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Karen B. Brown *Editor*

A Comparative Look at Regulation of Corporate Tax Avoidance

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A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE

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A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE

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Dedicated in loving memory to Leon E. Wynter. Il y a longtemps que je t'aime. Jamais je ne t'oublierai.

Preface

This book provides a comparative exploration of the ways in which a broad range of countries seek to regulate corporate tax avoidance. The reader will note in the Overview and in each of the country-related chapters that tax avoidance involves attempts by taxpayers to fashion transactions that take advantage of statutory provisions in ways not intended or anticipated by the legislature. Statutory language may contain ambiguous language susceptible to multiple interpretations that create so-called "loopholes" enabling the taxpayer to exploit this vulnerability in order to minimize tax liability. The taxpayer accomplishes tax avoidance, but not by illegal means (there is no fraud or deceit). At the heart of tax avoidance is manipulation of a statute to appropriate tax benefits and gain a tax advantage not enjoyed by others that do not enter into elaborate business structures in order to circumvent the expected operation of a statute or to bring a transaction within its purview.

The chapters that follow distill, analyze, and critique the myriad ways in which a legislature may address tax avoidance. All countries considered in this work take efforts to combat avoidance, but their approaches differ radically. Anti-avoidance tactics are disparate and cover the spectrum. They include adoption of general substance over form principles applied by courts to determine whether a business configuration meets the letter and spirit of a statute conferring tax benefits, use of targeted anti-avoidance rules that apply to a limited number of transactions, implementation of an overarching general anti-avoidance provision (GAAR) furnishing principles to guide the adjudicatory body in most cases, and enactment of disclosure and penalty regimes designed to deter entry into inappropriate tax-minimizing schemes.

Foundational principles of the reigning legal system bear tremendous influence on the manner in which a legislature addresses tax avoidance transactions. Countries that share the common law tradition in some instances have taken a more activist approach, allowing the courts more leeway in reading a statute to determine whether the scheme developed by the taxpayer involving circuitous steps, undertaken for no discernible business purpose, undermines the legislature's intent in enacting the

provision. Some countries following the civil law tradition are more reluctant to depart from actual statutory language in order to deny tax benefits when a transaction meets the literal letter of the law, but subverts the intention of the legislature. While approaches differ, all countries featured in this volume have opted to employ some type of strategy to limit the ability of taxpayers to engage in activity to unilaterally undercut the effect of legitimate rules intended to cover all taxpayers. To do otherwise would render the legislature unable to ensure that the tax burden is fairly apportioned among all taxpayers and is not limited to those not able or willing to hire fancy advisers to set up tax shelters and other types of vehicles that skirt the operation of the law.

Although some may characterize tax avoidance as sophisticated tax planning or even bottom-line-sanctioned mitigation, it is apparent that this burgeoning taxpayer self-help movement poses a serious threat to a country's prerogative to govern its citizens. A crucial component of sovereignty is the ability to raise revenue to fulfill the infrastructure and social needs of its constituents. Avoidance of duly enacted provisions poses a threat to the effective operation of a free society for the benefit of a small group of members who seek the privilege of shifting their tax burden onto others in order to compete more effectively in the world of commerce. At a time of sustained decline in world economies, all countries are under pressure to secure the revenue-raising capacity of tax systems. Yet the efficacy of a tax system rests substantially upon its ability to distribute the tax burden fairly. There is no buy-in to the legitimacy of a tax system if taxpayers perceive that they are shouldering more than a fair share of the obligation.

Because tax avoidance is one of the top concerns of many nations, the importance of this work cannot be overstated. It provides a fascinating look at the anti-avoidance strategies employed by more than fifteen countries in eastern and western Europe, Canada, the Pacific Rim, Asia, Africa, and the United States. This volume was conceived in connection with the 18th World Congress of the International Academy for Comparative Law ("the Academy"), an organization headquartered in Paris. Excerpts from many of the chapters were presented during a week long conference in July, 2010, in Washington, D.C. at the session entitled "Regulation of Corporate Tax Avoidance," as one of more than 30 panel and plenary sessions relating to cutting edge topics in comparative law. The 18th Congress was co-sponsored by the Academy, the American Society for Comparative Law, American University, Georgetown University, and George Washington University. I would like to heartily thank Peter Fahrner, a graduate of George Washington University (GWU) Law School, and Christopher Davis and Rachel Zelman, current students at GWU Law, for outstanding research assistance. Finally, thank you, Ian, for joy and friendship.

Washington, DC Karen B. Brown

Contents

1 **Comparative Regulation of Corporate Tax Avoidance: An Overview** 1
Karen B. Brown

Part I Country Reports

2 **Australia** 25
Maurice Cashmere

3 **Canada** 65
Carl MacArthur

4 **The People's Republic of China** 105
Kevin Holmes

5 **Croatia** 123
Nataša Žunić Kovačević

6 **France** 131
Daniel Gutmann

7 **Germany** 149
Ulrich Palm

8 **Hungary** 193
Éva Erdős, Zoltán Nagy, and Zoltán Varga

9 **Italy** 197
Carlo Garbarino

10 **Japan** 223
Keigo Fuchi

11 **Netherlands** 231
Raymond H.C. Luja

12 **New Zealand** 243
Zoë Prebble and John Prebble

13 Poland 267
Bogumił Brzeziński and Krzysztof Lasiński-Sulecki

14 Slovenia 277
Nana Šumrada

15 Taiwan 299
Keh-Chang Gee and Yuan-Chun (Martin) Lan

16 United Kingdom 305
Sandra Eden

17 United States 335
Tracy A. Kaye

Appendix 381

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Chapter 1
Comparative Regulation of Corporate Tax Avoidance: An Overview

Karen B. Brown

1.1 Introduction

Corporate tax avoidance presents a serious challenge to the effective administration of tax laws. Tax avoidance involves arrangement of a transaction in order to obtain a tax advantage, benefit, or reduction in a manner unintended by the tax law. It is an unacceptable manipulation of the law which is unlike legitimate tax mitigation. Mitigation involves use of the tax law to achieve anticipated tax advantages embedded in tax provisions. Tax avoidance is also to be distinguished from tax evasion. Evasion involves outright fraud, concealment, or misrepresentation in order to defeat application of the tax laws.[1]

Tax avoidance is an affront to tax administration when it violates core principles. Efficiency, fairness, and administrability support the effective administration of tax laws. Taxpayers engaging in tax avoidance transactions undermine the ability of the tax authority to predict the amount of revenue to be raised by a given tax provision. In addition, if the tax laws impact similarly situated taxpayers differently as a result of tax avoidance, fairness is sacrificed. Moreover, authorities expend significant resources in attempts to combat tax avoidance techniques. To the extent that tax avoidance transactions fail to enhance productivity or to marginally increase resources, increased costs of administration constitute a waste.

This overview fulfills two goals. It uses a number of measures to analyze and contrast the laws regulating corporate tax avoidance in more than 15 countries. It also considers whether a country's approach to

[1] The distinction between tax mitigation, avoidance, and evasion is detailed in Zoë Prebble and John Prebble, Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law, BULL. INT'L TAX. 151 (April 2008), electronic copy available at: http://ssrn.com/abstract=1605483.

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combating tax avoidance is guided by the manner in which tax avoidance techniques assault core values supporting the system. The Appendix includes a chart that summarizes the major features of the tax avoidance law of the countries covered in this overview.

1.2 Regulation of Tax Avoidance – In General

The divide between acceptable mitigation (tax planning) and unacceptable avoidance is variable and depends upon the foundational principles of a country's tax laws. In the U.S., maintaining a common law tradition at the federal level, the judiciary ultimately holds responsibility for determining whether to deny expected tax benefits in a tax avoidance transaction. As discussed below, the U.S. legislature has enacted a form of a general anti-avoidance rule, codifying the economic substance doctrine, a common law device employed by courts to scrutinize various tax-minimizing schemes. Despite codification of a key anti-avoidance principle, federal courts nonetheless retain the power to determine whether a transaction that meets technical requirements of a statute fails to achieve the tax-reducing result sought by the taxpayer.

While, generally, a taxpayer in the U.S. may organize its affairs so as to minimize the tax consequences of a deal,[2] Congress has taken the opportunity to curtail attempts to circumvent the expected application of a tax provision. One tool is to build into selected sections of the tax code itself statutory language restricting attempts to accomplish indirectly results prohibited by direct steps. These provisions, also known as targeted anti-avoidance rules, frequently deny tax benefits if the transaction is undertaken with the principal purpose of tax avoidance.

For example, one provision disallows any deduction, credit, or other tax benefit, if avoidance of income tax is the principal purpose of the acquisition of control of a corporation.[3] Another provision, attributes items of income, deduction, credit, and other allowances to the employee-owners of a professional corporation formed with the principal purpose of diverting tax liability from the owners.[4] Another more subtle provision, like the loss disallowance rule, which denies deduction of a loss sustained on direct sale of an asset to a related party, also disallows a loss on an indirect sale to a related party. Thus, the restructure of a transaction as a sale to an unrelated third party who immediately re-sells the asset to the intended related party

[2] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[3] Internal Revenue Code (IRC) §269.

[4] IRC §269A.

would not achieve allowance of the loss because the statute itself negates losses on indirect sales as well.[5]

Administrative regulations also contain targeted anti-avoidance rules ("TAARs"). Those contained in the conduit financing rules under Regs. §1.881-3 were issued after the IRS lost several cases in which the courts refused to curtail treaty shopping by disregarding entities inserted into a transaction in order to reduce or eliminate U.S. tax liability. Partnership anti-abuse regulations limit the ability to organize a business as a partnership in order to reduce tax liability of partners in a manner inconsistent with the intent of the partnership provisions.[6]

When the statute and regulations are silent regarding the results of circuitous steps taken by taxpayers, the courts have filled a gap to determine when tax planning crosses the line into unacceptable tax avoidance. They have employed some version of a "substance over form" approach to defeat manipulation of enacted provisions by ingenious schemes. The usual trigger for such an analysis is the tax authority's contention that a particular deal constitutes an end-run around the statute. Courts resort to the "step transaction," "sham transaction," or "business purpose" common law doctrines to determine whether the tax benefits sought are obtained. This inquiry by the courts requires maintenance of a difficult balance between scrutiny of tax code compliance, a legitimate task, and enactment of supplemental tax law, which constitutes illegitimate assumption of authority in a legal system like that in the U.S. where the executive, legislature, and judiciary possess discrete powers and spheres of influence.[7]

In addition to the more general doctrines described above, courts have also applied an "economic substance" test. Primarily, this test applies to find tax avoidance when a taxpayer enters into a transaction with no realistic possibility of economic profit ("economic substance") and with no business purpose other than tax minimization.[8] Although generally both the absence of a profit motive and lack of business purpose are necessary to disallowance of tax benefits, some courts have found no tax avoidance when the transaction had either economic substance or a business purpose.

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[5] IRC §267(a)(1).

[6] While courts accord substantial authority to regulations issued under general or specific authority delegated by Congress, regulations may be challenged as beyond the IRS's interpretive power. See, e.g., *Mayo Foundation for Medical Education & Research v. U.S.*, 131 S. Ct. 704 (Jan. 11, 2011); *Mannella v. Comm'r*, 132 T.C. 196 (2010), *rev'd*, 631 F.3d 115 (3rd Cir. 2011); *Swallows Holding Ltd. v. Comm'r,* 126 T.C. 96 (2006), *vacated and remanded*, 515 F.3d 162 (2008).

[7] *Coltec Industries, Inc. v. U.S.*, 62 Fed. Cl. 716 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006).

[8] Commentators often describe the inquiry into the existence of economic substance as an objective one, while the business purpose test is described as subjective.

While, as discussed below, the U.S. has chosen to codify the economic substance doctrine, in part, in order to dictate to courts the parameters of the tax avoidance inquiry, an alternative approach would emphasize the role of the courts in scrutinizing legislative intent. One well-regarded U.S. scholar argues that the economic substance doctrine is an ill-suited tax avoidance weapon. She finds it more appropriate to address the question whether "tax results are abusive" by leaving it to the courts to search for congressional intent. The ascertainment of congressional intent, she contends, offers a court the opportunity to balance the twin goals of an income tax statute – to measure income and to induce desired behavior. This is an enterprise more fruitful than the labeling of transactions as "tax shelters" and the subjective determination of the existence of economic substance.[9]

As described above, the U.S. courts have taken an "activist" approach to addressing tax avoidance techniques employed by taxpayers. The judiciary has employed a wide range of devices to shut-down taxpayer tax-minimizing schemes that are adjudged to run afoul of Congressional intent in enacting a particular statute. These judicial strategies are rarely condemned as an unauthorized exercise of legislative power.[10] The leeway afforded courts to disregard manipulative business transactions may explain the relatively late adoption by Congress in 2010 of a general anti-avoidance rule ("GAAR"), in the limited and modest form described in Part II, below. Yet even U.S. courts have acknowledged the potential risks of a judicial activist approach that frustrates the expectations of businesses to organize transactions in a manner that technically complies with a statute (although in a manner not contemplated by the drafters) and mitigates the impact of corporate taxation.[11]

At a moment in history where countries are competing to attract and retain the corporate presence believed to bring production, investment in infrastructure, jobs, and revenue for government spending, strategies employed by jurisdictions to limit tax avoidance may result in flight to more tax-friendly locales.[12] Action by governments hoping to deter unacceptable subversion of tax laws necessarily involves a balancing of competing concerns. This involves assessment of the importance of the country's desire to ensure that taxpayers contribute their fair share of revenue under a tax code reflecting the jurisdiction's moral values and fiscal policy choices as well as the legitimacy of the interest of corporate citizens in the

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[9] Leandra Lederman, W(h)ither Economic Substance? 95 Iowa L. Rev. 389, 396–397 (2010).

[10] But see *Coltec Industries, Inc. v. U.S.*, 62 Fed. Cl. 716 (2004), *vacated and remanded,* 454 F.3d 1340 (Fed. Cir. 2006).

[11] *ACM Partnership v. Comm'r.*, 157 F.3d 231 (3rd Cir. 1998).

[12] See the report on the United Kingdom.

ability to rely on the literal contours of tax provisions to structure business arrangements that bring predictable consequences.

Reporters in all other countries indicate that their legislatures have employed varying strategies to address unacceptable techniques employed by taxpayers to minimize tax liability. While all of the reported countries use legal doctrine to foreclose attempts to use statutes in an unintended way, there is wide variation in practice. Perhaps because none of these countries has emulated the judicial activist approach in operation in the U.S., many countries adopted a GAAR well before the U.S.[13]

In all common law countries, in some circumstances, the courts have been accorded the authority to determine whether a business transaction meets the literal terms of a statute. If the terms are ambiguous or it appears that allowance of the tax benefits sought would defeat the legislative intent in enacting a provision, many would allow the courts to employ anti-avoidance doctrine in order to prevent abrogation of the statute. Because in most of the common law jurisdictions, other than the U.S., courts have acknowledged significant limitations on their interpretive authority, many of these countries have adopted a GAAR in an effort to furnish guidance. The law of these countries prior to enactment of a GAAR is discussed below.

Because many of the common law countries are former colonies, the anti-avoidance approach in the U.K. has had influence. While there were some indications that the U.K. courts were willing to take a more activist approach in anti-avoidance jurisprudence, there is a pronounced reluctance to deny tax benefits to transactions that fall literally within the terms of a statute merely because of the presence of artificial steps. In a line of cases beginning with the Ramsay case in 1982, the courts appeared to announce a new purposive approach permitting a disregard, as a matter of statutory construction, of the insertion of transactional steps taken lacking a commercial purpose. This approach seemed especially appropriate when circuitous steps were taken to obtain a pre-ordained result in defeat of a statute.

However, in 2004, in *Barclays Mercantile Business Finance Ltd*, the British courts eschewed the idea of a judicial anti-avoidance rule and indicated that the approach is primarily one of statutory construction. It appears to involve an inquiry into whether on a realistic view of the transaction at hand the statute intended to provide the tax benefits sought. Although the British case law does not provide detailed guidance concerning the extent to which a court will examine the policy underpinnings in order to determine whether a given scheme seeks to undermine it,

[13] All of the common law countries, except the UK, adopted a GAAR well before 2010, the year in which the U.S. codified the economic substance rule. The UK has not yet adopted a GAAR.

Parliament has not attempted to provide further instruction to taxpayers in the form of a GAAR.

Although the British Parliament has not moved to enact a GAAR, it has taken steps to include TAARs in over 200 provisions. For example, one of the targeted rules works to deny capital loss relief if the main purpose of a transaction is to secure a tax advantage. In many of these provisions, the presence of a commercial purpose is determinative. When a TAAR is operative, the notes accompanying the legislation furnish a framework for application of the provision by the taxing authority. In the event the taxpayer and taxing authority do not reach agreement, the question whether a scheme is motivated by a business purpose will be decided by the court.

The anti-avoidance tradition in Canada traces its roots to the British *Duke of Westminster* case in which the court announced a strict interpretive approach. The Canadian courts have strictly construed the statutory language, finding generally that devices employed by taxpayers to avoid a given tax result are to be respected. A temporary shift to a modern view acknowledging the importance of the tax law as a tool of economic policy allowed the court in *Stubart Investments* to consider the object and spirit of legislation, in order to reach transactions intended to be covered by Parliament, even if they literally fell beyond statutory reach. The court in *Shell Canada Limited* found a role for a contextual and purposive approach, while noting that legal relationships must be respected.

Subsequent to *Stubart* some courts found a limitation on the purposive approach, determining that it only applied in the event of statutory ambiguity. Others, including *Canada Trustco Mortgage Co.* in 2005, recognized the dominant role of textual interpretation, but nonetheless authorized a search for ordinary meaning, context and legislative purpose in an effort to read a tax statute as a "harmonious whole." In general, however, the Canadian courts continue to apply a plain meaning/textual interpretation approach in order to afford taxpayers consistency and predictability.

As anti-avoidance doctrine developed in Canada, the courts rejected reliance upon a business purpose test or an economic substance test (termed a "reasonable expectation of profit") as a basis for disregarding a transaction for tax purposes. The enactment of a robust GAAR in 1988 is attributed to the reluctance of Canadian courts to take an activist approach.

Anti-avoidance law in two other important common law jurisdictions, Australia and New Zealand, has developed in conjunction with judicial interpretation of the application of the respective GAARs. These longstanding codifications have captured the direction of the jurisprudence and will be discussed below. The UK is the only common law country covered in this report that lacks a GAAR.

In most of the civil law countries, the "abuse of law" or "abuse of right" doctrine that targets circumvention of the law in general holds sway in tax law as well. In the tax law context, anti-abuse rules are founded on

the principle that citizen-taxpayers must be treated equally. Such equality means that each must pay its fair share of tax in accordance with ability to pay. To allow some taxpayers to shoulder less than the appropriate share of the tax burden through aggressive tax planning runs counter to this general principle. This notion of equality may be based in the Constitution, as in the case of Germany, or simply upon core values embedded into a country's social and political structure, as in the case of the People's Republic of China.

In France, both the tax administration and the legislature have shifted from addressing tax avoidance by crafting a clear and precise juridical rule to reliance on the more general principles that are now reflected in its GAAR, which was most recently modified in 2009. The complexity and sophistication of taxpayer strategies to reduce taxes has caused the French authorities to broaden the anti-tax avoidance arsenal to find a mechanism to address artificial transactions manufactured solely to achieve tax minimization. The GAAR, which is the centerpiece of the French effort, is discussed below with the GAARs of the other civil law countries.

Greece, a civil law country, has not enacted a GAAR. Greek law is characterized by strict, literal interpretation of tax legislation by the administrative courts and Council of State. However, "substance over form" operates as a general principle of tax law, based presumably on the principle of equality among taxpayers according to ability to pay embodied in the Greek Constitution. Accordingly, Greece relies upon TAARs, focusing on particular types of tax avoidance, including the use of offshore companies.

Although the legislature in Poland enacted a GAAR in 2003, it was declared unconstitutional in 2005 because of a concern about condemning lawful behavior. An anti-avoidance rule, short of a GAAR, exists in article 199A of the General Law, which allows the tax authority to look beyond the literal terms of the statute to the intention of the parties when determining the tax consequences of a transaction. Polish law also contains TAARs relating to transfer pricing, thin capitalization, and mergers and other corporate reorganizations.

Taiwan has not enacted a GAAR. In 2010, it enacted article 12-1 of the Tax Collection Act which gives the tax authority the power to employ a substance over form approach when determining tax consequences of a transaction.

Russia has enacted no GAAR. However, a substance over form approach allows the courts to determine whether the facts and circumstances support the existence of a business purpose that would justify allowance of the expected tax benefits.

While there was debate in Japan in the 1950s concerning adoption of an economic substance test, it was never enacted. Accordingly, the courts employ an approach based on strict interpretation of the statute in order to determine whether a taxpayer achieves the desired tax-reducing result. However, Japan's Supreme Court has found that the lack of a proper

business purpose justified defeat of a taxpayer's attempt to make use of an excess foreign tax credit by making a loan to a foreign branch.[14]

Although Japanese courts do not use the language of tax avoidance, as discussed above, they do consider the entire circumstances, including lack of a non-tax business purpose, in the decision-making process. In addition, the legislature has enacted two TAARs that govern certain transactions involving related parties. A transaction between a shareholder and related corporation is disregarded if the effect is an improper decrease of the corporation's income.

As a backstop to the GAAR, which is discussed below, Germany has enacted a number of TAARs. In contrast to a rule of general application, these are complex and are intended to address a narrowly prescribed set of circumstances. With the proliferation of clever anti-avoidance arrangements, the legislature's ability to combat unacceptable tax minimization is necessarily after-the-fact. The insertion of a targeted rule applicable to one type of transaction hampers the legislature's ability to systematically treat in a timely fashion a pervasive problem. Upon enactment of a targeted rule, a legislature is likely to uncover creative strategies that manage to circumvent taxation in a host of other not-yet-targeted areas. Perhaps for this reason, many countries, like Germany, with targeted anti-avoidance rules have nonetheless felt compelled to enact a GAAR.

Germany and other members of the European Union may not regulate tax avoidance if it infringes on community fundamental freedoms. To date the European Court of Justice ("ECJ") has found that national measures against tax avoidance do not violate these freedoms if the legislation covers artificial arrangements that do not reflect economic reality. However, legislation by member states that seek to prevent abusive transactions in areas covered by EU Directives, as in the case of Parent-Subsidiary, is handled by the ECJ on a case by case basis. While location of a subsidiary in a member state in order to take advantage of lower tax rates may not be penalized, allowance of a foreign tax credit in lieu of a participation exemption to foreign parents from member states has been found a valid mechanism to target anti-avoidance.

The progression of anti-avoidance jurisprudence has led to a third strategy for curtailing unacceptable exploitation of perceived loopholes in tax law, which consists of legislative enactment or codification of a general anti-avoidance rule. All but seven of the countries considered in this report have enacted varying types of GAARs. These will be considered in the next section.

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[14] See the report on Japan.

1.3 General Anti-Avoidance Rules (GAARs)

In recent years, codification of a general anti-avoidance rule has emerged as the anti-avoidance weapon of choice of many legislatures. The hallmark of a GAAR is that it provides to tax authorities and courts a set of parameters of broad application that aid in determining when a strategy for the reduction of tax crosses the line of acceptable tax planning and becomes unacceptable tax avoidance. While the existence of a GAAR does not obviate the need to interpret statutory language, it does signal the relevant considerations that support denying benefits to transactions that literally comply with the letter of the statute. Uniform application of anti-avoidance doctrine leads to a perception of fairness and taxpayer buy-in regarding the bona fides of the tax system. The four oldest GAARs in Australia, Canada, Germany, and New Zealand provide detailed guidance that applies widely.

After enacting previous GAARs which were viewed as unsuccessful, in 2008, Germany enacted a rule applicable to all taxpayers and to all taxes in the domestic or international sphere.[15] The statute applies when a taxpayer attempts to circumvent legislation by abusing legal options for tax planning. Abuse occurs where the taxpayer selects inappropriate legal options to obtain tax advantages unintended by law. If a transaction is covered, a court may determine tax consequences as if only appropriate steps were taken.[16] However, the presence of a sufficient nontax reason supporting the particular steps taken by the taxpayer, even if circuitous, renders the GAAR inapplicable.[17]

The most recent version of New Zealand's GAAR, embodied in its 2007 Income Tax Act, provides the example of one of the most detailed GAARs. It declares tax avoidance arrangements to be void and confers authority upon the Commissioner of Inland Revenue to deny the tax advantage sought.[18] A tax avoidance arrangement includes any contract, agreement, plan or understanding (including all steps) by which the taxpayer:

(1) directly or indirectly alters incidence of tax
(2) directly or indirectly relieves any person from current or future tax liability, or,
(3) directly or indirectly avoids, postpones, or reduces any current or future tax liability.

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[15] See report on Germany.

[16] The GAAR does not apply to transactions covered by a TAAR. Such transactions are safe if they are not caught by the anti-avoidance rule contained in the TAAR.

[17] See report on Germany.

[18] See report on New Zealand. The first New Zealand GAAR was enacted in 1891 as part of the Land Tax.

The Commissioner lacks the power to disallow any tax advantage if the arrangement does not have tax avoidance as its purpose or effect. However, if one of its (non-incidental) purposes or effects (whether or not attributed to standard business or family dealings) is tax avoidance, the tax benefit may be denied.

The New Zealand GAAR permits the Commissioner to determine tax consequences by reference to the true substance, giving effect to the "business reality" operative in absence of the arrangement. Because Inland Revenue's Adjudication Unit has authority to screen these cases at the administrative stage, fewer reach the courts and there is "relatively little tax litigation." However, the courts have reached opposite results for similar transactions, notably in situations in which professional individuals choose the corporate form in order to obtain lower tax rates.

The cases that end up in litigation tend to be the largest cases. While serious penalties result from disallowed tax avoidance schemes, where large sums are involved taxpayers may determine that the potential risks of disallowance are outweighed by the potential benefits. The New Zealand Supreme Court's recent application of the GAAR in a broader number of cases may restrict further taxpayer use of such a calculus.[19]

Although Australia has had a GAAR since 1879, the modern form has been in effect since 1981 without amendment. It accords the Commissioner of Revenue discretion to cancel any tax benefit arising out of a scheme and the authority to reconstruct the transaction in order to assess the tax where the dominant purpose is to obtain a tax benefit for any connected party.

A scheme is broadly defined to include any consensual or unilateral action and any inaction. The requisite dominant purpose may be discerned on the basis of a list of eight criteria. These include: the manner in which the scheme was carried out, the form and substance of the scheme, the income tax result but for the scheme, any change in the financial position of the taxpayer or any connected party, and the connection of the parties.

Canada's adoption of a GAAR followed a series of decisions in which the Supreme Court of Canada ("SCC") rejected use of a business purpose test and a reasonable expectation of profit test to assess tax transactions. While the SCC temporarily diverged from a "plain meaning" analysis in favor of a more modern "purposive" approach in which it looked beyond technical compliance (legal formalism) to scrutinize the contextual meaning of a statute, it ultimately returned to "textual interpretation," preferring "not to give too much weight to factors other than the clear requirements established by the words of a particular provision." This approach rested upon the court's desire not to erode the "consistency, predictability, and fairness" of the tax system.

[19] See report on New Zealand.

Canada's Parliament enacted its GAAR in 1988. It allows redetermination of the tax consequences of a transaction in order to deny a tax benefit that would result, directly or indirectly, from that transaction or a series of transactions. The GAAR is applicable only if it may reasonably be considered that the avoidance transaction would result directly or indirectly in a misuse of the provisions of the Income Tax Act read as a whole. It targets only an "avoidance transaction," which is a transaction or series of transactions undertaken or arranged primarily for no bona fide purpose other than to obtain a tax benefit. Determination of the applicability of the GAAR rests with the courts.[20]

The Canadian GAAR affords authority to the courts to re-determine the consequences of an "avoidance transaction" in order to "deny a tax benefit that ... would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction." An "avoidance transaction" is any transactions (or series) that "would result, directly or indirectly, in a tax benefit if it is undertaken or arranged primarily for no bona fide purpose other than to obtain a tax benefit." A tax benefit is any reduction, avoidance, deferral, or refund of tax whether under the Income Tax Act or any tax treaty. The GAAR may only be applied in the event of a direct or indirect misuse of the Act or any abuse of the Act "read as a whole."

While the Finance Minister determines whether to assess a tax under the GAAR, the court ultimately determines whether the GAAR applies. The Supreme Court of Canada views the GAAR as a means to balance support of taxpayer's right to certainty in planning affairs with a desire to maintain fairness for all taxpayers. Yet the taxpayer interest in certainty in planning would not cause the court to ignore the application of a tax statute to transactions clearly intended to be covered. The Supreme Court has rendered three decisions detailing application of the GAAR.

In implementing the GAAR, the Supreme Court employs a three-step analysis. The first two steps require determination of whether there has been a tax benefit (the taxpayer does not pay the maximum tax payable) and whether there is an avoidance transaction. The third requires the Court to limit its review to the relationship between the parties and the actual transactions taking place. The Court is not permitted to re-characterize the transaction by going beyond the legal substance and re-constituting it on the basis of its economic substance. Moreover, consistent with the Parliament's desire to preserve predictability and certainty in tax law, a

[20] See report on Canada. Although the courts ultimately determine applicability, the Minister of National Finance alone determines whether to assess a taxpayer under the GAAR. Taxpayers are not permitted to self-assess under the GAAR. A GAAR Committee, whose members represent the Department of Finance, the Department of Justice, and the Canada Revenue Agency, make a recommendation to the Minister on advisability of assessment.

lack of a business purpose is not fatal. Although existence of a non-tax or business purpose will remove a transaction from the ambit of the GAAR, there is no requirement of an independent business purpose because many Canadian tax benefits are conferred without regard to any such purpose.

The most difficult exercise in application of the Canadian GAAR is determination of the existence of an avoidance transaction. At this stage, the Court is required to engage in a textual, contextual, and purposive interpretation of the statute to discover whether the transaction frustrates legislative intent. Such a finding will occur:

> [W]here the result of the avoidance transaction (a) is an outcome that the provisions relied upon seek to prevent; (b) defeats the underlying rationale of the provisions relied on; or (c) circumvents certain provisions in a manner that frustrates the object, spirit or purpose of those provisions.[21]

Thus, the Court will look at the overall result of a series of transactions viewed as a whole. Here the interest in preserving taxpayer certainty must give way to the interest in preventing subversion of legislative intent.

The Canadian reporter notes that the Canadian GAAR "has had some degree of success in limiting the use of abusive tax avoidance transactions."[22] This includes situations not previously susceptible to challenge. However, because the Supreme Court remains divided in its interpretation of the GAAR, some aggressive transactions may escape the effects of the GAAR and a great deal of uncertainty may expose taxpayers seeking to arrange legitimate transactions to a level of uncertainty.

South Africa has had a GAAR since 1941. Most recently amended in 2008, the South African GAAR is viewed as a residual measure which may apply to situations covered by a specific anti-avoidance provision or as an alternative to any other. That GAAR gives the Commissioner of South African Revenue Service (SARS) the authority to reduce, eliminate or neutralize any tax benefit derived from an impermissible avoidance arrangement. The affected arrangements are those solely or mainly driven by tax considerations which lack commercial substance, possess abnormal features in the manner carried out, involve non-arm's length rights or obligations, or involve misuse or abuse of the provisions of the South African Income Tax Act.[23]

The People's Republic of China ("China") adopted a GAAR, effective in 2008. The rule of law in China is quite different than that in the other countries described in this report. There is no separation of powers and the law exists primarily as an instrument of the government. The Standing

[21] See the report on Canada.

[22] Of the 867 cases referred to the GAAR Committee as of November, 2009, the GAAR was found applicable in 614. The Finance Minister has been successful in 9 of the 18 cases heard by the courts.

[23] See Section 103 of the South African Income Tax Law.

Committee of the National People's Council ("NPC") possesses the sole power, derived from the Constitution, to interpret the law. The courts, on the other hand, exist primarily to regulate procedural, but not substantive, matters of tax law.

The Chinese GAAR is part of the corporate income tax law adopted in 2007. Article 47 of the Corporate Income Tax Law confers upon the State Administration of Taxation ("SAT"), the taxing authority, the power to re-characterize a business arrangement entered into without reasonable business purposes which result in reduction of taxable income or revenue. The accompanying regulations find a lack of a reasonable business purpose when the primary purpose of the arrangement is reducing, avoiding, or deferring payment of taxes. Transfer pricing, controlled foreign corporation, and thin capitalization arrangements are not covered by the GAAR because they are governed by separate targeted anti-avoidance rules. Numerous activities are covered by the GAAR, including treaty shopping, abuse of tax incentives, abuse of corporate organizational form, use of tax havens, and any business arrangement lacking a bona fide commercial purpose.

The substance over form approach sanctioned by the regulations requires consideration of the following factors:

- the form of the arrangement,
- the substance of the arrangement,
- the duration of the arrangement,
- the form of implementation,
- relationship of the steps taken to construct the arrangement,
- financial effects, and
- tax consequences.

The imprecision of the standard for the application of the GAAR, depending upon words like "reasonable," "business purpose," and "economic substance," has provided some cause for concern. Although the vague language may have an *in terrorem* effect on some business transactions, discouraging some legitimate ones, the legislation may also have the beneficent effect of encouraging more economically prudent arrangements that are not dependent upon tax reduction for profitability.

The GAAR appears to be aimed primarily at the use of conduit companies in international transactions. The use of special purpose vehicles by foreigners investing in China is under special scrutiny. In these arrangements, foreign investors hold investments in China through companies organized in tax haven or very-low-tax jurisdictions in order to take advantage of tax treaties that provide for reduced withholding taxes on dividend distributions or interest payments. If the decision to organize the holding country in the favorable treaty country is not supported by significant commercial reasons, the treaty benefits may be denied.

The French GAAR, contained in article L64 of the Code of Tax Procedure, which appeared in its current form in 2008, accords the taxing authority the power to disregard as an abuse of law transactions which are either fictional or designed to meet the literal terms of a statute or favorable decisions. These transactions may be disregarded if it appears that the steps were taken with the single goal of reducing the tax liability which would exist if the steps taken were disregarded and effect were given to the substance of the real arrangement.

The terms of article L64 remain ambiguous and, consequently, susceptible to a myriad of interpretations. Yet support for the legitimacy of such an approach is found in the general principle of abuse of right which justifies opposition to skillful tax-minimizing transactions by reliance on the constitutional tenet of equality among taxpayers. Concerns that the GAAR would be applied to nullify legitimate transactions were alleviated in 2009 when the Conseil d'Etat issued two decisions requiring that the government make a two-part demonstration. It held that the taxing authority must show not only an absence of a fiscal reason for the transaction but also that a literal application of the statute would frustrate the intention of the legislature.[24] Finding that the statute evinced no intention to require a minimum holding period, the Court allowed a foreign tax credit to a taxpayer acquiring stock temporarily for the purpose of obtaining the credit.

Austria, Hungary, and Slovenia have enacted a GAAR. The Netherlands enacted a GAAR in 1925 which has fallen out of use. Currently there is reliance on the substance over form approach, adopted by the Netherlands Supreme Court in 1985. The principle applies when there is an arrangement contrary to the objective and purpose of a tax statute and the taxpayer's primary objective is to reduce tax liability substantially.

The Swedish GAAR appeared in its current form in 1995. Originally enacted in 1980, it was abolished between 1993 and 1995. Like others referenced above, the Swedish GAAR applies where: (1) an action in which the taxpayer participates results in a considerable tax benefit, (2) obtaining the tax benefit was the predominant reason for the transaction, and (3) respecting the transaction would be in conflict with the general objectives of the statute. The administrative courts determine whether to apply the GAAR.

The Italian GAAR applies only if the transaction is one of seventeen listed. If such a transaction lacks a sound business purpose, is intended to circumvent tax law limitations, and is intended to obtain a tax savings or refund otherwise inapplicable, the taxing authority has the right to disregard any steps or parts of the transaction.

The narrow focus of the Italian GAAR has led the courts to resort to more general principles in denying tax benefits to abusive transactions. As the

[24] See report on France.

Italian report indicates, the doctrine of "fraus legis" has been resurrected to deal with impermissible tax avoidance arrangements. The difficulty in applying *fraus legis* to tax statutes, which are intended to be read literally, has led the legislature to consider amending the GAAR so that it may applied by the taxing authority and the courts to a broader group of transactions.

Under rules effective in March, 2010, the U.S. Congress shocked the tax world by clarifying the economic substance doctrine, codified in new Code section 7701(o).[25] The new rule is not expected to radically alter U.S. anti-avoidance law. By contrast, legislators in countries lacking activist courts have intended to effect significant change by adopting general anti-avoidance rules.

The legislation targets tax benefits sought to be gained in so called "tax shelters," by requiring that a business transaction change a taxpayer's economic position in a meaningful way and that a taxpayer have a substantial purpose for undertaking the transaction other than federal income tax effects. The new provision mandates that courts find that a transaction has economic substance only if the present value of "reasonably expected pre-tax profit" is substantial in relation to the present value of expected net tax benefits.[26] An additional dictate, seemingly aimed at reversing an approach adopted by the court in *Compaq Computer Corp*,[27] is that foreign taxes be treated as expenses in determining pre-tax profit, if the IRS issues regulations so providing.[28] Moreover, in determining whether a taxpayer has a substantial purpose for entering a transaction, other than federal income tax reduction, financial accounting benefits linked to tax reduction must be disregarded.[29]

Noting a lack of uniformity concerning proper application of the economic substance doctrine, the Joint Committee on Taxation, a tax-writing arm for Congress, indicated that the new provision "provides a uniform

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[25] IRC §7701(o) provides:

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE. –

(1) APPLICATION OF DOCTRINE. – In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if –

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
(B) the taxpayer has a substantial business purpose (apart from Federal income tax effects) for entering into such transaction.

[26] IRC §7701(o)(2)(A).

[27] *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214 (1999).

[28] IRC §7701(o)(2)(B). Expenses and other transaction costs must also be treated as expenses in determining pre-tax profit.

[29] IRC §7701(o)(4).

definition of economic substance, but does not alter the flexibility of the courts in other respects" and that it does not change the standard to use in determining whether an economic substance approach is warranted.[30] The IRS had long opposed codification of an economic substance doctrine, in part, because of its success in convincing the courts of its view of unacceptable tax avoidance. It perhaps for this reason, noted by a prominent tax practitioner, that estimated revenue gain from the new provision was reduced from $14 to $4.5 billion.[31]

Accordingly, even after codification of anti-avoidance doctrine, the Joint Committee on Taxation anticipates that the role of the courts largely will remain unchanged. The codification does, however, remove from the judiciary, the discretion to confer tax benefits in a case in which the taxpayer does not meaningfully change its economic position, even if the company has a substantial business purpose for undertaking the transaction.[32] One prominent tax practitioner predicted no impact on "certain basic business transactions," but he was uncertain whether other transactions would be treated differently.[33] He foresaw, however, the legislation's imposition of a penalty equal to 40% of the understated tax for undisclosed transactions lacking economic substance to be a potential deterrent to entry into bona fide transactions.[34]

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[30] Staff, Jt. Comm. Taxation, TECHNICAL PROVISIONS OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, JCX-18-10 at 152 (2010) (hereinafter Jt. Comm. Report).

[31] Richard M. Lipton, "Codification" of the Economic Substance Doctrine – Much Ado About Nothing?, 112 J. TAXATION 325, 328 (June, 2010) (hereafter Lipton, "Codification" of the Economic Substance Doctrine).

[32] Internal Revenue Service ("IRS") Associate Chief Counsel, William Alexander, suggested that codification of the economic substance doctrine will not vary the way in which the agency will deal with tax avoidance schemes, presumably because Congress enacted the standard advocated by the Service. *See*, Stephen Joyce, Official Says Codifying Doctrine Will Not Materially Affect IRS's Enforcement Views, 132 BNA DAILY TAX REP. G-1 (July 13, 2010).

[33] Lipton, "Codification" of the Economic Substance Doctrine, *supra* note 31, at 328. The IRS issued Notice 2010-62, 2010-2 C.B. 411, clarifying the prominent role of the common law economic substance doctrine, but failing to publish a so-called "angel list" that would have removed noncontroversial transactions from the purview of the new statute.

[34] Lipton, "Codification" of the Economic Substance Doctrine, *supra* note 31, at 328. Lipton notes that "it is possible that this new legislation will have little effect (other than for scoring revenue for purposes of passing the health care bill) and, in hindsight, will simply be viewed as a continuation of the status quo." *But see* Brett Wells, Economic Substance Doctrine: How Codification Changes Decided Cases, 10 FLA. TAX REV. 411, 452 (2010) ("[S]ection 7701(o) . . . does significantly alter the landscape with respect to the taxpayer's ability to benefit from many of the types of mistakes that were available in the past.").

The new standard incorporates a "facts and circumstances" inquiry, no different than the one employed by the courts when applying common law doctrines.[35] Perhaps because the codification provides little guidance for the courts that will apply it, the legislative history allows that basic business transactions are to be respected even where there is a choice between meaningful economic alternatives based primarily on comparative tax advantages. Examples in the Joint Committee Report include: the choice between capitalizing a business with debt or equity, the choice to use a foreign corporation instead of a domestic one in making a foreign investment, the choice to enter into corporate organization or reorganization in tax-free transactions, and the choice to use a related party in a transaction as long as transfer pricing and other requirements, such as anti-treaty shopping rules, are satisfied.

The U.S. legislature's codification of the economic substance doctrine places it with thirteen (out of 21) other countries discussed in this Overview that have adopted statutory anti-avoidance rules. Unlike the statutory rules enacted by the other reported countries, the U.S. rule is tailored to meet a particular concern – assuring that federal courts, choosing to employ a "substance over form" analysis, apply the economic substance doctrine when appropriate in the way advocated by the government in a series of tax shelter cases.[36]

GAARs have not resolved many questions of interpretation and approaches to abusive schemes vary widely. For example, two countries with general anti-avoidance rules, the U.S. and France take different positions concerning the tax consequences of similar transactions. The practice of dividend stripping, for example, which involves the temporary purchase of corporate stock in order to receive a dividend, claim a foreign tax credit, and a capital loss upon immediate re-sale, in a transaction primarily motivated by the prospect of a tax advantage and not economic profit became the basis for one of the most famous tax shelter cases in the U.S. The court in that case, *Compaq Computer Corp*., sided with the taxpayer and allowed the tax benefits sought.[37] The U.S. responded to the decision in two ways. First, it amended the statute to require more than a temporary holding of the stock in order to be eligible for a foreign tax credit. Second, it attacked the court's reasoning by enacting ultimately a codification of the economic substance rule that would directly reverse the result. On the other hand, the result would differ under the French GAAR. As Professor Gutmann's report indicates, a similar transaction would not violate the abuse of right

[35] Jt. Comm. Report, *supra* note 30, at 153.

[36] *Compaq Computer Corp. v. Comm'r*, *supra* note 27.

[37] *Compaq Computer Corp. v. Comm'r*, *supra* note 27.

principle in French tax law because there was no indication that the legislature did not intend to accord tax benefits to the owner of the shares at the time of distribution.

1.4 Disclosure and Penalty Rules

Whether a court scrutinizes a tax avoidance scheme by application of a set of judicially-developed principles (common law regimes), by reference to values embedded in a constitution or administrative code (civil law) or by interpretation of a codified rule of general application (GAAR), one cannot predict with absolute certainty whether it will disallow benefits for any given transaction. There remains an incentive to press the written law to its limits in the hope that the arrangement will either escape detection or ultimately will be blessed as not abusive by the adjudicatory authority. Legislatures have acted to offset the play-the-lottery mind-set of some taxpayers, especially those entering into schemes that offer substantial tax benefits, by enacting disclosure and penalty rules. These contribute to the taxing authority's ability to uncover and target transactions that attempt to exploit a tax advantage in a manner not intended or anticipated by the legislature. The South African Revenue Service describes its disclosure regime – the reportable arrangements provisions – as an "early warning system for detecting potential impermissible avoidance arrangements."[38]

A relatively small number of the jurisdictions covered in this report have enacted special disclosure or penalty rules for abusive tax arrangements. The U.S., the latest country to enact a GAAR, has actively sought to deter tax avoidance through a panoply of disclosure and penalty provisions, including rules aimed at tax advisors. This reflects a strategy to deter entry into unacceptable tax-minimizing arrangements, allowing early detection of these transactions. Early detection may allow resolution of these matters administratively and result in reduced opportunities for a court to reject the government's view of the case. At a minimum, the threat of serious penalties may result in self-restraint on the part of taxpayers that might otherwise pursue the benefits of a tax shelter. Among the countries reported the UK, Canada, South Africa, and the U.S., have extensive disclosure regimes.

In connection with enactment of the GAAR, the U.S. strengthened existing disclosure and penalty provisions. Pre-GAAR, there was a penalty equal to 20% of the underpayment of tax when the taxpayer substantially understates income tax.[39] This penalty is abated if the taxpayer has "substantial

[38] South African Revenue Service, Draft Comprehensive Guide to the General Anti-Avoidance Rule (2010) at 4 (hereinafter "South African Revenue Service, Draft Comprehensive Guide").
[39] IRC §6662(a),(d),(i).

authority" for taking the position on the tax return or if the taxpayer both adequately disclosed the relevant facts to the IRS, the tax authority, and had a reasonable basis for such tax treatment.[40] If the taxpayer had reasonable cause for the position taken on the return and acted in good faith, the 20% penalty was abated. For tax shelters, there is no abatement of the penalty even if the taxpayer has substantial authority for its position or discloses the transaction and has a reasonable basis for taking the position.[41]

While the above rules remain in place for underpayments attributable to negligence, valuation misstatements, overstatements, and undisclosed foreign financial assets, for any transaction lacking economic substance, the penalty is increased under the new GAAR to 40% of the underpayment of tax.[42] In addition, there is strict liability for non-disclosed noneconomic substance transactions, because a showing of reasonable cause and good faith in failing to report the transaction, does not prevent imposition of the penalty. A showing of reasonable cause and good faith on the part of the taxpayer regarding other non-disclosed transactions normally blocks the penalty. Despite requests by tax practitioners, the IRS has declined to issue a safe-harbor list excluding specified transactions from the purview of the new rules.

In addition to the new rules accompanying the GAAR, the U.S. legislature has enacted penalties applicable to promoters of abusive tax shelters that can rise as high as 50% of the gross income derived from the activity.[43] This provision can catch tax advisors and others who render advice regarding the allowability of a deduction, an exclusion from gross income, or any other tax benefits, if the advisor has reason to know that the advice is false or fraudulent or that there are gross overstatements of value regarding any material matter. For aiding and abetting an understatement of tax liability, there are additional monetary penalties of $1,000 for each document, claim, return, or affidavit provided.[44]

The IRS's adoption of a controversial disclosure provision relating to large corporations indicates the U.S.'s commitment to this modern approach to defeating tax avoidance. Announcement 2010-9, 2010-1 C.B. 408 (Jan. 26, 2010) will require large corporate taxpayers to report uncertain tax positions. These are positions taken on the tax return which are required for financial accounting purposes to be reflected in a reserve in the taxpayer's books and records or financial statements. FASB Interpretation

[40] IRC §6664(c).

[41] IRC §6662(d)(2)(C). A tax shelter is any partnership or other entity, plan, or arrangement where a significant purpose is the avoidance or evasion of federal income tax.

[42] IRC §6662(b)(6).

[43] IRC §6700.

[44] IRC §6701.

No. 48 requires such taxpayers to identify and quantify any uncertain tax position in those accounts. Disclosure will also be required of other tax positions which the taxpayer has not disclosed because it intends to litigate or it has determined that the IRS has a general administrative practice not to examine the issue. The announcement is controversial because it would require disclosure of transactions which are not reportable under the general rule which excuses disclosure, except for tax shelters and non-economic substance transactions, when there is substantial authority for a position taken on a return or the taxpayer believes its reporting position is more likely than not correct. The Commissioner of Internal Revenue indicated that the announcement was "consistent with the Service's 'policy of restraint' in requesting tax accrual work papers."[45]

Taxpayers failing to disclose certain reportable or listed transactions or to file the requisite returns are subject to penalties as high as $200,000.[46] These are transactions which the IRS has either determined to have a potential for tax avoidance or evasion or are listed as such in a periodic publication.

Attorneys and others seeking to represent clients before the IRS must comply with the requirements of the controversial Circular 230. In part, those provisions require disclosure to clients of the potential penalties resulting from taking various positions on the tax return when the attorney cannot indicate that success on the merits is more likely than not.

The UK lacks a GAAR, but it has adopted substantial disclosure rules regarding tax avoidance schemes. The disclosure obligation falls on the promoter (including the taxpayer in certain cases) in cases in which a tax arrangement will, or may be expected, to enable a person to obtain a tax advantage where it is the main benefit of the transaction. Failure to disclose is subject to an initial penalty of £5,000 and up to £600 per day.

Disclosure must be made on the date the tax avoidance scheme is ready for implementation. The reference number received by the promoter upon disclosure must be included in the tax return of each client-participant in the transaction. The Treasury has listed eight areas in which it has announced an intention to challenge schemes in court.

The UK provisions appear to have achieved the desired effect. While nearly 2,000 disclosures had been made by 2009 (the reporting regime began in full force in 2006), the rate of disclosure has decreased in subsequent years. The Treasury feels that the disclosure regime has "changed the economics of tax avoidance."[47]

[45] Richard M. Lipton, Reporting Uncertain Tax Positions Under Ann. 2010-9: Transparency or Overkill? J. TAXATION 260 (May, 2010).

[46] IRC §§6707, 6707A.

[47] See report on the UK.

Australia and Canada have enacted tax shelter promoter penalties. Apart from the federal rules in Canada, Québec has enacted disclosure rules concerning tax avoidance transactions, with penalties of 25% for those failing to comply.

Germany has no disclosure regime for tax shelters. It has enacted loss disallowance rules that target certain tax deferral schemes. This provision is credited with the elimination of the private market for film funds in Germany.

In France, abuse of the tax law may result in a penalty of between 40 and 80% of the tax avoided.

1.5 Prescriptions for Future Developments

One of the beauties and mysteries of a tax statute is that it may present the conundrum of precise, detailed, and technically complex language which may be interpreted in many different ways. The unavoidable lack of precision that results, when legislators drafting a statute are not able to anticipate inherent ambiguities in terms, may be exploited by taxpayers hoping to order their affairs as they choose so as to minimize their tax liability. Legislators have an interest in encouraging tax-minimizing behavior by eligible taxpayers when they wish to provide incentives. However, some taxpayers may undertake self-help tax reduction by arranging schemes that exploit statutory ambiguity or silence in a way that enables them to gain an advantage over others.

Legislatures are challenged to determine how to address unacceptable tax planning that allows some taxpayers to manipulate tax statutes in unintended ways. Reliance on judicially-developed substance over form, business purpose, and economic substance doctrines, or statutory interpretation that looks to legislative purpose has given way to incorporation of anti-avoidance provisions in specific statutes (TAARs) or codification of general anti-avoidance rules (GAARs). Yet codification of anti-avoidance prescriptions has not led to consistent, predictable results for taxpayers or legislators.

The recent strategy of employing disclosure and penalty regimes holds promise. When countries use different standards to evaluate tax avoidance schemes, taxpayers have an incentive to flock to those countries that not only feature lower rates, but also avoidance-friendly tax systems. While mass harmonization of law across different jurisdictions is not feasible, disclosure regimes which alert authorities to the existence of aggressive planning and advise taxpayers of the abusive features of specified transactions provide opportunities to curtail unacceptable tax planning. Disparities in jurisdictional approaches to tax avoidance may not be eliminated, but information disclosure (and a robust penalty regime to ensure compliance) also offers the prospect of international cooperation in combating abusive schemes through information sharing.

Part I
Country Reports

Chapter 2
Australia

Maurice Cashmere

2.1 Legal System

The Commonwealth of Australia is a common law country. Its system of government is known as the Westminster system. The Commonwealth of Australia, as a sovereign state, was established as a confederation of – what until that time – had been British colonies, pursuant to the Commonwealth of Australia Constitution Act 1900[1] (the Constitution). This was a statute passed by the United Kingdom Parliament.

The Constitution recognizes the separation of powers doctrine. As Isaacs J said in *State of New South Wales v Commonwealth:*

> To use the words of Marshall CJ in Wayman v Southard 10 Wheat 1 at 46:... the difference between the departments undoubtedly is that the legislature makes, the executive executes and the judiciary construes the law ....[2]

As to the role of the courts in Australia, the view was expressed in the Privy Council in *Kirby v R ex parte Boilermakers' Society of Australia:*

> [T]he executive body is at all times subject to the control of the legislature. On the other hand in a federal system the absolute independence of the judiciary is the bulwark against encroachment whether by the legislature or by the executive. To vest in the same body executive as well as judicial power is to remove a vital constitutional safeguard.[3]

So while the executive is accountable to Parliament for the way in which it exercises executive power, the judiciary is not accountable for the way it exercises judicial power.

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[1] Section 9, Commonwealth of Australia Constitution Act 1900.

[2] (1915) 20 CLR 54 at 90.

[3] (1957) 95 CLR 529 at 540–541.

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K.B. Brown (ed.), *A Comparative Look at Regulation of Corporate Tax Avoidance*, Ius Gentium: Comparative Perspectives on Law and Justice 12,
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At the time the Commonwealth of Australia was created each of the six colonies which existed in the Australian sub-continent at that time became a State,[4] and, each State retained the constitutional powers which it had at the time of Federation.[5] At the time of Federation, each of the States had responsible government, with its own House of Representatives and an upper Legislative Assembly.

The Constitution created a Federal Parliament consisting of the Queen of England, who is referred to in Australia as the Queen of Australia, a Senate, or upper Legislative Assembly and a House of Representatives, which is the lower legislative chamber. The powers of the Queen of Australia are exercised on her behalf by her appointed representative, who is known as the Governor General. The system is similar to that which prevails in Canada.

The fundamental scheme of the Constitution is that the powers of the Commonwealth, or Federal government, are specified in the Constitution and the States exercise plenary power, subject to the Constitution. There is no equivalent listing of State powers. For the Commonwealth/Federal Parliament, it has no sovereign power, unless it is conferred by the Constitution. For the States, they may exercise sovereign power to the extent that it is not taken away by the Constitution.

Section 51(ii) of the Constitution provides the Federal Parliament with power in relation to taxation, but not so as to discriminate between States, or parts of States. The taxes imposed by the Commonwealth include income tax, sales tax, excise and customs duties. Each State has the power to tax, but that power devolved through them being colonies of the United Kingdom.

Before World War II income tax was collected by both the State and Federal governments. In 1942, the Federal Government enacted a scheme designed to make it the sole income taxing authority.[6] Since that time the Commonwealth has remained the sole sovereign body imposing income tax,[7] although there is no constitutional impediment to the States imposing income tax again, if they choose to do so. Having assumed priority in taxation matters over State authority, the Commonwealth made grants to the States of tax money collected by the Commonwealth[8] dependent upon the States not levying income tax. In 1957 there was a constitutional challenge

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[4] The six original colonies were New South Wales, Queensland, Tasmania, Victoria, Western Australia and South Australia. To date no new States have been created. The Northern Territory is administered by the Federal Government.

[5] Section 106, Commonwealth of Australia Constitution Act 1900.

[6] Income Tax (War-time Arrangements) Act 1942; Section 221, Income Tax Assessment Act 1936; States Grant (Income Tax Re-imbursement) Act 1942.

[7] The legality of the legislation referred to in footnote 6 was upheld by the High Court in South Australia v Commonwealth (1942) 65 CLR 373 (the First Uniform Tax case).

[8] Section 96, Commonwealth of Australia Constitution Act 1900.

to this takeover of the taxation power by the Victorian State government, in a court case known as *Victoria v Commonwealth*[9] *(the Second Uniform Tax case)*. In this case the High Court invalidated the priority rule, but upheld the right to attach conditions to grants made to the States. After this, the Commonwealth abandoned the requirement that State grants be conditional upon the States not collecting income tax. There has been no attempt by the States subsequently to introduce their own income taxes.

Accordingly, income taxes are now enacted solely by legislation passed by the Federal Parliament and that means passed by the House of Representatives and the Senate. A tax law cannot be introduced by the Senate. Although the Senate may amend tax legislation, it cannot increase a tax.[10] This curtails the powers of the Senate in relation to tax laws, but does not limit its power to reject them.

Most of the substantive income tax law in Australia is contained in two pieces of legislation enacted by the Federal Parliament: the Income Tax Assessment Act 1936 and the Income Tax Assessment Act 1997. In total, the legislation exceeds 10,000 pages of tax law[11] and is growing exponentially by the year, notwithstanding that the Commonwealth undertook to simplify the system over 10 years ago.[12]

If a taxation law is to be amended, it must be amended by the Federal Parliament and the amendment must be passed by both the House of Representatives and the Senate. Neither the Federal Executive nor the Federal courts has the power to amend or promulgate tax laws. The Federal Executive has the power to promulgate regulations, which are a form of delegated legislation, but only to the extent that the delegated power to do so has been approved by a Statute first passed by the Federal Parliament. Delegated legislation is subject to review by either House of Parliament.[13]

Taxation is administered by the Federal Treasury and the Department of State within the Federal Treasury responsible for the collection of taxation is the Australian Taxation Office.

Revisions of taxation law are carried out by the Federal Treasury on its own initiative, or the request of the Federal Treasurer (a senior Federal Government Minister) or the Minister of Finance – who may or may not be the same person as the Federal Treasurer – or the Australian Taxation Office. Australia's tax law is revised and subjected to amendment with great

[9] (1957) 99 CLR 575.

[10] Section 53, Commonwealth of Australia Constitution Act 1900.

[11] Tran-Nam B, "Tax Reform and Tax Simplicity: a new and simpler tax system?" UNSW Law Journal Forum, 6 (2) at 8.

[12] The Income Tax Assessment Acts are supplemented by Acts such as the Income Tax Act 1986, which imposes income tax and the Income Tax Rates Act 1986, which sets the rates of income tax. Separate Acts are required for constitutional reasons.

[13] Acts Interpretation Act 1904; Legislative Instruments Act 2003.

regularity. There are often six or more Taxation Amendment Acts of considerable length passed through the Federal Parliament each year and most of the Taxation Amendment Acts contain legislation on many aspects of substantive taxation law.

From time to time a review of specific aspects of taxation law is undertaken by the Federal Government. Likewise, from time to time a general review of the taxation system is undertaken on behalf of the Federal Government. Australia has just had one of these reviews and the Henry Committee presented its Report – Australia's Future Tax System – to the Federal government in December 2009. It was released to the public with the government's response on 2 May 2010. The recommendations made by a committee that has reviewed the taxation system are often accepted by the Federal government and enacted by legislation, thereby becoming part of the taxation law of Australia.

The Commonwealth has its own system of administrative tribunals and courts which deal with the interpretation of Federal statutes, including taxation Statutes.

The States have their own system of administrative tribunals and courts and they deal with issues which fall within the constitutional power of the States.

Since the Federal government is now the only sovereign power exercising the power to tax, disputes involving matters of taxation law fall within the jurisdiction of the Federal Administrative Appeals Tribunal (the "Tribunal")[14] and the Federal courts. The Tribunal which has power, inter alia, to hear tax disputes, is part of the executive arm of the Federal government. Generally, an objection against a decision of the Federal Commissioner of Taxation ("Commissioner") regarding a tax issue will be referred to the Tribunal, but it is possible for the taxpayer to go directly to the Federal court for a determination.

2.2 Income Tax System

Australia's income taxation system is one where taxpayers are required to self assess their taxable income. Self assessment is defined as an assessment where the Commissioner accepts the statements made by the taxpayer for the purpose of determining the taxpayer's assessable income under the Income Tax Assessment Acts.[15]

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[14] Established by the Administrative Appeals Tribunal Act 1975 pursuant to Sections 51(ii) and (xxxix) of the Constitution, which provides the Federal Parliament with the power to establish non-judicial tribunals to undertake merit reviews of matters arising under statute law. There has been no challenge to the constitutionality of the Administrative Appeals Tribunal (including its taxation appeals division) to date.

[15] Section 995-1(1), Income Tax Assessment Act 1997.

The income tax year in Australia is from 1 July until 30 June, although it is possible for taxpayers to choose alternative tax years. For each income year taxpayers must complete a return of their world-wide income and submit the annual return (known as a tax return) of what is referred to as their assessable income to the Australian Taxation Office.[16] Each year the Commissioner publishes a notice calling for the lodgement of annual tax returns.[17] While there is some variation in the date by which tax returns must be lodged with the Australian Taxation Office (depending on the status of the taxpayer), it is generally recognised that returns must be lodged by 31 October. Longer periods are available to those who use professionals to lodge their tax returns. However, taxpayers deriving business or investment income are required to pay instalments on account of their annual tax liability. This is known as a pay-as–you-go (PAYG) system. Such taxpayers pay on the basis of the current year's gross quarterly income as estimated by the Commissioner. However, taxpayers are only required to make these PAYG payments, if the Commissioner has given written notice of the instalment rate payable.[18] These advance instalments are then offset against the final tax assessed.[19] Any excess paid is refundable. Any shortfall is recoverable.

A person who fails to lodge a tax return on time is subject to a penalty.[20]

In relation to the returns themselves for companies and superannuation funds, taxpayers must not only specify their assessable income, but also determine the tax which is payable (or refund due) on that income (their taxable income).[21] This then becomes the tax assessment (i.e., the amount of income tax which needs to be paid for the year) by virtue of statutory deeming powers.[22] If the Australian Taxation Office does not agree with the assessment, it may be amended by the Australian Taxation Office.

Individual taxpayers are not required to calculate the tax payable on their taxable income (i.e. their taxable income). The Australian Taxation Office actually determines the assessment once the annual tax return of taxable income has been lodged. The determination of the tax payable is known as a tax assessment.

The Australian Taxation Office administers this self assessment system. It does not scrutinise all returns before issuing an assessment, and may

[16] Section 161, Income Tax Assessment Act 1936.

[17] Section 161, Income Tax Assessment Act 1936.

[18] Section 45-15(2) and Section 45-140, Taxation Administration Act 1953.

[19] Section 45-30(1)-(4), Taxation Administration Act 1953.

[20] Div 286, Taxation Administration Act 1953.

[21] Section 161AA, Income Tax Assessment Act 1936.

[22] Section 166A, Income Tax Assessment Act 1936.

well accept them at face value, subject to certain risk assessment analysis, matching and comparative testing.[23]

While not all tax returns are examined by the Australian Taxation Office, it may undertake various taxpayer audits and amend the original assessment within the time limits specified in the legislation. The self-assessment system is supported by a range of penalty and general interest charges and late lodgement fees to encourage taxpayer compliance if the return is not correct.

There must be some power to protect revenue by amending assessments subsequently found to be incorrect, but at the same time, it is recognised that taxpayers need certainty that their tax affairs have been finalised. To this end the Commissioner has a discretion, but not an obligation, to amend an assessment, subject to various limitations. In relation to company and superannuation taxpayers, there is a time limit for amending an assessment which is generally 4 years from the date of the deemed assessment. For individual taxpayers, there is a time limit of 2 years from the date of the notice of assessment issued by the Commissioner. There is no time limit where the Commissioner considers there has been fraud or evasion.[24]

With tax laws, if a taxpayer disputes an assessment or a decision of the Commissioner in relation to an assessment, the taxpayer may apply to the Tribunal to have the matter re-determined. This Tribunal is part of the executive arm of the Federal government. The Tribunal was established in 1975 in response to a perceived need to develop a comprehensive, coherent and integrated system of Commonwealth administrative law. It has a specialist taxation division. As a review body it is independent of government ministers and their departments of State and this includes independence, in its tax jurisdiction, from the Australian Taxation Office. Appeals against a decision of the Tribunal may be taken to a single judge of the Federal Court, then to a sitting of the Full Federal Court, consisting of three Federal Court judges and ultimately to the High Court of Australia, which is the highest appellate court in the Australian Federal and State hierarchy. If the adjudicator in the Tribunal is a Federal Court judge, then the appeal is to the Full Federal Court, not a single judge of the Federal Court.

[23] Section 169A(1), Income Tax Assessment Act 1936, allows the Commissioner, in making an assessment, to accept any statement by a taxpayer.

[24] Section 170(1), Income Tax Assessment Act 1936. (This Act specifies the Commissioner's core powers and information gathering powers. This Act is supplemented by the Taxation Administration Act 1953 and the Income Tax Regulations 1936).

2.3 Tax Controversies

Tax controversies begin where the Commissioner has made a decision, or has not made a decision, which affects a taxpayer. The taxpayer may object to the decision or lack of a decision and must inform the Australian Taxation Office of that objection within the requisite time. The objection period generally matches the period within which the Commissioner may amend an assessment in the absence of fraud or evasion (i.e., 4 years for companies and full assessment taxpayers and 2 years for individuals and small business entities).[25] The Australian Taxation Office would decide either to allow the objection in full, or in part, or disallow it. The Australian Taxation Office then provides the taxpayer with its decision, within the requisite time period of 60 days, or such further period as agreed or allowed.[26] The taxpayer then has to decide whether to seek a review of that decision. As a matter of general practice a taxpayer would seek to resolve the dispute directly with the Australian Taxation Office before continuing with the formal proceedings procedure.

It is provided in the Income Tax Assessment Act 1936 that the notice of an assessment (including a deemed assessment) is conclusive.[27] This means that the process of assessment is rendered unchallengeable once a notice is produced, but the substantive result of the assessment – i.e., the amount of tax payable – can be challenged.[28]

In summary the objection decision is the outcome of the following steps:

- The Australian Taxation Office makes (or does not make) a decision which (either way) affects a taxpayer;
- The taxpayer objects to that decision (or lack of one) and informs the Australian Taxation Office within the time limit specified for that type of taxpayer;

[25] Section 14ZW(1) Taxation Administration Act 1953. In the case of companies and full self-assessment taxpayers, the objection period runs from the date that the deemed assessment is deemed to have been served on the taxpayer.

[26] Sections 14ZU–14ZYA, Taxation Administration Act 1953.

[27] Sections 175 and 177(1), Income Tax Assessment Act 1936. This approach is supported by Mason and Wilson JJ, Stephen J agreeing, in F J Bloeman Pty Ltd v FCT (1981) 147 CLR 360 at 375 and 378. More recently it appears to have been accepted that taxpayers can challenge an assessment where it breaches the "Hickman principles" i.e., where the taxpayer can show that the Commissioner did not make a bona fide attempt to exercise the power of assessment, did not relate the subject matter to the relevant legislation, or the assessment was not reasonably capable of reference to the power of assessment. Re Hickman; ex parte Fox and Clinton (1945) 70 CLR 598; ANZ Banking Group Ltd v FCT 2003 ATC 5041; Briggs v DFCT 86 ATC 4748; Briglia v FCT 2000 ATC 4247 at 4249–4250.

[28] Part IVC, Taxation Administration Act 1953.

- The Australian Taxation Office decides either to allow the objection in full or in part, or disallow it. The Australian Taxation Office then provides the taxpayer with its objection decision, within the requisite period of 60 days.[29]

Challenges regarding the decision made by the Commissioner in relation to the objection are made to the Tribunal for a merit review of the decision. This non-judicial review body has the function of reviewing the merits of decisions of the Commissioner in respect of tax matters. Applications to the Tribunal are made pursuant to Part IVC of the Taxation Administration Act 1953.

In all tax litigation the taxpayer has the burden of proof to establish that:

(1) the assessment was excessive or incorrect; or
(2) the Commissioner's decision should not have been made or should have been made differently.

Generally, the taxpayer is expected to show what the correct assessment should have been. The burden of proof is always with the taxpayer, even if an appeal is taken by the Commissioner.[30] This is different from the burden of proof generally borne by litigants in other civil litigation where the appellant/applicant bears the burden of proof.

However, before taxpayers can seek a merit review of the Commissioner's decision, they are generally required to have attempted to resolve the dispute directly with the Commissioner. This can be done before the taxpayer makes a formal objection, or subsequent to the Commissioner's decision regarding the objection. Various publications issued by the Australian Taxation Office – the most important being the Taxpayers' Charter – advise taxpayers on how to go about doing this and the standards and efficiencies that they can expect in dealing with the Australian Taxation Office.

Assuming that this administrative procedure has been applied and failed to resolve the dispute, the function of the Tribunal is to reconsider the decision under review. In general, the Tribunal is not concerned whether or not the decision-maker was right or wrong in his or her approach, or whether or not he or she was influenced by extraneous considerations.[31] The function of the Tribunal is not to decide whether the Commissioner or the taxpayer is right, but rather to consider the matter afresh, with a view to making a correct or more appropriate decision.

[29] The statutory requirements associated with these steps are specified in Sections 14ZU-14ZYA, Taxation Administration Act 1953.

[30] Sections 14ZZK and 14ZZO, Taxation Administration Act 1953.

[31] Woellner R, Barkoczy S, Murphy S, Evans C, 2009 Australian Taxation Law (Sydney: CCH, 20th ed, 2010), para 31–570.

Hearings before the Tribunal are conducted like a hearing before a court of law, but with reduced formality and with more relaxed rules of evidence. Hearings are in public, unless there is a request for a private hearing. Where a request for privacy is made approval is automatic.[32] At the conclusion of the hearing, the Tribunal will affirm the Commissioner's original decision, vary it or set it aside. The Tribunal does have the power to refuse to make a decision. Each party bears its own costs before the Tribunal. While the Tribunal has power to make a decision, it does not have power to implement it. This is the responsibility of the Commissioner, who must, within 60 days, take the action necessary to implement the Tribunal's decision, or appeal the decision. The taxpayer's liability to pay the assessed tax by the due date is not suspended during any objection proceedings.[33]

Either the taxpayer, or the Commissioner, may appeal – as of right – a decision of the Tribunal to the Federal Court, but only on a question of law. The appeal does not involve a rehearing of the matter. The appeal right must be exercised within 28 days of the decision being made. Decisions of a single judge of the Federal Court are appealable, as of right, to the Full Federal Court – which consists of three Federal Court judges – but appeals lie only on matters of law. If the adjudicator on the Tribunal was a judge, then the appeal is to a Full Federal Court.

While appeals can only be taken in relation to questions of law, in certain specified circumstances it is possible for the Federal Court to make findings of fact during the appeal process. This avoids the necessity of referring matters back to the Tribunal for findings of fact to be made. Either party may appeal a decision of the Full Federal Court to the High Court of Australia – which is the highest appellate court in Australia – on a matter of law, but not as of right. The leave, or permission, of the High Court must first be obtained. Court hearings are invariably heard in public.

Independently of the appeal procedure the Tribunal has the power to refer a question of law to the Federal Court for determination.[34]

As an alternative procedure, a taxpayer may appeal directly to the Federal Court against an objection decision made by the Commissioner, without first applying to the Tribunal.[35] This procedure is relatively common, but is generally taken only where there is a significant or very complex question of law involved.

The procedure in the Federal Court is very much the same as that which is adopted in the Tribunal and it is prescribed by the Federal Court Rules.[36] In the Federal Court the applicant, which would invariably be the taxpayer,

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[32] Section 35, Administrative Appeals Tribunal Act 1975.

[33] Section 14ZZM, Taxation Administration Act 1953.

[34] Section 45, Administrative Appeals Tribunal Act 1975.

[35] Part IVC, Taxation Administration Act 1953.

[36] O32 r 4 Federal Court Rules.

would make an opening address outlining the case, the facts and the issues. The applicant then provides the evidence to substantiate the case. As the evidence of each witness is completed, the responding party has the opportunity to cross-examine the witness. The applicant has the opportunity to re-examine the witness if necessary. Once the evidence is completed, the applicant then closes his/her case. The procedure is then repeated for the responding party. Once the responding party's evidence is completed and the case closed, then both parties make closing addresses, which are designed to summarise the party's position and highlight the strengths of the party's case.

Federal Court hearings would inevitably be heard in public and the unsuccessful party must bear the costs of the appeal.[37]

It is also possible to obtain a judicial review of a decision of the Tribunal by the Federal Court.[38] This requires there to be administrative law grounds for the review. A judicial review would also be heard in public.

2.4 Tax Avoidance Jurisprudence

The imprimatur to the dichotomy between tax avoidance and tax mitigation was provided by Lord Templeman in the Privy Council decision in *Challenge Corporation Ltd v Commissioner of Inland Revenue*,[39] on appeal from the Court of Appeal of New Zealand. There Lord Templeman said that a tax avoidance arrangement is one where a taxpayer derives a tax advantage from a transaction without suffering the reduction in income, loss or expenditure which Parliament intended those qualifying for a reduction in tax liability to suffer. On the other hand Lord Templeman considered that income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to a reduction in his tax liability.

But more recently this dichotomy has been rejected. This became apparent in the United Kingdom in 2001 in the speech given by Lord Hoffmann in the House of Lords case, *MacNiven v Westmoreland Investments Ltd.*[40] Lord Hoffmann said:

> [I]t has occasionally been said that the boundary ... can be defined by asking whether the taxpayer's actions constituted (acceptable) tax mitigation or

[37] The approach of the court to awarding costs is illustrated by Bazaniak v DCT [1999] FCA 864.

[38] Administrative Decisions (Judicial Review) Act 1997.

[39] [1968] 2 NZLR 513.

[40] [2001] UKHL 6; [2001] 1 All ER 865 at para 62: position confirmed by House of Lords in Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes) [2004] UKHL 51; [2005]1 AC 684.

> (unacceptable) tax avoidance ....But when the statutory provisions do not contain words like avoidance or mitigation, I do not think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not.

What Lord Hoffmann had in mind became clearer in an article which appeared in the British Tax Review in 2005, where he sought to provide assurance that under a purposive approach to the interpretation of tax statutes which he had been advocating tax avoidance should be a thing of the past. If Parliament intends a tax to be imposed, Lord Hoffmann considers that *"the courts should be trusted to give effect to its intentions."*[41]

That is because it is now suggested that a result can be achieved through purposive statutory interpretation. In other words, a decision can be reached about whether a particular tax provision applies by considering whether Parliament intended the provision to apply to the facts of the situation under review, without the necessity to consider separately whether there was tax avoidance or not. It should be borne in mind that in the United Kingdom there is no GAAR.

Lord Hoffmann's rejection of the dichotomy has also been accepted in New Zealand by the Supreme Court of New Zealand[42] in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue,*[43] where it was acknowledged that the distinction is seen as conclusory and is no longer helpful. In New Zealand there is a GAAR and it is not clear how far the New Zealand courts will follow the purposive interpretative approach advocated by Lord Hoffmann.

The law of the United Kingdom and New Zealand is not part of the law of Australia, but the conclusion about the place of the dichotomy in both countries accords with the position which prevails in Australia. The dichotomy does not arise in Australia, but for different reasons.

Australia has a GAAR and it provides a formula for determining whether there has been tax avoidance on the part of the identified taxpayer. Australia's GAAR does not specify with any particularity the kind of arrangements to which it would apply. It has been left to the courts to work out. The Australian courts have not done this utilising the dichotomy, largely because the dichotomy is neither expressly, nor implicitly, part of the statutory test. It requires a determination about whether the transaction under consideration manifests a dominant purpose of obtaining a tax benefit. A conclusion about whether the identified taxpayer has obtained a tax benefit is made through a process of objective statutory interpretation.

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[41] L. Hoffmann, "Tax Avoidance" [2005] BTR 197 at 206.

[42] This is highest appellate court in New Zealand after appeals to the Privy Council in the United Kingdom were abolished.

[43] [2008] NZSC 115 at para 95.

Having said that, it is obvious that the Australian Parliament, in enacting a GAAR, must have envisaged that the way in which specific provisions of the legislation were deployed would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into one where the dominant purpose of the taxpayer in entering into or carrying out the transaction was to obtain a tax benefit. However, ascertaining when that will arise is firmly grounded in the statutory language of the anti-avoidance provision itself.

Australia does, however, recognise a distinction between tax avoidance and tax evasion. A simplistic and therefore not necessarily strictly accurate summation is provided by the Australian Master Tax Guide:[44] "...avoidance involves arrangements within the law that take the taxpayer outside the scope of particular tax legislation, while evasion involves arrangements outside the law where liability to tax, having been incurred, is wilfully concealed or ignored." In other words, avoidance complies with the law while at the same time trying to obtain advantages not intended by the legislature to be available. Evasion is the deliberate understatement of income or overstatement of deductions and constitutes a criminal offence.

The commonly adopted test to describe "evasion" is to be found in the judgment of Dixon J in *Denver Chemical Manufacturing Co v Commissioner of Taxation (NSW)*.[45] There it was said that evasion involves some blameworthy act or omission on the part of the taxpayer or those for whom the taxpayer is responsible. In *Wilson v Chambers & Co Pty Ltd*[46] it was said that the word "evades" connotes at least a conscious act of will by the taxpayer in avoiding payment, whereas a mere failure to pay may be due to accident or mistake. The mere withholding of information or the supply of misleading information would not amount to evasion.

Situations which have been held to amount to evasion include situations where the taxpayer has:

- intentionally omitted income from a return without a credible explanation for doing so;[47]
- failed to disclose relevant matters in circumstances where the taxpayer's knowledge and experience were "such that he must be taken to have realised that a different view was tenable and that the Commissioner, or a tribunal might well decide that the relevant amounts were assessable."[48]

[44] Australian Master Tax Guide (Sydney: CCH, 46th ed, 2010), para 31-020.
[45] (1949) 79 CLR 296.
[46] (1926) 38 CLR 131.
[47] Denver Chemical Manufacturing Co., supra note 45.
[48] Case D47, 72 ATC 272.

2.5 The GAAR

Australia has adopted a GAAR. A GAAR first appeared as Section 53 Income Tax Act 1915. It then appeared in similar form as section 260 Income Tax Assessment Act 1936, when that Act was first enacted. In 1981 the GAAR was redrafted and appeared as Part IVA Income Tax Assessment Act 1936.

The original Australian GAAR was adopted from section 29 of the New Zealand Property Assessment Act 1879, which was primarily concerned with taxes on real estate. When a tax on income was first introduced in New Zealand the statutory taxing provisions were inserted into the New Zealand Property Assessment Act 1879 and the anti-avoidance provision, which originally applied only to land taxes, became referable to income tax as well.

The adjudicatory body decides whether there has been tax avoidance by applying Part IVA (Schemes to Reduce Income Tax) Income Tax Assessment Act 1936.[49] This is the statutory GAAR, known as Part IVA in Australia, which has been in its current form – without amendment – since 1981.

Part IVA provides the Commissioner with a discretion to cancel any tax benefit, which arises out of a scheme and which he has identified, where there has been a dominant purpose on the part of someone connected with the scheme (who may or may not be the taxpayer) to obtain the tax benefit and to assess the relevant taxpayer for tax on the basis of a reconstructed situation which avoids the identified tax benefit.

There are three component elements of the GAAR: a scheme, a tax benefit and the dominant purpose of obtaining the tax benefit. Each needs to be present before the GAAR is engaged.

The critical concepts which are pre-requisites to the operation of Part IVA – a scheme and a tax benefit – are defined in the legislation and those legislative definitions govern the application of Part IVA.

A scheme is any course of action, whether consensual, or unilateral and includes inaction.[50] The definition is so wide that a scheme can encompass anything at all and so potentially, any transaction could be subject to being annihilated by an application of the GAAR.

A tax benefit is:

- An amount not included in the assessable income of the taxpayer where the amount would have been included, or might reasonably have been expected to be included, if the scheme had not been entered into; or

[49] Sections 177A–177H, Income Tax Assessment Act 1936.

[50] Section 177A, Income Tax Assessment Act 1936.

- A deduction where the whole, or part of it, would not have been allowable or might reasonably be expected not to have been allowable, if the scheme had not been entered into.[51]

But a scheme, which attracts a tax benefit, does not contravene Part IVA, unless there is a dominant purpose on the part of someone connected with the scheme, to obtain the identified tax benefit. The requisite purpose need not be the purpose of the identified taxpayer. The requisite purpose is not that of the scheme itself. The dominant purpose of the identified taxpayer may accordingly be an imputed purpose and it is ascertained from a list of eight specified criteria.[52] These include: the manner in which the scheme was carried out, the form and substance of the scheme, the timing of the scheme, the result in relation to the operation of Income Tax Assessment Act that would have prevailed had it not been for the scheme, any change in the taxpayer's financial position or that of any other person connected with the scheme and the connection of the parties.

Even if the three elements are present, Part IVA is not self-activating. It does not come into play until the Commissioner makes a determination to take action to disregard the tax benefit, which he may or may not do.[53]

If the Commissioner makes a determination and cancels a tax benefit, he will reconstruct the taxpayer's income to counteract the tax benefit and issue an amended assessment.

To date sufficient case law has emerged from the courts to provide guidance on the manner in which Part IVA should be applied. The principles for applying Part IVA are neither definitive nor precisely formulated.

Since schemes are defined so widely that they may encompass any transaction, it may have been anticipated that all transactions would be caught by Part IVA. That is not so. The courts have endeavoured to limit what may properly be regarded as a Part IVA scheme.

Accordingly, where a deduction is claimed for expenses incurred in earning assessable income, the scheme must clearly identify the expense, or tax benefit, and the scheme must provide the context which gives the expense the character of deductibility for tax purposes. While it is accepted that a scheme may be broadly or narrowly defined, it cannot be defined so narrowly that it is incapable of standing on its feet without "*being robbed of all practical meaning.*"[54]

[51] Section 177C, Income Tax Assessment Act 1936. In Australia, a taxpayer is entitled to deduct expenses incurred in gaining or deriving assessable income in order to determine his taxable income and those expenses are known as deductions.

[52] Section 177D(b), Income Tax Assessment Act 1936.

[53] Section 177F, Income Tax Assessment Act 1936.

[54] FCT v Peabody (1994) 181 CLR 359 at 383–384.

This is illustrated by *Hart v Federal Commissioner of Income Tax (FCT)*,[55] the latest Part IVA case to go to the High Court. Here, the taxpayer had entered into a loan to assist in the acquisition of a residential and an investment property. The loan contained two facilities: one which related to the residential loan and the other which related to the investment loan. Interest was payable rateably in respect of both facilities, unless the taxpayer elected to utilise an option conferred by the loan, called a wealth optimiser option, which enabled the taxpayer to elect to apply all of the payments under the loan to repaying the home loan first.[56] In that event, all the interest due on the investment loan would be capitalised. The taxpayer elected to utilise this option and claimed to deduct capitalised interest on the investment loan and the compound interest which accrued. The Commissioner disallowed the claim and in doing so disallowed a deduction which would normally have been allowed. The only issue before the High Court was whether Part IVA applied to deny the deduction. The High Court decided that Part IVA applied.

One of the ways in which the Commissioner had sought to define the scheme in *Hart* was just by reference to the wealth optimiser option contained in the loan facility, without reference to the borrowing of funds necessary to acquire the properties.

The High Court emphasised that the definition of the scheme is important because the identification of the scheme is central to the operation of Part IVA. But, it must identify the challenged tax benefit and show how it is related to the identified scheme. In reaching its decision, the Court said that where the tax benefit is an allowable deduction, or part of an allowable deduction (as was the situation in *Hart*), the scheme must be defined by reference to the facts which enable the outgoing to be deductible in the first place.

Observations were made in *Hart* by Gleeson CJ and McHugh J regarding what is meant by a scheme being required to stand on its own feet "without being robbed of all practical meaning." This is what the judges said:

> The definition of the scheme in s177A is wide, but it must be related to the tax benefit obtained. The deduction here was for the incurring of a liability to pay interest on borrowed money. The tax benefit in connection with the relevant scheme was part of an allowable deduction for interest. This, it seems to us, is what was meant by references in the judgments in the full [Federal] court [and in Peabody] to the scheme being capable of standing on its own feet. The judges were making the point, which is undoubtedly correct, that where the tax benefit in question is part of an allowable deduction for interest, a search for the purposes of a scheme, identified in a manner that does not include the borrowing, is not an undertaking that conforms with the requirements of the legislation. In a given case, a wider or narrower approach may be taken to the identification of a scheme, but it cannot

[55] (2004) 55 ATR 712.

[56] In Australia, interest incurred in acquiring a residence in which the taxpayer lives is not deductible for tax purposes. Interest incurred in acquiring a residence, which is leased for deriving rental income, is deductible for tax purposes.

> be an approach which divorces the scheme from the tax benefit. Here, the borrowing was an indispensible part of that which produced the tax benefit. A description of the scheme that did not include the borrowing would make no sense.[57]

It followed that since the narrow scheme identified by the Commissioner did not include the borrowing, it could not be regarded as a Part IVA scheme, because this would ignore the facts which made the identified tax benefit deductible. It was, in fact, delineated too narrowly.

As already indicated, what the Commissioner had sought to do in *Hart* was identify the scheme by reference just to those facts which identified the tax benefit. The problem with such an approach is that if the scheme can be identified by reference just to the facts which constitute the tax benefit, then the inquiry which needs to be made about the purpose of the scheme has been pre-determined. This was highlighted by the Full Federal Court in *Hart*[58] and in *Macquarie Finance Ltd v FCT,*[59] the only superior court Part IVA case post *Hart.*

This raises the question of what facts give the character of deductibility for tax purposes. In Australia, deductibility is determined by reference to the use of the funds for the derivation of assessable income.[60] Normally, that connection can be made without difficulty because it is obvious. But sometimes (as with loan funds) that connection is less obvious and the courts then consider whether the outgoing was reasonably capable of being seen as desirable from the point of view of the pursuit of the business ends of the enterprise and the derivation of assessable income. This inquiry does not involve a tracing of funds. But it does require an assessment to be made of the various aspects of the circumstances, including the direct and indirect advantages which the taxpayer sought in making the outgoing. If, for instance, the inquiry disclosed that there was never any likelihood of assessable income being produced, then the necessary connection would be absent and the deduction would be denied.[61]

It follows that in relation to the identification of Part IVA schemes, the scheme would need to be identified by reference to sufficient facts to enable the appropriate connection to be made between the expense and the assessable income. It cannot be identified in isolation. If the benefit is an expense, it cannot be divorced from the facts which give the expense the character of deductibility. Similarly, if the tax benefit is part of an expense, it cannot be divorced from the facts that give the whole expense the character of deductibility.

[57] (2004) 55 ATR 712 at 716.

[58] (2002) 50 ATR 369, Hely J at 389.

[59] (2005) 61 ATR 1, Hely J at 60.

[60] Section 8-1, Income Tax Assessment Act 1997.

[61] Fletcher v FCT (1991) 173 CLR 1; Magna Alloys and Research Pty Ltd v FCT (1960) 11 ATR 276.

2.5.1 Tax Benefits

In order to determine whether a tax benefit exists, a prediction needs to be made about whether, in the case of income amounts, the amount which was not included in the taxpayer's income would have been included (or might reasonably have been expected to be included) if the scheme had not been entered into. Where deductions are claimed, a prediction needs to be made about whether the deduction would not have been allowable (or might reasonably have been expected not to have been allowable) if the scheme had not been entered into. This requires a comparison between the tax advantage claimed pursuant to the scheme which the Commissioner has identified and the hypothetical position which would otherwise have pertained.

To reach a conclusion about the existence of a tax benefit, there must be a reasonable expectation about what the situation would have been, if the relevant scheme had not been entered into. Furthermore, the prediction must be sufficiently reliable to be regarded as reasonable. The Commissioner cannot create a hypothetical situation based on speculation. The hypothetical position needs to be supported by the facts as established by the evidence before the court.[62]

2.5.2 Purpose

In Australia the dominant purpose of the taxpayer has to be ascertained by applying the statutory formula which is contained in Part IVA.[63] The formula comprises eight factors and they alone must determine the outcome. But the eight factors cannot by themselves provide an answer. They are just matters to be taken into account in determining whether the facts as a whole lean more in favour of finding a tax-driven purpose or not. This presents a problem.

The fact that a tax benefit has been identified does not lead to a conclusion that a dominant tax purpose exists.[64] But the pursuit of a better after-tax return may contravene Part IVA.[65] So, the real issue faced by the Australian courts is what more is required, apart from identifying the tax benefit, before a dominant purpose to obtain a tax benefit is manifest. While it is not explicit from the terms of Part IVA, it seems implicit that while

[62] FCT v Spotless (1996) 186 CLR 404; FCT v Spotless Services Ltd 95 ATC 4775 (Full Federal Court).

[63] Section 177D(b), Income Tax Assessment Act 1936.

[64] FCT v Eastern Nitrogen Ltd (2001) 46 ATR 474.

[65] FCT v Spotless Services Ltd (1996) 186 CLR 404 at 416.

the scheme itself is identified by reference to the facts, which give the expense the character of deductibility, the dominant purpose of the taxpayer needs to be determined against the facts of the situation as a whole. If this were not so, then a proper determination about the real advantage of the transaction to the taxpayer could not be ascertained. This suggests that the commercial purpose of the taxpayer needs to be taken into account in weighing the eight factors. But here difficulties arise because the High Court has made it clear that the presence of a rational commercial reason does not provide justification for obtaining the tax benefit.[66] A particular course of action may be both tax driven and bear the character of a rational commercial decision.

Furthermore, the High Court has been reluctant to allow the commercial purposes to be considered.[67] It has insisted that the statutory formula alone is to be utilised and the statutory formula makes no direct reference to the commercial objectives of the taxpayer. But this approach virtually ignores the statutory test which requires a determination to be made about the dominant purpose. If a dominant purpose is to be ascertained, then it is essential to consider all of the purposes and they must include the commercial objectives. If they are not, then it is impossible to determine which purpose was dominant in so far as the taxpayer was concerned.[68]

On the other hand, at the Full Federal Court level, there has been an attempt to address this difficulty. The Full Federal Court undertakes the inquiry required by the eight factors in the context of the commercial framework in which the transaction was carried out, and, in this way, is able to weigh the commercial against the tax purposes and so reach a decision about which drivers were more persuasive.[69]

The importance, in so far as outcome is concerned, is illustrated by *Hart*. There the Full Federal Court considered the dominant purpose of the taxpayer, by assessing the facts by reference to the perceived purpose of the taxpayer in entering into the transaction. As a consequence the Court was of the view that the dominant purpose of the taxpayer was a commercial purpose – to acquire a residence and an investment property. For that reason Part IVA did not apply. The High Court while acknowledging the existence of the commercial objectives of the taxpayer came to the opposite conclusion based largely on the form of the transaction.

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[66] FCT v Spotless Services Ltd (1996) 186 CLR 404 at 416.

[67] The most that has emerged from the High Court is the observation by Gleeson CJ and McHugh J in FCT v Hart (2004) 55 ATR 712, 718 that commercial factors may be relevant, but this was taken no further.

[68] Cashmere M, "Towards an appropriate interpretative approach to Australia's general tax avoidance rule – Part IVA" (2006) 35 AT Rev 231 at 240.

[69] Hart v FCT (2002) 121 FCR 206.

An examination of the approach of the High Court indicates that, in applying the statutory formula, the issues which are of prime importance are the form of the documentation and the manner in which the transaction is carried out. This is manifest in *Hart* and the earlier High Court decision in *FCT v Spotless Services Ltd.*[70]

This approach emerges clearly from the joint judgment of Gleeson CJ and McHugh J in *Hart:*

> Let it be assumed that . . . even if the "wealth optimiser structure" had not been available [the taxpayers] would have borrowed the money to buy their new home and also borrowed money in order to retain their former home as an income-earning investment. The "wealth optimiser structure" depended entirely for its efficacy upon tax benefits generated by arrangements between the taxpayers and the lender that had no explanation other than their fiscal consequences. What optimised the [taxpayers'] wealth was the tax benefit [. . .]: not the deductibility of interest as such; but the deductibility of additional interest [. . .] contrived by the particular form of the borrowing transaction.[71]

In *Spotless* a company had taken money off deposit in Australia and deposited the funds at interest in the tax haven of the Cook Islands. The interest derived in the Cook Islands was less than the interest derived on the Australian deposit, but because the interest was taxed at a low rate there, and, because at that time income which had been taxed off-shore was exempt from tax in Australia, the net income available in Australia was higher than if the funds had remained invested in Australia. The High Court decided that there was no explanation for the action to invest off-shore, other than to obtain the identified tax benefit. In reaching that decision, the Court took the view that the determining factors – drawn from the formula – were the form and substance of the transaction, and more particularly, the manner in which the transaction had been entered into and carried out.[72] On the other hand, the Full Federal Court had held that the taxpayer had been entitled to make the choice regarding the place of investment in the pursuit of a better after-tax return.[73]

The Full Federal Court has been consistent in holding that no one of the factors in the formula is any more important than any other and that each has equal weight. That is not borne out by the manner in which the High Court has reached its decisions.

Since *Hart* was decided by the High Court, the only Part IVA case to go to a superior court is *Macquarie Finance Ltd v FTC*.[74] Here, the Full Federal Court placed much more emphasis on the commercial aspects of the

[70] (1996) 186 CLR 404.

[71] FCT v Hart (2004) 55 ATR 712 at 729.

[72] FCT v Spotless Services Ltd (1996) 186 CLR 404 at 420.

[73] FCT v Spotless Services Ltd 95 ATC 4775.

[74] Macquarie Finance Ltd v FCT (2005) 61 ATR 1.

facts, than was apparent from the approach of the High Court in *Hart.* In this case, a subsidiary of Macquarie Bank issued a complex stapled security consisting of a redeemable preference share in Macquarie Bank and an interest bearing note in the finance subsidiary, in order to strengthen the Bank's tier 1 capital. Ultimately, the security holder could only be repaid by selling the redeemable preference shares. The issue was whether the interest on the notes was deductible, and, if it were, whether Part IVA applied to deny that deductibility. It is clear from the judgment that the commercial aspects of the particular scheme were particularly relevant in determining what the dominant purpose of the taxpayer was. Furthermore, the commercial aspects were seen as being determinative of the outcome – not the complex form of the hybrid security, or the manner in which the tier 1 capital was raised.

The approach advocated by the Full Federal Court does not deny the form which the transaction took, but it poses the question about purpose in relation to the commercial context of the transaction as a whole.

There have been no other superior court decisions on Part IVA subsequent to the *Macquarie Finance* case.

Another gloss on the application of Part IVA emerged as a result of the High Court's decision in *Hart.* There, two of the judges – Gummow and Hayne JJ – maintained that the identification of the dominant purpose requires an inquiry to be made to determine if the relevant tax benefit would have been available had the scheme not been carried out. This requires an hypothesis to determine what the tax position would have been in the absence of the scheme. It follows that a determination about purpose can only be made by comparing what was done with what the taxpayer could have done.[75] This has become known as the "alternate postulate." Implicit in this is the view that the only purpose which is relevant is tax. Gleeson CJ and McHugh J did not comment on this new counter-factual approach.

What this does is deflect the inquiry about the purpose of the taxpayer in entering into the transaction into speculation about what other kinds of scheme the taxpayer might have entered into or carried out. The alternate postulate test has been rejected subsequently by the Full Federal Court in *Macquarie Finance* on the basis that it contains a fallacy.[76] It confines attention to the tax consequences of the actual and counterfactual transactions and ignores the commercial advantage and consequences which would follow from what was actually done.

So it follows that what emerges from *Hart*, which is the latest High Court authority on the application of Part IVA, is that there is no definitive jurisprudence relating to the application of Part IVA at the present time, notwithstanding that Part IVA has been in force for almost 30 years. The

[75] FCT v Hart (2004) 55 ATR 712 at 730.
[76] Macquarie Finance Ltd v FCT (2005) 61 ATR 1 at 56–57, 61.

main issue over which difficulty is arising at present is in relation to the necessity to consider the commercial aspects of the taxpayer's purpose in entering into the transaction. The Full Federal Court does consider such aspects. The High Court does not and appears to decide the issue of purpose on a narrower basis – the form of the transaction and the manner in which it was effectuated. These two approaches produce markedly different results in practice.

Since the Australian legislation provides the court with a formula for determining whether the taxpayer had a dominant purpose to obtain a tax benefit, this effectively removes any necessity to consider whether there was unacceptable tax avoidance or acceptable mitigation. The court simply applies the formula and weighs the various factors with a view to ascertaining whether the weight lies in favour of a dominant tax driven purpose or not. Of course, it may be suggested that the formula is merely a device for enabling the court to reach an objective decision – but value-driven decision – about whether there was tax avoidance manifest in what the taxpayer did, but that is the consequence of using the formulaic approach.

The formulaic approach does not explicitly require the court to determine what the intention of Parliament was in relation to the transaction, although again it is arguable that this is implicit in the Australian approach. Moreover, to date there has been no discussion in Australia to the effect that the formula is a camouflaged methodology of achieving an assessment of what Parliament's intention may be in relation to the application of the GAAR; it is accepted as obviating the need for this inquiry.

Interestingly, the courts have eschewed any consideration of the purpose of the legislation, as explained in the Memorandum to the Bill which introduced the GAAR to Parliament, that Part IVA was designed to strike down transactions which were artificial, blatant, contrived or of a paper nature.[77] The courts have struck down transactions which are not artificial, blatant or contrived. *Spotless* is an example. Likewise, the courts have ignored what was said during the second reading speech in Parliament, when the Bill was introduced to Parliament to the effect that Part IVA was not designed to strike down ordinary business or family dealings.[78] *Spotless* again provides an example.

2.6 Targeted Anti-avoidance Rules

While the GAAR applies to all tax cases, there are many provisions in the income Tax Assessment Act that have their own specific anti-avoidance provision. The anti-avoidance provision in relation to tax on

[77] Explanatory Memorandum to the Income Tax Laws Amendment Bill (No 2) 1981.
[78] Second reading speech of the then Federal Treasurer, Mr. John Howard MP.

capital gains contained in Division 149, Income Tax Assessment Act 1997, is an example.

Since the Income Tax Assessment Act 1936 is Federal legislation, it is interpreted and applied by the Federal Court system. The Tribunal, a Federal administrative authority, deals with challenges to tax assessments which have been made by the Commissioner. Appeals lie from decisions of the Tribunal on a matter of law to a single judge of the Federal Court. Appeals lie from there to the Full Federal Court on a matter of law and an appeal on a matter of law may be taken to the High Court of Australia – but only if the High Court has granted leave to hear the appeal. Leave to appeal is granted only where there is a strong public benefit which can be ascertained in having the matter considered by the highest appellate court.

All of the bodies within this structure have authority to interpret the GAAR and apply it to cases which come before them. Decisions of the Tribunal are not binding on future Tribunals, but are binding on the parties including the Commissioner. Decisions of the Tribunal are of persuasive authority and would be followed where there was little doubt about the correctness of the decision. Since Australia has a system of stare decisis, decisions of a court are generally regarded as binding on a later court at the same level in the hierarchy. Full Federal Court decisions are binding on all courts lower in the hierarchy, including an administrative tribunal, and, decisions of the High Court bind all courts and of course, the Tribunal. Decisions of the Federal Court are generally regarded as binding on themselves. The High Court reserves the right to change its view on a previously decided issue.

In Australia, Part IVA is generally regarded as having been effective in controlling assertive tax avoidance practices and has been more successful than its predecessor – section 260 Income Tax Assessment Act 1936. This is partly attributable to the drafting of Part IVA (since it removed some of the shortcomings which had been exposed in section 260). More pertinently Part IVA enabled the courts to look afresh at the GAAR, without being trammelled by the interpretive approach which had constrained the application of the previous GAAR. However, it probably owes much to the more aggressive approach which a differently constituted High Court has taken to dealing with tax avoidance since 1981.[79]

[79] Several cases on s 260 Income Tax Assessment Act 1936 were heard after Part IVA was enacted and those decisions largely redressed the excesses caused by excessively favourable decisions for taxpayers by the High Court during the 1970s; FCT v Gulland, Watson v FCT, Pincus v FCT (1985) 160 CLR 55.

2.7 Regulation of Anti-avoidance

The Income Tax Assessment Act 1936, Income Tax Assessment Act 1997 and Taxation Administration Act 1953 confer the power on the Australian Taxation Office (which is part of the Federal Treasury) to administer the Australian tax system and to collect the taxes, which are due to the Federal Government. The statutes are supplemented by regulations, which are delegated legislation. These include the Income Tax Regulations 1936 and Taxation Administration Regulations 1976. The legislative provisions are of general application.

The GAAR, which confers the specific power on the Commissioner to countermand transactions which avoid tax, is contained in Part IVA of the Income Tax Assessment Act 1936. Part IVA gives the Commissioner the power and the discretion to cancel a tax benefit which contravenes the GAAR.[80] This is a general power and is not one which is targeted only at specific types of transaction. The key to its operation is the concept of a tax benefit.[81] If the tax benefit involves a deduction for an expense, the Commissioner may disallow the deduction, or part of it. If the tax benefit involves income which was not included in the taxpayer's assessable income, the Commissioner may make a determination, that the taxpayer is assessed on the income which should have been returned. If the transaction involves a capital loss, the Commissioner may determine that the capital loss, or part of it, was not incurred during the income year. Any tax benefit – as that term is defined in the legislation – can contravene the GAAR, provided the dominant purpose of someone who entered into, or carried out the challenged transaction, did so for the dominant purpose of enabling the identified taxpayer to obtain the tax benefit.

