question. That is, which branch of government should be charged with the responsibility of dealing with tax avoidance?

Little needs to be said about Croatia in relation to this theme. In pragmatic terms, Croatia is very permissive as regards tax avoidance. It almost entirely lacks any approach at all to the problem. Among institutions in other jurisdictions, the European Court of Justice appears to be the least effective at counteracting tax avoidance. The European Court has struck down such standard measures as controlled foreign company and transfer pricing legislation, and rules against loss transfers among multinational groups on the grounds that these measures undermine the freedom of establishment. This approach causes difficulties for governments of European Union member states who wish to collect tax. Their efforts to counteract tax avoidance and to prevent taxpayers from shipping income to what are effectively tax havens can be readily undone by the European Court of Justice.

A pragmatic comparison between the remaining jurisdictions discussed at the colloquium is complex. It is difficult to single out one jurisdiction as being clearly the most successful at preventing tax avoidance. On one view, the United States approach has been one of the harshest on tax avoidance, at least until the present century. Regardless of how a taxpayer manages to fit a dubious transaction within the words of a taxing statute, the courts are still able to look to the purpose of the legislation. The courts have a broad Common Law power to undo transactions that are outside of the

spirit of the law if the transaction appears, for instance, too good to be true. But the Civil Law jurisdictions' abuse of law doctrine also does well on pragmatic terms. It is an elegant concept that maps well onto tax avoidance scenarios, perhaps especially so when in addition it is embodied specifically in tax codes. The Australian and New Zealand approach of using a legislative general anti-avoidance rule also endows the courts with powers to undo tax avoidance provisions that are within the literal meaning, but outside the spirit, of the law.

If there is little to distinguish these jurisdictions in terms of how well they combat tax avoidance in practice, then it becomes particularly relevant to assess their laws in principled terms. It is difficult to compare Civil Law and Common Law jurisdictions; they operate within different frameworks and traditions. In principled terms, it is consistent for Civil Law jurisdictions to apply the abuse of law doctrine that pervades the whole Civil Law in the specific context of tax avoidance. The principled enquiry is a live issue, however, when it comes to comparing Common Law jurisdictions' approaches to tax avoidance. For the Common Law jurisdictions, this enquiry concerns constitutional matters, such as which branch of government should be charged with combating avoidance activity.

There is much to be said for the view that a general anti-avoidance rule, such as is used in New Zealand and Australia, is preferable to the judicially-led approach of countries with no statutory general anti-avoidance rule, such as the United States and United Kingdom. The principled advantage of a general anti-avoidance rule is that it legitimises what the judiciary tries to do in jurisdictions that lack general anti-avoidance rules. While general anti-avoidance rules can be difficult to apply on occasion, they provide a constitutional foundation upon which the courts can build to address avoidance activity. It is notable that even in the United States, the home of the judicially developed sham doctrine, there is considerable discussion as to whether the economic substance approach should be codified, and in the United Kingdom the possibility of enacting a general anti-avoidance rule is a frequent topic of debate.