The Commissioner's discretion allows him to cancel the whole, or only part of a tax benefit.[82] A determination must be made in writing[83] and can be issued at any time, even during a hearing before the Tribunal. However, a failure to serve a notice does not invalidate the determination.

In the administration of the Australian tax system, the Commissioner provides a considerable amount of advice and instruction, which is of a discretionary nature, but legally binding on him. Public[84] and Private Rulings[85] are the main examples.

[80] Section 177F, Income Tax Assessment Act 1936.

[81] The term "tax benefit" is defined in section 177C, Income Tax Assessment Act 1936.

[82] FCT v Sleight (2004) 55 ATR555 at 580.

[83] Section 177F(2B), Income Tax Assessment Act 1936.

[84] Division 358, Taxation Administration Act 1953.

[85] Division 359, Taxation Administration Act 1953.

The function of the Ruling system has been summarised by the Inspector-General of Taxation as follows:

> In principle, the [Commissioner's] rulings systems underpin taxpayer self assessment by allowing taxpayers to seek advice on how the [Commissioner] interprets the tax laws and what they must do to avoid having their self assessments challenged and amended by the Australian Taxation Office ... without an effective rulings system self assessing taxpayers bear high levels of uncertainty and risk.[86]

A Public Ruling is binding written advice, published for the information of taxpayers generally, on the way in which the Commissioner considers a tax law applies. The Ruling generally binds the Commissioner from the time notice of the Ruling is published in the Australian Government's Gazette. Public Rulings may be relied upon by anyone to whom they apply. Public Rulings may be tailored to a particular class of taxpayers.

A Private Ruling is a written advice of the Commissioner's view of the way in which a particular tax provision applies to the taxpayer who has sought the Commissioner's opinion. As with Public Rulings, the Commissioner is bound by it, if the Ruling applies to the taxpayer and the taxpayer relies on it.

The difference between a Public and Private Ruling is that a Private Ruling deals with a specific course of action by a specific taxpayer, whereas a Public Ruling is provided for the information of taxpayers generally, or a class of taxpayers.

The Public and Private Ruling regime applies equally to the application of the GAAR.

2.8 Cross-Border Transactions

There are four main areas where there are special rules which target cross-border transactions. The first three are contained in legislation. The fourth measure is to be found in treaties.

- Transfer pricing rules;
- Thin capitalisation rules;
- Attribution measures:
    - Controlled Foreign Company rules
    - Foreign Investment Fund rules
    - Double Taxation Agreements

[86] Inspector-General of Taxation (2003), Issues Paper, Number 3, Self-assessment.

2.8.1 Transfer Pricing

When related parties engage in international transactions there is the possibility that profits might be shifted from one jurisdiction to another. Australia has legislation designed to ensure that it can counter non-arm's length transfer pricing or international profit shifting arrangements in order to protect the revenue base.[87] This legislation adopts internationally accepted arm's length principles for taxation purposes as the basis for ensuring that Australia receives its fair share of tax by adjusting profits by reference to the conditions which would have existed between independent parties under comparable circumstances.[88]

The Commissioner has the power to impose penalty tax where a transfer pricing adjustment occurs.[89] The penalty is 50% of the shortfall amount[90] and the penalty may be reduced to 25% where it is reasonably arguable that the transfer pricing regime did not apply.[91]

2.8.2 Thin Capitalization Rules

Thin capitalization rules operate to limit the size of deductions which certain entities can obtain for interest payments, where there are excessive levels of debt.[92] Generally speaking, interest payments satisfy the tests for the deductibility of expenses for tax purposes. But, the object of the thin capitalization rules is to ensure that the affected entities do not reduce their tax liabilities by using an excessive amount of debt to finance their Australian operation. This is done by disallowing debt deductions that an entity can claim against Australian assessable income when the entity's debt to equity ratio exceeds certain limits. Examples of debt interests which are taken into account include interest on a loan and promissory notes as well as the discount on a bill of exchange. Expenses which are not taken into account include rental expenses on certain leases.

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[87] Part 3, Division 13 Income Tax Assessment Act 1936.

[88] TR 94/14 – para 10. Australian Taxation Office (2005) International transfer pricing: Introduction to Concepts and Risk Assessment, available online at: http://www.ato.gov.au/content/downlods/LBI_35283_introduction_concepts_risk_assessment.pdf. "Pricing for international dealings between related parties should reflect a fair return for the activities carried out in Australia, the Australian assets used (whether sold, lent or licensed) and the risks assumed in carrying out these activities."

[89] Section 225, Income Tax Assessment Act 1936.

[90] Section 184-75, Taxation Administration Act 1953.

[91] For a more detailed discussion see Section 2.9.2.3 below.

[92] Division 820, Income Tax Assessment Act 1997.

The thin capitalization rules affect entities with operations or investments both in Australia and overseas and apply to outward investing[93] and the associates of outward investing entities and inward investing entities,[94] together with financial institutions and authorised deposit-taking institutions.

2.8.3 Anti-deferral Measures

Australia taxes residents on both their domestic and foreign income. Domestic tax payable on foreign income may be deferred or even eliminated by interposing a foreign company or trust between the source of the income and the resident. For example, if a foreign company is interposed the shareholders will not be taxed on the company's profit until they are distributed by way of a dividend. If the foreign company retains, rather than distributes its profits, then there is at a minimum, a deferral of tax in respect of the shareholder.

2.8.3.1 Controlled Foreign Companies Rules

The existing provisions relating to a controlled foreign company (CFC) are complex, but the measures require Australian taxpayers to include in their assessable income a share of the income earned by foreign companies in which they have a controlling interest.[95] The regime operates to tax domestic controllers of foreign companies on at least some of the income of the non-resident company on an accruals basis. The objective is to ensure that domestic controllers of foreign companies do not shift income to a resident company in a lower tax jurisdiction.

In applying the measure there are four basic steps. The threshold question requires a decision to be made about whether a foreign company is a CFC. It will be, if it is controlled by Australian residents.

The second question is whether an Australian resident is an attributable taxpayer, i.e. a taxpayer to whom income of the CFC is attributed. Broadly, an Australian resident who has a 10% or greater control interest in the CFC is an attributable taxpayer in the CFC. This means that not every Australian taxpayer with an interest in a CFC is subject to attribution.

The third question is whether the CFC has attributable income. Whether the CFC has attributable income depends on its country of residence, the nature of the income derived and the application of an active income test.

[93] Subdivision 820-B, Income Tax Assessment Act 1997.

[94] Subdivision 820-C, Income Tax Assessment Act 1997.

[95] Sections 316–468, Income Tax Assessment Act 1936.

Changes introduced in 2004 have reduced the scope and range of income that is likely to be regarded as attributable.

The fourth question is what percentage of the attributable income the Australian taxpayer must account for and this may not be the same as its control interest in the CFC. This depends on where the CFC is resident and whether it passes an active income test.

2.8.3.2 Foreign Investment Funds

The Foreign Investment Fund (FIF) regime overlaps with the CFC regime and applies to foreign companies and trusts.[96] The rules were designed to prevent abuse of the control and substantial shareholder rules under the CFC regime, through Australian residents promoting the use of portfolio investment in companies in low tax jurisdictions, where distributions would be made by the release of capital rather than income. This would have the advantage of deferring the receipt of income and enabling Australian taxpayers to take advantage of the more favourable way in which capital gains are taxed in Australia.

Draft legislation to repeal the FIF rules was released in December 2009 and it was anticipated that this repeal would be effective from 1 July 2010. It is understood that new rules are being developed to prevent any advantage being taken of the repeal of the FIF regime.[97] To date no replacement rules have been released.

2.8.4 Double Tax Agreements

Australia taxes residents of Australia on their world-wide income and this raises the possibility of international double taxation on cross-border income flows. The income may be taxed in the country of source and then taxed again in the country of residence. The Double Tax Agreements which Australia has concluded are designed to give one of the signatory parties the right to tax certain types of income and the model for this has generally been the OECD model. In relation to income which is taxed at source overseas Australia has, with effect from 1 July 2008, adopted a regime of providing tax offsets to Australian residents which derive foreign source income for the foreign tax paid.

But even with such a system, Australian tax on foreign source income is capable of being deferred by interposing a non-resident company or trust

[96] Sections 469–624, Income Tax Assessment Act 1936.

[97] On 12 May 2009 the Federal Treasury issued a discussion paper titled "Foreign Source Income Attribution Rules" (www.treasury.gov.au) that sought comments on the suggested legislation design approach that could be used to implement the government's recommendations.

between the resident and the source of income. In this situation no Australian tax is payable until the income is repatriated in a taxable form to Australia. So there was an incentive to accumulate income overseas, particularly in low tax jurisdictions. It was for this reason that the CFC and FIF regimes were introduced.

It is anticipated that loop-holes which may exist under Australia's Double Tax Agreements will be addressed through legislation following on from the Board of Taxation Review of anti-tax deferral regimes, which considered tax policy considerations in relation to the reform of foreign source income attribution rules generally.

2.9 Tax-Avoidance Penalties

The GAAR, Part IVA Income Tax Assessment Act 1936 specifically authorises the Commissioner, having determined that there is a tax benefit (obtained through a dominant tax-driven scheme) and cancelled it, to reconstruct the tax position. This can be done either by reconstructing the assessable income which the taxpayer has returned, or the income of some other person connected with the scheme. Where, after such a reconstruction, it appears that the taxable income returned was less than it would otherwise have been, penalties of various kinds apply.

2.9.1 Specific Penalties in Relation to Part IVA Schemes

Where it appears that there is a shortfall of tax payable, the Commissioner may impose a penalty known as a scheme shortfall penalty.[98]

To determine a scheme penalty, it is necessary first to calculate the scheme shortfall amount. This is the amount of the benefit, which the taxpayer obtains from the scheme; i.e. the amount of the reduction in tax, or the increase of the credit which the Commissioner must provide as a result of the taxpayer's participation in the scheme.[99]

This shortfall amount is then reduced by an amount which is attributable to the taxpayer (or the taxpayer's agent) having relied on general tax law administrative practice, or advice, from the Commissioner including:

- advice given to the taxpayer in writing, e.g. a Private Ruling;
- statements in Public Rulings; and
- statements in approved publications.[100]

[98] Sub division 284-C, Taxation Administration Act 1953.

[99] Section 284-150, Taxation Administration Act 1953.

[100] Section 284-215, Taxation Administration Act 1953.

The base penalty is then calculated.[101] It is –

- 50% of the scheme shortfall amount: or
- 25% of the scheme shortfall amount, if it is reasonably arguable that some part of the penalty should be remitted, because Part IVA does not apply.

A matter is reasonably arguable, if it can be said that even if the position taken was wrong, it could be argued, on reasonable grounds, that it was right. The relevant Explanatory Memorandum explained that a reasonably arguable position applies to questions of interpretation of a contentious area of law, where the law is uncertain, or where there is a serious question about the application of the law to the circumstances of the case.[102]

The opinion of a lawyer, or accountant, on the matter in question is not considered to be an authority for a wrong position taken by a taxpayer. But if the opinion was based on statements by the Commissioner in a Public Ruling, or there was case law to support that position, this may provide support to the reasonably arguable position.[103]

The base penalty amount is increased by 20%, if the taxpayer took steps to prevent, or obstruct, the Commissioner from detecting the scheme shortfall amount (or part of it): e.g., the taxpayer took an unreasonably long time to respond to an inquiry made by the Australian Taxation Office, or destroyed relevant documents or had been previously penalised for a scheme shortfall amount.[104]

In like manner, the Commissioner may also reduce the base penalty amount on a scheme shortfall amount, if the taxpayer voluntarily discloses a scheme shortfall amount before notification that a tax audit is to be conducted. In such a situation the base penalty amount is reduced by 80%.[105]

Where the taxpayer voluntarily discloses a scheme shortfall amount after being notified that a tax audit will be conducted, the base penalty amount will be reduced by 20%.[106] This reduction is only allowed where the disclosure is expected to save the Commissioner a significant amount of time or resources in the audit.[107] However, the Commissioner may allow the

[101] Section 284-160(a), Taxation Administration Act 1953.

[102] Walstern Pty Ltd v FCT (2003) 54 ATR 423 approved in Pridecraft Pty Ltd v FCT (2004) 58 ATR 210 at para 108.

[103] Ruling MT 2008/2 discusses this point.

[104] Section 284-220(2), Taxation Administration Act 1953.

[105] Section 284-225, Taxation Administration Act 1953.

[106] Section 284-225(1), Taxation Administration Act 1953.

[107] Section 284-225(1) (c), Taxation Administration Act 1953.

80% reduction even though the disclosure was not made until after the commencement of the audit process.

There are no safe harbours where tax avoidance schemes are involved.

2.9.2 General Penalties Which Also Apply in GAAR Cases

2.9.2.1 Interest Payable on Overdue Tax

Regardless of whether any scheme shortfall penalty is imposed, the taxpayer is subject to a general interest charge imposed on any tax not remitted to the Commissioner on time. The taxpayer is also subject to a shortfall interest charge.

2.9.2.2 General Interest Charge[108]

The general interest charge is imposed in addition to any shortfall penalties and regardless of whether shortfall penalties are actually imposed.

The general interest charge is levied on a daily compounding basis on the unpaid tax outstanding, together with any unpaid interest payable on the deficit. The rate is 7 percentage points over a base rate, which is the monthly average yield on 90 day bank accepted bills (as determined quarterly by the Reserve Bank of Australia).

A taxpayer is not liable to pay a general interest charge to the extent that it relates to a scheme shortfall amount caused by the taxpayer reasonably relying in good faith on advice provided by the Australian Taxation Office, but not in a Ruling.[109]

The Commissioner has a discretion to remit the general interest charge – or part of it – where:

- the delay in paying the tax was not caused by an act, or omission of the taxpayer, and, the taxpayer has taken reasonable steps to correct the situation;
- the delay in payment was caused by an act or omission of the taxpayer and the taxpayer has taken reasonable steps to correct the situation and it would be fair and reasonable to remit all, or part of the charge;
- there are special circumstances which make it fair and reasonable to remit all, or part of the charge, or it would be otherwise appropriate to do so.[110]

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[108] Sections 8AAA–8AAH, Taxation Administration Act 1953.

[109] Section 361-5, Taxation Administration Act 1953.

[110] A decision not to remit is reviewable under the Administrative Decisions (Judicial Review) Act 1977 and not the Taxation Administration Act 1953. Muc v FCT [2008]

The Commissioner's guidelines on remission are set out in the ATO Receivables Policy – Chapter 93. The kind of things which would lead the Commissioner to exercise his discretion include: factors outside the taxpayer's control, like natural disasters, the unforeseen collapse of a major debtor, or the sudden ill health of key personnel in a small business situation or other cases where serious hardship would ensue.

But overall, the remission policy is administered with a view to ensuring that taxpayers who do not pay on time are not given an advantage over those who do.

2.9.2.3 Shortfall Interest Charge

If a taxpayer's income tax assessment is amended to increase the income, the taxpayer is liable for a tax known as the shortfall interest charge on the amount of the increase. The shortfall interest charge applies from the due date for payment of the income tax under the earlier understated assessment to the day before the Commissioner issues a notice of the amended assessment.[111] The charge is imposed on a daily compounding basis and calculated in the same way as the general interest charge, but instead of being 7 percentage points above the base rate (an average of bank bill yields) it is only 3 percentage points more. The shortfall interest charge applies regardless of whether the taxpayer is subject to a shortfall penalty.

The Commissioner has discretion to remit the shortfall interest charge in whole, or part.[112] In doing so, the Commissioner must have regard to two main principles.

First, the remission should not be granted just because the benefit, which the taxpayer received from the temporary use of the money, is less than the shortfall interest charge. In other words, a taxpayer cannot expect a remission simply because the taxpayer's cost of funds is less than the shortfall interest charge.

Secondly, a remission is justified where the Australian government is partly to blame for the delayed receipt of taxes due.[113]

FCA 668 held that the Commissioner has a duty to consider a request for a review of a decision not to remit the general interest charge.

[111] Section 280-100(1) and (2), Taxation Administration Act 1953.

[112] Section 280-160, Taxation Administration Act 1953.

[113] The Explanatory Memorandum to the Tax Laws Amendment (Improvement to Self Assessment) Act 2005, which introduced the charge, lists examples of situations where it would be appropriate to remit the shortfall interest charge. Practice Statement PS LA 2006/8 is relevant in terms of the appropriate principles to be applied.

2.10 Tax Evasion

The Crimes (Taxation Offences) Act of 1980 is aimed at those involved in schemes where there has been fraudulent evasion of tax by a company, or trust. Where a company, or the trustee of a trust, has taken action, which ensures that the entity will not be able to meet its liability for income tax, those individuals who are directly, or indirectly, responsible are guilty of a criminal offence under the Crimes (Taxation Offences) Act 1980 and liable to penalties. This arises where a person has entered into a transaction with the intention that the company, or trustee, should be unable to meet its income tax liabilities.[114] The company, or trustee, which has the primary liability, does not need to be a party to the transaction. This liability extends to those who have devised tax avoidance schemes such as directors and shareholders and professionals who have advised taxpayers in relation to such schemes. The Crimes (Taxation Offences) Act has application only where the liability of a company, or trustee, is involved. It does not apply where an individual has the primary liability.

The penalties are imprisonment for a period not exceeding 10 years and/or a fine not exceeding 1000 penalty points.[115] A penalty point is $110.[116] Prosecutions may be commenced at any time, but a person cannot be convicted of two or more offences arising out of the same transaction.

Anyone who has aided, abetted, counselled or procured another to enter into a transaction designed to enable a company, or trustee, to avoid its income tax liabilities may also be guilty of an offence.[117] An offence is committed where a person believes that the arrangement is being entered into by another with the intention of securing that the company or trustee will be unable to pay. The words “aids, abets or procures” refer to the employment of an act, or omission, to assist or encourage someone else to commit an offence, and, this does not involve any particular means of doing so.[118] The term “counsels” relates to advice on a particular arrangement which results in an offence being committed. This would encompass professional advisers.

Few prosecutions have been launched under this legislation, but it is credited with bringing certain blatant mass-marketed dividend stripping schemes to an end in the early 1980s.

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[114] Section 5(1) and (2), Crimes (Taxation Offences) Act 1980.

[115] Section 5-8, Crimes (Taxation Offences) Act 1980.

[116] As at 1.1 2009; Section 4AB, Crimes Act 1914.

[117] Section 6, Crimes (Taxation Offences) Act 1980.

[118] R v Ready [1942] VLR 85 at 88.

2.11 Administrative Offences

In addition to the special offences detailed above, a taxpayer may be guilty of offences under the Taxation Administration Act of 1953 which more generally relate to the administration of the tax system. They include:

a failure to comply with taxation requirements, e.g. a failure to lodge a tax return, failure to provide information, failure to produce documents or attend before a taxation officer to answer questions;[119]
a failure to answer questions, or produce documents, when appearing before a taxation officer;[120]
a failure to comply with an order to comply with a taxation requirement;[121]
false or misleading statements;[122]
falsifying or concealing identity with intention to deceive.[123]

The principles which regulate the prosecution policy of the Australian Taxation Office include:

- the taxpayer's compliance record and attitude to compliance;
- the seriousness of the taxpayer's conduct;
- feasibility of a monetary penalty;
- whether prosecution is appropriate;
- whether there is a reasonable prospect of conviction.

The penalties vary depending on whether the offender is an individual or a company and whether there has been a previous offence committed by the offender. Penalties range from 20 penalty units to 2 years imprisonment (500 penalty units for companies).

A successful prosecution does not relieve the taxpayer of the liability to pay tax that would otherwise be payable.[124] However, if a prosecution is commenced under the Taxation Administration Act, or any other taxation law, or under the Criminal Code in relation to conspiracies,[125] then any administrative penalty imposed on a taxpayer in respect of an act, or omission, that is the subject of the prosecution, is no longer payable, even if the prosecution is withdrawn, or fails.[126] Any penalty paid must be refunded.

[119] Section 8C, Taxation Administration Act 1953.
[120] Section 8D, Taxation Administration Act 1953.
[121] Section 8H, Taxation Administration Act 1953.
[122] Section 8 K and N, Taxation Administration Act1953.
[123] Section 8U, Taxation Administration Act 1953.
[124] Section 8ZH, Taxation Administration Act 1953.
[125] Section 11.5, Criminal Code Act 1995.
[126] Section 8ZE, Taxation Administration Act 1953.

2.12 Targeted Anti-avoidance Rules

There are special provisions relating to tax avoidance schemes which have been entered into where the taxpayer and/or associates have claimed deductions for expenditure in excess of the net expenditure incurred by the taxpayer.[127] These provisions are designed to disallow deductions where:

- expenditure was incurred where some other advantage is obtained that is not assessable income;
- expenditure was incurred in association with an associated company and the income of the associate is deferred; or
- deductions were claimed in respect of expenditure that is to be wholly or partly recouped.

The kind of expenditure which may fall within these provisions includes:

- borrowing money;
- discharging mortgages;
- losses or outgoings incurred in acquiring trading stock;
- interest expenses;
- rent;
- losses or outgoings incurred in producing, marketing or distributing a film, including the creation of copyright and sound recordings;
- market research;
- commissions paid for collecting assessable income;
- establishing, managing and harvesting forests;
- expenditure incurred to increase the value of shares.

The expected tax saving relevant in determining whether these special provisions apply is the difference between the tax that would have been payable, if the expenditure had not been an allowable deduction, and, the tax payable if the expenditure had been allowable.[128]

These provisions also relate to an associate. This concept is widely defined and has some correlation with the concept of an associate in company law. However, it is decidedly wider. For instance, where the taxpayer is a trustee any person who may benefit under the trust is deemed to be an associate.

The measures apply to deny deductions where property, or goods and services have been acquired by the taxpayer or an associate. Here, the amount which is denied deductibility is the amount which exceeds what

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[127] Sections 82KH, 82KJ, 82KK and 82KL, Income Tax Assessment Act 1936.

[128] TR 2007/8 for Commissioner's view on whether investment schemes and commercialisation schemes are tax avoidance arrangements.

would reasonably have been expected to be paid, ignoring any benefit relating to the acquisition or possible acquisition.

The measure also relates to recoupment agreements where the taxpayer obtains a benefit which is greater than would normally be expected from the expenditure.

There are also provisions which ensure that where expenditure has been incurred by one taxpayer, but the income relating to the expenditure will be received later, the expenditure is only allowable in the year in which the income is assessable. There are also provisions to ensure that a taxpayer does not get a benefit greater than the tax saving.

It is possible that in addition to being guilty of any of the special offences that relate to tax avoidance schemes, those involved in them could be guilty of crimes under the Criminal Code Act of 1995. Taxation offences which fall under the Criminal Code include:

- obtaining a financial advantage by deception;[129]
- dishonestly obtaining a gain or causing a loss;[130]
- falsely obtaining a financial advantage;[131]
- making a false or misleading statement;[132]
- providing false or misleading information and/or documents;[133]
- obstructing public officials.[134]

There are accessorial offences which relate to these primary offences. Advisers and scheme promoters may be prosecuted under these provisions.[135] Where fraud or deception is an element of an offence the prosecution must generally prove that the accused used dishonest means.[136] A person cannot defraud the Australian government merely by failing to declare assessable income.[137]

A person who has been convicted under the Criminal Code for an accessorial offence may also be ordered by the court to pay the Australian Government any amount up to the maximum amount of income tax payable by the principal.

[129] Section 134.2, Criminal Code.

[130] Section 135.1, Criminal Code.

[131] Section 135.2, Criminal Code.

[132] Section 136.1, Criminal Code.

[133] Section 137.1 and 137.2, Criminal Code.

[134] Section 149.1, Criminal Code.

[135] Pearce v R (2005) 59 ATR 260 where the financiers and advisers in relation to an investment scheme were prosecuted. McMunn v The Queen (2007) 69 ATR384 where the promoter of a mass-marketed scheme was prosecuted.

[136] R v Iannelli (2003) 52 ATR 86 at 89.

[137] R v Rigoli (2006) 61 ATR 429.

2.13 Promoter Penalty Regime

Since 2006 Australia has had special statutory provisions aimed at deterring the promotion or implementation of schemes, which exploit the tax system through avoidance or evasion. Indeed, schemes of this nature had been marketed to the public at large for decades prior to its introduction.

Some of these schemes took advantage of additional deductions for expenditure incurred in relation to special kinds of projects, such as making and distributing Australian films, or developing product through specialised research and development. There have been other schemes which just take advantage of the ordinary deduction for expenses incurred. These include agricultural projects e.g. tea tree plantations, forestry plantations and cattle breeding projects. With these schemes there is generally a deduction claimed at the beginning of the project for the expenses incurred and these may include large up-front fees or interest paid in advance. Often the projects have been financed with significant non-recourse loans. Sometimes, loan funds have not been used to undertake the venture, but have been recycled to the taxpayer or their lenders in some way. In many cases the deductions claimed have been sufficiently large to enable taxpayers to reduce their tax liability so significantly that the reduction in their tax has effectively funded their cash contributions. Sometimes, they have refunded tax paid, or eliminated the need to pay tax which would otherwise have been payable. Such schemes have been a significant feature of the tax landscape and have caused the Australian Taxation Office concern and it has been anxious for many years to try to stamp out the activities of those who promote these schemes.

The Taxation Administration Act now contains measures designed to curtail tax exploitation schemes.[138] A tax exploitation scheme is a scheme which was entered into, or if it has not been entered into is one which will be entered into, for the dominant purpose of obtaining a scheme benefit and it is not reasonably arguable that the scheme benefit would be available.[139] A scheme benefit is a tax liability which would be expected to be less than it would be apart from the scheme or a credit payable by the Commissioner which is larger than it could reasonably have been expected to be.[140]

Those who are targeted are those who promote such schemes. The regime is also targeted at those who promote schemes on the basis of conformity with advice provided by the Australian Taxation Office, yet the

[138] Division 290, Taxation Administration Act 1953.

[139] Section 290-65, Taxation Administration Act 1953

[140] Section 284-150, Taxation Administration Act 1953.Guidance on what constitutes a tax exploitation scheme can be found in Practice Statement PS LA 2008/7 and 2008/8.

scheme is materially different from the scheme considered by the Australian Taxation Office.[141] Those wishing to enter into a scheme are able to apply to the Australian Taxation Office for a Ruling, and, if the Ruling is favourable and the transaction is carried out strictly in conformity with that Ruling, the taxpayer is protected. Any deviation – even in terms of the documentation – would lead to a lack of protection.

The legislation is aimed not only at companies, but also individuals. Promoters in this context are:

- entities which market the scheme, or encourage its growth, or interest in it;
- an entity, or an associate, which receives consideration for marketing, or encouraging the growth, or interest in the scheme. In this context associates include relatives, partners, trusts that benefit the primary entity and companies influenced by the primary entity;
- an entity where it is reasonable to conclude that it had a substantial role in marketing, or encouraging the growth of, or interest in the scheme.[142]

Numerous entities may be involved in promotional activities, but only those which have a substantial role in marketing, or encouraging activities will be subject to the promoter penalty laws. Employees do not become subject to the provisions merely because they distribute information or material supplied by their employer,

Advisers, such as accountants, lawyers, tax planners and financial advisers are not necessarily caught by the definition of a promoter, but if such people do more than provide independent advice they could become subject to the legislation.[143] For instance, if a lawyer who had provided independent advice gave a presentation at a seminar for informing potential investors about the scheme and was paid a fee for doing so, this would bring the professional within the ambit of the legislation.

The maximum penalty which can be imposed by the courts is 5000 penalty points for an individual and 25,000 penalty points for a company[144] and twice the consideration received or receivable by the entity and associates in respect of the scheme. The penalty is a civil debt payable to the Australian government.

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[141] Section 290-50(1) and (2), Taxation Administration Act 1953.

[142] Section 290-60(1), Taxation Administration Act 1953.

[143] Section 290-60(2), Taxation Administration Act 1953. The Explanatory Memorandum to the Taxation Laws Amendment (2006 Measures No1) Bill 2006 which introduced the legislation provides that the measures are not intended to apply to accountants, legal practitioners and financial planners who have provided independent advice, unless there is participation in the marketing or encouragement of the scheme.

[144] As at 1.1.2009 a penalty point was $Aus 110.

The Commissioner must bring proceedings within 4 years after the entity last engaged in conduct that resulted in it being a promoter of the targeted scheme. These time limits do not apply to evasion.

There are some defences to this regime. An entity is not liable to the penalties if its conduct was due to:

- a reasonable mistake of fact; or
- the act or default of another entity (but not someone who was an employee or an agent of the entity when the alleged conduct took place);
- an accident, or to some other cause beyond the entity's control, provided the entity took reasonable precautions and exercised due diligence.

Where the conduct of an entity results in another being regarded as a promoter, the first entity is not liable to a penalty, if it satisfies the court that it did not know and could not reasonably have known that its conduct would produce that result.

The Federal Court cannot impose a scheme penalty, if the entity has already been convicted of an offence constituted by conduct that is substantially similar to the scheme penalty conduct.

To enable the Commissioner to enforce these remedies the Commissioner may apply to the Federal Court for an injunction, including an interim injunction, to stop the entity promoting a scheme and/or obtain a voluntary undertaking from the entity not to promote the scheme.

2.14 Statutory Interpretation

Australian courts are required to adopt a purposive approach to the interpretation of all statutes and this applies equally to tax statutes.[145] Notwithstanding this statutory directive, there is little evidence of a sufficiently robust substantive approach to ascertain the underlying objectives of the legislation whether it is of a general or tax nature. In tax matters the approach is still closely allied with a literal, rather than a substantive approach. In keeping with tradition, the assessment of what taxpayers have done is form-based, since this is understandably seen by the courts as providing the best basis to determine what they did, or purported to do, and the starting point is invariably to discover what the parties actually did. That leads the courts to consider what the substance of the transaction was and in anti-avoidance matters that requires a consideration of the

[145] Section 15AA, Acts Interpretation Act 1901 (Cth); approach confirmed in relation to tax statutes in Cooper Brookes (Wollongong) Pty Ltd v FCT (1981) 147 CLR 297 at 320 7 and 323; confirmed in CIC Insurance Ltd v Bankstown Football Club Ltd (1997) 187 CLR 384 at 408.

whole facts of the case. The concept of a sham is recognised in Australia, but very rarely does a transaction get struck down on this basis.[146] Invariably, taxpayers want their transaction to be real and supported by the documentation. Shams are the opposite.

The approach to the interpretation of Part IVA, the statutory GAAR, makes it clear that the interpretative approach in Australia is not concerned with a substance over form analysis, in which the adjudicator ignores or collapses disparate steps or transactions, in order to give effect to the overall result.

Statutory interpretation generally involves an inquiry to ascertain the intention of Parliament behind the legislative provision. That approach appears to have been established in the United Kingdom, which does not have a GAAR[147] and in New Zealand which does.[148]

The inquiry to be undertaken in Australia is not concerned with statutory interpretation in the traditional sense – in that the court is endeavouring to ascertain Parliament's intention behind the particular statutory provision – in order to determine whether it applies to the factual position under consideration. Rather, it is concerned with ascertaining the imputed purpose of the identified taxpayer, through the application a statutory formula. The formula comprises eight criteria and they alone must provide the outcome – which is a conclusion about whether the taxpayer entered into, or carried out, the transaction for the dominant purpose of obtaining the tax advantage. The eight factors are weighed to determine whether, on balance, they tip in favour of a dominant tax purpose on the part of the identified taxpayer, or not.

It follows, that Australia does not adopt a purposive, or substance over form approach, in relation to the interpretation of its GAAR. Nor does it seek to ignore parts of transactions which have no justifiable commercial explanation. It adopts traditional rules of statutory interpretation to apply the formula, which is provided by the GAAR. One of the factors is the substance of the transaction. Another is the form of the transaction and yet another is the manner in which the transaction was carried out. But the factors are considered together. Substance does not substitute for other considerations and neither does form under the statutory test.

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[146] The fact that a transaction is artificial or contrived does not mean that it is a sham: Oakey Abattoir Pty Ltd v FCT 84 ATC 4406; Equuscorp Pty Ltd v Glengallan Investments Pty Ltd (2004) 218 CLR 471. Examples of shams, Alloyweld Pty Ltd v FCT 84 ATC 4328; Richard Walter Pty Ltd v FCT 96 ATC 4550.

[147] Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes) [2004] UKHL 51; [2005] 1 AC 684.

[148] Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue [2008] NZSC 115.

2.15 Targeted Transactions

The Commissioner has issued a Practice Statement that describes arrangements indicative of a tax-driven purpose.[149] They include:

- an arrangement, or part of an arrangement which is out of step with arrangements ordinarily used to achieve the relevant commercial objective;
- an arrangement which is more complex than is necessary to achieve the commercial objective, or includes a step, or a series of steps, that appear to serve no real purpose, other than to gain a tax benefit. Among such transactions are those which interpose an entity to access a tax benefit, or an intra-group or related party dealing, that merely produces a tax result and arrangements which involve a circularity of funds, or no real money;
- arrangements where the tax result is at odds with its commercial result, such as a loss being claimed for what was a profitable business;
- the arrangement results in little risk, where significant risks would normally be expected. Such situations would include the use of non-recourse loans, or put options which minimise or eliminate risk;
- the parties are operating on non-commercial terms, or on a non-arms-length manner. Identified targets include interest rates charged at rates above or below market, insufficient security, or loan repayment deferred until the end of a lengthy period; and
- arrangements where there is a discrepancy between the substance of what is being achieved and the legal form. Targeted here are arrangements in a series, which taken together produce no economic gain or loss and are in effect self-cancelling.

Interestingly, the Full Federal Court has said that non-recourse loans are not inherently objectionable.[150] Nor are strategies which reduce or eliminate risk[151] or arrangements which disclose round robin money flows.[152] Notwithstanding this, the Practice Statement still stands unamended.

[149] Practice Statement Law Administration OS LA 2005/24.

[150] FCT v Firth (2002) 192 ALR 542 at 547.

[151] FCT v Cooke [2004] FCAFC 75 at [96]–[97].

[152] Lenzo v FCT [2007] FCA 1402 at para124; FCT v Sleight [2004] FCAFC 94 at para77.

Chapter 3
Canada

Carl MacArthur

3.1 Canadian Legal System

Canada is a constitutional monarchy and federal democratic state, consisting of 14 jurisdictional units. These are the federal government; ten provinces: British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Québec, Newfoundland and Labrador, Nova Scotia, New Brunswick, and Prince Edward Island; and three territories: the Yukon, the Northwest Territories, and Nunavut.

Responsibility for governing at the federal level is shared by the Executive, Legislative and Judicial branches of the federal government.

- The Executive Branch consists of the Governor General,[1] the Cabinet,[2] and the administration.[3]
- The Legislative Branch consists of the Governor General, an elected House of Commons and an appointed Senate.[4]
- The Judicial Branch consists of appointed judges[5] and the courts.

[1] This is Queen Elizabeth II's representative.

[2] These are high-ranking members of government, including the Prime Minister (the leader of the political party with the most elected representatives or seats in the House of Commons).

[3] This includes government departments, the armed forces and Crown corporations.

[4] The Governor General appoints senators upon the Prime Minister's recommendation. The House of Commons and the Senate together with the Governor General form the Parliament of Canada.

[5] Judicial appointments to the superior courts (trial or appellate) in each province or territory, the Federal Court, the Federal Court of Appeal, the Tax Court, and the Supreme Court of Canada are made by the Governor General on the recommendation of the federal cabinet. Appointments to the provincial court in each province are made by the Lieutenant Governor of the province on the recommendation of the provincial government.

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Section 91 of the Constitution Act, 1867 (the "Constitution") vests the federal government with the power "to make Laws for the Peace, Order, and good Government of Canada" and specifically includes the power to make laws in relation to the "raising of Money by any Mode or System of Taxation."

The power to enact laws in respect of direct taxation for the purpose of raising provincial revenue is also vested in the provincial governments pursuant to section 92 of the Constitution. Although the territories do not possess autonomous constitutional authority to enact tax laws, the federal government has conferred on the territories many of the rights and privileges granted to the provinces by the Constitution.

Canada has a bijural legal system. Each province and territory of Canada operates under a common law legal system with the exception of Québec, which follows the civil law. Canadian bijuralism is most evident in the laws enacted by the federal government where consideration is given to both legal traditions in legislative drafting in an attempt to harmonize federal legislation with Québec civil law.

3.2 Enacting Tax Laws

Major changes to tax laws are generally announced with the tabling of the federal budget in the early part of the year. However, the federal government has in the past introduced major tax policy changes in the form of a press release.[6] If not part of the budget package or press release, draft legislation is normally released for public consultation before the legislation is tabled as a bill in the House of Commons.[7]

Once a tax bill has received first and second readings in the House of Commons it is normally referred to the House of Commons Standing Committee on Finance for review and consideration prior to a third reading. After passage of the bill by the House of Commons it is sent to the Senate, which follows a procedure similar to that in the House of Commons, for review and consideration. Following passage of the bill by the Senate, the final stage in the legislative process is for the bill to

[6] For example, on October 31, 2006 the Minister of Finance announced new tax measures, including the proposed imposition of a tax on distributions from publicly traded income trusts. Draft legislation dealing with the taxation of SIFT (specified investment flow through) trusts and partnerships was released on December 21, 2006. Under this legislation the income of SIFT trusts and partnerships is no longer flowed through and taxed as income of the beneficiaries or partners but is instead is taxed as income of the SIFT at rates similar to corporations. Amounts distributed from the SIFT trust or partnership will be treated as eligible dividends to the beneficiaries or partners and will therefore qualify for the dividend tax credit.

[7] Section 53 of the Constitution states that "Bills for appropriating any Part of the Public Revenue, or for imposing any Tax or Impost, shall originate in the House of Commons."

be granted Royal Assent by the Governor General or a Deputy of the Governor, as a representative of the Crown.[8] In accordance with the Constitution, the approval of the Crown, signified by Royal Assent, is required for any bill to become law after passage by both the Senate and the House of Commons.

In addition to major changes which are introduced in the federal budget or a press release, the federal government will from time to time release draft technical changes to the ITA for public comment. Unlike other legislative amendments, which are normally the result of changes in tax policy, these technical changes are simply intended to clarify the law by addressing anomalies or unintended consequences arising from the application of existing legislation.

Although not all, many of these technical amendments are intended to address issues that have been identified by taxpayers and formally recognized by the Department of Finance in "comfort letters" addressed to such taxpayers. As the name would suggest, a comfort letter is intended to provide a taxpayer with comfort as to the potential application of a provision of the ITA. Although not obligated to do so, the Department of Finance will routinely issue comfort letters[9] to taxpayers which identify the taxpayer's concern and normally provide assurances that the Department of Finance will recommend to the Minister of Finance that an amendment be made to the ITA, generally with retroactive effect. However, it is important to note that the Department of Finance has no substantive authority to issue comfort letters or make changes to the law. Therefore any amendments proposed by these comfort letters do not have the force of law until such time as amending legislation is passed by Parliament. Notwithstanding the lack of legal force, the Canada Revenue Agency ("CRA") routinely takes account of comfort letters and draft legislation in the administration of the ITA. This reliance on comfort letters and draft legislation effectively confers a form of quasi-legislative authority on the Department of Finance since taxpayers are assessed in accordance with legislative proposals drafted by the Department of Finance that have not been enacted by Parliament. Concern over the use of comfort letters is further compounded by the fact that it is not uncommon for there to be a gap of several years between the date a comfort letter is issued and the date the proposed amendments become law. Significant delays with draft legislation are uncommon but not

[8] Royal Assent may be granted in two ways: through a written procedure and through the traditional ceremony of Parliament. Section 3 of the *Royal Assent Act*, S.C. 2002, c.15 preserves the traditional ceremony by requiring that it be used twice in each calendar year, including for the first appropriation bill in each session.

[9] The Department of Finance issues about 30 comfort letters each year. See paragraph 3.39 of the 2009 Report of the Auditor General of Canada.

unheard of.[10] In particular, this could lead to situations where the proposed amendments are ultimately not passed, or ultimately passed with substantive changes, but the CRA is prohibited from reassessing taxpayers that may have taken account of the proposed amendments in filing income tax returns for what have become statute barred years. For these reasons the use of comfort letters was criticized in the 1991 Report of the Auditor General of Canada (the "1991 Report").

In response to the 1991 Report, the Department of Finance stated that it "intended to release a package of income tax technical amendments on an annual basis, so that taxpayers will not be subject to more lengthy waiting periods as in the past before these amendments are released to the public."[11] However, to date the Department of Finance has been unable to achieve this goal and, in practice, it normally takes several years for technical amendments to make their way through the legislative process. The use of comfort letters and the process of introducing technical amendments were again reviewed in the 2009 Report of the Auditor General of Canada. In the 2009 Report, the Auditor General was again critical of the fact that technical amendments were not being enacted in a timely manner. In particular, the Auditor General noted that only four technical bills have been passed in the 18 years since the 1991 Report, the most recent of which (Bill C-22) received Royal Assent on June 14, 2001.[12]

[10] One notable example is the draft legislation dealing with non-resident trust (the "NRT Rules") and foreign investment entities (the "FIE Rules"). Originally introduced a decade ago, these rules have been re-introduced in various bills over the years, the last such one being Bill C-10 which was introduced on October 29, 2007 and died when Parliament was dissolved on September 7, 2008. The federal government announced in the 2010 Federal Budget that the FIE Rules would be abandoned and that a significantly narrowed version of the NRT Rules would be reintroduced following a period of public consultation. Draft legislation implementing the revised NRT Rules, together with minor draft changes to the existing rules dealing with investments in offshore investment fund property, were released on August 27, 2010.

[11] See the Department's response immediately following paragraph 2.68 of the 1991 Report.

[12] The other three bills received Royal Assent on May 12, 1994 (Bill C-92/C-15), June 15, 1994 (Bill C-27) and June 18, 1998 (Bill C-28). Bill C-33 was introduced November 29, 2006 but died after the Parliament prorogued. It was re-introduced as Bill C-10 on October 29, 2007 and again died when Parliament was dissolved on September 7, 2008. To date the technical amendments included in Bill C-10 have not been re-introduced. In addition to the 155 outstanding technical amendments that were included in Bill C-10, the Auditor General estimates that the Department of finance is aware of at least another 250 technical amendments that have not yet been drafted or released to the public for comment (See paragraph 3.30 of the 2009 Report). Draft legislation relating to a number of these outstanding technical amendments was released for public comment on July 16, 2010.

3.3 Administration and Enforcement of Tax Laws

3.3.1 Overview of the CRA

The CRA is responsible for the administration of federal tax programs, the delivery of federal economic and social benefits and the administration of certain provincial and territorial tax programs. In this role it is chiefly responsible for the administration of and compliance with the provisions of the ITA and Income Tax Regulations.

The Canada Customs and Revenue Agency was established as a government agency on November 1, 1999 following the enactment of the Canada Customs and Revenue Agency Act[13] by Parliament on April 29, 1999.[14] The name of the act and the agency were eventually changed with the enactment of amending legislation on December 12, 2005 following the separation of responsibility for revenue and customs operations between the CRA and the newly formed Canada Border Services Agency.

The Minister of National Revenue (the "Minister") is accountable to Parliament for all the CRA's activities, including the administration and enforcement of the ITA.[15] The responsibility for the day-to-day administration and enforcement of program legislation within the Minister's authority is delegated to the Commissioner of Revenue, who acts as the CRA's chief executive officer.[16] The Commissioner is also accountable to a Board of Management[17] for the daily management of the CRA, supervision of employees, and implementation of policies and budgets. The Commissioner of Revenue is appointed by the Governor in Council to hold office during pleasure for a term of not more than 5 years, which term may be renewed for one or more further terms of not more than 5 years each.[18]

[13] S.C. 1999, c.17.

[14] The CRA was formerly the Department of National Revenue, operating under the name Revenue Canada.

[15] Subsection 6(2) of the *Canada Revenue Agency Act*, S.C. 1999, c.17, as amended (the "CRA Act").

[16] Section 36 of the CRA Act.

[17] The Board of Management consists of 15 members appointed by the Governor in Council. Eleven of these members have been nominated by the provinces and territories. The Board has the responsibility of overseeing the organization and management of the CRA but has no authority to administer and enforce legislation or to access confidential client information.

[18] Section 25 of the CRA Act.

3.3.2 The Self Assessment System

The Canadian income tax system is a self-assessment system, meaning that the assessment and reporting of income tax payable is based on voluntary compliance by taxpayers in preparing and submitting to the Minister an income tax return in respect of each taxation year.[19]

A taxpayer that fails to file a return within the time specified by the ITA, will be subject to monetary penalties[20] and the Minister may, by delivery of a written notice, require the taxpayer to file a return within such reasonable time as the notice specifies.[21]

3.3.3 Assessment and Reassessments

Once the taxpayer has filed its return of income, the Minister is required, with all due dispatch, to examine the return of income and assess the tax, interest and penalties, if any, payable[22] and, following such examination, is required to send the taxpayer a notice of assessment.[23] However, the fact that a taxpayer has failed to file a return of income, does not preclude the Minister from issuing an assessment to the taxpayer.[24] At any time prior to the expiration of the taxpayer's normal reassessment period,[25] the Minister may make an assessment, reassessment or additional assessment of tax, interest and penalties.[26]

3.3.4 Objections and Appeals

If a taxpayer does not agree with an assessment or reassessment issued by the Minister, the taxpayer has the right to serve on the Minister a written

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[19] Subsection 150(1) provides that a taxpayer shall, without notice or demand, file with the Minister for each taxation year a return of income in prescribed form and that contains prescribed information. For individuals the filing due date is April 30 of the following year or June 15 if the individual carried on a business in the taxation year. In the case of a corporation, the filing due date is 6 months following the end of its taxation year.

[20] Section 162.

[21] Subsection 150(2).

[22] Subsection 152(1).

[23] Subsection 152(2).

[24] Subsection 152(7). These are commonly referred to as arbitrary or net worth assessments.

[25] A corporate taxpayer's normal reassessment period is defined, in general terms, as the period that ends 4 years (3 years for an individual) after the mailing of a notice of an original assessment for the taxation year – subsection 152(3.1).

[26] Subsection 152(4).

notice of objection setting out the reason for the objection and all of the relevant facts.[27] In the case of a corporate taxpayer, this notice of objection must be filed within 90 days of the date of mailing of the notice of assessment or reassessment. Once a notice of objection has been filed, the Minister is required, with all due dispatch, to reconsider the assessment or reassessment and vacate, confirm or vary the assessment or reassessment, as appropriate.[28] Of the 50,000 to 70,000 notices of objection that are filed with the Minister each year, 92% are normally resolved at this stage with the remaining 8% appealed to the Tax Court of Canada (the "Tax Court").[29]

Under the provisions of the ITA a taxpayer that disagrees with the decision of the Appeals Branch of the CRA has the right of appeal to the Tax Court,[30] provided the taxpayer commences the appeal no later than 90 days after the date on which the Minister mails notice of its decision to the taxpayer.[31]

In an appeal to the Tax Court the onus of proof normally rests with the taxpayer to prove, on the balance of probabilities, that the assessment or reassessment by the Minister was in error.[32] Accordingly, the factual assumptions on which the Minister based the assessment are assumed to be correct unless the taxpayer can show otherwise.[33] Once the taxpayer has successfully refuted the factual assumptions relied on by the Minister, the onus shifts to the Minister to rebut the prima facie case made out by the taxpayer.[34]

A judgment of the Tax Court may be appealed as of right to the Federal Court of Appeal by filing a notice of appeal within 30 days after the date

[27] Subsection 165(1).

[28] Subsection 165(3). In order to preserve the integrity and independence of the review process, the reconsideration of the taxpayer's assessment or reassessment is handled by the Appeals Branch, which operates independently in relation to other branches of the CRA.

[29] Paul Hickey, "GAAR Applied More Often, Fewer Appeals Allowed", *Canadian Tax Highlights*, Vol. 18, No. 1, January 2010.

[30] Section 169. The Tax Court was established in 1983 with the coming into force of the *Tax Court Act*, R.S., 1985, c. T-2 ("TCC Act"). In 1988 the TCC Act was amended to grant the Tax Court exclusive original jurisdiction over appeals arising under the ITA, which became effective on January 1, 1991.

[31] In actual fact the taxpayer has the right to commence an appeal to the Tax Court any time after the earlier of the date on which Minister has confirmed the assessment or reassessed or the date that is 90 days following service by the taxpayer of the original notice of objection. In practice, however, taxpayers rarely appeal to the Tax Court until the Minister has confirmed the assessment or reassessed.

[32] *Hickman Motors Ltd. v. Canada*, 97 DTC 5363 at p. 5376.

[33] Johnston v. M.N.R., 3 DTC 1182 (SCC).

[34] *Hickman*, *supra* note 32 at p. 5376.

of the judgment by the Tax Court.[35] A judgement of the Federal Court of Appeal may be appealed with leave to the Supreme Court of Canada by filling a notice of application for leave to appeal within 60 days after the date of the judgment of the Federal Court of Appeal.[36]

On pure questions of law the standard of review applied by an appellate court is "correctness" and the standard of review for findings of fact is such that they cannot be reversed unless the appellate court finds that the Tax Court judge made a "palpable and overriding error."[37] Where the issue under appeal deals with a question of mixed fact and law, the appropriate standard will depend on whether the question is more legal or factual. If the question pertains to the interpretation of a legal test, then the appropriate standard is "correctness". Where the question pertains to the application of facts to a properly formulated legal test, the judgment should only be reversed if the appellate court finds that the Tax Court judge has made a "palpable and overriding error."[38]

3.4 General Approach to Statutory Interpretation

Historically, Canadian courts applied a strict, as opposed to a purposive, approach to the interpretation of tax statutes and, consistent with this interpretive approach, generally resisted the development and adoption of judicial anti-avoidance rules aimed at preventing income tax avoidance. The justification for a strict interpretation of tax statutes was rooted in the idea that taxation represented an expropriation of a taxpayer's property by the government. Such an act of expropriation could only be done through clear statutory language and if a taxpayer was able to order his or her affairs in a way that avoided the literal scope of the legislation, then it was not permissible to interpret the legislation on the basis of its "substance" in an attempt to bring the taxpayer back within its scope.[39]

This approach to statutory interpretation is most closely associated with the judgment of the English House of Lords in *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1 (H.L.):

[35] Section 17.6 of the TCC Act and Subsection 27(1.1) of the *Federal Courts Act*, R.S., 1985, c. F-7.

[36] Subsection 40(1) of the *Supreme Court Act*, R.S., 1985, c. S-26.

[37] *Housen v. Nikolaisen*, [2002] 2 S.C.R. 235.

[38] *Camp Mini-Yo-We Inc. v. The Queen*, 2006 FCA 413, at para 17.

[39] See P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law*, 5th ed. (Toronto: Thomson Canada Ltd., 2005) at p. 561 and Randal N. Graham, *Statutory Interpretation: Theory and Practice* (Toronto: Edmond Montgomery, 2001) at pp. 194–195.

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.[40]

As discussed below, the above principle established by this case (commonly referred to as the "Duke of Westminster Principle") has and, notwithstanding a gradual shift of Canadian courts away from strict interpretation, continues to play an important role in the interpretation of Canadian tax statutes.

The strict interpretation approach was eventually replaced by an approach based on the interpretation of ITA provisions on the basis of their "object and spirit," beginning with the decision of the Supreme Court of Canada in *Stubart Investments Limited v. The Queen:*[41]

> It seems more appropriate to turn to an interpretation test which would provide a means of applying the Act so as to affect only the conduct of a taxpayer which has the designed effect of defeating the expressed intention of Parliament. In short, the tax statute, by this interpretative technique, is extended to reach conduct of the taxpayer which clearly falls within "the object and spirit" of the taxing provisions. Such an approach would promote rather than interfere with the administration of the *Income Tax Act*, supra, in both its aspects without interference with the granting and withdrawal, according to the economic climate, of tax incentives. The desired objective is a simple rule which will provide uniformity of application of the Act across the community, and at the same time, reduce the attraction of elaborate and intricate tax avoidance plans, and reduce the rewards to those best able to afford the services of the tax technicians.[42]

The adoption of this "modern approach" represented a shift in judicial thinking and a realization that taxation was not simply a means by which the government generated revenue (through the expropriation of taxpayers' property) but was also an important tool to be used in the pursuit of economic policy objectives:

> Income tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy.[43]

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[40] *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1 (H.L.) at pp. 19–20.

[41] 84 DTC 6305 (SCC).

[42] *Stubart*, *supra* note 41 at p. 6322.

[43] *Stubart*, *supra* note 41 at p. 6322.

The adoption of this expanded view on the role of taxation altered the court's perspective on how taxing statutes should be interpreted and (on its face) established a role in the interpretive process for assessing Parliamentary intent through a consideration of the object and spirit of the legislative provision.

Notwithstanding the shift in ideology that *Stubart* appeared to represent, subsequent decisions of Canadian courts at best paid lip service to the role of "object and spirit" and in substance continued to embrace the rule of strict construction through the adoption of an approach that placed significant importance on the "plain meaning" of the language used in a taxing statute. Under the plain meaning approach the words of the statute were normally given a highly textual interpretation based on their ordinary meaning except where the ordinary meaning of the language was ambiguous. Where the interpretation of a provision gave rise to some degree of ambiguity, it was permissible to deviate from a textual interpretation and consider the object and spirit of the provision in an attempt to resolve this ambiguity. For example, in *Antosko v. The Queen,*[44] Iacobucci, J., writing for a unanimous court, referred to the approach developed in *Stubart* as "determinative of the present dispute" but went on to state at p. 6320:

> While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain and where the legal and practical effect of the transaction is undisputed…

The question of the proper approach to statutory interpretation was again addressed by the Supreme Court of Canada in *Friesen v. The Queen*.[45] The question before the Court in *Friesen* was whether a taxpayer could deduct as a business loss the decline in value of vacant land held by the taxpayer as "an adventure in the nature of trade."[46] In claiming the deduction the taxpayer relied on subsection 10(1) which permitted a taxpayer to write-down the value of inventory for the purpose of computing income from a business. Accordingly, the principle question before the court was whether the vacant land constituted "inventory," which was defined in subsection

[44] 94 DTC 6314 (SCC).

[45] 95 DTC 5551 (SCC).

[46] The concept of an adventure in nature of trade is a judicial construction intended to distinguish between those transactions that do not otherwise constitute a business but still give rise to a gain on income account and those transactions that result in a gain on capital account. Where a particular transaction (for example, a sale of land) is an adventure in the nature of trade the gain realized on the disposition of the land will be taxed as business income and not capital gains (which are taxed preferentially). Although an adventure in nature of trade falls short of constituting a business, the definition of "business" in subsection 248(1) specifically includes it.

248(1) to mean "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year."

The taxpayer argued that based on a plain meaning of the term, the vacant land came within the definition of "inventory" under the ITA. The Minister argued that a proper construction of the term limited its scope to property held by stock-in-traders.

Major J., writing for a majority of the court, began his analysis by stating that "[i]n interpreting sections of the *Income Tax Act*, the correct approach, as set out by Estey, J. in [Stubart], is to apply the plain meaning rule" [emphasis added] and continues by citing, with approval, the approach adopted in *Antosko*. However, where Iacobucci, J.'s approach in *Antosko* significantly limited the role of "object and purpose" when interpreting the clear and plain words of a provision, Major, J.'s approach in *Friesen* goes even further by mandating that "the object and purpose of a provision need only be resorted to when the statutory language admits of some doubt or ambiguity."[47]

The Supreme Court of Canada again addressed the proper approach to statutory interpretation in *Shell Canada Limited v. The Queen,*[48] where Mclachlin, J. (as she then was), also for a unanimous court, summarized the role of the court in interpreting the ITA as follows:

> [T]his Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.... The courts' role is to interpret and apply the Act as it was adopted by Parliament. Obiter statements in earlier cases that might be said to support a broader and less certain interpretive principle have therefore been overtaken by our developing tax jurisprudence. Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.[49] [emphasis added]

Accordingly, although the modern approach developed in *Stubart* appeared to signal a departure from strict interpretation, this was not the case in practice. Canadian courts continued to avoid "rule making," preferring to limit the scope of their role to interpreting and applying the ITA as it was adopted by Parliament. As such, the Canadian courts continued to rely on the plain meaning approach to uphold transactions that often involved sophisticated tax planning structures designed to comply with the highly technical requirements of the ITA.

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[47] *Friesen*, *supra* note 45 at p. 5561.

[48] 99 DTC 5669 (SCC).

[49] *Shell Canada*, *supra* note 48 at p. 5677.

It was not until the beginning of the twenty-first century that the Supreme Court of Canada once again considered the proper approach to statutory interpretation with the formulation of the "textual, contextual and purposive approach" in *The Queen v. Canada Trustco Mortgage Company*.[50] Writing for a unanimous court in *Canada Trustco*, McLachlin, C.J. and Major, J. describe the "textual, contextual and purposive" approach as follows:

> It has been long established as a matter of statutory interpretation that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": see *65302 British Columbia Ltd. v. Canada*, [99 DTC 5799] [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.[51]

Although the court continued to emphasize the importance of interpreting the words of a provision that are "precise and unequivocal" in accordance with their ordinary meaning, it stopped short of requiring that the ordinary meaning of a clear and unambiguous provisions be determinative of its interpretation, as was the case under the plain meaning approach. In particular, the court recognized that an inquiry into "object and spirit" may reveal latent ambiguities in language that, on its face, appeared clear:

> Even where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities. "After all, language can never be interpreted independently of its context, and legislative purpose is part of the context. It would seem to follow that consideration of legislative purpose may not only resolve patent ambiguity, but may, on occasion, reveal ambiguity in apparently plain language." See P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law* (4th ed. 2002), at p. 563. In order to reveal and resolve any latent ambiguities in the meaning of provisions of the Income Tax Act, the courts must undertake a unified textual, contextual and purposive approach to statutory interpretation.[52]

However, notwithstanding the court's renewed emphasize on "context and purpose," it continued to recognize the dominate role of textual interpretation when considering detailed technical provisions of the ITA.

[50] 2005 DTC 5523 (SCC).

[51] *Canada Trustco*, Ibid. at p. 5526.

[52] *Canada Trustco*, Ibid. at p. 5531.

> [T]he particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.[53]

The detailed nature of these ITA provisions demanded an approach focused on textual interpretation since giving too much weight to factors other than the clear requirements established by the words of a particular provision would erode the "consistency, predictability and fairness" of the tax system:

> [12] The provisions of the Income Tax Act must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently. As stated at para. 45 of *Shell Canada Ltd. v. Canada*, [99 DTC 5669] [1999] 3 S.C.R. 622:
>
> [A]bsent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.
>
> [emphasis added.][54]

At best it can be said that the textual, contextual and purposive approach represents a minor departure from the highly textual plain meaning approach utilized until 2005 and still limits the scope for judicial activism in tax avoidance transactions.

3.5 The Absence of Judicial Activism

Consistent with a conservative approach to statutory interpretation, Canadian courts have generally been reluctant to develop and employ judicial anti-avoidance rules such as a business purpose test or economic substance doctrine. Instead, Canadian courts continue to embrace the Duke of Westminster Principle and the goal of preserving the "consistency, predictability and fairness" of the tax system, both of which support a largely textual interpretation of the ITA. Accordingly, Canadian courts continue to assess the validity of taxpayers' transactions largely on the basis of their legal form and substance.

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[53] *Canada Trustco*, Ibid. at p. 5526.

[54] *Canada Trustco*, Ibid. at p. 5526.

3.5.1 Rejection of a Business Purpose Test

The use of a judicial business purpose test in assessing the validity of transactions for tax purposes was formally rejected by the Supreme Court of Canada in *Stubart*. In *Stubart*, the corporate taxpayer and another corporation, Grover, were both subsidiaries of the same parent company. Stubart and Grover entered into an arrangement to transfer assets of Stubart's profitable business to Grover. At the same time Grover appointed Stubart as its agent to continue carrying on the business on behalf of Grover. Stubart continued to operate the business but the profits realized were reported as income of Grover and sheltered by Grover's accumulated losses. The Minister reassessed Stubart on the basis that the transaction was a sham and lacked a valid business purpose. In granting the taxpayer's appeal, the Supreme Court of Canada stated at p. 6322:

> I would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or *bona fide* business purpose.

As discussed below, the rejection of the business purpose test by the Supreme Court of Canada in *Stubart* is what ultimately led to the enactment of the general anti-avoidance rule (the "GAAR") in section 245.

3.5.2 The REOP Test

Another judicial test ultimately rejected by the Supreme Court of Canada was the reasonable expectation of profit ("REOP") test, which originally gained prominence following the Supreme Court of Canada decision in *Moldowan v. MNR*.[55] In *Moldowan*, Dickson, J., writing for a majority of the court, stated that "although originally disputed, it is now accepted that in order to have a 'source of income' the taxpayer must have a profit or a reasonable expectation of profit."[56] Following the decision in *Moldowan*, the REOP Test was applied inconsistently by the Courts and, in many instances, as a means of second-guessing the legitimate business decisions of

[55] 77 DTC 5213 (SCC).

[56] *Moldowan*, Ibid. at p. 5215. Under the scheme of the ITA, taxpayers compute income on a source by source basis. Absent a specific rule in the ITA, if an amount received by a taxpayer is not income from a source (e.g. lottery winnings), the amount is not taxable. Conversely, if a loss realized by a taxpayer is not connected with a source of income (to be more specific if it is not a loss for the year from an office, employment, business or property) it cannot be used by the taxpayer to reduce its income from other sources. Accordingly, if it is possible to argue that taxpayer's activities did not give rise to a source of income, any loss realized by the taxpayer in the pursuit of such activities would be disallowed.

taxpayers.[57] Due to the inconsistency in its application and the fact that the REOP Test had evolved into a broad-based tool for second-guessing the bona fide commercial decisions of taxpayers, it was eventually rejected as a stand-alone source test by the Supreme Court of Canada in *Stewart v. The Queen*[58] and the companion case *The Queen v. Walls*.[59]

In *Stewart*, the taxpayer owned four rental condominium units which he rented to "arm's length" parties on market value commercial terms. The taxpayer had financed the purchase of the condominium units almost entirely with borrowed money, on which a considerable amount of interest was paid. The taxpayer's own projected revenue and expenses for the condominium units (taking account of the interest payments) showed an expected loss for each of the first 10 years. The Minister reassessed the taxpayer, disallowing his losses claimed on the condominium units on the basis that he had no reasonable expectation of profit and therefore the condominium units were not a source of income.

The Supreme Court of Canada concluded that the condominium units were a source of property income, notwithstanding the fact that they could not, by design, produce net income, and restricted the application of the REOP Test to situations where a taxpayer's activity had some personal or hobby element associated with it. The Supreme Court of Canada stated at p. 6980:

> We emphasize that this "pursuit of profit" source test will only require analysis in situations where there is some personal or hobby element to the activity in question. With respect, in our view, courts have erred in the past in applying the REOP test to activities such as law practices and restaurants where there exists no such personal element....Where the nature of an activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such endeavours necessarily involve the pursuit of profit. As such, a source of income by definition exists, and there is no need to take the inquiry any further.

Furthermore, even in those situations where there is some personal element to the taxpayers activities and it therefore becomes necessary to determine if an activity has a sufficient degree of commerciality to be considered a source of income, the REOP Test is not to be applied as a stand-alone test but simply as one of a non-exhaustive list of various factors that need to be considered. Ultimately "[t]he overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner... [and] ...should not be used to second-guess the business

[57] For example, the REOP Test was applied in *Landry v. The Queen*, 94 DTC 6624 (FCA) to deny business losses realized by a 71 year-old lawyer who had unsuccessfully returned to practice after a 23 year retirement.

[58] 2002 DTC 6969 (SCC).

[59] 2002 DTC 6960 (SCC).

judgment of the taxpayer. It is the commercial nature of the taxpayer's activity which must be evaluated, not his or her business acumen."[60]

3.5.3 The Reliance on Legal Form and Substance

In determining the legal relationships created by transactions entered into by taxpayers for the purposes of the ITA, the Canadian courts have consistently adopted an approach that is driven by the legal form and substance of a transaction. This approach is reflected in the following often cited statement of McLachlin, J. (as she then was) in *Shell Canada Limited v. The Queen et al*.[61] (at p. 5677):

> [T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases.

Another commonly quoted passage is the statement of Linden, J.A. in *The Queen v. Friedberg*[62] (at p. 6032):

> In tax law, form matters. A mere subjective intention, here as elsewhere in the tax field, is not by itself sufficient to alter the characterization of a transaction for tax purposes. If a taxpayer arranges his affairs in certain formal ways, enormous tax advantages can be obtained, even though the main reason for these arrangements may be to save tax (see The Queen v. Irving Oil 91 DTC 5106, per Mahoney, J.A.). If a taxpayer fails to take the correct formal steps, however, tax may have to be paid. If this were not so, Revenue Canada and the courts would be engaged in endless exercises to determine the true intentions behind certain transactions. Taxpayers and the Crown would seek to restructure dealings after the fact so as to take advantage of the tax law or to make taxpayers pay tax that they might otherwise not have to pay. While evidence of intention may be used by the Courts on occasion to clarify dealings, it is rarely determinative. In sum, evidence of subjective intention cannot be used to "correct" documents which clearly point in a particular direction.

Although the general rule is that transactions are to be characterized by their legal form for the purposes of the ITA, in this context the term "legal form" is used by Canadian courts as synonymous with "legal substance". Accordingly, the proper approach to characterizing transactions for purposes of the ITA involves not only an examination of the legal relationships existing between parties to a transaction as evidenced by the words of the documents used to "paper" the transactions, but also an examination of the actions taken by such parties to determine if the legal rights and obligations prima facie established under the written agreements are the actual legal

[60] *Stewart*, *supra* note 58 at p. 6980.

[61] 99 DTC 5669 (SCC).

[62] 92 DTC 6031 (FCA).

rights and obligations agreed to by the parties. In other words, although the written terms of the transaction documents may provide strong prima facie evidence of the intention of the parties and their respective rights and obligations, the written terms alone are not determinative of the issue. In particular, if there is other evidence that shows that the parties did not act in accordance with the terms of the written agreements, such evidence becomes an important factor in determining the "legal substance" of a transaction. A written agreement that documents a legal relationship between parties to a transaction that was never followed has at times been referred to as a "sham."

In *Continental Bank of Canada et al. v. The Queen,*[63] Bowman J. (as he then was) acknowledged that there was a requirement to look beyond the legal form of the transaction adopted by the taxpayer and examine whether the taxpayer acted or behaved in a fashion consistent with the rights and obligations evidenced by the documentation. Stating at pp. 1866–67:

> This leads logically to the next question: did the appellants enter into the various transactions that they purported to, or was the elaborate series of steps envisioned by the master agreement a mere camouflage for what was in substance a single event. . .
>
> . . .
>
> Shams are more easily recognized than defined. The classic definition of sham is found in the judgment of Diplock, L.J. in Snook v. London & W. Riding Invest. Ltd., [1967] 1 All ER 518 at pp. 528–529:
>
> As regards the contention of the plaintiff that the transactions between himself, Auto-Finance, Ltd. and the defendants were a "sham", it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities (see Yorkshire Railway Wagon Co. v. Maclure [16]; Stoneleigh Finance, Ltd. v. Phillips [17], that for acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived. There is an express finding in this case that the defendants were not parties to the alleged "sham". So this contention fails.
>
> The statement has been adopted in Canada on many occasions. I shall therefore endeavour to consider its application to the facts of this case.

And further at p. 1868:

> If the legal relationships are binding and are not a cloak to disguise another type of legal relationship they are not a sham, however much the tax result may offend

[63] 94 DTC 1858 (TCC).

> the Minister or, for that matter, the court, and whatever may be the overall ulterior economic motive. When something is a sham the necessary corollary is that there is behind the legal facade a different real legal relationship. If the legal reality that underlies the ostensible legal relationship is the same as that which appears on the surface, there is no sham.
>
> The Supreme Court of Canada also recognized the difference between legal form and legal substance in its decision in Shell Canada in stating "[t]his Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form" and that "[r]echaracterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect."

In a more recent decision of the Tax Court, *CCLI (1994) Inc. v. The Queen,*[64] Miller, J. stated at p. 2700:

> This case highlights the difficulty reconciling tax laws to commercial practice. I have attempted on previous occasions to mesh legal and economic realities for the purpose of making sense of our complex tax legislation: this approach has not been universally embraced. Certainty and legal form do trump economic substance, if legal form reflects legal substance. I grapple here with whether a company in the business of financial leasing is, in legal substance, lending money. It is one thing to pit legal form against economic substance, but what if the question is framed as legal form versus legal substance? There are many examples where the courts find the legal form mischaracterizes the legal substance (a common example is a contract between an employer and employee that stipulates the contract is one of an independent contractor).
>
> [emphasis added.]

A classic example of the legal substance approach followed by Canadian courts is demonstrated by the decision of the Supreme Court of Canada in *Singleton* v. *Canada.*[65] In *Singleton* the taxpayer, who was a partner in a law firm, withdrew $300,000 of capital from the partnership which he used to purchase a house. Contemporaneously with the withdrawal from his capital account the taxpayer arranged to borrow $300,000 from a bank on the security of the new house which he contributed to the partnership as a capital contribution. The taxpayer claimed a deduction for interest paid on the $300,000 bank loan on the basis that the money was used for an income earning purpose, namely an investment in the partnership. The Minister reassessed the taxpayer claiming that the purpose of the borrowing was to fund the purchase of his house and therefore the interest was not deductable.[66]

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[64] 2006 DTC 2695 (TCC).

[65] 2001 DTC 5533 (SCC).

[66] In most circumstances, interest is only deductible for income tax purposes when its payment meets the requirements of paragraph 20(1) (c) which provides, in part, as follows:

> "...in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable

In the Tax Court, Bowman, T.C.C.J., found that the fundamental purpose of the borrowing was to buy a house and therefore the interest was not deductible:

> On any realistic view of the matter it could not be said that the money was used for the purpose of making a contribution of capital to the partnership. The fundamental purpose was the purchase of a house and this purpose cannot be altered by the shuffle of cheques...
>
> ...Money borrowed by a partner of a law firm that is initially put into the firm but in fact immediately paid out to him to fund the purchase of a house is used *as a matter of economic reality* for the purpose of buying a house....[67]
>
> [emphasis added]

The majority of the Federal Court of Appeal (Linden, J.A. dissenting) allowed the taxpayer's appeal and the Minister's appeal to the Supreme Court of Canada was dismissed. Major, J., writing for a unanimous Supreme Court of Canada rejected the view adopted by Bowman, T.C.C.J. in the Tax Court and Linden, J.A. in his dissenting judgment in the Federal Court of Appeal:

> The appellant, the Minister in Right of the Crown, relied on the reasons of the Tax Court Judge and Linden, J.A., in dissent, and urged the Court to examine the "economic realities" of the taxpayer's transactions in determining whether the requirements of s. 20(1)(c)(i) had been met.
>
> Applying Shell, I decline to do so. *This Court must simply apply s. 20(1)(c)(i) rather than search for the economic realities of the transaction*.
>
> In applying s. 20(1)(c)(i) here, the relevant question is: to what use were the borrowed funds put? The Tax Court Judge found that the purpose in using the money was to purchase a house and that this purpose could not be altered by the "shuffle of cheques" that occurred on October 27, 1988. I respectfully disagree. *It is this "shuffle of cheques" that defines the legal relationship which must be given effect*....[68]
>
> [emphasis added]

Although Singleton was decided 4 years prior to the introduction of the textual, contextual and purposive approach in *Canada Trustco*, the Supreme

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to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

...

(c) an amount paid in the year or payable in respect of the year..., pursuant to a legal obligation to pay interest on

(i) borrowed money used for the purpose of earning income from a business or property...,

...

or a reasonable amount in respect thereof, whichever is the lesser;"

[67] *Singleton* v. *The Queen*, 96 DTC 1850 (TCC) at p. 1852.

[68] *Singleton*, *supra* note 65 at pp. 5537–5538.

Court of Canada was recently presented with an opportunity to again consider the interpretation of 20(1)(c) in *Lipson et al. v. The Queen*[69] and effectively choose to affirm the interpretation it adopted in *Singleton*.

3.6 The General Anti-avoidance Rule ("GAAR")

A perceived lack of judicial activism by the Canadian courts and, more specifically, the Supreme Court of Canada's rejection of a business purpose test in *Stubart*, ultimately forced Parliament to proceed with a legislative solution to the issue of abusive tax avoidance, resulting in the enactment of the GAAR in current section 245.

The Canadian income tax system recognizes three basic forms of tax schemes. (i) Tax minimization or effective tax planning, which is acceptable; (ii) Tax avoidance or aggressive tax planning, which technically complies with the provisions of the ITA but is inconsistent with the overall object and spirit of the law; and (iii) Tax evasion, which is a failure to comply with the law (e.g. an intentional failure to report income) and can result in criminal prosecution.

The GAAR is designed to address tax avoidance or aggressive tax planning and where it is applicable it empowers the Minister with a broad discretion to re-determine the tax consequences of an avoidance transaction in order to "deny a tax benefit that…would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction."[70]

The term "avoidance transaction" is defined in subsection 245(3) to mean a transaction or series of transactions that "would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."

The term "tax benefit" is defined in subsection 245(1) to mean "a reduction, avoidance or deferral of tax or other amount payable under [the ITA] or an increase in a refund of tax or other amount under [the ITA], and includes a reduction, avoidance or deferral of tax or other amount that would be payable under [the ITA] but for a tax treaty or an increase in a refund of tax or other amount under [the ITA] as a result of a tax treaty".

The GAAR is, however, only applicable if it may reasonably be considered that the avoidance transaction would "result directly or indirectly in

[69] 2009 DTC 5015 (SCC).

[70] Subsection 245(2). Pursuant to subsection 245(7), only the Minister may redetermine the tax consequences arising from an application of the GAAR. A taxpayer is not permitted to self-assess under the GAAR.

a misuse" of the provisions of the ITA or "result directly or indirectly in an abuse having regard to" the provisions of the ITA "read as a whole."[71]

3.6.1 Interpretation of the GAAR

To date the GAAR has been considered by the Supreme Court of Canada four times. The first two decisions, *Canada Trustco*[72] and *Mathew v. Canada,*[73] were released concurrently on October 19, 2005 and the most recent decision of the Supreme Court of Canada in *Lipson*[74] released January 8, 2009. It is these decisions that establish the current framework for the interpretation and application of the GAAR. The fourth case, *Copthorne Holdings Ltd. v. The Queen,*[75] was heard on Jan. 21, 2011, judgment reserved.

The decision of the Supreme Court of Canada in *Canada Trustco* sets out the majority of the framework to be followed in future GAAR cases. McLachlin, C.J. and Major, J., for a unanimous Supreme Court of Canada, begin by summarizing the general approach to statutory interpretation, namely that "[t]he interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole"[76] noting, however, that "the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation."[77]

McLachlin, C.J. and Major, J. continue by reaffirming the need to achieve "consistency, predictability and fairness" in the interpretation of tax statutes, citing with approval the prior decision of the Supreme Court of Canada in *Shell Canada*:[78]

> The provisions of the Income Tax Act must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently. As stated at para. 45 of *Shell Canada Ltd. v. Canada*, [99 DTC 5669] [1999] 3 S.C.R. 622:

[71] Subsection 245(4). The GAAR is also applicable in respect of an avoidance transaction that results in a misuse or abuse of the *Income Tax Regulations*, *Income Tax Application Rules*, a tax treaty or any other enactment that is relevant in computing tax or determining an amount payable or refundable to a person under the ITA.

[72] *Supra*, note 50.

[73] 2005 DTC 5538 (SCC) (sub nom. *Kaulius v. The Queen*).

[74] *Supra* note 69.

[75] An appeal of 2009 DTC 5101 (FCA).

[76] *Canada Trustco*, *supra* note 50 at p. 5526.

[77] *Canada Trustco*, *supra* note 50 at p. 5526.

[78] *Supra* note 48.

> [A]bsent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way.
>
> [Emphasis added.][79]

However, McLachlin, C.J. and Major, J. conclude their preliminary analysis by suggesting that the GAAR may constitute a "provision to the contrary," which justifies a reduced emphasis on textual interpretation in situations involving abusive tax avoidance:

> The *Income Tax Act* remains an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation. Onto this compendium of detailed stipulations, Parliament has engrafted quite a different sort of provision, the GAAR. This is a broadly drafted provision, intended to negate arrangements that would be permissible under a literal interpretation of other provisions of the *Income Tax Act*, on the basis that they amount to abusive tax avoidance. To the extent that the GAAR constitutes a "provision to the contrary" as discussed in *Shell* (at para. 45), the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated. Ultimately, as affirmed in *Shell*, "[t]he courts' role is to interpret and apply the Act as it was adopted by Parliament" (para. 45). The court must to the extent possible contemporaneously give effect to both the GAAR and the other provisions of the *Income Tax Act* relevant to a particular transaction.[80]

Turning to the application of the GAAR, McLachlin, C.J. and Major, J. begin by reproducing an excerpt from the *Explanatory Notes* issued in connection with the enactment of the GAAR:

> The Explanatory Notes to Legislation Relating to Income Tax issued by the Honourable Michael H. Wilson, Minister of Finance (June 1988) ("Explanatory Notes") are an aid to interpretation. The Explanatory Notes state at the outset that they "are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe". They state the purpose of the GAAR at p. 461:
>
> New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.[81]

Finally, McLachlin, C.J. and Major, J. conclude that the GAAR functions to differentiate between legitimate tax minimization and abusive tax avoidance and that its purpose is "to deny the tax benefits of certain

[79] *Canada Trustco*, *supra* note 50 at p. 5526.
[80] *Canada Trustco*, *supra* note 50 at p. 5527.
[81] *Canada Trustco*, *supra* note 50 at p. 5527.

arrangements that comply with a literal interpretation of the provisions of the [ITA], but amount to an abuse of the provisions of the [ITA]".[82] The application of the GAAR therefore seeks to balance a taxpayer's right to certainty in planning its affairs with the need to preserve the fairness of the system for all taxpayers. This view of the GAAR was more recently articulated in the judgment of the Supreme Court in *Lipson v. The Queen*, 2009 DTC 5015. Lebel, J., writing for the majority, stated at paragraph 52:

> The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed, in the complex context of the ITA, to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved. A desire to avoid uncertainty cannot justify ignoring a provision of the ITA that is clearly intended to apply to transactions that would otherwise be valid on their face.

In its approach to applying the GAAR, the Supreme Court of Canada separates the analysis into three steps, all of which must be fulfilled before a re-determination under the GAAR is permitted. The first step is determining if the transaction has resulted in a "tax benefit"; the second step is determining if the transaction is an avoidance transaction; and the final step is determining if the avoidance transaction is abusive within the meaning of subsection 245(4). In general, the substance of the Supreme Court of Canada's approach largely focuses on the final step of determining if the avoidance transaction is abusive because "it is this requirement that has given rise to the most difficulty in the interpretation and application of the GAAR."[83] A summary of each step is provided below.

3.6.1.1 Tax Benefit

McLachlin, C.J. and Major, J.'s analysis on what constitutes a "tax benefit" is brief and results in an overly broad definition of the term, particularly in circumstances where the taxpayer is claiming a deduction against taxable income where the existence of a tax benefit is presumed:

> If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax.[84]

In other circumstances McLachlin, C.J. and Major, J. note that it may be necessary to compare the taxpayer's transaction with alternate arrangements in order to identify the existence of a tax benefit. Although McLachlin, C.J. and Major, J. do provide a couple of simple examples, they ultimately provide little if any real guidance on when such a comparison would be appropriate.

[82] *Canada Trustco*, *supra* note 50 at p. 5527.

[83] *Canada Trustco*, *supra* note 50 at p. 5529.

[84] *Canada Trustco*, *supra* note 50 at p. 5527.

Overall the above approach seems to suggest that a tax benefit will exist anytime the taxpayer does not pay the maximum amount of tax that could have been payable. This seems likely to be the result in almost every situation where the Minister may choose to reassess under GAAR.[85]

Consistent with the approach developed in *Canada Trustco*, little if any real analysis has been given to this stage of the analysis in subsequent GAAR cases, with the taxpayers in some cases simply conceding that a tax benefit exists.

Finally, McLachlin, C.J. and Major, J. confirm that at this stage of the analysis the burden of proof rests with the taxpayer to refute, on a balance of probabilities, the Minister's allegations that the transaction or series of transactions gives rise to a tax benefit.[86] Furthermore, because the determination is largely a question of fact, absent a palpable and overriding error the Appellate courts should generally give deference to the findings of the Tax Court judge.[87]

3.6.1.2 Avoidance Transaction

The second step of the inquiry is to determine if the transaction or series of transactions giving rise to the tax benefit constitutes an avoidance transaction within the meaning of subsection 245(3). Similar to the inquiry into what constitutes a tax benefit, McLachlin, C.J. and Major, J.'s analysis of what constitutes an avoidance transaction is fairly brief. In essence, the question of whether a particular transaction or series of transactions constitutes an avoidance transaction is based on a determination of whether the transaction or series of transactions was undertaken or arranged primarily for a "non-tax purpose" which, similar to a finding that a tax benefit exists, is a factual inquiry.

According to McLachlin, C.J. and Major, J., the inquiry into a "non-tax purpose" is not intended to operate as a business purpose test and, accordingly, subsection 245(3) will, in some circumstances, operate to exclude transactions from the scope of the GAAR notwithstanding that they lack an independent bona fide business purpose.

This approach is consistent with the fact that the ITA contains numerous provisions that confer tax benefits on taxpayers absent any business purpose. It is also consistent with Parliament's intention to preserve predictability, certainty and fairness in Canadian tax law:

> According to the Explanatory Notes, Parliament recognized the Duke of Westminster principle "that tax planning – arranging one's affairs so as to attract the least

[85] It is likely safe to assume that the Minister would not reassess under GAAR to reduce the amount of tax payable by the taxpayer.

[86] *Canada Trustco*, *supra* note 50 at p. 5533.

[87] *Canada Trustco*, *supra* note 50 at p. 5534.

> amount of tax – is a legitimate and accepted part of Canadian tax law" (p. 464). Despite Parliament's intention to address abusive tax avoidance by enacting the GAAR, Parliament nonetheless intended to preserve predictability, certainty and fairness in Canadian tax law. Parliament intends taxpayers to take full advantage of the provisions of the Income Tax Act that confer tax benefits. Indeed, achieving the various policies that the Income Tax Act seeks to promote is dependent on taxpayers doing so.
>
> Section 245(3) merely removes from the ambit of the GAAR transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose. Parliament did not intend s. 245(3) to operate simply as a business purpose test, which would have considered transactions that lacked an independent *bona fide* business purpose to be invalid.[88]

Finally, in determining the purpose of a transaction a court must limit its inquiry to the relationship between the parties and the actual transactions executed between them. It is not permissible to go beyond the legal substance of a transaction and "recharacterize" it on the basis of its economic substance. In considering this issue, McLachlin, C.J. and Major, J. make reference to the Explanatory Notes which provide, in part, that "subsection 245(3) [of the ITA] does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction."[89]

As is the case with the inquiry into what constitutes a tax benefit, this stage of the analysis is also largely a factual inquiry. Accordingly, the same burden of proof and standard of review is applicable.

3.6.1.3 Abusive Tax Avoidance

The final and most important stage of the analysis is the determination of whether an avoidance transaction constitutes abusive tax avoidance within the meaning of subsection 245(4). The first step in this determination is an interpretation of the relevant ITA provisions to determine their object, spirit and purpose. The next step is to determine whether the transaction falls within or frustrates that purpose.[90]

The determination of object, spirit or purpose is firmly grounded in a unified, textual, contextual and purposive interpretation of the specific provisions in issue.[91] This approach is mandated for two principal reasons. First, the formulation of tax policy is not the role of the judiciary:

> To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the [ITA] would inappropriately place the formulation of taxation policy in the hands of the judiciary,

[88] *Canada Trustco*, *supra* note 50 at pp. 5528–5529.

[89] *Canada Trustco*, *supra* note 50 at p. 5529.

[90] *Canada Trustco*, *supra* note 50 at p. 5530.

[91] *Canada Trustco*, *supra* note 50 at p. 5530.

> requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.[92]

Second, a determination of purpose based on a unified, textual, contextual and purposive interpretation is necessary to preserve the certainty, predictability and fairness of the tax system, which is, in turn, necessary to allow taxpayers to intelligently order their affairs:

> [T]o search for an overriding policy of the [ITA] that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs. Although Parliament's general purpose in enacting the GAAR was to preserve legitimate tax minimization schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law.[93]

That said, it is important to remember that the GAAR is intended to apply in situations where the taxpayer's transaction otherwise complies with the technical requirements of the ITA and, as such, it is inevitable that the GAAR will introduce some degree of uncertainty in tax planning. This uncertainty is, however, unavoidable if the GAAR is to have any substantive effect. As stated by the Supreme Court of Canada in *Lipson*, "[a] desire to avoid uncertainty cannot justify ignoring a provision of the ITA that is clearly intended to apply to transactions that would otherwise be valid on their face."[94]

Although a finding of abuse must be related to the specific transactions forming part of the series, the specific transactions must still be viewed in the context of the series as a whole.[95] Accordingly, it is permissible to consider the overall result of the series when assessing each specific transaction within the series.[96] It is, however, important to note that the focus is on the overall result of the series and not its overall purpose. Adopting an approach focused on the overall purpose of a series "might incorrectly imply that the taxpayer's motivation or the purpose of the transaction is determinative."[97] Although the taxpayer's motivations for entering into the series or the economic purpose or substance of the series are not determinative of a finding of abuse, they are still relevant "to the extent that they establish whether the transaction frustrates the purpose of the relevant provisions."[98]

[92] *Canada Trustco*, *supra* note 50 at p. 5530.
[93] *Canada Trustco*, *supra* note 50 at p. 5530.
[94] *Lipson*, *supra* note 69 at paragraph 52.
[95] *Lipson*, *supra* note 69 at paragraph 34.
[96] *Lipson*, *supra* note 69 at paragraph 34.
[97] *Lipson*, *supra* note 69 at paragraph 34.
[98] *Lipson*, *supra* note 69 at paragraph 38.

Based on the above analysis, abusive tax avoidance will generally be found "where the result of the avoidance transaction (a) is an outcome that the provisions relied on seek to prevent; (b) defeats the underlying rationale of the provisions relied on; or (c) circumvents certain provisions in a manner that frustrates the object, spirit or purpose of those provisions."[99]

Unlike the first two stages of the GAAR analysis, where the onus is on the taxpayer to disprove the existence of a tax benefit and/or an avoidance transaction, the onus of proof shifts to the Minister at this stage of the inquiry. Recall that the normal practice of placing the onus of proof on the taxpayer is justified by the fact that the relevant information is generally in the knowledge and control of the taxpayer. However, where the determination is one of legislative intent, placing the onus on the Minister becomes justified since it is the Minister and not the taxpayer who is in the better position to provide the information necessary to establish the object, spirit or purpose of the provision that is the subject of the alleged abuse or misuse:

> The taxpayer, once he or she has shown compliance with the wording of a provision, should not be required to disprove that he or she has thereby violated the object, spirit or purpose of the provision. It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated. . . . The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.[100]

Finally, the determination of whether an avoidance transaction constitutes abusive tax avoidance is a question of mixed fact and law. As such, the appropriate standard for review will depend on whether the question is more legal or factual. If the question pertains to the Tax Court Judge's interpretation of the provisions of the ITA, then the appropriate standard is "correctness". However, if the Tax Court judge has proceeded on a proper interpretation of the statutory provisions and on findings that are supported by the facts of the case, those findings should not be reversed unless the appellate court finds that the judge has made a "palpable and overriding error".[101]

3.6.1.4 Is the GAAR Effective?

As of November 2009 a total of 867 cases have been referred to the GAAR Committee. Of those cases the GAAR Committee determined that the GAAR was applicable in 614. Since the decisions of the Supreme Court

[99] *Lipson*, *supra* note 87 at paragraph 40.

[100] *Canada Trustco*, *supra* note 68 at p. 5533.

[101] *Canada Trustco*, *supra* note 68 at p. 5531.

of Canada in *Canada Trustco*[102] and *Mathew,*[103] approximately 18 GAAR cases have been heard by the various court levels, with each of the taxpayer and the Minister ultimately being successful in nine of those cases. These statistics provide some confirmation that the GAAR has been an effective tool in limiting some forms of abusive tax avoidance. In fact, the Minister has gone so far as to concede in *Lipson* that absent the GAAR the taxpayer's scheme would have been effective.[104]

Notwithstanding that the GAAR has had some degree of success in limiting the use of abusive tax avoidance transactions, a considerable amount of uncertainly in the interpretation and application of the GAAR still remains. This lack of certainty limits the effectiveness of the GAAR not only by potentially excluding its application to circumstances where it should arguably apply, but also by exposing otherwise legitimate tax planning to an unnecessarily increased level of uncertainty.[105]

One significant issue with the structure of the current GAAR is the lack of an express statutory requirement to consider the economic substance of a transaction for the purpose of determining if it constitutes abusive tax avoidance, and the continued reluctance of Canadian courts to consider economic substance in the absence of such express statutory authority. This limitation on the ability to determine whether or not a transaction or series of transactions is abusive by reference to its economic substance significantly limits the potential scope of transactions to which the GAAR will apply.

Although it has been advocated that an economic substance approach is supported by the current wording of section 245,[106] to date economic substance has played a limited role in the interpretive approach developed by the Supreme Court of Canada. The Supreme Court of Canada's reluctance to expand the role of economic substance in its GAAR analysis is likely influenced by the fact that it has consistently rejected any reference to economic substance in interpreting other provisions of the ITA, however, the position is also supported by the statements in the explanatory notes issued in connection with the introduction of the GAAR which provide that "subsection 245(3) [of the ITA] does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction" within the meaning of the GAAR.

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[102] *Supra* note 50.

[103] *Supra* note 73.

[104] *Lipson*, *supra* note 69 at para 19.

[105] The current difficulty in interpreting and applying the GAAR is clearly evident in the divided judgment of the Supreme Court of Canada in *Lipson*, which was heard before seven justices of the Supreme Court of Canada who split their decision three ways.

[106] Jinyan Li, " 'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance," (2006), vol. 54, no. 1 *Canadian Tax Journal*, 23–56.

In *Canada Trustco* the Minister argued that the policy underlying paragraph 20(1)(a) and the other capital cost allowance provisions in the ITA[107] was to permit taxpayers to claim capital cost allowance in respect of their real or economic cost in a capital property and not simply their legal cost. The Supreme Court of Canada rejected the Minister's argument on the basis that the provisions of the ITA and *Income Tax Regulations* relevant to the computation of capital cost allowance did not make reference to economic cost and therefore, on a proper interpretation of the relevant provisions in light of their context and purpose, it was inappropriate to limit the deduction on the basis of economic cost. McLachlin, C.J. and Major, J. described the circumstances where it might be appropriate to consider economic purpose at p. 5532:

> When properly interpreted, the statutory provisions at issue in a given case may dictate that a particular tax benefit may apply only to transactions with a certain economic, commercial, family or other non-tax purpose. The absence of such considerations may then become a relevant factor towards the inference that the transactions abused the provisions at issue, but there is no golden rule in this respect.[108]

McLachlin, C.J. and Major, J. ultimately concluded that the Minister's position could not be supported on a textual, contextual and purposive interpretation of the capital cost allowance provisions, stating at pp. 5535–5536:

> The appellant suggests that the usual result of the CCA provisions of the Act should be overridden in the absence of real financial risk or "economic cost" in the transaction. However, this suggestion distorts the purpose of the CCA provisions by reducing them to apply only when sums of money are at economic risk. The applicable CCA provisions of the Act do not refer to economic risk. They refer only to "cost". Where Parliament wanted to introduce economic risk into the meaning of cost related to CCA provisions, it did so expressly. . . . "Cost" in the context of CCA is a well-understood legal concept. It has been carefully defined by the Act and the jurisprudence. Like the Tax Court judge, we see nothing in the GAAR or the object of the CCA provisions that permits us to rewrite them to interpret "cost" to mean "amount economically at risk" in the applicable provisions. . . .
>
> The appellant's submissions on this point amount to a narrow consideration of the "economic substance" of the transaction, viewed in isolation from a textual, contextual and purposive interpretation of the CCA provisions. It did not focus on the purpose of the CCA provisions read in the context of the Act as a whole, to determine whether the tax benefit fell outside the object, spirit or purpose of the relevant provisions. . . . *While the "economic substance" of the transaction may be relevant at various stages of the analysis, this*

[107] Paragraph 20(1)(a) permits a deduction in respect of the capital cost of depreciable property acquired by the taxpayer for the purpose of earning income from business or property. The amount of the permitted deduction is computed primarily by reference to section 13 of the ITA and section 1100 of the *Income Tax Regulations*. This deduction is more generally referred to as capital cost allowance.

[108] *Canada Trustco*, *supra* note 50 at p. 5532.

> *expression has little meaning in isolation from the proper interpretation of specific provisions of the Act*. Any "economic substance" must be considered in relation to the proper interpretation of the specific provisions that are relied upon for the tax benefit.
>
> [*Emphasis added*]

Given the limited number of provisions in the ITA that make any explicit reference to economic substance, the above approach significantly narrows the scope of the GAAR.[109] This approach has recently been affirmed by the majority decision of the Supreme Court of Canada in *Lipson* where the Supreme Court of Canada again limited the role of economic substance to the determination of whether a transaction frustrates the purpose of a particular provision of the ITA.

> [I]t is clear from *Canada Trustco* that the proper approach under s. 245(4) is to determine whether the transaction frustrates the object, spirit or purpose of the provisions giving rise to the tax benefit. An avoidance purpose is needed to establish a violation of the GAAR when s. 245(3) is in issue, but is not determinative in the s. 245(4) analysis. *Motivation, purpose and economic substance are relevant under s. 245(4) only to the extent that they establish whether the transaction frustrates the purpose of the relevant provisions* (Canada Trustco, at paras. 57–60).
>
> [Emphasis added]

The above approach has been criticized for confusing the prohibition on the recharacterization of a transaction on the basis of its economic substance for the purpose of determining if a transaction is an avoidance transaction within the meaning of subsection 245(3), with an inquiry into whether a transaction is abusive on the basis that it lacks any real economic substance.[110] With respect to the analysis under subjection 245(4), the explanatory notes clearly indicate that the consideration of whether a particular transaction has any real economic substance is relevant in a determination of whether that transaction is abusive.[111]

The reluctance of the Supreme Court of Canada to inquire into the economic or commercial realties of a transaction for the purpose of determining if the transaction is an abusive tax avoidance transaction represents another limitation to the effective application of the GAAR.

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[109] See Brian J. Arnold, "Policy Forum: Confusion Worse Confounded – The Supreme Court's GAAR Decisions" (2006), vol. 54, no. 1 *Canadian Tax Journal,* 167–209 at p. 193.

[110] See Brian J. Arnold, "Policy Forum: Confusion Worse Confounded – The Supreme Court's GAAR Decisions" (2006), vol. 54, no. 1 *Canadian Tax Journal,* 167–209 at p. 193.

[111] The explanatory notes to subsection 245(4) state that "[s]ubsection 245(4) recognizes that the provisions of the [ITA] are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the [ITA] to avoid tax."

3.7 Tax Shelter and Tax Shelter Investment Rules

The ITA imposes specific information reporting requirements in respect of arrangements that constitute tax shelters for the purposes of the ITA. The term "tax shelter" is, in general terms, defined in subsection 237.1(1) to include certain arrangements under which it may reasonably be considered, having regard to statements or representations made or proposed to be made in connection with the arrangement, that a taxpayer entering into the arrangement would be required to make a political donation or gift to a "qualified donee"[112] and certain other transactions involving the acquisition of property, in respect of which it can reasonably be considered, having regard to statements or representations made or proposed to be made in connection with the property that the taxpayer would be entitled, within a period of approximately 4 years, to deductions in computing income (including the allocation of a loss from a property that is an interest in a partnership) or reductions in tax payable that, in the aggregate, equal or exceed the cost to the taxpayer of the property less the amount of certain prescribed benefits[113] the taxpayer (or another non-arm's length person) is expected to receive or enjoy, directly or indirectly, in respect of the property.

A promoter[114] of a tax shelter is required to apply for and obtain an identification number for the tax shelter from the Minister[115] and must make reasonable efforts to ensure that all persons who acquire or otherwise invest in the tax shelter are provided with the identification number issued by the Minister.[116] The sale or issuance of an interest in a tax shelter is prohibited prior to the issuance of a tax shelter identification number.[117] A promoter of a tax shelter is also required to file an annual information return with the Minister containing prescribed information about the investors in a tax shelter.[118]

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[112] Defined in subsection 237.1(1) as a "gifting arrangement". The term "qualified donee" is defined in subsection 149.1(1) and paragraphs 110.1(1)(a) and (b) and includes a Canadian registered charity.

[113] Defined in Regulation 231(6) and (6.1) of the *Income Tax Regulations* to include certain amounts that are limited recourse or otherwise have the effect of reducing the impact of any loss that the taxpayer may sustain in connection with the arrangement.

[114] Defined in subsection 237.1(1) to mean a person who in the course of a business:

(a) sells or issues, or promotes the sale, issuance or acquisition of, a tax shelter,

(b) acts as an agent or adviser in respect of the sale or issuance, or the promotion of the sale, issuance or acquisition, of a tax shelter, or

(c) accepts, whether as a principal or agent, consideration in respect of a tax shelter.

[115] Subsection 237.1(2).

[116] Subsection 237.1(5).

[117] Subsection 237.1(4).

[118] Subsection 237.1(7).

A person who sells, issues or accepts consideration in respect of a tax shelter before the issuance of a tax shelter identification number is liable to a penalty, which can potentially equal 25% of all consideration received or receivable by the person in respect of the tax shelter. Furthermore, any investor in a tax shelter is prohibited from claiming any deduction in respect of the tax shelter unless the taxpayer files prescribed information with the Minister, including the tax shelter identification number.[119]

In addition to the tax shelter information reporting rules in section 237.1, the ITA contains other rules which restrict a taxpayer's tax basis in property that is a "tax shelter investment"[120] or the amount of any expenditure made in respect of a tax shelter investment. It is important to note that these rules operate independent of the tax shelter information reporting rules and their application is therefore not dependant on a failure to comply with in section 237.1.

Where these tax shelter investment rules are applicable, the amount of any expenditure that is, or is the tax basis of, a taxpayer's tax shelter investment, and the amount of any expenditure of a taxpayer an interest in which is a tax shelter investment, is reduced by the aggregate of (i) any limited-recourse amount that can reasonably be considered to relate to the expenditure; and (ii) the taxpayer's at-risk adjustment in respect of the expenditure.[121]

For these purpose "limited-recourse amount" is defined to mean the unpaid principal amount of any indebtedness for which recourse is limited,[122] either immediately or in the future and either absolutely or contingently.[123] A taxpayer's "at-risk adjustment" in respect of an expenditure is defined, in general terms, to mean any amount or benefit that a taxpayer, or another non-arm's length taxpayer, is entitled to receive for the purpose of reducing the impact of any loss that the taxpayer may sustain in respect of making an expenditure or, where the expenditure is the cost of a property, any loss from the holding or disposition of the property.[124]

[119] Subsection 237.1(6).

[120] Defined in subsection 143.2(1) to include a property that is a "tax shelter" for purpose of the ITA or, in limited circumstances, a taxpayer's interest in a partnership.

[121] Subsection 143.2(6).

[122] Pursuant to subsection 143.2(7), the unpaid principal of indebtedness is deemed to be a limited-recourse amount unless the terms of the borrowing provide that the indebtedness is repayable in full within a reasonable period not exceeding 10 years and interest is payable on the indebtedness at least annually at a minimum prescribed rate.

[123] Defined in subsection 143.2(1).

[124] Defined in subsection 143.2(2).

3.7.1 Tax Treaty Abuse

Canada's approach to tax treaty abuse has been largely ineffective to date. With some exceptions, Canada generally does not include specific anti-avoidance provisions in the text of its tax treaties and those treaties that do include specific anti-avoidance provisions, for example the 1978 Canada-United Kingdom Income and Capital Gains Tax Convention,[125] are commonly included at the request of the other contracting state. The most recent (and comprehensive) treaty shopping provision to be adopted by Canada is the addition of a reciprocal[126] limitation of benefits ("LOB") provisions in the recently ratified 5th protocol to the 1980 Canada-U.S. Tax Treaty.[127] Similar to LOB provisions in other U.S. income tax treaties, this provisions establishes a series of objective tests that are applied in order to determine if a particular resident of a contracting state has a sufficient nexus to that contracting state to be deserving of treaty benefits.

Given the lack of specific avoidance rules in its bilateral tax treaties, Canada has more generally attempted to attack treaty abuse in two ways. The first approach involves the application of the GAAR to transactions which are considered to be abusive. In fact the original text of subsection 245(2) was amended on May 13, 2005[128] to retroactively confirm that the GAAR was applicable to income tax treaties effective September 12, 1988.

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[125] With respect to the payment of dividends, Article 10(7) reads as follows:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

Similar wording is found in Article 11 (Interest) and Article 12 (Royalties) of the Canada-U.K. Treaty. Income tax treaties concluded with Mexico, Oman, Peru, Uzbekistan, Chile, Kazakhstan, Ukraine, Columbia (pending) and Lebanon (pending) also contain similarly worded anti-avoidance provisions in respect of the payment of dividend, interest and/or royalties.

[126] The 1980 Canada-U.S. Treaty already included an LOB provision that only applied for U.S. tax purposes.

[127] The 5th Protocol was signed on September 21, 2007 and entered into force on December 15, 2008.

[128] Bill C-33, *A second Act to implement certain provisions of the budget tabled in Parliament on March 23, 2004*, s. 52(2), which was tabled on December 8, 2004 and received Royal Assent on May 13, 2005. Bill C-33 also amended the *Income Tax Conventions Interpretation Act*, R.S.C., 1985, c I-4, to add section 4.1, which reads as follows:

> 4.1 Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that section 245 of the Income Tax Act applies to any benefit provided under the convention.

The second approach largely focuses on a liberal and purposive interpretation of tax treaty terms in a way that best implements the intentions of the contracting states.[129]

These two approaches can be illustrated through an examination of two recent court decisions; *MIL (Investments) S.A. v. The Queen,*[130] involving the application of the GAAR, and *Prévost Car Inc. v. The Queen,*[131] which deals with the interpretation of the term “beneficial ownership”.

In *MIL* the taxpayer was a corporation owned by a non-resident of Canada that was initially incorporated in the Cayman Islands. Prior to June 1995, it owned 11.9% of Diamond Field Resources Ltd. (“DFR”), a Canadian public mining company. On June 8, 1995, the taxpayer exchanged 703,000 DFR shares for 1,401,218 common shares of Inco Limited (“Inco”), another large Canadian public mining company. This exchange of shares occurred on a tax-deferred basis in accordance with domestic Canadian tax laws. On July 17, 1995, the taxpayer was continued from the Cayman Islands to Luxembourg. Between August 14, 1995 and August 17, 1995, the taxpayer disposed of the 1,401,218 common shares of Inco and claimed exemption from Canadian tax on the resulting capital gain of $64,982,713 under Article 13 of the Canada-Luxembourg Tax Treaty (the “Luxembourg Treaty”).[132] On September 14, 1995, the taxpayer disposed of 50,000 DFR shares and again claimed exemption from Canadian tax on the gain of $4,492,556 under Article 13 of the Luxembourg Treaty. The taxpayer was not assessed in Canada in respect of either gain and also paid no tax in Luxembourg because the cost basis of the Inco and DFR shares for the Luxembourg tax purposes was the value at the time of the continuance which exceeded the sale price. On May 22, 1996, the DFR shareholders approved the Inco acquisition of all DFR shares to take effect on August 21, 1996. The taxpayer disposed of its remaining DFR shares and claimed an exemption from Canadian tax on the resulting capital gain of $425,853,942 under Article 13 of the Treaty. It is this gain that is the subject of the appeal.

In the Tax Court Bell, J. ultimately allowed the taxpayer’s appeal on the basis that none of the transactions at question were “avoidance transactions” and, in particular that the sale of shares and continuance from

[129] This approach is consistent with the approach adopted by the Supreme Court of Canada in *Crown Forest Industries Limited* v. *Canada*, 95 DTC 5389 (SCC), the leading Canadian authority on tax treaty interpretation.

[130] 2006 DTC 3307 (TCC), affrm’d 2007 DTC 5437 (FCA).

[131] 2008 DTC 3080 (TCC), affrm’d 2009 DTC (FCA).

[132] The *Convention Between Canada and The Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital*.

the Cayman Islands to Luxembourg were done primarily for bona fide commercial reasons.

However, what makes the judgment particularly troubling to the application of the GAAR in future treaty shopping cases is the fact that Bell, J. went on to conclude (at p. 3316) that the taxpayer's selection of an income tax treaty to minimize tax on its own cannot be viewed as abusive:

> In written argument, Respondent's counsel argued that "treaty shopping" is an abuse of bilateral tax conventions and that this is recognized by the Supreme Court of Canada. In oral argument, the following passage from *Crown Forest Industries Limited* v. *The Queen*, [95 DTC 5389] [1995] 2 S.C.R. 802 at page 825, was quoted to establish that if the Supreme Court had access to section 245, it would have used that section to deny a benefit from treaty shopping:
>
> It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements ...
>
> I do not agree that Justice Iaccobucci's *obiter dicta* can be used to establish a *prima facie* finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined.
>
> [footnote omitted] [emphasis added]

The approach adopted by Bell, J. in the Tax Court was unanimously affirmed by the Federal Court of Appeal in a short oral judgment delivered by Pelletier, J.A. However, Pelletier, J.A. provided some additional insight into the potential limitation on the use of the GAAR in future treaty shopping cases, stating at p. 5438:

> To the extent that the [Minister] argues that the Tax treaty should not be interpreted so as to permit double taxation, the issue raised by the GAAR is the instance of Canadian taxation not the foregoing of revenues by the Luxembourg fiscal authorities.

One common element of treaty shopping cases is that the tax regime of the jurisdiction in which the holding company is established is designed in a way that subjects the foreign source income of the holding company to little or no income tax. Accordingly if, as Pelletier, J.A. suggests, evidence of double non-taxation is not relevant in determining if there has been an abuse of a tax treaty under the GAAR, it becomes difficult to envisage a situation where tax treaty abuse could be established.

The potential difficulty in applying the GAAR to future treaty shopping cases is further illustrated by the decision of the Tax Court in *Garron v.*

The Queen.[133] In *Garron*, the principle taxpayers were two trusts settled by an individual resident in the Caribbean island of St. Vincent. The beneficiaries of the trusts were Canadian residents and the sole trustee of each trust was a corporation resident in Barbados. As part of an estate freeze, the trusts subscribed for shares of newly incorporated Canadian holding corporations and the corporations in turn subscribed for shares of PMPL Holdings Inc. ("PMPL"), a private Canadian corporation. Prior to the acquisition by the trusts, the shares of PMPL were directly and indirectly held by some of the Canadian beneficiaries of the trusts. The transactions were effected at nominal consideration. As part of an arm's length sale of PMPL, the trusts disposed of the majority of the shares that they held in the Canadian holding corporations and realized capital gains of over $450,000,000. In accordance with domestic Canadian tax rules the arm's length purchaser withheld some of the purchase price and remitted it to the Canadian government on account of potential tax payable on the capital gain. Relying on an exemption from tax in Article XIV(4) of *Canada-Barbados Tax Treaty,*[134] the trusts applied to the Minister for a refund of the withheld amounts. The Minister disallowed the exemption and reassessed the trusts in respect of the gain on various grounds, including under the GAAR on the basis that the steps undertaken in the reorganization, and in particular the use of the offshore trusts, was undertaken primarily to avoid Canadian tax.

In concluding that the GAAR did not apply to the particular transactions,[135] Woods J. commented briefly on the application of domestic anti-avoidance rules to bilateral tax treaties, stating at paragraphs 374–375:

> . . .I agree with the argument of counsel for the appellants that the Minister's position is contrary to commentary published by the OECD in 1977 in reference to the organization's Model Double Taxation Convention.
>
> The relevant commentary relates to Article I of the model convention. It corresponds with Article I of the Treaty. Paragraph 7 of that commentary confirms that treaties are not intended to help tax avoidance, but it suggests that treaties should be amended to take into account domestic tax avoidance legislation. The relevant paragraph is reproduced below.
>
> The purpose of double tax conventions is to promote by, eliminating international double taxation . . . they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, double taxation conventions being left aside, to exploit the differences in tax levels as between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned

[133] *Myron A. Garron and Berna V. Garron, as Trustees of the Garron Family Trust, Berna V. Garron, Myron A. Garron, St. Michael Trust Corp. as Trustee of the Fundy Settlement, Andrew T. Dunin, and St. Michael Trust Corp. as trustee of the Summersby Settlement v. The Queen*, 2009 DTC 1287 (TCC), aff'd 2010 DTC 5189 (FCA).

[134] *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital*.

[135] Woods, J. ultimately concluded that the trusts were factually resident in Canada and therefore subject to tax on the gain.

> to adopt provisions in their domestic law, to counter possible manoeuvres. Such states will then wish, in their bilateral double taxation conventions, to preserve the application of a provision of this kind contained in their domestic laws.
>
> [Emphasis added]

And at paragraph 394:

> The question is what the drafters of the Treaty from both countries intended. I would have thought that if Canada had intended that section 94 should override the Treaty, this would have been specifically mentioned in the Treaty.

Although some of Canada's tax treaties do make specific reference to that application of domestic anti-avoidance provisions, most notably the Canada-Germany Income Tax Treaty[136] and the 1980 Canada-U.S. Income Tax Treaty,[137] any attempt to apply the GAAR to a treaty that does not specifically preserve the application of domestic anti-avoidance rules could prove problematic.

In *Prévost Car*, the taxpayer was a Canadian resident corporation that was a wholly owned subsidiary of a Dutch holding corporation, Prévost Holding B.V. ("PHB"). PHB was in turn 51% owned by Volvo Bus Corporation ("Volvo"), a Swedish resident corporation and 49% by Henlys Group PLC ("Henlys"), a corporation resident in the United Kingdom. The taxpayer declared and paid dividends to PHB and, on the basis that PHB was the beneficial owner of the dividends, withheld tax on its payments at the 5% rate prescribed under paragraph 2 of Article 10 of the *Canada–Netherlands Tax Treaty* (the "Netherlands Treaty"). In accordance with the terms of a shareholders' agreement, Volvo and Henlys had agreed that 80% of the taxpayer's profits would be distributed to PHB as a dividend, loan or return of capital and subsequently distributed by PHB to Volvo and Henlys in proportion to their respective ownership interests. The Minister reassessed the taxpayer in respect of the dividends on the basis that Volvo and Henlys were the beneficial owners of the dividends and therefore the 5% reduced rate under the Netherlands Treaty was not applicable.

Consistent with Canada's other income tax treaties the Netherlands Treaty included a provision that required undefined terms to be given their

[136] Article 29(6) reads as follows:

> Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.

[137] Paragraph 7 of Article XXIX A (Limitation on benefits):

> It is understood that this Article shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under this Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of this Convention.

meaning under the relevant states domestic laws.[138] Article 3(2) of the Tax Treaty provided:

> As regards the application of the Convention by a State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

In concluding that PHB was the beneficial owner of the dividends, Rip J. interpreted the meaning of the term "beneficial owner" in a manner consistent with the meaning of that term under domestic Canadian law, stating at p. 3097:

> In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. When the Supreme Court in *Jodrey* stated that the "beneficial owner" is one who can "ultimately" exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word "ultimately", to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation. The word "ultimately" refers to the recipient of the dividend who is the true owner of the dividend, a person who could do with the dividend what he or she desires. It is the true owner of property who is the beneficial owner of the property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients. This is not the relationship between [PHB] and its shareholders.
>
> [footnotes omitted]

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[138] This approach is also required pursuant to section 3 of the *Income Tax Convention Interpretation Act*, R.S.C. 1985, c. 1-4, which states:

> Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that, to the extent that a term in the convention is
>
> (a) not defined in the convention,
> (b) not fully defined in the convention, or
> (c) to be defined by reference to the laws of Canada.
>
> that term has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the *Income Tax Act*, as amended from time to time, and not the meaning it had for the purposes of the *Income Tax Act* on the date the convention was entered into or given the force of law in Canada if, after that date, its meaning for the purposes of the *Income Tax Act* has changed.

In a brief judgment, the Federal Court of Appeal dismissed the Minister's appeal with costs.[139] Give the Canadian courts general approach to the interpretation of domestic income tax legislation, the result in *Prévost Car* is not surprising. It also highlights the potential difficulty in challenging future cases of tax avoidance through a purposive interpretation of Canada's income tax treaties, particularly in those circumstances where the interpretive issue before the court is the meaning of an undefined term in the income tax treaty.

3.8 Tax Avoidance Reporting Rules – Draft Section 237.3

Draft section 237.3 introduces a mandatory reporting regime for certain tax avoidance transactions that are entered into after 2010 or that are part of a series of transactions that began before 2011 and is completed after 2010. The rules are intended to enhance the CRA's ability to identify aggressive tax planning in a timely manner.

In accordance with draft subsection 237.3(2), mandatory reporting will be required in respect of a "reportable transaction", which is defined in draft subsection 237.1(1) as a transaction that constitutes an "avoidance transaction," as defined for purposes of the GAAR, and that satisfies at least two of the following three criteria:

- The fee paid to a promoter or advisor is (i) based on the amount of the tax benefit; (ii) contingent on obtaining the tax benefit; or (iii) dependent on the number of participants in the transaction (a "Special Fee");
- the promoter or advisor (or a non-arm's length person) has or had confidential or contractual protection in respect of the avoidance transaction; or
- either the taxpayer (or a person who enters into the transaction for the benefit of the taxpayer) or the promoter or advisor (or a non-arm's length person) has or had contractual protection in respect of the transaction.

A person subject to the reporting requirements and any promoter or advisor, who is entitled to a Special Fee or a fee for providing contractual protection, will be required to file an information return with the CRA reporting the transaction on or before June 30th of the year following the year in which the transaction first became a reportable transaction.[140] If more than one person is required to file an information return in respect of the same reportable transaction, the filing of a complete disclosure by one person will satisfy the obligation or all such persons.[141]

[139] 2009 DTC (FCA).

[140] Draft subsections 237.3(2) and (5).

[141] Draft subsection 237.3(4).

Failure to file an information return will result in the taxpayer who is entitled to the tax benefit under the transaction being liable to a penalty in an amount equal to the total of all Special Fees or fees for providing contractual protection that each promoter or advisor is entitled to receive.[142] Each person who was required to file an information return will be jointly and severally liable with the taxpayer for payment of such penalty.[143] In the case of a promoter or advisor this liability is limited to the portion of the fees included in computing the penalty that such promoter or advisor was entitled to receive.[144]

Failure to comply with the mandatory reporting regime in respect of a reportable transaction will also result in a denial of the tax benefit resulting from the avoidance transaction.[145]

A person who fails to file an information return if and when required will not be liable to a penalty if the person has exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.[146]

[142] Draft subsection 237.3(8).

[143] Draft subsection 237.3(9).

[144] Draft subsection 237.3(10).

[145] Draft subsection 237.3(6).

[146] Draft subsection 237.3(11).

Chapter 4
The People's Republic of China

Kevin Holmes

4.1 Introduction

Chinese civilization dates back more than 5,000 years. Throughout that period, the Chinese people have been subject to "top-down" directives, whether from emperors, fiefdom war lords, or the Communist Party of China (CPC). Never in that 5,000-year period has China been governed as a democracy as one understands it in developed Western societies.

The opening words of the "General Program" of the Constitution of the CPC state that "[t]he Communist Party of China is the vanguard ... of the Chinese people and the Chinese nation." The philosophical principles enshrined in the Constitution of the CPC are broadly reiterated in the Constitution of the People's Republic of China (PRC) such that, to a large extent, the "General Program" of the Constitution of the CPC is paraphrased and embedded in the original Preamble to the Constitution of the PRC and its subsequent amendments.[1]

Consequently, the manner in which China interprets and applies its laws is intertwined with its political system. Application of legislation by the Chinese bureaucracy is sometimes referred to as its "rule by law," meaning broadly that the law is an instrument of government,[2] which, according to some writers, is widely recognized as key to maintaining social order and stability.[3] This notion of the place of law in society is quite different from

[1] See, in particular, the Preamble to the Constitution and Chapter 1 – General Principles: http://english.people.com.cn/constitution/constitution.html (accessed 6 June 2010).

[2] See Tamanaha, Brian Z. (2004) *On the Rule of Law – History, Politics, Theory*, Cambridge University Press, 3.

[3] See, for example, Li, Jinyan, "Development and Tax Policy: Case Study of China", (2007) 3(4) *Comparative Research in Law and Political Economy*, CLPE Research Paper 27/2007, 32.

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the "exceedingly elusive notion"[4] of the "rule of law," which one would normally expect to be adopted in Western democracies, viz. "the government acts according to the rules produced in the political arena and respects the civil rights of its citizens, and that there is a judicial party to resort to that embodies the ethic of treating all cases before it neutrally and fairly."[5]

In China, there is no substantive separation of powers between the three pillars of government (the legislature, executive and judiciary) in the traditional Western sense. In particular, China has never had, and still does not have, a judicial system premised on the notion that the role of the courts is to act as a neutral cushion in the power imbalance relationship between the individual and the State.

Li Jinyan observes that:

> . . . Chinese tax law is largely administrative law. . . .
>
> The power of interpreting tax law is, in theory, shared among the legislature, the court, and the tax administration. In the case of statutes enacted by the legislature, the Standing Committee of the National People's Congress has the sole power to interpret "laws". The Supreme People's Court has the power to interpret the taxing statutes for the purposes of adjudicating cases. In practice, the Supreme Court has not heard any tax cases, so it has never rendered any interpretation.[6]

Most judges are party members and in practice their decisions are often reviewed by their supervisors before release or, in major cases, by private trial committees of court officials, thus ensuring subordination of the judiciary to the CPC controlled bureaucracy.[7]

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[4] Tamanaha, Brian Z. (2004) *On the Rule of Law – History, Politics, Theory*, Cambridge University Press, 3.

[5] Daniels, Ronald J. and Michael Trebilcock, "The Political Economy of Rule of Law Reform in Developing Countries", (2004) 26 *Michigan Journal of International Law*, 99, 104.

[6] Li, Jinyan, "Development and Tax Policy: Case Study of China", (2007) 3(4) *Comparative Research in Law and Political Economy*, CLPE Research Paper 27/2007, 40.

[7] Li, Jinyan, "Development and Tax Policy: Case Study of China", (2007) 3(4) *Comparative Research in Law and Political Economy*, CLPE Research Paper 27/2007, 34. Just quite how this approach reconciles with Article 126 of the Constitution of the PRC is not at all obvious. Article 126 stipulates that "[t]he people's courts shall, in accordance with the law, exercise judicial power independently and are not subject to interference by administrative organs, public organizations or individuals." For an instructive account of the subservient status of the judiciary, see Yardley, Jim, "A Judge Tests China's Courts, Making History", *New York Times*, 28 November 2005, http://www.ruanyifeng.com/blog/2006/04/rule_by_law_3.html (accessed 19 October 2009).

4.2 Tax Law as Part of the Broader Legal System

In China, primary legislation (including tax legislation) is passed by the National People's Congress (NPC), or its Standing Committee. The NPC is controlled by the CPC. The NPC may delegate its law making powers to the State Council (the Central People's Government of the PRC), as it did, for example, in Article 59 of the Corporate Income Tax Law (CITL).[8]

The language of primary tax law is very general, and requires explication. Therefore, secondary legislation, in the form of administrative regulations, is made by the State Council to expound the primary legislation. The State Council is the highest executive body of state power and the highest organ of state administration.[9] Article 89 of the Constitution of the PRC empowers the State Council to "adopt administrative measures, enact administrative rules and regulations and issue decisions and orders in accordance with the Constitution and the statutes",[10] to "lay down the tasks and responsibilities of the ministries ... of the State Council, to exercise unified leadership over the work of the ministries",[11] and to "direct and administer the work concerning civil affairs, public security, judicial administration, supervision and other related matters."[12]

Furthermore, the State Council may promulgate regulations on matters in respect of which the NPC (or its Standing Committee) has not even passed any primary law. In the taxation arena, this is how the value added tax, business tax (which is a tax on certain services), consumption tax (which is an excise tax on luxury goods, including tobacco and alcohol), land appreciation tax, resource tax, motor car purchase tax, and import and export duties came into being.

Further amplification of the primary law and the administrative regulations is provided in the form of administrative rules promulgated by the Ministry of Finance and the State Administration of Taxation (SAT), which is a ministry of the State Council. Administrative regulations and rules have the full force of law in their own right because of the power granted to the State Council under Article 89 of the Constitution of the PRC and to ministries under Article 90. Article 90, for example, provides that "the

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[8] Article 59 provides that "[t]he State Council shall formulate implementation rules on the basis of this Law." The CITL is also often referred to as the Enterprise Income Tax Law.

[9] Article 85 of the Constitution of the PRC. See http://english.people.com.cn/constitution/constitution.html (accessed 6 June 2010).

[10] Article 89, paragraph 1 of the Constitution of the PRC. http://english.people.com.cn/constitution/constitution.html (accessed 6 June 2010).

[11] Article 89, paragraph 3 of the Constitution of the PRC. http://english.people.com.cn/constitution/constitution.html (accessed 6 June 2010).

[12] Article 89, paragraph 8 of the Constitution of the PRC. See http://english.people.com.cn/constitution/constitution.html (accessed 6 June 2010).

ministries ... issue orders, directives and regulations within the jurisdiction of their respective departments and in accordance with the statutes and the administrative rules and regulations, decisions and orders issued by the State Council." This authority is echoed in SAT Decree No. 1, Article 2, which states that "Tax Regulations and Rules shall be promulgated in the form of decrees of [the] State Administration of Taxation."[13]

The initiative for revision of tax laws is normally taken in the Ministry of Finance or the SAT. Revision per se of tax laws is infrequent; however, the SAT frequently issues rulings and circulars concerning the manner in which extant tax laws are to be interpreted.

4.3 Enforcement of Tax Laws

Enforcement of the tax laws is within the purview of the SAT.

Taxpayers that are required to file tax returns generally prepare them on a self-assessment basis, which is subject to formal assessment by the local tax office. Tax controversies generally arise from an assessment raised by a local tax office or denial of tax clearance (required to facilitate some other transaction) by the local tax office.

Prior to assessment, the local tax office may solicit further information from the taxpayer. On matters of significance, the local tax office may seek advice or direction from the central SAT administration in Beijing. Ultimately the local tax office, on the advice or at the direction of the central SAT administration if the local office has liaised with it, will determine the tax outcome and inform the taxpayer. In this respect, it should be borne in mind that the overarching political framework sets the milieu, which is, amongst other things, intended to influence the decisions that bureaucrats must make when they are applying China's laws in practice from day to day. As well as the presence of CPC "secretaries," who are appointed at various levels in the state bureaucracy to ensure that CPC philosophy and policy is adhered to, there are numerous points in the General Program that come to bear on the mindset of Chinese tax administrators when they are deciding how to apply China's tax legislation. First, the pursuit of socialism by acting in "the fundamental interests of the overwhelming majority of the Chinese people;" second, application of the rule of law; third, raising moral standards of the nation; fourth, pursuing equity, justice, honesty and fraternity; and fifth, seeking truth from the facts or "proceeding from reality." Indeed, this approach is mandated by Article 9 of the Law on

[13] State Administration of Taxation Decree No. 1, *Implementation Measures Concerning Formulation of Regulations and Rules of Tax Administrations*, 27 October 2007: http://www.chinatax.gov.cn/n6669073/n6669088/6887607.html (accessed 6 June 2010).

Tax Administration (2007),[14] which, in addition to addressing professional qualities, requires tax offices to "constantly improve the political . . . qualities of their staff." Charged with these political imperatives, it is hardly surprising that a diligent Chinese tax administrator might apply the tax law in a way to maximize revenue collections for the benefit of the population (and give short shrift to tax avoidance arrangements, which he might encounter).

4.4 Dispute Resolution

A taxpayer may appeal against an assessment by the local tax office firstly to the tax office itself. Alternatively a taxpayer may also appeal directly to the People's Court. Typically, in practice, the controversy is decided by the SAT.

It is the role of the relevant arm of the State machinery, described in Section 4.2 above, to interpret laws so that they can be applied in practice to meet their underlying objectives. Whereas in Western jurisdictions clarification of the meaning of the law is normally derived ultimately from the Courts, that is not the case in China; in China, it is enshrined in the primary law that that clarification is obtained from the SAT. Given that political and legal framework, no one should be surprised that for practical purposes SAT decisions are rarely appealed, and that they are made to conform with the government's (and therefore the CPC's) political objectives.

Fundamentally, Article 67 of the Constitution of the PRC empowers the Standing Committee of the NPC to interpret statutes,[15] and to supervise the work of the State Council, the Supreme People's Court and the Supreme People's Procuratorate.[16] The courts have no statutory power to interpret legislation. The relative position of the Chinese judiciary is addressed in Article 3 of the Constitution of the PRC, which states that:

> [a]ll administrative, judicial and procuratorial organs of the state are created by the people's congresses to which they are responsible and under whose supervision they operate.[17]

Article 3 itself is titled, *The state organs of the People's Republic of China apply the principle of democratic centralism*. Thus, the courts, as state organs, must apply the principle of "democratic centralism." In essence,

[14] Law of the People's Republic of China on Tax Administration, 27 October 2007, promulgated by Order of the Chairman of the NPC [2001] No. 60 on April 28, 2001: http://www.chinatax.gov.cn/n6669073/n6669088/6887981.html (accessed 6 June 2010).

[15] Article 67, paragraph 4 of the Constitution of the PRC.

[16] Article 67, paragraph 6 of the Constitution of the PRC.

[17] http://english.people.com.cn/constitution/constitution.html (accessed 18 October 2009).

that principle means centralization of authority to guarantee that all strata of society are represented.[18]

That the SAT applies the principle of democratic centralism in this way in interpreting tax laws – so that they can be implemented in practice to meet their underlying political objectives of socialism for the benefit of all – relieves the need for courts to take on a role of interceding between the citizen and the power of the State, as in Western democracies. Li Jin notes that:

> ... almost no disputes are litigated and, if they are, the decisions are almost never appealed. ... Disputes and litigation almost always turn on small technical disputes – e.g. whether the tax official signed the assessment in the right place or whether the taxpayer filled out the right part of a form. There are virtually no disputes on conceptual issues, on the meaning of key concepts or provisions, or on other matters which form the basis for most litigation in common law jurisdictions ....[19]

With respect to the status of the judiciary, Li Jinyan observes that "tax expertise is concentrated in the tax administration. Tax officials are presumed to know tax laws better than anyone else (taxpayers, judges, and members of the Legislature). The small number of tax cases makes it difficult for judges to develop tax expertise. There is a lack of institutional competence on the part of the judiciary to deal with tax law interpretation."[20]

In practice, in an investigation the onus of proof falls on the taxpayer to convince the tax authority of the merits of the taxpayer's position because the tax authority ultimately decides the outcome of any resultant tax controversy.

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[18] The State Council puts it this way: "[d]emocratic centralism is the fundamental principle of organization and leadership of state power in China. When democratic centralism is practiced, it requires that we give full play to democracy and discuss matters of concern collectively, so that people's wishes and demands are fully expressed and reflected. Then, all the correct opinions are pooled, and decisions are made collectively so that the people's wishes and demands are realized and met. The practice of democratic centralism also requires that 'the majority be respected while the minority is protected.' " Information Office of the State Council of the People's Republic of China (2005) *Building of Political Democracy in China*, New Star Publishers, Beijing, October, Chp. 1: see http://english.peopledaily.com.cn/whitepaper/democracy/democracy(1).html (accessed 26 May 2010).

[19] Li, Jin, "Teaching Taxation Law in China", (2007) 61 (12) *Bulletin for International Taxation*, 183,186.

[20] Li, Jinyan, "Development and Tax Policy: Case Study of China", (2007) 3(4) *Comparative Research in Law and Political Economy*, CLPE Research Paper 27/2007, 40.

4.5 Tax Avoidance, Tax Evasion and Tax Mitigation

In the context of enterprises, "tax avoidance" occurs where an enterprise enters into an arrangement without a reasonable business purpose, which has the effect of reducing the enterprise's tax liability.[21] As noted in Section 4.4 above, in the context of tax law, the role of the courts in China is largely confined to regulating procedural matters, and does not extend to substantive issues of interpretation of the tax law. It is the SAT that determines whether a transaction involves tax avoidance. It addresses the issues of "reasonable business purpose." There are no safe harbors provided for in the law, which are immune from challenge.

Based on reported cases, and commentaries from major law and accounting firms, international tax avoidance arrangements are subject to heightened scrutiny. In particular, recent internationally cited examples of tax avoidance in China concern the use by multinational enterprises (MNEs) of intermediary conduit companies located in jurisdictions that have double tax treaties with China in terms of which China offers concessional tax rates on Chinese sourced income or gains. The intermediary companies are alleged to have no substantive economic or commercial purpose, and merely serve to relay income or gains sourced in China to their shareholders or other parties that are residents of third states and are unable to take advantage of the concessional tax rates in the relevant Chinese treaties. For instance, SAT Notice No. 1076[22] endorses the approach of the Urumqi, Xinjiang provincial tax office in rejecting, on the grounds of treaty abuse and tax avoidance (manifested by a lack of economic substance and commercial justification of an intermediary Barbados company), application of the China–Barbados double tax treaty (2000). In that case, the taxpayer attempted to avoid Chinese tax on the capital gain that arose from the sale by the Barbados company of its shares in a Chinese resident company to another Chinese resident company.

The *Xinjiang* case was concerned with the gain derived by a *non-resident* of China from the sale of shares in a company that was a resident of China. The Lianglukou, Chongqing tax office applied a similar "look-through" approach but where neither the vendor nor the company that was sold was resident of China. Here, a Singapore-resident company sold to a Chinese-resident company its shareholding in its Singapore-resident special purpose vehicle (SPV), which in turn owned an equity interest in a company resident in China. The basis for the SAT's denial of application of Article 13 of the China–Singapore double tax treaty (2007), which

[21] See under Section 4.6 below.

[22] *Guo Shui Han* [2008] "Notice on Correctly Dealing with Treaty Abuse Case", No. 1076 (30 December 2008).

gives the taxing right over the capital gain to the state of residence of the alienator (i.e. to Singapore), was that the sale of the Singapore SPV was in substance the transfer of its equity interest in the Chinese resident company to the new Chinese owner. It was determined, therefore, that the gain derived from the transaction was derived and taxable in China. The Singapore SPV had no commercial substance. It lacked personnel, assets and operations. The main purpose of the transfer of the SPV's shares by its Singapore-resident holding company was to dispose of its indirect equity interest in the Chinese company. The Singapore SPV was therefore interposed to take advantage of the concession offered by Article 13 of the China–Singapore double tax treaty. The arrangement was an abuse of the treaty.

Article 63 of the Law on Tax Administration (2007)[23] deems "tax evasion" to occur when a taxpayer:

- forges, revises, conceals or destroys, without official permission, its books of account, or supporting vouchers; or
- overstates deductible expenses; or
- does not state, or understates, income in its books of account; or
- refuses to file tax returns despite notification by the tax authorities; or
- files fraudulent tax returns; or
- refuses to pay, or underpays, an amount of tax payable.

The term "tax mitigation" is not recognized in China.

4.6 GAAR

Prior to the enactment of the CITL, there was no GAAR in China's income tax legislation. The impetus for adoption of the GAAR was past tax avoidance practices,[24] notably international tax avoidance practiced by some MNEs. There is no GAAR in the Individual Income Tax Law, and there have been no official pronouncements to foreshadow the incorporation of a GAAR into the latter law.

The CITL of the PRC was adopted at the 5th Session of the 10th NPC of the PRC on March 16, 2007, and on the same day was promulgated by the President to come into effect on January 1, 2008. Chapter VI – Special Adjustments contains Article 47, which provides that "[i]f an enterprise

[23] Law on Tax Administration, 27 October 2007, promulgated by Order of the Chairman of the NPC [2001] No. 60 on April 28, 2001: http://www.chinatax.gov.cn/n6669073/n6669088/6887981.html (accessed 5 June 2010).

[24] See Jin, Renqing (Minister of Finance), "Explanation on Draft Enterprise Income Tax Law" at http://www.china-embassy.org/eng/gyzg/t302221.htm (accessed 2 June 2010).

carries out any other business arrangements[25] *without reasonable business purposes* resulting in reduction of its taxable revenue or income, the tax authority shall be empowered to make adjustments using reasonable methods."[26] (Emphasis added).

Exactly what the NPC meant when it imposed the requirement of "reasonable business purposes" is left to be determined by other state organs, by way of administrative regulations and/or SAT administrative rules. In this respect, Article 120 of the Implementation Rules for the CITL (2007) states that the phrase "without reasonable business purposes" in Article 47 of the CITL refers to "having reducing, avoiding or deferring paying taxes as primary purposes."[27] The SAT also subsequently issued *Implementation Rules for Special Tax Adjustments (for Trial Implementation)* ("Notice No. 2").[28] With regard to the GAAR in Article 47 of the CITL, Article 92 of Notice No. 2 provides that the following activities carried out by an enterprise will be subject to a general anti-avoidance investigation by the local tax authorities:

- abuse of tax incentives;
- treaty shopping;
- abuse of organizational form of the enterprise;
- use of tax havens; and
- business arrangements lacking a bona fide commercial purpose.

In addressing these activities, Article 93 of Notice No. 2 prescribes that tax officials are to adopt a "substance over form" approach, comprehensively taking account of the following factors in determining whether or not the GAAR applies to an arrangement:

- the form of the arrangement;
- the substance of the arrangement;
- the time that the arrangement was entered into and its duration;
- its form of implementation;

[25] "Other business arrangements" refers to arrangements other than transfer pricing, controlled foreign enterprise and thin capitalization arrangements, which are specifically addressed earlier in Chapter VI of the CITL.

[26] There is no official English translation of the CITL. This translation of Article 47 is from KPMG, (2008) *PRC Corporate Income Tax Law*, 10 (see http://www.kpmg.com.hk/en/virtual_library/Tax/PRCtaxLawBook.pdf (accessed 16 October 2009)).

[27] The Implementation Rules for the Corporate Income Tax Law of the People's Republic of China, Decree of the State Council of the People's Republic of China, No. 512, 6 December 2007; translated in KPMG, (2008) *PRC Corporate Income Tax Law*, KPMG Huazhen, 37.

[28] *Guo Shui Fa* [2009] No. 2 (9 January 2009). The rules apply retroactively from 1 January 2008, the date on which the CITL came into effect.

- the relationship between the components of the arrangement and the steps by which it is put into place;
- the financial effects of the arrangement; and
- the tax consequences of the arrangement.

Where a tax avoidance arrangement has been detected, Article 94 of Notice No. 2 instructs the local tax office to re-characterize the arrangement according to economic reality, thus eliminating any tax benefits that would have otherwise arisen from the arrangement. When an enterprise has no economic substance, such as a "pass-through" entity located in a foreign jurisdiction, which results in avoidance of Chinese tax by third parties, the enterprise is deemed not to exist for Chinese tax purposes. This provision is clearly targeted at the use of conduit companies in international transactions where one part of the transaction falls within China's jurisdiction. Hence, the intention is to apply the domestic GAAR provision to international transactions involving perceived tax avoidance whether or not a double tax treaty might apply to the transaction.

An investigation into anti-avoidance arrangements by a local tax office, and any resultant tax adjustment, is subject to approval of the SAT in Beijing.[29]

Under Article 123 of the Implementation Rules for the CITL (2007), the SAT is empowered to make adjustments to a taxpayer's tax liability as a result of defeating a tax avoidance arrangement within 10 years of the year during which the offending transactions take place.[30]

The SAT has the authority to interpret the GAAR to effect its application in practice. Because the GAAR came into effect only on 1 January 2008, it is too early to say whether it has been a success or a failure. However we know from other jurisdictions the mischief that the broad language of a GAAR, using words such as "reasonable," "purpose" and "economic substance," causes.[31] The apprehension is not lost in the Chinese context either. For example, PricewaterhouseCoopers has "concerns about the meaning of 'Substance over Form' which could be very subjective and controversial . . .," to which the firm somewhat gratuitously adds: "[s]uch vague expression could encourage local-level tax bureaus to raise unnecessary

[29] Article 97 of Notice No. 2.

[30] The Implementation Rules for the Enterprise Income Tax Law of the People's Republic of China, Decree of the State Council of the People's Republic of China, No. 512, 6 December 2007; translated in KPMG, (2008) *PRC Corporate Income Tax Law*, KPMG Huazhen, 38.

[31] See, for example, the conflicting judicial approaches in *Commissioner of Inland Revenue v. Wattie* (1997) 17 NZTC 13,297 (CA) and (1998) 18 NZTC 13,991 (PC).

enquiries and challenges on taxpayers for whatever holding structures or transactions they do not understand or appreciate."[32]

Nevertheless the introduction of the GAAR is undoubtedly having some impact on the behavior of MNEs. Their advisors, which are the major international law and accounting firms, have been cautioning their clients to ensure that their arrangements, which utilize conduit companies, have economic substance and are not merely for the purposes of avoiding Chinese tax. Witness Baker & McKenzie ("foreign investors in China will want ... to evaluate their holding structures for investments in China in light of these emerging anti avoidance principles and practices. Although SPV structures will continue to provide benefits, it may become more important than in the past for an SPV to have some degree of economic substance."[33]); KPMG ("Particular consideration should be given to implementing and maintaining sufficient economic substance in the jurisdictions in which they establish offshore holding companies."[34]); Deloitte ("It is important that extra diligence and special consideration be given to demonstrate and support the business justifications of transactions/structures."[35]); PricewaterhouseCoopers ("The purposes of the holding structures and transactions have to be transparent and supported with commercial reasons. It is suggested that the SPVs should maintain certain business operations, management functions, or risk-taking roles (e.g. investment services, back office services or regional headquarters) other than just simply acting as a 'conduit'. ... Equally important, the selection of investment structures, the use of SPVs in chosen tax jurisdictions and the nature of holding vehicles should be justified by 'reasonable commercial purposes' as far as possible. Documentation should be prepared timely and complete records be kept properly so as to withstand the challenges of the Chinese tax authorities."[36]); and BKD ("investors should ensure that economic substance is established and adequately supported by documentation in structuring their investments in the PRC and avoid any perceived tax treaty abuse. ... Foreign investors should establish clear economic

[32] PricewaterhouseCoopers, "New Challenges to China Tax Avoidance by way of Special Purpose Vehicles", (2009) *News Flash – China Tax and Business Advisory,* Issue 08, March, 5.

[33] Eichelberger, Jon and Brendan T. Kelly, *New Challenges to Special Purpose Vehicles for Investing in China*, Baker & McKenzie, http://www.bakermckenzie.com/RRFinancingSPVinChinaJun09/ (accessed 6 June 2010).

[34] KPMG, (2009) *Private Equity Tax alert : China strengthening enforcement of anti-avoidance provisions,* Hong Kong, March, 1.

[35] Deloitte, "PRC Tax China Tightening Up on Tax Treaty Abuse", (2009) *Tax Analysis*, Issue P52, 16 January, 3.

[36] PricewaterhouseCoopers, "New Challenges to China Tax Avoidance by way of Special Purpose Vehicles", (2009) *News Flash – China Tax and Business Advisory,* Issue 08, March, 6.

substance when implementing investment holding structures in China and review their current arrangements to mitigate the risk of triggering the anti-tax avoidance measures."[37])

Furthermore, recently the SAT has increasingly used the GAAR to successfully challenge international tax avoidance arrangements. In each case the taxpayer acquiesced.[38]

4.7 Regulations Concerning Tax Avoidance

The SAT is authorized to regulate tax avoidance. Its authority is exercised by promulgation of regulations, notices, or rulings, which are binding upon taxpayers. These regulations relate to all tax avoidance transactions and are not limited to specified categories of transactions, although, as already noted, recent high-profile cases have involved conduit entity transactions.

The CITL contains no provisions that require that the GAAR be applied in any special way to cross-border or international tax avoidance transactions. The GAAR in Article 47 of the CITL applies to both domestic and international transactions entered into by companies. However, there is a number of SAT promulgations, which concern tax avoidance, targeted at international transactions. For example, Article 94 of Notice No. 2[39] specifically provides that an enterprise without any economic substance can be disregarded for the tax purposes, especially if it is located in a foreign jurisdiction and results in tax reduction of the related parties.

In addition, the SAT's *Notice on Issues Relevant to the Implementation of Dividend Provisions in Tax Treaties*,[40] which is concerned with documentation requirements when a non-resident applies to a local tax authority for approval to benefit from the lower withholding tax rate on dividends under one of China's double tax treaties, empowers the local tax office to investigate the nature of the recipient of the dividends and to deny treaty benefits where the main purpose of the transaction or arrangement is simply to obtain a more favorable tax treatment of dividends under the relevant treaty.[41]

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[37] Wagner, Robert J. and Thao Griepp, "Investing in China – New Tax Developments Strengthen Enforcement on Treaty Applications", (2009) *BKD Tax Feature*, February, 2.

[38] See, for example, the *Fujian* case (Fuzhou Tax Bureau, October 2009), the *Tianjin* case (Tianjin Tax Bureau, March 2010), the *Xuzhou* case (Xuzhou Tax Bureau, March 2010), the *Yangzhou* case (Jiangdu Tax Bureau, May 2010) and the *Anhui* case (Anhui Tax Bureau, March 2011). See also the Goldman Sachs *Henan* case (Luohe City Tax Bureau), the outcome of which was still to be determined at the time of writing.

[39] *Guo Shui Fa* [2009] No. 2 (9 January 2009).

[40] *Guo Shui Han* [2009] No. 81 (20 February 2009).

[41] Article 4.

Furthermore, the SAT's *Instructions on the determination of beneficial ownership under the dividend, interest and royalties articles in China's double tax treaties*[42] also takes a substance over form approach, specifically stating that adoption of a purely technical perspective is inadequate. Local tax offices are required to apply substance over form to the facts of a case in light of the objective and purpose of double tax treaties, which includes the prevention of fiscal avoidance and evasion. In particular, conduit companies – described in the circular as companies that are established with the objective of avoiding or reducing taxes, or shifting or retaining profits, registered merely to satisfy legal requirements, and lacking any substantial business – are not to be regarded as beneficial owners of the passive income that qualifies for concessionary rates of Chinese tax under its double tax treaties. The Instructions prescribe that a beneficial owner must have economic ownership of the income and engage in substantive business operations.

In addition, the SAT's *Administrative Measures on Tax Treaty Treatment of Non-residents*[43] advocate a substance over form analysis in a local tax office's determination of a non-resident's state of residence and beneficial ownership status. And the *Notice of Certain Issues Regarding the Enterprise Income Tax Treatment of Enterprise Reorganizations*,[44] issued on 30 April 2009, and the subsequent *Administrative Rules Regarding the Enterprise Income Tax Treatment of Enterprise Reorganizations*,[45] which set out special rules for the income tax treatment of mergers and acquisitions, are both premised on the merger or acquisition being undertaken for a bona fide business purpose; the primary purpose cannot be to reduce, avoid or defer payment of tax in China.

The SAT *Notice to enhance the monitoring and scrutiny of related-party transactions*,[46] which is primarily concerned with transfer pricing issues, also more generally encourages local tax offices to monitor cross-border transactions closely.

While China's double tax treaties do not contain a limitation on benefits article, specific anti-avoidance rules that limit the inappropriate use of treaties to avoid or reduce taxation are contained in the China–Singapore double tax treaty (2007) and the China–Hong Kong Double Tax Arrangement (2006).[47] Article 25 of the China–Hong Kong Arrangement states that:

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[42] *Cai Shui Han* [2009] No. 601 (27 October 2009).

[43] *Guo Shui Fa* [2009] No. 124 (24 August 2009).

[44] *Cai Shui* [2009] No. 59 (30 April 2009).

[45] Announcement No. 4 (2010).

[46] *Guo Shui Han* [2009] No. 363 (6 July 2009).

[47] As an aside, because Hong Kong is a Special Administrative Region of China, and operates a tax system separate from Mainland China, the double tax "treaty" between China and Hong Kong is referred to as an "arrangement" and the parties to the arrangement are

> Nothing in this Arrangement shall prejudice the right of One Side to apply its domestic laws and measures concerning tax avoidance, whether or not described as such. For the purpose of this Article, "laws and measures concerning tax avoidance" includes any laws and measures for preventing, prohibiting, avoiding or resisting the effect of any transaction, arrangement or practice which has the purpose or effect of conferring a tax benefit on any person.

Similarly, Article 26 of the China–Singapore treaty specifies that:

> Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the Agreement.

These articles are designed to allow Chinese domestic anti-avoidance rules to be applied in the context of the arrangement or agreement. In relation to the China–Singapore treaty, this approach is endorsed by Article 8 of the SAT's *Notice on the Interpretation and Application of Several Articles of the China–Singapore double tax treaty*,[48] which asserts that Article 26 of the treaty entitles the Chinese tax authority to apply China's domestic law to prevent tax treaty abuse. A similar statement is made with respect to the China–Hong Kong Arrangement in Article 13 of the *Circular of the State Administration of Taxation on Interpreting and Implementing Some Clauses in the Arrangement between Mainland China and Hong Kong SAR concerning Avoiding Double Taxation and Preventing Tax Evasion on Income*.[49]

Somewhat less succinctly, Article 4 of the 2010 Protocol to the China–Barbados double tax treaty (2000)[50] provides that:

> The provisions of this Agreement shall in no case prevent a Contracting State from applying the provisions of its domestic law for the prevention of fiscal evasion and avoidance, provided that the taxation in that State on the income concerned is not contrary to the Agreement.

There are also article-specific anti-avoidance provisions in some other double tax treaties. For example, Article 12(7) of the China–Belgium treaty (2009),[51] which concerns the taxation of royalties, specifies that "[t]he provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the royalties are paid to take advantage of this Article by means of that creation or assignment."

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referred to as "sides." China reserves the terms double tax "agreement" and "contracting states" (being parties to the agreement) for treaties with other states.

[48] *Guo Shui Han* [2007] No. 1212.

[49] See *Guo Shui Han* [2007] No. 403 (4 April 2007).

[50] The Protocol was concluded on 10 February 2010, but is not yet in force.

[51] Not yet in force.

4.8 Penalties for Tax Avoidance and Tax Evasion

Article 48 of the CITL states that where the tax authority makes an adjustment to a taxpayer's tax liability as a result of, amongst other things, defeating a tax avoidance arrangement, interest is imposed on the resulting deficient amount of tax. Article 121 of the Implementation Rules (2007) provides that the interest is to be calculated on a daily basis from 1 June of the year following the taxable year to which the underpayment relates until the date when the tax deficiency is paid. The rate of interest is the RMB loan base rate published by the People's Bank of China in the tax year(s) to which the underpaid tax relates for a loan for the same period for which the additional tax is payable, plus an additional 5%.[52]

However, if an enterprise files its annual tax return enclosing an annual report on the year's related party transactions, and provides information required under the Implementation Rules (2007) where the tax authority investigates the related party transactions, the additional 5% is not added to the RMB loan base rate.[53]

There is a late payment surcharge of 0.05% of the unpaid tax balance for each day that income tax is in arrears. Tax penalties and interest on the late payments are not deductible expenses in computing taxable income. Where a taxpayer fails to pay or underpays tax, the tax authority is subject to a limitation period of 10 years in which to collect the outstanding tax.

In cases of tax evasion, the taxpayer is liable to pay the amount of unpaid tax and a surcharge for overdue tax, as well as a fine ranging from 50 to 500% of the amount of the deficient tax. If the evasion constitutes a crime (e.g. fraud), the tax authority is empowered to seek criminal remedies. A range of offences (including failure to properly account for withholding taxes) and monetary penalties are prescribed in Articles 63 to 74 of the Law on Tax Administration (2007).[54]

In the case of tax fraud, evasion or refusal to pay tax, no time limitation is set for collection of the tax shortfall and penalties.

4.9 Disclosure Requirements

Article 95 of Notice No. 2[55] states that when a local tax office initiates a general anti-avoidance investigation, it should send a "Tax Inspection Audit Notice" to the taxpayer enterprise (in accordance with the Law

[52] Article 122 of the Implementation Rules (2007).

[53] Article 122 of the Implementation Rules (2007).

[54] Law on Tax Administration, 27 October 2007, promulgated by Order of the Chairman of the NPC [2001] No. 60 on April 28, 2001: http://www.chinatax.gov.cn/n6669073/n6669088/6887981.html (accessed 6 June 2010).

[55] *Guo Shui Fa* [2009] No. 2 (9 January 2009).

on Tax Administration and Collection and Detailed Rules for Its Implementation).[56] Within 60 days of receiving that notice, the enterprise must provide documents to the tax authority that prove that its arrangement is founded upon reasonable commercial purposes. If the enterprise fails to provide the documents within the prescribed period, or the documents fail to prove that the arrangement was entered into for reasonable commercial purposes, the tax authority is empowered to make a tax adjustment based on the information obtained, and to issue a "Special Tax Investigation Adjustment Notice" to the enterprise.

Furthermore, when the local tax office conducts a general anti-avoidance investigation, it can, in accordance with Article 57 of the Law on Tax Administration and Collection, require that the party that planned the alleged tax avoidance arrangement (which may not have been the taxpayer enterprise itself, but its attorneys or other tax advisers) to provide related documents and materials.[57]

The SAT *Circular on Strengthening the Management of Enterprise Income Tax Collection*[58] is designed to facilitate the gathering of information by local tax offices about direct and indirect transfers of foreign interests in Chinese companies. It requires foreign investors that purchase equity interests in a Chinese company to provide to the Chinese tax administration within 30 days of the transaction:

- the sale and purchase contract;
- details of the relationship between the foreign investor and the company the shares of which are being transferred and, if that company is an intermediary company, its relationship with the China-resident company in terms of capital, assets, sales and purchases;
- details of the operations, employees, assets and liabilities of any intermediary company;
- the reasonable business purpose of the transfer of the shareholding; and
- any other information that the tax administration may require.

With respect to indirect ownership interests in a Chinese-resident company, reporting is required where an intermediary company is incorporated in a jurisdiction where the intermediary faces an effective tax rate of less than 12.5% (or where that jurisdiction does not tax foreign income of its residents). Where there is no reasonable business purpose for the share

[56] Law of the People's Republic of China on Tax Administration and Collection and Detailed Rules for Its Implementation (4 September 1992, revised and re-promulgated 4 August 1993 and 28 February 1995): http://www.china.org.cn/business/laws_regulations/2007-06/22/content_1214782.htm (accessed 6 June 2010).

[57] Article 95 of Notice No. 2.

[58] *Guo Shui Han* [2009] No. 698 (December 2009, with retroactive effect from 1 January 2008).

transaction (other than to avoid a tax liability in China), the 10% domestic withholding tax applies.

Although the Law on Tax Administration (2007):[59]

- prohibits any organization or individual from impeding the tax authority from performing its duties in accordance with the law;[60]
- requires taxpayers, withholding agents[61] and other "relevant institutions" to supply the tax authority with truthful information;[62]
- forbids taxpayers from tampering with or destroying information;[63]
- allows the tax authority to assess tax where the taxpayer refuses to provide information related to tax payments;[64]
- empowers the tax authority to order a taxpayer or withholding agent to furnish documents, evidentiary material and information concerning tax payments, and to question the taxpayer and withholding agent in connection therewith;[65]
- requires a taxpayer or withholding agent to accept a tax inspection conducted by the tax authority, to provide relevant information, and not to refuse to cooperate or to conceal any fact;[66] and
- obliges institutions and individuals concerned with the taxpayer's tax-paying situation to provide truthful information and evidence pertaining thereto,[67] penalties for failure to do so are imposed only on the taxpayer or withholding agent.[68]

As a developing country, in which a sophisticated, comprehensive income tax regime is a relatively new phenomenon, China's rules for professional responsibility and other ethical rules governing attorney practice or taxpayer-adviser practice that relate to participants in tax avoidance transactions are not yet well developed.

No special standards of practice relate to advisers of taxpayers that seek entry into tax avoidance schemes or transactions.

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[59] Law of the People's Republic of China on Tax Administration, 27 October 2007, promulgated by Order of the Chairman of the NPC [2001] No. 60 on April 28, 2001: http://www.chinatax.gov.cn/n6669073/n6669088/6887981.html (accessed 6 June 2010).

[60] Article 5.

[61] "Withholding agents" are defined as institutions and individuals obliged to withhold and pay tax in accordance with the law or administrative regulations: Article 4.

[62] Article 6.

[63] Article 24.

[64] Article 35.

[65] Article 54.

[66] Article 56.

[67] Article 57.

[68] Articles 62 and 70.

4.10 Tax Shelters

China has not specifically addressed the issue of tax shelters.

4.11 Reforms

No reform concerning the regulation of tax avoidance transactions is currently under way. The recent major reform, which introduced the GAAR into the CITL, took effect on 1 January 2008. The SAT is now periodically issuing regulations, rules and circulars specifying how Article 47 of the CITL is to be interpreted and implemented.

Chapter 5
Croatia

Nataša Žunić Kovačević

5.1 Legal System

Croatia is a civil law country. It was established with the dissolution of the Socialist Federative Republic of Yugoslavia (SFRY) on June 25, 1991, when the Constitutional Decree of Sovereignty and Independence of Republic of Croatia was published. Croatia was officially recognized as a independent state on January 15, 1992. According to the Constitution of the Republic of Croatia, the Croatian government is organized on the principle of separation of powers into the legislative, executive and judicial branches. The principle of separation of powers includes the forms of mutual cooperation and reciprocal checks and balances provided by the Constitution and law. The Constitutional Court is *sui generis* and could be considered a fourth power.

The highest body or organ of legislative power is the Parliament of the Republic of Croatia. The Parliament has only one house. Representatives to the Parliament are elected in direct parliamentary elections held once every 4 years. The Parliament has 120 representatives and authority to enact laws in any session where a majority of representatives are present. There are two kinds of laws:

- Ordinary laws – the parliament is entitled to declare these in any session where more than 1/2 of the present representatives vote in favor.
- Essential laws (the Constitution calls them "organic" laws) – laws concerned with basic rights and freedoms of ethnic and national communities which must be passed by a qualified majority.

The executive power is divided between the President and the Cabinet. The President is elected in direct presidential elections for a period of 5 years.

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He or she may serve two terms. The President represents the state in the country and abroad, and his powers are essentially those of state protocol. He has the authority to dissolve the Parliament and he proposes a candidate for a mandate of Prime Minister.

The Cabinet holds the highest executive power in Croatia. According to protocol, the President appoints the Prime Minister of the Cabinet who is usually the head of the party that has the most votes in the Parliament. The Prime Minister is confirmed by the Parliament. He or she has the power to appoint the members of the Cabinet.

The judicial power in the Republic of Croatia is exercised by courts. The judicial power is autonomous and independent. Courts administer justice according to the Constitution and law.

Judicial power is regulated through Law of the Courts and is inspired by the idea of independent courts. State Judiciary Council appoints all judges for life as an independent state institution formed of Parliament members, judicial authorities, well-respected public persons and members of Croatian Bar Association. Minister of Justice names the presidents of the courts from among the appointed judges and the president of the Supreme Court of Croatia is chosen by the Parliament based on the proposition from the Cabinet.

The Supreme Court of the Republic of Croatia, as the highest court, ensures the uniform application of laws and equal justice to all. The President of the Supreme Court is elected and relieved of duty by the Croatian Parliament at the proposal of the President of the Republic with prior approval by the General Session of the Supreme Court and the authorized Committee of the Croatian Parliament. The Supreme Court is a court of full jurisdiction with respect to court decisions and it can void, confirm, or revise them. As the court of last resort, the Supreme Court decides on extraordinary legal remedies against decisions of the courts of general jurisdiction and all other courts in Croatia.

The Administrative Court of the Republic of Croatia decides on appeals against final administrative acts (administrative disputes). The process before this court commences by filing an action to set aside second instance decision of the executive body or first instance decisions against which appeal is not allowed by regulation. This court passes judgments solely by drawing information directly from the file and without directly determining the facts of the cases. It is not a full jurisdiction court and European court for human rights does not recognize its judicial powers.

5.2 Tax Law

The General Tax Act (OG 147/08) constitutes the foundation of the tax system in the Republic of Croatia. It governs tax relations between taxable persons and tax authorities. There are special tax laws relating to

specific types of taxes, such as the Corporation Tax Act, the Income Tax Act, and the Value Added Tax Act. The General Tax Act covers all public levies (taxes, customs duties, contributions, fees) and, unless the law prescribes otherwise, the Act on General Administrative Proceedings prescribes procedure regarding implementation of tax legislation.

The main administrative body is the Croatian Tax Administration, which is within the Ministry of Finance. It is the body responsible for drafting proposals for changes to tax policy and legislation, as well as implementation of tax legislation. The Tax Administration is managed by Director General who is also Assistant Minister of Finance. Tax audits are managed by the Tax Audit Division within the Central Office of the Tax Administration.

A single appeal procedure applies to all types of taxes. It is governed by the General Tax Act and the General Administrative Procedure Act. The appellate body is Independent Service for Second Instance Administrative Procedure. Judicial review is provided before the Administrative Court.

Only one article of the Constitution refers to tax matters. Article 51 provides that "[e]veryone is obliged to participate in the settlement of the public needs, according to his economic capacity. Tax system is based on the principles of equality and equity."[1] Other articles of the Constitution place limitations of the taxing powers of the Parliament, such as articles regulating basic economic rights.[2] The Constitutional Court has heard few tax cases, but it has provided an efficient check on the exercise of legislative powers in tax matters and its rulings resulted in tax law revision.

Tax laws are revised in Croatia relatively often. One of the most important and crucial revision of tax laws was in December 2000, when the government adopted a package of tax laws including the General Tax Law, the Law on Tax Advising, the Law on Corporate Profit Tax, and the Income Tax Law.[3] These laws are revised several times.[4]

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[1] Constitution, Consolidated text, Official Gazette, No. 41/041, 55/01.

[2] Arbutina, Hrvoje, Constitutional and Supranational limitations and Guidelines on Taxing Powers: The Case of Croatia, at 10th Mediterranean Research Meeting, March, 2009.

[3] The new laws reduced some rates, but widened the tax base. The corporate profits tax was reduced from 35 to 20%. Reduced corporate tax rates of 5, 10 and 15% were available for companies locating in "special care areas" (62 municipalities and towns deemed to be undeveloped) and in the Vukovar area. The corporate tax rate was reduced for larger new investments: 7% for investments of at least 10 million Kuna (about $1.56 million); 3% for investments of at least 20 million Kuna (about $3.12 million); and 0% on investments over 50 million Kuna (about $7.8 million). Companies operating in one of Croatia's 12 free trade zones (FTZs) pay half the standard corporate tax rate (10%) or 0% if their investment is more that one million Kuna (about $156,000).

[4] As of 1 January 2009 the new General Tax Law (GTL) is in force, as one of the steps in aligning the Croatian tax system with EU requirements.

5.3 Tax Avoidance

Defining tax avoidance is problematic, but it is embedded to the concept of abuse of right which prohibits the exercising of a right inconsistently with the general principles of correctness and good faith. Therefore, the definition of avoidance is not (and can not be) purely legal.[5]

Although there is no generally accepted definition, most scholars define tax evasion as an unlawful manner of reducing the tax liability – for example, underreporting the income made (as in the underground economy) or by over-stating business deductions.[6] In the case of tax avoidance, however, the taxpayer simply makes use of the opportunities provided in the law for the reduction of his or her tax liability. Tax avoidance involves lawful steps taken in order to reduce or totally obviate the tax liability, making use of all the legal shortcomings and loopholes. The taxpayer simply makes use of the opportunities that the government gives him via the tax laws, while in tax evasion he takes the law into his own hand, and determines which part of the tax duty he/she will pay to the state according to his own system for evaluating justice.[7] Non-compliance is an example of tax evasion, implying deliberate avoidance of the proper payment of taxes. Tax flight is an example of tax avoidance.[8] It occurs when companies re-register in areas with a lower tax burden or in tax oases, a legitimate act on the part of the taxpayer which may be viewed by the general public as fairly immoral.[9]

Tax evasion, unlike tax avoidance, is a criminal offense. Article 286 (1) and (2) of the Criminal Code provides:

> (1) Whoever, with an aim that he or another legal or natural person evades wholly or in part payment of tax, social security or health insurance contributions, other statutory contributions or levies, furnishes false data on legally acquired income, on items or other facts relevant for the assessment of such an obligation, or whoever, with the same aim, in the case of a mandatory tax return, does not report legally acquired income, or an item or other facts relevant for the assessment of such obligations which he is bound to report by law, whereas the amount of the obligation whose payment is being evaded exceeds ten thousand Kuna, shall be punished by imprisonment for six months to five years.

[5] Greggi, Marco, Avoidance and *abus de droit:* The European Approach in Tax law, *EJournal of Tax Research* vol. 6, no. 1 (2008), pp. 23–44.

[6] Madžarević-Šujster, Sanja, *An estimate of tax evasion in Croatia*, Occasional Paper No. 13, Institute of Public Finance 2002, p. 2. Šimović J., Rogić-Lugarić T., Cindori S., *Tax evasion in the Republic of Croatia and measures to prevent it,* Croatian annual of Criminal Law and Practice, vol. 14, no. 2 (2007), pp. 594–595.

[7] Madžarević-Šujster, cit. p.4.

[8] Madžarević-Šujster, Sanja, An Estimate of Tax Evasion in Croatia, *Financijska teorija i praksa* vol. 26, no. 1 (2002), p. 144.

[9] Madžarević-Šujster, loc.cit.

> (2) If, by the perpetration of the criminal offense referred to in paragraphs 1 of this Article, considerable damage is caused, while the perpetrator acts with an aim to cause such damage, the perpetrator shall be punished by imprisonment for three years to ten years.[10]

5.4 Power to Address Tax Avoidance

The legislature addresses tax avoidance. The Tax Administration Act and the General Tax Act limit this authority. No provision specifically authorizes a body to determine whether a transaction involves tax avoidance. Implicit authority derives from basic principles in the General Tax Act.

The tax administration has developed a special practice to issue "opinions of the Ministry of Finance." The aim is to simplify and clarify some complicated and uncertain tax issues. Since 1994 these opinions have developed into a specific source of law. Although initially they were assigned to employees of tax administration, they have developed into essential guidance for taxpayers as well. These opinions are in the nature of internal instructions and are not potential sources of law.[11]

5.5 GAAR

Croatia did not adopt a general anti-avoidance rule (GAAR). Some features of Croatia's tax system had provided an incentive to evade tax in illegitimate ways. Taxpayers often reported greater material costs via padded travel expenses, issued invoices without corresponding purchases and paid fees for authors' work or for services rendered (market research, administrative work and so on) in a manner that artificially reduced profits. Until 2001, tax avoidance was conducted primarily through application of the protective interest rate on company assets and use of accelerated depreciation allowances. After adoption of the new Profit Tax in 2001, the legal avoidance was permitted through tax exemptions on investment in capital assets of the firm and allowances for new staff. Such provisions (and similar

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[10] Criminal Code: The Official Gazette of the Republic of Croatia "Narodne novine" (hereinafter: NN) No. 110 of October 21, 1997 (entered into force on January 1, 1998), Corrections NN27/98, 129/2000, 51/2001, Amendments and Supplements to the Criminal Code NN 111/2003, 105/2004, 84/2005 and 71/2006.

[11] Arbutina, H., Constitutional and Supranational Limitations and Guidlines on Taxing Powers: The Case of Croatia, pp. 13–15.

ones) were abolished in 2006. Indirect opportunities for avoidance remain in provisions contained in other Acts.[12]

There is a potential problem if Croatia were to enact a general anti avoidance rule. Namely, Croatia's Constitution provides: "Individual decisions of administrative agencies and other bodies vested with pubic authority shall be grounded on law."[13] This is a key principle in Croatian law. Because similar issues were resolved by Germany and Austria, it appears likely that Croatia may surmount this obstacle and that it would benefit from a general anti-avoidance rule.[14]

Croatia has changed its tax legislation to reach harmony with EU and international law tax standards and is on its way to building a tax system that will be noted for its anti-avoidance legislation.[15]

5.6 Cross-Border Transactions

Croatia has enacted rules aimed at ending cross-border tax arbitrage in the areas of thin capitalization rules, transfer pricing, and dividend distributions.

Thin capitalization rules involve the use of excessive debt in funding subsidiaries. Companies that need to fund parent or subsidiary companies in other jurisdictions find it more tax-efficient to fund those subsidiaries with shareholder debt, rather than with equity. The interest on loans from shareholders is deductible by the borrowing company, but dividends are not. This provides a tax advantage for a borrowing company that pays interest on shareholder loans instead of large dividends. If the interest received by the shareholders is taxable as income and both the payor and payee are in the same jurisdiction, there is no loss to the tax authorities. However, in thin

[12] Indirectly a many incentives are granted not through provisions of Corporate income tax but others like: Areas of Special National Concern Act, (OG, 86/08), Areas of Hill and Mountain Law (OG, 12/02, 32/02, 117/03, 42/05, 90/05, 80/08), Law on the Reconstitution and Development of the City of Vukovar (OG, 44/01, 90/05, 80/08, 38/09), Free Zones Law (OG, 44/96, 92/05, 85/08), Investment Incentives Law (OG, 73/00), Investment Incentives Law (OG, 138/06), Directive of the Government of the Republic of Croatia on the Investment Incentives (OG, 64/07), Act on Science and Higher Education (OG, 123/03, 105/04, 174/04, 46/07), Law on the State Aid for Education and Further Training (OG, 109/07, 134/07, 152/08).

[13] Croatian Constitution, Art. 15.

[14] There is article on this topic – GAAR in Croatia and it is used in this Report, see, Prebble, R., Does Croatia Need a General Anti-Avoidance Rule? Recommended Changes to Croatia's Current Legislative Framework, *Financial Theory and Practice* vol. 29, no. 3 (2005), pp. 211–227.

[15] An international website about tax planning refers to Croatia as a country where is possible avoidance of the transfer tax on real estate, http://www.henleyglobal.com/countries/croatia/real-estate/.htm, last accessed 28 December 2009.

capitalisation schemes, the shareholders are usually situated in low-rate jurisdictions and pay low or no tax on the interest they receive.

Croatia has enacted legislation to prevent this kind of abuse. The interest rates on loans to companies from shareholders are compared to the rates of interest that would be available from banks regarding similar loans. If the interest rates paid to shareholders are excessive, the extra interest paid is not deductible against the company's income.[16]

Croatia's corporate tax is a tax on worldwide income, but tax credits are given for taxes paid abroad. The corporate tax rate is a relatively low – 20%. In recognition of the possibility of transfer pricing, the Croatian tax authorities may perform tax audits on transactions between resident and non-resident branches of companies to ensure that foreign profits (and domestic losses) are not being artificially inflated for tax purposes. The Profit Tax Act contains a number of methods that may be used to assure that companies conduct transactions at arm's length.[17]

Croatia has enacted provisions to combat hidden profit distributions.

5.7 Penalties

Misdemeanour proceedings for tax offenses are conducted in the first instance by administrative bodies with jurisdiction over misdemeanours. The 2002 Misdemeanour Act names the High Misdemeanour Court of the Republic of Croatia as the only court competent to resolve tax offenses in the second instance. Special penalties relating to tax avoidance transactions are not imposed.

Penalties imposed for misdemeanor offenses by Corporate Income tax Law and General tax Act. The Corporate Income Tax Act prescribes monetary penalties only.[18] The General Tax Act permits administrative bodies to prohibit the performance of certain activity. Namely, as a preventive measure taxpayers may be subject to an injunction against certain conduct for

[16] Profit Tax Act 2001, Chapter III, Art 6.

[17] Profit Tax Act 2001, Chapter III Art 7(7) and Chapter III Art 6., Prebble R., loc. cit.

[18] Corporate Income Tax Act, XII. PENAL PROVISIONS Article 38. "(1) A taxpayer shall be fined from HRK 1,000 to 200,000 for an offence, if: 1. he/she fails to assess his/her tax liability pursuant to this Act after the expiry of the tax assessment period, or fails to pay the tax in the assessed amount and within the prescribed time limits (Articles 5 and 32), 2. he/she fails to notify the Tax Administration on the changes in his/her status (Articles 18 and 19), 3. he/she fails to assess his/her withholding tax liability within the prescribed time limits, in accordance with this Act, or fails to pay the assessed withholding tax (Article 31), 4. he/she fails to pay the advance profit tax within the prescribed time limits (Article 34). (2) For a misdemeanour referred to in Paragraph 1 of this Article the responsible person of a taxpayer shall be fined from HRK 500 to 20,000."

a period of 2 years for repeated actions prescribed in Articles 207 and 208 by General Tax Act.[19]

Misdemeanor proceedings are conducted in the first instance by administrative bodies with jurisdiction. Since 2002, the High Misdemeanour Court of the Republic of Croatia has been the only court competent to resolve tax offenses in the second instance.

5.8 Economic Substance

Under the General Tax Act, facts relevant to taxation are determined on the basis of their economic nature. If income, revenue, profits and other tax benefits are derived without legal authority, the tax administration may redetermine the tax liability. Sham transactions are recharacterized so that the tax consequences may be determined on the basis of the true transaction which the sham conceals.

5.9 Penalties for Tax Advisers

External consultants and advisers may be liable for advice given as an organizer, instigator or accessory in the commission of a tax offense. Shareholders may be criminally liable if they play an active part in tax evasion. The rulings emphasize that criminal liability arises only in connection with deliberate acts undertaken with the intention of avoiding payment of taxes or duties. Persons who are represented are accountable for outstanding and underpaid taxes and the corresponding interest which ensues from the failure to resolve tax liabilities.

5.10 Conclusion

A tax system that constantly changes is a fertile ground for tax evasion and tax avoidance. It is difficult for the tax officials themselves to keep up with such system. In Croatia crucial fiscal reform (in shifting to a market economy) has taken place in the last two decades. The intention was to design a simple and clear tax system, supporting the effectiveness and efficiency of tax enforcement procedures. Such a system aims for ease in compliance by taxpayers who perceive the system to be fair and legitimate. Fighting tax avoidance or evasion is not a salient goal at the present time, but future projects should take these problems into account.

[19] General Tax Act, Article 210.

Chapitre 6
France

Daniel Gutmann

6.1 L'introduction

La fraude fiscale ne constitue que l'une des facettes du phénomène d'évaporation des ressources fiscales des Etats.[1] A côté de la fraude fiscale, entendue comme dissimulation pure et simple d'événements donnant prise à l'impôt, existe ce qu'on a coutume d'appeler l'évasion fiscale, c'est-à-dire un ensemble de techniques consistant à se soustraire à l'impôt sans pour autant heurter de front la législation fiscale. Il existe en effet de multiples moyens d'échapper à l'impôt, lesquels sont infiniment plus subtils que celui qui consiste à en cacher le fait générateur.

Dans la plupart des cas, l'exercice consistant pour un contribuable à diminuer sa charge fiscale ne souffre pas la contestation. Il relève de la simple habileté, voire de la saine gestion patrimoniale. Telle personne retarde la perception d'un revenu exceptionnel jusqu'à une année ultérieure, car elle sait que ses revenus ordinaires seront alors moins élevés. Nul ne songe à lui reprocher sa prévoyance et son souci, typique d'un bon père de famille, de lisser sa pression fiscale. Tel redevable de l'impôt de solidarité sur la fortune décide d'investir systématiquement en tableaux et autres œuvres d'art pour bénéficier de l'exonération que la loi attache à ces biens: peut-on l'en blâmer, alors que la loi l'incite à procéder ainsi en créant elle-même une distinction entre actifs imposés et actifs exonérés? Telle société, anticipant une hausse annoncée de la fiscalité sur une opération donnée, se hâte d'accomplir celle-ci avant l'entrée en vigueur de la nouvelle règle. Lui

[1] Ce rapport s'appuie sur plusieurs écrits antérieurs de l'auteur sur le même sujet, notamment "Les instruments non fiscaux de lutte contre l'évasion fiscale: réflexions sur la responsabilité sociale des entreprises", *Revue française de finances publiques*, n° 110, avril 2010, p. 2035 et s.; "Droit et fraude fiscale", *Commentaire*, Hiver 2009-2010, vol. 32/n° 128, p. 973 et s.; "Réflexions comparatistes sur la constitutionnalité de la répression de l'abus de droit", *Feuillet rapide Francis Lefebvre*, 56/08, p. 3 et s.

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fera-t-on grief d'avoir agi dans son intérêt bien compris ainsi que dans celui de ses actionnaires? A l'évidence, non. Selon une formule bien connue d'un juge américain, il n'existe pas de devoir patriotique d'augmenter ses impôts.

En pratique, cependant, la frontière entre la gestion avisée et l'optimisation "agressive" est souvent ténue. Peut-on reprocher à une société française de créer une filiale dans un Etat étranger afin de lui transférer des activités, matérielles ou immatérielles, dont le produit sera plus faiblement taxé en vertu de la législation locale qu'en France? Doit-on s'émouvoir de ce qu'une société étrangère restructure son réseau commercial en France afin que ses distributeurs deviennent indépendants et que la maison mère cesse d'être assujettie, de leur fait, à l'impôt sur les sociétés français? La réponse n'est subitement plus si claire. Intuitivement, on perçoit qu'il y a dans tous ces cas un "montage". Le mot est évocateur: ce qui est "monté" n'est pas naturel, c'est une construction qui contient un certain degré d'artifice ou, à tout le moins, de recul et d'élaboration. Or, l'artifice attise la méfiance. Jouer avec les règles, c'est jouer avec le feu. Lorsqu'on repère du jeu dans le système juridique, celui-ci vacille sur ses bases. On soupçonne alors celui qui le sollicite de vouloir s'en affranchir. Où tracer la frontière entre le joueur innocent et le joueur pervers?

Définir juridiquement les frontières du licite et de l'illicite constitue un exercice particulièrement délicat. Intuitivement, on se dit que la technique législative la plus simple consiste à identifier un ou plusieurs comportements répréhensibles, à les définir et à déterminer la sanction qui doit être infligée au contrevenant. C'est une technique que l'on peut qualifier "d'énumérative". Elle prend la forme d'une prescription juridique claire, précise. Elle incarne le règne de la règle de droit. Cependant, cette technique de lutte contre l'évasion fiscale est de plus en plus perçue comme insuffisante par l'administration et le législateur français. Depuis plusieurs années, le recours à la règle juridique est complété, voire remplacé, par des principes à la texture sémantique ouverte, tels que la nécessité de lutter contre la "fraude à la loi" ou "l'abus de droit". La règle juridique cède ainsi devant une autre forme de normativité, fondée sur les principes généraux. Marginalisée, la règle juridique ne devient plus qu'un élément parmi d'autres de l'arsenal juridique mis en branle pour lutter contre l'évasion fiscale. Mais ce processus de marginalisation n'en est peut-être encore qu'à ses tous premiers stades, compte tenu du développement contemporain de nouveaux modes de régulation du système économique. L'éthique d'entreprise, la responsabilité sociale des entreprises, les exigences de la bonne gouvernance des entreprises, joueront-elles en matière fiscale un rôle normatif analogue à celui joué en d'autres matières (environnementale, pénale, etc.)? Autant de questions qu'il est nécessaire d'examiner tour à tour.

6.2 Le règne de la règle de droit: les règles spéciales anti-abus

Pour un juriste français de formation classique, la qualité d'une règle juridique ayant pour objet de sanctionner un citoyen est étroitement liée à sa précision et à sa clarté. L'énumération et la description des comportements interdits ne procèdent pas seulement d'exigences de commodité et de rigueur; elles constituent une garantie fondamentale donnée au citoyen, une protection contre tout risque de décision arbitraire prise par les autorités publiques. En matière pénale, de tels principes sont présents de façon explicite dans la Déclaration des droits de l'homme et du citoyen.

En matière fiscale, le Conseil constitutionnel a estimé dans une décision du 29 décembre 2005 que "la loi, lorsqu'elle atteint un niveau de complexité tel qu'elle devient inintelligible pour le citoyen, méconnaît en outre l'article 14 de la Déclaration de 1789, aux termes duquel: Tous les citoyens ont le droit de constater, par eux-mêmes ou par leurs représentants, la nécessité de la contribution publique, de la consentir librement, d'en suivre l'emploi, et d'en déterminer la quotité, l'assiette, le recouvrement et la durée."[2] Ce principe a permis au Conseil constitutionnel de censurer, comme inconstitutionnelles, des dispositions si complexes "que les incertitudes qui en résulteraient seraient source d'insécurité juridique, notamment de malentendus, de réclamations et de contentieux."[3]

Les qualités des règles juridiques précises destinées à lutter contre la fraude et l'évasion fiscale expliquent sans nul doute pourquoi notre système fiscal en contient à profusion. Le Code général des impôts énonce de façon claire les différentes sanctions pénales applicables aux contribuables coupables de fraude fiscale. Plusieurs articles, notamment l'article 1741 du Code général des impôts, définissent ainsi les comportements réprimés et l'échelle des peines encourues.

En-dehors de la sphère pénale stricto sensu, le même procédé législatif est utilisé pour définir et sanctionner certaines pratiques évasives. A titre d'exemple, notre droit de l'enregistrement contient des règles précises destinées à éviter les dessous-de-table versés à l'occasion de transactions immobilières.[4] En matière d'impôt sur les sociétés, de multiples dispositions ont pour objet de prévenir la réduction anormale du résultat imposable: certaines s'appliquent aux sociétés sous-capitalisées, soupçonnées de s'endetter à l'excès pour amoindrir leur bénéfice;[5] d'autres s'appliquent aux sociétés appartenant au même groupe fiscal, dont on craint qu'elles n'abusent

[2] Cons. const., déc. n° 2005-530 DC, 29 déc. 2005, § 78.

[3] Ibid., § 84.

[4] Par ex. art. L 17 du Livre des procédures fiscales (LPF).

[5] Art. 212 du Code général des impôts (CGI).

de ce régime de faveur;[6] d'autres encore confèrent à l'administration fiscale un pouvoir d'appréciation sur l'opportunité de conférer aux sociétés parties à une fusion la jouissance de certains avantages fiscaux.[7]

Dans l'ordre international, nombreuses sont également les règles ayant pour objet de neutraliser les montages conduisant à priver la France de son droit d'imposer. Les sociétés françaises disposant de filiales ou de succursales situées dans des Etats étrangers où elles sont soumises à un régime fiscal "privilégié" peuvent ainsi être imposées, sous certaines conditions, sur les résultats de leurs implantations étrangères alors même qu'ils n'auraient pas été distribués sous forme de dividendes.[8] De même, les transactions conclues par des sociétés françaises à des conditions jugées anormales par l'administration fiscale peuvent être remises en cause par celle-ci afin d'éviter que certains flux financiers au départ de la France n'aboutissent en pratique à transférer des bénéfices imposables vers des cieux fiscaux plus cléments.[9]

Enfin, depuis la loi de finances rectificative pour 2009, les prélèvements et retenues à la source normalement mis à la charge des contribuables non résidents augmentés, lorsque le bénéficiaire du revenu réside ou lorsque le paiement est fait dans un "Etat ou territoire non coopératif". Ils s'élèvent alors à 50%. De même, le régime d'exonération des dividendes reçus par les sociétés mères est exclu lorsque la filiale est établie dans un tel Etat. Sont considérés comme non coopératifs, à la date du 1er janvier 2010, les Etats et territoires non membres de la Communauté européenne dont la situation au regard de la transparence et de l'échange d'informations en matière fiscale a fait l'objet d'un examen par l'Organisation de coopération et de développement économiques et qui, à cette date, n'ont pas conclu avec la France une convention d'assistance administrative permettant l'échange de tout renseignement nécessaire à l'application de la législation fiscale des parties, ni signé avec au moins douze Etats ou territoires une telle convention.[10] La première liste établie en 2010 présente un caractère évolutif. En effet, à compter de 2011, cette liste est amenée à être révisée annuellement par retrait ou adjonction de nouveaux États. La mise à jour tient compte du comportement des États vis-à-vis de la France et en particulier de l'efficacité concrète des dispositions visant à l'échange de renseignements.

Toutes ces règles ont un grand mérite. Elles donnent aux acteurs économiques des règles du jeu précises: ceux qui s'y soumettent sont assurés de

[6] Art. 223 et s. CGI.

[7] Art. 209 CGI; art. 210 B et C CGI.

[8] Art. 209 B CGI.

[9] Art. 57 CGI.

[10] Art. 238-0 A. 1 CGI. Sur ce texte issu de l'article 22 de la loi de finances rectificative pour 2009, cf. F. Lugand et A. Rocchi, Paradis fiscaux: la messe est dite?, Droit & Patrimoine, Févr. 2010.

n'être assujettis à aucune sanction; ceux qui s'en écartent connaissent le risque qu'ils encourent. Ces règles ont cependant un défaut: elles ne permettent pas de faire face à toutes les situations d'évitement de l'impôt. De fait, l'imagination des praticiens est fertile et conduit souvent à donner aux particuliers et aux entreprises un train d'avance, si l'on peut dire, sur la réaction du législateur. Le respect des conditions légales n'est, dans ces conditions, qu'un brevet trompeur de civisme fiscal.

Comment réagir efficacement face à une telle situation? La première réponse qui vient à l'esprit consiste à modifier la loi en permettant pour l'avenir à l'administration fiscale de combattre les schémas d'évasion nouvellement découverts. Commence alors une course poursuite: le législateur suit la pratique en élaborant une réglementation encore plus précise et détaillée; les contribuables visés, se sachant démasqués, découvrent de nouveaux moyens de passer entre les mailles du filet législatif; d'où une nouvelle réaction, toujours tardive, du législateur, etc. Ce petit jeu peut se poursuivre à l'infini, les finances publiques faisant les frais du décalage existant entre l'inventivité des uns et l'opiniâtreté des autres.

On comprend la nécessité d'une autre riposte, reconnaissant les limites intrinsèques de toute entreprise d'énumération précise des comportements évasifs. Celle-ci s'articule autour de l'idée que le droit s'arrête où l'abus commence, que l'utilisation frauduleuse des ressources du système juridique constitue une offensive contre celui-ci, bref, que la sanction de la fraude à la loi et de l'abus de droit constitue un principe général qui justifie suffisamment la sanction de ceux qui confondent malice et malignité. Première étape de la marginalisation de la règle juridique.

6.3 La première étape de la marginalisation de la règle juridique: la théorie de l'abus de droit

Le concept d'abus de droit n'est pas propre à la fiscalité. Il existe dans d'autres disciplines juridiques. Il n'est pas non plus nouveau. Dès le XIXe siècle, l'administration fiscale y recourt, avec la bénédiction de la Cour de cassation, pour éviter la fraude aux droits d'enregistrement. Il serait donc anachronique de voir dans l'avènement des principes généraux un processus de dissolution de la règle juridique s'inscrivant chronologiquement dans la succession de la technique des dispositions spéciales anti-abus.

Comment nier, toutefois, le développement spectaculaire du recours aux principes généraux pour lutter contre l'évasion fiscale? Depuis sa consécration législative dans une loi du 13 janvier 1941, la théorie de l'abus de droit n'a cessé de voir son champ d'application s'étendre, au point de concerner aujourd'hui tous les impôts. La notion d'abus de droit s'est elle-même considérablement élargie: initialement destinée à combattre des situations juridiques fictives ou simulées (donations déguisées en vente, sociétés de

pure façade, etc.), elle a progressivement étendu son empire à tous les cas dans lesquels un contribuable fait un ou plusieurs actes dont le but est exclusivement fiscal. Le Conseil d'Etat, auquel on doit cette mutation sémantique qu'aucun texte ne justifiait, décida en outre dans un arrêt rendu le 27 septembre 2006[11] que la notion de "fraude à la loi" permettait à l'administration de neutraliser des montages qui, faute d'entraîner une diminution de l'assiette ou du taux de l'impôt, ne constituaient pas un abus de droit au sens strict.

La jurisprudence, on le voit, joue un rôle considérable dans l'extension du domaine de l'abus du droit au cours de l'histoire ainsi que dans la délimitation de ses contours. Certaines questions demeurent pourtant ouvertes en raison précisément des hésitations de la jurisprudence. Ainsi, la question de savoir si l'abus de droit s'applique en présence de traités internationaux demeure incertaine. L'arrêt "Schneider" du 28 juin 2002, rendu au sujet du conflit entre l'article 209 B du Code général des impôts et la convention franco-suisse du 9 septembre 1966, avait semblé fermé la porte à l'application de la théorie à des traités internationaux en affirmant que "à supposer même qu'il soit établi qu'un objectif de lutte contre l'évasion et la fraude fiscales ait été assigné à la convention franco-suisse, cet objectif ne permet pas, faute de stipulation expresse le prévoyant, de déroger aux règles énoncées par cette convention".[12] La jurisprudence postérieure, notamment l'arrêt Bank of Scotland rendu par le Conseil d'Etat le 19 décembre 2006,[13] n'est plus si claire, même si l'écartement du bénéfice d'un traité international trouve dans cet arrêt son fondement dans le texte (interprété de façon audacieuse) de la convention fiscale elle-même.

Ces incertitudes n'ont pas été levées alors même que la loi de finances rectificative pour 2008 a entendu rectifier la définition de l'abus de droit afin de tirer les enseignements de la jurisprudence. Fusionnant l'abus de droit et la fraude à la loi en une seule définition, l'article 64 du Livre des procédures fiscales énonce ainsi désormais: "afin d'en restituer le véritable caractère, l'administration est en droit d'écarter, comme ne lui étant pas opposables, les actes constitutifs d'un abus de droit, soit que ces actes ont un caractère fictif, soit que, recherchant le bénéfice d'une application littérale de textes ou de décisions à l'encontre des objectifs poursuivis par leurs auteurs, ils n'ont pu être inspirés par aucun autre motif que celui d'éluder ou d'atténuer les charges fiscales que l'intéressé, si ces actes n'avaient pas été passés ou réalisés, aurait normalement supportées eu égard à sa situation ou à ses activités réelles."

[11] CE, 27 sept. 2006, n° 260050, Sté Janfin: Juris-Data n° 2006-081020; Dr. fisc. 2006, n° 47, comm. 744, concl. L. Olléon; RJF 2006, n° 1583.

[12] CE, ass., 28 juin 2002, n° 232276, Schneider Electric: Juris-Data n° 2002-080182; Dr. fisc. 2002, n° 36, comm. 657, étude P. Dibout.

[13] CE, 29 déc. 2006, n° 283314, Sté Bank of Scotland: Juris-Data n° 2006-081065; Dr. fisc. 2007, n° 4, comm. 87, concl. F. Séners, note O. Fouquet.

Il suffit de lire ce texte pour comprendre que le principe général de lutte contre l'abus de droit a une nature complexe. S'il s'agit bien d'un principe général, en ce sens qu'il ne prohibe aucun agissement particulier, sa mise en œuvre est subordonnée à des conditions précises dont la preuve incombe à l'administration fiscale: fictivité ou but exclusivement fiscal des actes concernés, contrariété entre objectifs du contribuable et objectifs de l'auteur de la norme fiscale éludée. Le Livre des procédures fiscales contient donc une norme dont le caractère principiel laisse néanmoins pleinement subsister l'exigence d'un raisonnement juridique rigoureux pour que l'administration obtienne gain de cause.

Le recours à la théorie de l'abus de droit a un mérite immense: il permet de débusquer les contribuables qui se croient à l'abri de toute sanction au seul motif qu'ils rendent un hommage de façade à la législation existante. La force de la théorie réside donc dans son flou. Son efficacité vient de ce qu'elle embrasse sans limite toutes les formes de comportement déviant. Partant, la théorie de l'abus de droit semble se présenter comme l'aboutissement ultime de la technique législative ou, mieux, comme l'expression de cette sagesse intemporelle selon laquelle tout ne se peut prévoir, de sorte que tout système a besoin, pour sa propre sauvegarde, de garde-fous formulés en termes généraux. La théorie de l'abus de droit, ce serait ainsi le refoulement du juridisme et l'affirmation de la confiance faite à notre administration et à nos juges, capables de discerner, sans le support des textes, les limites de l'acceptable et de l'inacceptable.

Toutefois, c'est dans la puissance même du principe général de lutte contre l'abus de droit que se situent les motifs d'interrogation sur la pertinence d'un recours trop systématique à cette théorie. Tout, dans l'article L64 du Livre des procédures fiscales, est ambigu: la notion de "caractère fictif", la notion de "texte", la notion "d'objectif", la notion "d'auteurs", l'adverbe "normalement", la notion de "situation ou d'activité réelle". Certes, il est naturel qu'un texte juridique donne lieu à interprétation. On peut même soutenir que la texture ouverte de cette norme générale anti-abus trouve sa légitimité dans la nécessité de lutter contre les comportements dont l'habileté excessive aboutit finalement à violer le principe constitutionnel d'égalité devant les charges publiques.

Les premières analyses du Conseil d'Etat relative à la nouvelle définition de l'article L64 sont cependant relativement rassurantes si l'on en croit les décisions prises dans les affaires qui avaient donné naissance, en 2006, à la théorie fiscale de la "fraude à la loi."[14] Il était en l'espèce reproché à des sociétés d'avoir acquis de façon éphémère la propriété de titres à la seule fin de bénéficier, à l'occasion de la distribution de dividendes, d'un crédit d'impôt (l'avoir fiscal) leur permettant de se libérer de leur propre impôt. L'intérêt de ces deux décisions est de mettre en évidence la nécessité de la

[14] CE, 7 sept. 2009, SA Axa, n° 305586; Sté Henri Goldfarb, n° 305596.

double preuve requise de l'administration fiscale: d'une part, celle d'un but exclusivement fiscal; d'autre part et surtout, celle de la contrariété entre l'application littérale des textes aux opérations concernées et les objectifs poursuivis par leurs auteurs. C'est à un cours de méthode que se livre le Conseil d'Etat, lorsqu'il recherche dans les travaux préparatoires de la loi du 12 juillet 1965 créant l'avoir fiscal d'éventuels indices d'une volonté du législateur de subordonner le droit à l'avoir fiscal à une durée minimum de détention des titres avant ou après la mise en paiement des dividendes auxquels il est attaché. N'en trouvant aucune trace, le Conseil d'Etat constate logiquement que le second critère de la fraude à la loi découlant de la jurisprudence Janfin fait défaut.

Cette démarche rigoureuse est de nature à rassurer les contribuables. Dans le silence du législateur, on ne peut donc présumer que certains objectifs occultes ou implicites ont été poursuivis. La divination fiscale n'a pas sa place dans la lutte contre l'abus de droit: il faut s'en réjouir.

Pour autant, le débat sur la légitimité de la sanction de l'abus de droit ne peut être considéré comme clos. A l'heure où la loi peut faire l'objet d'un contrôle de constitutionnalité postérieurement à sa promulgation, on ne peut faire abstraction du problème posé par l'incertitude de la notion d'abus de droit au regard du principe constitutionnel de légalité des délits et des peines.

En effet, la constatation d'un abus de droit par l'administration fiscale n'expose pas le contribuable au seul paiement des impôts par lui éludés, augmentés d'un intérêt de retard destiné à indemniser l'Etat du préjudice constitué par le paiement tardif de sa créance fiscale. Elle donne également lieu à l'acquittement d'une pénalité infligée par l'administration fiscale, dont le montant est de 40 ou de 80% de l'impôt éludé selon les circonstances.[15] Sachant que cette pénalité présente une sanction ayant le caractère d'une punition, au sens où l'entend la jurisprudence du Conseil constitutionnel, le législateur tient de l'article 34 de la Constitution ainsi que du principe de légalité des délits et des peines l'obligation de fixer lui-même le champ d'application de l'abus de droit et de définir les comportements sanctionnés en des termes suffisamment clairs et précis. Le Conseil constitutionnel justifie cette exigence de précision, s'agissant de la loi pénale, par le souci d'exclure l'arbitraire dans le prononcé des peines et d'éviter une rigueur non nécessaire lors de la recherche des auteurs d'infractions. Dans ces conditions, le recours au principe général de l'abus de droit fait naître de sérieuses réserves dans la mesure où il s'accompagne d'une sanction spécifique ayant un caractère répressif.

Plus fondamentalement, et à supposer même que la sanction de l'abus de droit soit révisée pour être dépouillée de son caractère punitif, on ne peut se dissimuler que la théorie de l'abus de droit ne constitue pas un moyen

[15] Art. 1729 CGI.

satisfaisant d'endiguer l'évasion fiscale. Sans verser dans un cynisme facile ni dans une critique systématique, il faut rappeler que l'abus de droit constitue une arme dont l'administration peut être tentée d'abuser, la menace de la sanction pouvant conduire le contribuable à accepter des redressements auxquels il ne serait pas soumis spontanément. La définition large des critères de l'abus de droit peut également faire craindre que, sous couvert de faire régner le droit dans ce qu'il a plus de noble, on aboutisse en réalité à faire prévaloir un certain arbitraire sur la nécessité tout aussi noble de respecter un minimum de sécurité juridique. En bref, si la théorie de l'abus de droit révèle que la norme fiscale spéciale ne peut toujours se suffire à elle-même, elle enseigne également que tout ce qui peut être prévu à l'avance doit l'être par voie législative et que l'on ne saurait faire peser en principe sur le contribuable le risque d'une malfaçon législative. La dissolution de la règle juridique dans les principes généraux doit donc être évitée autant que possible.

A ce stade de la réflexion, faut-il se laisser aller à un certain scepticisme concernant l'efficacité du droit dans la régulation des comportements adoptés par les acteurs économiques? Faut-il se résoudre à osciller entre deux pôles, la règle et le principe, en sachant qu'aucun des deux ne donne pleinement satisfaction au regard des principes fondamentaux de notre ordre juridique et politique? C'est une tentation forte, où l'on peut aussi voir l'expression d'une forme de pragmatisme normatif consistant à abandonner sereinement tout esprit de système. Ceci dit, l'histoire de la lutte contre l'évasion fiscale n'est sans doute pas finie. Il se pourrait bien, en effet, que les oscillations de la norme juridique ouvrent le champ à d'autres formes de régulation émanant non plus du législateur mais des acteurs économiques eux-mêmes. Vers une deuxième étape de la marginalisation de la règle juridique?

6.4 La deuxième étape de la marginalisation de la règle juridique: l'idée de responsabilité sociale des entreprises

L'essentiel (ou du moins une dimension essentielle) de la lutte contre l'évasion fiscale pourrait n'être pas encore advenu. L'essentiel, c'est que la contrainte pesant sur les décisions fiscales des entreprises ne viendra peut-être plus seulement, dans un proche avenir, de la règle fiscale ou pénale. Elle ne viendra plus de la crainte d'être découvert ou perquisitionné par l'administration fiscale. Elle viendra d'un *ailleurs du droit* ou, plus exactement, d'une force sociale qui trouvera dans le droit *non fiscal* un renfort nouveau.

Il faut, pour le comprendre, prendre au sérieux une théorie que les fiscalistes ont pour l'instant considérée comme largement étrangère à leurs préoccupations: celle de la "responsabilité sociale (ou sociétale)

des entreprises" (*corporate social responsibility*). Selon la Commission européenne,[16] l'essentiel de cette théorie repose sur l'idée selon laquelle l'entreprise ne doit pas se contenter de rechercher la maximisation de son propre profit. Elle doit également intégrer dans ses décisions des paramètres tenant à l'impact de son comportement en matière sociale et environnementale (les deux domaines de prédilection de la théorie) et rendre compte de son activité, non seulement à ses actionnaires, mais aussi à ses parties prenantes (*stakeholders*): employés, clients, voisins, ONG, autorités publiques etc.

A cette idée de responsabilité sociale des entreprises se relie aussi, fréquemment, l'idée de "l'investissement socialement responsable (ISR)," autrement dit d'une démarche selon laquelle tout choix d'investissement devrait s'appuyer sur une pluralité de critères: le profit espéré, bien entendu, mais aussi le respect par l'entité bénéficiaire de l'investissement de certaines valeurs et de certains principes se reliant à une éthique sociale largement définie.

Historiquement, les idées de responsabilité sociale des entreprises ou d'investissement socialement responsable n'ont pas été forgées pour organiser un contrôle des décisions fiscales des entreprises. Il s'agissait plutôt d'orienter le comportement des acteurs économiques en sensibilisant l'opinion et les investisseurs professionnels à la nécessité de contrôler les décisions intéressant notamment l'environnement et les droits de l'homme. Or, force est de constater que le succès de cette démarche a été rapide et considérable. En 1976, l'OCDE publiait la première édition de ses "Principes directeurs à l'intention des entreprises multinationales," ensemble de recommandations formulées par les Gouvernements à l'intention des entreprises multinationales. Ce document énonce des principes et des normes pour un comportement responsable des entreprises dans plusieurs domaines, notamment l'emploi et les relations professionnelles, les droits de l'homme, l'environnement, la publication d'informations, la concurrence... et la fiscalité. On peut d'ailleurs noter que ces principes directeurs encouragent fortement les sociétés à respecter non seulement la lettre, mais aussi l'esprit de la règle fiscale, ce qui n'est pas inintéressant à l'heure où cet esprit est au cœur de la définition française de l'abus de droit.

L'ONU a lancé en 2000 un "pacte mondial," plateforme politique et code de conduite à destination des entreprises contenant une liste de comportements "responsables" illustrant dix principes universellement acceptés en matière de droits de l'homme. Il semble que 4700 entreprises, dont

[16] Commission, Livre vert *Promouvoir un cadre européen pour la responsabilité sociale des entreprises*, COM(2001) 366 final. La Commission a publié depuis lors une importante communication le 22 mars 2006 (COM (2006) 136 final).

plus de 400 françaises, aient adhéré à ce pacte.[17] C'est également sous l'égide de l'ONU qu'ont été énoncés, le 27 avril 2006, les "Principes pour l'investissement responsable."

Enfin, l'Union européenne participe également au mouvement depuis 2001 et le Livre vert précité de la Commission européenne sur la responsabilité sociale des entreprises. Une résolution du Parlement Européen datée de mars 2007 et intitulée "La RSE: Un nouveau partenariat" a également a proposé l'instauration d'un régime de reporting dans le cadre des directives comptables communautaires, visant à inclure les informations sociales et environnementales à côté des exigences d'information financière dans les rapports annuels.

Certes, à l'heure actuelle, la fiscalité demeure un sujet de préoccupation marginal des institutions, commissions et autres groupes d'étude constitués pour donner vie à l'idée de responsabilité sociale des entreprises. Toutefois, cette situation se modifie d'ores et déjà en ce qui concerne l'OCDE. Cette organisation poursuit en effet actuellement sur le terrain fiscal la démarche engagée sur le terrain plus général de la gouvernance d'entreprise, comme en témoignent ses travaux récents.[18] Une déclaration publiée le 27 janvier 2010 sur le site de l'OCDE par les présidents du Comité des affaires fiscales du comité d'aide au développement sur la fiscalité et le développement annonce même la décision d'élaborer un programme visant à améliorer la transparence dans la communication des bénéfices et des paiements d'impôts. Ce programme, fortement appuyé par le Royaume-Uni, serait conduit dans le contexte des travaux que l'OCDE consacre depuis 1976 aux entreprises multinationales.

Au-delà de l'OCDE, il est également à parier que l'impact sur la fiscalité de la responsabilité sociale des entreprises ne se fera pas longtemps attendre. D'un point de vue conjoncturel, la crise financière actuelle a mis en lumière certains dysfonctionnements du système financier auxquels l'opinion publique est extrêmement sensible. Le reflux spectaculaire des paradis fiscaux en est une conséquence à court terme; la "moralisation" des comportements fiscaux des entreprises en sera un effet à moyen terme. A cela s'ajoute le fait que les objectifs non budgétaires de la fiscalité tendent à devenir centraux dans le débat public: les débats sur la fiscalité écologique ou l'imposition des bonus des traders en constituent des manifestations privilégiées; ce ne sont pas les seules.

Ce n'est donc pas un hasard si, du côté de la doctrine universitaire, les premières études de fiscalistes sur la responsabilité sociale des entreprises fleurissent: à titre d'exemple, dans un ouvrage récent consacré aux

[17] Source: "La responsabilité sociale des entreprises: l'engagement de la France", document publié par M. Doucin, Ambassadeur chargé de la bioéthique et de la responsabilité sociale des entreprises sur www.diplomatie.gouv.fr., juillet 2009.

[18] Forum on Tax Administration. Information Note. General Administrative Principles: Corporate governance and tax risk management, July 2009, spéc. p. 6 et s.

relations entre fiscalité et gouvernance d'entreprise,[19] plusieurs articles sont consacrés aux aspects fiscaux de la responsabilité sociale des entreprises.[20]

Du côté des entreprises et de la société civile, l'impact des décisions fiscales sur la communication externe et l'image de l'entreprise est aujourd'hui mieux connu et pris au sérieux, notamment à la suite de certains scandales ayant défrayé la chronique en Europe et aux Etats-Unis. Dans un discours fait à Washington D.C. devant le Tax Executives Institute, Jeffrey Owens, le directeur du Centre de politique et d'administration fiscales de l'OCDE relevait, en mars 2007, que des journaux tels que le Financial Times ou le Wall Street Journal n'hésitent pas à afficher en première page de leurs éditions des gros titres concernant les pratiques évasives de certaines sociétés ou le transfert de leur siège vers des juridictions offshore.[21] Le constat vaut aussi pour la France, où certains quotidiens[22] et d'autres publications économiques stigmatisent les pratiques fiscales agressives au nom d'une certaine idée de l'entreprise.[23]

Les ONG et entités assimilées s'intéressent également à la question. A titre d'exemple, SustainAbility, qui se définit comme "a *hybrid strategy consultancy and independent think-tank*" (expression intraduisible en français), a consacré un rapport important et bien documenté intitulé "*Taxing issues. Responsible business tax*"[24] engageant les entreprises à adopter des politiques fiscales responsables dans leur intérêt bien compris. Le rapport insiste sur l'atteinte à la réputation[25] qui pourrait résulter

[19] W. Schön (ed.), *Tax and Corporate Governance*, MPI Studies on Intellectual Property, Competition and Tax Law, Springer, 2008.

[20] R. S. Avi-Yonah, "Corporate Social Responsibility and Strategic Tax Behavior", p. 183 et s.; P. Timonen – Comment on the paper by R. S. Avi-Yonah, p. 199 et s. V. aussi par ailleurs J. Freedman, The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility, in *Current Legal Problems* 2006 (OUP); T. Rosembuj, *Minimizacion del impuesto y responsabilidad social corporativa*, El Fisco, 2009; D. F. Williams, Tax and Corporate Social Responsibility, KPMG's Tax Business School, 2007 (http://www.kpmg.co.uk/pubs/Tax_and_CSR_Final.pdf).

[21] Cf. également J. Owens, "Good Corporate Governance: The Tax Dimension", OECD Forum on Tax Administration, Sept. 2006.

[22] On se souvient par exemple de l'émotion suscitée en mars 2009 par l'ouverture d'une enquête concernant les groupes Michelin, Elf et Adidas concernant une fraude fiscale impliquant le Liechtenstein.

[23] Cf. par ex. sur ce sujet tout le numéro de la revue *Alternatives Economiques*, Pratique n° 41, Nov. 2009.

[24] Ce rapport date de mars 2006 et peut être consulté sur http://www.taxresearch.org/uk/Documents/taxing_issues.pdf. Le rapport mentionne en introduction qu'il a été sponsorisé par PricewaterhouseCoopers LLP.

[25] Le rapport cite une étude faite par PwC (What is a Responsible Tax Strategy?, www.pwcglobal.com) d'où il résulte que 97% des sociétés interrogées se déclare inquiète à la perspective d'une couverture défavorable par la presse de leurs pratiques d'optimisation fiscale.

d'une publicité orchestrée à l'encontre des sociétés coupable d'agissements fiscaux répréhensibles et sur les risques croissants liés au non-respect des obligations fiscales: risque financier, risque de sanction par le marché, risque de ne pas pouvoir contracter avec certaines autorités publiques etc.

Une démarche comparable a été engagée, entre autres,[26] par Actionaid, une organisation ayant pour objet de lutter contre la pauvreté dans le monde, dans un rapport de 2009 au titre éloquent: *Accounting for poverty. How international tax rules keep people poor.*[27] Ce rapport souligne que chaque année, les pays en développement perdent des milliards de dollars en raison de politiques fiscales agressives menées par les entreprises multinationales.

D'autres acteurs complètent le tableau, qu'ils relèvent de la sphère de l'audit, de l'expertise comptable ou du conseil.[28] Dans le domaine financier, Henderson Global Investors a publié un document suggérant aux entreprises de respecter un certain nombre d'orientations claires dans leur politique fiscale et dans la communication qu'elles adoptent à ce sujet.[29] En France, une démarche aussi précise n'a pas encore vu le jour mais l'idée de guider les investisseurs sur la base d'évaluations qualitatives des politiques "citoyennes" conduites par les entreprises est déjà bien ancrée. A titre d'exemple, Novethic, filiale de la Caisse des dépôts et des Consignations créée en avril 2001, est un centre de ressources et d'expertise sur la responsabilité sociétale des entreprises et l'investissement socialement responsable. Parmi d'autres activités, elle a développé un label "ISR Novethic" s'appliquant aux sociétés de gestion et prenant en compte quatre critères: l'analyse environnementale, sociale et de gouvernance, la transparence du processus, le reporting extra-financier de qualité et la publication de la composition intégrale du portefeuille. De même, Vigeo, structure créée et dirigée par Nicole Notat, propose des contrôles ISR aux investisseurs et des audits en responsabilité sociale aux entreprises.

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[26] Cf. aussi, par ex., les travaux du Tax Justice Network (par ex. *Closing the Floodgates: Collecting Tax to Pay for Development*, 2007).

[27] http://www.actionaid.org.uk/102212/accounting_for_poverty.html. Cf., dans le même sens les rapports publiés par Save the Children, *Beyond Rhetoric: Measuring Revenue Transparency*, 2005; Christian Aid, *The Shirts off Their Backs – How Tax Policies Freece the Poor*, 2005; Publish What You Pay (Publiez ce que vous payez), http://www.publishwhatyoupay.org/en/search/node/tax.

[28] Cf. par ex.les publications du "Tax Governance Institute" de KPMG, initiées par *Tax in the Boardroom* (2005), puis *Discussion Paper: The Governance of Tax* (2007); *The role of the audit committee in the management of enterprise tax risk*, 2007, et surtout *The Rising Tide – regulation and stakeholder pressure on tax departments worldwide*, 2007; Ernst and Young, *Tax Risk Management*, LexisNexis Butterworths, 2007.

[29] *Responsible Tax*, Oct. 2005 (sur www.taxjustice.net/cms/upload/pdf/Global_Henderson_-_ResponsibleTax_-_OCT_2005.pdf).

A supposer que cette tendance au renforcement du contrôle social sur les entreprises se confirme, quelles pourraient en être les conséquences sur la régulation des comportements fiscaux des entreprises?

Le premier effet à attendre de la RSE serait l'intensification de l'obligation de transparence des entreprises sur leurs comportements fiscaux.

A l'heure actuelle, en effet, il n'existe pas en droit français d'obligation générale de divulgation d'informations fiscales pour les entreprises françaises. De même, les conseils fiscaux des entreprises ne sont pas obligés de déclarer à l'administration fiscale les montages qu'ils ont conseillés à leurs clients. Bien que plusieurs projets de textes aient été conçus par l'administration fiscale pour introduire en France des obligations de transparence inspirées des dispositifs anglais ou américain, ces tentatives ont été un échec en raison de la forte réticence des milieux professionnels.

Du côté des entreprises, une obligation de transparence accrue prendrait évidemment une forme comptable que préfigure d'ores et déjà la révision de la norme IAS 12 pour obliger les entreprises à comptabiliser leurs "positions fiscales incertaines",[30] c'est-à-dire concrètement les risques fiscaux auxquels elles sont exposés.

Elle pourrait aussi prendre la forme d'une obligation, pour les sociétés dont les titres sont admis sur un marché réglementé de rendre compte dans leur rapport de gestion d'un certain nombre de données relatives à leur fiscalité. Cette perspective n'est nullement extravagante: depuis la loi du 15 mai 2001 sur les nouvelles régulations économiques, le rapport du conseil d'administration ou du directoire dans les sociétés cotées doit déjà rendre comprendre des informations sur la manière dont elles prennent en compte les conséquences environnementales et sociales de leurs activités.[31] Il suffirait d'étendre ce mécanisme existant en matière fiscale. La Commission des finances de l'Assemblée nationale a d'ailleurs présenté en septembre 2009 un rapport d'information sur les paradis fiscaux estimant "qu'il conviendrait d'améliorer significativement l'information apportée par les sociétés cotées, tant vis-à-vis de leurs actionnaires que de leur autorité de surveillance, en prévoyant par exemple la publication, en annexe de leur rapport annuel, de l'ensemble des activités conduites dans les paradis fiscaux, des montages utilisés, des entités impliquées et des risques ainsi induits. Cette obligation pourrait aussi être décomposée, comme pour les banques, en une obligation d'information générale en annexe au rapport annuel et une obligation d'information détaillée à destination de l'AMF."[32]

[30] Cf. le projet publié par l'IASB le 31 mars 2009. L'obligation est déjà d'actualité aux Etats-Unis: cf. à ce sujet l'interprétation de la norme FIN 48 par le Financial Accounting Standards Board, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48).

[31] Art. L 225-102-1 C. com.

[32] Rapport présenté par MM. Migaud, Carrez, Brard, Emmanuelli, Mancel et Perruchot, Ass. nat., 10 sept. 2009, n° 1902, p. 119.

En tout état de cause, si l'information fiscale faisait l'objet d'une publication élargie, il faudrait que les décisions fiscales à l'impact le plus important soient effectivement prises au plus haut niveau de la hiérarchie et que les sociétés organisent en leur sein des procédures transparentes de décision et de prévention des risques en la matière. Il conviendrait alors que soient aménagées d'autres procédures permettant de contrôler le respect des premières, à l'image de ce qui existe déjà en matière de transparence financière depuis la loi de sécurité financière du 1er août 2003. A l'heure actuelle, le président du conseil d'administration ou du directoire d'une société anonyme cotée doit rendre compte dans un rapport joint au rapport de gestion des procédures de contrôle interne mises en place par la société,[33] et le commissaire aux comptes doit présenter ses observations sur le rapport du président concernant les procédures de contrôle interne relatives à l'élaboration et au traitement de l'information comptable et financière.[34] Depuis la loi du 3 juillet 2008, le président du conseil d'administration ou du conseil de surveillance doit également indiquer le code de gouvernement d'entreprise auquel la société a choisi de se référer, le cas échéant, ou, à défaut, les pratiques de gouvernement d'entreprise mises en place par la loi.[35] Autant de règles dont l'application et/ou la transposition à l'information fiscale est parfaitement envisageable d'un point de vue théorique comme pratique.

Il est aussi certain que si les "parties prenantes" pouvaient plus aisément accéder à l'information fiscale, diverses entités s'y intéresseraient activement: l'administration, bien sûr, mais aussi des organisations à vocation citoyenne se donnant pour objet de guider les consommateurs et les investisseurs vers des entreprises "responsables". Pour ce faire, ces entités pourraient juger utile ou nécessaire de mettre en place des labels ou des certificats censés éclairer le public. En ce sens, on peut citer la proposition par Gérard Philippot dans le journal *Les Echos* du 13 mars 2009, consistant en la création d'un label "SPF": "sans paradis fiscaux". L'auteur suggère que ce label soit accordé aux sociétés qui déclarent solennellement que leurs comptes consolidés ne comportent aucune filiale dans les paradis fiscaux et qu'elles ne font pas de commerce avec ces pays.

En s'efforçant d'imaginer comment une telle idée pourrait être mise en pratique, on pourrait concevoir que ce type de label soit conçu, soit par des organismes ayant une forte légitimité technique et médiatique au niveau

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[33] Cf. art. L. 225-37, al. 6 C. com.

[34] Art. L. 225-235 C. com.

[35] Art. L. 225-37 et L. 225-68 C. com. issus de la loi n° 2008-649 du 3 juillet 2008 portant diverses dispositions d'adaptation du droit des sociétés au droit communautaire (en l'occurrence, la directive n° 2006/46/CE du 14 juin 2006 modifiant les quatrième et septième directives comptables). Les sociétés doivent également se conformer aux dispositions de l'ordonnance visant à transposer la directive 2006/43/CE prise en application de la loi DDAC, relative notamment à l'institution de comités d'audit.

national, soit dans un cadre multilatéral. Ici encore, rien de fantaisiste: l'Organisation internationale pour la normalisation (ISO) a constitué un groupe de travail auquel participent 90 pays représentés par une grande variété de parties prenantes, pour définir une norme internationale utilisable par tous types d'organisations définissant des lignes directrices en matière de responsabilité sociale des entreprises (ISO 26 000). Cette norme n'a pas encore été adoptée mais ses travaux préparatoires font apparaître que "l'engagement sociétal" et les "bonnes pratiques des affaires" constituent deux "questions centrales" examinées par ses auteurs.[36]

Reste à savoir s'il serait envisageable d'aller encore plus loin et de tirer des conséquences, sur le terrain non fiscal, de l'existence de comportements fiscaux non "responsables". Certains le souhaitent. Le rapport précité de la Commission des finances de l'Assemblée nationale n'hésite pas à proposer de restreindre l'accès au marché français des filiales de sociétés mères établies dans des territoires non coopératifs et qui ne respectent pas des normes prudentielles et comptables minimales.[37] Il est vrai qu'ici aussi, il existe des précédents, même si leur caractère comparable prête à discussion. Par exemple, depuis le 1er août 2006, le code des marchés publics prévoit que les objectifs de développement durable deviennent des éléments à prendre en compte autant dans la détermination des besoins à satisfaire (art. 5) que dans les conditions d'exécution d'un marché ou d'un accord-cadre (art. 14).

6.5 Faut-il en arriver là?

Il n'est pas certain que tous les effets fiscaux potentiels de la responsabilité sociale des entreprises se produisent dans la vie réelle. A cela s'ajoute que l'horizon temporel de la réalisation de ces événements est incertain. Il ne semble pas, cependant, que les fiscalistes puissent rester indifférents à ce qui promet malgré tout de constituer une évolution substantielle des pratiques fiscales. Nous croyons au contraire qu'il est de l'intérêt et de la "responsabilité sociale" des spécialistes de droit fiscal de regarder de près tout ceci et d'accompagner ce mouvement. Cette attitude proactive leur permettra, non seulement de participer à une évolution qui ne manquera pas de les affecter, mais aussi d'endiguer les excès prévisibles d'une "hyper-communication" organisée sur le mode de l'indignation morale.[38]

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[36] Cf. sur ce point les précisions fournies sur le site http://www.afnor.org.

[37] Rapport préc., p. 120.

[38] Un exemple de ce qu'il faudrait éviter: stigmatiser comme une déviance intrinsèque la différence entre le taux effectif d'imposition d'un groupe et le taux nominal de l'impôt sur les sociétés français ("Comment les stars du CAC 40 délocalisent leurs impôts", *L'Expansion*, 1er avril 2007; "Dans les cuisines fiscales des entreprises", *Alternatives économiques*, Pratique, n° 41, nov. 2009, etc.). Les économistes savent parfaitement

Une considération théorique, tout d'abord: pour "évaluer" une pratique fiscale, le spectre des appréciations est infini. Le "noir" que constitue la fraude fiscale à l'état pur (à savoir la dissimulation de revenus ou d'activités soumises à l'impôt) existe, bien sûr, mais il ne constitue pas la pratique quotidienne de la plupart des entreprises qui oscille entre le blanc et le gris. En revanche, l'objectif de l'optimisation fiscale et la connexion entre performance fiscale, performance financière et "performance éthique" sont des thèmes sur lesquels une réflexion approfondie s'impose. Faut-il remettre en cause le principe même de la recherche d'économies fiscales? Au nom de quelle morale ou de quelle justice les entreprises seraient-elles censées aller "plus loin" que ce qu'imposent les règles de droit?[39] Ce n'est pas ici le lieu d'une telle réflexion mais celle-ci est indispensable pour que la mise en œuvre de la responsabilité sociale des entreprises dans le champ fiscal repose sur des principes clairs.

Quelques considérations de méthode, ensuite: l'évaluation citoyenne des pratiques fiscales suppose une identification claire des informations pertinentes pour l'évaluation, ce qui ne va pas du tout de soi. Faut-il obliger les entreprises à divulguer, pays par pays, filiale par filiale, établissement par établissement, les impôts qu'elles ont acquittés? De telles informations ont-elles une valeur objective en l'absence de pédagogie et d'explications? Faut-il fournir une information plus fine, prenant en compte le bénéfice avant et après impôt? Les impôts différés doivent-ils faire l'objet de justifications et d'explications approfondies? Ce ne sont que quelques questions parmi mille autres.

A ce problème d'identification de l'information pertinente s'ajoute celui de la hiérarchisation qualitative entre informations.[40] On pourrait par exemple concevoir un modèle dans lequel les entreprises seraient tenues de fournir à leurs actionnaires certaines informations jugées essentielles; en-dehors du champ assigné à cette obligation, elles pourraient également, sur une base spontanée, fournir des informations complémentaires conformément, le cas échéant, à un code de conduite interne. Les entreprises les plus

que les mesures de réduction d'assiette minent le taux effectif. Les juristes relèvent que la loi elle-même encourage à choisir des dispositifs permettant d'alléger la charge fiscale des groupes (le bénéfice mondial pour ne citer que lui). La différence entre taux nominal et taux effectif de l'IS peut donc s'expliquer de multiples façons, certaines tenant à la structure du système fiscal, d'autres à des choix de politique industrielle, d'autres enfin par des montages fiscalement optimisants, lesquels peuvent être licites ou illicites selon les circonstances.

[39] L'OCDE préconise, comme on l'a vu plus haut, le respect de la lettre et de l'esprit de la loi. D'autres organisations vont plus loin et demandent aux entreprises de se demander si leur comportement est non seulement licite mais également "décent, honnête et sincère" (Advertising Standards Authority's Code of Advertising Practice, cité par le rapport de Henderson Global Investors, *Responsible tax,* préc.).

[40] On trouve sur ce sujet d'intéressantes réflexions dans le rapport précité de SustainAbility, *Taxing issues. Responsible business and tax*.

coopératives seraient ainsi distinguées, sans pour autant que les premières ne soient considérées comme les moutons noirs du système économique.

Une telle distinction entre les deux types d'information est délicate à opérer. Soit le cas des prix de transfert, exemple typique d'un domaine extrêmement technique qui présente néanmoins des enjeux politiques et économiques étatiques soulignés, parfois de façon inutilement polémique, par certains auteurs: relèvent-ils des informations dont la connaissance est indispensable à l'actionnaire, l'investisseur ou le consommateur? Si l'on répond positivement, cela veut dire qu'en pratique, il faudrait astreindre les multinationales à formuler des demandes de rescrits tous azimuts et à communiquer, sinon le détail des rescrits obtenus, du moins leur résultat positif et certaines informations essentielles y figurant. Si l'on répond négativement, cela veut dire que seules les entreprises ayant obtenu des rescrits les protégeant contre des redressements futurs pourraient, si elles le souhaitaient, en divulguer l'existence afin d'améliorer leur image fiscale auprès des tiers.

On se contentera d'évoquer sous forme abrégée la suite des interrogations en suspens. A supposer que des organes d'évaluation fiscale extérieurs aux entreprises se mettent en place, quels seraient les acteurs les mieux placés, techniquement et institutionnellement, pour jouer ce rôle? Dans quelle mesure les dispositifs existants en-dehors de la sphère fiscale peuvent-ils servir de source d'inspiration? Comment articuler les obligations de communication à l'égard des parties prenantes et les relations avec les autorités fiscales? Toutes ces questions se posent notamment dans l'hypothèse de la mise en place de labels ou d'un processus de normalisation. Jusqu'à quel point juridique faut-il pousser la stigmatisation des entreprises jugées non responsables? Il y a là une réflexion à la frontière du droit fiscal et du droit pénal. Comment trouver, enfin, le juste équilibre entre la nécessité d'informer les tiers et celle de limiter autant que possible les coûts administratifs potentiellement considérables mis à la charge des sociétés chargées de procéder à la collecte, à la mise en forme et à la communication de l'information?

On l'aura compris, l'heure est davantage aux questions qu'aux réponses, mais cette phase de recherche des solutions est sans doute indispensable pour parvenir à la définition d'une "conception citoyenne de la réalité fiscale," selon l'heureuse formule de Michel Bouvier.[41]

[41] M. Bouvier, *Introduction au droit fiscal général et à la théorie de l'impôt*, LGDJ, 4ème éd., 2001, p. 232.

Chapter 7
Germany

Ulrich Palm

7.1 Legal System

7.1.1 Basic Structural Principles

The Federal Republic of Germany is a constitutional state and a representative parliamentary democracy. It is governed by the rule of law and based on liberal-democratic principles. Its law is predominantly written law. The German constitution, the so-called Basic Law,[1] guarantees in a detailed bill of rights[2] the protection of liberties and equality before the law[3] and establishes a judicial review by independent judges.[4] All public power is committed to the protection and respect of basic rights which are binding as directly applicable law.[5] Human dignity is the fundamental principle of the German constitution.[6] Article 1.1 GG reads: "Human dignity shall be

[1] Grundgesetz für die Bundesrepublik Deutschland [GG] [Basic Law] May 23, 1949, Bundesgesetzblatt [BGBl] I at 1, last amended by Gesetz zur Änderung des Grundgesetzes (Artikel 87d), July 29, 2009, BGBl. I at 2247 (F.R.G.).

[2] See David P. Currie, Lochner *Abroad: Substantive Due Process and Equal Protection in the Federal Republic of Germany*, 1989 SUP. CT. REV. 333, 335 (1989) (comparing the German with the American Bill of Rights).

[3] Art. 1–19 GG (F.R.G.).

[4] Art. 92, 97 GG (F.R.G.).

[5] Art. 1.3 GG (F.R.G.).

[6] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 16, 1957, 6 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 32 (36, 41) (*Elfes*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] July 16, 1969, 27 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 1 (6) (*Mikrocensus*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] June 21, 1977, 45

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inviolable. To respect and protect it shall be the duty of all state authority."[7] In order to understand the meaning of human dignity as the supreme constitutional value enshrined in the Basic Law, it is vital to have a fundamental preconception (Vorverständnis) of this term.[8] In the case-law of the Federal Constitutional Court (FCC), the "personhood" of a human being takes centre stage in a manner that differs from the preconception in the United States' legal tradition.[9] The individual as a person with human dignity in the Basic Law stands for an image of the human being as a responsible individual who can freely develop his personality within society and whose individuality and self-determination must be respected by the state. On the basis of this concept, human beings are not isolated or autonomous individuals. They are involved in and linked with the community.[10]

The German constitution is built upon the idea of parliamentary sovereignty. According to its democratic constitutional order every state action must be democratically legitimized. "All state authority is derived from the people" (Article 20.2 sentence 1 GG). "It shall be exercised by the people through elections and other votes and through specific legislative, executive and judicial bodies" (Article 20.2 sentence 2 GG). The state authority is transferred to separate bodies, the three traditional powers. The balance of powers established by the Basic Law differs from the constitutional allocation of governmental powers in the United States. Instead of a strict separation of structures, it allocates governmental authority from a functional point of view.[11] The Basic Law does not require an absolute separation, but mutual control, inhibition and restraint of power. The most significant difference is that the Chancellor (*Bundeskanzler*) as Head of Government is not directly elected by citizens, but by parliament

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Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 187 (227) (*Lebenslange Freiheitsstrafe*) (F.R.G.); see also Paul Kirchhof, *Die Identität der Verfassung*, in 2 HANDBUCH DES STAATSRECHTS § 21-88, at 261, 309 (Josef Isensee and Paul Kirchhof, eds., 3rd ed. 2004) [hereinafter 2 HANDBUCH DES STAATSRECHTS]; Josef Isensee, *Menschenwürde: die säkulare Gesellschaft auf der Suche nach dem Absoluten*, 131 ARCHIV DES ÖFFENTLICHEN RECHTS [AÖR] 173, 180 (2006) (F.R.G.).

[7] "Die Würde des Menschen ist unantastbar. Sie zu achten und zu schützen ist Verpflichtung aller staatlichen Gewalt."

[8] Ulrich Palm, *Die Person als ethische Rechtsgrundlage der Verfassungsordnung*, 47 DER STAAT 41, 52–55 (2008) (F.R.G.).

[9] Mary Ann Glendon, *Conceptualization of the Person in American Law*, in CONCEPTUALIZATION OF THE PERSON IN SOCIAL SCIENCES 103, 108–110 (The Pontifical Academy of Social Sciences ed., 2006).

[10] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] July 20, 1954, 4 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 7 (15–16) (*Investitionshilfe*) (F.R.G.).

[11] See David P. Currie, *Separation of Powers in the Federal Republic of Germany*, 41 AM. J. COMP. L. 201, 202 (1993).

(*Bundestag*)[12] whose members are representatives of the whole people.[13] However, the distinction made in the constitutional distribution of weights among the three powers is safeguarded. No power shall be deprived of the competencies which are necessary to fulfill its constitutional duties.[14]

The separation of powers is associated with the idea of the rule of law,[15] but it is an independent structural principle of the constitution.[16] Its basic element is the act of parliament. Article 20.3 GG reads: "The legislature is bound by the constitutional order, the executive and the judiciary by law and justice."[17] This rule states the fundamental principle of statutory supremacy (*Vorrang des Gesetzes*). It is the centre of gravity of the separation of powers. "Law" according to Article 20.3 GG is only the parliamentary statute that directly represents the will of the people. The so-called formal laws are enactments which come into existence via a formal legislative procedure, are properly drawn up and promulgated in the Federal Law Gazette (*Bundesgesetzblatt*).[18] Furthermore, the executive is not only restricted to acting within the statutory framework. Various provisions of the Basic Law preclude the executive from acting without statutory authority having recourse to the principle of statutory reservation (*Vorbehalt des Gesetzes*).[19] The constitutional prohibition to act against the law is thereby supplemented by the constitutional order not to act without the law. Especially, any interference with basic rights that is not authorized by parliament which represents its citizens is against the Basic Law. In addition, a statute limiting basic rights has to fulfil certain formal and substantive requirements. It must apply generally and not merely to a single case.[20] The statute must expressly specify any right it intends to limit.[21] In no case may the essence of a basic right be encroached upon.[22] Furthermore, the law has to comply with fundamental maxims like the principle of legal certainty and clarity (*Bestimmtheitsgrundsatz*) and the prohibition on legislation with retrospective effect (*Rückwirkungsverbot*). However, the principle which plays the most pervasive role in the legal practice of the Basic Law is the

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[12] Art. 63.1 GG (F.R.G.).

[13] Art. 38.1 sentence 2 GG (F.R.G.).

[14] Udo Di Fabio, *Gewaltenteilung*, in 2 HANDBUCH DES STAATSRECHTS §§ 27-31-32, at 613, 628–629.

[15] PETER BADURA, STAATSRECHT, § D 47, at 312–313 (3rd ed., 2003).

[16] Udo Di Fabio, *supra* note 13, § 27-4, at 615.

[17] "Die Gesetzgebung ist an die verfassungsmäßige Ordnung, die vollziehende Gewalt und die Rechtsprechung sind an Gesetz und Recht gebunden."

[18] See Art. 76–78, 82 GG.

[19] See *id*. § 26-63-65, at 575–577.

[20] Art. 19.1 sentence 1 GG (F.R.G.).

[21] Art. 19.1 sentence 2 GG (F.R.G.).

[22] Art. 19.2 GG (F.R.G.).

principle of proportionality (*Verhältnismäßigkeitsgrundsatz*).[23] It is not expressly set out in the written text of the constitution, but it is inherent in the rule of law and the nature of the Basic Rights themselves.[24] All in all "[. . .] the Basic Law *does* provide significant protection against legislative infringement of basic rights."[25]

Germany is a federation (Article 20.1 GG) consisting of 16 federal states, each possessing its own constitution, parliament and cabinet. The state governments follow the same pattern as the federal government, with power divided among the executive, legislative and judicial branches. In contrast to a unitary state, the governmental authority in Germany is distributed between the Federation (*Bund*) and the states (*Länder*). Therefore, the classical threefold checks and balances between the various powers is supplemented by vertical separation of powers.[26] The federal principle is crucial for understanding the structure of government and administration in Germany. Also at this point, the separation of powers follows a pattern which is rather functional than structural. The states have tasks, functions and competencies in all three branches, but with different weightings. The *Bund* is primarily responsible for legislation whereas the enforcement of the laws lies mainly with the *Länder*.[27]

The Basic Law defines tasks, functions and competences of five constitutional bodies. *Bundestag* and *Bundesrat* with a special responsibility for legislation, the Federal President (*Bundespräsident*) and the Federal Cabinet (*Bundesregierung*) constituting the executive branch of government and the Federal Constitutional Court (*Bundesverfassungsgericht*) responsible for supreme court decisions.

7.1.2 European Union

A description of the German legal system would be incomplete if it did not take into account that Germany is an integral member of the European Union (EU). The preamble of the Basic Law emphasizes a fundamental commitment to a unified Europe. The openness to European integration

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[23] See DAVID P. CURRIE, THE CONSTITUTION OF THE FEDERAL REPUBLIC OF GERMANY 20 (1994).

[24] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Mar. 5, 1968, 23 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 127 (*Zeugen Jehovas*) (133) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] July 18, 1973, 35 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 382 (400–401) (*Ausländerausweisung*) (F.R.G.).

[25] DAVID P. CURRIE, *supra* note 11, at 20.

[26] See KONRAD HESSE, GRUNDZÜGE DES VERFASSUNGSRECHTS DER BUNDESREPUBLIK DEUTSCHLAND para. 223–233, at 100–102 (20th ed., 1995).

[27] *Id*. para 235, at 104.

is lent concrete shape by the empowerments to integrate into the EU. With its Article 23, the Basic Law grants powers to participate and develop a European Union which is bound by the principles of democracy, the rule of law, federalism and the principle of subsidiarity and that guarantees a level of protection of basic rights essentially comparable to that afforded by this Basic Law. For the purpose of European Integration, Germany may confer sovereign rights. However, European integration may not result in the system of democratic rule in Germany being undermined. The EU is designed as an association of sovereign national states (*Staatenverbund*), not as a federal state.[28]

Nevertheless, European integration is well advanced in many policy areas. The law of the EU is of significant importance to the German legal system. The principle of supremacy states that the EU law prevails in the case of conflict between the provisions of EU law and the provisions of the national law of a member state.[29] The fundamental features of the EU are laid down by the treaties between the Member States which constitute the primary legislation. The treaties set broad policy goals, establish institutions with the necessary legal powers, define responsibilities of the various actors in the decision-making process and determine the legislative procedures in the EU. In addition to the treaties and international agreements the secondary legislation is the third major source of law in the EU. This legislation consists mainly of regulations, directives and decisions adopted by the EU institutions which are binding legal instruments.[30] It is created in a process of interaction between the European Commission, Council and European Parliament. According to the principle of attribution of powers,[31] individual legal acts must be based on actual provisions of the treaties.[32] Furthermore, the use of Union competences is governed by the principles

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[28] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Oct. 12, 1993, 89 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 155 (181) (*Maastricht*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] 2 BvE 2/08, June 30, 2009, 62 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 2267, 2271 (2009) (*Lissabon*) (F.R.G.).

[29] See Case 6/64, Falminio Costa v. E.N.E.L., 1964 E.C.R. 585; 593; C-106/77, Staatliche Finanzverwaltung v. Simmenthal, 1978 E.C.R. 629; C-106/89, Marleasing v. Comercial Internacional de Alimentaction SA., 1991 E.C.R. I-7321.

[30] See Treaty Establishing the European Community, Dec. 24, 2002, Art. 249, 2002 O.J. C 325/33, 132 [hereinafter EC Treaty]; see also, Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, Dec. 13, 2007, Art. 2, § 235 (a) 2007 O.J. C 306/1, 113 [hereinafter Lisbon Treaty]; Consolidated Version of the Treaty on the Functioning of the European Union, May 9, 2008, Art. 288, O.J. C 115/47, 171 [hereinafter TFEU].

[31] See ALEXANDER H. TÜRK, THE CONCEPT OF LEGISLATION IN EUROPEAN COMMUNITY LAW: A COMPARATIVE PERSPECTIVE 72–74 (2006).

[32] EC Treaty Art. 5.1; see also Consolidated Version of the Treaty on the European Union, May 9, 2008, Art. 5.1 sentence 1, O.J. C 115/13, 171 [hereinafter TEU].

of subsidiarity[33] and proportionality.[34] Regulations apply directly in all the Member States, without requiring a national act to transpose them.[35] As soon as they enter into force, they become part of national legal orders. In contrast, directives are at first sight only binding as to the result to be achieved and upon the Member States to whom they are addressed. Their main purpose is to align national legislation. The Member States are left the choice of form and methods to achieve their objectives. An implementing measure by national legislators is required, whereby national law is adapted to the objectives laid down in directives. Finally, decisions are binding in their entirety, but only for those to whom they are addressed. The law of the EU is generally enforced by the Member States which are obligated to adopt all measures of national law necessary to implement legally binding Union acts.[36] The EU itself has only limited powers of enforcement.

7.2 Position of Tax Law

Germany is a constitutional state and as such financed by taxes. The Basic Law guarantees property rights and occupational freedom.[37] Therefore, the Basic Law contains a fundamental statement against a dominant state economy. The financing of the state is principally limited to his participation in the economic success of the private sector.[38] Like other modern industrial states Germany fulfills a large number of political tasks of a social and economic nature. The extent of tasks vested in the respective political system is reflected in the ratio of government expenditures to gross national product (GNP). In Germany, this ratio accounted for 44% in 2008.[39] The significance of contributions for the political system is illustrated by the fact that the ratio of taxes and social contributions to the GNP aggregated

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[33] See ANTONIO ESTELLA DE NORIEGA, THE EU PRINCIPLE OF SUBSIDIARITY AND ITS CRITIQUE 105–131 (2002).

[34] See Takis Tridimas, *Proportionality in Community Law: Searching for the Appropriate Standard of Scrutiny*, in THE PRINCIPLE OF PROPORTIONALITY IN THE LAWS OF EUROPE 65, 65–67 (Evelyn Ellis, ed., 1999).

[35] EC Treaty Art. 5.2, 5.3; see also Treaty on European Union, Dec. 24, 2002, Art. 2.2, 2002 O.J. C 325/5, 11 [hereinafter EU Treaty]; TEU Art. 5.1 sentence 2.

[36] EC Treaty Art. 10; see also TFEU Art. 291.1.

[37] Art. 12, 14 GG.

[38] Paul Kirchhof, *Die Steuern*, in 5 HANDBUCH DES STAATSRECHTS § 118-1-2, at 959, 960–961 (Josef Isensee and Paul Kirchhof, eds., 3rd ed., 2007) [hereinafter 5 HANDBUCH DES STAATSRECHTS].

[39] Bundesministerium der Finanzen, *Monatsbericht des BMF Februar 2009*, 80 (2009) (F.R.G.) (preliminary results of the national accounts), *available at* http://www.bundesfinanzministerium.de/nn_17844/DE/BMF__Startseite/Aktuelles/Monatsbericht__des__BMF/2009/02/inhalt/inhaltsverzeichnis.html (*last visited* Nov. 15, 2009).

in the same period to 40.2%.[40] The ratio of taxes to the GNP amounted to 23.9%.[41] The revenue of direct taxes (290.9 bn. €) was more or less on par with the revenue of indirect taxes (270.9 bn. €).[42] The expenditures of the state are predominantly financed by levying taxes and other contributions. Insofar, taxes give expression to a liberal constitution.[43]

7.2.1 Sources of Tax Law

Like every legal act, the tax statute must be compatible with the Basic Law. Taxes imply an economic burden for the taxpayer. Hence, taxation is an interference with basic rights. The tax burden falls within the scope of the guarantee of the right of property.[44] Due to the *Vorbehalt des Gesetzes*, the tax administration may only act with statutory authority. Tax acts must be formal laws.[45] Federal tax acts must comply with the formal legislative procedure as prescribed in Art. 76–78, 82, 105.3 GG.[46] Otherwise taxation would be unconstitutional. The tax law is based on and requires democratic legitimacy.[47]

Section X of the Basic Law contains the financial constitution which includes two areas, the federal financial system (Art. 104a–108 GG) and the budget system (Art. 109–115 GG). The rules concerning the federal financial system correspond to the reasons for public finance. Articles 104a–104b GG relate to spending competences. Article 105 determines the legislative competences of taxation. Articles 106–107 GG regulates the allocation of tax revenue and yield of fiscal monopolies. Finally, Article 108 GG deals with financial administration and financial courts.

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[40] *Id*. at 83 (preliminary results of the national accounts).

[41] *Id*. at 83 (preliminary results of the national accounts).

[42] *Id*. at 83 (tax revenue Estimate November 2008).

[43] Paul Kirchhof, *Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlagen der Besteuerung* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 8, on file with the author).

[44] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 18, 2006, 115 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 97 (110–112) (*Halbteilungsgrundsatz*) (F.R.G.); see also Paul Kirchhof, *Der Grundrechtsschutz des Steuerpflichtigen – Zur Rechtsprechung des Bundesverfassungsgerichts im vergangenen Jahrzehnt*, 128 ARCHIV DES ÖFFENTLICHEN RECHTS [AöR] 1, 12–16 (2003) (F.R.G.).

[45] See 7.1.1.

[46] See 7.1.1.

[47] Wolfgang Schön, *Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlagen der Besteuerung* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 4, on file with author).

Tax legislation is dominated by the *Bund*. The *Länder* also have legislative power in this field, but it is limited to minor taxes. All taxes with high revenue are based on federal laws. The Basic Law distinguishes between exclusive and concurrent legislative competences. In the first case, the *Länder* have power to legislate only when and to the extent that they are expressly authorised to do so by a federal law,[48] in the second case, as long as and to the extent that the *Bund* has not exercised its legislative power by enacting a law.[49]

The process of enacting a federal tax act is the same as for amending it. Initiatives to enact or amend a federal tax act may be introduced by the *Bundesregierung*, the *Bundesrat* or from the floor of the *Bundestag*.[50] In the field of taxation, most draft bills are introduced by the *Bundesregierung* which disposes of the personnel and institutional resources of the ministry administration. In the case of draft bills from the *Bundesregierung*, the *Bundesrat* is entitled to comment on the draft.[51] The *Bundesregierung* tables its response in a counter-statement. The draft bill is then submitted to the *Bundestag* along with above-said opinions. The *Bundestag* generally examines draft legislation in three readings (*Lesungen*). At the end of the first *Lesung*, the draft bill is sent to one or more committees. The second and third *Lesung* follow after deliberations in the committees. The second *Lesung* mainly involves tabling amendments, while the final vote is generally taken during the third *Lesung*.

After adoption by the *Bundestag*, the bill is forwarded to the *Bundesrat*. The scope for a *Bundesrat* intervention depends on whether the bill requires *Bundesrat's* consent[52] which is the most common case in the field of taxation. Especially, federal laws relating to the joint taxes require the consent of the *Bundesrat*.[53] In that case the *Bundestag* and the *Bundesregierung* may also demand that a mediation committee (*Vermittlungsausschuss*) be convened.[54] In its meetings the committee strives to reach a consensus between the divergent opinions. It may propose amendments to the bill. If the political majorities in the *Bundestag* and in the *Bundesrat* differ, the committee will be of particular importance.[55] In this case, tax reforms require the approval of the major political parties.

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[48] Art. 71 GG.

[49] Art. 72. 1 GG.

[50] Art. 76.1 GG

[51] See Art. 76.2 GG.

[52] See above in this section.

[53] See above in this section.

[54] Art. 77.2 sentence 4 GG.

[55] See Ulrich Palm, *Demokratie mit parlamentarischer Gesetzgebung*, 27 NEUE ZEITSCHRIFT FÜR VERWALTUNGSRECHT [NVwZ] 633, 633 (2008) (F.R.G.).

Once the *Bundesrat* has approved a bill or refrained from submitting an objection, or if its objection is overturned by the *Bundestag*,[56] the bill must then be counter-signed by the minister in charge and the *Bundeskanzler*,[57] duly authorized by the *Bundespräsident* and promulgated in the *Bundesgesetzblatt*.[58]

The major tax acts are accompanied by ordinances (*Rechtsverordnungen*). They are enactments passed by the executive. They require an authorization which specifies content, purpose and scope by formal law.[59] The legal basis must be stated in the *Rechtsverordnung*.[60] The essential legal conditions necessary for tax to become chargeable have to arise from formal law. For that reason, ordinances include only detailed and provisional rules. *Rechtsverordnungen* are created by the *Bundesregierung*, a *Bundesminister* or a *Landesregierung* which may delegate the authorization further by *Rechtsverordnung*.[61] In the field of taxation, *Rechtsverordnungen* are mainly adopted by the *Bundesregierung* or the Federal Finance Minister (*Bundesfinanzminister*).[62]

7.2.2 European Union Law

The legislative competences of the EU in taxation are, compared to other fields of law, not extended. Nevertheless, the influence of European law on the national tax law is constantly increasing. This particularly concerns the harmonisation of indirect taxation in the EU which is a necessity for the functioning of the internal market. The Treaty on the Functioning of the European Union ("TFEU") contains some provisions on harmonization in indirect taxation. Articles 110–113 TFEU[63] concern indirect taxes. Under Article 113 TFEU,[64] the Council is required to adopt measures for the harmonisation of turnover taxes, excise duties and other indirect taxes where necessary to ensure the establishment and functioning of the internal market and to avoid distortion of competition. On this legal basis, the Council may adopt regulations as well as directives. For the most part, the field of direct taxation is not directly regulated by European legislation.

[56] See Art. 78 GG.

[57] See Art. 58 sentence 1 GG.

[58] Art. 82.1 sentence 1 GG.

[59] Art. 80.1 sentence 2 GG.

[60] Art. 80.1 sentence 3 GG.

[61] Art. 80.1 sentence 4 GG.

[62] Joachim Lang, *Rechtsanwendung im Steuerrecht*, in STEUERRECHT § 5-6, at 140 (Klaus Tipke and Joachim Lang, eds., 20th ed., 2009).

[63] Ex Art. 90–93 TEC.

[64] Ex Art. 93 TEC.

Direct taxes are not even mentioned as such at any site. Therefore, the general harmonisation provisions are the only legal basis for harmonisation of direct taxation. Measures in this field are generally taken on the basis of Article 115 TFEU[65] covering measures to prevent distortions of the market. Nevertheless, several directives and the jurisprudence of the European Court of Justice (ECJ) establish harmonised standards for corporate tax and income tax. Moreover, communications and guidelines emphasise the concern to prevent tax evasion and double taxation within the EU.

7.2.3 Case Law

The decisions of the Federal Finance Court (*Bundesfinanzhof*) and the Finance Courts (*Finanzgerichte*) represent an important source of statutory interpretation in the field of taxation. They are binding only to the participating parties, but are regarded as precedents. Since the administration includes the most important decisions of the *Bundesfinanzhof* in its guidelines they have widespread impact.

7.2.4 General Tax Code

But the most significant German Tax Code is the General Tax Code (*Abgabenordnung*)[66] which is the fundamental law of taxation in Germany and contains rules concerning tax definitions, rules of origin and taxation procedure. Furthermore, the code determines the development and satisfaction of tax liabilities, the out-of-court legal remedies as well as tax offences and criminal prosecution in tax matters. The *Abgabenordnung* fundamentally applies to all taxes and tax refunds which are regulated by federal law or the law of the EU and administered by the federal and state fiscal authorities. Together with the Tax Court Code (*Finanzgerichtsordnung*),[67] the Tax Administration Act (*Finanzverwaltungsgesetz*)[68] and the

[65] Ex Art. 95 TEC.

[66] Abgabenordnung [AO] [General Tax Code] Mar. 16, 1979, BGBl. I at 613, newly collected by announcement of Oct. 1, 2002, BGBl. I at 3866; 2003 I at 61, last amended by Gesetz, July 30, 2009 BGBl. I at 2474, Art. 2 (F.R.G.).

[67] Finanzgerichtsordnung [FGO] [Tax Court Code] Oct. 6, 1965, BGBl. I at 1477 newly collected by announcement of Mar. 28, 2001, BGBl. I at 442, 2262, last amended by Gesetz, July 30, 2009 BGBl. I at 2449, Art. 6.

[68] Finanzverwaltungsgesetz [FVG] [Tax Administration Act] Aug. 30, 1971, BGBl. I newly collected by announcement of Apr. 4, 2006, BGBl. I at 846, 1202, last amended by Gesetz, Aug. 10, 2009 BGBl. I at 2702, Art. 6.

Valuation Tax Act (*Bewertungsgesetz*),[69] the *Abgabenordnung* forms the general part of the German tax law.

7.2.5 Revision of Tax Law

The German tax law, especially the law of taxation of proceeds, is contradictory and scattered throughout many sources. Problems of inconsistency, redundancy, and ambiguity render the German tax law overly complicated. An example may illustrate this. Section 52 of the Income Tax Code which only bears upon the temporal scope of the individual provisions of the Code has more than 80,000 letters, four times the length of the whole financial constitution. The provision has grown in the last 5 years by more than 50%.[70] Section 52a of the Income Tax Code which regulates the temporal scope of the new definitive withholding tax on capital gains has already 10,000 letters. One reason for this disturbing and alarming development is the ever increasing number of new anti-avoidance rules.[71] The legislator attempts to cater for every situation and employs targeted anti-avoidance rules (TAARs) which are regularly byzantine, hard to understand and difficult to apply.[72] The ideal of justice in the field of taxation has been lost.[73] Due to their complexity and contradictoriness, German tax laws are often revised. Over the last 7 years, the *Einkommensteuergesetz* has been amended almost 10 times a year. In the same period, the *Körperschaftsteuergesetz* has been revised more than 20 times. Sometimes, a tax code is revised before its last amendment has entered into force.[74]

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[69] Bewertungsgesetz [BewG] [Valuation Tax Act] Oct. 16, 1934, BGBl. I newly collected by announcement of Feb. 1, 1991, BGBl. I at 230, last amended by Gesetz, Dec. 24, 2008 BGBl. I at 3018, Art. 2.

[70] See Ulrich Palm, *Finanzgerichtsbarkeit und Verfassungsgerichtsbarkeit*, in BUNDESVERFASSUNGSGERICHTSGESETZ – MITARBEITERKOMMENTAR UND HANDBUCH, margin note 3, at 58, 60 (Dieter C. Umbach et al., eds., 2nd ed., 2005).

[71] See Johanna Hey, *Spezialgesetzliche Missbrauchsgesetzgebung aus steuersystematischer, verfassungs- und europarechtlicher Sicht*, 85 STEUER UND WIRTSCHAFT [STUW] 167, 167–168 (2008) (F.R.G.).

[72] See Johanna Hey, *Spezialgesetzgebung und Typologie zum Gestaltungsmissbrauch* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 1–2, on file with the author).

[73] See Paul Kirchhof, *Die freiheitliche Struktur der Steuerrechtsordnung – Ein Verfassungstest für Steuerreformen*, 83 STEUER UND WIRTSCHAFT [STUW] 3, 3 (2006) (F.R.G.).

[74] See Ulrich Palm, *supra* note 70, margin note 3, at 60.

7.3 Enforcement of Tax Laws

The financial administration competence is split between *Bund* and *Länder*. Customs duties, fiscal monopolies, taxes on consumption regulated by a federal law and levies applicable within the framework of the European Communities are administered by federal finance authorities.[75] The Federal Ministry of Finance (*Bundesfinanzministerium*) is the supreme authority of the Federal Revenue Administration. Subordinate to it are various senior authorities which perform specific functions for which central government is responsible.[76] All other taxes are administered by the financial authorities of the *Länder*.[77] State tax authorities comprise the state ministries of finance (*Landesfinanzministerium*) as the supreme authorities, regional tax offices (*Oberfinanzdirektionen*) as medium-level authorities and tax offices (*Finanzämter*) as local authorities.[78] Taxes are principally administered by the tax offices, except for taxes whose administration has been transferred to the municipalities.[79] To the extent that taxes accrue to the *Bund* at least partially,[80] the federal finance authorities act on federal commission.[81]

7.3.1 Assessment of Tax

Section 3.1 AO defines the term "taxes" as payments of money, other than payments made in consideration of the performance of a particular activity, which are collected by a public body for the purpose of raising revenue and imposed by this body on all persons to whom the characteristics on which the law bases liability for payment apply; the raising of revenue may be a secondary objective. Pursuant to Section 38 AO, claims arise from the tax debtor-creditor relationship as soon as the matter to which the law attaches liability for payment has occurred. Therefore, the tax is not based on the notice of assessment, but directly by operation of statute.[82]

Nevertheless, pursuant to Section 155.1 sentence 1 AO, taxes are assessed by the revenue authority by way of tax assessment notice, unless prescribed otherwise. The assessment is the first step of actually collecting

[75] Art. 108.1 sentence 1 GG.
[76] See § 4, 5 FVG.
[77] Art. 108.2 sentence 1 GG.
[78] See § 2.1 FVG.
[79] See Art. 108.4 sentence 2 GG.
[80] See 7.2.1.
[81] Art. 108.3 sentence 1 GG, see also Art. 85 GG.
[82] DIETER BIRK, STEUERRECHT para 254, at 75 (12th ed., 2009).

the tax that is due. Tax assessment notices are principally issued in writing.[83] They identify the type and amount of the assessed tax and indicate the person owing the tax.[84] An assessment of the tax by tax assessment notice is principally not required where a tax has to be self-assessed as a result of a statutory obligation.[85] In this case, the taxpayer shall calculate the tax and the tax return himself.[86] Such a self-assessment is especially provided for the VAT[87] and the insurance tax.[88] In this context, the revenue authority assesses the tax by tax assessment notice only where the assessment leads to a divergent tax or the persons owing the tax or liability do not submit the self-assessed tax return.[89]

The obligation to submit a tax return is determined by the individual tax codes.[90] Corporate income tax returns must be filed once a year with the tax office of the district in which the company has its place of management.[91] The general deadline is 31 May of the calendar year following the tax year concerned.[92] An entrepreneur is legally obliged to keep accounts.[93] The fiscal determination of profits is, in principle, conducted by way of operating assets comparison.[94]

7.3.2 Tax Controversies

Objection to administrative acts in fiscal matters to which the *Abgabenordnung* applies is admissible as a means of legal remedy.[95] Fiscal matters are all matters connected to the administration of taxes including tax refunds or matters otherwise connected with the application of tax

[83] See § 157.1 sentence 1 AO.

[84] § 157.1 sentence 2 AO; see Roman Seer, *§ 155 AO*, in ABGABENORDNUNG FINANZGERICHTSORDNUNG – KOMMENTAR ZUR AO UND FGO, margin note 18, at 5 (Klaus Tipke and Heinrich W. Kruse, eds., looseleaf, 121. Lief. Oct. 2009).

[85] § 167.1 sentence 1 AO.

[86] § 150.1 sentence 3 AO.

[87] § 18 UStG.

[88] § 8 VersStG.

[89] § 167.1 sentence 1 AO.

[90] § 149.1 sentence 1 AO.

[91] § 149.1 sentence 1 AO, § 31.1 KStG, § 25.3 EStG.

[92] § 149.2 sentence 2 AO.

[93] § 140 AO, Handelsgesetzbuch [HGB] [Commercial Code] May 10, 1897, RGBl. I at 219 in the adjusted version published in Bundesgesetzblatt Teil III, Gliederungsnummer 4100-1, last amended by Gesetz, July 31, 2009 BGBl. I at 2512, Art. 6a, § 238.1 sentence 1, §§ 1–7 (F.R.G.).

[94] See §§ 4.1, 5.1 EStG, §§ 7.1, 7.2, 8.1 sentence 1 KStG.

[95] § 347.1 sentence 1 AO

and excise provisions by the revenue authorities.[96] Only the party asserting to have been aggrieved by an administrative act or the omission thereof is authorized to lodge an objection.[97] An objection must be lodged within 1 month after notice of the administrative act.[98] An objection against a self-assessed tax return must be lodged within 1 month of the revenue authority receiving the self-assessed tax return.[99] The submission of an objection has mostly not the effect of blocking implementation of the disputed administrative act,[100] but the revenue authority concerned may suspend implementation in whole or in part.[101]

The legal aid procedure in tax matters is divided in out-of-court remedy on the one hand and remedy by legal process on the other which are regulated in the *Abgabenordnung* and in the *Finanzgerichtsordnung*.

The out-of-court remedy for all kinds of taxes is the so-called objection (*Einspruch*). The revenue authority which has issued the administrative act takes a decision on the *Einspruch* by means of an objection ruling.[102] The out-of-court remedies do not serve only as legal aid for the taxpayer, but also allows the revenue authority to check its decisions without introducing or instigating a procedure with the *Finanzgericht*. Last, but not least, the objection procedure contributes to taking the burden off the courts.[103]

The revenue authority ruling on the *Einspruch* re-examines the matter in its entirety.[104] The administrative act may also be amended to the detriment of the appellant where he has been instructed of the possibility of a detrimental ruling stating the reasons, and he has been given the opportunity to respond.[105] An objection ruling shall only be required to the extent that the revenue authority does not remedy the *Einspruch*.[106] The objection ruling is issued in writing and is substantiated. It contains advice on applicable legal remedies and is disclosed to the participants.[107] Participant in the procedure is whoever has submitted the *Einspruch* and whoever has been enlisted in the procedure by the revenue authority.[108] Where third

[96] § 347.2 AO.

[97] § 350 AO.

[98] § 355.1 sentence 1 AO.

[99] § 355.1 sentence 2 AO.

[100] § 360.1 sentence 1 AO.

[101] § 360.1 sentence 1 AO.

[102] § 367.1 sentence 1 AO.

[103] See Roman Seer, *Rechtsschutz in Steuersachen*, in STEUERRECHT § 22-9, at 1069, 1071 (Klaus Tipke and Joachim Lang, eds., 20th ed., 2009).

[104] § 367.2 sentence 1 AO.

[105] § 367.2 sentence 2 AO.

[106] § 367.2 sentence 3 AO.

[107] § 366 AO, see also § 55 FGO.

[108] § 359 AO.

parties are involved in the contentious legal relationship in such a way that a ruling can only be taken in a uniform manner in relation to them as well, they must be enlisted in the proceedings.[109] An *Einspruch* which is lodged after the deadline is incontestable. It is rejected whether it is lawful or not, except if it is very gravely erroneous as is apparent when all relevant circumstances are duly considered.[110] In this case, the taxpayer may apply under certain conditions for a correction of the assessment based on other provisions of the *Abgabenordnung*.

Pending objections which affect a crucial legal issue ruled on by the ECJ, the *Bundesverfassungsgericht*, or the *Bundesfinanzhof* and which cannot be remedied before these courts following the outcome of the proceedings may only be withdrawn by way of general order.[111] The highest revenue authority has subject-matter jurisdiction over the issue of the general order.[112]

As in other cases of administrative legal aid, the citizen can, if his preliminary *Einspruch* was not successful, claim his rights in a legal procedure. The taxpayer has the possibility of starting proceedings before the *Finanzgericht* within 1 month after he has received the objection ruling of the *Finanzamt*.[113] If the court decides against the taxpayer, he may start proceedings before the *Bundesfinanzhof*[114] which is the tax court of last instance. The *Bundesfinanzhof* reviews the judgments of the *Finanzgerichte* regarding the legitimate application of federal law, in exceptional cases also of the law of the *Länder*.[115]

The *Bundesfinanzhof* has established eleven senates with a total of 61 judges.[116] Regularly each senate is staffed with a presiding judge and four judges. In cases of adjudication, the senates decide by five judges, decisions outside the oral proceedings are being taken by the presiding judge and two other judges.[117] At the *Bundesfinanzhof* a Large Senate (*Großer Senat*) has been established[118] which is a division, created to harmonize the rulings within the court. Its members are the court's president and one judge of each senate not chaired by the president.[119] The *Große Senat* decides in those cases in which one senate wants to deviate from the adjudication of

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[109] § 360.3 sentence 1 AO.
[110] See § 125.1 AO.
[111] § 367.2b sentence 1 AO.
[112] § 367.2b sentence 2 AO.
[113] § 47.1 sentence 1 FGO.
[114] See § 115.1, § 128 FGO.
[115] § 118.1 FGO.
[116] See § 10.2 FGO.
[117] § 10.3 FGO.
[118] § 11.1 FGO.
[119] § 11.5 FGO.

another.[120] Furthermore, cases of fundamental importance can be brought before the *Große Senat*.[121]

The appeal on a point of law before the *Bundesfinanzhof* can only be raised if leave to appeal has been granted by the *Finanzgericht*. It may be also granted by the *Bundesfinanzhof* itself following an appeal against denial of leave to appeal.[122] This presupposes that the case is of fundamental legal significance, the case law or the consistency of the jurisdiction make a decision by the *Bundesfinanzhof* necessary or a procedure error has been asserted on which the appealed judgment might be based.[123]

As an appellate court, the *Bundesfinanzhof* exclusively decides upon points of law[124] whereas the finding of the facts concerning the merits of a case has to be made by the *Finanzgerichte* as courts of first instance. Generally, the *Bundesfinanzhof* is bound by their findings of facts.[125] It refers the case back to the *Finanzgericht* if not all essential facts concerning the merits of the case are ascertained.[126]

The decisions of the *Bundesfinanzhof*, however, may be taken to the *Bundesverfassungsgericht* by constitutional complaint (*Verfassungsbeschwerde*) which can only be based on violations of basic rights.[127]

The revenue authority ruling on the *Einspruch* re-examines the matter in its entirety.[128] This means that the revenue authority reviews the tax assessment notice on its lawfulness as well as on its expedience.[129] In contrast, the *Finanzgericht* only reviews the lawfulness of the administrative act.[130] The burden of proof is not explicitly stated in German tax law. The fiscal jurisprudence shares the burden of proof between the taxpayer on the one hand and the revenue authority on the other according to the spheres of responsibility.[131] Generally, the revenue authority must

[120] §§ 11.2, 11.3 FGO.

[121] § 11.4 FGO.

[122] § 115.1 FGO.

[123] § 115.2 FGO.

[124] See § 118.1 FGO.

[125] § 118.2 FGO.

[126] See § 126.3 no. 2 FGO.

[127] Art. 93.1 no. 4a GG; Bundesverfassungsgerichtsgesetz [BVerfGG] [Federal Constitutional Court Act] Mar. 12, 1951, BGBl. I at 243, newly collected by announcement of Aug. 11, 1993, BGBl. I at 1473, last amended by Gesetz, July 29, 2009 BGBl. I at 2346, Art. 2, §§ 13 no. 8a, 23, 90–95 (F.R.G.).

[128] § 367.2 sentence 1 AO.

[129] See Roman Seer, *supra* note 103, § 22–33, at 1069, 1076.

[130] See § 100.1 sentence 1, 101, 102 FGO

[131] Bundesfinanzhof [BFH] [Federal Fiscal Court] Oct. 17, 2001, 197 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 68 (F.R.G.); see Roman Seer, *§ 96 FGO*, *supra* note 84, margin note 78–94, at 78-26/2.

prove the taxable event and the tax-increasing circumstances whereas the taxpayer must provide evidence for all tax-reducing circumstances.[132]

The procedure before the fiscal courts is governed by the constitutional guarantee of complete and effective judicial protection.[133] The *Finanzgericht* determines the facts of the case ex officio.[134] Therefore, the *Finanzgericht* is obliged to investigate the truth without being bound by the evidence presented by the parties.[135] It has control of the cause of litigation. The *Finanzgericht* decides according to its free conviction formed from the overall result of the proceedings.[136]

7.4 Tax Mitigation, Tax Avoidance, and Tax Evasion

At first sight, defining “tax mitigation” (*Steuergestaltung*), “tax avoidance” (*Steuerumgehung*) and “tax evasion” (*Steuerhinterziehung*) seems to be an easy task.[137] All three terms have in common that they describe a situation in which the taxpayer attempts to reduce the tax payable. Decreasing the tax burden is neither punishable nor illegal, but within the taxpayer’s scope of freedom. He is free to mitigate his liability to tax, as the *Bundesverfassungsgericht* states in its early case law.[138] In a recent judgment, the Court even referred to the possibility of tax mitigation to justify the constitutionality of a specific tax provision.[139] As opposed to tax mitigation, tax avoidance is characterized by abuse.[140] Tax evasion, in contrast, is an illegal means of reducing the tax payable. Tax avoidance as such is neither prohibited nor punishable as long as the tax payer does not, in

[132] See Roman Seer, *supra* note 103, § 22–191, at 1069, 1114.

[133] See Art. 19.4 GG.

[134] § 76.1 sentence 1 FGO.

[135] § 76.1 sentence 5 FGO.

[136] See 81.1 FGO.

[137] See Victor Thuronyi, *Tax Aspects of Offshore Financial Centers*, in 2 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 263, 27576 (International Monetary Fund ed., 2003).

[138] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Apr. 14, 1959, 9 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 237 (250) (*Ehegatten-Mitwirkungsverträge*) (F.R.G.).

[139] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 15, 2008, 120 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 1 (52-53) (*Abfärberegelung*) (F.R.G.); but see Wolfgang Schön, *supra* note 47 (manuscript at 12).

[140] Johanna Hey, *supra* note 71, at 169; Klaus-Dieter Drüen, *§ 42 AO*, margin note 4, at 136/16, 136/18 in ABGABENORDNUNG FINANZGERICHTSORDNUNG – KOMMENTAR ZUR AO UND FGO (Klaus Tipke and Heinrich W. Kruse, eds., looseleaf, 121. Lief. Oct. 2009).

violation of his duties, provide any inaccurate or incomplete information to the revenue authorities. Generally, only the disguising of tax avoidance is punishable.[141]

7.4.1 *Role of Abuse*

On the face of it, the three terms seem to be clearly defined. However, it is hardly feasible to draw clear lines between them. Aggressive tax planning is a tightrope walk which can result in the opposite or even lead into illegality.[142] The distinction between tax avoidance and tax evasion has been increasingly blurred, at least by the revenue authorities. Tax avoidance has a broad economic and social-ethical dimension.[143] Some consultants consider their work as an intellectual challenge,[144] but the breach of social contract in the case of tax avoidance[145] is seen by tax officials as criminal behaviour. Furthermore, clear differences between tax mitigation and tax avoidance are even more difficult to discern. Defining tax avoidance with the element of abuse still begs the question as to what kind of abuse should be acted upon. An inexact legal concept is defined by a vague legal term. The same applies to the definition of "inappropriate" for the path that the taxpayer chooses to reduce the tax burden.[146] An unknown is replaced by another unknown.[147] At this level of abstraction, we do not know what is reasonable and what is not. Hardly any provision is being abused more than

[141] Bundesfinanzhof [BFH] [Federal Fiscal Court] Feb. 1, 1983, 138 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 4 (F.R.G.); Peter Fischer, *§ 42 AO*, margin note 56, at 46 in HÜBSCHMANN/HEPP/SPITALER ABGABENORDNUNG/FINANZGERICHTSORDNUNG – KOMMENTAR (looseleaf, 204. Lief. Oct. 2009).

[142] See Tina Ehrke-Rabel and Georg Kofler, *Gratwanderungen – Das Niemandsland zwischen aggressiver Steuerplanung, Missbrauch und Abgabenhinterziehung* in 62 ÖSTERREICHISCHE STEUERZEITUNG [ÖSTZ] 456, 456 (2009) (Austria).

[143] Markus Heintzen, *Die Neufassung des § 42 AO und ihre Bedeutung für grenzüberschreitende Gestaltungen*, 63 FINANZ-RUNDSCHAU [FR] 599, 605 (2009) (F.R.G.).

[144] See Hendrik Jacobsen, *Die Suche nach steuerlicher Gestaltung*, 63 FINANZ-RUNDSCHAU [FR] 162 (2009) (F.R.G.).

[145] See RACHEL ANNE TOOMA, LEGISLATING AGAINST TAX AVOIDANCE 14–15 (2008).

[146] See Bundesfinanzhof [BFH] [Federal Fiscal Court] Nov. 29, 1982, 137 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 433 (F.R.G.); Johanna Hey, *supra* note 71, at 169.

[147] Paul Kirchhof, *Steuerumgehung und Auslegungsmethoden*, 60 STEUER UND WIRTSCHAFT [STUW] 173, 176 (1983) (F.R.G.).

a rule against abuse.[148] Tax avoidance is a major problem of German tax law, known for centuries, but still urgent and unsolved.[149]

7.4.2 Need for Guidance

The previous version of the German general anti-avoidance rule also fell back on the concept of "abuse." Section 42.1 sentence 1 AO read: "It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes."[150] The term "abusing" was initially not defined by law. Therefore, the rule was mainly shaped by the jurisprudence of the *Bundesfinanzhof*. The *Große Senat* of the *Bundesfinanzhof* noted that the mere motive to reduce taxes does not lead to an inappropriate legal construction.[151] In its rulings, the *Bundesfinanzhof* considered tax planning as tax avoidance when the tax payer chose a legal construction which was inappropriate in view of the objective pursued, it involved a lower tax cost and could not be justified on the basis of business or other considerable nontax reasons.[152]

The interpretation of the GAAR by the court was regarded as restrictive.[153] The case law of the *Bundesfinanzhof* varied from one senate to another. The 5th Senate rejected any subjective element[154] whereas the 1st and the 3rd Senate held that not only a deliberate attempt, but also the intent to avoid taxes must be proved.[155] The legislature took the view

[148] Paul Kirchhof, supra note 43 (manuscript at 15).

[149] Paul Kirchhof, supra note 43 (manuscript at 2–5); Lutz Diwell, *Das Steuerrecht als permanente Herausforderung für den Gesetzgeber*, 46 DEUTSCHES STEUERRECHT [DSTR], Supplement of issue 17, at 7 (2008) (F.R.G.).

[150] "Durch Missbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden."

[151] Bundesfinanzhof [BFH] [Federal Fiscal Court] Nov. 29, 1982, 137 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 433 (F.R.G.).

[152] Bundesfinanzhof [BFH] [Federal Fiscal Court] Aug. 29, 2007, 219 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 32 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Dec. 17, 2003, 205 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 70 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Jan. 16, 1996, 179 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 400 (F.R.G.); see also Michael Wendt, *§42 AO vor dem Hintergrund der Rechtsprechung* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 2, on file with the author).

[153] See Georg Crezelius, *Kodifizierte und rechtsprechungstypisierte Umgehungen*, 72 STEUER UND WIRTSCHAFT [STUW] 313, 315 (1995) (F.R.G.).

[154] Bundesfinanzhof [BFH] [Federal Fiscal Court] Feb. 23, 1989, 155 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 503 (F.R.G.).

[155] Bundesfinanzhof [BFH] [Federal Fiscal Court] Feb. 5, 1992, 166 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 356 (F.R.G.); Bundesfinanzhof [BFH]

that there was need for a more accurate and effective rule[156] and, in 2007, introduced a legal definition of tax abuse in the Annual Tax Act 2008 (*Jahressteuergesetz 2008*)[157] which under Section 42.2 AO reads as follows:

> [1]An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. [2]This shall not apply where the taxpayer provides evidence of nontax reasons for the selected option which are relevant when viewed from an overall perspective.[158]

The provision supersedes the definition of abuse given by the rulings of the *Bundesfinanzhof*. The case law to the former version of the GAAR may only be used as a guide to interpret the legal definition.[159] The new GAAR is not considered as the last word in wisdom. If an abuse is deemed to exist, it may not lead to tax advantages, except in cases where the provision does not apply.[160] Most of all, however, Section 42 defines abuse by the vague legal term of "inappropriate" (*unangemessen*). What is an "inappropriate" legal option and what is an "appropriate" one? The financial jurisdiction has not yet found a consistent definition of "inappropriateness" for any of the versions of the GAAR.[161] Despite major efforts, the academic discussion has not been able to develop reasonable standard criteria for inappropriateness.[162] The attempts by the *Bundesfinanzhof* and literature in defining "inappropriate" have not been convincing[163] or, at least, have not yet gained broad acceptance. It is increasingly recognized that a GAAR could not have a separate standard definition. Tax avoidance

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[Federal Fiscal Court] Mar. 18, 2004, 205 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 470 (F.R.G.).

[156] BTDrucks 16/6290, at 81 (F.R.G.).

[157] Jahressteuergesetz 2008 [JStG 2008] [Annual Tax Act 2008] Dec. 20, 2007, Bundesgesetzblatt [BGBl] I at 3150, 3171, Art. 14 no. 2 (F.R.G.).

[158] "Ein Missbrauch liegt vor, wenn eine unangemessene rechtliche Gestaltung gewählt wird, die beim Steuerpflichtigen oder einem Dritten im Vergleich zu einer angemessenen Gestaltung zu einem gesetzlich nicht vorgesehenen Steuervorteil führt. Dies gilt nicht, wenn der Steuerpflichtige für die gewählte Gestaltung außersteuerliche Gründe nachweist, die nach dem Gesamtbild der Verhältnisse beachtlich sind."

[159] Michael Wendt, *supra* note 152 (manuscript at 2–3); see also ROLF EICKE, TAX PLANNING WITH HOLDING COMPANIES – REPATRIATION OF US PROFITS FROM EUROPE 309 (2009).

[160] Michael Wendt, *supra* note 152 (manuscript at 3).

[161] *Id*. (manuscript at 3–4).

[162] See Peter Fischer, *supra* note 141, margin note 88–104, at 66–77; Klaus-Dieter Drüen, *Unternehmerfreiheit und Steuerumgehung*, 85 STEUER UND WIRTSCHAFT [STUW] 154, 162 (2008) (F.R.G.).

[163] See Peter Fischer, *Überlegungen zu § 42 AO i.d.F. des JStG 2008*, 62 FINANZ-RUNDSCHAU [FR] 306, 307 (2008) (F.R.G.).

is a sub-category of the abuse of law.[164] In contrast to the general abuse of law, the aggrieved party is not a private person, but the state with its legislative power, if taxes are avoided.[165] The problem of tax avoidance arises where the grammatical interpretation of the elements of a tax ends and the systematic and teleological interpretation of the tax law begins.[166] Therefore, inappropriateness can only be defined in the context of the provisions intended to be avoided.[167] It must be determined normatively and not empirically.[168]

Furthermore, the term "tax advantages" which has been included within the definition of tax abuse is also contained in the legal definitions of tax evasion and of tax offences. The distinction between tax avoidance and tax evasion is being increasingly blurred not only by the revenue authorities, but also by the legislator.[169]

7.4.3 Examples of Abusive Transactions

The following specific examples of application of Section 42 AO show how the rule has been interpreted by the *Bundesfinanzhof*.[170] The rulings concern the old version of Section 42 AO as the *Bundesfinanzhof* has not yet decided a case to which the new version applies.

A typical case of tax avoidance is the so-called chain donation (*Kettenschenkung*).[171] To benefit from tax allowances, a father transfers

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[164] Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 19, 1980, 130 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 422 (F.R.G.); Klaus-Dieter Drüen, supra note 140, margin note 1, at 136/17–136/18.

[165] Albert Hensel, *Zur Dogmatik des Begriffs "Steuerumgehung"*, in BONNER FESTGABE FÜR ERNST ZITELMANN ZUM FÜNZIGJÄHRIGEN DOKTORJUBILÄUM 217, 230 (1923).

[166] Paul Kirchhof, *supra* note 147, at 174.

[167] Paul Kirchhof, supra note 38, margin note 34-38, at 977-980; SUSANNE SIEKER, UMGEHUNGSGESCHÄFTE 29 (2001); Heinrich WEBER-GRELLET, STEUERN IM MODERNEN VERFASSUNGSSTAAT 222-24 (2001); Klaus-Dieter Drüen, *supra* note 162, at 159-60, 162; Markus Heintzen, *supra* note 143, at 603; Johanna Hey, *Gestaltungsmissbrauch im Steuerrecht nach der Neufassung des § 42 AO und dem dazu ergangenen BMF-Erlass*, 64 BETRIEBS-BERATER [BB] 1044, 1044 (2009) (F.R.G.); Steffen Neumann, *Steuergestaltung aus der Sicht der Verwaltungspraxis* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 10, on file with the author).

[168] See BTDrucks 16/7036, at 24 (F.R.G.); see also Johanna Hey, supra note 167, at 1044.

[169] See Klaus-Dieter Drüen, *supra* note 162, at 162.

[170] See for more examples Klaus-Dieter Drüen, supra note 140, margin note 55–103, at 149–163; VICTOR THURONYI, COMPARATIVE TAX LAW 192-93 (2003); Wolfgang Schön, *Statutory Avoidance and Disclosure Rules in Germany*, in BEYOND BOUNDARIES – DEVELOPING APPROACHES TO TAX AVOIDANCE AND TAX RISK MANAGEMENT 47, 50 (Judith Freedman, ed., 2008).

[171] See HEINRICH WILHELM KRUSE, 1 LEHRBUCH DES STEUERRECHTS 147 (1991).

one portion of his property directly to his children and another portion to his spouse who likewise transfers it to the children. If the second donation to the children is based on the father's will, Section 42 AO applies.[172]

Furthermore, the planned acquisition of two properties of equal value combined with their reciprocal leasing while claiming income-related expenses is an abusive transaction.[173] In contrast to this ruling, the *Bundesfinanzhof* decided that the taxpayer transferring ownership of one of two apartments to a close relative combined with reciprocal leasing is just engaged in tax mitigation. In the grounds of the judgment, the court stated that the transactions did not neutralize each other as they did in the first case.[174]

7.4.4 European Tax Law

Tax avoidance is also defined in European tax law.[175] Anti-avoidance rules which apply to cross-border or international tax-avoidance transactions could be considered as an infringement of one of the fundamental freedoms of the internal market.[176] According to the rulings of the ECJ, the need to prevent tax avoidance can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms.[177] The notion of tax avoidance is however limited to the prevention of abusive practices. The specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due

[172] Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 14, 1962, 74 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 554 (F.R.G.).

[173] Bundesfinanzhof [BFH] [Federal Fiscal Court] June 6, 1991, 164 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 498 (F.R.G.).

[174] Bundesfinanzhof [BFH] [Federal Fiscal Court] Sep. 12, 1995, 178 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 542 (F.R.G.). BFHE 178, 542.

[175] See Wolfgang Schön, *Gestaltungsmißbrauch im europäischen Steuerrecht*, 5 INTERNATIONALES STEUERRECHT [IStR], Supplement 2, at 1–16 (1996) (F.R.G.); DENNIS WEBER, TAX AVOIDANCE AND THE EC TREATY FREEDOMS 166–235 (2005); Joachim Englisch, *Rechtsmissbrauch im Gemeinschaftsrecht*, 86 STEUER UND WIRTSCHAFT [STUW] 3, 3–22 (2009) (F.R.G.); Georg Kofler, *Steuergestaltung im Europäischen und im Internationalen Recht* in GESTALTUNGSFREIHEIT UND GESTALTUNGSMISSBRAUCH IM STEUERRECHT (Rainer Hüttemann, ed., forthcoming 2010) (manuscript at 3–7, on file with the author).

[176] See Wolfgang Schön, *Rechtsmissbrauch und Europäisches Steuerrecht*, in FESTSCHRIFT FÜR WOLFRAM REISS ZUM 65. GEBURTSTAG 571, 576–578 (Paul Kirchhof and Hans Nieskens, eds., 2008).

[177] Case C-446/03, Marks and Spencer v. David Halsey, 2005 E.C.R. I-10837.

on the profits generated by activities carried out on national territory.[178] This definition of abuse is at least as vague as its national counterpart.[179] The term "artificial arrangements" is wide and even open to the arm's-length criterion.[180] To delineate its meaning remains a challenging task for the ECJ.[181] Most of all, however, the definition is to the detriment of the member states which have to accept good business reasons excluding their anti-avoidance rules.[182] The allegation that the ECJ has become the silent driving force behind the EU's harmonization in the field of direct taxation[183] cannot be easily rejected.[184]

7.4.5 Criminal Offenses

Tax evasion is legally defined in Section 370.1 AO. The provision reads as follows:

> A penalty of up to 5 years imprisonment or a monetary fine shall be imposed on whoever
>
> 1. furnishes the revenue authorities or other authorities with incorrect or incomplete particulars concerning matters of substantial significance for taxation,
> 2. fails to inform the revenue authorities of facts of substantial significance for taxation when obliged to do so, or
> 3. fails to use revenue stamps or revenue stamping machines when obliged to do so
>
> and as a result understates taxes or derives unwarranted tax advantages for himself or for another person.[185]

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[178] Case C-196/04, Cadbury Schweppes v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995.

[179] Peter Fischer, *supra* note 141, margin note 155–157, at 97–99.

[180] Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107.

[181] Georg Kofler, *supra* note 175 (manuscript at 5–6, 14).

[182] Christian Seiler, *Das Steuerrecht unter dem Einfluss der Marktfreiheiten*, 82 STEUER UND WIRTSCHAFT [STUW] 125, 125 (2005) (F.R.G.).

[183] AXEL CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN UND NATIONALES STEUERRECHT 25–32 (2002); Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice* in 59 TAX LAW REVIEW [TAX L. REV.] 65 (2005); Tobias Stewen, Der EuGH und die nationale Steuerhoheit – Spannungsverhältnis und Konfliktlösung, 43 Europarecht [EuR] 445, 446 (2008) (F.R.G.); HANNO KUBE, EUGH-RECHTSPRECHUNG ZUM DIREKTEN STEUERRECHT 39 (2009) (F.R.G.).

[184] But see Heinrich Weber-Grellet, *Neu-Justierung der EuGH-Rechtsprechung*, 47 DEUTSCHES STEUERRECHT [DSTR] 1229, 1229-36 (2009) (F.R.G.).

[185] "Mit Freiheitsstrafe bis zu fünf Jahren oder mit Geldstrafe wird bestraft, wer

1. den Finanzbehörden oder anderen Behörden über steuerlich erhebliche Tatsachen unrichtige oder unvollständige Angaben macht,

Pursuant to Section 370.4 AO, taxes are deemed to have been understated in particular where they are not assessed at all, in full or in time. This shall also apply even where the tax has been assessed provisionally or assessed subject to re-examination or where a self-assessed tax return is deemed to be equal to a tax assessment subject to re-examination. Furthermore, tax advantages also include tax rebates. Unwarranted tax advantages are deemed derived to the extent that these are wrongfully granted or retained.

Furthermore, in particularly serious cases, a penalty from 6 months up to 10 years of imprisonment is imposed.[186] A case is generally be deemed to be particularly serious where the perpetrator (1) deliberately understates taxes on a large scale or derives unwarranted tax advantages, (2) abuses his authority or position as a public official, (3) solicits the assistance of a public official who abuses his authority or position, (4) repeatedly understates taxes or derives unwarranted tax advantages by using falsified or forged documents, or (5) as a member of a group formed for the purpose of repeatedly committing acts pursuant to Section 370.1 AO, understates turnover taxes or excise duties or derives unwarranted turnover tax or excise duty advantages.

Section 370 AO presupposes an intentional act. A taxpayer or a person looking after the affairs of a taxpayer who acts through gross negligence commits an offence which may be punished with a monetary fine of up to 50,000 euros.[187]

7.5 Counteracting Tax Avoidance – GAAR

According to the case law of the *Bundesverfassungsgericht*, equality before the law implies not only equality in tax legislation but also equality in application of the tax law. Equality before the law requires an equal tax burden in accordance with the ability-to-pay-principle.[188] The tax

2. die Finanzbehörden pflichtwidrig über steuerlich erhebliche Tatsachen in Unkenntnis lässt oder
3. pflichtwidrig die Verwendung von Steuerzeichen oder Steuerstemplern unterlässt und dadurch Steuern verkürzt oder für sich oder einen anderen nicht gerechtfertigte Steuervorteile erlangt."

[186] § 370.3 sentence 1 AO.

[187] § 378 AO.

[188] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] June. 27, 1991, 84 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 239 (272) (*Zinsbesteuerung*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Mar. 9, 2004, 110 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 94

has to be fundamentally inevitable.[189] Therefore, tax avoidance does not comply with the inevitability of the tax burden required by the principle of equality.[190] The prevention of tax avoidance is legitimized by the constitution.[191] Hence, the *Bundesverfassungsgericht* has qualified the general anti-avoidance rule as a proven means to prevent tax avoidance.[192] Counteracting tax avoidance is a constitutional task for legislation and financial administration.[193] In general, anti-avoidance rules actualize the ability-to-pay-principle and do not require any special justification.[194]

First, the financial administration determines whether a transaction involves tax avoidance. If so, the taxpayer may file a tax court petition as described above. After the taxpayer has received the objection ruling of the *Finanzamt*, he may start proceedings before the *Finanzgericht*.[195] Therefore, in addition to the financial administration it is the task of the courts to determine where tax mitigation ends and tax avoidance begins. Due to the principle of statutory supremacy (*Vorrang des Gesetzes*) and the principle of statutory reservation (*Vorbehalt des Gesetzes*), the standard for both is the tax act of the legislature which is binding on both the executive and the judiciary.[196] It is up to the directly elected parliament

(112, 113) (*Spekulationsgewinne*) (F.R.G.); see also Paul Kirchhof, *supra* note 38, margin note 200–201, at 1057–1058; Uwe Kischel, *Gleichheitssatz und Steuerrecht – Gefahren eines dogmatischen Sonderwegs*, in GLEICHHEIT IM VERFASSUNGSSTAAT – SYMPOSION AUS ANLASS DES 65. GEBURTSTAGES VON PAUL KIRCHHOF 175, 179 (Rudolf Mellinghoff and Ulrich Palm, eds., 2008).

[189] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] June. 27, 1991, 84 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 239 (268) (*Zinsbesteuerung*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Apr. 10, 1997, 96 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 1 (6) (*Arbeitnehmerfreibetrag*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Nov. 10, 1999, 101 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 297 (309) (*Arbeitszimmer*) (F.R.G.); but see Uwe Kischel, *supra* note 188 passim.

[190] See Paul Kirchhof, *supra* note 43 (manuscript at 10–11).

[191] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 24, 1962, 13 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 290 (316) (*Ehegatten-Arbeitsverhältnisse*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 24, 1962, 13 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 331 (344-345) (*Personenbezogene Kapitalgesellschaften*) (F.R.G.); Klaus-Dieter Drüen, *supra* note 162, at 157–159; but see Wolfgang Schön, *supra* note 47 (manuscript at 9–10).

[192] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Jan. 24, 1962, 13 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 290 (315) (*Ehegatten-Arbeitsverhältnisse*) (F.R.G.).

[193] Peter Fischer, *supra* note 141, margin note 46, at 40.

[194] Johanna Hey, *supra* note 71, at 174.

[195] See 7.3.2.

[196] See 7.1.1.

representing the citizens to take the essential decisions. Especially, any interference with basic rights must have a statutory basis that is constitutional. Hence, every tax must be based on statutory authority.[197] Taxation is strictly based on the principle of legality.[198] Neither, the financial administration nor the financial courts may alter the legal consequences of the tax act.[199] They are both interpreters of the statute[200] which determines tax avoidance.[201] Due to the principle of equality, the financial administration is fundamentally not entitled to take discretionary decisions in the field of taxation.[202] For that reason, the range of statutory interpretation which is determined by the principle of legal certainty and clarity (*Bestimmtheitsgrundsatz*)[203] and the prohibition of analogy limits the scope of the financial administration and the courts.[204]

7.5.1 New GAAR

The German tax law has been provided a general anti-avoidance rule (GAAR) for over 90 years. At the beginning of the Weimarer Republic, the statutory interpretation by the fiscal jurisdiction was strictly based on wording and governed by the primacy of the private law.[205] This judicial interpretation facilitated tax avoidance significantly.[206] In this context, the so-called Mitropa-Case,[207] the first known case of a shell company acquisition, was given importance to the parliamentary debate of the National Assembly.[208] Thus, it was considered necessary to legislate on this specific problem and to enact a general anti-avoidance rule in 1919 within the

[197] See 7.5.

[198] Joachim Lang, *Rechtsstaatliche Ordnung des Steuerrechts*, in STEUERRECHT § 4-150-165, at 107–112 (Klaus Tipke and Joachim Lang, eds., 20th ed., 2009).

[199] Wolfgang Schön, *supra* note 47 (manuscript at 4).

[200] Paul Kirchhof, *Die Gleichheit als staatsrechtlicher Auftrag*, in GLEICHHEIT IM VERFASSUNGSSTAAT – SYMPOSION AUS ANLASS DES 65. GEBURTSTAGES VON PAUL KIRCHHOF 1, 18 (Rudolf Mellinghoff and Ulrich Palm, eds., 2008).

[201] See Wolfgang Schön, *supra* note 47 (manuscript at 35–36).

[202] Joachim Lang, *supra* note 62, § 5–114, at 170.

[203] See 7.5.

[204] Peter Fischer, *supra* note 141, margin note 46, at 40; RALF P. SCHENKE, DIE RECHTSFINDUNG IM STEUERRECHT 235–236 (2007).

[205] See SUSANNE SIEKER, *supra* note 167, at 18; Peter Fischer, *supra* note 141, margin note 1–2, at 11–14.

[206] See Albert Hensel, *supra* note 165, at 258–260.

[207] Reichsfinanzhof [RFH] [Fiscal Court of the Reich] July 16, 1919, 1 Sammlung der Entscheidungen des Reichsfinanzhofs [RFHE] 126 (F.R.G.).

[208] See Peter Fischer, *supra* note 141, margin note 1, at 11–12.

General Tax Code of the Reich.[209] But Section 5 RAO did not meet the expectations,[210] neither did the uniform provision of the General Tax Code of 1931.[211] Therefore, Section 6.1 of the *Steueranpassungsgesetz*[212] used the term "abuse of forms and structural possibilities of the civil law."[213] The legislator of the *Abgabenordnung* of 1977 also considered a general anti-avoidance rule as essential and urgently needed.[214] In its first version, Section 42 AO[215] had a simple, hardly changed wording. The provision read as follows:

> It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. If there is such an abuse, the taxpayer shall be taxed as if he had chosen an adequate legal arrangement.[216]

As the term required explanation, it was left to the jurisprudence to define "abuse"[217] As stated above, the financial courts have failed to perform this task to the satisfaction of the legislature and the financial administration.[218] According to judgments of the *Bundesfinanzhof*, the general anti-avoidance rule has not been applied alongside with targeted anti-avoidance rules.[219] The legislator tried to counteract this case law in 2001 by adopting Section 42.2 AO.[220] The provision stated that the general anti-avoidance rule should "apply unless its applicability was expressly excluded by law."[221] To justify the provision, the legislature pointed out

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[209] Reichsabgabenordnung [RAO] [General Tax Code of the Reich] Dec. 13, 1919, RGBl. I at 1993, 1994, § 5 (F.R.G.).

[210] See Albert Hensel, *supra* note 165, at 222; Peter Fischer, *supra* note 141, margin note 4, at 16–18.

[211] Reichsabgabenordnung [RAO] [General Tax Code of the Reich] May 22, 1931, RGBl. I at 161, 162, § 10 (F.R.G.).

[212] Steueranpassungsgesetz [StAnpG] [Tax Adaption Act] Oct. 16, 1934, RGBl. I at 925, 926 (F.R.G.).

[213] See Peter Fischer, *supra* note 141, margin note 7, at 19.

[214] BTDrucks VI/1982, at 114 (F.R.G.).

[215] Abgabenordnung [AO] [General Tax Code] Mar. 16, 1976, BGBl. I at 613, 626.

[216] Durch Missbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden. Liegt ein Missbrauch vor, so entsteht der Steueranspruch so, wie er bei einer den wirtschaftlichen Vorgängen angemessenen Gestaltung entsteht.

[217] BTDrucks VI/1982, at 114 (F.R.G.).

[218] See 7.4.2.

[219] Bundesfinanzhof [BFH] [Federal Fiscal Court] Dec. 15, 1999, 190 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 446 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Jan. 19, 2000, 191 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 257 (F.R.G.).

[220] Gesetz zur Änderung steuerlicher Vorschriften [Steueränderungsgesetz 2001 – StÄndG] Dec. 20, 2001, Bundesgesetzblatt [BGBl] I at 3794, 3803, Art. 8 no. 9 b) (F.R.G.); see also Johanna Hey, National Report Germany, in TAX COMPETITION IN EUROPE 253, 274 (Wolfgang Schön, ed., 2003).

[221] "(2) Absatz 1 ist anwendbar, wenn seine Anwendbarkeit gesetzlich nicht ausdrücklich ausgeschlossen ist."

that the rulings delivered by the *Bundesfinanzhof* had undesirable legal consequences.[222] However, the provision failed to achieve substantial success in countering tax avoidance.[223]

Hence, the legislature made a fresh attempt to tackle the matter and introduced the new GAAR with a legal definition of tax abuse by the Annual Tax Act 2008 (*Jahressteuergesetz 2008*),[224] as described above.[225] The former Parliamentary State Secretary stated in the consultation with the *Bundestag* that she did not know a single case in the field of corporate tax law where the former GAAR had applied.[226] The amendment is understood as a clear signal of the legislature's distrust in the financial jurisprudence and its intention to intensify the application of the GAAR.[227] The new GAAR reads as follows:

Section 42

Abuse of tax planning schemes

(1) It shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. Where the element of an individual tax laws provision to prevent circumventions of tax has been fulfilled, the legal consequences shall be determined pursuant to that provision. Where this is not the case, the tax claim shall in the event of an abuse within the meaning of subsection (2) below arise in the same manner as it arises through the use of legal options appropriate to the economic transactions concerned.
(2) An abuse shall be deemed to exist where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party. This shall not apply where the taxpayer provides evidence of nontax reasons for the selected option which are relevant when viewed from an overall perspective.[228]

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[222] BRDrucks 399/1/01, at 20.

[223] See Peter Fischer, *supra* note 163, at 306–307.

[224] Jahressteuergesetz 2008 [JStG 2008] [Annual Tax Act 2008] Dec. 20, 2007, Bundesgesetzblatt [BGBl] I at 3150, 3171, Art. 14 no. 2 (F.R.G.).

[225] See 7.4.2.

[226] BTPlenarprot. 16/63, at 6209 D.

[227] See Markus Heintzen, *supra* note 143, at 599–600; Johanna Hey, *supra* note 72 (manuscript at 1); Michael Wendt, *supra* note 152 (manuscript at 1).

[228] "§ 42 Missbrauch von rechtlichen Gestaltungsmöglichkeiten

(1) Durch Missbrauch von Gestaltungsmöglichkeiten des Rechts kann das Steuergesetz nicht umgangen werden. Ist der Tatbestand einer Regelung in einem Einzelsteuergesetz erfüllt, die der Verhinderung von Steuerumgehungen dient, so bestimmen sich die Rechtsfolgen nach jener Vorschrift. Anderenfalls entsteht der Steueranspruch beim Vorliegen eines Missbrauchs im Sinne des Absatzes 2 so, wie er bei einer den wirtschaftlichen Vorgängen angemessenen rechtlichen Gestaltung entsteht.
(2) Ein Missbrauch liegt vor, wenn eine unangemessene rechtliche Gestaltung gewählt wird, die beim Steuerpflichtigen oder einem Dritten im Vergleich zu einer angemessenen Gestaltung zu einem gesetzlich nicht vorgesehenen Steuervorteil

7.5.2 Critique of GAAR

According to most academics, the legislature has failed to improve the application of the GAAR for a second time within just a few years.[229] In contrast to the far more ambitious original draft[230] which has been subject to serious criticism,[231] the central elements of the GAAR have remained unchanged, as the President of the *Bundesfinanzhof* pointed out.[232] According to the wording of the original draft, an abuse would be deemed to exist where an unusual legal structure which leads to tax advantages was selected.[233] But the term "unusual legal structure" did not meet the agreement of the *Bundesrat* which referred to objections raised by the German Association of Tax Advisers.[234] Then, the finance committee of the *Bundestag* changed the definition of abuse and replaced the term "unusual" by "inappropriate"[235] with approval of the parliament.[236] However, this term has been explicitly taken from the case law of the *Bundesfinanzhof*[237] which has not yet found a clear definition of "inappropriateness."[238] Furthermore, nobody knows which tax advantage is

führt. Dies gilt nicht, wenn der Steuerpflichtige für die gewählte Gestaltung außersteuerliche Gründe nachweist, die nach dem Gesamtbild der Verhältnisse beachtlich sind."

[229] Klaus-Dieter Drüen, *"Präzisierung" und "Effekturierung" des § 42 AO durch das Jahressteuergesetz 2008?*, 1 UNTERNEHMENSBESTEUERUNG [UBG] 31, 31–38 (2008) (F.R.G.); Peter Fischer, *supra* note 163, at 306–312; Alexandra Mack and Markus Wollweber, § 42 AO – Viel Lärm um nichts?, 46 DEUTSCHES STEUERRECHT [DSTR] 182, 182–186 (2008) (F.R.G.); Anna Leisner-Egensperger, *Das Verbot der Steuerumgehung nach der Reform des § 42 AO*, 95 DEUTSCHE STEUER-ZEITUNG [DSTZ] 358, 358–365 (2008) (F.R.G.); Paul Kirchhof, supra note 43 (manuscript at 14–15).; Michael Wendt, *supra* note 152 (manuscript at 10); Johanna Hey, supra note 167, at 1048; Markus Heintzen, *supra* note 143, at 603, 605.

[230] BRDrucks 544/07, at 28, 105–106.

[231] Stefan Köhler and Martina Tippelhofer, *Verschärfung des § 42 AO durch das Jahressteuergesetz 2008? – Zum unterschiedlichen Missbrauchsbegriff nach deutschem und europäischem Steuerrecht*, 16 INTERNATIONALES STEUERRECHT [ISTR] 681, 681-84 (2007) (F.R.G.); Hans Bernhard Brockmeyer, *Bedenkliche Neufassung des § 42 Abs. 1 AO im Referentenentwurf des JStG 2008*, 45 DEUTSCHES STEUERRECHT [DSTR] 1325, 1325–1330 (2007) (F.R.G.); Peter Fischer, *§ 42 Abs. 1 AO i.d.F. des Entwurfs eines JStG 2008 – ein rechtskultureller Standortnachteil*, 61 FINANZ-RUNDSCHAU [FR] 857, 857-63 (2007) (F.R.G.).

[232] Wolfgang Spindler, *§ 42 AO n. F. – was hat sich geändert?*, 60 STEUERBERATER-JAHRBUCH 2008/09 [STBJB] 39, 49–61 (F.R.G.).

[233] BRDrucks 544/07, at 28.

[234] See BRDrucks 544/1/07, at 81-82; BRPlenarprot. 836, at 293.

[235] BTDrucks 16/6981, at 51–52; 16/7036, at 24.

[236] BTPlenarprot. 16/123, at 12809 A.

[237] See BTDrucks 16/7036, at 24.

[238] See 7.4.2.

"unintended by the law."[239] Therefore, the legal definition of the term "abuse" in Section 42.2 AO is in fact nothing more than a capitulation as to providing one. The judiciary's task to interpret the GAAR has not been facilitated by introducing the vague legal term of "inappropriate."[240] After all, the amendment could be titled "Much Ado About Nothing."[241]

7.5.3 Broad Scope of GAAR

The scope of Section 42 AO is broad. Tax avoidance could concern every tax act. The application of the GAAR is not excluded for any tax act in the first place.[242] The provision applies to the national as well as to the international tax law.[243] It also covers taxpayers with limited tax liability.[244] It affects material as well as procedural tax law.[245] But there is an important exception to be made. Germany has not only adopted a general anti-avoidance rule, but also numerous targeted anti-avoidance rules. Within its scope, a targeted anti-avoidance rule regulates tax avoidance definitively.[246] Tax abuse is legally defined.[247] Hence, transactions which are not inappropriate according to the definition of the targeted anti-avoidance rule may not be challenged on the basis of the general anti-avoidance rule.[248] The amendment of Section 42 AO in 2001 did not change this case law of the

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[239] Dietmar Gosch, *Die Zwischengesellschaft nach "Hilversum I und II", "Cadbury Schweppes" und den Jahressteuergesetzen 2007 und 2008*, in FESTSCHRIFT FÜR WOLFRAM REISS ZUM 65. GEBURTSTAG 597, 600 (Paul Kirchhof and Hans Nieskens, eds., 2008).

[240] See Peter Fischer, *supra* note 163, at 309.

[241] See Alexandra Mack and Markus Wollweber, *supra* note 229, at 182, 186.

[242] See Bundesfinanzhof [BFH] [Federal Fiscal Court] May 24, 2000, 15 BFH/NV – Sammlung der Entscheidungen des Bundesfinanzhofs [BFH/NV] 162 (2001) (F.R.G.).

[243] Johanna Hey, *Nationale Missbrauchsvorschriften im Spannungsfeld von DBA- und EU-Recht*, in WO STEHT DAS DEUTSCHE INTERNATIONALE STEUERRECHT? 137, 143–144 (Jürgen Lüdicke, ed., 2009); Markus Heintzen, *supra* note 143, at 601–605.

[244] Bundesfinanzhof [BFH] [Federal Fiscal Court] Jan. 29, 2008, 220 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 392 (F.R.G.).

[245] Klaus-Dieter Drüen, supra note 140, margin note 19, at 139.

[246] Peter Fischer, *Geltungsanspruch des Steuergesetzes, Steuerumgehung und "wirtschaftliche oder sonst beachtliche außersteuerliche Gründe"*, 55 FINANZ-RUNDSCHAU [FR] 1212, 1215 (2001) (F.R.G.); Dietmar Gosch, *§ 50d EStG*, margin note 45, at 1772–1773 in ESTG KOMPAKTKOMMENTAR (Paul Kirchhof, ed., 8th ed., 2008); Klaus-Dieter Drüen, supra note 140, margin note 20b, at 140–141.

[247] Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 20, 2002, 198 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 506 (F.R.G.); JÜRGEN DANZER, DIE STEUERUMGEHUNG 94–95 (1981); Peter Fischer, *supra* note 141, margin note 25, at 29; Johanna Hey, *supra* note 72 (manuscript at 8).

[248] Markus Heintzen, *supra* note 143, at 603.

Bundesfinanzhof. The court explicitly rejected the request of the legislature. According to the rulings of the court to the former version of the GAAR, Section 42.1 sentence 1 AO was applicable, but its conditions could not be fulfilled if a legal option fell within the scope of a TAAR and was not viewed as tax abuse under this provision. In this case, the conditions of Section 42.2 AO were not fulfilled either.[249] It is expected that this case law will be continued under the new version of the GAAR.[250] Section 42 AO is superseded if a TAAR applies. Insofar as this is the case, the special anti-abuse rule precludes the additional application of the GAAR.[251] However, the financial administration has not yet accepted this case law. Pursuant to the application decree, the mere existence of a more specific anti-abuse provision does not affect the applicability of the GAAR.[252] It is doubtful whether the courts, which are not bound by the decree, will agree with this interpretation.[253]

Pursuant to Section 42.2 sentence 2 AO, an abuse is excluded where the taxpayer provides evidence of nontax reasons for the selected option which are relevant when viewed from an overall perspective. Therefore, the taxpayer may rebut the presumption of tax abuse by showing sound business reasons for the legal option. The burden of proof of whether a structure is considered “inappropriate” remains with the tax authorities. However, once the authorities find a structure inappropriate, the burden of proof rests with the taxpayer who must give and prove the existence of relevant nontax reasons for the selected structure.[254] Incidentally, the issues of relevant nontax reasons were already addressed by the courts before the new

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[249] Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 20, 2002, 198 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 506 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] May 31, 2005, 210 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 117 (F.R.G.).

[250] Dieter Drüen, *supra* note 162, at 161; Dietmar Gosch, *supra* note 239, at 604; Markus Heintzen, *supra* note 143, at 603; Johanna Hey, *supra* note 72 (manuscript at 3–7).

[251] Bundesfinanzhof [BFH] [Federal Fiscal Court] Dec. 15, 1999, 190 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 446 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Jan. 29, 2008, 220 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 392 (F.R.G.).

[252] Anwendungserlass zur Abgabenordnung [AEAO] [General Tax Code Application Decree] Jan. 2, 2008, BStBl. I at 26, last amended by letter of the Federal Ministry of Finance, July 30, 2009, BStBl. I at 807, no. 1 to § 42 AEAO (F.R.G.).

[253] See I. 3. b) (5).

[254] See no. 2.6 to § 42 AEAO; Klaus-Dieter Drüen, *vor § 42 AO*, .Klaus-Dieter Drüen, margin note 27-33, at 136/9-136/12 in ABGABENORDNUNG FINANZGERICHTSORDNUNG – KOMMENTAR ZUR AO UND FGO (Klaus Tipke and Heinrich W. Kruse, eds., looseleaf, 121. Lief. Oct. 2009); Markus Heintzen, *supra* note 143, at 604.

GAAR was enacted. A legal option was not inappropriate if it was justified in this way.[255]

The financial administration is fundamentally not entitled to take discretionary decisions in the field of taxation.[256] Therefore, decisions regarding previous transactions do not provide precedential authority for new or subsequent transactions. Incidentally, an illegal administrative practice would violate the principle of legality and of equality in application of the tax law. For that reason, a taxpayer may not rely on the principle of equality if the administration acts illegally.

7.5.4 TAARs

Pursuant to the rulings of the *Bundesfinanzhof*, transactions which fall within the scope of a targeted anti-avoidance rule (TAAR) but are not abusive according to the provision may not be challenged on the base of the GAAR. A recourse to Section 42 AO is not possible because this would run counter to the purpose of the TAAR.[257] The special German anti-avoidance rules provide safe harbors which are immune from challenge.[258] They are also called "legal vacuum."[259]

The targeted anti-avoidance rules have very different areas of application.[260] But the cases of tax avoidance may be divided in three main groups: (1) the transfer or shifting of income or capital assets to other legal entities solely for tax purposes such as in the case of the interposition of an other legal subject, (2) if a third party, on considering the economic facts and effects of the structure, would not have chosen the same legal structure without the generated tax benefit (overall tax-planning strategies) and (3) the interposition of relatives or other closely related persons or companies solely for tax purposes (non-arm's-length transactions).[261] The same classification applies to the TAARS which may be supplemented by the group's financial planning and aggressive use of losses.[262]

Taxation is strictly anchored on the principle of legality. Every tax must be based on statutory authority. The financial administration may not alter

[255] See Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 20, 2002, 198 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 506 (F.R.G.).

[256] See 7.5.

[257] See 7.5.3.

[258] See Johanna Hey, *supra* note 72 (manuscript at 9, 25, 33).

[259] Dietmar Gosch, *supra* note 239, at 601–602.

[260] See Johanna Hey, *supra* note 71, at 167–168.

[261] Peter Fischer, *supra* note 141, margin note 84, at 63-64; Markus Heintzen, *supra* note 143, at 601; Johanna Hey, *supra* note 72 (manuscript at 14–15); see also SUSANNE SIEKER, *supra* note 167, at 46–57.

[262] Johanna Hey, *supra* note 72 (manuscript at 15–19).

the legal consequences of the tax act. Therefore, the range of statutory interpretation restricts the margin of discretion of the executive branch.[263] An exception would have to be made, if there were a legal basis for ordinances[264] to detail the GAAR. But an authorization for a regulation of this kind does not exist. Therefore, the superior authorities of the executive may only issue non-statutory provisions in the field of general anti-avoidance which bind the lower ranking authorities of the administration, but not the courts.[265] The *Bundesfinanzministerium* issued an application decree interpreting the GAAR.[266] The decree defines the abuse in the meaning of § 42 AO in four steps. (1) The taxpayer selects a legal structure without economic necessity and is therefore inappropriate. (2) The selected structure leads to a tax advantage for the taxpayer or a third party as compared with an appropriate structure. (3) This tax advantage is not intended by the law. (4) The taxpayer cannot provide nontax reasons for the selected option which are relevant when viewed from an overall perspective.[267]

7.6 Cross-Border Tax-Avoidance

As a high-tax country, Germany is particularly affected by cross-border and international tax avoidance methods. Under international tax arbitrage, international companies and high net-worth individuals take advantage of tax differentials between several countries to reduce their total worldwide tax liability in comparison to what the taxpayer would have paid if only one jurisdiction had exercised its taxing authority.[268] Germany counters cross-border tax avoidance by the GAAR, a differentiated statutory framework and special anti-abuse treaty provisions. Pursuant to the rulings of the Bundesfinanzhof, Section 42 applies also to cross-border transactions and

[263] See 7.5.

[264] See 7.5.

[265] See 7.5.

[266] Anwendungserlass zur Abgabenordnung [AEAO] [General Tax Code Application Decree] Jan. 2, 2008, BStBl. I at 26, last amended by letter of the Federal Ministry of Finance, July 30, 2009, BStBl. I at 807, § 42 AEAO (F.R.G.).

[267] "Ein Missbrauch i. S. d. § 42 Abs. 2 liegt vor, wenn eine rechtliche Gestaltung gewählt wird, die den wirtschaftlichen Vorgängen nicht angemessen ist, die gewählte Gestaltung beim Steuerpflichtigen oder einem Dritten im Vergleich zu einer angemessenen Gestaltung zu einem Steuervorteil führt, dieser Steuervorteil gesetzlich nicht vorgesehen ist und der Steuerpflichtige für die von ihm gewählte Gestaltung keine außersteuerlichen Gründe nachweist, die nach dem Gesamtbild der Verhältnisse beachtlich sind."

[268] See BRDrucks 544/1/07, at 76 (F.R.G.); Georg Kofler, *supra* note 175 (manuscript at 10).

to taxpayers with limited tax liability.[269] But the legislature and the financial administration have regarded the interpretation of the GAAR by the court as too restrictive, as noted above.[270] In this connection, too, the case law of the *Bundesfinanzhof* is seen as cause for the significant increase in TAARs,[271] which in turn superseded the GAAR,[272] according to the rulings of the court.[273]

Cross-border tax avoidance methods may be distinguished in two categories. Individual and corporate income may be shifted directly into low-tax countries or indirectly by shifting debt to high-tax jurisdictions. Germany combats both methods by TAARs. The German Foreign Tax Act (*Außensteuergesetz*)[274] counters mainly profit shifting, but its scope is not restricted to tax abuse.[275] Further TAARs concerning cross-border transactions can be found in the major tax acts.

7.6.1 Transfer Pricing

The adjustment of inappropriate transfer prices is based on Section 1 AStG. As do many other countries, Germany applies the Arm's Length Principle to assess transfer prices and the related income filed by related parties. Detailed transfer pricing regulations concerning the cross-border transfer of functions were incorporated into Section 1.3 AStG by the Business Tax Reform Act of 2008 (*Unternehmenssteuerreformgesetz 2008*).[276] In addition, the *Bundesfinanzministerium* issued an ordinance providing details on how the new transfer pricing provisions relate to business restructurings and function transfers.[277] Moreover, these provisions are supplemented by further rules. They concern hidden profit distribution and hidden capital injection (Section 8.3 KStG, Section 4.1 EStG with Guideline R 40 of the

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[269] Bundesfinanzhof [BFH] [Federal Fiscal Court] Oct. 29, 1997, 184 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 476 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Jan. 29, 2008, 220 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 392 (F.R.G.); see also GERRIT FROTSCHER, INTERNATIONALES STEUERRECHT, margin note 243–244, at 115–117 (3rd ed., 2009).

[270] See 7.4.2.

[271] Johanna Hey, *supra* note 243, at 143.

[272] See Dietmar Gosch, *supra* note 239, at 601.

[273] See 7.5.4.

[274] Außensteuergesetz [AStG] [Foreign Tax Act] Sept. 8, 1972, BGBl. I at 1713, last amended by Gesetz, Dec. 19, 2008 BGBl. I at 2794, Art. 9 (F.R.G.).

[275] See Johanna Hey, *supra* note 243, at 142.

[276] Unternehmenssteuerreformgesetz 2008 [UStRG 2008] [Business Tax Reform Act 2008] Aug. 14, 2007, BGBl. I at 1912, Art. 7 (F.R.G.).

[277] Funktionsverlagerungsverordnung [FVerlV] [Base Shifting Ordinance] Aug. 12, 2008, BGBl. I at 1680 (F.R.G.).

Corporate Tax Guidelines[278]). Furthermore, there are special obligations of the participants to cooperate where circumstances relate to transactions having a bearing on another country (Section 90.3 AO with ordinance law[279]). Where a taxpayer countervenes these obligations to cooperate, it is rebuttably presumed that his income which is subject to tax in Germany is higher than the income he declared (Section 162.3 AO). Finally, numerous non-statutory provisions issued by superior authorities of the executive ensure the uniform application of these rules and methods.[280]

7.6.2 Controlled Foreign Corporations

Furthermore, the *Außensteuergesetz* contains the German Controlled Foreign Corporation (CFC)-Legislation. Sections 7–14 AStG closely follow the U.S. Subpart-F-legislation, introduced in 1962.[281] These rules address resident shareholders of controlled foreign corporations investing in low-taxed passive business operations. They may be deemed to have received a dividend paid out of certain retained profits considered as passive income of an intermediary company (*Zwischengesellschaft*) resident in a low-tax jurisdiction. The German CFC-legislation had to be harmonized with EU law, due to the judgment of the ECJ in the Cadbury Schweppes case

[278] Körperschaftsteuer-Richtlinien 2004 [KStR] [Corporate Tax Guidlines] Dec. 13, 2004, BStBl. I Sondernummer 2 S. 2 (F.R.G.).

[279] Gewinnabgrenzungsaufzeichnungsverordnung [GAufzV] [Records of Allocation of Income Ordinance] Nov. 13, 2003, BGBl I at 2007, last amended by Gesetz, Aug. 14, 2007 BGBl. I at 1912 (F.R.G.).

[280] Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen [Verwaltungsgrundsätze] [Principles Governing the Examination of Income Allocation between Multinational Enterprises] Feb. 23, 1983, BStBl I at 218; Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen mit grenzüberschreitenden Geschäftsbeziehungen in Bezug auf Ermittlungs- und Mitwirkungspflichten, Berichtigungen sowie auf Verständigungs- und EU-Schiedsverfahren [Verwaltungsgrundsätze-Verfahren] [Administrative Principles for the Examination of Income Allocation between Related Persons with Cross-Border Transactions in Respect of Income Adjustments, Investigation and Compliance Obligations, Mutual Agreement Procedures and EU Arbitration Proceedings (Administrative Principles Procedures)] Apr. 12, 2005, BStBl I at 570; see further Thomas Menck, *§ 1 AStG*, in Blümich, Einkommensteuergesetz, Körperschaftsteuergesetz, Gewerbesteuergesetz (Bernd Heuermann, ed., looseleaf, 103. Lief. May 2009).

[281] Gabriele Vogt, *vor §§ 7-14 AStG*, margin note 22, in Blümich, Einkommensteuergesetz – Körperschaftsteuergesetz – Gewerbesteuergesetz (Bernd Heuermann, ed., looseleaf, 103. Lief. May 2009).

which concerned the validity of the similar U.K. CFC-rules.[282] Therefore, the *Bundesfinanzministerium* announced its intention of changing the *Außensteuergesetz* in a decree instructing tax offices to suspend the income attribution rules in all comparable cases with immediate effect[283] before the *Jahressteuergesetz* 2008 brought the CFC-rules into line with the case law of the ECJ.[284] Furthermore, the *Bundesfinanzministerium* issued a circular concerning the application of principles of the *Außensteuergesetz* which also applies to the CFC-legislation.[285]

7.6.3 Thin Capitalization Rules

The impact of the ECJ on cross-border anti-avoidance rules has also become apparent in the field of thin capitalization. In the *Lankhorst-Hohorst* case, the ECJ decided that the German thin-capitalization legislation as in force at the relevant time breached the freedom of establishment principles in European law and was not justifiable.[286] Pursuant to the case law of the court, the difference in treatment between resident and non-resident borrowing companies constitutes a restriction on freedom of establishment that could only be justified on the ground of prevention of abusive practices. However, the restriction must not go beyond what is necessary to attain that objective.[287] Against this background, the Business Tax Reform Act of 2008 (*Unternehmenssteuerreformgesetz 2008*)[288] replaced the previous thin-capitalization legislation with a debt/equity ratio of 1.5:1 (ex Section 8a.1 no. 2 KStG) with a so-called general interest barrier (*Zinsschranke*) which is applicable not only to corporations as debtors, but also to all other forms of organization, irrespective of whether these businesses are owned by resident or non-resident persons (Section 4h EStG, Section 8a KStG). The

[282] Case C-196/04, Cadbury Schweppes v. Commissioners of Inland Revenue, 2006 E.C.R. I-7995; but see also Case C-298/05, Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt, 2007, E.C.R. I-10451.

[283] Schreiben betr. Hinzurechnungsbesteuerung nach dem Außensteuergesetz (AStG), Jan. 8, 2007, BStBl. I at 99 (F.R.G.).

[284] Jahressteuergesetz 2008 [JStG 2008] [Annual Tax Act 2008] Dec. 20, 2007, Bundesgesetzblatt [BGBl] I at 3150, 3185, 3186 Art. 24 (F.R.G.).

[285] Schreiben betr. Grundsätze zur Anwendung des Außensteuergesetzes, May 14, 2004, BStBl. I special no. 1/2004 at 3, no. 5 (F.R.G.).

[286] Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-1179.

[287] Case C-524/04, Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue, 2007 E.C.R. I-2107; Case 105/07, Lammers & Van Cleeff NV v. Belgische Staat, 2008 E.C.R. I-173.

[288] Unternehmenssteuerreformgesetz 2008 [UStRG 2008] [Business Tax Reform Act 2008] Aug. 14, 2007, BGBl. I at 1912, Art. 1 no. 6, Art. 2 no. 5 (F.R.G.).

Bundesfinanzministerium published an application circular concerning the *Zinsschranke*.[289]

7.6.4 Double Taxation Conventions

Germany has an extensive treaty network. The treaties generally follow the OECD Model Tax Convention which does not include special rules that limit the inappropriate use of treaties to avoid or reduce taxation aside from the limitations to the beneficial owner in Art. 10–12 of the convention.[290] However, several double tax conventions (DTC) with Germany contain rules which have been developed to combat tax avoidance through circumvention of the convention.[291] Article 28 of the German DTC with United States is a limitation on benefits clause and, pursuant to Article 1.6 of the treaty, the German CFC-legislation is explicitly applicable.[292] Article 45.2 a) of the German DTC with Denmark[293] as well as Article 43.2 a) of the German DTC with Sweden[294] generally stipulates that nothing in the convention shall be construed as encouraging tax avoidance. Furthermore, numerous DTC with Germany contain switch-overclauses[295] and subject-to-tax-clauses.[296] The switch-over-clauses are now superseded by Section 50d.9 EStG. This overriding treaty provision was enacted by the Annual Tax Act of 2007 (*Jahressteuergesetz 2007*)[297] and allows selection, under certain conditions, of the credit method instead of the exemption method without any consultation. Finally, several German DTC contain explicit

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[289] Schreiben betr. Zinsschranke (§ 4h EStG; § 8a KStG), July 4, 2008, BStBl. I at 718 (F.R.G.).

[290] But see Commentary to Art. 1 of the OECD Model Convention, ¶ 7-27.

[291] See Klaus Vogel, *vor Art. 6-22 OECD-MA*, in DOPPELBESTEUERUNGSABKOMMEN – KOMMENTAR, margin note 16–34 (Klaus Vogel and Moritz Lehner, eds., 5th ed. 2008); Gerrit Frotscher, supra note 269, margin note 251, at 119; Johanna Hey, *supra* note 243, at 144.

[292] Doppelbesteuerungsabkommen mit den Vereinigten Staaten von Amerika [DBA-USA] [Double Tax Convention with the United States of America], Aug. 29, 1989, BGBl. 1991 II at 354 as amended by Protocol, June 1, 2006, BGBl. II at 1184 (F.R.G.).

[293] Doppelbesteuerungsabkommen mit Dänemark [DBA-Dänemark] [Double Tax Convention with Denmark], Jan. 30, 1962, BGBl. 1963 II at 1311.

[294] Doppelbesteuerungsabkommen mit Schweden [DBA-Schweden] [Double Tax Convention with Sweden], July 14, 1992, BGBl. 1994 II at 686.

[295] See Rainer Prokisch, *Art. 1 OECD-MA*, in DOPPELBESTEUERUNGSABKOMMEN – KOMMENTAR, margin note 136-136d (Klaus Vogel and Moritz Lehner, eds., 5th ed., 2008).

[296] See Rainer Prokisch, *supra* note 295, margin note 142; Klaus Vogel, *supra* note 291, margin note 31–34.

[297] Jahressteuergesetz 2007 [JStG 2007] [Annual Tax Act 2007] Dec. 12, 2006, Bundesgesetzblatt [BGBl] I at 2878, Art. 1 no. 41 (F.R.G.).

permission for the contracting states intending to apply their domestic anti-abuse rules to treaty provisions.[298]

Section 50d.3 EStG contains another override provision[299] which counters treaty-shopping and has been recently strengthened by the *Jahressteuergesetz 2008*.[300] Pursuant to Section 2 AO, treaty provisions prevail over domestic tax law. However, a statutory provision that became effective after a convention may override the treaty.[301] The lex specialis as well as the *lex posterior* principle is applicable. The treaty provision is not necessarily the rule which governs the specific subject matter in this meaning and may be overridden,[302] as in the case of Section 50d.3 EStG. The unilateral anti-avoidance rule denies treaty benefits to a non-resident company if it is not the beneficial owner of the income and its shareholders would not be entitled to the treaty benefit; and if one of the following three conditions is fulfilled: (1) The use of the intermediary company does not have economic or other important reasons; or (2) the foreign company does not generate more than 10% of its gross income from its own active business activities; or (3) the foreign company is not adequately equipped for carrying out its business activities. Particularly, the second requirement is new, and it remains to be seen whether such a test would be considered to be compatible with EU law. The amendment overshoots the mark.[303]

7.7 Penalties

Particular criminal penalties are imposed only in case of tax crimes. There are no criminal penalties relating to tax avoidance, as long as the transaction was not at the same time a punishable offence.[304] The legal consequences of tax avoidance are depending on whether the transactions fall within the scope of a TAAR or not. In the first case, the legal consequences are determined pursuant to that provision.[305] The legal consequences of the TAARs are not based on a single model. They range from retroactive

[298] See Rainer Prokisch, *supra* note 295, margin note 135-35a, 137.

[299] See Alexander Rust and Ekkehart Reimer, *Treaty Override im deutschen Internationalen Steuerrecht*, 14 INTERNATIONALES STEUERRECHT [IStR] 843, 844–849 (2005) (F.R.G.).

[300] Jahressteuergesetz 2008 [JStG 2008] [Annual Tax Act 2008] Dec. 20, 2007, Bundesgesetzblatt [BGBl] I at 3150, 3171, Art. 1 no. 41 a) (F.R.G.).

[301] Bundesfinanzhof [BFH] [Federal Fiscal Court] May. 21, 1997, 184 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 281 (F.R.G.); Bundesfinanzhof [BFH] [Federal Fiscal Court] Nov. 28, 2001, 197 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 68 (F.R.G.).

[302] Johanna Hey, *supra* note 243, at 148.

[303] See Dietmar Gosch, supra note 259, at 618.

[304] See II. 3.; see no. 3 to § 42 AEAO.

[305] § 42.1 sentence 2 AO.

refusal of tax exemptions to stand-alone tax obligations.[306] In the second case, the tax claim arises in the same manner as it arises through the use of legal options appropriate to the economic transactions concerned. The legal structure is disregarded for tax purposes.[307]

The tax offices and the Federal Central Tax Office may upon application provide advance ruling on the treatment for tax purposes of precisely defined, as yet unrealized circumstances where this is of special interest in the light of the significant tax implications.[308] However, the interpretation of the discretionary provision is specified by decree. Thereafter, an advance ruling should not be issued if the taxpayer intends to derive a tax advantage.[309] Nevertheless, Section 178a AO provides an advance pricing agreement procedure with a view to the future consensual distribution of profits between a domestic enterprise and its foreign permanent establishment or with a view to the future consensual determination of profits of a domestic permanent establishment of a foreign enterprise.

7.8 Statutory Interpretation

7.8.1 GAAR

Section 42 AO is regarded as one of most demanding rules of the German tax law – intellectually as well as dogmatically.[310] The high level of abstraction of the GAAR means that, without the context of a particular case, defining the terms of the provision is a more or less impossible task. It would be tantamount to the philosophical reflection on justice. If we could define it exactly, we would not need another law. As long as such a definition is not found, the function of the GAAR must be considered in the context of the particular case and the applicable statutory provisions. However, this is the field of statutory interpretation. The role which statutory interpretation plays is similar to the role of the GAAR. The goal of the GAAR is to realize the purpose of tax law. Though, the purpose of tax law is subject to the teleological interpretation. Tax avoidance is a sub-category of the abuse of law.[311] Abuse of law is within the letter of the law, but against

[306] See Johanna Hey, *supra* note 72 (manuscript at 12–13).

[307] § 42.1 sentence 3 AO.

[308] § 89.2 sentence 1 AO.

[309] No. 3.5.4. to § 89 AEAO (F.R.G.).

[310] Markus Heintzen, *supra* note 143, at 605.

[311] Bundesfinanzhof [BFH] [Federal Fiscal Court] Mar. 19, 1980, 130 Sammlung der Entscheidungen des Bundesfinanzhofs [BFHE] 422 (F.R.G.); Klaus-Dieter Drüen, supra note 140, margin note 1, at 136/17–136/18.

the spirit of the law.[312] Therefore, abuse of law as well as tax abuse may be understood as a problem of statutory interpretation.[313] Tax abuse is derived from the grammatical interpretation of the elements of a tax, but it is doubtful whether it is consistent with the systematic and teleological interpretation of the tax law.[314] That depends on what significance both interpretation methods have. Pursuant to the German civil law jurisprudence, these methods are sufficient to reject a separate doctrine of abuse of law.[315]

However, the methodological standpoint in German tax law has not been clarified yet.[316] The principle of legal certainty and clarity (*Bestimmtheitsgrundsatz*)[317] and the prohibition of analogy argue in favour of a narrow interpretation of tax law. For that reason, some academic writers conclude that the traditional civil law terms used in tax law should be interpreted in the meaning of the civil law jurisprudence. They follow a textualist approach, insisting strictly on the literal meaning of a tax provision and rejecting a general "substance over form" rule.[318] From this point of view, the GAAR has independent significance and is "a meaningful instrument which is necessary in order to discourage abusive behavior".[319] The legal consequence of the GAAR is a fiction.[320] However, the textual approach also leads to a narrow interpretation of the GAAR. The facts of an inappropriate legal option are substituted by the facts of an appropriate option. Its application is restricted to "outright artificial constructions"[321] and to the case of inner contradictions.[322] In the end, tax avoidance may only be effectively tackled if the legislator foresees all legal options.[323]

In contrast, other writers as well as the *Bundesverfassungsgericht* take a teleological approach and interpret the traditional civil law terms within the framework of the tax law. Pursuant to the rulings of the court, equality before the law requires an equal tax burden in accordance with the

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[312] See Heinrich Wilhelm Kruse, *supra* note 171, at 145; Arndt Teichmann, Die "Gesetzesumgehung" im Spiegel der Rechtsprechung, 58 JURISTENZEITUNG [JZ] 761, 762 (2003) (F.R.G.).

[313] See *id*. at 765.

[314] Paul Kirchhof, *supra* note 147, at 174.

[315] Arndt Teichmann, *supra* note 312, at 767.

[316] See Wolfgang Schön, *supra* note 170, at 48–49.

[317] See 7.5.

[318] Heinrich Wilhelm Kruse, *supra* note 171, at 144-45; Wolfgang Schön, *supra* note 47 (manuscript at 17–20, 22–25).

[319] Wolfgang Schön, *supra* note 170, at 48; see also Michael Wendt, *supra* note 152 (manuscript at 9–10).

[320] Heinrich Wilhelm Kruse, *supra* note 171, at 145.

[321] Wolfgang Schön, *supra* note 170, at 48.

[322] Wolfgang Schön, *supra* note 47 (manuscript at 17–20, 31–34).

[323] See Wolfgang Schön, *supra* note 47 (manuscript at 7).

ability-to-pay-principle.[324] The tax should be as inevitable as possible.[325] Therefore, the principle of equality calls for a broader statutory interpretation of the civil law terms which are used in tax law. The tax law has its own doctrine of interpretation[326] which is based on the relativity of legal terms.[327] The development of the law by judicial interpretation and the teleological and constitution-based approach make a special doctrine of abuse of law in the field of taxation as well as the GAAR superfluous.[328] The GAAR is nothing more than a guide for interpretation.[329]

7.8.2 Other Provisions

Tax acts which involve economic performance are interpreted by an economic approach which is part of the teleological interpretation. Hence, the terms of civil law must be construed in accordance with the purpose of the tax law.[330] However, this does not mean that the interpretation of tax law is detached from civil law. Transactions between civil law persons are initially to be considered according to civil law. In a second step, the result must be reviewed using the economic approach. Review under private law is decisive as long as it corresponds to the purpose of the tax law. Otherwise, the teleological interpretation of the legal term principally calls for priority.[331] The *Bundesverfassungsgericht*, for example, decided that the legal form of a business does not justify that an exemption from turnover tax for medical services is not granted.[332]

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[324] See 7.5.

[325] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Apr. 10, 1997, 96 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 1, 6 (*Weihnachtsfreibetrag*) (F.R.G.); Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] Dec. 7, 1999, 101 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 297, 309 (*Häusliches Arbeitszimmer*) (F.R.G.).

[326] Paul Kirchhof, *Der Vertrag als Ausdruck grundrechtlicher Freiheit*, in FESTSCHRIFT FÜR PETER ULMER ZUM 70. GEBURTSTAG AM 2. JANUAR 2003, 1211, 1223–1224 (Mathias Habersack et al., eds., 2003).

[327] Paul Kirchhof, supra note 43 (manuscript at 13–14).

[328] Paul Kirchhof, supra note 38, margin note 34, at 979.

[329] SUSANNE SIEKER, *supra* note 261, at 28–35; Peter Fischer, *supra* note 141, margin note 74, at 57–58; Paul Kirchhof, supra note 43 (manuscript at 14–15).

[330] Manfred Groh, *Die wirtschaftliche Betrachtungsweise im rechtlichen Sinne*, 66 STEUER UND WIRTSCHAFT [STUW] 227 (1989) (F.R.G.); KLAUS TIPKE, 3 DIE STEUERRECHTSORDNUNG 1283–1296 (1993).

[331] Joachim Lang, *supra* note 62, § 5-77-81, at 157–158.

[332] Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] May 29, 2000, 101 Entscheidungen des Bundsverfassungsgerichts [BVerfGE] 151 (155-56) (*Umsatzsteuerbefreiung*) (F.R.G.).

7.9 Disclosure Requirements

The German tax law does not impose disclosure requirements for taxpayers entering into tax avoidance transactions. However, in the legislative process of the *Jahressteuergesetz 2008,*[333] the finance committee of the *Bundesrat* recommended introduction of a new provision in the *Abgabenordnung* containing disclosure rules for international tax avoidance schemes,[334] but the *Bundesrat* rejected the recommendation.[335] Initially, the *Bundesfinanzministerium* had launched this plan, but it had not been part of the original draft of the *Jahressteuergesetz 2008*.[336] The disclosure rule was supposed to be embedded in Section 138a AO and would have focused on the promoter as in the U.K. disclosure rules. The scope of application would have only concerned external schemes, especially, cross-border transactions tackling "double dipping" and "white income" effects. Penalties with a maximum of 5 million € for each promoted structure were envisaged. Germany would have been the first civil-law country to introduce such anti-avoidance provisions.[337]

7.10 Tax Shelters

Germany addresses the issue of "tax shelter" in Section 15b EStG. The provision was enacted in 2005[338] to counter the use of losses generated by certain "tax deferral schemes" which, generally, may not be used to offset income. This includes the general loss carryback and carryforward provision is excluded.[339] However, such losses may be used to offset income of the taxpayer which arises in the following financial years from the same source as the losses.[340] Pursuant to Section 15b.2 sentence 1 EStG, circumstances constitute a "tax deferral scheme" if they give rise to tax benefits in the form of losses. This is the case if a pre-designed scheme offers the opportunity to offset projected losses against other income, at least in the

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[333] See 7.5.1.

[334] BRDrucks 544/1/07, at 64–67.

[335] BRPlenarprot. 836, at 293 (C).

[336] Gesetzentwurf zur Anzeigepflicht von Steuergestaltungen, June 25, 2007, available at http://rsw.beck.de/rsw/upload/FDMA/StGestAnzPflG_RefEntw.pdf.

[337] See Wolfgang Kessler and Rolf Eicke, *Legal but Unwanted: The German Tax Planning Disclosure Draft*, 48 TAX NOTES INTERNATIONAL [TNI] 577–582; Wolfgang Schön, *supra* note 170, at 54–55.

[338] Gesetz zur Beschränkung der Verlustverrechnung im Zusammenhang mit Steuerstundungsmodellen [StStundMVBG] [Tax Deferral Schemes Act] Dec. 22, 2005, Bundesgesetzblatt [BGBl] I at 3683, Art. 1 no. 4 (F.R.G.).

[339] § 15b.1 sentence 1, § 10d EStG.

[340] § 15b.1 sentence 2 EStG.

initial phase of the investment.[341] The provision applies only if the total projected losses are expected to exceed 10% of invested capital during the initial phase.[342] According to a circular concerning the application of the provision,[343] the broad wording mainly targets media funds, game funds, new energy funds, life insurance secondary market funds and closed-end property funds. This legislation has more or less eliminated the private investor market for film funds in Germany.

7.11 Conclusions

Following the amendment of the GAAR, no new legislation proposal concerning § 42 AO is yet in sight. The response of the *Bundesfinanzhof* to the existing provision is predictable. But, there are hardly any reasons for hope in a stringent application of the GAAR by the court.[344] Meanwhile, the battle against tax avoidance and tax fraud continues. The German government fights with the gloves off. The Tax Fraud Combat Act (*Steuerhinterziehungsbekämpfungsgesetz*)[345] was enacted in July 2009, its accompanying ordinance being issued in September 2009.[346] This legislation is aimed at combating tax evasion and fraud in cross-border situations, especially in cases involving offshore tax havens without OECD standards. However, it is only a snapshot in the cat-and-mouse game between the small minority of taxpayers who abuse the tax system and deceive the government. The promoters of tax shelters will always find new ways to avoid taxes, with the legislature reacting with the adoption and the amendment of TAARs as far as it is possible in a globalized world. This dynamic process will not end until a fundamental reform which radically simplifies the tax system is adopted.[347]

[341] § 15b.2 sentence 2 EStG

[342] See § 15b.3 EStG.

[343] Anwendungsschreiben § 15b EStG, July 17, 2007, BStBl. I 542 (F.R.G.).

[344] See 7.4.2.

[345] Steuerhinterziehungsbekämpfungsgesetz [JStG 2008] [Tax Fraud Combat Act] Dec. 20, 2007, Bundesgesetzblatt [BGBl] I at 3150, 3171, Art. 14 no. 2 (F.R.G.).

[346] Steuerhinterziehungsbekämpfungsverordnung [SteuerHBekV] [Ordinance of the Tax Fraud Combat Act] Sept. 18, 2009, BGBl. I at 3046 (F.R.G.).

[347] See Paul Kirchhof, *Der Karlsruher Entwurf und seine Fortentwicklung zu einer Vereinheitlichten Ertragssteuer*, 85 Steuer und Wirtschaft [StuW] 3, 3–22 (2002) (F.R.G.); Paul Kirchhof, *Die Besteuerung des Einkommens in einem einfachen, maßvollen und gleichmäßigen Belastungssystem*, 61 Betriebs-Berater [BB] 71–75 (2006) (F.R.G.); see also Hanno Kube and Ulrich Palm, *The Unified Income Tax – An Initiative To Reform Income Tax Law in Germany*, in 31 Intertax 12–20 (2003) (Neth.).

Chapter 8
Hungary

Éva Erdős, Zoltán Nagy, and Zoltán Varga

8.1 Legal System

Hungary features a continental-type legal system. There is separation of powers relating to the legislative, executive, and judicial branches of government.

The main organization of state power is the Parliament. The Parliament secures the constitutional order of the society and defines the government's organization and direction.[1] The Parliament is a legislative body that constructs the Constitution and the Acts.

The state's head is the President of the Republic, elected by the Parliament for 5 years. The balance of executive power lies in the Prime Minister and other ministers. Below the cabinet, the first level of the central administration (ministries) is determined after proposal by the Parliament.

Adjudicatory authority lies in the Supreme Court, the judgment boards, the Capital Court, and the local courts. Special courts may also be established for cases defined by law.[2] The Constitutional Court, as the main organ of constitutional protection, re-examines the constitutionality of legislative acts.

[1] 1949. évi XX. tv. A Magyar Köztársaság Alkotmánya (Constitution of Hungary) 19.§ (1)–(2).

[2] Alkotmány (Constitution of Hungary) 45.§–50.§. az 1994. évi LXXI. törvény alapján eseti vagy állandó választott bíróság kialakítására van lehetőség.

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8.2 Tax System

The power to tax rests in Parliament as well as in local governments. The Revenue & Customs Tax Office is responsible for enforcement of tax laws. First-level judicial review of tax controversies is binding, unless the Supreme Court agrees to hear the merits of the case. Decisions of appellate courts are also reviewable.

8.3 Tax Mitigation, Avoidance, and Evasion

In Hungarian law, tax mitigation is tax planning or optimization in which the taxpayer obtains the most favorable result.[3] Tax avoidance is abuse of the law without violation of criminal law. Tax evasion is connected to the untaxed economy and involves crimes, like fraud, money laundering, bribery, and violation of accountancy rules.[4]

8.4 Substance Over Form

A general principle in Hungarian law provides that a tax reduction, exemption, or other benefit is available only if the legal transaction accords with the purpose of the rule.[5] There are additional special corporate taxation rules that take a purposive approach.

8.5 GAAR

Hungary was the first among the Middle-Eastern-European countries to adopt a GAAR. The GAAR provides for the following:[6]

- classification of a transaction in conformity with its real content;
- requirement of proper legal practice;
- reference to rules of connected transactions;
- limitation on transfer pricing among related parties.

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[3] Földes in Pénzügyi Jog I. (Financial law) (2007) p. 410 and more about: Deák, Dániel: Adótervezés a nemzetközi gyakorlatban (Tax planning in the international practice) (IFA) Adventura 2000 Kft. Budapest, 2000. pp. 1–211.

[4] Deák, (2005) p.192.

[5] Tao. tv. 1.§ (2)

[6] Földes Gábor: Adójog, (Tax Law) Osiris Kiadó, Budapest, 2004. 80. o.

The adoption of GAAR rules was motivated by growing tax avoidance which increased in tandem with the complexity of tax law. The legislature hoped to close loopholes that provided opportunities for tax avoidance.

The rules can be viewed as a success as they have slowed entry into tax avoidance transactions. It is also an important weapon for the taxing authority.

The constitutional basis for anti-avoidance legislation is the obligation of equality of sacrifice.

8.6 Cross-Border Rules

In general, cross-border rules cover improper use of off-shore tax havens, controlled foreign corporation rules, rules regarding transactions between related parties, and treaty shopping. An offshore regime, reducing corporate tax from 18 to 3% for investments by foreigners in off-shore corporations, was eliminated in 2004 in connection with Hungary's accession to the European Union.

8.7 Statutory Interpretation

Both the legislature and the courts have employed a substance over form analysis in the following circumstances:[7]

- when qualifying transactions according to their real content;
- when interpreting national law in harmony with EU law;
- when determining whether eligibility for tax relief is based on a fictitious contract.

Courts are given discretion to examine every step of a transaction, viewing the transaction as a whole in determining tax law consequences.

8.8 Disclosure Requirements

There are no disclosure requirements for taxpayers engaging in tax avoidance transactions. Similarly, tax advisers, including attorneys, are not required to disclose tax avoidance activities of their clients. An attorney may not disclose any document or fact pertaining to his client in the course

[7] Bírósági döntések (Court decisions): EBH 2006.1568.; KGD 2006.85.; EBH 2006.1571.; KGD 2006.86.

of an official inquiry, but he may not obstruct proceedings of the taxing authority. There is an exception to the no-reporting rule in the case of money laundering or terrorist financing.

Under Act XI of 1998 on Attorneys at Law and the Act CXXXVI of 2007 on the Prevention and Combating of Money Laundering and Terrorist Financing, obligations of attorneys in terms of clients are the following:

1. They are required to carry out a verification of the identity of the customer.
2. They are required to apply customer due diligence procedures.
3. Reporting is mandated if there is any information, fact or circumstance giving rise to suspicion of money laundering or terrorist financing.

There is a penalty of 2 years of imprisonment if this provision is violated.[8]

[8] 1978. évi IV. törvény/law 3030/B. §. A

Chapter 9
Italy

Carlo Garbarino

9.1 Legal System

The Italian legal system[1] can be qualified as a civil law system heavily influenced by Roman Law and the Napoleonic codification experience as well as the doctrinal influence of the German-speaking legal tradition (either due to the prestige traditionally exerted by German legal scholarship or by the close contacts and – in some areas of Italy – legacy – of the Austrian Legislation). In recent years, some typically common law-backed legal concepts and tools, such as trusts, have made their way into the Italian legislation, scholarly debate,[2] and, practice.

Tax law is a special branch of the broader Italian legal system. On the grounds of the intrinsic unity and indivisibility of any legal system, where autonomy of different branches of law is to be seen as a scientific taxonomy rather than an ontological one,[3] tax law can be said to stand at the crossroads of public law and private law from a functional point of view, while its substantial core, as well as its boundaries are to be found in the notion of tax.

There are inevitable overlaps with Constitutional Law, as the Italian Constitution foresees provisions specifically dealing with taxation matters. Art. 3 of the Italian Constitution states the general principle of equality. All citizens (all citizens in their vest of taxpayers, it may be read, for

[1] For a comprehensive introductory reading in English to the Italian legal system, reference could well be made to J.S. LENA, U. MATTEI (Eds.), *Introduction to Italian Law*, Zuidpoolsingel, 2002.

[2] In this respect, it is quite curious to remark the existence of a domestic law review, written in Italian, titled "*Trust*".

[3] P. DE BARROS CARVALHO, *Curso de direito tributário*, São Paulo, 2008, 14.

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K.B. Brown (ed.), *A Comparative Look at Regulation of Corporate Tax Avoidance*, Ius Gentium: Comparative Perspectives on Law and Justice 12,
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our purposes) are equal before the law, without regard to their sex, race, language, religion, political opinions and personal and social conditions.

The foundation for the discussion of "abuse of rights" non-written judge-made law, which will be developed further in this chapter, is found in the legality principle, enshrined in Art. 23 of the Italian Constitution, which, similarly to the "no taxation without representation" slogan, establishes that personal or patrimonial obligations can be imposed only if established by Law.

Article 53 of the Italian Constitution extends the principle of equality to tax matters by introducing the public finance – derived concept of "ability to pay" as well as endorsing the principle of progressive taxation so that: "(1) Everyone has to contribute to public expenditure in proportion to their ability to pay and (2) The tax system has to conform to the principle of progression." On the grounds of these fundamental constitutional provisions, the Italian Constitutional Court has issued a copious number of judgments whose outline and assessment, even in summary terms, would, however, probably fall outside of the scope of this work.[4]

As a member of the EU, Italy's tax system has been increasingly shaped by Community Law. This applies both to the implementation of European secondary law (e.g., the implementation of VAT Directives as well of the European Directives introducing specific regimes within the context of income taxation) and to the often groundbreaking effects on Member States' tax system exerted by the case law of the European Court of Justice.

Italy adopts separation of powers between the judiciary, the legislative and the executive powers, with legislative power awarded to the Parliament, composed of a House of Deputies and a Senate. Nonetheless, under some circumstances and within the context of peculiar lawmaking techniques, the Italian Constitution[5] awards the competence to legislate, that is, to issue acts having the same powers of a law, also to the Government.

Art. 76 of the Constitution allows the Parliament to delegate its legislative power to the Government, which, in turn is provided with the power to issue a so-called legislative decree. The legislative decree is a legislative tool that is often deployed in tax matters and, in general, in all those matters where a strong technical content is present.

Art. 77 of the Constitution awards the Government a special type of legislative power, to be exerted in case of necessity and urgency, which allows the issuing of a law decree. A law decree must be submitted to the Parliament, which must convert the decree into a law within sixty days from its issuance, otherwise it will be deprived of its effects. This legislative instrument is also frequently deployed in tax law matters.

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[4] An introductory reading in this respect may be G. MARONGIU, *I fondamenti costituzionali dell'imposizione tributaria*, Torino, 1991.

[5] In particular, Art. 76 and 77 of the Italian Constitution.

The Government may also exert normative power by issuing legal instruments that do not have the same power of a law, such as ministerial decrees. Within the context of tax legislation, ministerial decrees are the instrument of choice for providing the legislative package of a tax measure with the related procedural rules as well as other implementation details. Based on the interpretation of Art. 23 of the Italian Constitution, which sets forth a legality principle with respect to the imposition of taxes, in no case could a ministerial decree be used to introduce a new tax or as the legal instrument of promulgating the core substantive rules governing a tax measure.

Law No. 212/2002 contains the "Taxpayer's Bill of Rights," which provides a framework applicable to any area of Italian tax legislation[6] in which the introduction of new taxes or the extension of the personal scope of application of a tax may not be achieved by issuing a law decree.

The revision of tax laws is almost a constant work in progress in Italy, as the annual Budget Law often represents the chance to intervene on public revenues by amending some aspects of the existing tax laws. An example of how Budget Laws offer the opportunity for overturning existing provisions dates back to the Budget Law for 2008, where thin capitalization rules were discarded in favor of an earnings stripping provision akin to that introduced in the previous years in Germany.

At the same time, organic reforms of the tax system are much less frequent. The last one dates back to 2004, when the Income Tax Code was significantly modified and renumbered and a new corporate income tax was introduced. The 2004 tax reform would have been an excellent field of study for comparative lawyers, as many tax models from the US and from other European Countries circulated to the point of being transplanted into the Italian tax jurisdiction: this the case of the participation exemption rule, the fiscal unit rule (both domestic and worldwide) as well of the now defunct thin capitalization rule.

9.2 Enforcement of Tax Laws

Inland Revenue Agency ("Agenzia delle Entrate," hereinafter I.R.A) is responsible for the enforcement and administration of tax laws, with particular respect to income taxation and indirect taxes. The Italian tax authorities can also rely on a special Tax Police ("*Guardia di Finanza*"), which, as well as being a fully fledged military corps, shares the same administrative powers and duties of the I.R.A. The collection of taxes has now been outsourced to a company which is controlled by the I.R.A., "*Equitalia S.p.A.*"

[6] The scope of Application of this legislative instrument is provided by its Art. 1.

The tax system is based on co-operation between taxpayers and Tax Authorities and practically relies on a self-assessment by the taxpayers, who are expected to file annual tax returns and determine their tax liability. Nonetheless, the I.R.A. as well as the Tax Police may conduct tax audits in order to ascertain that taxpayers have determined their tax obligations correctly and that no tax offenses have occurred.

9.3 Tax Controversies

Tax controversies are decided by judicial bodies which are special tax courts. The first tier tax courts are in every Italian province. Within each provincial first tier tax court (Commissione tributaria provinciale) it is possible to find different chambers. Different chambers are however equal in terms of competence as no specialization *ratione materiae* is foreseen at a first tier level.

Tax controversies are always triggered by the taxpayer, who is entitled to refer to court by challenging one of the following notices or decisions issued by Tax Authorities:

- a tax assessment notice;
- a tax payment notice;
- a tax penalties notice;
- a tax roll;
- a tax levy;
- an arrears notice;
- deeds concerning the property Register;
- the (express or tacit) refusal of tax and undue tax penalties refunds;
- the refusal or the repeal of tax allowances;
- the refusal of request for tax agreements;
- any other deed with reference to which a separate challenge before tax Courts is foreseen by Law.

Article 7 of the Taxpayer's Bill of Rights establishes that any tax assessment notice issued by Tax Authorities must be properly motivated, otherwise it is invalid. Along with the motivation, the tax assessment notice must always state the amount of the assessed taxable base, the applied tax rates, the settled amount of the tax, the competent unit within the Tax Administration and the contact details of the person to whom the taxpayer may refer to in order to obtain clarifications. Such rules are directly linked to the right of defense of the taxpayer who needs to be provided with this basic information so that he can assess whether and how to challenge the assessment.

In addition to challenging an assessment, the taxpayer must notify the competent tax court of its intention to start a proceeding. This notification should be given within sixty days of the date of challenge of the assessment. Taxpayers must be assisted by a qualified tax attorney, who may be a lawyer or a certified public accountant at the first two stages of the contest. A lawyer admitted to plead before the Court of Cassation is needed for the third and last stage.

Both the taxpayer and the tax authorities may appeal the decision of a first tier Provincial Tax Court by resorting to the corresponding second tier Regional Tax Courts. As the name suggests, second tier regional tax Courts are also established on the basis of a territorial criterion, one for each Italian Region.

The decisions of the second tier regional tax Courts may be appealed by resorting to the Italian Court of Cassation, which currently features a Tax Chamber. The decision of the Tax Chamber of the Court of Cassation only revolves around the strictly juridical terms of a dispute, while a factual re-assessment of the controversy is not foreseen.

9.4 Tax Mitigation, Tax Avoidance, and Tax Evasion

Italian tax jurisprudence is no exception in embracing the tripartite taxonomy – tax mitigation, tax avoidance, and tax evasion – even though, actual legislative and administrative definitions of these three distinct behaviors is often lacking. Nonetheless, these concepts are widely referred to in case law, administrative practice and, in particular, legal scholarship.

Developments in Italian legislation which subsequently led to the enactment of provisions tantamount to a general anti-avoidance rule (hereinafter GAAR) in the 1990s were highly influenced by the academic definition of tax avoidance. This occurred differently from the US and the UK experiences, where tax avoidance emerged as an industry within the context of tax legal practice rather than as a concept.

The setting of a theoretical framework for defining and identifying tax avoidance was developed by legal scholars (both German and Italian) in the Thirties and predates by far explicit normative references on the point. The most concise and vivid definition of tax avoidance is probably the one set forth by the Italian-German scholar Albert Hensel, who concluded that, tax avoidance takes place where interpretation comes to an end.[7] The underlying assumption is that any tax avoiding behavior may be countered by an adequately extensive interpretation of the applicable tax laws (*interpretazione antielusiva*). In this respect, tax avoidance may prosper where

[7] A. HENSEL, *Zur Dogmatik des Begriffs Steuerumgebung*, in ID. (Ed.) *Festgabe der Bonner Juristenfacultät für E. Zitelmann*, München, 1923, 244.

a formalistic and literal interpretation is endorsed, since tax avoidance can be defined as a form of tax saving achieved by privileging (legal) form at the detriment of (economic) substance in interpreting tax laws.

A working definition of tax avoidance is summarized in the following elements of the current GAAR (Art. 37-*bis* of Presidential Decree No.600/1973). Tax avoidance can be detected when the following simultaneously take place:

- tax saving
- lack of valid business purpose
- use of abnormal legal arrangements
- specific intent

Regarding such a conceptual background, no GAAR existed in the Italian tax system until 1990, when with Law No. 408/1990, an explicit anti-avoidance clause, although not of general import, was first introduced.[8] The scope of application was broadened with the insertion of Art. 37-*bis* into Presidential Decree No. 600/1973, which took place in 1997.

In particular, the GAAR provides that tax authorities may disregard single or connected acts, facts and transactions:

- intended to circumvent obligations or limitations provided under tax law
- intended to obtain tax savings or refunds otherwise undue, and
- lacking a sound business purpose.

This GAAR is applicable provided that such acts, facts or transactions include at least one of the seventeen transactions listed under Para. 2. As it will be outlined hereinafter, the list thereby encompassed is so broad that the GAAR may be considered one of general application.

Rulings issued by the tax authorities have labeled some specific transactions as tax avoiding. A few reoccurring cases may be mentioned. Applicable to corporate reorganizations, a reoccurring tax avoiding scheme has centered around real estate demergers followed by a sale of the shares of the beneficiary company. In these cases, the tax authority has considered the demerger a means to carve out some assets or a portion of the company in order to tax advantage of the tax imposed upon a subsequent sales of share, which is usually more favourable than the tax regime applicable to a sale of assets.

Tax evasion is a general concept encompassing a wide variety of different forms of tax offenses which can trigger administrative sanctions, including interest for delayed payments that basically have a restitutory nature, and criminal sanctions. The very notion of tax evasion as a general category

[8] F. PAPARELLA, "Riflessioni in margine all'art. 10 della Legge 1990, n. 408, relativo alla ristrutturazione delle imprese", (1995) 6 *Dir. prat. trib.*, 1835.

thus finds no reference in the wording of any specific national provision, but, at a domestic level, it is rather the result of doctrinal categorizations.[9] On the other hand, frequent reference is made to the words "tax evasion" in double tax treaties as well as in provisions resulting from the process of implementation of EU secondary legislation.[10]

In this respect, tax evasion can be qualified as the open violation of tax rules concerning tax accounting requirements, the issuing of invoices on taxable transactions, the filing of tax returns, the correct payment of taxes due. It is an illegal tax behaviour which is carried out by hiding the existence of taxable situations and is subject to (administrative and criminal) sanctions. In this respect, there are a few reoccurring characteristics that signal tax evading behaviour, which can be summarised in the following three points:

- the circumstance that a tax-triggering behaviour has been put into place and the awareness thereof;
- the awareness that a specific tax obligation is connected to the specific behaviour which has been put into place;
- the attempt to circumvent such tax obligation (in part or in full) by means of specific actions or omissions.[11]

A tax fraud is a particular type of tax evasion and qualifies as an illegal tax behaviour which is carried out as a result of deliberate intent and through the alteration of documents and accounting books.

References to tax mitigation may be found in Italian tax scholarship under the expression "lecito risparmio *d'imposta*" or legitimate tax savings. The tax authorities have attempted to separate tax mitigation from tax avoidance in issuing administrative rulings. In particular, according to Ruling No. 117/1999:

> [T]he deployment of arrangements that are legal per se but that are not approved by the tax legal system is what distinguishes tax avoidance from a legitimate tax saving, the latter implying the deployment of the most favorable tax rules picked among those that the tax legal system offers to the taxpayer, on level of equal legitimacy.

[9] A. LOVISOLO, "L'evasione e l'elusione tributaria", (1984) *Dir. prat. trib.,* 1287.

[10] See for instance Art. 11 of Directive No. 90/434/EEC ("*Mergers Directive*") or Art. 1 of Directive No. 90/435/EEC ("Parent Subsidiary Directive"). The case law of the ECJ has somewhat suffered from terminological inconsistencies in the Italian versions of its decisions with respect to the notions of tax avoidance and tax evasion. In this respect, see P. PISTONE, "L'elusione fiscale come abuso del diritto. Certezza giuridica oltre le imprecisioni terminologiche della Corte di Giustizia Europea in materia di I.v.a", (2007) 3 *Riv. dir. trib.,* 17.

[11] A. CONTRINO, *Elusione fiscale, evasione e strumenti di contrasto. Profili teorici e problematiche operative*, Bologna, 1996, 25.

Such an approach seems to be consistent with the most recent international studies on this specific topic as well as with the experience of other countries.[12]

Apart from the theoretical benchmark provided by scholarship and the occasional guidelines rendered by tax authorities, there is no clear-cut legislative definition determining the boundaries of legitimate tax saving (e.g., in the form of the safe harbors).

In this latter respect, a legitimate tax saving can generally be defined[13] as the achievement of a tax saving through the correct use of tax rules and therefore is a legal tax behaviour which leads to the result of reducing or minimizing taxes in a legal way. Legitimate tax saving is also defined as tax planning, i.e., a deliberate activity carried out by the taxpayer to reduce taxes by complying with tax legislation and regulations. By contrast, tax avoidance, although carried out openly like "legitimate tax saving," constitutes an abuse of tax laws. It is interesting to remark that, within the existing Italian framework, the very same transaction may be labelled as a form of legitimate tax saving rather than a tax avoiding one on the grounds of the existence of a sound business purpose and the lack of apparent signals of a purposive scheme aimed at circumventing tax laws.

In the definitive, more efforts in sorting out tax avoidance from legitimate tax saving/tax mitigation should be attempted in the Italian experience; as it has been observed, the line between legitimate tax saving/tax mitigation and tax avoidance is necessarily a fine one, however, the legislative and the judiciary as well as the tax authorities responsible for the enforcement of tax laws should endeavour to more clearly mark such a line, so that taxpayers could be provided with a consistent, predictable and fair approach and thus be put in a position to act efficiently and confidently and yet be inspired by mutual bona fides.[14]

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[12] Reference in this respect should be made to the extensive study "Comparing the General Anti-avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law" by Zoe and John Prebble, published in the April 2008 issue of *European Taxation* (151–170).

[13] In the lack of excerpts of case law or documents issued by the Tax Authorities dealing with the contours of tax mitigation, reference should once more be made to scholarly classification. See, in English, V. UCKMAR, "Tax Avoidance and Tax Evasion General Report", in *Cahiers de droit fiscal international*, Vol. LXVIII a, Amsterdam, 1983, *passim*.

[14] Such is stated in J. PREBBLE, Z. PREBBLE, "Comparing the General Anti-avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law," (2008) 4 *European Taxation*, 168.

9.5 Authority to Address Tax Avoidance

The authority to operationally address tax avoidance by conducting special tax assessments and interpreting and enforcing the GAAR lies in the hands of Tax Authorities. The constitutional roots of the authority to address tax avoidance are illustrated by a recent case of the Italian Court of Cassation, covering the currently highly debated topic of the existence of a general anti-abuse of right doctrine in Italian tax law.[15] In 2007, capitalizing on the legacy of the ECJ decision *Halifax*,[16] the Italian Court of Cassation started applying the abuse of right test as developed by the ECJ to purely domestic transactions. In *Halifax*, the ECJ provided two general conditions under which a form of abuse of rights can be detected with reference to VAT.[17]

An abuse of right within the context of VAT can be found to exist only if the transactions concerned, notwithstanding formal application of the conditions laid down by the Sixth VAT Directive (as well as the national legislation transposing it) results in "[t]he accrual of a tax advantage the grant of which would be contrary to the purpose of those (VAT Sixth Directive and national legislation) provisions." Additionally, in order for an abusive practice to be detected, it must be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. Such a requisite shall however be interpreted rather narrowly, since the ECJ confirmed that "the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages."[18] At the domestic level, clarifications were set forth, in this respect, by the I.R.A. in Circular Letter No. 67/E of 13th December 2007, which substantially replicates the conclusion set forth by the ECJ in *Halifax*.[19]

Although initially, the cases applying the ECJ-derived abuse of right test dealt with VAT matters and touched on EU harmonized tax law. However, in three decisions dating back to December 2008, the abuse of right approach

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[15] As a matter of fact, the debate on abuse of rights is not a new one. For an introductory overview in French with a comparative approach see C. DAVID, "L'abus de droit en Allemagne, en France, en Italie, aux Pays-Bas et au Royaume -Un essai de comparation", (1991) 1 *Riv. dir. fin.*, 220 and, in Italian, with focus on the German experience, P. PISTONE, *Abuso del diritto ed elusione fiscale*, Padova, 1995.

[16] ECJ, Case C-255/02, Decision of 21st February 2006, "*Halifax c. Commissioners of Customs & Excise*".

[17] It should be remarked that reference to the abuse of right principle had already been made the European Court of Justice in Case C – 206/94, Case C – 367/96, Case C – 167/01.

[18] ECJ, Case No. 255-02 of 21st February 2006, "*Halifax c. Commissioners of Customs & Excise*", Paragraph 74.

[19] For a Commentary, see B. SANTACROCE, "Il concetto comunitario di abuso del diritto in una recente circolare delle Entrate sull'elusione nell'IVA", (2008) 1 *Dialoghi Tributari*, p. 117.

was the basis of assessment also with respect to non EU harmonized corporate income tax. In subsequent decisions of the Italian Court of Cassation which were issued in 2009,[20] the application of the abuse of right concept was by contrast justified under the "ability to pay" principle enshrined in Art. 53 of the Italian Constitution, which can be considered the focal point of the whole Italian tax legal system.

9.6 Dispute Resolution

The detection of tax avoiding behaviors is among the prerogatives of the I.R.A., which is currently also entrusted with the task of interpreting Art. 37-*bis* of Presidential Decree No. 600/1973 in order to issue pre-emptive rulings at the request of taxpayers. Due to the complex scope of the GAAR and the existence of ample grey areas, a specific Task Force competent in setting forth specific rulings on specific transactions upon request by the taxpayer ("*Comitato Consultivo per l'Applicazione delle Norme Antielusive*") was created in 1998. The Task Force was disbanded in 2007 and its functions have been taken up by the I.R.A.

Paras. 4 through 8 of Art. 37-*bis* of Presidential Decree No. 600/1973 provide the procedural rules for conducting tax assessments based on the GAAR. In Particular, tax authorities, before serving an assessment notice concerning Art. 37-*bis* of Presidential Decree No. 600/1973, must request from the taxpayer clarification in regard to the transaction and specify the reasons of the assessment.

The subsequent assessment notice may not be issued before sixty days after the date of the request to the taxpayer, who must provide explanation, in particular with respect to the business purpose of the transactions under scrutiny. The assessment notice so issued by the Tax Authorities must indicate clearly and detail its reasons, and must specifically refer to the information previously submitted by the taxpayer. As a result of these safeguards in favour of the taxpayer, an assessment notice based on Art. 37-*bis* of Presidential Decree No. 600/1973 is null and void if:

- tax authorities, before serving an assessment notice concerning Art. 37-*bis*, do not request from the taxpayer clarifications in regard to the transaction; and
- the subsequent assessment notice does not indicate clearly (and in detail) its reasons, and/or does not specifically refer to the clarifications previously submitted by the taxpayer.

While a set of transactions may at first be deemed as tax avoiding by the I.R.A., the taxpayer can clearly challenge the tax assessment and the court may review earlier conclusions of the I.R.A.

[20] See, in particular, Court of Cassation, Decision, No. 8487/2009.

Deciding whether a given transaction or chain of transactions represents illegal tax avoidance or a form of legitimate tax saving relies on the application of the six pronged test encapsulated in the Italian GAAR, Art. 37-*bis* of Presidential Decree No. 600/1973, which will be examined in further detail in the following sections. As it will be outlined, the structure of the test is relatively clear, but there are various problems in regard to the actual meaning of the requirements, considering, in particular, that the provision under scrutiny can be applied on a case-by-case basis to a great variety of actual transactions that often exhibit a great deal of economic and legal complexity, leaving much to the factual characterisation undertaken by the examining body.

Along with the issue of an assessment of the valid business purpose underlying a transaction, which will be addressed in the following section of this chapter, it can be anticipated that the two main items on which the I.R.A. and, eventually, tax judges will focus their attention when assessing a GAAR is probably to be found in the following aspects:

- the detection of the use of abnormal legal arrangements so as to bypass tax laws
- the assessment of the existence of a specific intent concretised in a purposive scheme.

By-passing of tax duties is the typical situation in which the taxpayer arranges its own course of affairs in such a way as to unduly avoid or prevent the application of the normal taxing rules (the “tax duty” or “obligation”) provided for the normal course of action. By-passing of tax rights is more difficult to assess. The Government Report on the introduction on the GAAR clarified that “by-passing” of tax rights does not occur when the taxpayer makes an election which is expressly provided for by tax rules among two alternative courses of action equally available to achieve a tax reduction. In such cases, the taxpayer has a right to choose among alternative tax treatments that are considered by the tax system to be equally available and legally obtainable. This typically occurs when a tax relief is obtained as a result of an election of certain options or of the meeting of certain requirements. In summary, there is *“by-passing”* of tax rights under Art. 37-*bis* of Presidential Decree No. 600/1973 only when the taxpayer takes undue advantage of a tax treatment through abuse of a beneficial treatment offered by the tax system.

There is a purposive scheme when the transaction (and its result) conflict with:

- general principles of tax law;
- specific principles of a certain area of tax law;
- the function of tax rules; and
- the natural entitlement of tax positions.

The Government Report to Art. 37-*bis* of Presidential Decree No. 600/1973 clarified that a transaction may be tax avoiding on the grounds of the detection of a purposive scheme when the taxpayer skillfully combines various arrangements, which are perfectly legitimate, in order to obtain a final result – a tax saving – which is not legitimate because it conflicts with tax principles (combination method). The combination method is based on a "substance over form" approach. For example, a taxpayer may violate:

- the general principles of tax law according to which one should not allocate income to other parties; or
- specific principles of a certain area of tax law such as the rule in which if capital gains on participations are exempt, capital losses are not deductible; or
- the function of tax rules, such as the function of jurisdictional links for taxing income sourced in Italy; or
- the natural entitlement of tax positions by allocating portions of income to related parties.

A behaviour of the taxpayer may however be deemed to have a purposive scheme even if it does not amount to overt tax evasion or tax fraud.

9.7 Business Purpose

A transaction avoids the tax avoidance label if there is an underlying valid business purpose.

In this respect, the Government Report on Art. 37-*bis* of Presidential Decree No. 600/1973 clarified that the notion of valid business purpose encompasses all economic reasons which do not involve the reduction or minimization of taxes. Valid business purpose cannot be defined ex ante. It must be assessed on a case-by-case basis by considering various elements related to the economic behaviour of the taxpayer.[21]

With reference to assessment of the valid business purpose, three possible cases can be envisaged:

- In the first case, the transaction has only a valid business purpose and no tax purpose – there is no tax saving and therefore no tax avoidance under Art. 37-*bis* of Presidential Decree No. 600/1973.
- In the second case, the transaction has no valid business purpose, the transaction does not lead to any business goal, and the tax saving is the

[21] In this sense, L. POTITO, "Le "valide ragioni economiche" di cui all'art. 37-*bis* del D.p.r. n. 600/1973: considerazioni di un economista d'azienda," (1999) 1 *Rassegna tributaria*, 63.

only reason to carry out the transaction – this transaction is tax-driven and has the typical features of tax avoidance.

- In the third case, the transaction has both a valid business purpose and tax purpose – the tax saving is not the only reason to carry out the transaction and therefore tax reduction arises only as a by-product of the transaction. In these cases, which are quite normal in current practice, one must assess the prevailing nature of tax reasons versus business reasons; for example, in structured finance transactions it is usually required that the transaction be "*pre-tax positive*;" i.e., that the gain from the transaction is not exclusively derived from tax savings.

The I.R.A. has developed an aggressive approach under which the lack of valid business purpose is, by definition, an indicator of a by-passing and of a purposive scheme.[22] On the other hand, the existence of valid business purpose is not believed, in the more sophisticated tax planning circles, to be per se a safeguard against the enforcement of the GAAR, but, rather, an element that supports additional evidence excluding the occurrence of the typical features of tax avoidance – in particular – of the existence of a purposive scheme.

It should be remarked that the interpretation of Art. 37-*bis* of Presidential Decree No. 600/1973 is conducted on a case-by-case basis with respect to single transactions. In this respect, apart from the rule that the principles elaborated by the Court of Cassation are binding on lower Courts, even in the field of anti-avoidance interpretation, there is no formalized rule of precedent in the Italian system with respect to tax avoidance.

In the Italian experience, referring to "safe harbors" is slightly inappropriate, as similar phenomena have mostly to do with the objective scope of application of the GAAR. There is however one notable exception in this respect; namely, based on Para. 3 of Art. 176 of the I.T.C., deeds of conferral of a going concern carried out by paying a step up substitute tax or by maintaining the tax values of the assets conferred unchanged, followed by a transfer of the acquired participation in order to benefit from the participation exemption regime set forth by Art. 87 I.T.C. are never considered as tax – avoiding transactions. Such case, justified on the grounds of reasons of coherence of the tax legal system, is peculiar because if it were not for the open exclusion of Para. 3 of Art. 176 of the I.T.C., this kind of transaction would wholly fall within the scope of application of Art. 37-*bis* of Presidential Decree No. 600/1973.

Another aspect to be underlined is that the "purposive scheme" is almost always central to the detection of a tax avoiding scheme; in this respect, an

[22] Such an approach has however been severely criticized in literature (See, on this specific aspect and among the most recent publications, G. ZIZZO, "Ragioni economiche e scope fiscali nella clausola antielusione," (2008) 1 *Rassegna tributaria*, 170) and it has often been eventually dismissed by Court Decisions.

isolated transaction, such as for instance, a single merger, a single division, or a single conferral is almost never considered as sufficing to lead to avoidance of taxes.

9.8 GAAR

The provision in Italian tax law which more closely qualifies as a GAAR is Art. 37-*bis* of Presidential Decree No.600/1973. Unlike a proper *Generalklausel* such as the one found in the German legal tradition, Art. 37-*bis* only applies with respect to a specific – although extremely broad – array of transactions.

Article 37-*bis* of Presidential Decree No. 600/1973 has a complex structure which can be summarized as follows:

(a) Para. 1, states the basic requirements of tax avoidance by providing that: "Tax authorities have the power to disregard for tax purposes acts, facts and legal arrangements, also in their functional connection, lacking a valid business purpose,[23] aimed at by-passing rights and duties provided for by tax rules, and at obtaining tax reductions or tax reimbursements which would not be legally available";
(b) Para. 2, provides that "Tax authorities have the power to disallow tax benefits achieved through the acts, facts and legal arrangements mentioned at Para. 1, by applying taxes in accordance with the tax rules which were thereby avoided";
(c) Para. 3, provides that Article 37-*bis*, Para. 1 and 2, are applied upon the condition that, within the taxpayer's behaviour, one or more transactions expressly listed by Para. 3 are carried out. Such transactions include:

   - transformations, mergers, divisions, voluntary liquidations and distributions to the shareholders other than profit distributions;
   - sale or deeds of conferral of going concerns (or of rights of *jouissance* thereupon);
   - transfers of credits;
   - transfers of excess tax credits;
   - transactions covered by the legislation implementing the Merger Directive;
   - transfer of the tax residence of a company;
   - classifications made in financial statements;
   - transactions concerning transfers and valuations of participations and transfers of securities,

[23] Literally: "*without valid economic reasons*."

- foreign currencies and precious metals and transactions on derivative instruments;
- payments of interest and royalties eligible for the exemption under the EC Interest and Royalties Directive (2003/49/EC), if made to a person directly or indirectly controlled by one or more persons established outside the European Union;
- transactions between resident entities and their affiliates resident in tax havens; and
- transactions concerning the payment of an amount under a penalty clause.

(d) Paras. 4–8 provide procedural rules for assessments based on Article 37-*bis*.

The overall procedure to assess tax avoidance under Art. 37-*bis* of Presidential Decree No. 600/1973 can be summarized in the following *six-step procedure*:

(1) one should determine the *overall transaction* adopting a functional approach, also combining different arrangements being carried out by the taxpayer and adopting a substance over form approach.
(2) once the transaction as a whole has been identified, one should verify whether one, or more, or all of the acts, facts and legal arrangements carried out by the taxpayer are expressly included in the "*list*" of Para. 3; only if one, or more, or all of the acts, facts and legal arrangements included in the list of Para. 3 are a carried out by the taxpayer, Art. 37-*bis* of Presidential Decree No. 600/1973 can be applied as a GAAR.
(3) once the transaction as a whole has been identified including the arrangements listed at Para. 3, one should quantify the "*actual tax saving,*" by comparing the taxes paid as a result of the transaction with the taxes which would have been paid should the taxpayer had followed an alternative "normal course of action"; only if tax saving is achieved, Art. 37-*bis* of Presidential Decree No. 600/1973 can be applied as a GAAR.
(4) once it is determined that Art. 37-*bis* can be applied as a GAAR, one should assess whether the transaction *lacks a valid business purpose*; only if the transaction lacks of a valid business purpose, one should proceed to verify the other requirements.
(5) once it is determined that the transaction lacks a valid business purpose, one should assess the requirements of "*By-passing*" and/or "*Purposive Scheme*";
(6) once all requirements described above at 4 through 5 above are assessed, the tax effects of the transaction can be disregarded by Tax Authorities for tax purposes.

The actual application of the above described six pronged test lies among the prerogatives of Tax Authorities and, in particular, the I.R.A. which is in charge of issuing pre-emptive rulings and conducting tax audits from which a tax assessment notice based on Art. 37-*bis* of Presidential Decree No.600 could well be the outcome. The same interpretative and logical process is then carried out by tax courts when the deeds issued by the I.R.A. are challenged by the taxpayer.

As earlier mentioned, the current Art. 37-*bis* of Presidential Decree No. 600/1973 had a forerunner in Art. 10, Para. 1 of Law No. 408/90 which, according to many commentators, was the real breakthrough in the Italian tax jurisdiction with respect to the introduction of a fully fledged tax avoidance rule.[24] However, this first attempt to introduce an anti-avoidance provision in the Italian tax system did not prove successful and required subsequent amendments which lead to the current Art. 37-*bis* of Presidential Decree No. 600/1973.

If the introduction of an express anti-avoidance clause was a fairly recent innovation in the Italian tax landscape, the same cannot be held with respect to the existence of anti-avoidance interpretative canon, consistently applied by Tax Authorities in their rulings and by tax courts, with particular reference to the Italian Court of Cassation. The interpretative orientations adopted by administrative and jurisdictional organs is probably not less important than the "law in the books," as these organs are not only in charge of interpreting the GAAR, but are also influential in anticipating trends, as it is currently testified by the abuse of rights case law legacy. Such a pioneering role, although probably not fully endorsable and justifiable in the light of the legality principle enshrined in Art. 23 of the Italian Constitution, can also be mirrored retrospectively with regard to the introduction of anti-avoidance sensitivity in the Italian tax environment.

Some fairly ancient case law of the Court of Cassation can be mentioned as having a paramount importance in shaping the so-called anti-avoidance interpretation canon. Said decisions are, in particular, cases No. 1793/1966, No. 780/1968, No. 1472/69 and 1530/69, where a substance over form approach was adopted by the Court, even though these *arrêts* remained relatively isolated in the history of the supreme Court's Case Law.[25]

Against such a background, it could be probably set forth that the impetus in introducing a GAAR, first in 1990 and then in 1997, although with different scopes and depth, was motivated not less by the need of a reform

[24] In this sense, see, among the most recent literature I. VACCA, "Abuso del diritto ed elusione fiscale", (2008) 1 Riv. dir. trib., 1069, according to whom the introduction of Art. 10 of Law No. 408/1990 was an "*absolute novelty*."

[25] For an accurate review and analysis of the case law of the Court of Cassation with respect to the last forty years (up to the end of the XX Century), reference should be made to G. ZOPPINI, "Prospettiva critica della giurisprudenza "antielusiva" della Corte di Cassazione (1969–1999)," (1999) 1 *Riv. dir. trib*., 919.

than by the need of a reaction, driven, inter alia, by the safeguard of legal certainty, against the "*nomopoietic hybris*" of the Court of Cassation in applying an often unpredictable anti-avoidance interpretative canon.[26] Namely, in the light of such a legislative innovation, all previous cases suitable to amount to tax avoidance were dismissed from such charge, as it was made clear that, despite any anti-avoidance interpretation canon, anti-avoidance did not exist as a punishable misconduct before the introduction of the (quasi)-GAAR.

The currently existing GAAR appears however almost out of date in the current lively debate concerning the introduction of a anti-abuse of rights judge-made clause primarily inspired by similar experiences in other advanced jurisdictions, as well as by the legacy of some ECJ decisions concerning EU harmonized VAT and, finally by the re-emergence of anti-abuse interpretative canon allegedly rooted in the fulfillment of the ability to pay principle enshrined in Art. 53 of the Italian Constitution.

What could be said from an empirical perspective is that Art. 37-*bis* of Presidential Decree No. 600/1973 did not prove so effective as a GAAR and such a conclusion is somewhat corroborated by the circumstance that, as it will be outlined further on in this work, the Court of Cassation has felt the need to revive an approach based on the abuse of rights principle. Such an occurrence actually arose from very practical reasons; namely, an apparently tax avoiding indecent dividend washing scheme emerged unscathed from the judgment of lower tier Courts in the late 1990s, as the latter endorsed a restrictive and legalistic interpretation of the GAAR. In the last few years, appeals filed by the losing Tax Authorities reached the Court of Cassation which, in turn, has tried to apply the ECJ derived abuse of rights doctrine to these cases, so to avoid the subtleties that render the current GAAR unsuitable to deal with such forms of tax avoidance.

9.9 Cross-Border Transactions

Special rules apply to cross-border and international tax – avoiding transactions. The source of these rules is a legal one, either deriving from domestic and community provisions, as well as from tax treaty clauses to be found in the Italian treaty network, which is typically adherent to the standards to be found in the OECD Model Convention.

Art. 37-*bis* of Presidential Decree No. 600/1973 is not bound to a specific territorial scope of application. Foreign transactions may be covered by the

[26] The thesis of the "*counter-reformist*" import of the introduction of an anti-avoidance clause has also recently been set forth by G. FALSITTA, "L'interpretazione antielusiva della norma tributaria come clausola generale immanente al sistema e direttamente ricavabile dai principi costituzionali," (2009) *Corriere Giuridico*, 296.

GAAR as long as they lead to tax savings in Italy achieved by means of a purposive scheme and resorting to transactions that are not justified by valid business reasons.[27]

A peculiar aspect in this respect which has rarely been considered by the I.R.A. or the *Comitato Consultivo* and which has not so far been explicitly addressed in a decision of the Court of Cassation is whether a saving of foreign taxes can be considered as a sufficient valid business reason for justifying a given set of transactions which may lead to a tax saving also in Italy. Such an issue becomes extremely relevant in the light of the emerging issue of international tax arbitrage,[28] however an ultimate clearcut position on the issue has not yet emerged.[29]

The most obvious form of anti-avoidance clause superseding cross-border transactions is transfer pricing. Unlike other European Countries, the implementation aspects of transfer pricing have not been the object of specific legislation but have been left to the guidance provided by ministerial circular letters dating back to the 1980s[30] which currently appear inadequate to cover the range of problems connected to this very sensitive and ever-evolving area of international taxation.

Italy has also introduced controlled foreign corporation (CFC) set forth by Art. 167 of the I.T.C. The underlying mechanism is in line with the model provision earlier developed in the United States in the form of Subpart F of the Internal Revenue Code: the profits of a CFC are taxed directly on the head of the Italian resident shareholders, regardless of whether the CFC distributes dividends.

Originally, CFC legislation applied only to companies which were resident of a black listed country, i.e., a country with low tax rates and which did not cooperate with Italy in terms of effective exchange of information. Starting from 2010, however, as result of Law Decree No. 78/2009, the territorial perimeter of application of CFC rules will be extended to include also controlled foreign companies wherever located whose revenues derive for more than 51% from holding activities, royalty licensing and supply of infra-group services and whose tax burden is less than 51% of the virtual tax burden these companies would have in Italy by applying Italian corporate income tax rules.

[27] See C. GARBARINO, *Manuale di tassazione internazionale*, II Ed., Milano, 2008, 882 et seq.

[28] For an updated introductory reading in English to this topic, see L. DELL'ANESE, *Tax Arbitrage and the Changing Structure of International Tax Law*, Milano, 2006.

[29] For an analytical survey of the matter see P. LUDOVICI, "La rilevanza dei tributi esteri ai fini dell'art. 37-*bis* del D.P.R. 600/1973," in G. MAISTO (Ed.), *Elusione ed abuso nel diritto tributario*, Milano, 2009, 263.

[30] In particular, Circular Letter No. 32/9/2267 of 1980 and Circular Letter No. 42/12/1587 of 1981.

Another anti-tax haven provision is set forth by Art. 110, Para. 10 of the I.T.C., according to which cost and expenses arising from transactions with parties that are resident of black listed countries are considered as non-deductible, unless the involved taxpayer can alternatively demonstrate that the non-resident carries on a real business activity or that the relevant transactions had a real business purpose and actually took place.

With respect to the broader issue of treaty shopping, the inclusion of specific anti-treaty shopping clauses in Italian tax treaties is rather uncommon. The preferred approach in dealing with such issue is by adopting a look-through interpretive approach which is well served by the above described positions on beneficial ownerships and by an abstinence approach, according to which Italy avoids concluding tax treaties with tax havens or with countries that offer particular benefits to companies and that may therefore be domiciled there simply in order to act as conduits.

A separate issue involves limitation of benefits clauses which are to be found in the tax treaty currently in force between Italy and the United States[31] dating back to 1984 as well as the new tax treaty signed in 1999 and recently ratified in Italy, which should imminently enter into force following the exchange of the instruments of ratification.

9.10 Penalties

Following the introduction of the GAAR, tax avoidance is a sanctioned behavior, although the sanctions have a merely restitutory nature towards the Treasury.[32] No explicit additional administrative or criminal penalty is foreseen, even though there has been a debate among scholars concerning the possible criminal law implications of a tax avoiding behavior.[33]

9.11 Statutory Interpretation

Statutory interpretation by the Italian Court of Cassation and centered on the application of a doctrine of abuse of rights largely predates the introduction of a GAAR in the Italian system.

Following the introduction of a formal GAAR, it seemed that the role of an extensive statutory interpretation had lost its *raison d'être*.

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[31] See also L. DELL'ANESE, "L'evoluzione della disciplina anti-abuso di trattato nelle convenzioni contro le doppie imposizioni sottoscritte dagli Stati Uniti," (1998) 3 *Dir. prat. trib*, 697.

[32] F. MUCCIARELLI, "Abuso del diritto, elusione fiscale e fattispecie incriminatrici", in G. MAISTO (Ed.), *Elusione ed abuso del diritto tributario*, Milano, 2009, 436.

[33] See, in particular, F. GALLO, "Rilevanza penale dell'elusione," (2001) *Rass. trib*., 321.

Such an orientation has however recently regained weight on the Italian tax agenda, leading to an extremely lively debate among scholars and practitioners alike.[34] In a recent series of decisions, culminating in 2008 and 2009, the Court of Cassation introduced a new judicial anti-abuse principle into the Italian tax system. According to this principle the transactions carried out by the taxpayers which have the exclusive goal of obtaining a tax benefit are deemed to constitute tax abuse, and therefore the tax effects of such transactions can be disregarded by Tax Authorities.[35]

The arguments used by the court in virtually all the cases is based on a common structure which can be summarized as follows. There is no doubt that the taxpayer can freely choose to carry out its activities in the most effective way to reduce the tax burden, as the freedom to conduct private economic activities is expressly protected by Article 42 of the Italian Constitution. The limit to the exercise of such a freedom is the inappropriate use of legal arrangements which amount to an abuse of law ("*abuso della forma giuridica*"). Such an abuse results from the selection of a particular legal arrangement whose exclusive goal is to obtain a tax reduction, and therefore is an abuse of a fundamental right (the freedom to conduct private economic activities) provided for by the domestic legal system and community law.[36]

The judicial anti-abuse principle has been introduced in a system already endowed with a GAAR and many other specific anti-avoidance rules. Given that the courts in Italy generally adopt a literal approach to application of tax laws, the introduction of such a judge-made anti-abuse principle amounts to a significant departure from usual practice. This occurrence has triggered criticisms from commentators based on two principal arguments. First, it is said that the judicial creation of an anti-abuse principle violates the so-called "principle of legality" in tax matters, enshrined in Article 23

[34] For an introductory overview in English language, see R. CORDEIRO GUERRA, P. MASTELLONE, "The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution," forthcoming in *European Taxation*. Among the scholarly contributions to the current debate in Italian see, *inter alia*, A. MANZITTI, I. VACCA, R. LUPI, D. STEVANATO, "Contrasto all'elusione e incertezza del diritto," (2009) 1 *Dialoghi Tributari*, 32; R. LUPI – D. STEVANATO, "Tecniche interpretative e pretesa immanenza di una norma generale antielusiva," (2009) 6 *Corr. trib.*, 403; A. LOVISOLO, "Abuso del diritto e clausola generale antielusiva alla ricerca di un principio," (2009) I *Riv. dir. trib.*, 89; G. MARONGIU, "Abuso del diritto o abuso del potere?," (2009) 13 *Corr. trib.*, 1077.

[35] Court of Cassation, Decision No. 221221/2006 (direct taxes); Court of Cassation, Decision No. 11226/2007 (direct taxes); Court of Cassation, Decision No. 18374/2007(stamp duty); Court of Cassation, Decision No. 18218/2007 (excises); Court of Cassation, Decision No. 8772/2008 (direct taxes); Court of Cassation, Decision No. 10257/2008, (direct taxes); Court of Cassation, Decision No. 14509/2008 (excises); Court of Cassation, Decision No. 23633/2008 (direct taxes); Court of Cassation, Decision No. 30055, 30056 and 30057/2008 (direct taxes).

[36] See for example: Court of Cassation, Decision No. 8772/2008.

of the Italian Constitution, according to which taxes can be levied only by operation of law. Second, it has been argued that the discretionary powers granted by the anti-abuse principle to tax agencies as well as tax courts undermine the basic principle that tax laws be certain in their purpose and meaning.

In the cases decided in 2005, the Court of Cassation held that a contract used by the taxpayer to obtain an "*unlawful*" reduction of taxes could be declared void, with the consequence that the tax benefits resulting from such a contract could be disregarded. The judicial anti-abuse doctrine was developed further in 2008, when it was extended to cases in which the transaction amounts to an abuse of tax law rather than simply a violation of tax law. It is worth noting that while initially it was held that it was upon the taxpayer to prove that the behaviour was not of an abusive nature,[37] in the most recent cases it has been held that it is upon the Tax Authorities to prove that the behaviour was abusive.[38]

In the cases involving the abuse of tax law, the Court of Cassation has expressly acknowledged that a principle of law was being created. In continental law principles of law are not just generic statements or policy guidelines but are binding in respect to Tax Authorities and taxpayers as well. For example, the Court of Cassation has developed in recent years a principle according to which the change of the position of Tax Authorities given in a ruling or in a circular letter on which a taxpayers had previously relied does not have any effect on the taxpayer. Thus the anti-abuse principle is not a policy, but is a binding rule, obviously not aimed at regulating a specific transaction, but a general clause aimed at identifying an abuse of tax law. The most essential feature of such a clause is that it constitutes a kind of "empty box" in which, on a case-by-case basis, Tax Authorities and tax courts can include the most diverse transactions when they trespass the boundaries of the normal use of tax laws. The anti-abuse principle has an open texture,[39] meaning that it is applicable to a potentially unlimited range of situations.

The first pillar of the Court of Cassation in developing the anti-abuse principle is EU tax law: the Court expressly states that the anti-abuse principle is newly created law imposed by *Halifax* case and other cases decided by the European Court of Justice (ECJ),[40] and that this principle applies to

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[37] Court of Cassation, Decision No. 10257/2008.

[38] Court of Cassation, Decision No. 25374/2008.

[39] This concept of "*open texture*" or "*penumbra*" has been coined by H.L.A. HART. ID., *The concept of law,* II Edition, 1961, Oxford.

[40] In particular, ECJ Case C-223/03, Decision of 21st February 2006, "*University of Huddersfield Higher Education Corporation v HMRC*"; ECJ, Case C-425/06, Decision of 21st February 2008, "*Ministero dell'Economia e delle Finanze v Part Service srl*"; ECJ, Case C-279/93, Decision of 14th February 1995, "*Finanzamt Köln-Altstadt v Schumacker*"; Case C-330/91, Decision of 13th July 1993 "*The Queen v IRC ex*

all areas of tax law, from indirect taxes such as VAT or stamp duty to direct taxes such as personal or corporate income taxes.

The case law of the ECJ clearly establishes that the ECJ's goal is not to define what should be a common EU tax policy concerning tax avoidance and tax abuse, but to set limitations to potentially overreaching domestic anti-avoidance rules impacting negatively on fundamental freedoms. For example, the ECJ has made it clear that, although tax-driven transactions do fall under the reach of anti-avoidance domestic rules, there can be no generic presumptions such as that the establishment of a foreign subsidiary is for the purposes of tax avoidance.[41] The ECJ has also established that domestic legislation restricting freedom of establishment is justified only if it prevents wholly artificial arrangements.[42] Within this scenario, domestic legislators and courts have the power to enact anti-avoidance clauses, but it is up to the national judges to decide, on a case-by-case basis, whether the guidelines set forth by the ECJ have been violated.

It should however be remarked that in three cases decided at the very end of 2008,[43] the Court of Cassation abandoned the "top down" approach based on community law and held that the anti-abuse principle is derived directly from the principle of ability to pay enshrined in Article 53 of the Italian Constitution.[44] This reconstructive shift is possibly due to the fact that the judges of the supreme Italian Court realised that the top down community approach might be flawed. Moreover, the anti-abuse principle encased in the Halifax legacy was designed to apply to VAT, so that the automatic extension to non-EU harmonised direct taxation raised some perplexities with respect to the application of the principle of legality and to the application of the safeguards provided by the Taxpayer's Bill of Rights. Under these three decisions Art. 53 of the Constitution is the basic norm from which all the statutory norms of the tax system are derived, including those which attribute benefits to the taxpayers, with the consequence that the taxpayer who gains a benefit from a misuse or abuse of tax legislation violates the ability to pay principle.

The facts of the decision in 2009 are the following. Piaggio and Daihatsu had entered a corporate joint venture agreement according to which the corporate joint venture (P&D) basically did not own equipment as Piaggio was allowing P&D to use it own equipment for the production at no charge. The tax office denied tax depreciation and other tax deductions for P&D on

parte Commerzbank"; ECJ, Case C-250/95, Decision of 15th May 1997, "*Futura Participations SA v Administrations des Contributions.*"

[41] Case C-196/04, Decision of 12th September 2006, *"Cadbury Schweppes plc v Commisioners of Inland Revenue,"* fn. 13 at [50].

[42] Ibid., fn. 13 at [51].

[43] Court of Cassation, Decisions No. 30055, 30056 and 30057/2008.

[44] Article 53 provides that "all taxpayers must contribute to public expenditures in accordance with their ability to pay."

the ground that it did not own the equipment in an abusive transaction. The Court of Cassation first acknowledged the existence of the anti-avoidance principle as defined by its own previous cases, but eventually held that the anti-avoidance principle could not be applied in the case under review as the arrangements neither amounted to tax avoidance nor were abusive. As a consequence the Court of Cassation held that tax depreciation and other tax deductions were allowed for P&D.

The Court of Cassation reached this conclusion by pragmatically looking at the economic and business structure of the joint venture agreement as a whole and acknowledging that such an agreement did pursue truly economic and market-oriented goals; the main point of these analysis are the following:

- in a joint venture agreement there are economies of scale and therefore a set of interlocked agreements does not constitute in itself avoidance or abuse of tax law;
- costs are tax deductible even if not directly matched by corresponding income produced by the same company bearing the costs;
- a transaction is abusive of tax law when the abusive purpose is the exclusive purpose of such a transaction;
- a commercial transaction with valid business reasons can legitimately lead to tax savings.

This decision confirms that the anti-abuse principle operates on a case-by-case analysis of the facts of the transaction and commits the Court of Cassation in the future to factual analysis on economic substance and valid business reasons.

Although it is difficult to foresee precisely how the abuse of rights doctrine will interact with the existing GAAR, nonetheless, it seems reasonable to assume that the GAAR and the abuse of rights test will be maintained as two separate anti-avoidance tools, with the former applying as the default rule and the latter serving a supplemental purpose: only those arrangements of taxpayers which do not fall under the legislative GAAR and specific anti-avoidance rules will be targeted directly by the anti-abuse principle, so that the anti-abuse principle should operate as a filler for the gaps left open by the GAAR and specific anti-avoidance rules.

9.12 Disclosure Requirements

There are no disclosure requirements for taxpayers (or their advisers) entering into tax avoidance transactions.

9.13 Tax Shelters

Tax shelters are not addressed separately from other forms of tax avoidance in Italy. This circumstance is somewhat consistent with the historical development of anti-avoidance legislation in Italy, which was the result of scholarly debate more than of a way to deal with sophisticated tax avoidance scheme concocted by shrewd and skillful practitioners. Nevertheless, when examining the judicial decisions issued on the application of the GAAR and the administrative rulings issued by Tax Authorities, it can clearly be seen that there have been some re-occurring fads in fashion somewhat akin to the tax shelters market in other countries.

Among the different trends, one of the most influential ones is the so – called "dividend washing" practice. Dividend washing is typically carried out by acquiring participations, deriving the tax-exempted dividend and subsequently reselling the participation at a lower price thus benefitting from a deductible capital loss. Even though a specific anti-dividend washing provision, which makes it impossible to double dip from a substantial dividend exemption (taxable for only 5% of their amount) and the capital loss has been rendered non-deductible if holding period requirements are not met, new legislation has been recently introduced under Paras. 3-*bis* and 3-*ter* of Art. 109 the I.T.C.,[45] to target these transactions. Dividend washing has been widely used as a tax minimizing device, often with no adverse consequence. It could be argued that the recent *arrêts* of the Court of Cassation which have mirrored a rise of the abuse of rights test have been possibly influenced by the need to condemn dividend washing notwithstanding the fact that Art. 37-*bis* of Presidential Decree No. 600/1973 did not expressly deal with it at the time when the transactions had been put into place.[46]

9.14 Reform Efforts

The main item of debate on the current Italian tax agenda is undoubtedly the judge made abuse of right principle and its implications for tax administration and lower courts. The main criticism is that such a principle violates the legality principle enshrined in Art. 23 of the Constitution.

In this respect, it is not clear whether the abuse of rights doctrine will be codified in accordance with the common legislative practice found in civil law tradition. If so, the legislative process may lead to the introduction of a super GAAR, combining the analytical approach of the currently existing Italian GAAR with the open texture of the abuse of rights test.

[45] And somewhat anticipated by Circular Letter No. 21/2006.

[46] See also P. PICCONE FERRAROTTI, "Sull'applicabilità dell'art. 37, 3o co., del d.p.r. n. 600 del1973 al cosiddetto *dividend washing*," (2000) 11 *Rassegna Tributaria*, 933.

The proponents of a legislative amendment[47] believe that a cryptotype (unwritten rule expressed by judicial principles or shared values), such as the abuse of rights principle, would be a too dangerous weapon in the hands of the Tax Authorities.

The proposed bill has two components:

- defining the actual scope of application of the “abuse of rights” test;
- introducing specific procedural rules in relation to tax assessments involving the use of the abuse of rights test.

With respect to scope, the proposed bill would remarkably broaden the scope of application of the current version of Art. 37-*bis* of Presidential Decree No. 600/1973. In particular, the GAAR would be of general application and would not be restricted to a specific set of transactions. Additionally, it would apply not only to income taxes but to taxes of every kind. Additional safeguards in the proposed bill are as follows:

- Tax Authorities must distinctly identify the tax rules alleged to have been circumvented by the taxpayer
- The new GAAR may be applied and outlined only by the Tax Authorities in a specific assessment notice
- The additional tax re-determined may not be collected before a decision adverse to the taxpayer has been issued by a Provincial Tax Court (such a guarantee already applies to the current version of the GAAR while these procedural matters have not been settled with respect to the abuse of rights test).
- In no case can the uncovering of an abusive behavior lead to the application of criminal sanctions.
- The procedural protections would have retroactive effect for pending cases.

[47] Proposta di Legge N. 2521, di iniziativa del Deputato M. Leo.

Chapter 10
Japan

Keigo Fuchi

10.1 Legal System in Japan

10.1.1 General Overview

Japan has a legal system similar to that of European civil law jurisdictions.[1]

Starting in the last quarter of the 19th century, it has introduced political and legal systems often associated with western civilization, including political and legal systems. These systems evolved gradually until the period between 1930 and post-Second World War when they experienced a drastic change, while maintaining a similar basic structure. Regarding the political system, the Diet, a parliament composed of two houses,[2] remains. Under Article 41 of the Constitution of Japan, the Diet is the highest body of state power and the sole legislative body of the State. The executive power is vested in the Cabinet,[3] a body organized by the Prime Minister and other ministers.[4] Like the United Kingdom, the Cabinet members are collectively responsible to the Diet for the exercise of executive power.[5] The judicial power is vested in the Supreme Court and lower courts.[6] Local governance is a fundamental principle. Article 92 of the Constitution, however, makes it

[1] For an overview of Japanese law, *see* J. Mark Ramseyer and Minoru Nakazato, JAPANESE LAW–AN ECONOMIC APPROACH (1999). For the political process of tax legislation in Japan, *see* Junko Kato, THE PROBLEM OF BUREAUCRATIC RATIONALITY: TAX POLITICS IN JAPAN (1994).

[2] *See* Article 42 of the Constitution of Japan.

[3] *See* Article 65 of the Constitution of Japan.

[4] *See* Article 66 (1) of the Constitution of Japan.

[5] *See* Article 66 (3) of the Constitution of Japan.

[6] *See* Article 76 of the Constitution of Japan.

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clear that matters regarding organization and management of local governments must be determined by national code with regard to the principle of local governance. In fact, no local administrative bodies have autonomous power like states of the U.S. The local governments are grouped into two tiers: 47 prefectures and thousands of cities, towns and villages.[7] Each has a governor and a municipal assembly. There are no courts at the local level. In sum, there is separation of the legislature, judiciary, and executive, as well as limited separation of powers between national and local governments.

10.1.2 Position of Tax Law Within the Legal System

Tax law is a branch of administrative law. In the last three decades, academic research has increased, causing tax law to be identified as a distinct area of law. The Diet promulgates tax acts, while the staff of the Tax Bureau of the Ministry of Finance prepares the bills to be introduced. The Ministry of Finance is responsible for issuing interpretive "orders" under authority delegated by the acts. The National Tax Office, which administers tax matters, issues "circulars" on almost every article of the acts. "Circulars" are similar to "orders" because they also make clear the meaning of an article and are useful sources of information for the taxpayers. Neither one is a source of law because they are interpretations issued by the National Tax Office.

Tax acts are revised once a year. The process of revision is as follows. First, the staff of the Tax Bureau prepares by collecting information and hearing requests from many interest groups, local governments and other ministries.[8] After negotiations between the Bureau and other ministries, politicians of the ruling party make a final decision as to the revision for the year. In December, a paper submitted by government's Tax Commission[9] to the prime minister and a paper prepared by the ruling party provide a synopsis of the yearly tax revision. Based on these papers, the government presents a proposal for the yearly tax revision usually in January. During the next month, the staff of the Tax Bureau drafts the bill and the government submits the bill to the Diet. After approval, the bill becomes law in March and the law becomes effective on April 1st.

[7] *See* Article 1–3 of the Local Autonomy Act (Act No. 67 of 1947).

[8] Lobbying is part of the process that initiates the tax act revision.

[9] The Tax Commission has been composed of economists, tax law professors and members representing various interest groups. In 2009, however, Prime Minister Hatoyama of the Democratic Party of Japan took over the administration and changed the role of the Commission. Now the Commission's members are the Minister of Finance, the Minister of Internal Affairs, Senior Vice Ministers of all ministries, and Vice Ministers of the Ministry of Finance and the Ministry of Internal Affairs.

10.1.3 Tax Enforcement

The National Tax Agency enforces the tax laws.[10] Before the Second World War, Japan followed a German style of tax administration where the tax office assessed the tax each year. In response to the Shoup Mission's report on Japanese taxation, the legislature introduced self-assessment based on the U.S.'s system. Every taxpayer is required to file a yearly tax return. Tax liability is determined when the taxpayer files a tax return, but the tax is due at the end of the taxable year. When the district director of the tax office finds a deficiency in a return, based on an audit by one of his tax examiners, he must determine the amount of tax due.[11] The determination is the core of the tax dispute. The taxpayer and the government dispute the correctness of the amount determined by the director.[12] The taxpayer may request reconsideration in two ways. It may request reconsideration by the tax office. In addition, it may request that the National Tax Tribunal adjudicate the tax dispute. The Tribunal is a branch of the National Tax Agency. The tribunal judges are employees of other branches of the Agency. Therefore, the tribunal is an administrative body. Except in certain cases, the taxpayer must complete the administrative procedure before seeking a judicial remedy. In Japan, there are no special courts for selected issues.[13] Judges preside over a range of cases, including civil law and administrative cases, as well as tax cases. Judges handling criminal cases adjudicate tax evasion cases.

10.1.4 Tax Controversies

A tax case begins when the taxpayer brings suit in the district court against the government to nullify the district director's decision. A tax litigation division under the Ministry of Justice specializes in representing the government, which is the defendant in these actions.

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[10] Tax Divisions of prefectures and cities administer local taxes.

[11] In practice, tax officials ask taxpayers to file a corrected return which, once filed, may not be amended. This practice is known as the "recommendation of a corrected return."

[12] Civil procedure law in Japan assumes the existence of the object of the dispute (in German, *der Streitgegenstand*) as a necessary element of the civil case. Administrative law follows the assumption and regards the determination by the administrative (in German, *der Verwaltungsakt*) agency as the object. Those who are not satisfied with the determination have to sue the government to nullify the determination. A court reviews the determination.

[13] Article 60 of the former constitution (1889–1947) allowed special courts. Article 61 allowed an administrative court. Article 76 (2) of the Constitution of Japan (1947) prohibits special courts. It is evident that the section 1 of article III of the Constitution of the United States influenced the new provision.

The burden of proof in tax cases is, in principle, on the defendant. However, the plaintiff bears the burden of producing evidence to which the defendant would not otherwise have access. Review by the tax tribunal and the court is deferential to the district director's determination. Both review the facts de novo to decide whether there is sufficient evidence to support the determination by the district director. The appellate courts use the same standard of review.

10.2 The Concept of Tax Avoidance

Japanese law acknowledges tax mitigation, tax avoidance and tax evasion as three disparate concepts. Tax mitigation is a reduction in tax burden anticipated by the tax legislator. Examples of tax mitigation include buying tax-favored bonds, delaying the sale of assets until they have been held long enough to merit favorable capital gain taxation upon sale,[14] and deferral of capital gain taxation by fulfilling the conditions for special treatment of exchange of lands.[15] Tax avoidance is the taxpayer's mitigation of tax burden by an abnormal transaction to obtain a result not anticipated by the legislature.[16] A leading treatise provides the following example of tax avoidance. For the sole purpose of mitigating capital gain taxation, a landowner, instead of selling the property, allows a would-be purchaser to use the land for a period of years in exchange for a loan in an amount of money equal to the market value of the land for the same period. This transaction is an attempt to convert a sale into a lease in order to qualify for a lower rate of taxation available only in the case of land held for a given period.

The Japanese concept of tax avoidance is derived from that of Germany before World War II.[17] The concept remains unchanged since its introduction, but is used mainly in academic or law making discussions and it is not marshaled in legal disputes. Although the tax authorities sometimes refer to the concept in tax cases, courts never decide the cases based upon the fact that a transaction contains elements of tax avoidance.

Tax evasion involves the act of hiding all or a part of the facts underlying the tax liabilities. In the tax code, this action is defined as a taxpayer's evasion of his tax liability with "fraudulent or other dishonest acts."[18] The

[14] The tax for capital gain from land held longer than 5 years is reduced to 50% of the normal rate.

[15] Article 33 of the Act on Special Measures Concerning Taxation.

[16] Some commentators define tax avoidance to include a wide range of behavior, including tax mitigation and tax evasion.

[17] In 1931, Professor Shozaburo Sugimura of the University of Tokyo translated a treatise written by Professor Albert Hensel of Germany. The treatise explains the concept of tax avoidance (in German, *der Steuerumgehung*).

[18] *See*, for example, Article 238 (1) of the Income Tax Act.

term "fraudulent or other dishonest acts" is interpreted strictly. It goes beyond failure to file a tax return.[19] However, it generally does not include mere filing a tax return that understates income,[20] which is subject to different penalties. Tax law academics tend to apply the concept of tax evasion broadly, while tax practitioners and tax officials generally apply it narrowly.

10.2.1 Authority to Regulate Tax Avoidance

The Constitution of Japan includes no reference to authority to regulate tax avoidance. However, it is assumed that the legislative branch has the power to regulate tax avoidance under its general law making power. In the late 1950s, when the National Tax Procedure Act of 1959 was about to be enacted, a fierce debate concerned whether the Constitution gave the executive branch the power to "tax according to the transaction's economic substance." This was understood as a debate about the power to regulate tax avoidance generally.[21] Thus, in a sense, the debate was about the adoption of GAAR.

10.3 Legal Weapons to Combat Tax Avoidance

10.3.1 Business Purpose

In Japan, the presence of a tax avoidance motive does not have any legal consequence. Neither the court nor any other adjudicatory body determines whether a transaction involves tax avoidance. There is simply a factual determination whether a given transaction involves acceptable tax mitigation.

In the 1970s Japanese tax academics introduced the notion of tax avoidance in the U.S. sense.[22] The Supreme Court in 1995 for the first time looked to the existence of a "proper business purpose" in a case in which a bank corporation attempted to make use of its excess foreign tax credit limitation by making a foreign branch- based loan.[23] The court determined

[19] *See e.g.*, Supreme Court Decision, July 9th, 1949 (Criminal Case Reporter, 3-8-1213).

[20] *See e.g.*, Supreme Court Decision, March 20th, 1973 (Criminal Case Reporter, 27-2-138).

[21] Some maintained that tax should be imposed in accordance with the actual facts, obviating the need to introduce and "economic substance" doctrine.

[22] *See* for example, Hiroshi Kaneko, *Sozeiho to Shiho* (Tax Law and Private Law), 6 JAPAN TAX LAW REVIEW 21–24 (1978) (an introduction to *Gregory v. Helvering*, 293 U.S. 465 (1935)).

[23] See Supreme Court Decision of December 19th, 2005 (Civil Case Reporter, 59-10-2964).

that the transaction lacked a business purpose other than tax mitigation and that Article 69 of the Corporate Tax Act should be strictly interpreted so as not to allow foreign tax paid in the branch transaction to be credited. It remains to be seen whether this kind of reasoning will be followed in other tax avoidance case decisions or in lower court decisions.

10.3.2 Targeted Anti-avoidance Rules

Although Japan has no GAAR, there are rules similar to a GAAR. The Income Tax Act and the Corporate Tax Act have provisions that authorize the tax authorities to negate transactions involving affiliated companies where inter-company transactions would lead to an improper decrease of the group's income.[24] These provisions derive from an amendment in 1923 of the former Income Tax Act. At that time the Act contained a provision taxing undistributed income of related companies, but the provision had not been effective in combating tax avoidance through affiliated company transactions. Consequently, the targeted anti-avoidance rule, a GAAR-like provision, was enacted. The provision has to some degree created a disincentive to fashion tax avoidance transactions using affiliated companies. However, the low levels of income reported by most Japanese corporations with affiliated companies suggest that some tax avoidance remains.

10.3.3 Cross-Border Tax Avoidance Rules

Like other countries, Japan has special rules applicable to cross-border tax-avoidance transactions, such as transfer pricing regulations, controlled foreign corporation regulations, and thin-capitalization rules. The US-Japan tax treaty (2003) contains a limitation of benefit clause and limits the tax benefits to qualified residents.

10.3.4 Additional Taxes and Penalties

In general, additional tax is imposed if the taxpayer fails to declare the proper amount of income. If fraud or misrepresentation is involved, the taxpayer must pay a special additional tax. These additional taxes are not criminal penalties and they are assessed even in the absence of tax evasion. When a taxpayer's tax avoidance scheme fails, it is normally subject to these additional taxes. Generally, tax avoidance transactions are not treated like evasion which is subject to penalties. Penalties for tax evasion are monetary and may include imprisonment.

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[24] See Article 157 of the Income Tax Act and Article 132 of the Corporate Tax Act.

10.3.5 Statutory Interpretation

In Japan, statutory interpretation was employed one time only by the Supreme Court to defeat tax avoidance in the foreign tax credit scheme involving affiliated companies described above. There the business purpose doctrine was marshaled as the court attempted to determine whether the meaning of the statute. The court determined tax consequences in accordance with the true legal content of the transaction. However, it does not examine the economic substance of a transaction. Normally, statutory interpretation plays a limited role in tax avoidance cases.

10.3.6 Tax Shelters

In Japan, a "tax shelter" is defined as a marketed scheme is used to mitigate or avoid tax liability. Participation in partnerships that invest in movie films or an aircraft form the basis for the typical tax shelter schemes. Legislation has curbed the benefits of tax shelters. In addition, in the courts, the government prevailed in a case involving a movie films shelter when depreciation deductions were denied because the film was not in fact used as a business asset.[25]

Despite an increase in tax avoidance transactions and tax shelters, the government has been slow to move against them. It has not issued any white papers on this topic.

[25] Supreme Court Decision of January 24, 2006 (Civil Case Reporter, 60-1-252).

Chapter 11
Netherlands

Raymond H.C. Luja

11.1 Legal System

The Dutch legal system is a civil law system with a traditional separation of powers – judicial, legislative and executive. Members of the House of Representatives (*Tweede Kamer der Staten-Generaal*) can submit a proposal for tax legislation themselves, but the most common source of tax legislation is proposals submitted to parliament by the Government. Such legislation has to be adopted first by the House of Representatives and then by the Senate (*Eerste Kamer der Staten-Generaal*). The House of Representatives has a right to amend proposals made by the government before adopting them.

Many revisions in tax law are done on an annual basis, in particular in respect of the income tax and the corporate tax (for which the taxable year runs from 1 January to 31 December). Most changes are made as of 1 January of each year based on proposals submitted by the end of September (the start of the parliamentary year). The more substantial changes to tax laws, like replacing a corporate tax in full or for a major part, may be done by means of a separate legislative proposal. The excessive speed at which many legislative proposals find their way through the parliamentary process (because of the 3-month period available to adopt most tax legislation) at times gives rise to unanticipated tax avoidance structures and to retroactive or interim changes to tax law in order to deal with those structures accordingly.

It should be pointed out that, in accordance with tax laws adopted by parliament, the executive (i.e., the under-Secretary of Finance responsible for taxation) may be delegated authority implement the legislation by issuing regulations. In turn, the Director-General of the Dutch tax authorities may be mandated by the executive to issue certain guidelines and regulations.

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11.2 Tax Procedure

Taxes are to be enforced by the Dutch tax authorities (*Belastingdienst*), which is a branch of the Ministry of Finance. For income taxes, corporate taxes and inheritance taxes, taxpayers first submit their assessment of taxes due, upon which the tax authorities will adopt a decision stating the amount of tax due (within 3 years after the end of the fiscal year). After receipt of that decision, taxes are to be paid. Often an interim-decision is taken (processed automatically) within some months after submitting the assessment which will be in line with that assessment, unless it is found to deviate unexpectedly from previous assessments or from information otherwise available to the tax authorities. This is done to expedite payment without the need to wait for the final decision, thereby limiting additional interest payments. An interim decision can also be handed down ex officio or on request at the beginning of the fiscal year in order to create a pay-as-you-go system where, based on this initial estimate, taxes are being paid on a monthly basis during the fiscal year.

Wage taxes and value added taxes are based on a self-assessment, which may be subject to review. Taxes are due upon submission of the self-assessment.

With respect to income taxes and corporate taxes the tax authorities will normally contact the taxpayer prior to deciding to divert from the initial assessment submitted. In the absence of an assessment the tax authorities may render a decision on their own authority. Once a formal decision has been taken stating the amount of taxes due, the tax authorities – upon receipt of new information not previously available to them (when taking the first decision) or of proof of bad faith of the taxpayer when he submitted his assessment – may take another decision in order to secure the payment of additional taxes due. Such decision should be taken within 5 years after the end of the fiscal year concerned. As for wage taxes and VAT a decision for additional payment of taxes may be taken within 5 years as well. For these taxes no new information is needed as a result of the self-assessment system.

If a taxpayer disagrees with a formal decision he/she must first go through an administrative review procedure, in which the tax authorities have the opportunity to review their initial assessment. This is normally done by a person not involved in the initial decision. (The tax authorities may give leave for a direct appeal, skipping the administrative review procedure. This happens rarely, often in test cases where court confirmation of a legal interpretation is sought.)

If the initial assessment is upheld, the taxpayer may go to court. First, the tax chamber of one of five regional courts of first instance (*Rechtbank*) is competent to do a full review of both facts as well as the law. If this court upholds the outcome of the administrative review (the initial decision as such is not subject to review, the decision to uphold that decision is)

the taxpayer may go to the tax chamber of the regional court of appeals (*Gerechtshof*) which again can do a full review of both facts as well as the law. The tax authorities can also appeal against a decision of the court of first instance finding in favour of the tax payer. Both the taxpayer and the tax authorities can go to the tax chamber of the Dutch Supreme Court (*Hoge Raad*) if they disagree with a decision of the court of appeals. This review, however, is limited to legal issues and to procedural shortcomings and not to a further review of facts. In case the final outcome of a case depends on facts not previously settled in the lower courts, the Supreme Court may, after giving its ruling on legal interpretation, refer the case back to the lower courts for further review (these lower courts would be within another region, in order to prevent the same regional court dealing with the same case a second time, after annulment of its previous decision).

As indicated above, tax controversies are normally dealt with by the tax authorities and regular courts, albeit in special tax chambers of those courts. In case of tax fraud or gross negligence it would be possible, upon a joint recommendation of the tax authorities and the public prosecutor to hand cases over to the public prosecutor's office for criminal prosecution (next to the abovementioned process dealing with the settling of the tax due). This happens rather rarely, since the tax authorities are empowered to impose fines themselves. These fines can be very substantial in case of intentional filing of an incorrect assessment, amounting up to a 100% of taxes due in corporate tax cases.

11.3 Tax Avoidance

The constitution does not provide any particular authority to address tax avoidance, apart from the general possibility to change or adapt laws to it. It is possible to do so retroactively (for those cases not already adjudicated), if the legislature expresses its intent to do so. Neither the Dutch constitution nor Dutch tax law provides for a general definition of terms like tax mitigation, tax avoidance and tax evasion. Instead, more specific anti-abuse provisions have been introduced in Dutch tax law addressing tax avoidance. The general framework to deal with tax avoidance structures stems from jurisprudence.

First a general anti-avoidance provision ("rightful levying," in Dutch: *richtige heffing*) was included in Dutch administrative tax law in 1925, applicable to direct taxes only.[1] It allowed the tax authorities to address situations in which a taxpayer claimed a tax reduction when it circumvented the law by entering into transactions substantially similar to transactions

[1] Art. 31 ff of the General Tax Act (*Algemene wet inzake rijksbelastingen*).

in which other taxpayers bore a higher tax burden. In order for the tax authorities to apply this provision, it was necessary to get approval from the Ministry of Finance as well as to go through a separate procedure to establish tax avoidance. The provision fell into disuse by mid-1987 because of the growing importance of the *fraus legis* principle. Although introduced in 1926, the principle of *fraus legis* was resurrected in 1984 and 1985 when the Supreme Court confirmed the possibility for its parallel application to the general anti-avoidance rule (*richtige heffing*) in 1985.[2]

11.4 *Fraus Legis*

Fraus legis may be invoked by the tax authorities. As a result of its application the tax authorities and the courts may either eliminate or substitute a legal action and determine the resulting tax burden on the basis of the legal circumstances as altered by the application of *fraus legis*. It permits the tax authority to take a substance over form approach with the result that tax would be paid as intended by the legislator.

Fraus legis applies only if the decisive reason (i.e. the only or by far the most important objective) for entering a transaction is to save a substantial amount of (Dutch) taxes. The way the arrangement has been put together must lead to a result that is contrary to the objective and purpose of the law. Moreover, the arrangement as such should have no other practical meaning than to save taxes.[3]

Fraus legis cannot be used if the legislative body foresaw the potential evasion and did not alter the law accordingly or if a legal action is provided to address a particular evasion. In such case no further action can be taken than the action provided, even if insufficient. If the legislative body did not foresee a situation at all (including comparable situations not covered by existing rules), *fraus legis* can only be applied if the avoidance is not the result of inherent flaws in the system of the law. If an action was not foreseen and if the resulting reduction in the payment of taxes is unacceptable to society at large, *fraus legis* applies. Should a substantial business motive be present for creating a particular legal situation (in addition to a tax avoidance motive), then *fraus legis* may not apply.

Value added taxation is mostly regulated by European Law. Since Dutch VAT law provides for an implementation of the European VAT directive, the application of national anti-avoidance principles in respect of this tax is largely governed by the scope of application of their European counterparts.

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[2] Hoge Raad, 21 November 1984, No. 22 092, *Beslissingen Nederlandse Belastingrechtspraak* 1985/32 and Hoge Raad, 27 February 1985, No. 22 315, *Beslissingen Nederlandse Belastingrechtspraak* 1985/158.

[3] See Hoge Raad, 21 November 1984, No. 22 092, loc. cit.

The (restrictive) applicability of the *fraus legis* principle in this area has only been clearly confirmed relatively recently by the 2006 *Halifax* case decided by European Court of Justice. In this decision the Court states the following:

> The [VAT] Directive must be interpreted as precluding any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice. For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the [VAT] Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be *contrary to the purpose* of those provisions. Second, it must also be apparent from a number of objective factors that *the essential aim of the transactions concerned is to obtain a tax advantage*. Where an abusive practice has been found to exist, *the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice*.[4]

As a result, if a legal arrangement can be explained by a business purpose other than to avoid taxation or to attain tax advantages there seems to be no room to apply anti-avoidance provisions even if tax avoidance would have been one of several objectives of such action.

11.5 Targeted Anti-avoidance Rules

The government's primary response to tax avoidance structures is to include specific anti-avoidance provisions in the relevant tax laws. As a result, the scope of application of *fraus legis* becomes rather limited because – once anti-avoidance provisions are introduced – any gaps known to the legislator which have been left open are rather unlikely to be filled by the application of *fraus legis* in future.

Some of the anti-avoidance provisions introduced in Dutch corporate tax law are listed below:

- some intra-group interest may be non-deductible, unless either a business objective has been proven (i.e. a transaction not aimed at avoiding taxes) or the recipient pays a sufficient tax (the recipient being subject to tax on the interest received, with a minimum tax levied comparable to a 10% tax on a tax base similar to the Dutch one);
- deferral of tax in case of a merger or split-up will not be granted if the primary objective of such action is to avoid or postpone the payment

[4] ECJ C-255/02 of 21 February 2006, *European Court Records* 2006, I-1609; italics added. As a result of the entry into force of the Lisbon Treaty on 1 December 2009, the Court of Justice of the European Communities has now become the Court of Justice, which is part of the Court of Justice of the European Union.

of taxes; it is for the taxpayer to establish credibly that such merger or split-up serves a genuine business purpose (like corporate restructuring); if shares in entities involved in a merger or split-up are sold outside of the company's group within 3 years there is a legal assumption that such genuine purpose is absent;
- special rules have been introduced to address tax arbitrage between natural persons/shareholders and the incorporated companies they hold;
- intra-group transactions that are not at arm's length and intra-group loans at extraordinary conditions may be revised or requalified;
- a thin-capitalization provision has been introduced in order to limit the deductibility of interest;
- the deduction of losses is limited in case of a company take-over, in order to prevent such losses from being used for new business purposes;
- the general participation exemption (applying to shareholdings of at least 5%) is replaced by a system of foreign tax deductions, in case the participation held concerns a low-taxed corporation involved in (non-business related) portfolio investment.

In June 2009 a white paper proposed changes to corporate taxation rules, addressing issues of thin capitalization by private equity companies as well as a more general limitation on interest deduction (replacing the large number of single anti-avoidance provisions currently in place). Further action on this project has been postponed.

11.6 Establishing Tax Avoidance

As addressed above, the Netherlands does apply a GAAR by means of the *fraus legis* principle developed by the courts, although it de facto abandoned the general anti-avoidance provision provided by law. The scope of application of *fraus legis* is rather limited, however, because of the policy focus to include specific anti-avoidance provisions in tax laws. Should the tax authorities call upon *fraus legis* when deciding upon the tax burden or in court, they have the initial burden of proof to show that this anti-avoidance rule applies.

On the application of specific anti-avoidance provisions, the burden of proof is split between the taxpayer and the tax authorities depending on what is claimed. The tax authorities must establish the presence of income. When establishing entitlement to an interest deduction, participation exemption, etc. the burden of proof is on the tax payer. Special provisions may divide the burden of proof differently or qualify the burden of proof that has to be met (varying from "making credible," as a result of which the other party has to show differently, to actually proving that certain conditions have been met).

Corporations and individuals carrying out a business are under an obligation to keep books and a reliable administration. If they are found not to have kept their books in good order (or not to have kept books at all) the burden of proof may shift to the taxpayer as a result of a reversed-onus clause in the general administrative tax law, allowing the tax authorities to make reasonable assumptions about the tax burden requiring evidence of the contrary from the taxpayer.

Sometimes the law itself provides for rather sophisticated provisions on burden of proof. For instance, certain intra-group financing arrangements are deemed to result in non-deductible interest. In order to get around some of these limitations it is possible for the taxpayer to make a showing that (i) the loan transaction served a business purpose or (ii) the recipient of the interest is subject to a reasonable level of tax. The law provides that a 10% tax (with reference to a tax base comparable to the Dutch tax base) would suffice. While the initial burden of proof is thus on the taxpayer, once it is met the tax authorities may still make a credible showing that – even in case of reasonable taxation – the transaction did not serve a business purpose. If a party has to make his position credible (a lighter burden of proof), it is up to the other party to provide evidence of the contrary (a heavier burden of proof).

Tax authorities will normally allow a court decision in respect of a previous year to serve as a precedent for upcoming years in respect of the same element of the tax assessment, as long as neither the facts nor the law does change. As far as their own actions are concerned, an explicit communication about a decision made in respect of previous transactions – other than the mere acceptance of a (self-) assessment at face value – may give rise to legitimate expectations in respect of future years if the situation remains unchanged (in fact or in law), unless the tax authorities indicate their intent to change their initial assessment for future years in time. The latter may call for an interim/phase-out period. In respect of the application of *fraus legis*, it should be pointed out that the tax authorities must raise the issue in its decisions for each year, although it is most likely that a court decision in respect of a previous year will be sustained for subsequent years under the same circumstances (if the tax payer would go to court a second time around).

11.7 International Transactions

The Dutch Supreme Court has not ruled that the principle of *fraus legis* may not be applied in cases where the application of double tax conventions is concerned (in which respect *fraus legis* is commonly referred to as *fraus tractatus* or *fraus conventionis*). Even so, the Court has allowed

itself very little room to apply this principle in case of tax treaty interpretation. It seems possible to apply this principle in a legal setting that provides a result contrary to the objective and purpose of double tax convention (DTC) provisions as intended by the parties involved.[5] Unlike the legislative process often little is known about the preparatory phases of a DTC as a result of which in the absence of an explicit statement of intentions in the DTC or annexes thereto there seems little room for applying the *fraus legis* concept in respect of the application of DTC's to date. For this reason, the application of *fraus legis* in the context of a DTC has hereto been unsuccessful.[6] The Supreme Court made clear, however, that saving taxes by means of moving residency to the other contracting state, thereby shifting the power to tax to the other state and resulting in the avoidance of Dutch taxes, normally falls within the objective and purpose of a DTC.[7]

In respect of cross-border transactions, it should be pointed out that a number of special anti-avoidance provisions listed in Section 11.5 explicitly apply in cross-border situations, i.e. where the tax burden on interest receipt abroad or on profits made abroad is rather low or non-existent.

In order to overcome certain tax avoidance schemes making use of DTC's, subject-to-tax clauses have been introduced in respect of pensions in some tax treaties. Sometimes, special tax regimes may be excluded from a treaty in order to prevent granting treaty benefits to (nearly) exempt undertakings in the other contracting state. Moreover, some treaties contain special anti-avoidance provisions. For instance, the NL-UK tax treaty provisions on dividends, interest and royalties explicitly provide that exemption of withholding tax will not be granted if the respective share, loan or license has mainly been created in order to be able to benefit from these provisions in the absence of any bona fide business purpose. Furthermore, in conformity with the OECD Model Tax Treaties, beneficial ownership clauses have been included in most DTC-provisions on dividends.

Limitation of benefits (LOB) provisions are rather rare in DTC's signed by the Netherlands due to restrictions imposed by European Law (in particular in respect of LOB-provisions attached to nationality rather than residency). The NL-US DTC is the only one with a relatively long-standing tradition of containing over-all LOB-provisions.

[5] See in particular Hoge Raad, 15 December 1993, No. 29 296, *Beslissingen Nederlandse Belastingrechtspraak* 1994/259 and Hoge Raad, 14 July 2006, No. 42 522, *Beslissingen Nederlandse Belastingrechtspraak* 2007/42.

[6] Except for the application of this principle on a sort-of-DTC with the Dutch Antilles. Since the Antilles are part of the Kingdom of the Netherlands, the nature of this agreement is different from that of normal DTCs and will therefore not be discussed here.

[7] Hoge Raad, 12 May 2006, No. 39 223, *Beslissingen Nederlandse Belastingrechtspraak* 2007/36; Hoge Raad, 14 July 2006, No. 42 522, loc. cit.

11.8 Penalties

Penalties may only be imposed if a taxpayer's position was not "pleadable" in court, which means that he took a position so clearly contrary to the law that his position could not reasonably be considered an acceptable plea, essentially resulting in gross negligence or even intent to defraud. Given the complexity of a *fraus legis* analysis, a finding of *fraus legis*/tax avoidance would therefore not necessarily be sufficient ground for imposing tax penalties. To the contrary, most tax avoidance transactions are by their very nature often in accordance with the letter of the law (albeit not with the spirit and objective of the law as such) and therefore seldom qualify as a punishable offence.

In the rather unlikely case of criminal prosecution of tax avoidance structures, where gross negligence could be proven, criminal penalties may either be of a monetary nature or – to the extent the actual managers of a corporation would be charged themselves next to their company – consist of a prison sentence. Again, this would be extraordinary and not common practice.

11.9 Disclosure Rules

No specific disclosure provisions apply to either the taxpayer or his tax consultant involved in anti-avoidance schemes. Neither is there an obligation to register any anti-avoidance schemes designed by tax consultants. However, corporate taxpayers have a general obligation to provide information relevant for the tax authorities on request. To the extent tax consultant communications reflect the determination of a taxpayer's legal position, even in respect of tax avoidance structures, such communication would normally be privileged.

Tax consultants are under an obligation to report cases of money laundering or the financing of terrorism.[8] In order to do so they need to do an initial assessment of new clients. In case of potential involvement in illegal activities, a more in-depth analysis would be required, according to the

[8] While the Netherlands are said to have the highest number of tax consultants per capita in the world, it should be pointed out that being a tax consultant is not a government-regulated profession in the Netherlands. Most importantly, while many tax consultants may be lawyers most of them are not "advocates" in court, partly because of the fact that in tax procedure there is no need to be represented by an "advocate" in court. The taxpayer may essentially hire anyone he prefers or represent himself. Most larger firms employ or hire in tax consultants next to their accountant and their corporate lawyer. Accountants normally refrain from handling tax affairs for the most part, except for small and medium sized enterprises.

Code of Conduct of one of the largest Dutch associations of tax consultants (*Nederlandse Orde van Belastingadviseurs*). As indicators of illegality this code mentions the use of intermediary corporations for which there seems not to be a "legitimate" tax, legal or commercial reason as well as the use of foreign corporations that are located in a country known for its mild tax climate (and/or strict bank secrecy) for which their neither seems to be a legitimate reason. While both the use of intermediaries as well as the use of foreign corporations may be elements of certain tax avoidance (and/or evasion) structures, these indicators for an in-depth investigation are not meant to necessarily result in an obligation to report transactions aimed at tax avoidance, in the absence of any underlying illegal activity – i.e. the tax avoidance structure as such is not considered illegal for the purpose of this analysis.

The two largest associations of tax consultants in the Netherlands provide in their code of conduct provisions that indeed may cover their involvement in tax avoidance structures, while in practice such structuring is deemed acceptable practice to the extent there would be a "pleadable position." One association (*Nederlandse Federatie van Belastingadviseurs*) provides that its members shall not take part in legal constructions that violate law and jurisprudence, albeit that taking a "pleadeable" position would be acceptable. Another association (*Nederlandse Orde van Belastingadviseurs*) introduced a special code of conduct stating that its members play their part in ensuring that tax laws are implemented in accordance with their nature and objective. The latter suggests that any involvement in tax avoidance schemes covered by *fraus legis* – as a result of which the objective of a law is deemed not to have been complied with – would already result in a violation of the code of conduct. It is unclear whether this was actually intended.

Larger taxpaying companies may apply for an alternative system of review by tax authorities called horizontal supervision (*horizontaal toezicht*). If the tax authorities are satisfied with the (certified) tax control framework in place and with the companies' current and previous cooperation, they may be eligible for this less stringent system of review. As part of this review system, companies are expected to notify tax authorities of substantial changes in their tax position in advance and to consult them in order to determine their tax position upon engaging in certain tax structures. Failure to inform the tax authorities in advance as well as cases of extreme tax avoidance may affect their eligibility; the tax authorities would probably respond by withdrawing from this horizontal supervision agreement and return to standard (if not more stringent) supervision methods (mostly ex-post).

As of 1 July 2009, administrative fines can be imposed by the tax authorities on tax consultants who assist their clients in actions for which the latter may be fined themselves as well (from small penalties for late payment or the late or non-filing of assessments to more severe penalties for

filing incorrect assessment with the intent to pay insufficient taxes or in case of gross negligence). The government has committed itself to limit the fining of tax consultants to the more extreme and clear cut cases, requiring the tax inspector to be authorized by senior management. As a result, active involvement in tax avoidance structures is unlikely to trigger such authorization, because many tax avoidance structures are often "pleadable" in court and would not have led to non-payment or insufficient payment of taxes in the absence of the application of *fraus legis*. (In accordance with criminal law, the tax consultant himself could be tried as a co-conspirator if criminal charges were filed even prior to 2009, which, as stated in Section 11.8, would be very unlikely in respect of tax avoidance structures.)

11.10 Tax Shelters

No special penalty provisions apply to making use of tax shelters, although the use of such shelters may result in the application of specific anti-avoidance rules. For instance, (i) a tax shelter abroad resulting in low-tax portfolio investment by subsidiaries may forfeit the full application of the participation exemption or (ii) no relief may be granted from an interest deduction limitation in the absence of a reasonable level of taxation at the recipient's side.

Two of the most famous corporate tax shelters in the Netherlands will be mentioned here. First, the participation exemption is available which is a longstanding, integral part of the Dutch tax system.[9] The latter essentially excludes any dividend income or capital gain from shares held in other companies. It operates under the presumption that business income will be taxed at the subsidiary operating the business (either in the Netherlands or abroad) and prevents double taxation of such profits at the shareholding level.

Secondly, the absence of withholding taxes on interest and royalties paid from the Netherlands should be mentioned. Together with an elaborate tax treaty framework providing mostly for a rather low to nil withholding tax on royalty payments flowing into the Netherlands, the use of Dutch conduit companies may result in a flow-through of royalties at a relatively low tax rate (i.e. the normal tax due on the on balance royalty income based on an at arm's length spread.) With the introduction of the EU's Interest & Royalty Directive in 2004 this tax shelter has become less attractive in intra-EU situations, because of the EU-wide obligation to reduce such withholding taxes if the beneficial owner resides within the EU.

[9] Art. 13 ff., Corporate Income Tax Act of 1969 (*Wet op de vennootschapsbelasting 1969*).

11.11 Concluding Observations

The Netherlands has a long-standing tradition of providing tools to address tax avoidance. While a legal basis to do so was introduced in 1925 it effectively has been replaced by the *fraus legis* principle developed in jurisprudence since 1926, which allows both for a broader application as well as for the substitution of legal transactions (next to elimination thereof) in order to overcome tax avoidance structures that go contrary to the purpose and objective of tax law provisions. There is little room to apply the *fraus legis* principle as a general anti-avoidance rule in those cases where the legislator foresaw transactions and failed to act at all or to act efficiently. In the last decennium corporate tax law has been extended by a large number of specific tax avoidance provisions regulating particular avoidance structures. Only recently a government white paper indicated an interest in replacement of these specific provisions by broader anti-avoidance rules in order to reduce the complexity of the tax system albeit at the cost of overkill. A follow-up to this paper has been postponed for the time being.[10]

[10] This report was finalized in January 2010.

Chapter 12
New Zealand

Zoë Prebble and John Prebble

12.1 Legal System

New Zealand is a common law jurisdiction and a former British colony. Its legal system is heavily based on the English one, and remains similar in many respects. There are also important differences, which reflect the unique legal culture that has developed in New Zealand. New Zealand has a unicameral Parliament, having abolished its upper house in 1951. The country has a unitary (rather than federal) system of governance.

The primary sources of New Zealand law are statutes enacted by the New Zealand Parliament and decisions of the New Zealand courts. Three related principles underpin the law: parliamentary sovereignty; the rule of law; and the separation of powers.

The principle of separation of powers is an important constitutional concept in New Zealand law. The principle is conceptually adhered to, although in formal terms less rigidly than in some other jurisdictions. The judicial branch of government is separate and independent. The legislative and executive branches are conceptually distinct, but in formal terms there is some overlap. New Zealand follows the Westminster parliamentary system, which means that ministers are also members of Parliament.

12.1.1 Drafting, Enactment, Promulgation and Revision of Tax Law

12.1.1.1 Enactment and Promulgation of Tax Legislation

New Zealand Tax legislation comprises both statutes, which are enacted by Parliament, and secondary tax legislation promulgated by the Executive

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Council, which is essentially the Cabinet. The secondary legislation in the tax area is less significant than in other countries because New Zealand manages to include more material in primary legislation. New Zealand's main tax statute, the Income Tax Act 2007, tends as a result to contain more detail than is perhaps the case in many other countries. In addition, the Commissioner of Inland Revenue has authority to issue binding rulings.

The Inland Revenue Department, known as IRD, has its own drafting unit, which drafts all tax bills. It is the only department to do its own bill drafting. All other bills are drafted by the Parliamentary Counsel Office, known as the PCO. This unusual situation arose largely as a result of historical accident. In the 1990s, the PCO was severely under-resourced and there were concerns about drafting style. There was a desire for a re-draft of the Income Tax Act in plain language, and it was believed that better progress could be made if IRD took on the work itself. In 1995, the Statutes Drafting and Compilation Act 1920 was amended to allow for the drafting of tax statutes by IRD. A recent Law Commission report has recommended that tax drafting should return to the PCO.[1]

12.1.1.2 Process of Tax Legislation Revision

There is a continuous process of tax legislation revision. Changes usually originate within IRD. Because New Zealand has a unicameral Parliament and is a unitary country, it is relatively easy, and quick, to pass legislation. The introduction of a Mixed Member Proportional electoral system in 1996 has to some extent slowed the legislative process, since Parliament comprises a larger number of parties, and it is common for there to be a minority or coalition government. MMP has not slowed the legislative process to a great extent in respect of tax statutes though, except perhaps in respect of rate changes and other changes of considerable political significance. As a result, there are frequent amendments to tax legislation. Tax legislation is revised as often as necessary. There may be as many as five or more amending statutes to the Income Tax Act in any one year.

Since 1994, tax policy has been developed in accordance with the Generic Tax Policy Process.[2] The process involves IRD issuing consultation documents and carrying out various stages of public consultation. Until the mid-1980s, the public usually had its first look at proposed tax reforms when a bill introducing them was tabled in Parliament. The opportunity to express views on proposed changes usually came only when the select committee considering the bill invited submissions. This was almost too late in

[1] Law Commission *Review of the Statutes Drafting and Compilation Act 1920* (NZLC R 107, Wellington, May 2009) recommendation 8, p 28.

[2] See IRD website: http://taxpolicy.ird.govt.nz/corporate/process.html (accessed 27 June 2009).

the process if affected taxpayers did not agree with the general concept of a proposed change.

During the 1980s, major tax reform included the introduction of a value added tax, revision of the international tax system, the adoption of full imputation of credits to shareholders of tax paid by companies, and the enactment of a comprehensive timing regime for financial instruments. These changes were accompanied by the publication of government consultation documents, draft bills, public submissions, and consideration by committees of private sector experts. The public consultations of the 1980s were on an ad hoc basis. In 1994, similar, though less elaborate, procedures were adopted for nearly all tax changes. These procedures became the "Generic Tax Policy Process", a voluntary process adopted by the government to try to improve legislative outcomes. The process is not stipulated by a constitutional statute, but rather an administrative practice that has been adopted for tax law.

In many Westminster systems, finance bills do not go before a parliamentary select committee, but since the mid-1980s New Zealand tax bills have gone before the Finance and Expenditure Committee, which often hears extensive submissions.

12.2 Enforcement of Tax Laws

The IRD is responsible for the enforcement of tax legislation in New Zealand. The legal system provides for self-assessment. IRD's relatively mechanical processing of returns and its default position of accepting what taxpayers say at face value means that a large proportion of IRD compliance-related resources can be committed to audits, though the total number of audits is a fairly small fraction of returns.

12.2.1 Tax Controversies

A tax controversy may arise when a taxpayer and IRD cannot reach agreement on a tax position taken in a taxpayer's self-assessment, and often follows an audit of the taxpayer. If no agreement has been reached on some or all issues, IRD will begin the disputes process by issuing a Notice of Proposed Adjustment. Alternatively, a taxpayer may dispute his or her own assessment or a disputable decision made by the Commissioner by issuing a Notice of Proposed Adjustment.

The Tax Administration Act of 1994 imposes time limits for increasing assessments, or refunding overpaid tax.[3] The time bars do not apply if the

[3] If a taxpayer has furnished a return and made an assessment, the Commissioner may not amend the assessment to increase the amount assessed if 4 years have passed from

Commissioner considers a return to be fraudulent or wilfully misleading,[4] though that decision is reviewable by the courts.

12.2.1.1 The Dispute Process

Part IVA of the Tax Administration Act of 1994 sets out the procedure to be followed in the event of a tax dispute about an assessment or other disputable decision. IRD may not amend a taxpayer's assessment before the dispute resolution process is complete, except in limited circumstances.[5] The dispute resolution process requires formal documents to be issued by both IRD and the taxpayer, covering details of the adjustment in dispute, the relevant facts and evidence involved, and the propositions of law relied on by each party.

A dispute is initiated by the issuing of a Notice of Proposed Adjustment, or NOPA, by one party to another that states and explains the proposed adjustment as compared to the taxpayer's prior tax position, which can be the taxpayer's liability as returned. One corollary is that the remedy for taxpayers who have made a mistake and acknowledged derivation of too much income is to issue a NOPA. If the recipient disagrees with the NOPA, the recipient (who may be either the Commissioner or the taxpayer) must reject the proposed adjustment by issuing a Notice of Response ("NOR"). Where the Commissioner has issued a NOR in response to a taxpayer initiated NOPA, the taxpayer must reject the Commissioner's NOR in writing to ensure the dispute process continues.[6]

If the dispute is not resolved because the NOR is not accepted, the Commissioner may issue a Disclosure Notice, or DN. A DN requires both Inland Revenue and the taxpayer to detail in writing their respective Statements of Position, or SOPs. The DN is an important document because it triggers the application of the evidence exclusion rule. The evidence exclusion rule limits any challenge by the taxpayer and Inland Revenue to the facts, evidence, issues and propositions of law disclosed in their respective SOPs.

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the end of the income year in which the taxpayer provided the return: Tax Administration Act 1994, s 108, and for GST assessments, s 108A. The Commissioner is prevented from refunding amounts of overpaid income tax after 8 years from the end of the year in which the original assessment was made: Income Tax Act 1994, s MD 1(1). The Commissioner cannot refund amounts of overpaid GST after 8 years from the end of the taxable period in which tax was assessed: Goods and Services Tax Act 1985, s 45.

[4] Tax Administration Act 1994, s 108(2).

[5] Tax Administration Act 1994, s 89N.

[6] Tax Administration Act 1994, s 89H(3).

If the initial adjustment has been proposed by the Commissioner, the Commissioner may provide additional information in response to any additional matters raised in the taxpayer's SOP.[7] This will usually be called an Addendum to the Commissioner's Statement of Position. The parties also may agree at any time to further information being added to either of their SOPs.[8]

Generally, responses are required within 2 months of the formal stages during the dispute process discussed above (and 4 months in relation to a taxpayer wishing to propose an adjustment to any assessment received).[9]

Agreement may be reached at any stage in the process, but if the matter remains unresolved the Commissioner's practice is that generally all matters will be referred to IRD's Adjudication Unit for consideration. This is an administrative (not legislative) part of the dispute resolution process.

In the event that the Adjudication Unit decides in favour of the taxpayer, IRD has no right of appeal against the decision. However, where the Adjudication Unit finds in favour of Inland Revenue, a taxpayer has further rights. The taxpayer may continue the dispute by filing a challenge in the Taxation Review Authority or the High Court, whose respective jurisdictions are considered below.

Where IRD has issued a Disclosure Notice, both IRD and the taxpayer may raise during challenge only the facts, evidence, issues and propositions of law that are disclosed in the SOPs.[10]

12.2.1.2 The Adjudication Unit

The Adjudication Unit is part of the Office of the Chief Tax Counsel (OCTC), based in the capital city, Wellington, and part of IRD's National Office.[11] The Adjudication Unit is separate from IRD's audit and investigation function and takes a fresh look at disputes, providing an independent and impartial decision on the issues.

Each dispute is considered by a team of three people, all of whom have professional legal or accounting qualifications, or both, and have experience in researching and analysing tax issues. The team members have differing levels of seniority and involvement in the consideration of the dispute. The final decision is made by an Adjudication Manager. The adjudication team

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[7] Tax Administration Act 1994, s 89M(8).

[8] Tax Administration Act 1994, s 89M(13).

[9] Tax Administration Act 1994, s 3.

[10] Tax Administration Act 1994, s 138G.

[11] The OCTC also houses the Taxpayer Rulings, Public Rulings and Escalation and Advising Units.

takes into account the NOPA, NOR, both parties' SOPs and evidence sent to the Adjudication Unit at the time of the referral.

A comprehensive adjudication report is produced and provided to the parties. In addition to the adjudication decision and the reasons for it, the report also sets out the facts of the dispute, a summary of the parties' arguments, the issues that need to be addressed, the analysis of the legal issues involved, the application of that legal analysis to the facts of the dispute, and the conclusions reached on each issue. In some instances, it may also be necessary to resolve disputed facts where the parties have not agreed. These reports can sometimes be lengthy, but it is considered important for them to embody all relevant information in a single document and to provide full analysis and reasoning, including the reasons why any particular arguments were not accepted. It is intended that such detail will assist the parties in decisions as to their next steps in the dispute or in future dealings on similar issues.

A letter goes to both parties setting out a summary of the report. The letter also provides some information and guidance should the taxpayer wish to take the matter further, in the event that the Adjudication Unit decides in favour of IRD.

The Adjudication Unit does not perform a mediation or arbitration function. It considers the dispute on the materials provided and does not conduct further investigations. The dispute is decided on the papers, with no oral submissions or discussion. The Unit does not have any direct communication with either IRD officers or the taxpayer involved in the dispute during the course of the adjudication. The object is to make it clear that the Unit operates impartially and independently.

The Adjudication Unit completes approximately 50–80 adjudications each year. Since disputes can involve many issues, decisions can be made fully or partly in favour of either party. In recent years, on average approximately two thirds of the decisions made by the Adjudication Unit were made predominately in favour of Inland Revenue's position and one third in favour of the taxpayer's position.[12]

12.2.1.3 Tax Review Authority

The authority of first instance for most tax controversies is the Taxation Review Authority ("TRA"). The TRA is totally independent of IRD. It is based in the capital city, Wellington, and also travels to other areas so that cases can be heard as close as possible to where taxpayers live.

[12] "The Adjudication Unit – its role in the dispute resolution process" IRD Website http://www.ird.govt.nz/technical-tax/general-articles/ga-adjudication-unit.html (accessed 4 July 2009).

The TRA is divided into two levels of jurisdiction: small claims and general. The majority of taxpayers have their challenges heard before the TRA rather than the High Court. A number of factors contribute to this choice:

- The TRA is less formal than the High Court (and it is possible and not unusual for taxpayers to represent themselves in the TRA);
- The cost is generally lower than for hearings in the High Court;
- Costs are not usually awarded in the TRA;
- TRA hearings are not open to the public and taxpayers' names are not published;
- The TRA judges are tax specialists.

12.2.1.4 The High Court

Taxpayers in cases of great complexity, great value, or both can opt to have their objection first heard in the High Court instead of the TRA. The High Court is more formal than the TRA. Unlike the TRA, it can award costs. Hearings are open to the public.

In the TRA, the taxpayer's identity is kept confidential. Reports of TRA judgements are published, but with names and other identifying features removed. However, in tax controversies before the High Court, whether on appeal or at first instance, there is no confidentiality and taxpayer names are revealed. Similarly, reports of appeals to the Court of Appeal and Supreme Court reveal taxpayer names.

12.2.1.5 Appeals

Taxpayers or the Commissioner may appeal against TRA decisions in its general jurisdiction (but not its small claims jurisdiction) and against decisions of the High Court. The hierarchy is TRA, High Court, Court of Appeal and Supreme Court. Until 2003, New Zealand's court of final appeal was the Judicial Committee of the Privy Council, in London, United Kingdom. This was not a limitation of sovereignty. Rather, New Zealand preferred to resort to the Judicial Committee, most of whom are members of the House of Lords, one of the world's most experienced commercial courts. Among other things, ceding final appeals to an independent court in another jurisdiction gives confidence to foreign investors. Nevertheless, in 2003 New Zealand replaced the Judicial Committee with its own Supreme Court. As at 2009, the Court had determined only one case on the GAAR, *Ben Nevis Forestry Ventures Limited v CIR; Accent Management Limited v CIR*,[13] sometimes known as the *Trinity* case.

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[13] [2008] NZSC 115.

12.2.1.6 Burden of Proof

Taxpayers bear the burden of proof in tax controversies. Generally speaking, the TRA affords very little deference to earlier IRD determinations, instead considering the facts and the law de novo.

12.3 Tax Mitigation, Tax Avoidance, and Tax Evasion

Tax mitigation, tax avoidance, and tax evasion are not terms of art in New Zealand general and judge-made law, but "tax avoidance" is defined the Income Tax Act 2007 for purposes of New Zealand's general anti-avoidance rule, known as the "GAAR." This definition is an essential element of the GAAR, though it is not exhaustive and somewhat circular. By section YA 1 of the Act, "tax avoidance" includes:

- directly or indirectly altering the incidence of any income tax;
- directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax;
- directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential of prospective liability to future income tax.

In practice, when New Zealand courts or lawyers speak of "tax avoidance" they are generally referring to this statutory definition. As will be explained, the definition cannot be taken literally.

Tax mitigation and tax evasion, standing analytically before and after tax avoidance, have no statutory definitions. The term "tax mitigation" is reasonably well understood in New Zealand and it was used notably by Lord Templeman in the Privy Council in the leading case of *Challenge.*[14] However, as a result of a later, unacknowledged, misunderstanding, New Zealand courts and practitioners prefer not to use the term "mitigation." Instead, they employ circumlocutions like "permissible tax minimisation."

"Permissible tax minimisation" indeed encapsulates the meaning of tax mitigation, which is to reduce one's tax in a manner that not only complies with the letter of the law but that is consistent with the policy behind the legislation. The simplest examples of tax mitigation involve laying out money for investments that Parliament encourages by offering tax incentives. For instance, buying into tax-preferred savings schemes or life assurance policies where subscriptions are deductible for tax purposes, or buying investments where the income is exempt are examples of tax mitigation. Other possibilities include choosing one structure over another when the two are equally available and taking advantage of statutory

[14] *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC).

rules passed to mitigate unfairness. An example of the first is setting foreign operations up in a branch rather than in a subsidiary so as to deduct losses from start-up years against domestic profits. An example of the second is for a profitable company to make a deductible payment to a loss-making company in the same group in order to consolidate losses. Otherwise, one or more group members may wind up paying taxes when the group as a whole is breaking even or in loss.

Turning to tax avoidance, it is apparent that if taken literally the statutory definition quoted above would embrace all of the examples of tax mitigation given in the previous paragraph. Concluding that Parliament cannot intend to take with one hand what it has given with the other, the courts have done their best to gloss the statutory definition in a manner that makes it operable. The result is that, broadly speaking, "tax avoidance" means reducing one's tax in a way that complies with the letter of the law but that is contrary to the policy of the legislation, or, as it is often put, contrary to the scheme and purpose of the legislation. For example, the case of *Mangin* involved avoidance by income splitting through a scheme known as a "paddock trust."[15]

Mangin, a farmer from the Canterbury region, owned six fields, or "paddocks," as they are called in New Zealand. The paddocks were fertile enough to produce crops only every sixth year and had to be left to pasture for the rest of the time. Mangin rotated the cropping paddock every year. In any one year, the cropping paddock would be the most profitable.

Mangin established a trust with his wife and children as beneficiaries. Each year he leased the cropping paddock to the trust at a low rental. The trust engaged him as a contractor to sow the paddock in wheat and then to harvest it. The profits went to the trust. In respect of that paddock the taxpayer derived only rent and fees for his work. This rotation was repeated from year to year. Mangin thus reduced his income and incidence of tax. The trust was taxed each year on the income derived from the cropping paddock, but at a lower tax rate than the taxpayer would have suffered.

The Privy Council agreed with the Court of Appeal's finding that the scheme fell within a general anti-avoidance provision, with the result that it should be ignored for tax purposes.[16] It followed that the taxpayer was taxable on the profits from the cropping paddock. He has sold the wheat on behalf of the trust, and his accounting to the trust for the profits was ignored. Notionally, he had derived and kept the profit and was therefore taxable on it.

[15] *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591.

[16] *Mangin v CIR,* above, n 15, 598 Lord Donovan.

"Tax evasion" means reducing one's tax by secret and dishonest means, for example, by suppressing part or all of the takings of a business, or over-claiming business expenses and generating false receipts to support the claims.

New Zealand has no written constitution. Under its unwritten constitution, there is what Dicey described as Parliamentary sovereignty.[17] As a result, Parliament has the authority to regulate tax avoidance. It does so by passing general and specific anti-avoidance rules in the Income Tax Act 2007. When the Commissioner challenges a tax return, arguing that the taxpayer has avoided some tax, the Commissioner is relying on authority conferred on him by the Tax Administration Act 1994 and on the law to be found in the Income Tax Act 2007.

12.4 The Limits Of Acceptable Tax Planning

Initially, IRD decides whether a scheme appears to involve tax avoidance. IRD has a self-regulating protocol which says that it will not deploy the general anti-avoidance rule, or GAAR, without first obtaining a lawyer's opinion on the transaction. But in any event, it is IRD officials who make the decision that a scheme may involve tax avoidance. If there is a taxpayer objection to IRD's decision that a scheme is a tax avoidance scheme, then that objection goes through the judicial processes described above.

The decision by the TRA, or higher courts, as to whether a transaction is tax avoidance is largely a matter of fact and degree, although it is expressed as a question of whether the particular arrangement frustrates the policy of the legislation.

12.4.1 Tax Avoidance Doctrines

In the context of deciding whether transactions involve tax avoidance, the New Zealand courts consider a number of factual and substantive inquiries that are analogous to the United States tests. The business purposes and economic substance tests are among the more important of these, though New Zealand courts do not necessarily use the same terminology.

In principle, decisions regarding previous transactions provide precedents when considering new or subsequent transactions. New Zealand follows the United Kingdom in observing stricter rules of precedent that the

[17] Albert Venn Dicey *Introduction to the Law of the Constitution* (1885): "Parliament... has... the right to make or unmake any law whatever; and further, that no person or body is recognised by the law of England as having a right to override or set aside the legislation of Parliament. Parliament is not bound by its predecessor."

United States. However, there is a wide variation possible in commercial transactions. This variation, along with other factors, means that in practice the doctrine of precedent seems not to be applied as rigorously in tax cases in general, nor in avoidance cases in particular, as it is in other areas.

12.4.2 Safe Harbors

Specified transactions, or safe harbors, are not immune from challenge by the Commissioner. It is possible for a taxpayer to use the tax benefit of a safe harbour in a way that amounts to tax avoidance.

The *Challenge* case is an example.[18] The case involved a crude safe harbor according to which two companies that had common ownership as at the end of the tax year could consolidate their losses. In *Challenge*, the common ownership came about only shortly before the end of the year because that was when the taxpayer company bought the loss making company in question. The Privy Council held that although the taxpayer was within a safe harbour, the transaction was still tax avoidance and therefore void against the Commissioner under the New Zealand GAAR.

The fact that transactions within safe harbors are not immune from challenge as tax avoidance makes it difficult to administer the Act in circumstances where possible tax avoidance transactions are within safe harbours. In such cases, New Zealand courts have to determine the policy behind a safe harbour rule in order to decide whether taxpayers were operating in accordance with that policy.

12.5 The GAAR

New Zealand's GAAR is section BG 1 of the Income Tax Act 2007, which applies to all income tax cases. It provides that:

> *Avoidance arrangement void*
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> *Reconstruction*
>
> (2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

"Arrangement," "tax avoidance" and "tax avoidance arrangement" are defined in s YA 1. Respectively:

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[18] *Challenge Corporation Ltd v CIR*, above, n 14.

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

"Tax avoidance" includes –

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

"Tax avoidance arrangement" means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

(a) has tax avoidance as its purpose or effect; or
(b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

Where a tax avoidance arrangement is void under section BG 1, the Commissioner may counteract the tax advantage:

GA 1 Commissioner's power to adjust

Commissioner's general power

(2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

In so adjusting these figures, essentially the Commissioner may have regard to the business reality of the transactions that would have eventuated but for the arrangement.

Together with sections BG 1 and YA 1, section GA 1 allows the Commissioner to undo or ignore avoidance schemes taxpayers may have devised. The GAAR allows the Commissioner to look behind legal appearances of tax avoidance schemes and to give effect to the true substance of the transactions.

There is also a separate GAAR that applies to goods and services tax, section 76 of the Goods and Services Tax Act 1985. It has much the same effect as the Income Tax Act's GAAR.

12.5.1 History of Adoption of the GAAR

The New Zealand GAAR may be the oldest in the world. Lord Donovan set out its history in the case of *Mangin*.[19] The first GAAR was section 62 of

[19] *Mangin v CIR*, above, n 15.

the Land Tax Act 1878,[20] and pre-dated the introduction of income tax in New Zealand by 13 years. The rule was primarily designed to prevent parties to land transactions from shifting the tax burden between themselves. The GAAR was carried over in the Property Assessment Acts 1879,[21] and 1885.[22]

The first income tax was introduced in New Zealand by the Land and Income Tax Assessment Act 1891, and the GAAR was translated from its previous version and included as section 40.[23] The GAAR has been reformed and refined through a number of iterations since then, but its basic thrust has remained the same since its introduction 130 years ago.

Despite its long history, although there were one or two cases involving the GAAR before the Second World War, broadly speaking IRD did not seek to rely on the GAAR until the 1960s. Even then, those early cases were relatively few. Since the 1960s, numbers have increased.

Several bodies interpret the application of the GAAR, the first being the Adjudication Unit of IRD. Then, if the taxpayer challenges an IRD assessment, the TRA or higher courts can also interpret the GAAR.

12.5.2 Success of the GAAR

New Zealand's GAAR has been a qualified success. However, the fact remains that taxpayers, and sometimes quite sophisticated taxpayers, still attempt very aggressive tax avoidance schemes from time to time. This activity is perhaps surprising in the face of a GAAR. However, it may

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[20] The Land Tax Act 1878, s 62: "Every covenant or agreement heretofore made or hereafter to be made between landlord and tenant, mortgagor and mortgagee, or between any other persons, altering or attempting to alter the nature of the estate in any land so liable to duty for the purpose of defeating or in any other manner evading the payment of land-tax imposed by this Act, or which shall be in any manner contrary to the true intent of this Act, or calculated to prevent its operation in any respect, shall, so far as regards any such covenant or agreement, be void and of no effect as between the parties thereto."

[21] Property Assessment Act 1879, s 29: "No contract, covenant, or agreement touching the payment of taxes to be charged on their respective premises heretofore made, or hereafter to be made, between any persons which is contrary to the intent and meaning of this Act shall be binding on the parties."

[22] Property Assessment Act 1885, wording unchanged from the 1879 version.

[23] The Land and Income Tax Assessment Act 1891, s 40: "Every covenant or agreement heretofore made or hereafter to be made between landlord and tenant, mortgagor and mortgagee, or between any other persons, altering or attempting to alter the nature of the estate or interest in any land or mortgage for the purpose of defeating or in any other manner evading the payment of tax imposed under this Act, or which shall be in any manner contrary to the true intent of this Act, or calculated to prevent its operation in any respect, shall, so far as regards any covenant or agreement, be void and of no effect as between the parties thereto."

be explained by the fact that the courts do occasionally allow aggressive schemes.

An example is the case of *Peterson*[24] in which the Privy Council allowed deductions under a very aggressive film tax shelter arrangement. Another example relates to the fact that, in New Zealand, from time to time the personal tax rate is higher than the corporate tax rate. When that happens, taxpayers sometimes try to reduce their tax by restructuring their private practices into corporate form with one of the consequences being that undistributed income is taxed at the company rate, thereby saving tax relative to the top marginal rate. Similarly, people from time to time try to split their income by diverting professional fees to trusts or other entities from which they then derive salaries that are lower than the profits that they would reap as sole traders or partners.

In one such case, *Hadlee*,[25] the CA said that assigning professional income to trusts was ineffective, and there was therefore no reduction in tax. However, in the 2009 case of *Hooper and Penny*,[26] the High Court allowed an arrangement whereby an orthopaedic surgeon reorganised his practice as a company (meaning that the tax rate was 30 per cent rather than 39 per cent). In the case, Justice MacKenzie distinguished *Hadlee* on the basis that *Hadlee* related to assignment, rather than derivation. No more substantial grounds for distinguishing the cases existed. *Hooper and Penny* is under appeal and may be overturned.

In the light of examples such as these, taxpayers may sometimes consider that the benefits of an aggressive scheme, should it be allowed, outweigh the risk that it will be defeated by the GAAR, even if that risk is substantial.

Furthermore, as mentioned earlier, a result of giving the Adjudication Unit of IRD the ability to look at tax cases before they proceed to the courts, in conjunction with the requirement that there should be full disclosure at this early stage, has been that there is now relatively little tax litigation. The few cases that do go to court tend to be the largest ones.[27] In those cases, the sums of money at stake are high enough that taxpayers may consider it to be worth trying a tax avoidance scheme even if the odds of it succeeding are low.

While aggressive schemes are sometimes allowed, the trend as at 2009, led by the Supreme Court in the *Ben Nevis* case,[28] is to apply the GAAR

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[24] *Peterson v IRC* [2006] 3 NZLR 423 (PC).

[25] *Hadlee v CIR* [1993] 2 NZLR 385 (CA).

[26] *Penny v CIR*; *Hooper v CIR* CIV-2007-409-1153, CIV-2007-409-1154 (High Court, Christchurch Registry, 19 March 2009) MacKenzie J.

[27] For instance: *Ben Nevis Forestry Ventures Limited v CIR*; *Accent Management Limited v CIR* [2008] NZSC 115 (*Trinity*).

[28] *Trinity*, ibid.

more strictly. Furthermore, the GAAR probably has some *in terrorem* effect, in that there are penalties for tax planning that turns out to be contrary to the GAAR.

12.6 Tax Avoidance Regulation

IRD is authorised to issue advice to tax payers, and does so. On occasion, the Commissioner makes several kinds of public statements that are in effect legal opinions.[29]

12.6.1 Binding Rulings

Binding rulings, issued under Part VA of the New Zealand Tax Administration Act 1994, are the most formal of the Commissioner's statements. Binding rulings are of three types: public rulings, product rulings, and private rulings. The first two are published, but private rulings remain confidential to the taxpayers that apply for them. The Commissioner issues public rulings essentially on his own initiative, in order to clarify some area of law of general interest. Taxpayers apply for product rulings in order to obtain certainty as to the tax consequences of investments that are to be marketed to the public. Private rulings relate to transactions proposed by individual taxpayers. The merit of binding rulings from taxpayers' point of view is that they can rely on them for the duration specified in the ruling even if the Commissioner changes his mind or a later case shows him to have been wrong. Private rulings are also known as "advance rulings".

The Commissioner can give rulings as to the validity of schemes in reference to the GAAR and sometimes does give such rulings. However, this does not occur very often as taxpayers are often concerned about the possibility of the ruling being made against them. More typically, at least with regard to aggressive avoidance, taxpayers will attempt to keep the whole transaction secret, even though in principle that should not be necessary if the plan in question escapes the GAAR.

12.6.2 Determinations

Akin to rulings are "determinations,"[30] which are issued in somewhat similar circumstances but which relate to two specific areas of the Income

[29] Discussed in greater detail in John Prebble "Practical Problems from Publication of the Commissioner's Interpretation Guidelines" (Working Paper No 8, Working Paper Series, Victoria University, Wellington, New Zealand, 2002).
[30] Tax Administration Act 1994, Part V.

Tax Act 2007 only: the calculation of income and expenditure in respect of loans and other financial arrangements and certain matters in respect of petroleum mining. Determinations are separate from rulings largely for historical reasons, in that Parliament first provided for determinations in limited areas where they were particularly necessary, before later enacting legislation for a general rulings process.

12.6.3 Standard Practice Statements

Standard practice statements differ from binding rulings and determinations in several respects. First, the Commissioner issues them pursuant to his inherent administrative powers as Commissioner, rather than pursuant to specific statutory authority. Secondly, they are not binding on the Commissioner, though the Commissioner and IRD endeavour to abide by them. Thirdly, standard practice statements are produced by IRD's Operations Division, rather than by the Rulings Units of the Office of the Chief Tax Counsel (OCTC). Standard practice statements concern IRD's administrative practices or set out policy that is to be applied in the exercise of discretions that the Income Tax Act vests in the Commissioner.

Binding rulings are one of the responsibilities of the Taxpayer Rulings Unit, and Public Rulings Unit of the Office of the OCTC. The Adjudications Unit, also housed within the OCTC, also performs in-house quasi-judicial assessments of disputes between the Commissioner and taxpayers.

12.6.4 Policy Statements and Interpretation Guidelines

Another form of public statement made by IRD is interpretation guidelines, or as they were known prior to 1995, policy statements. In a sense, these guidelines fall between binding rulings and standard practice statements. Like standard practice statements they are not binding and are issued under the Commissioner's inherent powers. On the other hand, like binding rulings they are the responsibility of the OCTC, which houses the Adjudication Unit and Taxpayer Rulings and Public Rulings Units. A further similarity to rulings is that they deal with difficult points of law, and often read rather like legal opinions.

The Commissioner issues interpretation guidelines when it appears to be desirable to offer an element of certainty, or, at least, to minimise uncertainty, in respect of a general area of law. Although they are not legally binding on the Commissioner, he generally follows them administratively. One advantage of a guideline over a public ruling is that in circumstances where the Commissioner does not wish to make a statement as a public ruling that is certainly to be binding come what may, a guideline is able to serve. Nevertheless, one should not make too much of this factor.

In 1990, the Commissioner published a policy statement on the application of the GAAR.[31] The statement commented on a range of generic tax avoidance transactions, including transactions involving dividend stripping, valuation of trading stock, contrived deductions, and the pre-payment of interest. The problem with such policy statements by the Commissioner is that sometimes they are mistaken, and often they are too general, to be of wide use. Furthermore, such policy statements are not binding on the courts, and the courts have expressly said that the 1990 statement is not law at all.[32]

12.7 Penalties for Tax Avoidance Transactions

Taxpayers face penalties for engaging in tax avoidance transactions that are not allowed. Fundamentally, taxpayers are expected to exercise a reasonable standard of care in meeting their obligations. This standard is breached by lack of reasonable care, taking an unacceptable position, gross carelessness, abusive avoidance, and tax evasion. Sanctions apply according to the seriousness of the offence and the amount of revenue at stake. The penalty rates are:

- Not taking reasonable care – 20 per cent of the tax shortfall;[33]
- Unacceptable tax position – 20 per cent of the tax shortfall;[34]
- Gross carelessness – 40 per cent of the tax shortfall;[35]
- Abusive avoidance – 100 per cent of the tax shortfall;[36]
- Tax evasion – 150 per cent of the tax shortfall.[37]

The levels of penalty can be adjusted to take account of matters such as hindrance or voluntary disclosure. The penalties imposed are monetary, though evasion can be visited with imprisonment.

[31] Taxpayer Information Bulletin, no 8, February 1990, appendix C.

[32] *Miller v CIR* [2001] 3 NZLR 316 PC.

[33] Tax Administration Act 1994, s 141A(2). The term “reasonable care” is not defined in the legislation.

[34] Tax Administration Act 1994, s 141B(4). The 20 per cent shortfall penalty will apply provided that the shortfall arising from the unacceptable tax position is more than both $50,000 and 1 per cent of the taxpayer’s total tax figure for the return period. A taxpayer takes an unacceptable tax position if, viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct (s 141B(1)).

[35] Tax Administration Act 1994, s 141C(2). Gross carelessness means doing or not doing something in a way that, in all the circumstances, suggests or implies complete or a high level of disregard for the consequences (s 141C(3)).

[36] Tax Administration Act 1994, s 141D(3).

[37] Tax Administration Act 1994, s 141E(4).

12.7.1 Safe Harbors

No safe harbors are provided to enable taxpayers to avoid penalties. Reliance on published guidance or decisions will not necessarily save a taxpayer involved in an avoidance scheme. Certainly, a taxpayer may rely entirely on a binding ruling, but binding rulings have no precedential value for other taxpayers or even for the same taxpayer who repeats a transaction. Taxpayers cannot necessarily rely on public guidance issued by the Commissioner, particularly if the transaction exploits the published guidance in a contrived manner.

Taxpayers may not rely on previous judicial decisions, except to the extent implied generally by the doctrine of precedent. Where a taxpayer can show that a previous decision has precedential value with regard to his own transaction he can rely on it. But, as mentioned earlier, precedent in tax law tends to be more elusive than in other areas. The taxpayer's reliance is a matter of arguable submission rather than an irrefutable legal conclusion.

It is also no defence, where there is tax avoidance, for a taxpayer to say he has relied on the advice of an advisor, attorney or not.

12.8 The Role of Statutory Interpretation

Statutory interpretation plays an important role in adjudicating tax avoidance controversies. The standard principles of Anglo-American Common Law jurisdictions must be applied in order to interpret the tax Act itself. The decision as to whether a transaction fits within the section with which it is designed to comply also relates to statutory interpretation. If the transaction does fit within the section, then step two is to apply the GAAR if avoidance is alleged.

Broadly speaking, the GAAR is applied in a way that treats the standard rules and the GAAR as operating in tandem, such that the GAAR does not always trump the standard rule. In some cases, it is very clear that the GAAR should not be applied to a transaction that fits within a standard rule. For example, if a standard rule contains an incentive for taxpayers to engage in certain kinds of behaviour in return for fiscal benefit, then the GAAR does not prevent taxpayers from taking up that incentive. Some structural choices are also clearly not avoidance. For instance, a taxpayer about to set up a division of his business in a foreign country has the option of setting it up as either a branch or a subsidiary. The choice affects the tax result. Nevertheless, choosing on the basis of which options would result in lower overall tax liability would not be regarded as tax avoidance. In a sense, that distinction involves a kind of statutory interpretation.

In cases where the TRA or higher courts must consider more seriously whether the GAAR applies, they apply the "scheme and purpose" approach. This involves determining the scheme and purpose of the standard rule,

as well as the scheme and purpose of the anti-avoidance provision, and determining the overall effect of the two provisions. This approach can lead the TRA or higher courts to place a greater emphasis on the scheme of the standard rule, so that if a particular arrangement fits within an Act's relatively complicated scheme, sometimes the TRA or court will hold that the arrangement is not avoidance, even if it has exploited the standard rule. However, in most cases the court applies "scheme and purpose" as if the test were "purpose" alone, and proceeds with a fairly ordinary exercise of purposive statutory interpretation. Generally speaking, the "in tandem" metaphor should be interpreted as "both at once." That is, when a court considers the application of the GAAR it takes account of the policy of the relevant charging provisions at the same time.

The scheme and purpose test, despite certain flaws, does clearly involve statutory interpretation. That is, the TRA and higher courts do certainly take account of statutory interpretation in deciding tax controversies.

12.8.1 Substance over Form

A substance over form analysis, in which the adjudicator ignores or collapses disparate steps or transactions in order to give effect to the overall result, is not expressly employed in New Zealand.

On the other hand, there are a number of cases that make it clear that the New Zealand GAAR is an "in substance" test.[38] Literal compliance with the law is not enough to save a taxpayer from the GAAR; the courts look at the substance and economic effect of the arrangements that the taxpayer has employed. Further, section GA 1 of the Act, which empowers the Commissioner notionally to reconstruct tax avoidance arrangements and to levy tax on the basis of the notional reconstructions, is essentially a substance over form test.

12.9 Disclosure by Taxpayers

New Zealand does not impose disclosure requirements for taxpayers entering into tax avoidance transactions. There is an exception in respect of trusts settled by Australian settlers or New Zealand resident trustees. Such settlements do not in their nature avoid New Zealand tax, but they must be disclosed whether or not the object is to avoid Australian tax.

[38] Income Tax Act 2007, s BG 1.

12.10 Disclosure by Advisers

As for taxpayers, New Zealand does not impose disclosure requirements on attorneys or other tax advisers regarding their clients' participation in tax avoidance transactions.

12.11 Rules of Professional Responsibility Relating to Advice in Tax Avoidance Transactions

There are no rules of professional responsibility, or other ethical rules, governing attorney practice or tax adviser practice that relate particularly to participants in tax avoidance transactions. General ethical rules of professional conduct apply,[39] but they do not relate specifically to tax or tax avoidance.

Compulsory regulation of tax practice is very light handed in New Zealand. Provided that a tax adviser is not doing any work that is reserved for solicitors, he or she can give tax advice, and file tax returns, for clients without needing to be registered or being otherwise bound by rules of professional conduct. However, tax advisers have a strong incentive to bring themselves within a voluntary supervisory regime, though that regime is itself also relatively light handed. Advisers who file returns of 10 or more clients may,[40] voluntarily register with IRD as tax agents.[41] Once registered, agents:

- have access to a range of automated telephone services specially designed to help with most common enquiries;
- receive a monthly newsletter containing up-to-date information from IRD;
- are assigned an agent account manager to facilitate their relationships with IRD;
- can choose to have their clients' tax information sent directly to them or to their clients;
- can spread their return filing over the year rather than have it all occur during one peak period.

The last of these is an important practical advantage. A tax agent may spread his or her clients over a number of months, and complete a certain

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[39] Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008 (made under Lawyers and Conveyancers Act 2006, ss 94 and 95).

[40] Tax Administration Act, s 34B(2)(a).

[41] Tax Administration Act, s 34B(2).

percentage of them each month. This concession relates only to the filing of returns. The tax itself must be paid on time.

The Commissioner is required to compile and maintain a list of registered tax agents.[42] The Commissioner can deregister an agent if continuing to list the person "would adversely affect the integrity of the tax system."[43] Before deregistration, or before refusing to register a prospective tax agent, the Commissioner must give the tax agent or applicant notice of the reasons for the proposed decision, and must consider any arguments advanced by the person as to why they should be, or continue to be, registered.[44] In practice, the Commissioner very rarely deregisters tax agents.

12.12 Tax Shelters

Apart from a general effort to collect tax intelligence and disseminate it, New Zealand has no special approach to anything that might be called a tax shelter. However, from time to time IRD announces that people who are engaged in avoidance transactions, according to a generic description given by IRD, will be reassessed and will suffer severe penalties. Those sorts of announcements often relate to what could be described as tax shelters.

New Zealand does not experience the mass marketing of tax shelters that happens in some other countries, such as Australia. In New Zealand, there are occasionally tax shelters that are fairly widely marketed, but usually only to reasonably wealthy people. One reason may be that employees may not deduct employment-related expenses from their income.[45] They may deduct business losses, for example from moonlighting, but most tax returns are relatively simple. Indeed, formal returns are not required from most taxpayers who have only employment and passive income. As a result, claiming deductions of shelter expenses would tend to draw attention.

The *Ben Nevis* case is a good example of this kind of moderately widely marketed scheme.[46] The case involved a forestry scheme, marketed to numerous investors. The taxpayers invested in a genuine forestry investment (a forest was planted), but the scheme was structured to take advantage of specific taxation provisions authorising deductions and depreciation allowances.

Investors in the scheme bought land for $60,000 per hectare, and were granted a 50-year licence to grow Douglas fir on the land. The licence was

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[42] Tax Administration Act, s 34B(1).

[43] Tax Administration Act, s 34B(8)(b).

[44] Tax Administration Act, ss 34B(9) and (10).

[45] Income Tax Act 2007 s DA 2(4).

[46] *Ben Nevis Forestry Ventures Limited v CIR*; *Accent Management Limited v CIR* [2008] NZSC 115 (*Trinity*).

valued at $2 million per hectare. The $2 million per hectare was artificially not payable until the end of the scheme, which was in 50 years from the time of the sale. But the scheme was constructed in a way that made deductions available from day one.

The investors also entered into an insurance arrangement with a special purpose insurance company established in the British Virgin Islands for the purposes of the scheme, and controlled by the scheme's promoter. The insurance company assumed the risk that in 50 years' time the forest would be worth less than the licence premium amount that would then be due. Investors paid an initial insurance premium of $1,307 per hectare at the outset. A further $32,791 per hectare was due for payment in 50 years' time. The entire insurance premium was treated by investors as having been incurred and as being deductible at day one.

These expenses gave rise to tax deductions for the investors in the 1997 income year of about $38,000 per hectare, as compared to a cash outlay of only $5,000 per hectare. In subsequent years, investors received deductions of about $41,000 per hectare and made a cash outlay of only $50 per hectare.

The principal judgment in the Supreme Court was delivered on behalf of Justices Tipping, McGrath, and Gault. Their Honours upheld the investors' arguments on the specific deductibility provisions and rejected Inland Revenue's allegations of sham, but agreed with the lower courts that the GAAR applied. The taxpayers' use of the specific provisions was not within Parliament's purpose and contemplation when it authorised deductions of the kinds in question. The taxpayers altered the incidence of income tax by means of a tax avoidance arrangement that the Commissioner correctly treated as void against him.

Another example of a recent high profile tax shelter in New Zealand was *BNZ Investments Ltd v CIR*,[47] which involved structured financial transactions, (in this case "repo" arrangements) set up by New Zealand banks. These deals were complex cross-border transactions with large overseas parties involving hundreds of millions of dollars. Because the trading banks are foreign owned, they were able to take advantage of a provision in the Income Tax Act that let them deduct expenses in borrowing costs while the overseas income was tax free.

The legislative response to the repo transactions was to close the loophole. The administrative response from IRD was to disallow the arrangement. The Commissioner disallowed the taxpayer's borrowing costs (deduction of which had greatly reduced income as returned) and taxed the resulting income that was disclosed. The Commissioner won at first instance in the High Court in July 2009. Similar litigation is in process

[47] *BNZ Investments LTD v CIR* (HC WN CIV 2004-485-1059) [15 July 2009] (HC) Wild J.

against most other trading banks, and appeals are expected to take some years. There is as yet no ruling as to penalty.

In the case of *Mangin*, discussed earlier, the administrative response from IRD was to disallow the arrangement, which action was upheld judicially. There was no legislative response in terms of closing the loophole because the arrangement was so egregious that it was not properly characterised as a legitimate loophole. The *Ben Nevis* case, discussed above, was similar.

12.13 Current Reform Efforts

There are no white papers on avoidance or the GAAR. The closest publication to a white paper is probably *Tax Compliance*,[48] a 1999 Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, which addresses inter alia a number of aspects of avoidance practices and anti-avoidance measures. Broadly speaking, official circles appear to be happy with the current language of the GAAR. IRD concentrates its efforts on detection, enforcement, and on publicity to discourage non-compliance and as at 2009 is not seeking amendments to the GAAR. In particular, there appears to be little official support for amendments that would add significant detail to the GAAR in the style of its Australian counterpart, Part IVA of the Income Tax Assessment Act 1997. Since IRD started to enforce the GAAR in a reasonably systematic manner in the 1960s IRD litigation has had more successes than failures. The present approach of the New Zealand Court of Appeal and Supreme Court suggests that the department will continue to be able to rely on the GAAR with reasonable, if not full, confidence.

[48] I McKay, A Molloy, J Prebble and J Waugh Tax *Compliance* ISBN 0-477-01857-2 (1999) i–xliii, 1–348.

Chapter 13
Poland

Bogumił Brzeziński and Krzysztof Lasiński-Sulecki

13.1 The Concept of Tax Avoidance Under Polish Law

The terms "tax mitigation," "tax avoidance," and "tax evasion" are not defined in Polish tax law. Although the terms frequently come up in the tax law doctrine,[1] courts are not willing to use or clarify them, and rarely undertake attempts to define them.[2] Tax mitigation (*optymalizacja podatkowa*) is understood as the legally acceptable behavior of taxpayers resulting in the diminishment of tax liability. Although tax mitigation (for example, availing oneself of tax incentives provided by statute) is generally accepted by tax authorities, tax authorities and courts often claim that provisions providing tax exemptions should be interpreted strictly. Any exemption is treated as an exception to the general rule of taxation. This view is based upon Art. 84 of the Constitution of the Republic of Poland[3] which states: "Everyone shall comply with his responsibilities and public duties, including the payment of taxes, as specified by statute." Emphasis is placed on the word "everyone" in the cited provision.[4] Others take the position that Art. 84 is directed at the legislature, requiring a levy as enumerated by statute.[5]

[1] See, for instance, J. Głuchowski, *Polskie prawo podatkowe*, Warszawa 1998, pp. 107–115; M. Kalinowski, *Granice legalności unikania opodatkowania w polskim systemie podatkowym*, Toruń 2001, pp. 9–12.

[2] The problem does not pertain solely to Polish courts – see, for instance, A. Zalasiński, *Some Basic Aspects of the Concept of Abuse in the Tax Case Law of the European Court of Justice*, Intertax 2008, Vol. 36, issue 4, p. 167.

[3] Dziennik Ustaw (Journal of Laws, Dz. U.) No. 78, item 483 as amended.

[4] See, for instance, the judgment of the Supreme Court (*Sąd Najwyższy*) of the 6th of April 2001, III RN 90/00, LEX, No. 448051.

[5] See, for instance, the judgment of the Regional Administrative Court (*Wojewódzki Sąd Administracyjny*) in Warsaw of the 12th of September 2008, III SA/Wa 922/08, LEX, No. 462039.

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Taxation is perceived, both in legal scholarship[6] and by courts,[7] as an exception to the right of property, which – in the Polish legal order – is expressed in Art. 64 of the Constitution.[8] This view is held by the authors of this chapter.

Tax avoidance (*unikanie opodatkowania*) is the reduction of tax liability by a taxpayer that conducts a transaction in a way that deviates from expected standards. Tax avoidance appears to be a fully legal activity, but it is not sanctioned by tax authorities. In Poland the commonly respected distinction between acceptable and unacceptable tax avoidance is rather unknown, but in fact the tax administration contests only certain types of tax avoidance. Similarly, although courts do not tend to use the term "tax avoidance" or any of those mentioned above, from time to time they issue judgments in cases involving avoidance that are unfavorable to taxpayers. The general opinion is that if a taxpayer's legal actions result in decreased tax liability there is no legal basis to question these actions, especially on constitutional grounds.

Illegal activities aimed at the reduction of tax liability involve "tax evasion." A taxpayer who engages in tax evasion ignores the requirements stemming from tax law.[9] Often, his actions or failures to comply with tax law are penalized by criminal law. As a result, tax evasion is sometimes treated as nearly synonymous with "tax fraud." As in other countries, the problem does not lie in determining the meaning of the concepts presented above, but in determining their respective limits.

13.2 Constitutional Background

The Constitution provides arguments both for and against tax avoidance, protecting taxpayers, as long as their actions are legal, from tax avoidance charges. The legislature is limited considerably when enacting anti-avoidance regulations. The principle that taxation should be based on a written statute enacted by the parliament (Art. 84 of the Constitution) is in stark opposition to the idea of a general anti-avoidance rule (GAAR). This principle has been further developed in Art. 217 of the Constitution which provides:

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[6] See, M. Kalinowski, op. cit., p. 58.

[7] See, for instance, the judgment of the Constitutional Tribunal (*Trybunał Konstytucyjny*) of the 21st of June 2004, SK 22/03.

[8] K. Lasiński-Sulecki, *Proper Publication of Legal Texts Relevant for Taxation*, Intertax 2009, Vol. 37, issue 6/7, p. 418.

[9] See, J. Głuchowski, op. cit., p. 111.

> The imposition of taxes, as well as other public imposts, the specification of those subject to the tax and the rates of taxation, as well as the principles for granting tax relief and remissions, along with categories of taxpayers exempt from taxation, shall be made by means of statute.

General anti-avoidance rules are, by their nature, rather general or even vague and may be perceived as contrary to the rule of law principle expressed in Art. 2 of the Constitution.[10] The constraints stemming from Arts. 2, 84 and 217 of the Constitution do not influence issuance of specific anti-avoidance regulations.

The Constitution also restricts the role of courts in counteracting tax avoidance. Polish law belongs to the continental family of laws and differs greatly from common law systems. Separation of powers is the main rule governing constitutional order (Art. 10). Courts interpret laws and apply them, but they may not create them. Any action undertaken by courts must have a legal basis. The principle that taxation should be based on a written statute enacted by the parliament has significantly restricted courts' activity in the battle with tax avoidance.[11] The legislature is responsible for constructing necessary means and instruments for counteracting tax avoidance.

In summary, the Constitution contains provisions seriously hindering both legislative and judicial attempts to regulate tax avoidance. While their efforts are restricted, they are not totally eliminated when the legislature meets particularly strict requirements. The activity of courts is similarly limited. As a result, no clear anti-avoidance judicial doctrine has emerged.

13.3 History of the GAAR

Poland began to create its current tax system in the early 1990s when there was reorientation towards a market economy. The Corporate Income Tax Law was adopted on the 15th of February 1992[12] and is still in force after significant amendments. Soon after enactment, the legislature became aware of a need for mechanisms to counteract tax avoidance.

Enactment of a GAAR grew from two developments. Courts attempted to create anti-avoidance doctrine, while the legislature attempted the same by legislation. At the end of the twentieth century the courts began attempts to

[10] The Republic of Poland shall be a democratic state ruled by law and implementing the principles of social justice.

[11] This is unlike Anglo-Saxon countries where one may notice "judicial legislation" within the sphere of means serving to counteract tax avoidance. See B. Brzeziński, *Anglosaskie doktryny orzecznicze dotyczące unikania opodatkowania*, Toruń 1996, pp. 5–8.

[12] Dz. U. No. 54, item 654, as amended.

counter tax avoidance.[13] They relied mainly on the provisions of the Civil Code of the 23rd of April 1964[14] concerning the circumvention of law (*obejście prawa*). Toward the end of the twentieth century certain unsuccessful attempts were made to introduce a GAAR through legislation. The proposal covered income taxes only.

Under the proposed legislation, in assessing the tax consequences resulting from a transaction, the intent of parties was to be taken into account, and not solely the literal wording of the contract. Tax authorities and fiscal control authorities would be permitted to ignore the consequences of legal actions undertaken by the taxpayer as long as the taxpayer could not have been expecting any economic advantages apart from decreased tax liability.[15]

This attempt to provide the legislature and taxing authorities a mechanism to curtail avoidance of tax statutes failed because the doctrine employed was inapplicable to tax transactions. One problem was that courts relied upon Art. 58 of the Civil Code to target circumvention of tax law. The doctrine employed by the courts, *ius dispositivum,* restricts legitimate actions taken to reach results not sanctioned by law, where taxpayers are acting *in fraudem legis.*[16] The doctrine of *ius dispositivum* does not apply to tax transactions because tax law is *ius cogens*, requiring a very literal interpretation of the statute. In addition, Art. 58 is applicable only in civil matters involving natural and legal persons. Tax law – involving a relationship between a taxpayer and the taxing authority – does not involve a civil law matter. Tax law is a public, not private matter, which is not within the purview of civil law. Polish legal culture strongly rests upon this division between private and public law. Moreover, the relationship between a taxpayer and a tax authority can hardly be perceived as one between natural or legal persons. A tax authority's actions, particularly, cannot be perceived as the actions of a legal person.

Finally, treating a transaction as an invalid circumvention of tax law may not be successful even if a court did not refer expressly to Art. 58 of the Civil Code. There is no corresponding provision in Polish tax law. Applying provisions of the Civil Code in the sphere of tax law has been and remains unacceptable, because it would amount to *per analogiam* reasoning to the detriment of a taxpayer (obviously any measures countering tax avoidance are detrimental to a taxpayer). It is commonly accepted that *per analogiam*

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[13] See the judgment of the Supreme Administrative Court of the 7th of November 1991, I SA/Po 1198/91, where the judicial anti-avoidance doctrine began to develop.

[14] Dz. U. No. 16, item 93 as amended.

[15] See H. Litwińczuk, *Obejście prawa podatkowego w świetle doświadczeń międzynarodowych*, Przegląd Podatkowy 1999, No. 9.

[16] See Z. Radwański, *Prawo cywilne – część ogólna*, Warszawa 1997, p. 237.

reasoning may not be applied to the detriment of a taxpayer.[17] This does not differ from tax law interpretation standards common in other countries, where *per analogiam* reasoning is perceived as a threat to the basic rights of individuals[18] and is prohibited even if it could efficiently combat tax avoidance.[19] The rejection of *per analogiam* reasoning in the field of criminal law should be taken as a limitation on its application in tax law where avoidance and evasion may be closely related.

Although references to Art. 58 of the Civil Code (or at least implicit references to the circumvention of law) have been quite frequent in judgments, courts have relied on a variety of legal norms of the Civil Code, without detailing the one forming the legal basis of the judgment. Courts have confused circumvention of law with ostensible transactions (*czynności pozorne*) in which a taxpayer may be hiding other real transactions and they have concluded that civil law cannot be used for evading or avoiding taxes.[20]

The courts' attempts to introduce a GAAR through their jurisprudence reached a peak at the turn of the twenty-first century. Controversies surrounding measures aimed at counteracting tax avoidance (or rather circumvention of tax law) were most common during this period. The attempts to introduce a "judicial" GAAR were heavily criticized by the Supreme Administrative Court (*Naczelny Sąd Administracyjny*) in its judgment of the 24th of November 2003 in the case FSA 3/03 (*Optimus*), which involved goods and services tax (GST). Under the Goods and Services Tax and Excise Duty Law of the 8th of January 1993[21] and the Customs Code of the 9th of January 1997[22] importation of certain technological ("IT") equipment for schools was exempt from GST. Domestic sales of such equipment did not benefit from a similar exemption. Schools did not conduct any economic activity and, therefore, could not deduct input GST. Without an exemption they would have otherwise had to bear the burden of the tax. An IT equipment manufacturer, based in Poland, decided to arrange its sales in such a manner so as to make its products more attractive for Polish schools. Computers were first sold to one of two Slovakian companies (avoiding the GST upon exportation) and then brought back to Poland.

[17] See B. Brzeziński, *Szkice z wykładni prawa podatkowego*, Gdańsk 2002, p. 70; R. Mastalski, *Interpretacja prawa podatkowego*, Wrocław 1989, p. 120.

[18] See E. Zuelta-Puceiro, *Statutory Interpretation in Argentina*, [in:] *Interpreting Statutes. A Comparative Study*, eds. D. MacCormick, R. Summers, Dartmouth 1991, p. 47.

[19] See J. Van Houtte, *Principles of Interpretation in Internal and International Tax Law*, Amsterdam 1968, p. 36.

[20] See, for instance, the judgment of the Supreme Administrative Court of the 25th of June 1998, I SA/Po 1883/97, LEX No. 35484.

[21] Dz. U. No. 11, item 50 as amended.

[22] Dz. U. 2001, No. 75, item 802 as amended.

Goods were transported to Slovakia and back to Poland in the same vehicles. Tax authorities considered this business scheme to be a circumvention of tax law.

The Supreme Administrative Court held that there was no GAAR in force when the disputed actions took place. The Court supported the view that a taxpayer cannot be required to organize his activities in such a manner as to be required to pay the highest tax possible. The Court argued additionally that the GAAR was introduced by the legislature to address the matter in question.

Further efforts to establish a judicial anti-avoidance doctrine were significantly limited after the judgment in the FSA 3/03 case. Although a significant number of judgments at the turn of the century used a kind of anti-avoidance analysis based partly on civil law, the courts have never been unanimous in this regard. Other courts had rejected this specific anti-avoidance doctrine even before the FSA 3/03 judgment.[23]

Another significant event in the history of Polish GAAR took place on the 1st of January 2003 when the General Tax Law of the 29th of August 1997[24] (applicable to all taxes) was amended. Art. 24a(1) of the General Tax Law, in force since the 1st of January 2003, provided that tax authorities and fiscal control authorities, in determining the content of legal action, were to take into account the consistent intent of the parties and the purpose of their activities, and not only the statements of the parties. 24a(2) stated that if the parties entering into a legal transaction were concealing other legal activities, tax authorities and fiscal control authorities could determine tax consequences based on the concealed legal action.

Under Art. 24b(1) of the General Tax Law, if a tax or fiscal control authority demonstrated that a taxpayer concluding a particular transaction could not have expected significant tax benefits other than those resulting from reduction of tax liability, an increased tax reimbursement, or an increased loss, the authority could disregard the tax-related consequences of such a transaction. According to Art. 24b(2), if parties conducting legal actions referred to in 24b(1) reached an intended economic result for which other legal action or legal actions are appropriate, tax consequences could to be determined on the basis of the other legal action or legal actions.

Art. 24a(1) of the General Tax Law was criticized as duplicative soon after its entry into force. Commentators noted that it resembled civil law regulations concerning the interpretation of statements of will which had to be taken into account by tax authorities even prior to the 1st of January 2003. Moreover, as Art. 24a(1) resembled interpretation principles founded

[23] See, for instance, the judgments of the Supreme Administrative Court of the 31st of January 2002, I SA/Gd 771/01; of the 29th of May 2002, III SA 2602/00 and the judgment of the Supreme Court of the 19th of October 2000, III RN 55/00.

[24] Dz. U. No. 137, item 926 as amended (currently: Dz. U. 2005, No. 8, item 60 as amended).

in the Civil Code, it could only lead to further interpretative problems.[25] Art. 24a(2) appeared to be an attempt to regulate the tax consequences of ostensible declarations of intent known to civil law.

The attempted GAAR was partly quashed by the Constitutional Tribunal, although – as some writers pointed out – it was not significantly different from the GAAR adopted in other countries,[26] and removed by the legislature from the General Tax Law, effective from the 1st of September 2005.[27]

The Tribunal's judgment rejected the GAAR, setting a very high bar to the viability of any future attempts to adopt a GAAR. It held that:

> One of the elements of the principle of trust in the State and its laws, as derived from the principle of the rule of law (Art. 2 of the Constitution), is the prohibition of sanctioning – in the sense of attributing negative consequences to, or refusing to recognise positive consequences of – the lawful behaviour of legal norms' addressees. Thus, where the addressee of a legal norm concludes a lawful transaction and thereby achieves a goal which is not prohibited by law, the objective (including the tax objective) accomplished in this manner should not be regarded as tantamount to prohibited objectives.

In addition, the Tribunal denoted the clear difference between unlawful tax evasion and the avoidance of tax. It held that the constitutional obligation to pay taxes specified by statute (Art. 84) does not constitute either an obligation for taxpayers to pay the maximum amount of tax or a restriction on taxpayers seeking to take advantage of various lawful methods of tax reduction. According to the Tribunal the legislature must comply with rule of law principles. These are connected to principles of legal certainty, legal security and protection of trust in the State and its laws. Constitutional prescriptions for the appropriate exercise of legislative power are violated when the wording of a legal provision is so vague and imprecise that it creates uncertainty concerning their rights and duties of those subject to the law. Creation of an exceedingly broad statute allows the judiciary to inappropriately assume the roles of law-makers.

The Tribunal cited a number of vague clauses used in Art. 24b of the General Tax Law, such as: "one could not have expected," "other significant benefits," and "benefits stemming from the reduction of tax liability."[28] The judgment of the Tribunal marked the virtual end of the legislative GAAR. Only a portion of the law remains. Nonetheless fewer courts continue to refer to concepts of tax avoidance or circumvention of law.

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[25] See M. Kalinowski, *Wykładnia oświadczeń woli oraz ich pozorność w prawie podatkowym*, Przegląd Podatkowy 2003, No. 1, pp. 45–50.

[26] See P. Karwat, *Obejście prawa podatkowego*, Przegląd Podatkowy 2003, No. 2, p. 46 et seq.

[27] K 4/03.

[28] www.trybunal.gov.pl.

13.4 Current Anti-avoidance Rules

Art. 199a of the General Tax Law, effective September 1, 2005, is viewed as a type of GAAR. It requires the taxing authority to take into account the intention of parties to a transaction and the purpose, instead of relying only on the literal wording of the declarations of will of the parties. Under Art. 199a(2) parties concluding transactions other than the ones they are pretending to conclude are subject to tax consequences re-determined on the basis of the true transaction. Under Art. 199a(3) of the General Tax Law, if there is doubt concerning the true steps of a transaction, the taxing authority must file a suit in civil court to determine the existence or non-existence of a legal relation or right purportedly giving rise to tax consequences.

The Constitutional Tribunal upheld the constitutionality of Art. 199a(3), finding a proper separation of judicial and legislative powers. It held:

> The determination of the existence of a legal relation or right in civil, family and custodial, labour and social insurance law lies within the purview of the common courts. In turn, the making of any determinations, and establishment of the consequences thereof by way of administrative decisions, is a competence of relevant public-administration organs. A common court's decision regarding the existence or non-existence of a particular legal relation or right is not of an autonomous nature, but rather constitutes a basis upon which tax cases may be resolved by the competent authorities. Such a division of competence provides a significant safeguard where taxpayers are concerned. The professional knowledge and competence residing in common-court judges favours correct adjudication in complex matters from the aforementioned branches of law, while civil proceedings ensure just procedure for private entities, as based around adversarial proceedings and the right to be heard.[29]

Although Art. 199a of the General Tax Law resembles an anti-avoidance provision, it is not a GAAR. There are neither plans nor advanced discussions concerning the introduction of GAAR into Polish tax law. However, certain regulations in force serve as anti-avoidance provisions aimed at combating specific avoidance cases. These include thin capitalization rules and certain provisions in double taxation conventions.

13.5 Thin Capitalization

Article 16(1)(60) of the Corporate Income Tax Law contains rules concerning thin capitalization. They were introduced with effect from 1999 and were initially aimed at combating tax avoidance in cross-border transactions. Currently these regulations are applicable to both national and cross-border transactions. Rules on thin capitalization restrict the tax deductibility of interest payments in situations where the amount of loan

[29] www.trybunal.gov.pl.

financing from a shareholder, who holds at least 25% of the share capital, exceeds three times the level of share capital. Only excessive interest, as defined, is not deductible.[30]

13.6 Specific Anti-avoidance Measures Based on EC Law

Directives of the European Community (EC) expressly require Member States of the EC to adopt measures aimed at counteracting tax avoidance and tax evasion. Art. 15 of the Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of SE or SCE between Member States,[31] allows Member States to deny tax benefits when it appears that the merger, division, transfer of assets or exchange of shares has as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance. Poland has adopted this measure in the Corporate Income Tax Law. Similar anti-avoidance measures are allowed by another directive regulating direct taxation,[32] which Poland has not adopted.

13.7 Specific Anti-avoidance Measures in Double Tax Conventions

General anti-avoidance provisions are almost non-existent in double tax conventions concluded by Poland with other states. A. Zalasiński indicates that although one such provision may be found in the Israel treaty of 1991, as part of the limitation-of-benefits clause, it has not yet been applied.[33] A number of provisions, usually part of tax treaties concluded by Poland, can be perceived as specific anti-avoidance provisions. These are:

- beneficial ownership clauses in provisions regarding reduced withholding tax on passive income;[34]

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[30] Restrictions are also applicable in the case of loans granted by one company to another company, provided that the same shareholder owns at least 25% of shares in both companies.

[31] OJ L 310, pp. 1–5.

[32] See Art. 5(2) of the Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, pp. 49–54.

[33] A. Zalasiński, National Report – Poland, [in:] *Tax Treaties and Tax Avoidance: Applications of Anti-Avoidance Provisions*, IFA Cahiers 2010, Vol. 95A, p. 648.

[34] Reference to beneficial ownership is rather common in the Polish tax treaties.

- holding period threshold to qualify for a reduced withholding tax on dividends;[35]
- motive/purpose test concerning creation or assignment giving rise to passive interest payment;[36]
- switch-over clauses;[37]
- limitation on benefits clauses;[38]
- capital gains from alienation of shares in companies with substantial real estate assets;[39]
- clauses preventing double non-taxation of pensions;[40] and
- arm's length provisions applicable to "other income."[41]

13.8 Possibility for Reform

In practice, tax authorities tend to adopt the anti-avoidance approach to transactions entered into by taxpayers, setting aside the literal wording of contracts. However, neither tax authorities nor administrative courts are in possession of any clear, consistent and well elaborated judicial anti-avoidance doctrines. Their decisions and judgments might often be labeled as *contra legem* adjudication.

The need to address anti-avoidance activity in Poland remains under discussion, but there are no crystalized ideas regarding the appropriate tools. As a practical matter, concerning anti-avoidance activity, the situation is unclear and decisions in this field are unpredictable.

[35] Art. 10(2) of the treaty with the United Kingdom of 2005, Art. 10(2) of the treaty with Denmark.

[36] Art. 11(7) of the treaty with Greece of 1987, Art. 11(8) of the treaty with Mexico of 1998, Art. 11(7) of the treaty with Chile of 2000.

[37] Art. 24(3) of the treaty with Germany of 2003.

[38] Art. 25 of the treaty with Israel of 1991, Art. 27 of the treaty with Sweden of 2004.

[39] For instance, Art. 13(2) of the treaty with Austria of 2004, Art. 13(4) of the treaty with Belgium of 2001, Art. 13(5) of the treaty with Denmark, Art. 13(4) of the treaty with New Zealand, Art. 13(2) of the treaty with the United Kingdom.

[40] Art. 17(2) of the treaty with Denmark of 2001, Art. 18(2) of the treaty with the Netherlands.

[41] Art. 22(3) of the treaty with Germany of 2003, A. Zalasiński, National Report..., op. cit., p. 648.

Chapter 14
Slovenia

Nana Šumrada

14.1 Legal System

Slovenia's tax law is a component of its public finance law and is characterized by both the civil law tradition and the separation of legislative, executive, and judicial powers.[1]

All Slovenian national legislation is enacted and amended by the assemblymen of the National Assembly of the Republic of Slovenia (Državni zbor Republike Slovenije)[2] and promulgated by the President of the Republic no later than the eighth day following the enactment by the Parliament. The National Council of the Republic of Slovenia (Državni svet Republike Slovenije, the upper house) has the preliminary right to require the Assembly to reconsider a piece of legislation within 7 days of its enactment.[3]

Depending on the subject matter of laws to be enacted or amended, ministries of the respective jurisdictions – in the case of tax laws, the Ministry of Finance – make proposals for enactment or amendments of laws in the name of the Government (Vlada Republike Slovenije). The National Council may also advance proposals for enactment or amendments.[4] This

[1] Article 3 and Chapters IV and VIII of the Constitution of the Republic of Slovenia (Ustava Republike Slovenije, hereinafter: the "Constitution"), published in the Official Gazette of the Republic of Slovenia (Uradni List Republike Slovenije, hereinafter: "Ur.l. RS") No. 33/91 of 28 December 1991, p. 1373, as amended.

[2] Taxes are imposed by the State according to Article 147 of the Constitution. Local taxes are regulated by local authorities on the basis of the conditions set by the Constitution and legislation.

[3] Article 91 of the Constitution.

[4] Article 97 of the Constitution.

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is also true for Slovenian substantive tax laws[5] and fiscal procedure acts,[6] which have been revised and amended relatively frequently since their first enactment, some amendments having been necessitated by decisions of the Slovenian Constitutional Court (Ustavno sodišče Republike Slovenije).[7]

The administrative organ charged with the enforcement of Slovenian tax laws is the Tax Administration of the Republic of Slovenia (Davčna Uprava Republike Slovenije, hereinafter the "Tax Administrator"), a body within the Ministry of Finance. Enforcement is shared by the Tax Administrator and the Ministry of Finance. In the case of international double taxation conventions (hereinafter "DTCs"), each DTC designates the body with jurisdiction to enforce the terms of the treaty.[8]

In cases that come within the scope of its jurisdiction, the Tax Administrator is charged with the collection of taxes and other obligatory duties, the availability of procedural remedies, and timely compliance with tax obligations as defined in the tax regulations.[9] The Tax Administrator is responsible for the prevention and discovery of tax offenses. It is also in charge of the enforcement of legislation of the European Union, as well as other international agreements, together with the cooperation and exchange of data with bodies of the European Union, and the relevant agencies of other European Union Member States (hereinafter the "EU Member States") and third countries.[10] It also coordinates with international organizations and professional associations in fiscal matters.

[5] The Slovenian Corporate Income Tax Act (Zakon o davku od dohodkov pravnih oseb), first published in Ur.1. RS No. 40/2004 of 20 April 2004, p. 4694, as corrected and amended, and Personal Income Tax Act (Zalpm p dpjpdmomo. ZDoh-1), published in Ur.1. RS No. 54/2004 of 20 May 2004, p. 7133, as corrected and amended.

[6] The Slovenian Tax Procedure Act (Zakon o davčnem postopku, ZDavP-2).

[7] On reforms of the Slovenian tax legislation, see mag. Aleš Kobal, *Davčne reforme in njihov vpliv na davčno pravo RS*, Podjetje in delo Vol. 7, p. 1531 (2006) (on Personal Income Tax Act); on reforms in general see mag. Boštjan Petauer, *Davčna reforma – korak v pravo smer, a premajhen*, Pravna praksa Vol. 1, p. 3 (2007), the authors comments on further necessity of reforms in general; also see Boštjan Koritnik, *Nova davčna zakonodaja*, Pravna praksa Vol. 4, p. 32 (2007).

[8] Article 70, paragraph 5, of the Tax Procedure Act.

[9] On the Tax Administration's tasks and powers in general see Maja Bohorič and Daša Oštir, *Davki v podjetju*, Inštitut za javne finance, pp. 63–68, 69–79 (2006).

[10] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15), with amendments, is transferred by Chapter II of the Fourth Section of the Slovenian Tax Procedure Act. Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (OJ L 157, of 26 June 2003, p. 38), was transposed into the Slovenian legal system by Chapter I, Subchapter 10 of the Fifth Section of the Tax Procedure Act. DTCs represent legal grounds for the exchange of information with other countries. The Tax Procedure Act also transposes Council Directives Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (OJ L 157, of 26 June 2003, p. 49) and 2008/55/EC

14.2 Slovenian Tax Procedure – General Overview

In Slovenia, tax law enforcement and tax collection rely on two important schemes. These are, first, self-assessment by taxpayers of their tax liability by filing annual tax returns,[11] and, second, advance tax payment (akontacija davka).[12] Advanced payments by taxpayers are credited against their annual tax liability and may be offset against such liability.

While, *in concreto*, advance tax payments are calculated according to the applicable laws, self-assessment naturally implies self-calculation by taxpayers of their tax liability, which presupposes a correct application of laws and regulations determining applicable tax base, tax rate, and tax credits,[13] including a calculation of tax deductions and social security contributions. Such self-assessment is considered final unless the relevant fiscal enforcement body establishes that the tax liability has been incorrectly determined. The fiscal enforcement system is supported by imposition of an obligation upon taxpayers to transmit information necessary to insure a correct determination of tax liability, effective tax collection, and audit ("tax control") by the relevant tax law enforcement body.[14] They must report such information on their annual tax returns.[15]

Accordingly, tax liability may be determined either by taxpayers or by the Tax Administrator. In particular, should the tax liability reported in an annual tax return prove incorrect, the relevant enforcement body may reach a decision on the definitive extent of the subject's tax liability (odmerna odločba,[16] hereinafter "tax determination decision") according to information obtained from the annual tax return or information gathered during a tax audit,[17] which includes inspection of documents. When determining tax liability, the onus of proof is both on the taxpayer (regarding their statements, including statements leading to a decrease

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of 26 May 2008 on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures (OJ L 150, of 10 June 2008, p. 28).

[11] According to Article 68, paragraph 1, of the Corporate Income Tax Act, a taxable legal entity in Slovenia is required to calculate and report its own tax liability. Similar provisions in terms of the calculation and reporting of tax liability are found in the Personal Income Tax Act and Article 49, paragraph 1, of Tax Procedure Act.

[12] In the case of personal income, such partial payment is monthly. Due to the different nature of the legal entities' transactions, Article 69 of the Corporate Income Tax Act does not make reference to their periodic character.

[13] Articles 44 and 49 of the Tax Procedure Act.

[14] Articles 39 to 43 of the Tax Procedure Act.

[15] Article 61, paragraphs 1 and 2, of the Tax Procedure Act.

[16] Articles 65 and 73 of the Tax Procedure Act.

[17] Article 65, paragraph 2, of the Tax Procedure Act; the Tax Procedure Act regulates tax determination decisions issued by the administration on the basis of information obtained in tax returns or following a tax inspection procedure.

in their tax liability) and on the tax law enforcement body (regarding facts leading to the imposition of a tax liability, whether an increase or decrease).[18]

In general, tax procedures commence ex officio upon receipt of a tax return[19] or other documents defined in Article 72, paragraph 2, of the Tax Procedure Act (Zakon o davčnem postopku, ZDavP-2), as well as upon the initiation of a tax enforcement procedure. The procedure may also commence upon the request of a party directly concerned.[20]

The tax procedure is governed by principles of good administration and impartiality,[21] of proportionality,[22] of legal certainty, the duty of the administration to provide information and assistance,[23] the right to privacy,[24] the principal of timely fulfilment and payment of tax obligations,[25] and the obligation of the taxpayer to transmit information to tax law enforcement bodies.[26] During the tax procedure, the taxpayer has the right to legal representation. In procedures against taxpayers, the tax authorities must act in accordance with the principles set out in the Code of Ethics for employees of the Tax Administrator (Kodeks etike davčnih delavcev) and ensure the protection and exercise of the rights and interests of the parties involved.[27]

Tax determination decisions set out the reasoning and the grounds for the final decision reached by the Tax Administrator.[28] According to the General Administrative Procedure Act (Zakon o splošnem upravnem postopku)[29] and the Tax Procedure Act, seven legal remedies can be

[18] Articles 76 and 77 of the Tax Procedure Act.

[19] Where information in a tax return is complete and correct, the tax law enforcement body issues a tax determination decision without formal opening of a tax procedure, in accordance with Article 73, paragraph 2, of the Tax Procedure Act.

[20] Article 72, paragraph 1, of the Tax Procedure Act.

[21] Article 4 of the Tax Procedure Act refers to legality, while Article 5 of Tax Procedure Act refers to “material truth.”

[22] Article 6 of the Tax Procedure Act.

[23] Article 7 of the Tax Procedure Act.

[24] Article 8 of the Tax Procedure Act defines obligation on the part of tax administration of data protection.

[25] Article 9 of the Tax Procedure Act.

[26] Article 10 of the Tax Procedure Act. Further on principles of the Slovenian tax procedure, see dr. Polona Kovač, *Načela davčnega postopka*, Pravna Praksa Vol. 2006, No. 30, p. 8 (2006).

[27] Article 73, paragraph 1, of the Tax Procedure Act.

[28] Articles 80 and 81 of the Tax Procedure Act.

[29] The General Administrative Procedure Act, condensed version (Zakon o splošnem upravnem postopku, uradno prečiščeno besedilo), as published in Ur. l. RS No. 24/2006 of 7 March 2006, p. 2477, as amended.

invoked against tax administration decisions:[30] an appeal on the merits and six types of extraordinary appeals. The latter consist of: retrial of the matter, cancellation ab initio, extraordinary quashing of a decision, and revision of a decision in accordance with the supervisory right set out in the General Administrative Procedure Act, as well as special retrial, cancellation ab initio, extraordinary quashing of a decision, and change of a decision as set out at Article 90 of the Tax Procedure Act.[31]

Appeals of tax determination decisions of the Tax Administrator (decisions at first instance) are heard by a panel of the Ministry of Finance, which is the tax law enforcement body with appellate jurisdiction. Appeal of a tax determination decision does not suspend enforcement.[32] For extraordinary appeals, however, the same tax enforcement body that issued the tax determination decision hears the plea of retrial. Persons concerned by the tax determination decision may request a retrial on the grounds of new facts and circumstances, unknown at the time of issuance of the decision, which would have influenced the outcome of the tax procedure or the final decision.[33]

A further measure of internal tax administration control exists insofar as a controlling tax law enforcement body may extinguish or repeal a tax determination decision as a result of procedural mistakes or tax liability incorrectly (i.e., set too high or too low) calculated.[34] Similarly, a tax law enforcement body may exercise control over tax calculation and tax investigation – the latter is undertaken when there is a reasonable suspicion that the Tax Procedure Act, tax laws or other laws regulating tax law enforcement have been violated, or for reasons of assistance to other EU Member States' or third countries' bodies.[35]

After a tax determination decision enters into force or upon another executive title referred to in Article 145 of the Tax Procedure Act, and when a tax liability has not been paid within the prescribed deadlines,[36] the tax law enforcement body proceeds to execute it. The taxpayer concerned has

[30] In the Slovenian legal system, the principles of legal certainty and *res judicata* take priority; see, in this sense, the *res judicata* principle as expressed in Article 224 of the General Administrative Procedure Act, with commentaries, as well as Article 158 of the Constitution of the Republic of Slovenia. See also Kovač, supra note 27.

[31] A comprehensive comment on types of extraordinary appeals is provided by dr. Polona Kovač, *Pravna sredstva zoper davčno odločbo*, Pravna praksa Vol. 2007, No. 17, p. 9 (2007).

[32] Article 87, paragraph 1, of the Tax Procedure Act.

[33] Article 89 of the Tax Procedure Act.

[34] Articles 88 and 90 of the Tax Procedure Act.

[35] Article 131 of the Tax Procedure Act.

[36] Article 143 of the Tax Procedure Act.

the right of appeal against the decision to proceed to execution, but appeal does not have the effect of suspending the execution procedure already commenced.[37]

14.3 Slovenian Regulation of Corporate Tax Avoidance and Tax Evasion

While the Tax Procedure Act refers to a general concept of abuse of law and avoidance of legally-imposed obligations, the terms "tax mitigation" and "tax avoidance" are not defined in Slovenian tax legislation. In contrast, "tax evasion" is a criminal offence in Slovenia. While both Slovenian tax law and criminal law criminalize the provision of incorrect information for the calculation of a tax liability, what distinguishes an "innocent" error or omission, giving rise to tax penalties, from a criminal tax evasion, is the intention on the part of the perpetrator to reduce the tax liability by misrepresentation or concealment of taxable income, the perpetrator's intention to defraud tax law enforcement bodies, and the gravity of the offense, which is assessed on the basis of the benefits derived from the fraud.

Thus, in order to assess tax mitigation, tax avoidance, and tax evasion within the Slovenian legal landscape and the role of Slovenian tax law enforcement bodies, one needs to look at provisions of the Slovenian Tax Acts, the Criminal Code of the Republic of Slovenia (Kazenski zakonik Republike Slovenije)[38] and Slovenia's DTCs read together with case-law of the Court of Justice of the European Union (hereinafter the "European Court of Justice").[39]

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[37] Article 157, paragraph 3, the Tax Procedure Act. Further, on Slovenian tax procedure in the context of corporate taxation, Bohorič and Oštir, supra note 10.

[38] The Criminal Code (Kazenski zakonik, KZ-1), as published in Ur.l. RS No. 55/2008 of 4 June 2008, p. 5865 (as corrected in Ur.l. RS No. 66/2008 of 1 July 2008, p. 9028); as amended in Ur.l. RS No. 39/2009 of 26 May 2009, p. 5501; as confirmed by Decision of the Constitutional Court No. U-I-73/09-19, published in Ur.l. RS No. 55/2009 of 17 July 2009, p. 7656.

[39] Commentators do not agree as to how to assess the treatment of tax avoidance and tax abuse in case law of the European Court of Justice. See Francisco Alfredo García Prats, *Is It Possible to Set a Coherent System of Rules on Direct Taxation under EC Law Requirements?*, in A Vision Of Taxes Within And Outside European Borders, Festschrift in honour of Prof. Dr. Frans Vanistendael, Luc Hinnekens and Philippe Hinnekens (eds.), Kluwer Law International, pp. 429–448, at p. 440 (2008), and Koen Lenaerts, "*United in Diversity" – also in Fiscalibus?*, in A Vision Of Taxes Within And Outside European Borders, supra, pp. 617–634, at p. 625.

14.3.1 *Penal Provisions – Economic Criminality and Tax Evasion*

The twenty-fourth chapter (Article 249) of the Criminal Code of the Republic of Slovenia, entitled "Criminal offences against the Economy," references the crime of tax evasion. The first paragraph of the article states that whoever provides false information regarding income, expenses, items or other circumstances that may influence the determination of the liability to pay personal income taxes, other taxes, and other liabilities imposed on physical persons and legal entities,[40] or whosoever defrauds a tax law enforcement body in any other way with the intention of partially or fully evading tax liability or of enabling others to do so, is punishable by up to 3 years imprisonment, provided the liability evaded represents an important economic benefit.[41]

14.3.2 *Provisions of Slovenian Tax Acts*

14.3.2.1 General Anti-abuse Clause

Article 74 of the Tax Procedure Act contains what may be considered a general "anti-abuse" provision, entitled "Determination of Facts." Under Article 74, the illegality of an action or activity, or the nullity of a transaction, should economic consequences of such activity or action exist or persist after its commission, does not influence the tax liability – the liability remains. Similarly, the tax liability remains unaltered by sham transactions.[42]

More specifically, Article 74, paragraph 4, of the Tax Procedure Act, establishes that it is not possible to circumvent tax or other legislation by

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[40] The Slovenian Criminal Liability of Legal Entities Act (Zakon o odgovornosti pravnih oseb za kazniva dejanja), first published in Ur.l. RS No. 59/1999 of 23 July 1999, p. 7529, as corrected in Ur.l. RS No. 12/2000 of 11 February 2000, p.1627; as amended in Ur.l. RS No. 50/2004 of 6 May 2004, p. 6706; as condensed in Ur.l. RS No. 98/2004 of 9 September 2004, p. 11837; as amended in Ur.l. RS No. 65/2008 of 30 June 2008, p. 8692, establishes conditions for the criminal liability of legal entities for tax evasions.

[41] For further comment on the Slovenian tax evasion system see, *inter alia*, mag. Liljana Selinšek, *Kazenskopravni vidiki izmikanja plačilu davka*, Revizor No. 7-8/2003 (2003).

[42] Article 74, paragraph 3, of the Tax Procedure Act. See Explanation of the Tax Administration of Republic of Slovenia, (Pojasnilo Davčne Uprave Republike Slovenije), No. 4217-238/2008, of 21 July 2008, as to hidden distributions of profits. Also see dr. Aleš Kobal, *Pravne podlage za obdavčitev prikritih izplačil dobička in njihov razvoj v slovenskem davčnem pravu*, published on 19 August 2009, available at: http://www.findinfo.si/Register/Besedilo.aspx?SOPI=FIND-CLANKI|Razvoj%20obdavcitve%20fizicnih%20oseb%20in%20pravna%20podlaga%20za%20obdavcitev%20prikritih%20izplacil%20dobicka%20na%20ravni%20njihovih%20prejemnikov|0|&Doc=DAVC.

means of avoidance or abuse.[43] If such avoidance or abuse is established, taxes are levied as they would have been if the full economic consequences of the transactions in question had been taken into consideration. Should a fraudulent, abusive or sham transaction be established, no safe harbor requirements can render transactions immune from challenge. Thus, in tax disputes coming under the jurisdiction of the Tax Administrator, Article 74 of the Tax Procedure Act determines the consequences of avoidance of tax liability and denotes the Tax Administrator's power to deal with avoidance issues.

Article 74 of the Tax Procedure Act provides an approach comparable to the doctrine of substance over form, the latter based on the premise that two transactions producing the same economic result should incur the same fiscal consequences.[44] The language of the Tax Procedure Act implies that this regime functions on a case-by-case consideration of the facts by the Tax Administrator.

In view of the lack of further clarification as to the content and the use of Article 74 of the Tax Procedure Act, concrete assessments must take into consideration the criteria for judging wholly artificial arrangements as set out in the judgments of the European Court of Justice in cases *Eurofood IFSC* and *Cadbury Schweppes and Cadbury Schweppes Overseas,*[45] and the Court's earlier jurisprudence on abuse of law.[46] In accordance with this case law, the judicial inquiry turns on objective indicators as to the existence of sham corporations as well as a motive test[47] applying to a determination of the taxpayer's abuse of rights, avoidance of legislation, or purposeful causation of a nullifying transaction for the purposes of tax avoidance.

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[43] Abuse is not commented on separately in the context of tax regulation. In terms of the classical theory of abuse of rights see dr. Marijan Pavčnik, *Teorija prava: Prispevek k razumevanju prava*, 3rd ed, GV založba (Pravna obzorja Series No. 32), pp. 208–214 (2007).

[44] Slovenian regulation however does not include an expression of the *business purpose doctrine* or *the economic substance doctrine*.

[45] Judgments of the European Court of Justice of 2 May 2006, in C-341/04 Eurofood IFSC [2006] ECR I-3813, paragraphs 34 and 35, and of 12 September 2006, in C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas [2006] ECR I-7995, paragraphs 67 and 70.

[46] For interpretation of abuse of law, in the context of the value added tax, see judgment of the European Court of Justice of 21 February 2006, in C-255/02 Halifax e.a. [2006] ECR I-1609, paragraphs 69 and 71.

[47] See judgment in C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas mentions, at paragraph 72. As to doubts concerning the motive test, see Michael Lang and Sabine Heidenbauer, *Wholly Artificial Arrangements*, in A Vision Of Taxes Within And Outside European Borders, supra note 39, pp. 597–615, at p. 608.

It is not clear whether Article 74 of the Tax Procedure Act will apply in cases of "treaty shopping" and international tax avoidance. Slovenian commentators and tax authorities have not yet taken a position as to such use of Article 74 of the Tax Procedure Act.[48] The authorities may determine that treaty shopping, as such, is not addressed by the Tax Procedure Act. They may conclude that Articles 260 and 262 of the Act only introduce rules for non-residents who claim tax benefits under applicable international treaties. There is no formal limitation of benefits clause (hereinafter "LOB") in Slovenian DTCs.

With the exception of the anti-avoidance and anti-abuse clauses of Article 74 of the Tax Procedure Act, no general anti-avoidance rule (hereinafter "GAAR") has been adopted by the Slovenian legislature. Neither adoption of a GAAR nor implementation of reforms to the current anti-avoidance rules appears likely in the short or medium term. The reasoning of the European Court of Justice in cases like *Leur-Bloem,*[49] *Cadbury Schweppes and Cadbury Schweppes Overseas,* and *Halifax*, on Directive 90/434 (relating to mergers and acquisitions among member states),[50] and regarding wholly artificial arrangements and value-added tax, respectively, and the court's case-law on controlled foreign corporations (hereinafter "CFCs"), may be considered an application of principles expressed in the common European Union anti-avoidance rules set out in the EU secondary legislation on indirect and direct taxes.[51]

A particular application of the anti-abuse provision set out in the Tax Procedure Act is reflected in certain provisions of the Corporate Income Tax Act (Zakon o davku od dohodkov pravnih oseb, ZDDPO-2). The Act

[48] Article 74 of the Tax Procedure Act is not discussed in these terms in the commentary to the act. See dr. Tone Jerovšek et al., *Zakon o davčnem postopku s komentarjem*, Davčno izobraževalni inštitut & Davčno finančni raziskovalni inštitut, Komentar člena 74 (Commentary of Article 74 of the Tax Procedure Act), pp. 193–194 (2008); Matjaž Kovač, *Davki od a do ž, Celovit pregled obdavčitev v Republiki Sloveniji in njihova obrazložitev z veljavno zakonodajo*, Primath (2008). In comparison, Austrian tax authorities, interpreting a similarly-worded provision of Article 22 of the Austrian Federal Tax Code (Bundesabgabenordnung), have established that the latter can be used to combat base companies and treaty shopping and can also be applied to international tax cases. In Gerald Toifl, *Austria*, in The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law, Peter HJ Essers, Guido JME de Bont and Eric CCM Kemmern (eds.), Eucotax, pp. 41–84, at p. 41 (1998); on references to domestic law in terms of interpretation of terms in international treaties see the same author at p. 41 and footnote 10. Treaty-shopping is, as yet, undefined in Slovenian tax legislation.

[49] Judgment of 17 July 1997, in C-28/95 [1997] ECR I-4161.

[50] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (OJ L 225 of 20 August 1990, p. 1).

[51] Leif Mutén, *Will Case Law Do?*, in A Vision Of Taxes Within And Outside European Borders, supra note 40, pp. 657–667, at p. 666, sees this legislation as the common GAAR.

implements EU Directives 90/434, 90/435,[52] and 2003/49, principally in its Chapter VII and Articles 71 to 73, respectively. The Act does not introduce any specific anti-abuse provision with the aim of discouraging either improper use of tax allowances and deductions or directive shopping.[53]

Article 43, paragraph 3, of the Corporate Income Tax Act, regulating information that must be provided to the tax authorities on the transfer of capital between companies for the purposes of obtaining tax relief (tax allowances) and deductions established in Article 40 of the same Act, stipulates that the tax authority can refuse partial or full deductions and relief claimed if it is established that the main purpose or at least one of the purposes of the transaction in question is to diminish a tax liability or to avoid tax. Paragraph 4 of Article 43 refers directly to the Tax Procedure Act concerning the enforcement of this regime.

A similar regime exists for deductions and allowances concerning tax on profits in the context of exchanges of shares between companies by virtue of Article 47, paragraphs 3 and 4, of the Corporate Income Tax Act, which is enforced by paragraph 4 of Article 43 of Tax Procedure Act. Similar rules exist regarding taxation of mergers and the dissembling of companies by virtue of Article 53, paragraphs 3 and 4, of the Corporate Income Tax Act.

Without specifying anti-abuse rules in particular, the Personal Income Tax Act generally regulates, among other matters, tax exemption claims based on double taxation treaties[54] and the avoidance of double taxation on income received outside Slovenia.[55]

14.3.2.2 Specific Anti-abuse National Regulation

In addition to general rules on taxation of a Slovenian permanent establishment, including rules for avoiding double taxation and taxation of residents of Slovenia with regard to their foreign income,[56] Slovenia has introduced provisions for the specific regulation of income derived from non-EU countries with a general nominal corporate profit tax rate lower than 12.5

[52] Council Directive 90/435/EEC of 23 July 1990, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 225 of 20 August 1990, p. 6).

[53] The opposite is true for transposition of Directive 90/435 in Austrian Individual Income Tax Act and Corporate Income Tax Act. In Toifl, supra note 48, at p. 49, footnote 14.

[54] Article 110 of the Personal Income Tax Act.

[55] Articles 136 to 141 of the Personal Income Tax Act.

[56] Chapter X of the Corporate Income Tax Act.

percent, which includes CFC legislation and rules relating to transfer pricing, thin capitalisation, avoidance of double taxation of dividends,[57] and the taxation of pension plans.

Income derived from low-tax jurisdictions within the meaning of Article 8, paragraph 13, of the Corporate Income Tax Act, relating to income for services of all kinds paid to persons having their registered office or seat in non-EU countries where the general or average nominal corporate profit tax rate is lower than 12.5 percent, is considered to be taxable in Slovenia if the income is paid by a resident of Slovenia or a non-resident having a permanent establishment in Slovenia. According to Article 70, paragraph 1, subparagraph 6, of the Corporate Income Tax Act, such payments are taxable at a 15 percent tax rate.

Under Article 24, paragraph 1, subparagraph 3, of the Corporate Income Tax Act, dividends are exempted from tax if the person paying such dividends is subject to tax on income of profits comparable to the tax levied under the Slovenian Corporate Income Tax Act. Such person must not be a resident of, or, in case of a permanent establishment, it must not have its seat or effective management in, a country where the general nominal corporate profit tax rate is lower than 12.5 percent which appears on a list of offending jurisdictions published under Article 8. Like most CFC legislation, Slovenian provisions target dividends deriving from entities resident in low-taxed foreign countries. This provision does not regulate payments of dividends by a resident of an EU Member State.

Gain on the sale of corporate shares by a Slovenian resident or non-resident with a permanent establishment in Slovenia is reduced by 50 percent under Article 25, paragraph 3, of the Corporate Income Tax Act. This provision does not apply in the case of gain on the sale of shares in companies located in certain non-EU tax havens.

Regarding transfer pricing, Article 19 of the Corporate Income Tax Act stipulates that interest rates between related parties, as defined by Articles 16 and 17, are calculated in accordance with the official interest rate most recently published.[58] In the context of profit transfers, transfers between related parties must fulfill the conditions of the arm's length principle, as defined in Article 9 of the Organisation for Economic Cooperation and Development (hereinafter "OECD") Model Tax Convention on Income and on Capital.[59]

[57] Articles 24, on exemption of dividends and dividend-like income, and 71 of the Corporate Income Tax Act.

[58] Unless the taxpayer concerned demonstrates the loan could be given to an independent person at an interest rate lower that the official one. Also see Article 95 of the Corporate Income Tax Act.

[59] In context of dividend-like income, Article 74 of the Corporate Income Tax Act defines "fair value" as the amount at which a financial instrument may be sold or exchanged or

Additional anti-tax-avoidance measures appear in thin capitalisation rules set out in Article 32 of the Corporate Income Tax Act.[60] Under paragraph 1 of Article 32, interest on loans to thinly capitalized entities is not considered deductible for income for taxation purposes.[61] Interest on loans to third parties, including bank loans, for which the shareholder or partner of the thinly capitalized entity provides a warranty, or loans granted in connection with the holdings of such a shareholder or partner in the bank or other legal entity is also not deductible.[62]

Article 70, paragraph 3, of the Corporate Income Tax Act exempts dividends paid by Slovenian persons to residents of an EU or EEA member state from a 15 percent tax. This exemption applies so long as the EU/EEA resident is not paid through a permanent establishment of a non-resident of Slovenia and the EU/EEA resident may not claim a tax reduction in its state of residence (where, for example, the residence state does not tax such dividends). Articles 71 to 73 of the act regulate payment of dividends, including hidden dividends, and interest rates between related companies within the European Union, as well as their non-taxable status in the Republic of Slovenia.

Regarding pension plans, Article 70, paragraph 5, of the Corporate Income Tax Act exempts from the 15 percent withholding tax investment income paid to institutions, investment funds, and insurance companies that provide pension plans and are resident in an EU or an EEA member state, provided that the income has not been paid to a Slovenian permanent establishment. This rate reduction applies only if the non-resident entity may not claim the 15 percent tax rate in its country of residence (whether the rate reduction is in the form of an exemption from taxation or

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an obligation settled or at which there would be a possible exchange of a capital instrument between well-informed, non-dependant, and equal parties entering into a voluntary transaction. Article 16, paragraph 1, of the Personal Income Tax Act, states that in the case of transactions between associated parties, *market prices* are used to calculate the amount of income; Article 16, paragraph 3, of the same act defines associated parties.

[60] Explanation of Tax Administration of Republic of Slovenia No. 4200-24/2007-2, of 17 April 2007. National rules on thin capitalization must respect the case-law of the European Court of Justice on thin capitalization, such as the judgments of 12 December 2002, in C-324/00 Lankhorst-Hohorst [2002] ECR I-11779; and of 13 March 2007, in C-524/04 Test Claimants in the Thin Cap Group Litigation [2007] ECR I-2107.

[61] There is an exception to this rule for loans between borrowing banks or insurance companies and their shareholder or a partner who possesses 25 percent of the share capital or controls 25 percent of the voting rights in the taxable entity directly or indirectly and at any time in the taxable year.

[62] Article 32, paragraph 2, of the Corporate Income Tax Act. Paragraph 3 of the same article regulates the calculation of the value of the shareholding of such shareholder or partner. Article 70a of the Corporate Income Tax Act defines exemption from taxation for interest on debt securities that are not convertible to equity securities and are issued by Slovene companies traded in an EU or an OECD country stock exchange.

a 0 percent tax rate).[63] The dividend and pension plan exemptions are not effective if there is no system for exchange of information between Slovenia and the EU/EEA member states concerned.

14.3.2.3 Provisions of Slovenian DTCs

Anti-abuse provisions for international transactions are contained in the DTCs that Slovenia has concluded with other countries. These contain anti-abuse provisions based primarily on the OECD Model Tax Convention on Income and Capital.[64] Under Commentaries to the OECD model treaty, member countries are not obligated to grant benefits of a DTC to arrangements that constitute abuse of the provisions of the convention.[65]

Slovene DTCs contain rules for the determination of residence and permanent establishments, the evaluation of business profits, transactions between associated companies, beneficial ownership in relation to dividends, interest, and royalties, and anti-abuse provisions taxing the income of an entertainer or a sportsman in the Contracting State in which his activities are performed, even if the income accrues to another person. The concept of beneficial ownership is recognized in Slovenian tax legislation for interest and royalties[66] and for personal savings income of residents of EU member states in the form of interest[67] and, thus, determines the availability of rate reductions for all such income.

In addition to provisions on mutual consultation and exchange of information calculated to prevent fraud, tax avoidance and tax evasion,

[63] Slovenia has a "three-pillar" pension insurance scheme, including obligatory pension plan and additional voluntary pension plans. Article 58 of the Corporate Income Tax Act sets out a tax relief for payments made to additional voluntary pension insurance schemes established in Slovenia or in other EU Member States.

[64] As to Articles 1, 4 and 6 of the OECD Model Tax Convention on Income and on Capital, see Miloš Milan Matijevič, *Slovenia's Tax Treaty Policy*, in European Union: Tax Treaties of the Central and Eastern European Countries, Michael Lang et al. (eds.), Linde, pp. 191–206, pp. 193, 198 (2008). According to Matijevič, most Slovenian DTCs contain provisions for preventing types of treaty abuse, at p. 195.

[65] The OECD, Model Tax Convention on Income and on Capital (Condensed version), Article 1, Commentary 7.1, at p. 48 (2008), also available at: http://www.oecd.org/dataoecd/14/32/41147804.pdf. On OECD model convention and Commentaries as customary international law see, inter alia, Sjoerd C.W. Douma and Frank A. Engele, *The Legal Status of the OECD Commentaries*, IBFD p. 166 (2008).

[66] Article 72 of the Corporate Income Tax Act in the context of related parties from different EU Member States.

[67] Article 33, paragraph 2, of the Personal Income Tax Act. Also see Fifth Section, Chapter I, Subchapter 10 of the Tax Procedure Act.

Slovenian DTCs include certain specific anti-abuse provisions, predominantly rules on the allocation of taxing jurisdiction[68] and taxation of profits derived by permanent establishments.

A special anti-abuse provision in the Slovenia-Luxembourg DTC limits treaty benefits to certain categories of income or to certain persons paying such income. Article 29 establishes that the DTC does not apply to holding companies (*sociétés holding*) within the meaning of special Luxembourg laws, currently the Act (*loi*) of 31 July 1929 and the Decree (*arreté grand-ducal*) of 17 December 1938 or to income derived from such companies by a resident of Slovenia or to shares or other rights in such companies.

As to taxation of partnerships, Article 24 of the Slovenia-U. K. DTC regulates tax allocation. The second paragraph of the Protocol to the Slovenia-U. K. DTC posits that dividends shall not be taxed in the Contracting State where the company paying the dividends is a resident if the beneficial owner of the dividends is a pension scheme as defined in the Protocol.

The Slovenia-Estonia, Slovenia-Latvia, and Slovenia-Lithuania DTCs contain provisions concerning profits of a permanent establishment derived from the sale of goods[69] which are considered attributable to a permanent establishment if it is established that such sales or activities were structured in a manner intended to avoid taxation in the State where the permanent establishment is situated.

While Article 4 of the Slovenia-U. S. DTC defines residency in general,[70] Article 22 – an LOB clause – defines residency of a Contracting State for the purposes of entitlement to the benefits in accordance with the DTC.[71] Certain categories of residents described in Article 4, paragraph 2, under c), (i) and (ii), are entitled to the treaty benefits if more than 50 percent of

[68] These usually do not prevent a Contracting State from applying its domestic legal provisions for the prevention of tax evasion or tax avoidance. For use of France's domestic CFC rules in addition to DTCs, see Patrick Dibout and Rene Offermanns, *France*, in The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law, supra note 48, pp. 85–96, at p. 89.

[69] Article 7, paragraph 1, of the DTCs mentioned.

[70] Matijevič counts Article 4 of the DTC as an LOB clause as well; supra note 65, at p. 195; Article 22 of the DTC refers to its Article 4.

[71] Under Article 22, paragraph 2, of the DTC, persons entitled to such benefits are an individual, a qualified governmental entity, as well as a company, if all the shares in the class or classes of shares representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange, or if at least 50 percent of each class of shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits, provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits under the DTC. According to Matijevič, Article 22, paragraph 2, of the DTC contains the so-called qualification test; supra note 65, at p. 195. Article 22, paragraph 2, under f, of the DTC also includes, subject to specified conditions, a person other than an individual.

the person's beneficiaries, members or participants are individuals resident in either Contracting State.

A resident not otherwise entitled to benefits of a DTC may be eligible if it meets the active trade or business test under Article 22, paragraph 3. Under paragraph 4, a resident of a Contracting State not otherwise eligible may be granted benefits under the DTC if the competent authority of the State from which benefits are claimed so decrees. An LOB clause may be found also in the Protocol to the Slovenia-Israel DTC. The LOB in the Slovenia-Malta DTC denies treaty benefits to persons entitled to any special tax benefit under a law of either one of the Contracting States or any substantially similar law subsequently enacted and which is identified by the Contracting States.[72] DTCs between Slovenia and Spain[73] as well as between Slovenia and the U.K.[74] refer to limitation of relief rather than benefits, but they are substantially LOB clauses.

14.4 Dealing with Tax Avoidance in Slovenia

When, according to national legislation or a DTC, the transactions of a person or an entity are taxable in Slovenia, the respective tax offices of the Tax Administrator will examine examples of tax circumvention (tax avoidance) on a case-by-case basis by assessing the economic substance as well as the main purpose or the purposes of the transaction in question.

Since the Tax Administrator's duties to prevent fraud, abuse, and sham transactions are defined in general terms, the assessment of tax avoidance transactions will principally depend on the interpretation given to each of the abuse of right, fraud, and sham transactions or arrangements. In addition, certain complex conditions for tax relief or tax exemption set out in national tax legislation or DTCs are detailed by Tax Administration Explanations. These cover the notion of residence in Slovenia, the

[72] The Protocol to the DTC defines the persons who are entitled to a special tax benefit referred.

[73] The Protocol to the Slovenia-Spain DTC's Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 13 (Capital gains), define entitlement to the relief provided for by the Convention in respect of dividends, interest, royalties, and capital gains arising in the other Contracting State. A company that would not be entitled to the benefits of the DTC in respect of the aforementioned items of income, can still be granted such benefits if the competent authorities of the Contracting States agree under Article 26 of the DTC that the establishment of the company and the conduct of its operations are founded on sound business reasons and thus do not have obtaining of such benefits as its primary purpose.

[74] Article 25 of the Slovenia-United Kingdom DTC.

taxation of non-residents, and interpretation of certain of the DTC articles.[75] Explanations include concrete tax cases analysed by the Tax Administrator based on actual questions addressed by taxpayers to the Tax Administrator. Other guidance remains quite formalistic.[76] While such explanations are of great interpretative and advisory value, they do not have precedential authority.[77]

There is no particular national tax procedure in cases of tax avoidance or tax evasion. No special disclosure provisions apply to tax avoidance transactions. Thus, general rules under the Tax Procedure Act govern audit and enforcement actions in these cases.

One type of procedure, the tax determination procedure, is initiated ex officio on the basis of a tax return. It may result in the issuance of a tax determination procedure by the Tax Administrator after careful and diligent consideration of the evidence.[78] In accordance with Article 74 of the Tax Procedure Act, the economic consequences of illegal, invalid, and sham transactions are taken into account in the calculation of the tax liability, which is determined as if the actions are accurately reported.[79] After such a procedure, the taxpayer has the right to appeal against the Tax Administrator's final decision.

In cases of doubt as to irregularities or circumvention of the regulations as a result of wrongful or fraudulent information provided in a tax return, the Tax Administrator may commence audit procedures (tax control or davčni nadzor), which consists of verifying the calculation of tax as stated in the tax return. These include a tax supervision (davčna preiskava) or a tax inspection procedure (davčni inšpekcijski nadzor).[80] The tax inspection procedure is used to examine all the business transactions of a taxable legal

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[75] Part of explanations is in form of answers to frequent questions. See http://www.durs.gov.si/si/davcni_postopek/.

[76] For instance in the Tax Administration Explanations No. 42105-138/2007 of 6 July 2007 and No. 42105-53/2007 of 27 March 2007.

[77] According to the Tax Administrator, the cases published as explanations do not have the status of a regulation; they are orientation tools, demonstrating interpretation and understanding of certain tax problems by the administrator. See: http://www.durs.gov.si/si/mednarodno_obdavcevanje/druge_mednarodne_pogodbe/.

[78] Article 73, paragraph 1, of the Tax Procedure Act.

[79] See Articles 76 and 77 of the Tax Procedure Act. All facts and circumstances important for calculating tax liability are determined usually by written accounting documentation.

[80] Although the Tax Procedure Act defines only tax supervision and tax auditing as types of tax investigation, combating tax evasion is also one of the main purposes of the international exchange of information. Tax investigation as a form and method of work of the Tax Administrator is a field not yet regulated by law in Slovenia. See Gregor Dešman, *Davčni nadzor v boju proti davčnim zatajitvam* (Tax Supervision in Combating Tax Evasion), 3. Davčna konferenca Slovenskega inštituta za revizijo (3rd conference of the Slovene institute of Auditors), Slovenski inštitut za revizijo (2002).

entity during the previous three last taxable periods.[81] The tax inspection procedure is instituted by notice to the entity resulting from issuance of a tax inspection order, an action which the taxable entity may not appeal.[82]

The taxpayer concerned has the right to be notified at the commencement of the tax inspection procedure of his or her right to designate a person to provide information and clarification during the procedure.[83] There is no specification regarding the qualifications of the representative, who may be an attorney. The taxpayer concerned also has the right to be informed of the type of tax inspection procedure[84] invoked and to be present during the procedure.[85]

At the end of the tax inspection procedure,[86] the Tax Administrator may issue a tax determination decision or a decision concerning changes not influencing the calculation of the tax liability.[87] Upon such designation, if appropriate, a tax is collected. If the taxpayer concerned does not pay the liability, the Tax Administrator may proceed to (compulsory) tax collection.

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[81] In large corporations, the tax inspection procedure is normally limited to the last taxable period. Articles 133, paragraph 2, of the Tax Procedure Act.

[82] Article 135, paragraph 5, of the Tax Procedure Act. By virtue of paragraph 3 of the same article, should the purpose of the tax inspection be compromised by such notification, the inspection is commenced when a tax inspector takes any action on the premises of the taxable entity which initiates a tax inspection procedure.

[83] Article 138, paragraph 6, of the Tax Procedure Act.

[84] Business premises, documentation, merchandise, equipment and land may be inspected if the inspection is necessary for the correct estimation of the taxpayer's business activity. Article 138, paragraphs 2 and 3, of the Tax Procedure Act.

[85] Article 139, paragraph 1, of the Tax Procedure Act. A tax inspection procedure takes place during business hours; inspection outside such hours is conditioned by agreement of the taxpayer concerned or by an absolute necessity of such inspection for purposes of the tax inspection procedure; Article 137, paragraph 7, of the Tax Procedure Act.

[86] According to Article 141, paragraph 2, of the Tax Procedure Act, a regular tax inspection procedure may not surpass a 6-month period; if this time limit is surpassed, a tax determination decision must be issued, in designated types of procedure, 9 months after the initiation of the inspection (Article 141, paragraph 3). Two examples of tax inspection procedures where tax evasion of a corporation was established are Davčna uprava Republike Slovenije, *Nepravilnosti, ugotovljevljene v inšpekcijskih nadzorih*, Davčni bilten Vol. 7 No. 12, pp. 46–47, p. 47 (2006); Davčna uprava Republike Slovenije, *Nepravilnosti, ugotovljevljene v inšpekcijskih nadzorih*, Davčni bilten Vol. 7 No. 11, pp. 71–75 (2006).

[87] Article 141, paragraph 1, of the Tax Procedure Act. Decisions concerning irregularities not influencing the calculation of tax liability are issued in accordance with the Inspection Act, condensed version (Zakon o inšpekcijskem nadzoru, uradno prečiščeno besedilo), as published in Ur. l. RS No. 43/2007 of 18 May 2007, p. 5937. Also see Kovač, supra note 31.

14.5 Liability for Tax Avoidance

Only tax evasion is considered a tax offense and, depending on the economic consequences, it may be a criminal offense. Tax avoidance is not classified as a tax offense in the Tax Procedure Act.

Criminal tax evasion in the Criminal Code relates to taxpayers' failure to disclose the entirety of their taxable income or to provide information necessary for the correct calculation of tax liability to the Tax Administrator.[88] Both individuals and entities may be liable for criminal tax evasion.[89] With certain exceptions, designated persons or entities are under obligation to report relevant tax information. At present, there is no Slovenian case law or academic commentaries on the subject of liability for disclosure of tax-related information. However, the commentary to Article 10, paragraph 4, of the Tax Procedure Act, states that anyone possessing information necessary for the correct evaluation of tax liability must report such data to the tax enforcement agencies. This includes information indicating tax evasion.[90] Accordingly, private tax advisers and attorneys have the obligation to report tax evasion.

Failure by an individual to file a tax return, to file it on time, to provide information requested by a tax enforcement body, or to provide accurate information, is considered a tax offense, punishable by (administrative) fine of 200 to 400 euros.[91] A serious tax offense may be punished by (administrative) fine from 400 to 1,200 euros.[92] A taxpayer is not subject to a fine if he or she files a corrective return prior to a tax inspection procedure.[93]

Tax offenses of a legal entity or a sole trader are punishable by (administrative) fine ranging from 800 to 30,000 euros.[94] The responsible person within the legal entity or the sole trader may be held liable for failure to file accounts for tax purposes or for not filing them in accordance with the Tax Procedure Act and may be subject to an (administrative) fine ranging from

[88] See Articles 10, 39 to 43 and 61 of the Tax Procedure Act.

[89] See the Personal Income Tax Act and the Tax Procedure Act. See also Article 68 of the Corporate Income Tax Act and in the Tax Procedure Act.

[90] Commentary to the Tax Procedure Act, supra note 48, at p. 39, referring also to Article 78 of the Tax Procedure Act and Articles 66 and 139 of the General Administrative Procedure Act.

[91] Article 394 of the Tax Procedure Act.

[92] Article 395 of the Tax Procedure Act.

[93] Article 396 of the Tax Procedure Act. Article 63, paragraph 1, of the act stipulates that a taxpayer who did not file a tax return or filed such a return containing incorrect, incomplete or untruthful information, may at any time file a new tax return, at the latest before the issuance of a tax determination decision or notification of an order of commencement of a tax inspection procedure, a tax offence procedure or a criminal procedure.

[94] Article 397 of the Tax Procedure Act.

600 to 4,000 euros. Serious tax offences of legal entities or sole traders are punishable, depending on the gravity of the economic consequences and on the particular provisions of the Tax Procedure Act in question, by fines ranging from 20 to 45 percent of the unpaid tax liability.[95]

14.5.1 Position of Attorneys and Tax Advisers

Under Slovene law, there are no specific disclosure procedures for tax avoidance transactions that would apply to attorneys or tax advisers in relation to their clients' transactions. In addition, the responsibility for filing a complete and non-fraudulent tax return lies with the taxpayer. In some instances, however, a taxpayer may have a claim against a tax adviser or attorney.

There is no regulation of tax advisers apart from responsibility for damages and the general obligation to report tax- and tax-evasion-related information according to Article 10, paragraph 4, of the Tax Procedure Act. However, if a taxpayer files an incorrect tax return in accordance with a tax adviser's instruction, the taxpayer may institute proceedings against the adviser and seek pecuniary damages, provided that the tax adviser has provided wrongful advice.[96] It must be established, on a case-by-case basis, which person (the taxpayer or the tax adviser) is at fault. Where a tax adviser is responsible for wrongful information included in a tax return, the entity responsible for indemnification will usually be the tax advisory entity employing the tax adviser.[97] However, the tax advisory entity is only responsible for compensation of damages caused by the adviser's negligence. If the adviser acts intentionally or out of gross negligence, the tax adviser is personally responsible for damages.[98] In case of mutual fault of the taxpayer and the tax adviser or partial fault of the tax adviser, the tax advisory entity

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[95] On responsibility for general tax advising, see Vili Perner, Odgovornost za davcno svetovanje, 3. Davcna konferenca Slovenskega institute za revizijo (3rd conference of the Slovene institute of Auditors), Slovenski institute za revizijo (2002).

[96] On responsibility for general tax advising, see Vili Perner, *Odgovornost za davčno svetovanje*, 3. Davčna konferenca Slovenskega inštituta za revizijo (3rd conference of the Slovene institute of Auditors), Slovenski inštitut za revizijo (2002).

[97] On two levels of liability for irregularities, see Urška Kukovič, *Kdo je kriv, če je nasvet svetovalca napačen*, Finance, article No. 233/2007 of 6 December 2007, also available at: http://www.finance.si/198568.

[98] Article 147 of the Code of Obligations (official condensed version) (Obligacijski zakonik, uradno prečiščeno besedilo), published in Ur.l. RS No. 83/2001 of 25 October 2001, p. 8345, as amended, establishing responsibility of an employer for the torts of its employees.

provides compensation, most usually though a liability insurance policy.[99] Liability insurance is not obligatory.

The provision of tax advice by attorneys and conditions permitting disclosure of tax are not regulated under Slovenian law.[100] While attorneys' liability for their clients' non-filing of tax returns is excluded by law, Article 10, paragraph 4, of the Tax Procedure Act defines attorneys' general obligations to report tax- and tax-evasion-related information. This obligation is corroborated by Article 4, paragraph 2 of the Prevention of Money Laundering and Terrorist Financing Act (Zakon o preprečevanju pranja denarja in financiranja terorizma),[101] which requires attorneys to report money laundering and terrorist financing on the part of their clients.

General liability in relation to the client is the subject of regulation. Thus, should wrongful tax advice, leading to tax avoidance, be given by an attorney, he or she may be responsible for compensation of damages, usually on the basis of contract law (mandate).[102] If the attorney is liable for a breach of contract, according to Article 243, paragraphs 1 and 2, of the Code of Obligations (Obligacijski zakonik), he or she will be required to compensate the client for foreseeable damage.[103]

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[99] Kukovič, supra note 100. Damage caused by tax advisers' wrongful instructions can be limited to a certain amount. However, where the damage is caused intentionally or by gross negligence, the tax advisers' clients are entitled to full compensation.

[100] According to Article 6 of the Slovene Attorneys Act (Zakon o odvetništvu), published in Ur. l.RS No. 18/1993 of 9 April 1993, p. 828, as amended, an attorney must guard the secrecy of information that was entrusted to him/her by the client. Also see Attorney's Ethics Code, adopted by Assembly of the Bar Association of Slovenia on 16 December 1994; amended by the same body on 7 December 2001 and on 25 April 2009.

[101] Published in Ur.l. RS No. 60/2007 of 6 July 2007, p. 8332, as amended. The act transposes Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005, on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (OJ L 309 of 25 November 2005, p. 15), and Commission Directive 2006/70/EC of 1 August 2006, laying down implementation measures for Directive 2005/60 of the European Parliament and the Council as regards the definition of "politically exposed person" and the technical criteria for simplified customer due diligence procedures and for exemption on grounds of a financial activity conducted on an occasional or very limited basis (OJ L 214 of 4 August 2006, p. 29). The Prevention of Money Laundering and Terrorist Financing Act defines money laundering and terrorist financing in its Article 2. In this sense, also see the judgment of the European Court of Justice of 26 June 2007, in C-305/05 in Ordre des barreaux francophones et germanophone e.a. [2007] ECR I-5305.

[102] Judgments of the Supreme Court of the Republic of Slovenia (Vrhovno sodišče Republike Slovenije), Civil Department, No. II Ips 450/2000 of 22 March 2001, VS05921; and (judgment and order) No. II Ips 694/2007 of 10 September 2008, VS0011037.

[103] In any event, according to Article 9, first parenthesis, of the Attorneys Act, the Bar Association of the Republic of Slovenia insures an attorney for liability for damage suffered by clients, when damage is associated with the attorney's services.

If the damage suffered did not result from a breach of contract, the attorney may be liable under tort law.[104] The attorney's actions are measured against the diligence of a good expert – an attorney is considered a legal expert – which he or she should employ while advising a client.[105] In case of tort liability, the responsible attorney is liable for full damages determined on an objective basis under Article 169 of the Code of Obligations.

14.6 A Final Remark

There are no current reform efforts in Slovenia concerning the regulation of tax avoidance transactions. Responsible bodies have not issued a white paper or other consultative paper on this topic.

[104] Mag. Bogomir Horvat, *Odškodninska odgovornost odvetnikov za strokovno napako*, Pravna Praksa No. 5, p. 6 (2007). Also see Simona Toplak, *Odškodninska odgovornost odvetnika*, Pravna praksa Vol. 2007, No. 37, p. 30. Under the Code of Obligations, the attorney is responsible for compensation of damages if all the requirements for establishment of a tort (a civil wrong) are met: there must be an unlawful act on the part of the attorney concerned, actual damage suffered, a causal relationship between the two, and a subjective element (attorney's liability or fault). See judgments of the Higher Court of Ljubljana (Višje sodišče v Ljubljani), Civil Department, order No. II Cp 3850/2008 of 18 February 2009; and of the Supreme Court of the Republic of Slovenia, Civil Department, judgment and order No. II Ips 594/2006 of 10 September 2008, also on the basis of now invalidated Article 18 of the revoked Obligation Relationships Act (Zakon o obligacijskih razmerjih, as invalidated in Ur.l. RS No. 83-4287/2001 of 25 October 2001, p. 8345).

[105] This type of diligence is regulated by Article 6 of the Code of Obligations, which sets as a measure a typical, usual or normal conduct of an average expert in the same field of expertise. See dr. Ada Polajnar Pavčnik et al., *Obligacijski zakonik s komentarjem*, 1st book, dr. Nina Plavšak and dr. Miha Juhart (eds.), GV Založba, at p. 146 (2003). In practice, this standard is compared with the actual conduct of the attorney.

Chapter 15
Taiwan

Keh-Chang Gee and Yuan-Chun (Martin) Lan

15.1 Legal System

The legal system in Taiwan is based on the civil law tradition but at the same time it has been strongly influenced by the common law system. The idea of separation of powers has been incorporated in the Constitution and adapted according to our individual conditions. Simply put, in addition to the original three powers of branches as judicial, legislative, and executive, there are the Examination branch and the Control branch, making five separate five powers.

The Legislative Yuan, i.e., the legislative branch of Taiwan, takes charge of the legislative process, whereas the promulgation of tax law is officially assigned to the President. Revisions of tax laws are made through the process of legislation in principle and are revised with serious scrutiny but at a regular yet frequent level if necessary.

15.2 Enforcement of Tax Law

The Administrative branch assumes the power of the enforcement of tax laws. There is in principle a system under which taxpayers are to report their taxes voluntarily by filing a tax return, making payment to the public treasury, and then submitting the return to the collection authority-in-charge within a period of time as prescribed by law. However, in the case of property tax and any other tax assessed by the collection authority-in-

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charge, it is required that a notification of collection be issued and delivered to every taxpayer with a demand for payment within a specified period of time.[1]

15.3 Adjudication of Tax Controversies

In spite of the general procedures for collection and administrative remedies, appeals for relief concerning domestic taxes on imported goods levied by Customs are governed by the Customs Act and the Customs Anti-Smuggling Act, while other current cases of administrative remedy for taxation come under other different jurisdictions depending on the nature of the competent superior authority of the collection agency-in-charge concerned, as shown in the following table:[2]

	Level of administrative remedy		
National or local cases	Review	Appeal	Administrative lawsuit
National tax cases	Taipei/Kaohsiung National Tax Administrations and National Tax Administrations of Northern/Central/Southern Taiwan Province; Keelung/Taipei/Taichung/Kaohsiung Customs Offices	Ministry of Finance	Administrative Court
Local tax cases in Taipei/Kaohsiung City Government	Revenue Service Offices of Taipei/Kaohsiung city	Taipei/Kaohsiung City Government	Administrative Court
Local tax cases in Taiwan/Fukien	County and city tax collection agencies of Taiwan/Fukien	County and City Government of Taiwan/Fukien Province	Administrative Court

A detailed explanation of the tax litigation process in Taiwan is described below.

[1] Guide to ROC Taxes 2010, Taxation and Tariff Committee, Ministry of Finance, 2010.6., p. 172.

[2] Guide to ROC Taxes 2010, Taxation and Tariff Committee, Ministry of Finance, 2010.6., p. 180.

15.4 Tax Dispute Process

There have been three levels of administrative remedy for tax matters since 1st July, 2000 – they are review, appeal, and administrative lawsuit. For review, an application should be made to the tax collection authority that originally handled the case; for appeal, the matter should be referred to a competent superior authority.

For an administrative lawsuit, the case should be referred to the Administrative Court under the Judicial Yuan. With respect to tax controversies, there are no specialized courts like the Intellectual Property Court at the present time, but these are special sub-divisions established for each judge's individual interests in the field of taxation.

15.4.1 Review

A taxpayer may, if he or she should find the determination unacceptable, request a review in accordance with the following provisions by filing a petition with the tax collection authority that originally handled the case in a prescribed form stating the reasons and accompanied by documentary evidence.

The collection authority-in-charge shall complete the review and issue a written determination to the taxpayer concerned within 2 months after receipt of the petition for a review. If the collection authority-in-charge fails to make a determination after the expiration of the 2-month period, the taxpayer may proceed to file an appeal.

15.4.2 Appeal

A taxpayer who is unconvinced of the determination of the review, may appeal the determination in accordance with the provisions of the Appeal Act within 30 days from the day after receipt of the determination.

15.4.3 Administrative Process

A taxpayer may invoke the appeal process if he or she opposes an administrative decision. It is available if the taxpayer views the administrative act to be prejudicial to his or her rights or if no decision was made 3 months after the appeal was filed or 2 months after the extended period for decision. The taxpayer may file an administrative lawsuit with the Administrative Court within 2 months from the day after the delivery of the appeal decision or upon the expiry of the period during which the appellate authority, by law, should make a decision.

15.5 Substance over Form

The tax authority has issued the following admonition regarding post-1987 tax law:

> [The requirement that] people shall have the duty to pay tax in accordance with law is intended to point out that the people have the duty to pay tax pursuant to the prescriptions in respect of taxpaying bodies, tax denominations, tax rates, methods of tax payment, and time of tax payment as set forth by law.[3]

A "substance over form" doctrine as in the United States has long been recognized in practice in Taiwan and was promulgated and put into effect on May 27, 2009 as Article 12-1 of the Tax Collection Act.

15.6 Tax Avoidance, Tax Mitigation, and Tax Evasion

The concepts of tax avoidance, mitigation, or evasion are not defined in the texts of tax laws. Only the term "tax evasion" has appeared in the text. However, the differentiation of the concepts of tax savings, tax avoidance, and tax evasion has long been recognized and discussed in the academy as well as in actual practice in both administrative and judicial branches.

As a practical matter these concepts are viewed as follows. In practice tax evasion is subject to penalties. Mitigation is viewed as similar to tax saving and refers to legitimate employment of transactions that derive tax benefits. Avoidance refers to abusive transactions with no business purpose used to gain tax benefits.

15.7 Addressing Tax Avoidance

The judicial branch highly respects the assessment made by tax authorities. As a result, judicial opinions often agree with that of tax administration, which makes the tax collection authority a frequent winner in tax litigation and heightens the risk of infringing on taxpayer's rights.

Under principles of administrative law, the legislative branch is mainly responsible for the interpretation of statutes as well as the concepts therein, including the contours of concepts like "tax avoidance."

The administrative branch determines whether a transaction involves tax avoidance. The line between tax mitigation and tax avoidance is stipulated in the Income Tax Act, which does not apply to all taxes. Article 43-1 of the Income Tax Act provides:

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[3] http://www.judicial.gov.tw/CONSTITUTIONALCOURT/en/p03_01.asp?expno=217

> A profit-seeking enterprise which has an affiliated relationship with, or is directly or indirectly owned or controlled by another enterprise within or without the territory of the Republic of China, whereof, if it is found that arrangement of their mutual income, cost, expense, profit or loss distribution does not conform with the regular business practice, hence, results in a tax evasion or reduction, the collection authority-in-charge for the purpose of computing the accurate income of the enterprise may report it to the Ministry of Finance for approval in effecting an adjustment in accordance with the regular business practice.

15.8 GAAR

A GAAR has not been adopted in the Taiwan system. However, new Article 12-1 of Tax Collection Act, which is somewhat similar to a GAAR, is viewed as providing general principles.

Because Article 12-1 has been viewed as a general principle, it is expected to apply to all cases, however, due to its infancy, at present stage, most issues arise under the Profit-Seeking Enterprise Income Tax.

15.9 Penalties

Tax avoidance, separate from tax evasion, is not punishable due to the lack of intention to evade taxes. Consequently, the only effect of tax avoidance is to require payment of the outstanding tax, the amount of which is to be determined according to transaction sought to be avoided so as to meet the standard of tax equity. However, tax evasion and tax avoidance are difficult to distinguish, as the burden of proving the intent of taxpayers is difficult.

Regarding tax evasion, administrative and criminal penalties apply, but there are no civil penalties such as punitive damages. The penalty is imposed based upon a broad concept of "tax equity," which requires interpretation by the authority-in-charge as well as the judicial branch. Type of penalty is mainly monetary, excluding certain administrative sanctions such as prohibition of operation. According to Article 41 of the Tax Collection Act, a taxpayer who evades tax payment by fraud or other unrighteous means shall be sentenced to imprisonment for no more than 5 years, detention, or in lieu thereof or in addition thereto, a fine of no more than sixty thousand New Taiwan Dollars (NT$60,000).

15.10 Statutory Interpretation

The judicial branch, paying much deference to the expertise of the administrative branch, is inclined to uphold the taxing authority in tax controversies accordingly. Statutory interpretation takes place within the scope of the authorizing rules or regulations and does not extend to the substance of the law itself.

Although both the administrative and judicial branches are competent to interpret statutes, decisions of the administrative branch do not bind judicial interpretation. Because the system of precedent is widely recognized, interpretations by the judicial branch have a strong effect.

15.11 Disclosure Rules

Neither taxpayers nor tax advisers are subject to laws requiring disclosure of tax avoidance transactions.

15.12 Ethical Rules for Tax Advisers

The ethical obligation of attorney or tax advisers is generally regulated in Article 42 of the Tax Collection Act. Section I, Article 43 of Tax Collection Act provides:

> A person who instigates or assists another person to commit an offense set forth in Article 41 or 42 hereof shall be sentenced to imprisonment for no more than three (3) years, detention, or in lieu thereof, be imposed with a fine of no more than sixty thousand New Taiwan Dollars (NT$60,000).

Section II of Article 43 states;

> Where a tax official, an attorney, a certified public accountant, or any other legitimate agent commits an offense described in the preceding Paragraph, the penalty to be imposed shall be increased by up to one-half (1/2).

With respect to instigation or assistance of tax evasion, disciplinary action in each profession is regulated under the profession's laws, such as Section 3 in Article 26 of the Certified Public Bookkeepers Act, Section 2 in Article 61 of Certified Public Accountant Act.

15.13 Tax Shelters

The concept of "tax shelter" has long been acknowledged in the practice, but there are no special rules of regulation.

15.14 Prospects for Reform

New Article 12-1 of the Tax Collection Act, may be viewed as a codification of the type of substance over form approach applied in actual practice over the past decades. It is indicative of the government's determination to address the modern challenge of tax avoidance techniques. There is no current white paper or other blueprint for reform.

Chapter 16
United Kingdom

Sandra Eden

16.1 Legal System

Although the United Kingdom is a single jurisdiction for the purposes of international law, it is actually comprises three separate jurisdictions: England and Wales, Northern Ireland, and Scotland. The first two are common law jurisdictions, whereas Scotland is a mixed jurisdiction, involving elements of both common law and the civil law tradition and operating both principle and precedent within one system. Whilst the UK is bicameral, in relation to tax legislation, the upper chamber has a role.

The UK has no written constitution.[1] Most written constitutions emerged in the aftermath of some sort of tectonic shift in the political framework of a country, whether as a result of revolution, freedom from colonial rule or following peaceful negotiation, reflecting the need for a fresh start. Whilst there has by no means been an absence of dramatic political shift in the UK, there has been no perceived need for such a constitutional "fresh start". Consequently, constitutional development in the UK has been, on the whole, gradual and incremental. As a result of the lack of a modern, written constitution, the sorts of principles which one would normally find are generally absent from the UK's juridical map, except to the extent they have been imported from elsewhere through the European Convention of Human Rights and membership of the European Union. Thus, there is no indigenous principle of equality, proportionality or non-discrimination to which the courts in the UK can reach.

[1] This is not entirely true – it is (more or less) written down, just not all in the same place and it is not entirely certain whether some bits on the periphery are actually part of the constitution or not.

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The separation of powers is, conceptually at least, a thread which runs through the British constitution,[2] although, as is often the case in British constitutional arrangements, the position in practice is more textured. There is, for example, a greater degree of overlap between the legislative and executive branches than in many constitutions, with Cabinet ministers, who are elected members of Parliament and part of the legislature, playing key roles in the executive. The role of the Lord Chancellor, until reform in 2005, spanned each of the three organs of state. The House of Lords, (until replacement by the Supreme Court in 2009) was at the same time the unelected second chamber and its judicial committee provided the highest UK court with its judges. Judges were appointed by the executive until the introduction of the Judicial Appointments Commission in 2006. However, despite the fact that the judiciary were not institutionally separate from Parliament, they were and are regarded as having exercised (and exercising) a considerable degree of independence.

Key to the understanding of the realities of the separation of powers is the principle of parliamentary sovereignty and the part played by the courts in this respect. Since the Bill of Rights 1689, which regulated the relationship between the Crown and Parliament in a constitutional monarchy, it has been practice of the courts to recognise the supremacy of an Act of Parliament. Indeed, the notion of parliamentary sovereignty itself is regarded by some as deriving from the common law: "Parliament is sovereign because the judges acknowledge its legal and political supremacy."[3] In traditional constitutional theory, law is what the Queen in Parliament enacts.

> The principle of parliamentary sovereignty means neither more nor less than this: namely, that Parliament thus defined has, under the English constitution, the right to make or unmake any law whatever; and, further, that no person or body is recognised by the law of England as having a right to override or set aside the legislation of Parliament.[4]

From where does the notion of parliamentary sovereignty derive? Political theory might point to the will of the people, but its *legal* basis in the UK would appear to be the common law, in particular from the decisions of the courts that they will not interfere with the enactments of the elected body. It has not always been thus: there was once a view that the courts could disregard an Act of Parliament if it was contrary to the "common right and reason, or repugnant, or impossible to be performed",[5] but by time of the Bill of Rights 1689, it appears to have been accepted that judges would

[2] The principle has its origins in the reign of Edward 1st, 1272–1307.

[3] W. Wade, "The Basis of legal Sovereignty" (1955) *Camb. L.J.* 172.

[4] A. Dicey, *An Introduction to the Study of the Constitution* (1885) p. 39.

[5] *Dr Bonham's case* (1610) 8 Co Rep 113b.

respect legislation as having a higher status than any other source of law, including the common law.

Dicey's strict view of parliamentary sovereignty, quoted above, has had it critics[6] and in more recent times there is some evidence of a "new era of judicial assertiveness",[7] evidenced primarily by judicial statements from the very highest sources which might be regarded as implying that the courts regard themselves as retaining some residual rights to deny the authority of legislation. Lord Woolf, writing extra-judicially, said, "ultimately there are even limits on the supremacy of Parliament which it is the courts' inalienable responsibility to identify and uphold."[8] Lord Steyn, in *Jackson v AG*,[9] expressed doubt on whether the Diceyan notion of parliamentary sovereignty was still correct:

> The classic account given by Dicey of the doctrine of the supremacy of Parliament, pure and absolute as it was, can now be seen to be out of place in the modern United Kingdom. Nevertheless, the supremacy of Parliament is still the *general* principle of our constitution. It is a construct of the common law. The judges created this principle. If that is so, it is not unthinkable that circumstances could arise where the courts may have to qualify a principle established on a different hypothesis of constitutionalism.

However, despite such judicial utterances, judicial challenge to parliamentary sovereignty, other than those authorised under EC law and, to a more limited extent, the Human Rights Act 1998, remains at best a theoretical possibility and one which, if exercised in practice, would constitute no less than a legal revolution.

So, in terms of checks and balances, the courts have declined to exercise a power or veto in relation to the legislature, although they are increasingly being called upon to protect the individual against misuse of power by the executive, and this is explored further in the tax context below.

16.2 Tax Law

16.2.1 Legislation

The UK Parliament has legislative competency on tax matters across the UK. No central taxing power is devolved to Northern Ireland or Wales, although the Scottish Parliament has limited competency to raise or lower by

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[6] E.g., W.I. Jennings, *The Law and the Constitution* (1959) pp 159–160.

[7] P. Leyland, "*The Constitution of the United Kingdom, a contextual analysis*" p. 224.

[8] [1995] PL 57 at 69.

[9] [2006] 1 AC 262. at [102]. It is interesting that the challenge in this case, which concerned the procedural legitimacy of the Hunting Act 2004, was made on the absence of due process rather than substantive grounds, reflecting a particularly British obsession.

3% the basic rate of income tax only.[10] It has not used this power to date.[11] Jurisdiction over local government finance is devolved to Scotland.

Most direct tax law is contained in primary legislation, although power is occasionally given in primary tax legislation to enable Ministers to promulgate regulations in specific areas, particularly in the area of VAT. Regulations relating to taxation are drafted by HMRC. Delegated legislation weakens the operation of parliamentary sovereignty in the interests of legislative efficiency, although secondary legislation is subject to review by the courts as well as to scrutiny by parliamentary committees. The areas in which regulations may be made are limited, usually used to fill in detail left out of legislation. The principle that tax may only be imposed by Parliament is stringently upheld by the courts and delegated legislation which purports to give wide powers to HMRC to determine the level of taxation in a particular situation will be struck down.[12]

On the whole tax law does not have special status. Judicial interpretation and application of substantive tax law follow no special principles and judicial regulation of the actions of tax authorities is exactly the same as any other public body. A few special features of tax law might be noted, however.

Tax may only be imposed by Parliament and not by judges or by Royal Prerogative. There is no common law of taxation. This derives from the constitutional crisis in the 17th century, provoked in part by the assertion by the Stuart monarchs of the Crown's prerogative to tax. This crisis led to the Bill of Rights 1689 in terms of which Parliament was stated to be the only body with the power to impose taxation.

Related to the above is the convention that certain UK taxes (income tax and corporation tax, but not VAT, stamp duty or inheritance tax) must be imposed annually by Parliament. The annual Budget[13] is presented by the Chancellor of the Exchequer in the spring of each year and is then followed by an annual Finance Act.

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[10] Scotland Act 1998 s 73.

[11] Currently, there are proposals to give the Scots a greater range of tax powers: see the Government's white paper "Scotland's Future in the United Kingdom" at http://www.scotlandoffice.gov.uk/scotlandoffice/files/Scotland's%20Future%20in%20the%20United%20Kingdom.pdf.

[12] *Commissioners of Customs and Excise v. Cure and Deeley Limited* [1962] 1 QB 340.

[13] This statement of the current economic and financial state of the UK includes the announcement of tax changes to be contained in the following Finance Bill. This means that, unusually for a government department, the Treasury has guaranteed access to Parliamentary time each year and, each year, changes are implemented. In recent years, the amount and complexity of new legislation, frequently targeted at avoidance, has been the subject of considerable adverse comment.

The third peculiarity of tax law is the rule that the Parliament's upper chamber, the House of Lords, is largely excluded from the process of enacting legislation in relation to "money bills" and cannot block them.[14] This is regarded as a flaw by some commentators. The House of Lords has the possibly of having some input to the Finance Bill debates since 2003 through a sub-committee of the House of Lords Select Committee on Economic Affairs, but this is only at a late stage, once policy has been determined.[15]

16.2.2 Tax Policy

The division of responsibilities for the development of tax policy between the tax authorities and the Treasury was blurred before changes which took place in 2005. A review of the Revenue departments in 2004[16] concluded that any coherence in tax policy in the UK was *despite* the existing organizational structure rather than because of it. The review proposed that the Treasury be responsible for overall tax policy, with Her Majesty's Revenue and Customs (HMRC), a non-ministerial government department, taking a more limited role. These changes were implemented.[17] Parliament does not initiate tax legislation.

The strength of the political party in office under the Westminster model of government means that tax policy, indeed all policy, is to an unusual extent within the control of that party. Formal consultation,[18] if it is going to take place at all, is generally issued only at an advanced stage, once policy has been determined, and is thus normally restricted to technical implementation rather than informing policy development. In recent years, there has been much more consultation on detailed proposals although this is not as a result of a statutory obligation and continues to be selective. At

[14] Parliament Act 1911 The background to this legislation was the proposal by the Liberal Government to introduce a land tax, which was opposed by the Conservatives, who had a majority in the House of Lords, and which blocked the budget. The Act restricts the power of the House of Lords to block Commons legislation.

[15] It is clear that input is intended to be limited to the technical aspects of the Bill rather than its policy but it is a task that the sub-committee has taken on board in a way which allows more serious consideration of some of the clauses of the Bill. It takes evidence from various independent persons on several matters and, although it is hard to evaluate its impact, the involvement of the Upper House is a welcome step forward.

[16] The O'Donnell Review: "The Review of the Revenue Departments", 1994. Available at http://www.hm-treasury.gov.uk/bud_bud04_odonnell_index.htm (accessed 16 November 2009).

[17] Commissioners for Revenue and Customs Act 2005.

[18] The UK Government has a Code of Practice on Consultation available at http://www.berr.gov.uk/files/file47158.pdf and the specific practice in the tax context is as http://www.hmrc.gov.uk/large-business/consultation-framework.pdf.

a later stage, draft legislation is sometimes circulated for comment prior to publication as a Bill although this is not especially common.

Once policy emerges from the Treasury in the form of a draft finance Bill, there is little scope for further development during its parliamentary stages. The main debate, on the Bill, since 1967, takes place before a "standing committee" rather than being debated in front of the whole House of Commons. The opposition is allowed to choose some clauses to be debated in the whole House, which will be the more controversial clauses from a policy aspect. Standing committees are made up of members of parliament drawn from the political parties in proportion with their respective strengths in the House of Commons. Although the clauses of the Bill are in theory debated one by one, in practice it is only possible for a limited number to be considered in detail. Amendments can be suggested by any party, although the chance of an Opposition amendment being successful is extremely limited as the members of the standing committee tend to vote on party lines.

Parliamentary scrutiny of tax legislation is almost universally regarded as inadequate in the UK. There are a number of reasons for this

- the nature of the subject matter (often extraordinarily complex);
- the Parliamentary timetable (unless the Act of Parliament follows the Budget within about 4 months, any Budgetary resolutions fall);
- the exclusion of the House of Lords from the debates.

The following, taken from a 2008 report to the Mirrlees Review, provides a critical summary:

> [I]n the UK the processes of analysis, negotiation, and marketing take place much more within the Executive Branch than in the legislature, or indeed in politicians' campaigns for election. The Executive has extensive agenda power, and Government proposals are rarely subject to significant amendment, let alone veto. The centralisation of revenues, lack of information and expertise in Parliament, rarity of coalition bargaining, and absence of any powers of initiative and referendum reinforces the familiar executive dominance of British politics.[19]

16.2.3 Revision of Tax Laws

Each year, changes in tax laws are made in the annual Finance Bill, although these changes are generally on an ad hoc and incremental basis and could not perhaps be described as wholesale revision. Announcements of

[19] Alt, Preston and Sibieta, "The Political Economy of Taxation", draft report to the Mirrlees Review, at http://www.ifs.org.uk/mirrleesreview/reports/political_economy.pdf.

changes to the law are often announced in advance of a Finance Act, especially in the context of avoidance schemes which become apparent as a result of the disclosure regime, discussed below. The change becomes effective immediately on announcement as, provided there is sufficient detail of the future provision in the announcement, it is considered that the fact that the legislation will be retrospective to the date of announcement (or other date of implementation) does not give rise to significant detriment to the taxpayer. There are often two Finance Acts in the year of a general election, but apart from this, amending legislation normally takes place annually.

There appears to be no appetite in the Treasury for wholesale revision and there is no body in the UK, such as a Tax Law Commission, which might be charged specifically to make proposals for tax reform. Moreover, Finance Acts are excluded from a system of post-legislative scrutiny introduced in 2008, by virtue of which the responsible Department must submit to the relevant Commons departmental Select Committee a Memorandum on how an Act of Parliament is working, 3–5 years after Royal Assent.

16.3 Enforcement

The enforcement of tax laws takes place under legislative powers given to HMRC, one of the largest government departments.[20]

Self assessment for individuals was introduced in the tax year 1996–1997 with corporate self assessment operational in relation to accounting periods ending after 1 July 1999.

Although the personal and corporate systems are similar in many respects, there are some important differences[21] and it is proposed here to focus on the corporate system.

The process starts with HMRC issuing a brief notice requiring a company to deliver a return.[22] If no notice is received, the company has an obligation to give notice that is chargeable to corporation tax within 12 months of the end of its accounting period,[23] and this will trigger the issue of a notice requiring a return.

The return, which must normally be made within 12 months of the end of the accounting period, must be accompanied by computations and a

[20] In particular, the Taxes Management Act (TMA) 1970 and the Commissioners of Revenue and Customs Act 2005.

[21] The various obligations on payers to deduct tax at source (the cumulative system of deduction of tax on employment income, the tax deducted for interest at source and tax credits attached to dividend income) means that many individuals have no untaxed income and are not required to make a return unless they are specifically required to do so by HMRC.

[22] FA 1988 Schedule 18.

[23] FA 1988 Sch 18 para 2.

copy of audited accounts for the accounting period. If no return is made, penalties are levied for failure to make a return.[24] Corrections may be made to the return by the taxpayer within 12 months of submission. HMRC will amend any obvious errors in the return such as arithmetical errors.

The system is described as "process now, check later." Initially the form is simply processed, with any obvious errors identified by HMRC and notified to the taxpayer. Whether or not the return is one which will be looked into further depends on a variety of factors.

A new compliance checking regime was introduced from 1 April 2009,[25] rationalising information gathering powers across several taxes by providing common authorisation levels, appeals and penalties. No longer are HMRC required to open a formal enquiry before exercising certain information gathering powers, although these powers may only be used where "reasonably required by the officer for the purposes of checking a tax position."[26] The taxpayer can appeal against the issue of a notice requiring further information, and notices requesting information from third parties will normally require the prior permission of the Tribunal.[27]

As well as, or instead of using the new regime, HMRC might engage in the more formal process of opening an "enquiry" into a return.[28] Whilst HMRC do not have to give any reasons for opening an enquiry into a tax return, most returns which are subject to an enquiry are those identified as being at risk of under-reporting tax (how this is done is not made public),[29] although a small proportion of enquiries, affecting about 1 in 1000 taxpayers, are opened on an entirely random basis. HMRC say this in their guidance:

> In general something will have triggered a check. For example, it is usually that the figures entered on a return appear to disagree with each other, such as a very small business suddenly makes a very large claim for VAT or one with a large turnover declares a very small amount of tax. The only way HMRC can find out whether the return is correct is by making a check.[30]

Enquiries must be started within a year after the return was delivered.[31] They are fact finding journeys, with the opening of an enquiry triggering various additional information seeking powers. If, on completing the

[24] FA 1998 Sch 18 paras 17–20. A new system which will apply to several taxes is contained in FA 2009 Sched 55 and 56, although this is not yet in effect.

[25] FA 2008 Schs 36–39.

[26] FA 2008 Sched 36 para 1.

[27] FA 2008 Sched 36 para 3. The tribunal is the first judicial tier, described in more detail later.

[28] TMA 1970 ss 9A–9C.

[29] See http://www.taxationweb.co.uk/tax-articles/general/hmrc-enquiry-selection.html for an account of a former HMRC employee on the factors which were taken into account.

[30] http://www.hmrc.gov.uk/agents/enquiries.htm.

[31] TMA 1970 s 9A.

enquiry, HMRC believe that tax has been understated, it will make amendments to the return or issue a "discovery" assessment.[32] If the taxpayer disagrees with the amendment or assessment, it must let HMRC know within 30 days. At that point, a negotiated settlement might be possible. If it is not, there is one more opportunity for the taxpayer to have the matter dealt with at an administrative level, as he can ask that the decision be reviewed by another official of HMRC.[33]

If the taxpayer is not satisfied with the outcome of the review, or if it does not wish to seek a review, an appeal to the First Tier Tribunal can be lodged within thirty days of the assessment or review decision. In the context of tax avoidance schemes, appeals will normally concern a dispute over whether the scheme has the effect which is being claimed by the taxpayer.

The taxpayer bears the burden of proof of showing that an assessment is wrong:

> If on appeal it appears ... that the appellant is overcharged ... the assessment ... shall be reduced accordingly, but otherwise the assessment ... shall stand good.[34]

The test is the civil one of the balance of probabilities rather than the criminal "beyond reasonable doubt." The balance of probabilities is a flexible standard, weighted according to the likelihood of what it is that the party is seeking to establish. Lord Hoffmann expressed this in the following characteristically idiosyncratic way:

> It would need more cogent evidence to satisfy one that the creature seen walking in Regent's Park was more likely than not to have been a lioness than to be satisfied to the same standard of probability that it was an Alsatian.[35]

The substantive appeal system in the UK starts with two layers of tribunals, followed by, potentially, two further UK appellate courts. Where the complaint is of procedural unfairness rather than a dispute as to law, there is the alternative route of seeking judicial review of a decision of HMRC.

The tribunal system in the UK was formerly fragmented across many areas of law, e.g. tax, employment, social security and immigration, with different rules operating in each area. This system was reformed into a unified structure by the Tribunals, Courts and Enforcement Act 2007 (TCEA), which operates under a common set of procedural rules whilst keeping a

[32] A discovery assessment is on issued by HMRC when they believe they have discovered that tax has been underpaid: TMA 1970 s 29. "Discovery" includes coming to a new conclusion on facts already known to them. This includes subsequent scrutiny of an assessment by an HMRC expert in tax avoidance: *R (on the application of Patullo) v HMRC* [2010] STC 107.

[33] TMA 1970 s 49B, 49C and 49E.

[34] TMA 1970 s 50(6).

[35] *Secretary of State for the Home Department v Rehman* [2001] UKHL 47 at 55.

degree of expertise in the Tribunal members by having different chambers.[36] There are two layers of tribunal: the first tier and the upper tribunal. Most substantive appeals against a decision of HMRC will start in the First Tier Tribunal (Tax Chamber) which is staffed by tax judges although, in complex cases, the case may go straight to the Upper Tribunal (Finance and Tax). Appeals from the First Tier will normally be to the Upper Tribunal. The right of appeal from the First Tier to the Upper Tribunal may only be exercised with permission from the First Tier Tribunal or the Upper Tribunal. The decisions of the Upper Tribunal set precedents for the First Tier tribunal.

An application for permission to appeal will first involve the Tribunal in a consideration of whether to review the original decision.[37]

Appeal from a decision of the Upper Tribunal may be made to the Court of Appeal (England and Wales) or the Court of Session (Scotland) and from there to the Supreme Court (the successor to the House of Lords). Appeals may only be made on matters of law, although the courts have characterised the analysis of a transaction in the context of tax avoidance as a matter of law, thus enabling avoidance appeals to be heard.

The number of appeals in the UK is small in comparison with many other jurisdictions. For example, the number of substantive tax appeals at the lowest level, ignoring those on penalties or procedural grounds, will not exceed 100 in a year, and the Supreme Court is unlikely to hear more than four or five tax cases each year.

Whether the courts are deferential to the tax authorities is a difficult question to judge. On the whole, assessing the terms of the judgments issued in tax cases concerning the substantive law, one would generally say that they appear even-handed. However, a possibly entirely unrepresentative scan of direct tax cases in 2008 (excluding tribunal decisions) found that 23 direct tax case appeals were decided in favour of HMRC and only nine in favour of the taxpayer. These figures reflect the fact that taxpayer was the appellant more often than HMRC (24 cases by the taxpayer in comparison to 8 by HMRC) and most decisions of the lower court were upheld on appeal. However, looking at the cases overturned on appeal, HMRC were successful in six out of eight appeals, whereas the taxpayer was only successful in seven out of twenty-four appeals.

Judicial review rather than appeal is the appropriate route for the taxpayer where the question involves a procedural rather than substantive element. The numbers of cases in general being heard under the judicial review process have increased dramatically over the last 15–20 years and, in the context of taxation, often concern the failure of the tax authorities to respect the taxpayer's legitimate expectations. Prior to the reform of the

[36] The tax chamber commenced on 1 April 2009.

[37] TCEA ss 39 and 40.

tribunal system, judicial review was within the jurisdiction of the courts alone. Since 2009, the power to engage in judicial review has been extended to the Upper Tribunal.

In judicial review cases, where procedural fairness is often the issue, the courts place considerable weight on the experience and expertise of the tax authorities. The concept of fairness has developed specific limitations[38] and in particular it is clear that a high degree of unfairness, unfairness amounting to an abuse of power,[39] is required before the courts will get involved.[40] Simon Brown L.J.'s observation in *R v IRC ex p. Unilever* is representative of the court's attitude here. In the context of whether HMRCs behaviour was challengeable, he remarked that there is a distinction between:

> [O]n the one hand mere unfair conduct which may be characterised as "a bit rich" but nevertheless understandable – and on the other hand a decision so outrageously unfair that it should not be allowed to stand.[41]

16.4 Tax Avoidance, Tax Mitigation, and Tax Evasion

The terms tax mitigation, tax avoidance and tax evasion frequently appear in court judgments, departmental statements and analysis by commentators, although in the UK, as in most jurisdictions, they are not usually used in technical way and the meaning usually has to be taken from context.[42]

16.4.1 Avoidance or Evasion

Tax evasion is normally distinguished from the basis of the avoidance or mitigation on the basis that it is illegal. Dennis Healey, a former Chancellor of the Exchequer is alleged to have said that the distinction between tax avoidance and tax fraud is "the width of a prison wall", although most would view this as not an entirely satisfactory dividing line. John Tiley's example is more helpful: "If two people marry in order to reduce their tax burden

[38] Judge J in *R v Board of Inland Revenue ex parte MFK Underwriting Agencies Ltd* [1989] BTC 561 at 584.

[39] *R v IRC ex parte Preston* [1985] BTC 208 per Lord Templeman at 217–218.

[40] Simon Brown LJ in *Unilever* at 194, Judge J in *MFK Underwriting Agencies* stated at 586, "the court should be extremely wary of deciding to be unfair actions which the Commissioners themselves have determined are fair." See also e.g. *R on the application of Accenture Services v HMRC* [2009] STC 1503.

[41] *R v IRC ex parte Unilever plc* [1996] BTC 183 at 195.

[42] Sometimes it appears that "evasion" is used deliberately in the context of avoidance, to signify moral disapproval, for example Lord Scarman in *Furness v Dawson* [1984] BTR 71 at 73.

they are practising tax avoidance; if they tell the Revenue that they are married when they are not, they are guilty of evasion."[43]

With the aim of giving advice to tax advisers, HMRC attempted to explain the distinction between avoidance and evasion in 2000, when a new statutory criminal offence aimed at tax fraud was created:[44]

> Where a scheme labelled as "avoidance" by its participants and their advisers admittedly fails, the key issue as a matter of criminal law would be whether they have been dishonest in the unsuccessful effort to reduce the relevant tax liability. It would be for the courts to decide as a question of fact whether that is the case. ... (P)ossible dishonesty becomes a consideration in this context only in certain circumstances. That is where there is some suggestion that the participants in an avoidance scheme are not merely relying on the intrinsic technical soundness of the arrangements actually put in place to reduce the liability but also on concealment of the facts from the inspector. ...(W)here there is no trace of any concealment of the true facts of arrangements for which there is a respectable technical case, it is hard to imagine how a criminal offence can have been committed.[45]

So, for the tax authorities, the distinction is based on concealment as distinct from accidental non-disclosure, implying a level of deliberate deceit.

Philip Baker, a distinguished tax lawyer and academic, identifies "knowledge" as the key to evasion:

> Tax fraud must surely involve a degree of knowledge; in particular, it must involve the absence of an honest belief that a person is not liable to the particular tax. If a taxpayer cannot show that he has an honest belief that he is not liable to the tax, that seems prima facie to fall within the scope of tax fraud.[46]

He goes on to express the view that reckless conduct might be harder to classify but puts negligent conduct out of the reach of the criminal law.

It is reasonably clear that there will be no prosecution for a criminal offense on the basis of an avoidance scheme which does not work without further factors being present. In two fairly recent cases,[47] tax advisers ended up on the wrong side of the dividing line. In each case, a jury had found that there had been sufficient dishonesty to convict of cheating the public revenue and the Court of Appeal found in each that there was sufficient evidence for that conclusion. Both cases involved the creation of an offshore company which turned out to be UK resident as it was managed in the UK and in both, there was evidence of non-disclosure of facts in the tax

[43] Tiley Revenue Law 6th ed, 101.

[44] FA 2000 s 144. There is also the common law offence of cheating the public revenue, which continues to exist in England and Wales.

[45] Inland Revenue, Tax Bulletin, Issue 49.

[46] http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf.

[47] *R v Charlton* [1996] STC 1418, *R v Dimsey* [2001] UKHL 46.

return. It is this which distinguishes the cases from ones which are merely failed avoidance cases.

16.4.2 *Avoidance or Mitigation*

Turning to the distinction between tax mitigation and avoidance, whilst many attempts at a definition have been offered, they are usually accompanied by acknowledgement of the limitations of the exercise. The two terms are often used in juxtaposition to indicate on which side of the dividing line a particular activity falls, usually with the words "acceptable" or "legitimate" and "unacceptable" or "abusive" prefacing the respective terms. In this sense, the terms are used as a justification of a conclusion rather than a test to be applied.

There are various hall marks which the judiciary have identified as relevant distinguishing features in the context of applying statutory anti-avoidance provisions.

In 1986, the Privy Council were asked in *CIR v Challenge Corporation Ltd*[48] to make a determination on New Zealand's general anti-avoidance provision.[49] Lord Templeman identified the distinction as turning on whether or not the taxpayer had actually incurred expenditure:

> Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an "arrangement" but from the reduction of income which he accepts or the expenditure which he incurs. ... Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.[50]

Clearly this analysis is not sufficient to deal with many types of avoidance behaviour. In *IRC v Willoughby,*[51] Lord Nolan in the House of Lords pointed to the economic consequences (or lack thereof) attaching to the transaction. He explained the distinction in the following terms:

> Tax avoidance was to be distinguished from tax mitigation. The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation,

[48] [1986] STC 548.
[49] Section 99 of the Income Tax Act 1976.
[50] [1986] STC 548 at 554.
[51] [1997] STC 995 at 1003-4.

> on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. Where the taxpayer's chosen course is seen upon examination to involve (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax.

In *Willoughby* the taxpayer claimed a statutory relief which was protected by a targeted anti-avoidance rule and which was therefore only available where it could be shown "that the purpose of avoiding liability to taxation was not the purpose or one of the purposes" of the transaction.[52]

Turning to the situation where there is no legislative term such as "avoidance" in the background, some earlier cases on the development of a judicial anti-avoidance approach attempted to draw upon the distinction. In *Ensign Tankers (Leasing) Ltd. v Stokes*, Lord Goff, after remarking that there is a "fundamental distinction" between "unacceptable avoidance" and mitigation, identifies the characteristics of the latter as "involving complex artificial structures by which, as though the wave of a magic wand, the taxpayer conjures out of the air a loss, or a gain, or expenditure". More recent decisions appear to be careful to distance themselves from the avoidance/mitigation distinction where the case does not turn on a statutory provision containing the words "tax avoidance", acknowledging that tax avoidance is not per se prohibited in the post *Barclays Mercantile* world.[53]

The most obvious examples of tax mitigation involve the use of reliefs which deliberately encourage certain types of behaviour, for example the use of certain savings vehicles, or the purchase of shares in certain types of companies rather than others. Examples can also be found of other transactions which were tolerated, despite not being promoted by legislation. For example, certain types of UK resident companies within a corporate group are permitted to surrender income losses to other members of the group but are not permitted to surrender capital losses.[54] However, the intra-group transfer of assets takes place at a no gain/no loss value,[55] so if one group member (Co A) wishes to dispose of a capital asset (thus realising a loss which it is not in a position to use), it could transfer the asset to another group member, Co B, who *is* able to benefit from the loss which arises when the asset is disposed of by Co B outside the group.

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[52] ICTA 1988 s 741.

[53] The development of the judicial approach to tax avoidance and *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51 are discussed in more detail at V below.

[54] This process was finally made redundant by the introduction of legislation in 2009 which permits an election that a disposal by one group member is treated as being made by another group member: TCGA 1992 s 171A.

[55] TCGA 1992 s 171.

The dividing line between tax mitigation (in the sense of what the executive is prepared to tolerate) and tax avoidance is not fixed and legislation is sometimes introduced to stop tax planning devices which had been thought to be acceptable.

16.5 Authority to Address Tax Avoidance

The legal power to regulate tax avoidance in the UK derives mainly from primary legislation emanating from Westminster, although the government departments of the Treasury and the Board of Revenue and Customs have limited powers to make regulations (secondary legislation) in certain areas, including in relation to the disclosure regime.

As noted below, there was once a point where the judiciary might have been regarded as developing an anti-avoidance rule, but subsequent case law has deliberately pulled back from this, with a sense of constitutional propriety often being evident in judgments.[56]

16.6 Determination of Tax Avoidance

It is necessary to distinguish between different contexts in which the term "tax avoidance" is used, as the significance of the term and the purpose of the determination that tax avoidance is present varies, depending on context.

First, as will be seen from the discussion of the judicial approach at V, below, the current position is that the courts deny that a judicial anti-avoidance doctrine exists as such. In the UK, the taxpayer is entitled to reduce his or her tax bill *within the terms of the statute*. The existence of a motivation to avoid tax or the presence of a circular or artificial transaction does not of itself lead to the outcome that the taxpayer is denied the relief or exemption claimed, although it can be a factor which impacts on the application of the law to the transaction.[57] This is explained in more detail below.

Second, there are many reliefs or exemptions which are hedged with a purpose test (or similar), often referred to as TAARs (targeted anti-avoidance rules). Some of these are extremely wide, for example, section 16A of the Taxation of Chargeable Gains Act 1992 which excludes relief for a capital loss if:

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[56] E.g. Lord Oliver in *Craven v White* [1988] BTC 268 at 289.

[57] For example, Lord Oliver in *Craven v White* [1988] BTC 268 at 292.

- it accrues to the person directly or indirectly in consequence of, or otherwise in connection with, any arrangements, and
- the main purpose, or one of the main purposes, of the arrangements is to secure a tax advantage.

There are over 200 TAARs, expressed in various different terms.[58] Some, for example, the CGT TAAR quoted above, use the concept of the "purpose" to gain "a tax advantage." Tax advantage is usually defined in legislation.[59] Sometimes the rules bite if the "purpose" is to "obtain a reduction in tax liability"[60] or if it is "tax avoidance."[61] In most provisions, the "tax avoidance" etc. purpose must be the "main purpose" or "one of the main purposes."[62] Sometimes, instead of "purpose", the term used is "object"[63] or "avoidance intention."[64] Sometimes, instead of "tax avoidance" etc, the TAAR is triggered where the purpose is to create a specific tax benefit.[65] Some TAARs look to the purpose of the taxpayer,[66] others to the purpose of the scheme or transaction.[67] Sometimes, there must be a "scheme" or "arrangement" before the TAAR operates,[68] in other cases no scheme or arrangement is required.[69] Some TAARs contain no purpose test: instead, a list of transactions is provided which would otherwise give rise to a reduction in tax.[70]

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[58] The Tax Law Review Committee has criticised the disparities between TAARS, "Having a plethora of different forms of wording gives rise to arguments over whether small differences cause the provisions to operate differently and means that, as and when the TAARs are litigated, a decision of a court as to the interpretation of one TAAR will have reduced significance for a differently worded TAAR." IFS "Countering Tax Avoidance in the UK: Which Way Forward?" TLRC Discussion Paper No 7 para 8.12. HMRC have recently agreed to review the disparities in the terms used, as part of the Simplification Review announced in 2007. It has been consulting on how to achieve a greater degree of improve "comprehension, clarity and consistency" in what it collectively call the "purpose tests".

[59] For example, TCGA s 16A (2) defines it as "relief or increased relief from tax, repayment or increased repayment of tax, the avoidance or reduction of a charge to tax or an assessment to tax, or the avoidance of a possible assessment to tax."

[60] FA 2007 s 26. In such a case, the appropriate comparator must be established.

[61] E.g. FA 2002 s 69.

[62] E.g. FA 1999 s 38.

[63] E.g. FA 2002 s 84.

[64] FA 2007 Sched 5.

[65] FA 2005 s 82, where the company triggers a loss in respect of a loan relationship for tax purposes only.

[66] FA 2005 s 82.

[67] TA 1988 s 798B.

[68] FA 2001 s 82.

[69] FA 2007 s 26.

[70] FA 2007 s 71.

In practical terms, it will be the tax authorities which provide the framework for the application of a particular TAAR, frequently through the publication of notes which accompany legislation. The wider the scope of the TAAR, the greater the scope given to the tax authorities. For example, the explanatory notes provided by HMRC on the CGT TAAR referred to earlier ran to 17 pages of detailed exposition as to the types of transaction that the HMRC viewed as being caught, or not, by the provision.

Beyond issuing general guidance, the first determination in a particular case as to whether or not the anti-avoidance provisions apply is made by the tax authority.

Challenging such a determination is only possible by appeal and the relatively few tax appeals in the UK have already been noted. If the taxpayer is seeking to claim that his treatment by the administration differs from that which could be anticipated under published guidance, for example that the transaction in question has been stated to be outside of the scope of the provision, judicial review rather than appeal is the appropriate route.

The approach to statutory anti-avoidance provisions taken by the courts is that they should be applied in a broad way. Lord Wilberforce's observation in 1975 is still cited with approval:[71]

> For whereas it is generally the rule that clear words are required to impose a tax, so that the taxpayer has the benefit of doubts or ambiguities, Lord Reid made it clear that the scheme of the sections, introducing as they did a wide and general attack on tax avoidance, required that expressions which might otherwise have been cut down in the interest of precision were to be given the wide meaning evidently intended, even though they led to a conclusion short of which judges would normally desire to stop.[72]

Here we shall consider the legislative terms "purpose" and "tax advantage". "Tax avoidance" has been considered in part 3 above.

The term "purpose" has been discussed on many occasions in the context of allowable business deductions which are required to be for "the purposes of a trade."[73]

The purpose of a taxpayer or transaction is a matter of fact, not law, which means that an appellate body should be slow to reverse the decision of the fact-finding court.[74] The test is subjective,[75] although objective factors can be used as evidence, and it is not confined to conscious purposes.[76]

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[71] E.g. *IRC v USS Ltd* [1997] STC 1.

[72] *IRC v Joiner* [1975] STC 657 at 662.

[73] ITTOIA 2005 s 34.

[74] *IRC v Brebner* [1967] 43 TC 705, *Sema Group Pension Scheme Trustees v IRC* [2003] BTC 106.

[75] *Vodafone Cellular Ltd & Others v Shaw* [1997] BTC 247.

[76] *Mallalieu v Drummond* [1983] 57 TC 330.

Purpose is not the same as effect[77] although, "(s)ome consequences are so inevitably and inextricably involved in the payment that unless merely incidental they must be taken to be a purpose for which the payment was made."[78]

As indicated above, where tax advantage is used in legislation, it is usually defined, for example, section 16A of TCGA 1992 defines tax advantage as:

- relief or increased relief from tax,
- repayment or increased repayment of tax,
- the avoidance or reduction of a charge to tax or an assessment to tax, or
- the avoidance of a possible assessment to tax

In determining whether a tax advantage has been gained by the taxpayer, there is necessarily a comparator transaction which must be identified. The meaning of tax advantage was considered by Lord Wilberforce in *IRC v Parker*[79] where he said:

> The [relevant legislation], as I understand it, presupposes a situation in which an assessment to tax, or increased tax, either is made or may possibly be made, that the taxpayer is in a position to resist the assessment by saying that the way in which he received what it is sought to tax prevents him from being taxed on it; and that the Revenue is in a position to reply that if he had received what it is sought to tax in another way he would have had to bear tax. In other words, there must be a contrast as regards the "receipts" between the actual case where these accrue in a non-taxable way with a possible accruer in a taxable way, and unless this contrast exists, the existence of the advantage is not established.

16.6.1 Business Purpose/Economic Substance

When interpreting TAARs, considerations such as whether there was a business purpose behind the transaction or the extent to which there is economic substance may be relevant, if the terms of the legislation permit such consideration. The existence or not of a commercial purpose is commonly relevant in UK TAARs.

To the extent that the business purpose and economic substance are referred to in judicial doctrines, this is discussed below, but for present purposes, the short answer is that, whilst the judiciary might have flirted with developing these doctrines independently of legislation, they are not part of current jurisprudence.

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[77] *IRC v Brebner* [1967] 43 TC 705.

[78] *Vodafone Cellular Ltd & Others v Shaw* [1997] BTC 247.

[79] [1966] AC 141 at 178 F to G.

In a broader sense, the motive of the taxpayer or the substance of the transaction might be considered relevant as part of the overall process of construction of tax statutes and the application of those statutes to the facts. In other words, even where there is no TAAR, the motive of the taxpayer/effect of the transaction might be relevant in the process of applying normal principles of statutory construction. For example, whether or not one has achieved a trading loss will involve consideration of whether what the taxpayer was involved in could be correctly analysed at a "trade".[80]

The normal rules of precedent apply in tax avoidance cases, although because many of the cases are so fact specific, it is not difficult to wriggle round previous decisions.

The term "safe harbour" is not commonly used in the UK. Statutory "safe harbours" would simply be regarded as part of the application of a particular exemption or relief. For example, recent legislation introduced in relation to offshore fund investments will be followed by regulations containing a "white list" of transactions which are not regarded as trading.[81] As noted earlier, HMRC does provide a degree of non-statutory guidance and this might include a list of transactions which are not regarded as coming within an anti-avoidance rule, which could be regarded as safe harbours.

16.6.2 GAAR

The UK does not have a General Anti-Avoidance Rule or GAAR. A report by the Tax Law Review Committee in 1997[82] was cautiously in favour of a GAAR, subject to appropriate protections and, in the following year, the Government published a consultation on the introduction of a GAAR for corporate taxpayers, together with draft clauses.[83] Responses to the Government proposals were not positive, primarily on the basis that they offered insufficient safeguards for the taxpayer[84] and they appear to have been dropped. Since then, the UK has seen the introduction of many TAARs, as outlined earlier, and the suggestion has been made that the advantage for the Government of having multiple TAARS (which have a

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[80] E.g. *F.A. & A.B. Ltd v Lupton* [1971] 3 All ER 948, *Overseas Containers Finance Ltd v Stoker* [1989] STC 364.

[81] Another example was the Excluded Countries Regulations (SI 1998/3081) – the "white list" of states to which the CFC regime did not apply.

[82] "Tax Avoidance – a report by the Tax Law Review Committee" Nov 1997, http://www.ifs.org.uk/comms/comm64.pdf. The TLRC operates under the auspices of the influential Institute for Fiscal Studies.

[83] Inland Revenue "A General Anti-Avoidance Rule for Direct Taxes: a consultative document", 1998.

[84] See for example the response by the IFS "A general anti-avoidance rule for direct taxes", http://www.ifs.org.uk/publications/1906.

similar effect to a GAAR) is that they have not had to concede the introduction of the wide-scale clearance procedures which a GAAR would require.[85]

16.6.3 Regulation of Tax Avoidance

In practice, there is a considerable amount of power in the hands of HMRC to regulate tax avoidance. To a limited extent, secondary legislation can be promulgated in the area of tax avoidance. The most important example of this lies in the context of the tax avoidance disclosure regulations, which determine in which areas of tax law disclosure should be made and provide detail for the application of the scheme.[86]

More importantly, as indicated earlier, HMRC frequently provide non-statutory guidance which may include an indication of what types of transactions they regard as acceptable or unacceptable. This guidance is issued as part of their general duty to administer the tax system rather than being related to anti-avoidance in particular. This guidance can be provided in the form of notes on the Finance Act when it is enacted, or can be published subsequently, perhaps in response to pressure from the tax profession, or following a judicial decision. Whilst this guidance can be challenged through the courts, in practice it has considerable impact on taxpayer behavior.

Some statutory TAARs provide for an advance clearance procedure.[87] HMRC also operate a non-statutory clearance procedure for business customers in relation to issues where there is material uncertainty around the tax outcome, but this does not extend to advising on the efficacy or otherwise of tax motivated transactions: HMRC guidance here states, “In particular, we do not ‘approve’ tax planning arrangements.”[88]

An innovative approach of the executive has been to introduce “risk rating” for large businesses in the UK following upon recommendations made by the Varney review.[89] Working on the stick and carrot approach, large businesses are to be given a risk rating which will determine where they will fall between the light-touch and more interventionist approach by

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[85] IFS “Countering Tax Avoidance in the UK: Which Way Forward?” TLRC Discussion Paper No 7, 2009, http://www.ifs.org.uk/publications/4461.

[86] Initially the disclosure regime applied only to employment schemes and certain financial products. The regime has been given increasingly wide application through regulations.

[87] A list is provided by HMRC at http://www.hmrc.gov.uk/cap/statutory-clearances.pdf

[88] HMRC “Clearance service for businesses – how to get certainty on significant business tax issues” http://www.hmrc.gov.uk/cap/links-dec07.htm.

[89] HMRC “Review of Large Businesses” November 2006 http://www.hmrc.gov.uk/large-business/review-report.pdf.

HMRC.[90] Companies are rated on inherent risks (change, complexity and international relationships) and behavioural risks (including their attitude towards tax avoidance).[91] They can choose to be seen on the low risk end of the scale, thus leading to a full review by HMRC only every 2 or 3 years, or high risk, leading to more HMRC interventions.

16.7 Cross-Border Transactions

There are a number of specific domestic rules which only apply in the context of international transactions. One example is the rules applying to the use of hybrid entities or hybrid instruments where the "main purpose or one of the main purposes of the scheme is to obtain a UK tax advantage."[92] As one might expect, transfer pricing and thin capitalisation rules are also found.[93]

The UK does not seek to include general anti-abuse or limitation of benefits clauses into its treaties, preferring instead to insert anti-avoidance provisions into particular items.[94] Many specific articles have what might be regarded as a TAAR attached, reflecting the drafting of domestic TAARs. From 1960 to 1991, it was common to find a treaty advantage protected by a "bona fide commercial reason" clause. From 1992, the "bona fide" test has been replaced by a "main purpose" provision. Recent interest articles refer to "beneficial ownership" following the OECD model. UK treaties do not commonly include a look through approach, under which the tax obligation is shifted from a company to its shareholders.

The UK courts have only been asked to consider tax treaties at all on a very small number of cases and on anti-avoidance provisions in only one or two cases.[95] On the whole, they appear to apply the same principles in interpreting treaties as they do in domestic law.

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[90] See Tax Compliance Risk Management Process at http://www.hmrc.gov.uk/manuals/tcrmanual/index.htm.

[91] For example, "frequent tax planning that requires disclosure to HMRC or innovative interpretation of tax law" is on the high risk scale, see note 89 above.

[92] F(No 2) Act ss 24–26.

[93] ICTA 1988 s 770A and Schedule 28AA.

[94] Although the US/UK treaty of 2001 does contain such a general provision. See further J Schwarz, *Schwarz on Tax Treaties* 2009.

[95] *Steele v European Vinyl Corp Holdings BV* [1996] STC 785 CA, *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] EWCA Civ 158 (on beneficial ownership).

16.8 Penalties

There are no penalties for tax avoidance in the UK provided taxpayers or advisers do not stray over the line into evasion.

16.9 Statutory Interpretation

Constitutionally, judges only have the authority to interpret tax statutes. There is no common law of taxation. Against this background, the development of what appeared to be a judicial anti-avoidance principle by the House of Lords from 1981 to the early years of the 21st century has sometimes been difficult to explain.

In the years leading up to what became known as "the new approach," the judicial approach to the interpretation of tax statutes remained mired in literalism[96] despite a gradual shift in other areas of law towards a more purposive approach. Occasionally the taxpayer would not achieve the end he was hoping for on the basis that the steps put in place were a sham, i.e. did not possess the legal character that was claimed[97] but on the whole, the courts adopted a narrow legal analysis: if a scheme succeeded on a technical level, it was given the tax treatment sought. The tax avoidance industry was flourishing and it was estimated that millions of pounds of revenue were being lost each year.

The seminal "new approach" case, *WT Ramsay Ltd v IRC*[98] concerned a completely artificial circular off-the-peg avoidance scheme, designed to generate a capital loss. Whilst the scheme failed technically, the significance of the case lay in the purposive approach taken by the House of Lords. The precise intellectual basis for the decision was, in the immediate aftermath, hard to pin down. Lord Wilberforce's leading judgment contains certain statements which support the step approach "It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series of transactions which may be regarded."[99] Elsewhere, he identifies the task as one of statutory construction: "To say that a loss (or gain) which appears to

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[96] For example, a highly artificial scheme in *IRC v Plummer* (1979) 54 TC 1 was successful in front of the House of Lords, whereas functionally the same scheme was defeated under the "new approach" before the same court in *IRC v Moodie* [1993] BTC 85.

[97] The "sham" doctrine has a very different operation in the UK than in the US. The UK courts do not give effect to a transaction if the acts done or documents created did not actually create the legal rights and obligations which are claimed: *Snook v London and West Riding Investments Ltd* [1967] 2 QB 686, *Hitch v Stone* [2001] STC 214.

[98] [1982] AC 300.

[99] Lord Wilberforce at 185 C.

arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, is not such a loss (or gain) as the legislation is dealing with, is in my opinion well and indeed essentially with in the judicial function."[100] However, at the same time, he expressly rejects the substance over form approach.[101]

In *Burmah Oil*,[102] subsequent judicial statements in the House of Lords appeared to add further "instructions" to the step transaction doctrine, with much clearer overtones to the effect that a specific anti-avoidance approach was being developed:

> It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that *Ramsay's* case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable.[103]

This appears to locate the judicial development as specifically one of anti-avoidance. As noted earlier, one reading of *Ramsay* was that the court was simply engaging in normal statutory construction rather than developing a tax avoidance principle.

Both *Ramsay* and *Burmah Oil* concerned self-cancelling schemes, but the House of Lords had the opportunity of considering the application of the new approach in a linear transaction in *Furniss v Dawson*,[104] and the dicta in this case continue to indicate that the judges perceived themselves as developing a judicial anti-avoidance approach. Lord Brightman in particular appeared to counsel the operation of a "step approach" when the composite transaction contained tax avoidance steps, excising the inserted tax avoidance steps.[105]

There was some concern expressed that judges may have strayed into a constitutional area which was prohibited to them[106] and in *Craven v*

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[100] Lord Wilberforce at 187 F.

[101] At 185 A.

[102] *Burmah Oil Co Ltd v IRC* (1982) 54 TC 200.

[103] Per Lord Diplock at 214. See also Lord Scarman at 222, "it is of the utmost importance that the business community (and others, including their advisers) should appreciate ... that Ramsay's case marks "a significant change in the approach adopted by this House in its judicial role" towards tax avoidance schemes."

[104] *Furniss v Dawson* (1984) 55 TC 324.

[105] *Furniss v Dawson* per Lord Brightman (1984) 55 TC 324 at 401. See also Lord Scarman at 389.

[106] E.g. Bartlett "The constitutionality of the Ramsay Principle" [1985] BTR 338, The Rt Hon. Lord Oliver of Aylmerton, "A Judicial View of Modern Legislation" (1993) 14 Statute L.R. 1.

White,[107] 4 years later, the entire bench were at pains to stress that what they were doing was engaging in a process of statutory interpretation rather than applying a judge made anti-avoidance principle. Despite these statements, when the bench come to deal with the case, it does appear that they consider the facts and then engage in a process of excisement to find the "end result", rather than looking particularly at the words of the statute. However, one thing which was made clear in *Craven* was that there is no *general* principle that a tax benefit should be denied to those who engage in transactions merely for tax avoidance purposes.[108] In *Craven,* the taxpayers were successful as the House decided that there much be a very close relationship between the different steps before the approach could apply – a level of pre-ordainment amounting to a "practical certainty" that the later steps would follow the first.

The process of elaborating the approach as one of statutory construction continued to be emphasised in the judicial opinions, whilst, on the whole, cases in which the principle was cited appeared more concerned with an analysis of the facts rather than interpretation of the statutory provision. In 2001, in *Westmoreland Investments Ltd v MacNiven*,[109] the House of Lords engaged in a revisionist analysis, downgrading the line of cases of *Ramsay* et seq from a "principle" to a "useful aid."[110] Lord Hoffmann explained that there is no useful distinction between acceptable tax mitigation and unacceptable tax avoidance unless the term is used in the statute:

> The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not.[111]

The same judge then introduced a distinction, which proved to be short-lived, between statutory terms which were "commercial" and those which were "legal." In dealing with the application of a commercial term of a statute to the transaction in hand, the existence or otherwise of a tax avoidance motive is relevant in determining whether what has happened falls within that term, properly construed. On the other hand, if the term under consideration is a legal term then it is simply a question of asking what actually happened. There was no guidance given as to whether a particular term was to be adjudged to be legal or commercial. The distinction, as indicated earlier, was short-lived. In *Barclays Mercantile Business Finance Ltd v Mawson* [*BMBF*] it was abandoned.[112] However, the mantra that the

[107] *Craven v White* (1988) 62 TC 1.

[108] E.g. per Lord Oliver at 193.

[109] [2001] UKHL 6.

[110] *Westmoreland,* Per Lord Nicholls at 8.

[111] Lord Hoffmann at 62.

[112] *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51.

courts were simply engaging in statutory construction was repeated, and Lord Hoffman himself, writing extra-judicially, concluded:

> The primacy of the construction of the particular taxing provision and the illegitimacy of rules of general application has been reaffirmed by the recent decision of the House in [*BMBF*]. Indeed it may be said that this case has killed off the *Ramsay* doctrine as a special theory of revenue law and subsumed it within the general theory of the interpretation of statutes ...[113]

Once again though, one cannot ignore the attention given to the facts in the case. Ribeiro P.J.'s statement in *Arrowtown*[114] was quoted in *BMBF* with approval:

"The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically." Purposive construction, identified here as the first task of the judge, can be difficult and often particularly so in tax statutes which are mired in detail and technicalities. However, it is a normal part of the judicial function. It is the second part of the quote which is harder to absorb under the revisionist approach. What is a "realistic" view of facts and when should it be engaged? How many views of "facts" can there be?

Freedman concludes post-*BMBF* that:

> UK case law has failed to provide coherent guidance for dealing with tax avoidance. The House of Lords has admitted that all attempts at clarification have only raised fresh doubts and further appeals. The latest opinions in [*BMBF*] will not have ended this cycle, denying as they do the existence of a judicial doctrine of revenue law but apparently applying a strengthened version of the *Ramsay* principle on the very same day. Under the guise of purposive statutory interpretation the courts are making distinctions based not on the wording of the statute in context, but on external, policy considerations.[115]

The twenty or so years of judicial decision making after *Ramsay* were described by John Tiley as a period of "struggle, experiment and semi-rational limitations"[116] but it might appear that the courts have come full circle. After more than two decades of judicial decision making the position can be summarized as follows:

- There is no specific judicial anti-avoidance rule – it is all a matter of construction of statute.
- Unless the courts are dealing with a piece of anti-avoidance legislation which operates a motive test, using the expression "tax avoidance" or something similar, the courts do not have to engage in any consideration of the term.

[113] Hoffmann "Tax Avoidance" 2005 BTR 197.

[114] *Collector of Stamp Revenue v Arrowtown Assets Ltd* 2003 HKCFA 46.

[115] Freedman "Interpreting tax statutes: tax avoidance and the intention of Parliament" 2007 LQR 53.

[116] Tiley "Tax avoidance jurisprudence as normal law" 2004 BTR 304.

16.10 Disclosure Rules

In 2004, the UK government introduced rules requiring the disclosure of tax avoidance schemes (DOTAS) in order to receive earlier intelligence on what is being offered in the market, to enable them to take steps to close down schemes more quickly. There can be rather a long time before defective legislation can be rectified if HMRC have to wait until self assessment returns reveal a new scheme. The disclosure regulations allow for a speedier response. Typically, where a scheme has been disclosed, the Financial Secretary to the Treasury will announce that anti-avoidance provisions will be contained in the next Finance Act, although they usually come into effect from the date of the announcement. Such an announcement can be made within a few days of receiving notification of a scheme. There is normally sufficient detail given in the announcement of the scope of the anti-avoidance legislation in order to avoid the charge of uncertainty and retrospectivity, and the announcement is frequently accompanied by draft legislation.

Initially, the direct tax disclosure regulations applied only to employment schemes and certain financial products,[117] but stamp duty land tax was added in 2005[118] and the regime was extended significantly in 2006 to cover all income tax, corporation tax and inheritance tax.[119] Also in 2006, the disclosure regime moved from a series of filters, designed to ensure that normal tax planning was not affected, to a "hallmark" system. A similar regime was introduced in relation to national insurance contributions in 2007.[120]

Under the current system, a tax arrangement must be notified[121] if it comes within regulations made by the Treasury and if:

- it will, or might be expected to, enable any person to obtain a tax advantage
- that tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement, and
- any of the following hallmarks are present:
  - wishing to keep the arrangements confidential from a competitor
  - wishing to keep the arrangements confidential from HMRC
  - arrangements for which a premium fee could reasonably be obtained
  - arrangements that include off market terms

[117] SI 2004/1863 (now repealed), /1864 and /1865.

[118] SI 2005/1868. At present these only apply to commercial property but will be extended to residential property from 2010.

[119] SI 2006/1543.

[120] SI 2007/785.

[121] FA 2004 s 306.

- arrangements that are standardised tax products
- arrangements that are loss schemes
- arrangements that are certain leasing arrangements
- arrangements for certain pension benefits.

The obligation to disclose the scheme lies with the promoter of the scheme, unless the promoter is not UK resident, in which case it is on the user.[122] The definition of promoter is wider than those who market pre-packaged schemes and applies also to professional advisers.[123] The promoter is required to give details of the scheme on a specified form, including how it is expected that it works, and will be allocated a reference number which must be included on the tax return of any taxpayer who uses the scheme. The current rules require that the scheme is disclosed, broadly, at the point at which the promoter makes the scheme available for implementation.[124] There is evidence that promoters are developing schemes, lining up potential clients and then releasing the scheme to them, all on the same day, in order to maximise the coverage of the scheme before it is closed. HMRC are seeking to bring forward the obligation to notify to the date on which the scheme is developed in sufficient detail and clients are made aware of its existence.

There is also a requirement that the taxpayer disclose a scheme with similar characteristics if he has designed it himself.[125] The numbers of schemes disclosed each 6 month period are reported by HMRC. By September 2009, nearly 2,000 disclosures[126] had been made, distributed between the different taxes as follows:[127]

Financial	Employment	Main regime (incl NIC)	SDLT	VAT	Total
465	198	483 (29 NIC)	796	886	2,828

The rate of disclosure would appear to be slowing down (150 reports of direct tax schemes reported between September 2008 and 2009 and only 9 reports of VAT schemes), which might suggest that the obligation to disclose is acting as a disincentive to create new schemes. This conclusion is bolstered by the impression of practitioners. Despite initial concern that these regulations would affect relatively low-key tax planning, after the

[122] FA 2004 s 309.
[123] FA 2004 s 307.
[124] FA 2004 s 308.
[125] FA 2004 s 310.
[126] These are the number of disclosures rather than the number of schemes. More than one person might disclose the same scheme.
[127] http://www.hmrc.gov.uk/avoidance/avoidance-disclosure-tatistics.htm.

first 2 years of operation at least there appears to have been a remarkable degree of acceptance by those advising taxpayers, and some evidence that more aggressive tax planning devices had very much reduced.[128] The HMRC concludes in a consultation document in 2009: "There is considerable anecdotal evidence that DOTAS has changed the economics of avoidance."[129] However, schemes do continue to emerge: on 9 December 2009 for example, 11 new schemes were closed with immediate effect.[130]

VAT has had its own regime since 2004, which requires the registered trader to make disclosure of any "designated" or "notifiable" scheme.

A scheme is designated if it involves:

- the first grant of a major interest in a building
- payment handling services
- value shifting
- leaseback agreements
- extended approval periods
- groups and third party suppliers
- education and training by a non-profit making body
- education and training by a non-eligible body
- cross-border face-value vouchers, or
- a surrender of a relevant lease

A scheme is notifiable if it has one of the listed hallmarks, which are:

- confidentiality agreements
- agreements to share a tax advantage
- contingent fee agreements
- prepayments between connected parties
- funding by loans, share subscriptions or subscriptions in securities
- off-shore loops
- property transactions between connected persons, and
- issue of face-value vouchers

[128] Evidence given to the House of Lords Select Committee on Finance Bill 2006, para 15–20. http://www.publications.parliament.uk/pa/ld200506/ldselect/ldeconaf/204/20405.htm.

[129] HMRC consultation document "Disclosure of tax Avoidance Schemes (DOTAS)" 9 December 2009.

[130] In the 2009 Pre-budget report: http://www.hm-treasury.gov.uk/prebud_pbr09_press03.htm

16.11 Disclosure Penalty Regime

The penalty regime[131] for those who deliberately fail to disclose is regarded as inadequate as it is limited to an initial penalty of up to £5,000 and penalties of up to £600 per day for continued failure to disclose after the initial penalty. Although the numbers of those who have been identified as deliberate non-disclosures is small (identified as six in the first 6 years of operation), HMRC is seeking an increase to the level of penalty on the basis that promoters have an economic incentive to continue to market their schemes and simply pay the penalty when discovered.

Promoters who fail to give a registration numbers to their client will be liable to a maximum penalty of £5,000. Taxpayers who fail to show scheme registration numbers on returns will be liable to an initial penalty of £100 rising to £500 for subsequent failures.

HMRC list certain avoidance schemes of which they are aware and which they believe do not work, advertising that they intend to challenge them in the courts when they appear. At 1 April 2010, there are eight areas listed.[132]

16.12 Professional Ethics

The professional bodies of tax advisers[133] have a common position on tax avoidance, namely that it is acceptable, but that the tax advisers should be aware of his or her legal responsibilities to disclose information. Typical of the advice is this:

> 2.17 Tax avoidance is legal and is to be distinguished from evasion which is illegal. All taxpayers have the right to arrange their affairs under the law to minimize their liability to tax. The member should consider carefully the merits of arrangements which may be considered artificial by the tax authority concerned. Such schemes should be considered in the light of the client's wider interests because of the risk that they may be challenged by the tax authorities. A scheme which depends fundamentally on concealment from the tax authorities may very well amount to tax evasion, or at least may be viewed in that light by the tax authorities.[134]

[131] SI 2007/3104.

[132] http://www.hmrc.gov.uk/avoidance/spotlights.htm.

[133] The Chartered Institute of Taxation, the Association of Taxation Technicians, The Institute of Indirect Taxation, The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Association of Chartered Certified Accountants.

[134] This is from the professional conduct guidelines issued by ICAEW to their members, available at http://www.icaew.com/index.cfm/route/142673/icaew_ga/Technical_and_Business_Topics/Faculties/Publications_and_technical_guidance/TAXGUIDE_7_06_Professional_Conduct_in_Relation_to_Taxation/doc .

16.13 Tax Shelters

There is no approach in the UK which specifically attacks tax shelters, except to the extent mentioned earlier.

16.14 Reform

Each year, HMRC produce a document produced on protecting tax revenues. In the 2009 document, tackling avoidance was identified by HMRC as an important part of dealing with the "tax gap"[135] and four ways of doing this were identified: the disclosure regime, highlighting areas regarded as vulnerable to judicial challenge (the "spotlights" system mentioned earlier), working with foreign tax jurisdictions and using "principles based" anti-avoidance legislation. The principles based approach has only been used on a handful of occasions so far, following extensive consultation. It is too soon to make a judgment on its success, but it is clear that it is now intended to be used, where appropriate, in subsequent anti-avoidance legislation.[136]

There have been several high-profile instances recently of international companies moving headquarters outside the UK, complaining not just about the levels of taxation in the UK but the tax environment in general. It is apparent that the UK is concerned that its tax system might be driving industry away and there is obviously a tension between the uncertainty that anti-avoidance rules tend to create (whether statutory or judicial) and the desire to protect revenues.[137] How it manages this tension is likely to remain high on the agenda.

[135] HMRC "Protecting Tax Revenues 2009." Whilst acknowledging that the figures are not based on robust data, it is estimated that the tax gap in the UK is 8% of total revenue, of which 17.5% is attributable to "avoidance." The tax gap is defined as the difference between the tax collected the theoretical tax liability, which is "the tax that would be paid if all individuals and companies complied with both the letter of the law and HMRC's interpretation of the intention of Parliament in setting law (referred to as the spirit of the law). This includes unpaid tax, and tax not collected when HMRC's interpretation of the law is successfully challenged." Not all states include tax avoidance in their definition of the tax gap.

[136] In the areas of financial products avoidance, the transfer of income streams, foreign profits dividend exemptions.

[137] A consultation document was issued in March 2008, "Simplifying anti-avoidance legislation."

Chapter 17
United States

Tracy A. Kaye

17.1 Introduction

In the United States, the line that divides tax "avoidance" and tax "evasion" is legality.[1] The term tax "avoidance" denotes taxpayer activity aimed at decreasing tax liability within the bounds of the law.[2] The label is often applied to the reduction of taxes as a result of loopholes in the law, unintended by the drafters of the Internal Revenue Code ("Code")[3] or the income tax regulations.[4] Tax "evasion," however, denotes a diminution in tax liability through direct violation of the law.[5] In the criminal context, the

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[1] Tracy Kaye and Stephen Mazza, *Tax Evasion and Tax Avoidance in the United States, in* SHARING INFORMATION ACROSS BORDERS IN INDIRECT AND DIRECT TAX, 73–91 (Servaas van Thiel, ed., 2011).

[2] Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 954 n.1 (2004); *see also* Tracy A. Kaye, *The Regulation of Corporate Tax Shelters in the United States*, 58 AM. J. COMP. L. 585, 588 (2010) for a summary of this report. This version has been updated to take into account new developments.

[3] Most enacted tax legislation is codified as part of the Internal Revenue Code ("I.R.C."), which is Title 26 of the United States Code. The current Code is entitled the "Internal Revenue Code of 1986."

[4] Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 328–332 (2002); *see also* Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 703–704 (2009).

[5] Likhovski, *supra* note 2, at 954 n.1.

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Code broadly describes tax evasion as a "willful[] attempt[] in any manner to evade or defeat any tax."[6]

The boundary between avoidance and evasion is blurred[7] by the general and often-used label "tax shelter."[8] Tax shelter investments, which parties employ to generate losses, credits, and other tax benefits, typically involve innovative financial instruments, tax-indifferent parties, or extremely complex business structures.[9] The widespread use of potentially illegal tax shelters had become a profitable business for accounting firms, investment banks, and law firms across the United States in the 1990s.[10] According to many commentators, the international tax arena remains rife with such exploitation.[11] Current estimates suggest that the U.S. loses $100 billion annually in tax revenues due to international tax abuses.[12] Not only do abusive tax shelters cost the U.S. government much in lost revenue, their use also weakens public trust in the tax system.[13] The Senate Finance Committee has referred to abusive tax shelters as the U.S.'s "most significant tax compliance problem."[14]

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[6] I.R.C. § 7201 (2011); *see also* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 7A.02[1][a] (rev. 2d. ed. 2002–2006).

[7] Likhovski, *supra* note 2, at 954 n.1; *see also* Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 524 (1989) (distinguishing between "abusive" and "legitimate" transactions); Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 55–57 (2001) (distinguishing between tax practitioners and tax shelter practitioners).

[8] *See* CAMILLA E. WATSON and BROOKES D. BILLMAN, JR., FEDERAL TAX PRACTICE AND PROCEDURE: CASES, MATERIALS AND PROBLEMS 542 (2005).

[9] *See* I.R.S. Notice 2004-67, 2004-2 C.B. 600; *see also* Deborah H. Schenk, *Symposium on Corporate Tax Shelters, Part I: Foreword*, 55 TAX L. REV. 125 (2002).

[10] NORM COLEMAN and CARL LEVIN, PERMANENT SUBCOMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY REPORT, at 6 (Comm. Print 2005).

[11] *See, e.g.,* Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169 (2007–2008).

[12] STAFF OF S. COMM. ON HOMELAND SEC. & GOV. AFF., PERM. SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REPORT ON TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 1 (2008), *available at* http://hsgac.senate.gov/public/_files/071708PSIReport.pdf; *see also* JANE G. GRAVELLE, CONG. RESEARCH SERV., TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 1 (2010), *available at* http://assets.opencrs.com/rpts/R40623_20100604.pdf.

[13] WATSON and BILLMAN, JR., *supra* note 8, at 542; *see also* S. Rep. No. 99-313, at 714 (1986) ("Extensive shelter activity contributes to public concerns that the system is unfair and to the belief that tax is paid only by the naïve and the unsophisticated.").

[14] STAFF OF S. COMM. ON THE JUDICIARY, 109TH CONG., THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY 3 (Comm. Print 2005); *see also Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing about It?: Hearing Before the S. Comm. on Finance*, 108th Cong. 3 (2003) (statement of Sen. Carl Levin, Ranking Member, Permanent Subcommittee on Investigations).

"Tax shelters" can be legal, and constitute "tax avoidance," or illegal, and constitute "tax evasion."[15] Either way they contribute to the federal budget deficit. In tax year 2001, the Internal Revenue Service ("IRS") estimated "that abusive corporate tax shelters contributed $10–15 billion of the $30 billion in unreported . . . corporate income taxes."[16] Thus, the large current and projected federal budget deficits have generated much legislative and executive branch interest in raising revenue by closing such "tax loopholes" or reducing the tax gap through further restrictions on tax shelters.[17]

17.2 Regulation of Tax Avoidance – In General

The English common law tradition formed the foundation for the legal system in the American colonies and became the basis for the American justice system governed by the United States Constitution.[18] The United States Constitution establishes a national government and allocates authority to three branches: the legislative power is vested in Congress; the executive power in the President; and the judicial power in the Supreme Court of the United States, as well as the inferior courts created by Congress.[19] In the American common law system, lawmaking is not delegated entirely to one particular branch of government.[20] No one branch dominates the process; consequently, American laws are affected by statutory changes, regulatory guidance, and judicial decisions.[21] This is particularly true in the regulation of tax avoidance where all three branches of government have played a role. Furthermore, the common law system affords U.S. courts

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[15] Jane G. Gravelle, Cong. Research Serv., Major Tax Issues in the 111th Congress 11 (2008).

[16] James M. Bickley, Cong. Research Serv., Tax Gap, Tax Enforcement, and Tax Compliance Proposals in the 111th Congress 6 (2009). 2001 was the most recent year for which data was available. *Id.*

[17] *Id.* at 1. The IRS defines the tax gap "as the aggregate amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely. True tax liability for any given taxpayer means the amount of tax that would be determined for the tax year in question if all relevant aspects of the tax law were correctly applied to all of the relevant facts of that taxpayer's situation." U.S. Dep't of the Treasury, Internal Revenue Service, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance 6 (2007), *available at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

[18] Lawrence M. Friedman, American Law: An Introduction 31, 64 (rev. ed. 1998). Louisiana, a former French colony, is the exception to this statement as its state legal system is based on French civil law traditions. *Id.* at 60.

[19] Erwin Chemerinsky, Constitutional Law: Principles and Policies 1 (3d ed. 2006).

[20] *See* Laurence H. Tribe, American Constitutional Law 136–141 (3d ed. 2000).

[21] Roger H. Davidson, Walter J. Oleszek and Frances. E. Lee, Congress and its Members 293–94 (12th ed. 2010); *see also* Chemerinsky, *supra* note 19, at 30–31.

broad interpretive powers when reviewing a law, in contrast to the civil law tradition of narrow judicial interpretation.[22]

No other topic in the tax realm has sparked more controversy and commentary than the subject of corporate tax shelters.[23] Even with decades of legislation specifically focused on shutting down corporate tax shelters, some tax advisors continue to create ingenious plans to exploit any tax law inconsistencies including those still remaining between the financial accounting and tax treatment of certain transactions.[24] Most of the legislative reforms with respect to corporate tax shelters have targeted specific transactions on a prospective basis.[25] For example, Congress responded to contingent liability shelter transactions[26] by enacting section 358(h) in 2000.[27] Contingent liability shelters involved the transfer of a high basis asset to a corporation in exchange for stock and the corporation's assumption of a contingent liability.[28] Section 358(h) largely eradicated contingent liability shelters by requiring that a taxpayer reduce the basis of the stock received in the transfer by the amount of any liability assumed by the party as part of the transaction.[29] Thus, the sale of that stock no longer accelerates and duplicates the loss or deduction.[30]

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[22] Michael Rosenfeld, *Constitutional Adjudication in Europe and the United States: Paradoxes and Contrasts*, 2 INT'L J. CONST. L. 633, 634 (2004); *see also* TRIBE, *supra* note 20, at 210–211, n.11.

[23] There is even a *New York Times* best seller written about the topic. *See* DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH-AND CHEAT EVERYBODY ELSE (2003).

[24] *See generally* Daniel Shaviro, *The Optimal Relationship between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423 (2009).

[25] Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of* Long Term Capital Holdings v. United States, 3 BERKELEY BUS. L.J. 381, 384 (Fall 2006) [hereinafter Keinan, *Aftermath of* Long Term Capital Holdings]; *see also* Marvin Chirelstein and Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951–1952 (2005) (suggesting that the complexity of modern tax shelters is what prevents Congress from proscribing them).

[26] *See, e.g.,* Black and Decker Corp. v. United States, 436 F.3d 431, 431 (4th Cir. 2006).

[27] Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309(a), 114 Stat. 2763, 2763A-638 (2000).

[28] I.R.S. Notice 2001-17, 2001-1 C.B. 730.

[29] I.R.C. § 358(h) (2011). Ordinarily, basis would be reduced under section 358(d) but there is an exception for situations where the assumed liability is contingent or excluded under section 357(c)(3) (liabilities where payment gives rise to a deduction). The required stock basis step-down does not apply where the trade or business with which the liability is associated or substantially all of the assets with which the liability is associated are transferred to the party assuming the liability as part of the transaction. I.R.C. § 358(h)(2).

[30] *See* Christopher H. Hanna, *From Gregory to Enron: The Too Perfect Theory and Tax Law,* 24 VA. TAX REV. 737, 788 (2005).

In the international arena, Congress has also been vigilantly terminating specific abusive transactions on a prospective basis. In August 2010, Congress added section 909 to the Code[31] in response to a technique known as "foreign tax credit splitting."[32] In general, U.S. corporations are taxed on their worldwide income but may elect to take a credit for the foreign income taxes paid on their foreign source income in order to reduce any double taxation on their foreign source income.[33] Companies were "splitting" the credit by structuring transactions to delay U.S. taxation on the foreign-source income giving rise to the credit (often through the use of multiple subsidiaries), while currently claiming the foreign tax credit to lower their U.S. tax liability.[34] Section 909 provides a matching rule to pair the usage of the foreign tax credit with the taxation of the associated foreign income.[35] Thus, when there is a foreign tax credit splitting event, recognition of the foreign tax credit is suspended until the related income is accounted for in the U.S. by the same taxpayer who paid or accrued the taxes.[36]

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[31] Education Jobs and Medicaid Assistance Act, Pub. L. No. 111-226, § 211, 124 Stat. 2389, 2394–2396 (2010).

[32] *See* Marie Sapirie and Kristen A. Parillo, *A Guide to The New Foreign Tax Credit Rules And Other Revenue Raisers*, 128 TAX NOTES 814 (2010). A splitting event occurs when foreign taxes and the associated income are allocated to different but related persons. *See* Rebecca Rosenberg, *New Foreign Tax Credit Anti-Splitting Rule*, 129 TAX NOTES 701 (2010).

[33] *See* I.R.C. § 901(a) (2011). The credit may not exceed the pre-credit U.S. tax on income from foreign sources. *See* I.R.C. § 904(a).

[34] *See, e.g.,* Guardian Industries Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007) (corporation entitled to a foreign tax credit where it utilized foreign taxes paid by a hybrid entity holding company, even though the income that related to the tax was earned by other members of the affiliated group). Section 909 would change the result in *Guardian Industries* to delay the allowance of the foreign tax credit until the foreign source income was taken into account for U.S. tax purposes. CHARLES H. GUSTAFSON, ROBERT J. PERONI and RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXTS AND PROBLEMS ¶ 5,010 (4th ed. 2011); *see also* Sapirie and Parillo, *supra* note 32, at 814.

[35] I.R.C. § 909(a) (2011). Section 909 applies for tax years beginning in 2011. STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE SENATE AMENDMENT TO THE HOUSE AMENDMENT TO THE SENATE AMENDMENT TO H.R. 1586, SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON AUGUST 10, 2010, 6–7 (2010) [hereinafter TECHNICAL EXPLANATION OF H.R. 1586].

[36] I.R.C. § 909(a); *see also* TECHNICAL EXPLANATION OF H.R. 1586, *supra* note 35, at 4. Section 902 and 960 credits are subject to a slightly different rule. *See* Rosenberg, *supra* note 32, at 701. In December, 2010, Treasury provided guidance on the application of section 909 by publishing an exclusive list of arrangements that would give rise to a splitting event for pre-2011 tax years. I.R.S. Notice 2010–92, 2010–2 C.B. 916. The Treasury Department anticipates publishing more guidance with respect to section 909 in the future. *Id.*

As discussed further in Part II, the United States has finally enacted a limited form of a general anti-avoidance rule. There had been at least five bills introduced in the 111th Congress that included an economic substance doctrine codification proposal.[37] On March 30, 2010, President Obama signed the final piece of health care reform legislation, the Health Care and Education Reconciliation Act of 2010 ("HCERA" or "2010 health care legislation"),[38] which was funded in part by codification of the economic substance doctrine.[39] The provision codifying the doctrine applies to transactions entered into after March 30, 2010.[40] This legislation marks the culmination of many proposals to codify the doctrine over the last decade.

Regulatory guidance can also target specific abuses.[41] The anti-conduit regulations provide an administrative "substance-over-form" response to international corporate tax avoidance.[42] Section 7701(l) authorizes the Treasury Department to promulgate regulations recharacterizing a

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[37] *See, e.g.,* Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. (2009); Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009); H.R. 2979, 111th Cong. (2009); S. 1309, 111th Cong. (2009); and H.R. 3200, 111th Cong. (2009). No votes were taken on these bills except that the economic substance provisions included in H.R. 3200 were adopted by the House Ways and Means Committee in a markup on July 16, 2009. STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., DESCRIPTION OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, PART TWO: BUSINESS TAX PROVISIONS 37 (Comm. Print 2009) [hereinafter REVENUE PROVISIONS IN 2010 BUDGET].

[38] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010) [hereinafter HCERA]. This Act amends certain aspects of the Patient Protection and Affordable Care Act of 2010.

[39] *Id.* § 1409. The Joint Committee on Taxation estimated that the provision would raise $4.5 billion over ten years. STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATED REVENUE EFFECTS OF THE AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 4872, THE "RECONCILIATION ACT OF 2010," *AS AMENDED*, IN COMBINATION WITH THE REVENUE EFFECTS OF H.R. 3590, THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT ('PPACA')," AS PASSED BY THE SENATE, AND SCHEDULED FOR CONSIDERATION BY THE HOUSE COMMITTEE ON RULES ON MARCH 20, 2010 3 (COMM. PRINT 2010).

[40] HCERA, *supra* note 38, § 1409(e)(1); STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," *AS AMENDED*, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT 156 (Comm. Print 2010) [hereinafter 2010 RECONCILIATION ACT EXPLANATION].

[41] The U.S. Treasury Department and the Internal Revenue Service, an administrative agency within the Treasury Department, have authority to issue rules and pronouncements to aid in the interpretation of the Code. In general, courts give deference to the regulations promulgated by the Treasury, although they have on occasion invalidated regulations. LEANDRA LEDERMAN and STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE 32 (3d ED. 2009) [hereinafter LEDERMAN and MAZZA].

[42] These regulations were promulgated in 1995, after several cases in which corporations attempted to engage in treaty shopping by inserting intermediary entities into a transaction in order to reduce or eliminate U.S. tax liability. *See, e.g.,* Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971).

financing transaction with multiple parties as a transaction directly between two parties when necessary to prevent tax avoidance.[43] For example, Treasury Regulation section 1.881–3 may preclude foreign taxpayers from using an intermediate entity in a financing arrangement to obtain favorable tax treatment in the United States.[44] Under these regulations, an intermediate entity will be considered a conduit entity, and thus ignored for tax purposes, if three factors are present: (1) the "participation of the intermediate entity … reduces the tax imposed by section 881";[45] (2) the intermediate entity is participating in the arrangement as part of a tax avoidance plan;[46] and (3) either the "intermediate entity is related to the financing entity or the financed entity" or the "intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that" the financing party engaged in the transaction with the intermediate.[47]

These regulations may come into play in situations involving the tax avoidance technique of "treaty shopping." "Treaty shopping" occurs when foreign taxpayers investing or doing business in the United States arrange transactions in such a way as to take advantage of a favorable income tax treaty either because their home country has no treaty with the U.S. or they prefer the terms of a treaty negotiated by another country.[48] If a U.S. corporation wants to borrow from a foreign lender in a jurisdiction without a U.S. treaty, absent the anti-conduit regulations, it might be advantageous to structure the deal through an intermediary in a jurisdiction

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[43] I.R.C. § 7701(l) (2011). In 2011, the Supreme Court opined on the appropriate level of deference to be given to tax regulations. Mayo Found. for Med. Educ. v. United States, 131 S. Ct. 704, 714 (2011). The U.S. Supreme Court held that courts should review Treasury Regulations under the *Chevron* standard, which applies a two-part inquiry: (1) whether Congress has directly addressed the precise issue in question; and (2) if it has not (i.e. the statute is ambiguous), "whether the agency's answer is based on a permissible construction of the statute." *Id.* at 712 (quoting Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 843 (1984)).

[44] Treas. Reg. § 1.881-3(a)(1) (1995).

[45] Treas. Reg. § 1.881-3(a)(4)(i)(A) (1995). Section 881 imposes a 30 percent tax on U.S.-sourced income "not effectively connected with the conduct of a trade or business within the United States." *See* I.R.C. § 881(a) (2011).

[46] Treas. Reg. § 1.881-3(a)(4)(i)(B) (1995).

[47] Treas. Reg. § 1.881-3(a)(4)(i)(C) (1995). The regulations also provide a series of factors which will determine whether there is a tax-avoidance purpose to the transaction. Treas. Reg. § 1.881-3(b)(2) (1995). These factors look at the characteristics of the transaction and the entities, such as whether the conduit would have been able to make an advance without advances from the financing company, whether the section 881 tax reduction is "significant," the period of time between the respective transactions, and whether the transactions occurred in the ordinary course of business. *Id.*; *see also* GUSTAFSON, PERONI and PUGH, *supra* note 34, ¶ 4,095.

[48] *See* GUSTAFSON, PERONI and PUGH, *supra* note 34, ¶ 4,055.

with a favorable treaty.[49] If the anti-conduit regulations are applied, the conduit would essentially be ignored for tax purposes, such that payments in the scenario described above would be deemed paid directly by the foreign lender. Thus, the advantageous tax treaty with the jurisdiction of the intermediary would not be applied to the transaction.[50]

In 2008, the Treasury Department published regulations designed to prevent abuse of the foreign tax credit.[51] These regulations were promulgated to combat arrangements known as foreign tax credit generator transactions that create improper foreign tax credits, thereby depleting United States tax revenue.[52] Specifically, the regulations seek to prevent certain transactions that use a structured passive investment arrangement ("SPIA") to exploit the differences between the foreign tax credit rules in foreign countries and the United States.[53] The regulations provide a six part test to determine whether a particular arrangement constitutes an SPIA.[54] A payment made to a foreign government that is attributable to an SPIA will not be considered compulsory, and thus, will not give rise to a foreign tax credit.[55] The IRS continues to aggressively attack foreign tax credit generator transaction abuses in its efforts to limit corporate tax avoidance.[56]

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[49] For example, Treasury Regulation section 1.1441–6 allows nonresidents to receive a reduced rate of withholding to a level specified by treaty. Ordinarily, sections 1441 and 1442 would require the U.S. payor of interest to withhold 30 percent of the amount paid from U.S. sources.

[50] *See generally* GUSTAFSON, PERONI and PUGH, *supra* note 34, ¶ 4,095.

[51] T.D. 9416, 2008-2 C.B. 1142; *see also* Notice 2004-19, 2004–1 C.B. 606 (describing the strategy to be employed by the Treasury in dealing with foreign tax credit abuse).

[52] *See* T.D. 9416, 2008-2 C.B. 1142. It has been estimated that $3.5 billion in U.S. tax revenue is at stake in foreign tax credit generator transactions. Achim Pross and Raffaele Russo, *OECD Disclosure Initiatives on the Rise*, 61 TAX NOTES INT'L 744, 744 (2011).

[53] *See* Temp. Treas. Reg. § 1.901-2T (2008); *see also* Roberto P. Vasconcellos and H. David Rosenbloom, *Measuring a Foreign Tax Credit Generator Transaction Against the Codified Economic Substance Doctrine*, 60 TAX NOTES INT'L 119, 122 (2010).

[54] Temp. Treas. Reg. § 1.901-2T(e)(5)(iv)(B)(1)-(6) (2008). The regulations provide that an arrangement will constitute an SPIA if: (1) the arrangement is a special purpose vehicle ("SPV"); (2) a domestic taxpayer would be eligible to claim a foreign tax credit from the transaction; (3) the foreign tax payments attributed to the domestic taxpayer substantially exceed the foreign taxes they would have received had the attribution of foreign tax payments been based on the domestic taxpayer's direct ownership interest of the SPV; (4) the arrangement results in a foreign tax benefit for a counterparty or taxpayer related to the counterparty; (5) the arrangement involves a counterparty, as defined by the regulations; and (6) the U.S. and other foreign country treat the arrangement differently, permitting the domestic taxpayer to recognize a "materially" lower amount of income or claim a materially larger amount in tax credits. *See id.*

[55] Temp. Treas. Reg. § 1.901-2T(e)(5)(iv) (2008) ("[A]n amount paid to a foreign country . . . is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable . . . to a structured passive investment arrangement . . .").

[56] Internal Revenue Service, LMSB Tier I Issue Foreign Tax Credit Generator Directive – Revision 1, Feb. 19, 2009, *available at* http://www.irs.gov/businesses/article/0,,id=204526,00.html (providing guidance on foreign tax credit generators and declaring

U.S. taxpayers may arrange their affairs in such a manner to ensure that their taxes are as low as possible, but must do so within the boundaries of the law.[57] The Internal Revenue Service, however, may assess a deficiency if it disputes the correctness of the taxpayer's tax return.[58] Taxpayers disagreeing with this assessment of tax liability may pursue litigation in the federal district courts, the Court of Federal Claims, or the United States Tax Court.[59]

The courts have been policing abuses of the Code since 1934 as reflected in the landmark case of *Gregory v. Helvering*,[60] where both the Second Circuit and the Supreme Court interpreted a corporate tax reorganization statute as "implicitly requiring a business purpose."[61] Despite originating in the context of corporate reorganization statutes, the business purpose doctrine "has evolved to become an implied requirement of many other statutory provisions."[62] Although U.S. tax law is primarily a statutorily based system, there are important common law aspects that substantially affect the outcomes of tax controversies.[63] There are several doctrines the judiciary employs when assessing whether a taxpayer has participated in unacceptable tax avoidance or acceptable tax mitigation. These common law doctrines have been developed to "disallow certain tax advantages not contemplated by the literal words expressed in a statute."[64]

The judicial doctrines that courts have developed over time are often a result of the courts' responses to attempts on the part of taxpayers to

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them a Tier I issue within the IRS). "Tier I issues are of high strategic importance to LMSB and have significant impact on one or more industries." Internal Revenue Service, Internal Revenue Manual § 4.51.5.1, *available at* http://www.irs.gov/irm/part4/irm_04-051-005.html.

[57] Christopher M. Pietruszkiewicz, *Economic Substance and the Standard of Review*, 60 ALA. L. REV. 339, 370 (2009).

[58] *See* LEDERMAN and MAZZA, *supra* note 41, at 91.

[59] Stephen W. Mazza and Tracy A. Kaye, *Restricting the Legislative Power to Tax in the United States*, 54 AM. J. COMP. L. 641, 645 (2006); *see generally* Thomas D. Greenaway, *Choice of Forum in Federal Civil Tax Litigation*, 62 TAX LAW. 311 (2009).

[60] 293 U.S. 465 (1935), *aff'd* 69 F.2d 809, 810 (2d Cir. 1934). The Court held in *Gregory* that the transfer of the original corporation's assets to its sole shareholder did not qualify as a reorganization, as it was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character." *Id.* at 469.

[61] Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 393 (2010).

[62] Martin McMahon, *Comparing The Application of Judicial Interpretative Doctrines To Revenue Statutes On Opposite Sides of The Pond*, *in* COMPARATIVE PERSPECTIVES ON REVENUE LAW: ESSAYS IN HONOUR OF JOHN TILEY 40, 57–59 (John Avery Jones et al. eds., 2008) (citing Knetsch v. U.S., 364 US 361 (1960), Goldstein v. Commissioner., 364 F.2d 734 (2d Cir. 1966), *cert. denied,* 385 U.S. 1005 (1967)).

[63] Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 11 (2000).

[64] Pietruszkiewicz, *supra* note 57, at 339.

thwart the intended purpose of the statutes with creative tax schemes.[65] These judicial doctrines are most often centered on preventing tax avoidance by taxpayers who follow the literal language of the Code but disguise the true economic reality of the transaction. The doctrines include the economic substance doctrine and the business purpose test, as well as the step-transaction doctrine, sham transaction doctrine, and the broader concept of substance-over-form.[66] There are more than 1,500 cases in the judicial pipeline[67] and the Government is winning many of them.[68] Government victories in 2009 and 2010 included favorable decisions in the district courts,[69] the Court of Federal Claims,[70] and the Tenth and Fifth Circuit Courts of Appeals.[71]

Described as "the most potent and most unpredictable doctrine in the Internal Revenue Service's quiver of arrows to fight tax avoidance schemes,"[72] the economic substance doctrine has been used by many U.S.

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[65] *See generally* BITTKER and LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.1 (3d ed. 1999).

[66] Bankman, *supra* note 63, at 5; *see generally* McMahon, *supra* note 62; Jeffrey Glickman and Clark Calhoun, *The "States" of the Federal Common Law Doctrines*, 61 TAX LAW. 1181, 1183–89 (Summer 2008).

[67] This data comes from Internal Revenue Service (IRS) records. Deborah A. Butler, Assoc. Chief Counsel, I.R.S., Address Before ABA Tax Section Court Procedure Comm. (Jan. 21, 2011) (on file with author).

[68] *See, e.g.,* Jeremiah Coder, *Practitioners, Government Officials Debate Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Nov. 20, 2009, *available at* 2009 TNT 222-6 ("[N]ow, by [the special counsel in the IRS Large and Midsize Business Division's] count, the government has a 10-0 track record in recent appellate court decisions involving tax shelter cases."); Calvin H. Johnson and Lawrence Zelenak, *Codification of General Disallowance of Artificial Losses*, 122 TAX NOTES 1389, 1390 (2009) ("The government's post-2004 litigation record in tax shelter cases has been nearly perfect."); Dennis Ventry, *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405, 1405 (2008) [hereinafter Ventry, *Save the Economic Substance Doctrine*] (noting that the government's victories in 2007 include "three favorable district court decisions, two victories in the Court of Federal Claims, and two U.S. Supreme Court denials of certiorari").

[69] *See, e.g.*, Altria Group, Inc. v. United States, 694 F. Supp. 2d 259 (2010) (denying a motion for a new trial after a jury verdict that certain Lease-In, Lease-Out (LILO) and Sale-In, Lease-Out (SILO) transactions entered into by the taxpayer corporation lacked economic substance); Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219 (D.N.J. 2009), *motion for a new trial denied sub nom.* Merck & Co. v. United States, No. 05-2575(KSH), 2010 U.S. Dist. LEXIS 41405 (D.N.J. Apr. 28, 2010).

[70] *See, e.g.*, Wells Fargo & Co. v. United States, 91 Fed. Cl. 35 (2010) (holding in the Government's favor and declaring that the SILO transactions were "offensive to the Court on so many levels.").

[71] *See, e.g.,* Sala v. United States, No. 08-1333, 2010 U.S. App. LEXIS 26910 (10th Cir. Nov. 19, 2010) (holding that a currency investment program to create a $60 million loss for an S Corporation lacked economic substance); Enbridge Energy Co. v. United States, 354 Fed. App'x 15 (5th Cir. 2009).

[72] McMahon, *supra* note 62, at 61.

courts to thwart corporate tax abuses.[73] This doctrine is most often employed in situations where taxpayers participate in transactions that have no reasonable possibility of profit, other than the tax benefits realized.[74] The doctrine has a subjective and an objective prong, with the subjective prong providing that "a transaction has economic substance if the transaction is rationally related to a useful nontax business purpose"[75] and the objective prong providing that "a transaction has economic substance if the transaction results in a meaningful and appreciable enhancement in the net economic position of the taxpayer other than from the reduction of taxes."[76]

Although the prongs have been applied conjunctively as well as disjunctively, the majority of circuit courts interpret the test as requiring a taxpayer to establish both prongs (business purpose and economic substance) in order to survive judicial scrutiny.[77] The Fifth Circuit, for example, adopted the conjunctive economic substance test in *Klamath Strategic Investment Fund v. United States*,[78] stating:

> We conclude that the majority view more accurately interprets the Supreme Court's prescript in *Frank Lyon*. The Court essentially set up a multifactor test for when a transaction must be honored as legitimate for tax purposes, with factors including whether the transaction (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features. Importantly, these factors are phrased in the conjunctive, meaning that the absence of any one of

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[73] *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235 (1999) (agreeing with the majority in ACM P'ship v. Commissioner, 157 F.3d 231, 265 (3d Cir. 1998), that the economic substance doctrine is sufficiently more substantial than the dissent's characterization of the doctrine as a "smell test"); *see also* Yoram Keinan, *The Many Faces of the Economic Substance Doctrine's Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & Bus. 371 (2004–2005); Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 Va. Tax Rev. 783 (2007–2008); David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 Am. L. & Econ. Rev. 88 (2002).

[74] *See, e.g.*, *ACM P'ship*, 157 F.3d at 248 ("In assessing the economic substance of a taxpayer's transactions, the courts have examined 'whether the transaction has any practical economic effects other than the creation of income tax losses.'" (citing Jacobson v. Commissioner, 915 F.2d 832, 837 (2d Cir. 1990))).

[75] Pietruszkiewicz, *supra* note 57, at 343.

[76] *Id*.

[77] *See* Yoram Keinan, *The Economic Substance Doctrine*, 508-1st Tax Mgmt. (BNA) at 112 (2009) [hereinafter Keinan, *Economic Substance Doctrine*] (stating that the inquiry into whether a transaction has economic substance depends on "'the objective economic substance of the transaction'" and the "'subjective business motivation' behind it"); *see also* Rice's Toyota World v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists." (citing Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 194, 209 (1983))).

[78] 568 F.3d 537 (5th Cir. 2009).

> them will render the transaction void for tax purposes. Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations.[79]

New section 7701(o) "clarifies and enhances the application of the economic substance doctrine."[80] It provides that in the case of any transaction to which the economic substance doctrine is relevant, the transaction shall be found to have economic substance only when two tests are satisfied.[81] This delineation resolves the split between circuit courts in the application of the doctrine. Previously, the disjunctive test (requiring either a change in economic position or a non-tax business purpose in order to satisfy the economic substance doctrine) was applied in the Second, Fourth, Eighth, and D.C. Circuits whereas the conjunctive test was applied in the First, Seventh, Eleventh, and Federal Circuits.[82]

Courts also use the substance-over-form doctrine evaluating a tax transaction based on the "substance of what took place rather than the formal steps the taxpayer took to achieve the particular result."[83] The effect of applying this doctrine to a transaction "is to produce a different tax result than that which would have been required solely by its legal form."[84] Along these lines, a court may evaluate a transaction by using the step-transaction doctrine, which is "generally viewed as a subset or extension of the broader substance doctrine."[85] Here, the reviewing court "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[86] Other courts have used the sham transaction doctrine[87] and the business purpose doctrine[88] to evaluate transactions.

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[79] *Id.* at 544 (citing Frank Lyon Co. v. United States, 435 U.S. 561, 583–584 (1978)).

[80] 2010 Reconciliation Act Explanation, *supra* note 40, at 152.

[81] I.R.C. § 7701(o)(1) (2010).

[82] 2010 Reconciliation Act Explanation, *supra* note 40, at 154; *see also* Keinan, *Economic Substance Doctrine*, *supra* note 77, at 113, 133.

[83] Glickman and Calhoun, *supra* note 66, at 1185.

[84] *Id*.

[85] *Id*. at 1186.

[86] *Id*. at 1187 (citing Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987)).

[87] *Id*. at 1188 (stating that the transaction may be categorized as a "sham-in-fact" or a "sham-in-substance," the former being "one in which the alleged transaction never actually took place" and the latter occurring where "the alleged transactions actually took place, but are nonetheless without economic substance").

[88] *Id*. at 1189 (stating that this doctrine is "generally applied as one of the two prongs required to satisfy the economic substance or sham-in-substance doctrine. It is the subjective inquiry into the taxpayer's intent to enter into a transaction, and a taxpayer must show that it had an independent non-tax purpose for the transaction").

The employment of the economic substance and business purpose doctrines is limited by some rules that are inherent to the U.S. tax system.[89] Because Congress uses tax incentives to encourage certain transactions that might otherwise not be profitable, some commentators argue that the courts must consider the purpose of tax legislation in the determination of whether a particular transaction constitutes tax avoidance.[90] For example, Congress may induce taxpayers to invest in a particular business or choose a particular investment vehicle by creating favorable tax treatment for those choices.[91] Some courts will not apply judicial doctrines that focus on subjective purpose where Congress has intended to motivate a specific economic activity.[92]

Professor McMahon views the substance-over-form and the step-transaction doctrines as interpretive doctrines that assist in clarifying the facts before applying the statute.[93] In contrast, the business purpose

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[89] Bankman, *supra* note 63, at 13.

> Whether abuse exists, however, cannot be determined apart from the facts of the particular case, the nature of the tax benefit sought, the legislative purpose in enacting the relevant provision of the Code, the way the provision relates as a structural matter to other relevant Code sections and the nature and extent of other relevant anti-abuse rules. Application of the rule needs to be sensitive to the nature of the provision of the Internal Revenue Code being construed.
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> New York State Bar Association Tax Section, Summary Report on the Provision of Recent Senate Bills that Would Codify the Economic Substance Doctrine 11 (May 21, 2003).

[90] Lederman, *supra* note 61, at 392–393. "[P]rovisions that incentivize behavior by providing tax benefits affirmatively rely on taxpayers' desire to minimize their taxes. Thus, the presence of a tax-avoidance purpose is not a reliable barometer of an abusive transaction." *Id.* at 393. Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. Rev. 195, 205–06 (2001) [hereinafter McMahon, *Thoughts on Applying Judicial Doctrines*] ("The Code abounds with provisions that not only influence economic behavior, but that also are intended to influence economic behavior.").

[91] Corporations may take advantage of the low-income housing tax credit computed with respect to part of the cost of developing low-income housing projects. I.R.C. § 42. A corporate entity may also receive more tax-advantageous treatment, including pass-through taxation, by selecting "S corporation" status. I.R.C. § 1361 (2011). *See* Bankman, *supra* note 63, at 13.

[92] Sacks v. Commissioner, 69 F.3d 982, 991 (9th Cir. 1995) ("Absence of pretax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' . . . where Congress has purposely used tax incentives to change investors' conduct." (quoting Casebeer v. Commissioner, 909 F.2d 1360, 1365 (9th Cir. 1990))); David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 Tax L. Rev. 29, 31 (2006) (arguing that a transaction that lacks a business purpose and economic substance should not be denied tax benefits unless it is "clearly inconsistent with tax policy and congressional intent").

[93] McMahon, *supra* note 62, at 55.

and economic substance doctrines are “overarching judicial anti-abuse doctrines” that are applied after the determination of the facts and the construction of the statute.[94] Other commentators see the economic substance doctrine as a doctrine of purposeful statutory construction,[95] which looks to the intent and purpose of the statute along with the letter of the law.[96]

17.3 General Anti-avoidance Rule (“GAAR”)

Prior to the enactment of section 7701(o), there was serious debate over the possibility of codifying the common law economic substance doctrine in the United States.[97] A former Treasury official expressed the belief that the courts would not have the flexibility that they possessed if the doctrine were codified.[98] Most academics have consistently expressed the concern that codifying the economic substance doctrine would lead to more abuse as ingenious tax advisors would “manipulate the statutory line between permissible and impermissible behavior.”[99] A minority expressed the view that such a change “would reduce some of the competitive advantage aggressive

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[94] *Id.*

[95] Bernard Wolfman, *Why Economic Substance is Better Left Uncodified*, 104 TAX NOTES 445 (2004); *see also* Coltec Indus. v. United States, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007) (“From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit ... not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.”).

[96] Sandra Favelukes O’Neill, *Let’s Try Again: Reformulating the Economic Substance Doctrine*, 121 TAX NOTES 1053–54 (2008) (quoting Helvering v. Gregory, 69 F.2d 809, 810–11 (2d Cir. 1934)) (“The meaning of a sentence may be more than that of separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.”).

[97] Bankman, *supra* note 63, at 5; *see generally* Samuel Thompson, *Despite Widespread Opposition, Congress Should Codify the ESD*, 110 TAX NOTES 781 (2006); Wolfman, *supra* note 95; Ellen Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001); Steven Bank, *Codifying Judicial Doctrines: No Cure for Rules But More Rules?*, 54 SMU L. REV. 37 (2001); Canellos, *supra* note 7. For a more in-depth analysis of the application of judicial doctrines to tax controversies, see McMahon, *Thoughts on Applying Judicial Doctrines*, *supra* note 90.

[98] “[T]he doctrine right now is a very flexible doctrine that is applied by the courts as needed. I think any codification of it even if in codifying it we say that we do not intend to override any other doctrines, I think it is going to make it more wooden and less flexible than it currently is.” *Nomination of Pamela F. Olson, Hearing Before the Senate Finance Committee,* 107th Cong. (2002).

[99] Ventry, *Save the Economic Substance Doctrine*, *supra* note 68, at 1405.

tax planners have over their more responsible competitors in attracting clients."[100]

Nevertheless over the last decade, there had been many efforts and proposals to codify the economic substance doctrine in the United States.[101] In the 110th Congress, bills that included an economic substance codification proposal each passed one body of Congress.[102] Although initially intended to force courts to apply the doctrine, the purpose of the more recent proposals was to clarify the application of the economic substance doctrine. The proposals did not intend to "change ... [the] standards used by the courts in determining when to utilize an economic substance analysis."[103]

The Obama Administration's fiscal year 2010 revenue proposals included one designed to codify the economic substance doctrine.[104] The proposal provided that a transaction only satisfies the economic substance doctrine if (1) it changes the taxpayer's economic position "in a meaningful way (apart from federal tax effects)," and (2) "the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction."[105] Thus, the Administration's proposal, if enacted into law, would have codified the conjunctive two-prong test. The proposal also provided that profit potential is not determinative of economic substance "unless the present value of the reasonably expected pretax profit is substantial in

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[100] *Hearing on Corporate Tax Reform Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means,* 109th Cong. (2006) (statement of Samuel Thompson, Jr., Professor of Law).

[101] *See, e.g.,* U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, 25–26, Doc 2009-106664 (2009) [hereinafter 2010 Revenue Proposals]; *see also* Revenue Provisions in 2010 Budget, *supra* note 37, at 52 (describing a 2001 proposal for the codification of economic substance that differed significantly from the current proposal in that it "required that the present value of the reasonably expected pretax profit, after taking into account foreign taxes as expenses and transaction costs, not be insignificant compared to the present value for the reasonably expected net tax benefits"); Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 Tax Notes 289, 289 n. 3 (2010) [hereinafter Jackel, *New Era*] (naming each congressional attempt to codify the economic substance doctrine beginning in 2001).

[102] Revenue Provisions in 2010 Budget, *supra* note 37, at 63. H.R. 4351 passed the House on December 12, 2007 and H.R. 2419 passed the Senate in the form of an Engrossed Amendment on December 14, 2007. *Id.*

[103] Staff of Comm. on Ways and Means, 111th Cong., Revenue Provisions Included in the America's Affordable Health Choices Act of 2009 2 (Comm. Print 2009).

[104] 2010 Revenue Proposals, *supra* note 101, at 25–26; *see also* Jefferson VanderWolk, *Codification of the Economic Substance Doctrine: If We Can't Stop It, Let's Improve It*, 55 Tax Notes Int'l 547, 547 (2009).

[105] 2010 Revenue Proposals, *supra* note 101, at 25.

relation to the present value of the net federal tax benefits" received from the transaction.[106]

In November 2009, the House adopted the economic substance provisions as a $5.7 billion offset in H.R. 3962, "Affordable Health Care for America Act."[107] Economic substance was defined in a similar manner to the Administration's proposal,[108] while ensuring that the courts retained their current flexibility "to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine."[109] The House's proposal clarified that the transaction must satisfy both prongs: the objective inquiry into the transaction's effect on the taxpayer's economic position, as well as the subjective inquiry into the taxpayer's motives for entering into the transaction. Further, in March 2010, the Senate passed a tax extenders bill, H.R. 4213, which included a provision codifying the economic substance doctrine.[110] This codification proposal was very similar to the Administration's proposal.[111]

Ultimately, the economic substance doctrine was codified in March 2010 with statutory language[112] that is generally similar to that used in H.R. 4213. All of the proposals required the economic substance doctrine's tests to be applied conjunctively.[113] This serves to eliminate the current disparity among the Federal circuit courts with respect to application of the economic substance doctrine.[114] Each proposal also indicated that profit potential is not determinative of economic substance "unless the present

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106 *Id.* The Treasury Department would be authorized to publish regulations to implement this proposal. *Id.*

107 Amy S. Elliott, *Alexander Downplays Effect of Economic Substance Codification,* 126 TAX NOTES 1309, 1309 (2010); *see also* H.R. 3962, 111th Cong. (1st Sess. 2009), which was passed by the House on November 7, 2009.

108 STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN H.R. 3962, THE "AFFORDABLE HEALTH CARE FOR AMERICA ACT" *AS AMENDED* 89–94 (Comm. Print 2009) [hereinafter JOINT COMM. ON TAX'N-H.R. 3962].

109 *Id.* at 91.

110 H.R. 4213, 111th Cong. § 421 (2010). Another version of the proposal can be found in the Stop Tax Haven Abuse Act introduced by Senator Levin on March 2, 2009. Stop Tax Haven Abuse Act, S. 506, 111th Cong. (2009). For an analysis, *see* VanderWolk, *supra* note 104, at 547.

111 STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN WORKERS, STATE, AND BUSINESS RELIEF ACT OF 2010," AS PASSED BY THE SENATE ON MARCH 10, 2010 189–94 (Comm. Print 2010).

112 *See* HCERA, *supra* note 38, §1409(a)(1), (2)(A); *see also* I.R.C. § 7701(o) (2011).

113 *See* 2010 REVENUE PROPOSALS, *supra* note 101, at 25; *see also* H.R. 4213, 111th Cong., § 421(a)(2)(A); H.R. 3962, 111th Cong., § 562(a)(1).

114 STAFF OF JOINT COMM. ON TAX'N-H.R. 3962, *supra* note 108, at 89–94; *see also* H.R. 3962, 111th Cong., § 562(a)(1)(A)–(B); H.R. 4213, 111th Cong., § 421(a)(1)(A)–(B).

value of the reasonably expected pretax profit is substantial in relation to the present value of the net federal tax benefits" received from the transaction.[115] Additionally, the final legislation states that the "determination of whether the economic substance doctrine is relevant shall be made in the same manner as if this subsection had never been enacted."[116]

New section 7701(o) "clarifies and enhances the application of the economic substance doctrine."[117] It provides that in the case of any transaction to which the economic substance doctrine is relevant, the transaction shall be found to have economic substance only when two tests are satisfied.[118] First, the transaction is required to alter the taxpayer's economic position in a meaningful way, in addition to the Federal income tax effects.[119] Second, the taxpayer must have a substantial purpose for engaging in the transaction, other than Federal income tax savings.[120] In determining whether a taxpayer has such a substantial purpose for entering a transaction, financial accounting benefits linked to Federal income tax reduction must be ignored.[121] Thus, the conjunctive economic substance test now applies in all circuits.

This new provision does not require that a taxpayer show a certain return to satisfy the profit potential test.[122] A taxpayer may demonstrate a meaningful change in economic position by relying on a transaction's potential for profit "if the present value of the reasonably expected pretax profit from the transaction is substantial in relation to the present value of the expected net tax benefits" of the transaction.[123] Transaction fees and other expenses are taken into account and the IRS must issue regulations on when foreign taxes should be treated as expenses.[124] This requirement is intended to address the failure of certain courts to take foreign taxes paid into account when assessing a transaction's profit potential before

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115 2010 Revenue Proposals, *supra* note 101, at 25.

116 H.R. 4213, 111th Cong. § 421(a)(5)(D); *see also* H.R. 3962, 111th Cong., § 562(a)(5)(D); HCERA, *supra* note 38, § 1049(a)(5)(C); I.R.C. § 7701(o)(5)(C).

117 2010 Reconciliation Act Explanation, *supra* note 40, at 152.

118 I.R.C. § 7701(o)(1) (2011).

119 *Id.* A state or local income tax effect related to a Federal income tax effect is treated like a Federal tax effect. § 7701(o)(3).

120 I.R.C. § 7701(o)(1).

121 I.R.C. § 7701(o)(4).

122 2010 Reconciliation Act Explanation, *supra* note 40, at 155.

123 I.R.C. § 7701(o)(2)(A).

124 I.R.C. § 7701(o)(2)(B).

domestic taxes.[125] However, a taxpayer may also rely on factors besides profit potential to demonstrate a meaningful change.[126]

The Code requires the application of these tests when the economic substance doctrine is relevant to the transaction.[127] This provision does not change current law standards regarding the determination of whether the economic substance doctrine is relevant to a transaction.[128] The determination of the relevancy of the doctrine to the transaction is to be made in the same manner as if section 7701(o) had never been enacted.[129] Thus, if the transaction results in the realization of tax benefits that are consistent with Congressional intent, such benefits should be allowed.[130]

The Joint Committee on Taxation ("JCT") Technical Explanation of this legislation states that new section 7701(o) "is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages."[131] The explanation lists four basic transactions that will be safe from challenge by the IRS[132] but indicates that the list is not exhaustive.[133] For example, the codified doctrine is not intended to alter the tax treatment of certain basic business transactions

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[125] Martin J. McMahon, Jr., *Living With the Codified Economic Substance Doctrine*, 128 TAX NOTES 731, 740 (2010) [hereinafter McMahon, *Living With the Codified ESD*]. For example, the Fifth Circuit did not treat foreign taxes as an expense in determining the pretax potential for profit of a dividend stripping tax shelter leading the Court to find a pretax possibility of profit. Compaq Computer Corp. v. United States, 277 F.3d 778, 783–85 (5th Cir. 2001). "Had the foreign taxes been recognized as an expense in *Compaq*, the lack of any profit potential would have been obvious." McMahon, *Living With the Codified ESD*, *supra*.

[126] 2010 RECONCILIATION ACT EXPLANATION, *supra* note 40, at 154–155.

[127] I.R.C. § 7701(o)(1).

[128] 2010 RECONCILIATION ACT EXPLANATION, *supra* note 40, at 152.

[129] I.R.C. § 7701(o)(5)(C).

[130] 2010 RECONCILIATION ACT EXPLANATION, *supra* note 40, at 152 n. 344 (citing Treas. Reg. § 1.269-2 (1962)).

[131] *Id.* at 152. "If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed." *Id.* at 152 n.344.

[132] *Id*. at 152–153 (stating that the types of transactions safe from challenge are: "(1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction") (citations omitted).

[133] *Id.* at 152 n.345 ("The examples are illustrative and not exclusive."); *see also id*. at 153 (indicating that a transaction's qualification for "specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance").

such as the choices between using either debt or equity to finance a business and "between utilizing [either] a foreign corporation or a domestic corporation to make a foreign investment."[134] The JCT explanation also describes various tax credits such as the low-income housing credit that are not intended to be disallowed presuming the "taxpayer makes the type of investment . . . the credit was intended to encourage."[135]

The codification of the economic substance doctrine has generated significant questions and commentary from taxpayers, advisors, and attorneys.[136] A Treasury representative has stated in various venues "that nothing has changed" on account of the codification. Taxpayers can continue to rely on standards set forth in "long-standing judicial and administrative practices ... as indicated in case law."[137] Michael Schler agrees, stating that codification ensured that the Supreme Court would not deny the doctrine's existence "based on a literal reading of the Code" but that such a rejection had been unlikely.[138] Nevertheless, many commentators have requested that the IRS draft "angel lists" for transactions, noting that the case law pertaining to the economic substance doctrine involves "only tax shelter types of transactions," and thus "does not provide any guidance whatsoever about the application of the doctrine to common business transactions."[139] In response, Deputy Counsel Christensen stated that the "Treasury is unlikely to issue an 'angel list' exempting specific types of transactions from the doctrine."[140]

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[134] *Id*. at 152 and nn.344–47 (citing John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) for the proposition that debt characterization is based on all the facts and circumstances); Sam Siegel v. Commissioner, 45 T.C. 566 (1966), *acq*. 1966-2 C.B. 3.

[135] *Id.* at 152 n.344 (indicating that the production tax credit, new markets credit, rehabilitation credit, and the energy credit are not intended to be disallowed by the new legislation).

[136] Mark J. Silverman and Amanda P. Varma, *Firm Seeks Guidance on Economic Substance Doctrine*, TAX NOTES TODAY, July 8, 2010, *available at* 2010 TNT 130-11; *see also* Jeremiah Coder, *Living with GAAR Lite?*, TAX NOTES TODAY, June 14, 2010 [hereinafter Coder, *Living with GAAR Lite?*], *available at* 2010 TNT 113-4.

[137] Jeremiah Coder, *Treasury Official Reiterates Limited Scope of Economic Substance Guidance*, TAX NOTES TODAY, June 21, 2010 [hereinafter Coder, *Treasury Official Reiterates Limited Scope*], *available at* 2010 TNT 118-2; *see also* 2010 RECONCILIATION ACT EXPLANATION, *supra* note 40, at 152 ("The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted.")

[138] Michael Schler, *Thoughts on the Economic Substance Doctrine*, 2 COLUM. J. TAX L. TAX MATTERS 1 (2011) [hereinafter Schler, *Thoughts on the ESD*], http://www.columbiataxjournal.org/wp-content/uploads/2011/06/schler-TM.pdf.

[139] Monte A Jackel, *Jackel Urges Tax Professionals to Comment on Economic Substance Codification*, TAX NOTES TODAY, June 14, 2010, *available at* 2010 TNT 114-4.

[140] Amy S. Elliott, *Economic Substance Guidance May Address Rules of Disclosure, Treasury Official Says,* TAX NOTES TODAY, June 10, 2010, *available at* 2010 TNT 111-3.

IRS Notice 2010-62[141] confirms this by expressly stating that "[t]he Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substances doctrine either applies or does not apply."[142] The notice also does not provide guidance as to when a contested transaction may be "relevant" and require application of the economic substance doctrine.[143] In formal comments submitted by the American Bar Association ("ABA") Section of Taxation (in conjunction with the American Institute for Certified Public Accountants ("AICPA")) to the Commissioner in January 2011, the Section of Taxation stated that the term "relevant" is defined in neither the statute itself nor the JCT Technical Explanation and asserted that "the absence of any meaningful analysis of relevance ... has created significant uncertainty as to the circumstances in which the codified rule will apply."[144] Other commentators have also complained, noting that prior cases in which a court has utilized the economic substance doctrine do not explicitly state that the economic substance doctrine is relevant. Instead, the courts have merely chosen to apply the doctrine or disregard the doctrine.[145] The Section of Taxation comments also note that while case law allows taxpayers to "indirectly discern ... certain circumstances in which the economic substance doctrine might apply, it does not per se frame the threshold question of when the doctrine is 'relevant.'"[146]

Another undefined term that may cause confusion for courts applying the codified doctrine is what constitutes a "transaction" as intended by the statute.[147] Although the term is used sixteen times in section 7701(o), it is never specifically defined.[148] While the JCT Technical Explanation offers some additional guidance,[149] the Section of Taxation comments note that the scope of how broadly or narrowly a court defines a transaction will cause outcomes to be uncertain.[150] The Section of Taxation comments

[141] I.R.S. Notice 2010–62, 2010–2 C.B. 411.

[142] *Id*. at 412.

[143] *Id*. at 411,

[144] A.B.A. Sec. of Tax'n, "Comments on Notice 2010-62," 9–10 (Jan. 18, 2011), http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2011/011811comments.authcheckdam.pdf [hereinafter A.B.A. Economic Substance Comments].

[145] Amy S. Elliott, *Practitioners Blast Economic Substance Guidance With No Angel List*, Tax Notes Today, Sept. 14, 2010, *available at* 2010 TNT 177-1.

[146] A.B.A. Economic Substance Comments, *supra* note 144, at 10.

[147] *Id*. at 26.

[148] *Id*. (citing I.R.C. § 7701(o)).

[149] 2010 Reconciliation Act Explanation, *supra* note 40, at 153 ("The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine.").

[150] A.B.A. Economic Substance Comments, *supra* note 144, at 26-27 ("[T]he more narrowly defined the transaction is, the more difficult it will be for a taxpayer to show that it has the requisite non-tax purpose and economic substance ...".).

argue that in light of the potential strict liability penalty of 40 percent for violations of the doctrine, "the historical approach of defining the transaction on a case-by-case basis without any definitional frameworks should be abandoned and that published guidance on this critical question should be issued."[151] However, Schler points out that one can determine "whether a particular step in a transaction is *Dover*-style 'legitimate tax planning' or *Gregory*-style 'abusive tax avoidance'" by applying the test as to whether the realization of tax benefits is consistent with Congressional intent.[152]

The Section of Taxation comments also criticize the codification for its lack of a clear definition of the economic substance doctrine in both statutory language and in the Technical Explanation.[153] Noting that courts have not uniformly applied the doctrine or have applied it while referring to the doctrine under a different name, the Section of Taxation comments state that the statute's inclusion of the "or lacks a business purpose" clause may make it possible for IRS agents "to apply the new statute (including the penalty) to situations in which claimed tax benefits are not realized solely because an independent 'business purpose' requirement is not satisfied."[154] The Section of Taxation comments note that several other provisions found in the Code and Regulations contain independent business requirements.[155] Because of the strict liability penalty if economic substance is not found under section 7701(o), the Section of Taxation comments recommend that the IRS "issue guidance clarifying that section 7701(o) encompasses transactions to which the common law economic substance doctrine applied . . . but that the new statute will not apply to situations in which an independent business purpose . . . is not satisfied."[156]

17.4 Disclosure and Penalty Rules

The 2010 health care legislation also increased the penalties for tax avoidance activity. In conjunction with the codification of the economic substance doctrine,[157] section 6662 was amended to include a 20 percent penalty on underpayments attributable to "any disallowance of claimed tax

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[151] *Id*.

[152] Schler, *Thoughts on the ESD*, *supra* note 138.

[153] A.B.A. Economic Substance Comments, *supra* note 144, at 25 ("[T]he term 'economic substance' appears to be used both as a shorthand for the two-prong test and as shorthand for the meaningful economic effect prong of that test. The Technical Explanation does little to elaborate on the definition . . . .").

[154] *Id*.

[155] *Id*. at 26 (citing I.R.C. §§ 274(d), 357(b)(1), 706(b)(1)(C); Treas. Reg. §§ 1.355-2(b), 1.701-2(a)).

[156] *Id*.

[157] *See* HCERA, *supra* note 38, § 1409.

benefits by reason of a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law."[158] This penalty is increased to 40 percent if the transaction has not been disclosed.[159] Furthermore, this underpayment penalty for transactions lacking economic substance is considered a strict liability penalty because the reasonable cause exception for underpayments, as well as the more stringent reasonable cause exception for reportable transaction understatements, is inapplicable.[160]

Strict liability penalties are very controversial. Proponents argue that they are necessary to deter aggressive taxpayers by making the loss of the taxpayer's position more costly.[161] The ABA Section of Taxation, the New York State Bar Association Tax Section, the AICPA, and many practitioners, oppose strict liability penalties.[162] IRS Notice 2010-62 contains guidelines regarding adequate disclosure for avoiding the 40 percent penalty that expressly require taxpayers to disclose "the relevant facts affecting the tax treatment of the transaction"[163] on Forms 8275, 8275-R, or other prescribed forms.[164] IRS counsel have stated that the "proposed economic

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[158] I.R.C. § 6662(b)(6) (2011), enacted by HCERA, *supra* note 38, § 1409(b)(1); *see generally* I.R.C. § 7701(o) (2011) (defining the Economic Substance Doctrine).

[159] I.R.C. § 6662(i), enacted by HCERA, *supra* note 38, § 1409(b)(2). This penalty is distinct from the penalty of 30 percent imposed on underpayments related to listed and reportable transactions that have not been disclosed under § 6662A, and the penalties imposed by § 6707A for failure to disclose participation in a listed or reportable transaction. *See* Erin M. Collins and Edward M. Robbins, Jr., Internal Revenue Service Practice and Procedure Deskbook § 12:5:6:G (4th ed. 2010) [hereinafter Collins and Robbins, Jr.].

[160] I.R.C. § 6664(c)(2), (d)(2) (2011); *see also* Jackel, *New Era*, *supra* note 101, at 295. Treasury Official Christensen has stated that the § 6662(b)(6) penalty is unique because it does not have a reasonable cause defense, but insists that the penalty will be applied only in appropriate situations. Coder, *Treasury Official Reiterates Limited Scope*, *supra* note 137. Members of the legal community argue that "several layers of internal review" should apply before a taxpayer faces a strict liability penalty relating to a transaction lacking economic substance due to the uncertainty that exists now that the economic substance doctrine has been codified. Coder, *Living with GAAR Lite?*, *supra* note 136; *see also* Silverman and Varma, *supra* note 136.

[161] Revenue Provisions in 2010 Budget, *supra* note 37, at 63.

[162] "[S]trict liability penalties are legitimate only if taxpayers have fair warning of what is prohibited. As proposed, the codification of the economic substance doctrine leaves so much uncertainty for taxpayers that we believe it would be unfair to impose strict liability penalties in these circumstances." New York State Bar Ass'n Tax Section, Summary Report on the Provision of Recent Senate Bills that Would Codify the Economic Substance Doctrine 17 (2003). *See also* Letter From Susan P. Serota, Chair, A.B.A. Sec. of Tax'n to Max Baucus, Chair, Senate Finance Comm. and Chuck Grassley, Ranking Member, Senate Finance Comm. (April 12, 2007), *available at* http://www.abanet.org/tax/pubpolicy/2007/070412codificationeconsubdoc.pdf.

[163] I.R.S. Notice 2010–62, *supra* note 141, at 412.

[164] *Id*. Other forms may be prescribed in publications or other guidance.

substance penalty will not be a 'knee-jerk reaction' by agents"[165] and that the IRS would like to issue "small 'g' guidance" such as "internal procedures for training IRS personnel rather than notices or regulations."[166]

The Section of Taxation comments assert, however, that the newly codified doctrine contains no "statutory or regulatory limitations on the circumstances in which it will be asserted" and IRS agents may "see it as their responsibility to consider application in connection with every issue raised in an examination."[167] The consequences of such potential overzealousness on the part of the IRS could thus have "a significant chilling effect on a wide range of business transactions that the doctrine has historically been thought not to cover."[168] Similarly, Thomas Greenaway notes that most taxpayers will attempt to avoid transactions that would trigger this heavy penalty and thus avoid entering "close-call transactions."[169] He states that in the absence of an "angel list," the IRS and taxpayers "will have to build, together, a body of fresh experience around the codified economic substance provision."[170] However, Peter Blessing points out that the "*in terrorem* effect of the penalty will be a substantial additional factor in discouraging participation in certain aggressive transactions that garnered 'should' level opinions in years past."[171]

For taxpayers engaging in tax-avoidance transactions, the standard accuracy-related penalties apply to underpayments attributable to negligence or to careless or reckless disregard of rules or regulations,[172] as well as to underpayments due to a substantial understatement of a corporate taxpayer's income tax.[173] When such a penalty applies, 20 percent of the

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165 Jeremiah Coder and Amy S. Elliott, *IRS Officials Hint at Limited Economic Substance Guidance*, TAX NOTES TODAY, Sept. 28, 2010, *available at* 2010 TNT 187-1 (quoting Henry Schneiderman, IRS special counsel).

166 *Id*. (quoting Deborah Butler, IRS associate chief counsel).

167 A.B.A. Economic Substance Comments, *supra* note 144, at 11.

168 *Id*.

169 Thomas Greenaway, *The Ethereal Angel List*, 29 ABA SEC. TAX'N NEWS Q, 4 (Summer 2010).

170 *Id*.

171 Peter H. Blessing, *Codified Economic Substance Doctrine*, 2 COLUM. J. TAX L. TAX MATTERS 8 (2011), http://www.columbiataxjournal.org/wp-content/uploads/2011/06/blessing-TM1.pdf.

172 I.R.C. § 6662(b)(1), (c) (2011).

173 I.R.C. § 6662(b)(2), (d); *see also* STEPHEN W. MAZZA, FEDERAL TAX PRACTICE AND PROCEDURE § 16:04 (8th ed. 2010). To be substantial, the understatement must exceed the lesser of 10 percent of the tax for the year (or, if greater, $10,000) or $10 million. I.R.C. § 6662(d)(1)(B). This applies to any corporate taxpayers other than S corporations and personal holding companies. *Id.* Underpayment penalties can also result from a substantial valuation misstatement. § 6662(e). Moreover, increased underpayment penalties may result from a gross valuation misstatement or an undisclosed foreign financial asset understatement. I.R.C. §§ 6662(h), 6662(j).

underpayment is added to the tax return of a corporate taxpayer.[174] The penalty can be avoided by satisfying the reasonable cause exception for underpayments, under which the taxpayer must demonstrate "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[175] In determining whether a taxpayer acted with reasonable cause and in good faith, all pertinent facts and circumstances are examined.[176]

Moreover, the "substantial understatement" portion of the penalty can also be avoided by a reduction in the tax understatement[177] if the taxpayer had substantial authority for taking the position[178] or if the relevant facts were disclosed with the tax return and there was a reasonable basis

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174 I.R.C. § 6662(a); *see also* MAZZA, *supra* note 173, § 16.04; COLLINS AND ROBBINS, JR., *supra* note 159, § 12:5:5:B:1; Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 115 (2009). The penalty increases to 40 percent for a gross valuation misstatement or the failure to disclose a foreign asset understatement. I.R.C. § 6662(h)(1), 6662(j)(3). An underpayment may be attributable to more than one type of misconduct, but these penalties cannot be "stacked." MAZZA, *supra* note 173, § 16:04. Therefore, the maximum penalty imposed on any portion of an underpayment is 20 percent (40 percent for gross valuation misstatements or an undisclosed foreign financial asset). *Id.*

175 I.R.C. § 6664(c)(1) (2011).

176 Treas. Reg. § 1.6664-4(b)(1) (2003). "Generally, the most important factor is the extent of the taxpayer's effort . . . . Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of . . . the experience, knowledge, and education of the taxpayer." *Id.* If the advice of a tax adviser, lawyer or accountant was relied upon by the taxpayer, then the advice cannot "be based on unreasonable factual or legal assumptions." Treas. Reg. § 1.6664-4(c)(1)(ii) (2003). The Tax Court found that the taxpayer had unreasonably relied on the opinion of a tax adviser where the opinion was based on "an irrelevant revenue procedure" with no foundation in case law or statutory authority. Canal Corp. v. Commissioner, 135 T.C. 199, 219 (2010). The taxpayer's reliance on the "should" opinion was unreasonable where the tax adviser had a conflict of interest because he would not be paid unless the taxpayer completed the transaction. *Id.* at 220-22. Courts have consistently found that reliance on the opinion of a tax adviser is unreasonable where the adviser is "actively involved in planning the transaction" and has a conflict of interest. *Id.* at 218.

177 For purposes of this section, an understatement is "the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax imposed which is shown on the return, reduced by any rebate," as defined under section 6211(b)(2). I.R.C. § 6662(d)(2)(A).

178 I.R.C. § 6662(d)(2)(B)(i). Substantial authority "is less stringent than the more likely than not standard . . . but more stringent than the reasonable basis standard." Treas. Reg. § 1.6662-4(d)(2) (2003); *see also* Doran, *supra* note 174, at 117 n.26 (citing STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) 160 (1999) [hereinafter JOINT COMMITTEE STUDY] (noting that the substantial authority standard has been interpreted to require a 40 percent likelihood of success on the merits); J. Timothy Philipps, *It's Not Easy Being Easy: Advising Tax Return Positions*, 50 WASH. and LEE L. REV. 589, 606 (1993) (noting that the

for such tax treatment of the items in question.[179] Substantial authority for the tax treatment of an item exists only if "the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment."[180]

However, the stakes are raised for tax shelter activity.[181] In 2004, Congress undertook comprehensive action against corporate tax shelters in the American Jobs Creation Act of 2004 ("2004 Jobs Act"),[182] enacting new penalties and strengthening disclosure requirements and existing penalties.[183] The Joint Committee Staff estimated that the anti-shelter provisions relating to disclosure and penalties would raise approximately $1.5 billion over a 10-year period.[184] For example, under these heightened requirements if a substantial understatement is attributable to participation in a tax shelter, the understatement cannot be reduced to lessen the penalty even if the taxpayer can establish either substantial authority for the tax

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standard is estimated to require about a 40 percent chance of success on the merits because the regulations state that the standard is less stringent than a 50 percent likelihood of success standard and more stringent than a reasonable basis standard).

[179] I.R.C. § 6662(d)(2)(B)(ii). The Treasury Regulations provide that for purposes of this exception, disclosure on a Form 8275 is considered to be adequate. Treas. Reg. § 1.6662-4(f) (2003). The reasonable basis standard has generally been described as requiring a one in five likelihood of success on the merits. Timothy F. Malloy, *Corporate Decisionmaking: Disclosure Stories*, 32 FLA. ST. U. L. REV. 617, 641 (2005) (citing JOINT COMMITTEE STUDY, *supra* note 178, at 155 tbl. 7).

[180] Treas. Reg. § 1.6662-4(d)(3) (2003). In determining if there is substantial authority, "[a]ll authorities relevant to the tax treatment of an item" are looked at, "including the authorities contrary to the treatment." *Id.* The substantial authority standard is objective, and therefore the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is in fact substantial authority for that treatment. Treas. Reg. § 1.6662-4(d)(2) (2003).

[181] I.R.C. § 6662(d)(2)(C)(i). The term "tax shelter" is defined for purposes of the underpayment penalty to include "any partnership or other entity . . . , any investment plan or other arrangement . . . , or any other plan or arrangement . . . if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C)(ii).

[182] American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (2004) [hereinafter 2004 Jobs Act].

[183] Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U.L. REV. 267, 308 (2008); *see also* I.R.C. § 6707A(a) (2011), enacted by 2004 Jobs Act, *supra* note 182, § 811(a) (imposing a separate penalty for failing to disclose reportable transactions); I.R.C. § 6662A(b)(2) (2011), enacted by 2004 Jobs Act, *supra* note 182, § 812(a) (imposing an accuracy-related penalty for understatements of tax arising from listed and reportable transactions). The 2004 Jobs Act provided the much-needed "'stick' or 'hammer'" in terms of meaningful penalties for tax shelter activity, thereby greatly strengthening Congress' efforts to battle tax avoidance transactions. *See* COLLINS AND ROBBINS, JR., *supra* note 159, § 12:5:6:C.

[184] STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 2896 THE "AMERICAN JOBS CREATION ACT OF 2003" 4 (2003).

treatment of the item, or disclosure of relevant facts with the tax return and a reasonable basis for such tax treatment.[185] Instead, in order to avoid an underpayment penalty, taxpayers with a substantial understatement resulting from a tax shelter must meet the heightened standard of the reasonable cause exception for underpayments. This exception requires the taxpayer to have acted in good faith and to establish reasonable cause for the underpayment.[186]

Accuracy-related penalties play "a key role in attempts to crack down on tax-motivated transactions."[187] Thus, the 2004 Jobs Act also created section 6662A,[188] which imposes a 20 percent accuracy-related penalty specifically on understatements of income tax attributable to "reportable transactions" and "listed transactions."[189] Listed and reportable transactions are specifically defined in the regulations.[190] The penalty rate increases to 30 percent if the taxpayer has not adequately disclosed the transaction.[191]

These accuracy-related penalties under 6662A may be set aside only when the reportable transaction understatement is not attributable to a transaction lacking economic substance and the reasonable cause exception for reportable transaction understatements is met.[192] To meet this exception, not only must the taxpayer demonstrate good faith and reasonable cause for the taxpayer's position, but the taxpayer must also satisfy the more stringent requirements of the exception, including nonreliance on

[185] I.R.C. § 6662(d)(2)(C)(i).

[186] I.R.C. § 6664(c) (2011), enacted by 2004 Jobs Act, *supra* note 182, § 812(c)(2); *see also* Doran, *supra* note 174, at 117.

[187] Keinan, *Aftermath of* Long Term Capital Holdings, *supra* note 25, at 384.

[188] I.R.C. § 6662A, enacted by 2004 Jobs Act, *supra* note 182, § 812(a).

[189] I.R.C. § 6662A(a), (b)(2). Section 6662A(b)(2) makes the penalty applicable to any listed transactions and "any reportable transaction . . . if a significant purpose of such transaction is the avoidance or evasion of Federal income tax." For this purpose, a reportable transaction is defined as "any transaction with respect to which information is required to be included with a return or statement because . . . such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." I.R.C. §§ 6662A(d), 6707A(c)(1). A listed transaction is a "reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011." I.R.C. §§ 6662A(d), 6707A(c)(2). The "understatement" from a reportable transaction is the increase in taxable income that results from the difference between the proper tax treatment of an item and the taxpayer's incorrect treatment of the same item. James M. Delaney, *Where Ethics Merge With Substantive Law-an Analysis of Tax Motivated Transactions,* 38 IND. L. REV. 295, 312-13 (2005) (citing I.R.C. § 6662A(b)(1)(A)).

[190] Treas. Reg. § 1.6011-4(b)(2)–(6) (2010).

[191] I.R.C. § 6662A(c); *see also* COLLINS AND ROBBINS, JR., *supra* note 159, § 12:5:6:C.

[192] I.R.C. § 6664(d)(1)-(2) (2011).

either the opinion of a disqualified tax advisor or a disqualified opinion.[193] The reasonable cause exception for reportable transaction understatements also requires that the relevant facts governing the tax treatment of the item are adequately disclosed, there was substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not the proper treatment.[194]

The 2004 Jobs Act also created a new penalty under which non-individual taxpayers face a $50,000 penalty for failing to disclose a reportable transaction, whether or not the transaction results in an understatement of tax.[195] This penalty is increased to $200,000 if the shelter is a listed transaction.[196] These nondisclosure penalties are in addition to the accuracy-related penalties.[197] In an effort to reduce the harshness of these reporting penalties, the Small Business Jobs Act of 2010[198] amended section 6707A(b) by creating minimum and maximum penalties[199] as well

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[193] I.R.C. § 6664(d)(1), (d)(4)(B)(ii). A disqualified tax advisor (1) is a material advisor who participates in the promotion or sale of the transaction or is related to someone who so participates; (2) is compensated directly or indirectly by a material advisor in relation to the transaction; (3) has a fee arrangement that is contingent on the tax benefits of the transactions being sustained; or (4) has a disqualifying financial interest with respect to the transaction. I.R.C. § 6664(d)(4)(B)(ii). An opinion is disqualified if it "is based on unreasonable factual or legal assumptions, . . . [or] unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person." I.R.C. § 6664(d)(4)(B)(iii). This definition seems to broadly encompass many advisors trying to market tax shelter opinions, and therefore appears to greatly limit the ability of a taxpayer avoid penalties by relying upon an opinion of a tax advisor marketing tax "opinions." Delaney, *supra* note 189, at 314–15.

[194] I.R.C. § 6664(d)(3). For purposes of the reasonable cause exception for reportable transaction understatements, disclosure is adequate when a completed Form 8886, a "Reportable Transaction Disclosure Statement," has been filed. Treas. Reg. § 1.6011-4(d) (2010).

[195] I.R.C. § 6707A(a)–(b) (2011); *see also* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 100 (2006). Any person who fails to include on their return or statement information required under section 6011 will be subject to penalties. I.R.C. § 6707A(a)-(b). Disclosure is adequate if a complete Form 8886 ("Reportable Transaction Disclosure Statement") is filed. I.R.S. Form 8886, Reportable Transaction Disclosure Statement (2011), *available at* http://www.irs.gov/pub/irs-pdf/f8886.pdf; *see also* Rochelle L. Hodes, *The Case for a Different Kind of Disclosure Regime*, TAX NOTES TODAY, July 22, 2010, *available at* 2010 TNT 170-6.

[196] I.R.C. § 6707A(b)(2) (2011); *see also* Rostain, *supra* note 195, at 100 n.112.

[197] I.R.C. § 6707A(f) (2011).

[198] Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2041, 124 Stat. 2504, 2560 (2010).

[199] The minimum penalty for a reportable transaction "shall not be less than $10,000." I.R.C. § 6707A(b)(3) (2011). The maximum penalty cannot exceed "in the case of a listed transaction, $200,000 . . . or in the case of any other reportable transaction, $50,000." I.R.C. § 6707A(b)(2).

as providing a formula for achieving "proportionality between the penalty and the tax savings that were the object of the transaction."[200] There is no reasonable cause exception for failure to disclose, but the IRS does have discretion to abate the penalties in certain circumstances with respect to a reportable transaction other than a listed transaction when taxpayer compliance would be promoted by withdrawal of the penalty.[201] Thus while the IRS can rescind penalties for failure to disclose reportable transactions, the penalties for failing to disclose listed transactions cannot be revoked.[202]

Moreover, the 2004 Jobs Act heightened obligations for those corporations that report to the Securities and Exchange Commission ("SEC").[203] These corporations must disclose to the SEC those enhanced penalties under sections 6662A and 6707A that are paid with respect to their underpayments resulting from undisclosed listed and reportable transactions.[204] The failure to report the imposition of penalties to the SEC will result in a penalty of $200,000.[205] Finally, the 2004 Jobs Act disallows any deduction for interest paid regarding any deficiency relating to an undisclosed reportable transaction.[206]

In 2004, the IRS revised Schedule M-3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*, for use by certain large corporate taxpayers filing a corporate income tax return.[207] This Schedule M-3 dramatically expanded the disclosure and reconciliation of financial and tax accounting differences by increasing the number of book-tax differences subject to required disclosure from eight to sixty-seven.[208] These detailed requirements allow for greater precision in

[200] The "amount of the penalty under subsection (a) with respect to any reportable transaction shall be 75 percent of the decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes)." I.R.C. § 6707A(b)(1).

[201] I.R.C. § 6707A(d)(1); *see also* Rostain, *supra* note 195, at 100 n.112.

[202] I.R.C. § 6707A(d)(1).

[203] 2004 Jobs Act, *supra* note 182, § 811.

[204] I.R.C. § 6707A(e); *see also* David Pratt, *Standards of Practice for Pension Practitioners*, 39 J. MARSHALL L. REV. 667, 674 (2006).

[205] I.R.C. § 6707A(e), (b)(2)(A) (2011).

[206] I.R.C. § 163(m) (2011), enacted by 2004 Jobs Act, *supra* note 182, § 838.

[207] Internal Revenue Service, Treasury and IRS Issue Revised Tax Form for Corporate Tax Returns, http://www.irs.gov/newsroom/article/0,,id=124997,00.html (last visited June 17, 2011) [hereinafter I.R.S. M-3 Notice]; *see also* I.R.S. Form 1120, Schedule M–3, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More (2010), *available at* http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf. Schedule M-3 mandates that any corporation required to file Form 1120, U.S. Corporation Income Tax Return, that reports total assets at the end of the corporation's taxable year that equal or exceed $10 million on Schedule L of Form 1120 must complete and file Schedule M-3. Christopher H. Hanna, *The Real Value Of Tax Deferral*, 61 FLA. L. REV. 203, 245 n.200 (2009).

[208] Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 591 (2006). By more clearly elucidating

identifying aggressive transactions and determining which returns need to be audited, as well as narrowing the issues examined on returns selected for audit.[209] For tax years beginning in 2009, these filers must also complete a new Schedule B, *Additional Information for Schedule M-3 Filers*.[210]

Corporate taxpayers subject to U.S. generally accepted accounting principles are also subject to disclosure requirements with respect to their financial statements pursuant to Financial Accounting Standards Board ("FASB") Statement 109 ("FAS 109") and its interpretation by FASB, Financial Interpretation No. 48 ("FIN 48") Accounting for Uncertainty in Income Taxes.[211] FIN 48 requires certain corporate taxpayers to identify and quantify uncertain tax positions so that their shareholders will know what tax reserves have been set aside in the event that the IRS challenges the transactions.[212] Corporate taxpayers are only allowed to recognize a tax benefit in the financial statements if it is "more likely than not" that their position will be accepted.[213] The entity must consider the effect of litigation, appeals, and similar factors before determining whether a position will likely be accepted.[214] Furthermore, the entity must assume that the pertinent taxing authority will have access to and will review all relevant financial information.[215] These disclosures may facilitate the discovery and elimination of abusive tax shelters.[216]

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differences between financial accounting net income and taxable income, Schedule M-3 is intended to help IRS agents determine whether a particular tax return should be audited and identify the differences that are most important in an audit. *Schedule M-3, Controller's Tax Letter* (Sept. 2004). The Schedule also is supposed to have a "deterrent" effect on taxpayers who want to take aggressive positions on tax returns. *Id.*

[209] I.R.S. M-3 Notice, *supra* note 207 (explaining the new Schedule M-3 and the reasons behind its modification).

[210] Rev. Proc. 2010–15, 2010–7 I.R.B. 404.

[211] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes 7, 115 (1992), Financial Accounting Standards Board, FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes 1 (2006) [hereinafter FIN 48].

[212] *See* FIN 48 Implications LMSB Field Examiners' Guide, LMSB-04-0507-045 (May 2007) [hereinafter FIN 48 Implications], *available at* http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html. FIN 48 is designed to clarify a taxpayer's financial statements with respect to uncertain tax positions.

[213] FIN 48, *supra* note 211, at 2.

[214] FIN 48 also requires corporate taxpayers to accrue interest and penalties that the taxpayer would incur if the uncertain tax positions ultimately were not sustained. As a result, corporate taxpayers must properly reflect the potential expense of adverse tax positions.

[215] FIN 48 Implications, *supra* note 212.

[216] *Id*. Although FIN 48 is a response to investors' desire for greater disclosure of financial information, some of the information is arguably protected under the work-product doctrine, which protects documents that are produced in anticipation of litigation. Lutof Awdeh and Leanne Oneschuk, *Transparency and Compliance in Light of the New*

The Service also seeks to obtain information about uncertain positions on corporate tax returns and the amount by which tax liability is affected by the positions.[217] On September 24, 2010, the IRS issued Announcement 2010-75,[218] the Schedule of Uncertain Tax Positions ("Schedule UTP"),[219] and instructions providing guidance for when corporations must file Schedule UTP.[220] The instructions require that those corporations required to file Schedule UTP provide a concise description of the tax position, including relevant facts and information that will allow the Service to ascertain "the identity of the tax position and the nature

Schedule UTP, TAX ADVISER, Aug. 2010, at 531, 532. While the IRS has stated that tax accrual workpapers are not protected under the doctrine because they serve financial reporting requirements and are not in anticipation of litigation, the IRS has exercised restraint in regards to obtaining this information. *Id.* Courts have held that the work-product doctrine protects the information even if it was produced for another reason, in addition to being produced in anticipation of litigation. *Id.* at 533 (citing United States v. Adlman, 134 F.3d 1194, 1198 (2d Cir. 1998)); *see also* United States v. DeLoitte L.L.P., 610 F.3d 129, 138 (D.C. Cir. 2010) (holding that "a document can contain protected work-product material even though it serves multiple purposes, so long as the protected material was prepared because of the prospect of litigation"); United States v. Textron, Inc., 577 F.3d 21, 31 (1st Cir. 2009), *cert. denied*, 130 S. Ct. 3320 (2010) (holding that "the work product privilege is aimed at protecting work done" in preparation for litigation and "Textron's work papers were prepared to support financial filings and gain auditor approval").

[217] Specifically, IRS Chief Counsel Wilkins noted that "three chief IRS current goals are improving tax administration through the better use of information, enhancing the capacity for dealing with increasingly complex and global structures for businesses and investments, and assisting in the implementation of nontax economic and social policies." Stephen Joyce, *Schedule UTP Will Not Be Withdrawn, Will Not Threaten Policy of Restraint, Wilkins Says*, 117 DAILY TAX REP. (BNA), June 21, 2010, at G-5.

[218] I.R.S. Announcement 2010–75, *available at* http://www.irs.gov/pub/irs-drop/a-10-75.pdf [hereinafter Announcement 2010–75].

[219] I.R.S. Form 1120, Schedule UTP, Uncertain Tax Position Statement (2010), *available at* http://www.irs.gov/pub/irs-pdf/f1120utp.pdf. Final regulations under section 6012 were issued requiring corporations to file a Schedule UTP. Treas. Reg. § 1.6012-2(a)(4) (2010) (as amended by T.D. 9510, 2011-6 I.R.B. 453); *see also Final Regs Require Statement Disclosing Uncertain Tax Positions*, TAX NOTES TODAY, Dec. 14, 2010, *available at* 2010 TNT 239-6. The Service has provided answers to frequently asked questions regarding Schedule UTP. Internal Revenue Service, *Frequently Asked Questions on Schedule UTP*, March 23, 2011, *available at* http://www.irs.gov/businesses/article/0,,id=237538,00.html. This guidance addresses such issues with respect to reporting on the Schedule, as well as the changes to the Policy of Restraint that were announced in Announcement 2010-76. *Id.*

[220] Internal Revenue Service, *Instructions for Schedule UTP,* Sept. 24, 2010, *available at* http://www.irs.gov/pub/newsroom/2010_instructions_for_sch_utp.pdf [hereinafter *Instructions for Schedule UTP*]. Corporations that must file the Schedule UTP are those filing a Form 1120 with assets equal to or exceeding $100 million and which have issued audited financial statements. *Id.* at 1.

of the issue."[221] Beginning in 2010,[222] these new reporting requirements apply to certain corporations[223] filing a Form 1120[224] but give no specific requirements governing tax shelters.[225] Furthermore, the instructions do not provide specific guidance on penalties.[226]

Announcement 2010-75 also states that if a corporate taxpayer files a Schedule UTP, there will be no need to file a Form 8275 or 8275-R for purposes of section 6662(i) disclosure requirements unless the transaction is a reportable transaction.[227] There are no new penalties under the final Schedule UTP.[228] Instead, the IRS has indicated that it intends to review compliance under the new schedule and take appropriate action when necessary.[229] These new reporting requirements will likely have significant implications with respect to participation in corporate tax shelters.

Finally, another tactic that the IRS has used in its war on tax shelters is "shaming sanctions."[230] As part of many tax shelter settlements with large corporations, the IRS has issued press releases (after insisting on confidentiality waivers as a condition of the settlement).[231] For example, the IRS released a press release on February 14, 2007 after Merck agreed to pay $2.3 billion to settle all of its tax disputes for the tax years 1993 through

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[221] Announcement 2010–75, *supra* note 218, at 7. A corporation filing Schedule UTP must report tax positions for which "[e]ither the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that tax position because the corporation expects to litigate the position." *Instructions for Schedule UTP, supra* note 220, at 4.

[222] Announcement 2010–75, *supra* note 218, at 2; *see also Instructions for Schedule UTP, supra* note 220.

[223] Corporations that must file a Schedule UTP for the 2010 tax year are those that file a Form 1120 and have assets equal to or exceeding $10 million. *Instructions for Schedule UTP, supra* note 220; *see also* Announcement 2010–75, *supra* note 218, at 4. This threshold will be reduced in future years. *Id*.

[224] Form 1120 is the U.S. Corporate Income Tax Return by which domestic corporations report income, gains, losses, deductions, and credits and determine tax liability. *See* I.R.S. Form 1120, *supra* note 207.

[225] *See generally* Announcement 2010–75, *supra* note 218.

[226] *Id*. at 16–17.

[227] Announcement 2010-75, *supra* note 218, at 17.

[228] *Id*.; *see also* Amy S. Elliott, *Practitioners Consider Whether Schedule UTP Contains Protected Work Product*, TAX NOTES TODAY, Oct. 7, 2010, *available at* 2010 TNT 194-2.

[229] Announcement 2010–75, *supra* note 218, at 17.

[230] Joshua Blank, *What's Wrong With Shaming Corporate Tax Abuse*, 62 TAX LAW REV. 539, 539 (2009).

[231] *Id*. at 540 (citing Dustin Stamper, *Korb Pledges Careful Use of Press, More Guidance on Disclosures*, TAX NOTES TODAY, Oct. 25, 2006, *available at* 2006 TNT 206-2; Donald Korb, The War on Tax Shelters, NYU School of Law (March 6, 2007)). Otherwise the settlements are protected by confidentiality rules. I.R.C. § 6103(a).

2001.[232] While the employment of shaming sanctions demonstrated another effort on the part of the IRS to deter tax abuse, the effectiveness of these public announcements is disputed by some commentators.[233]

Modern tax shelters frequently involve the assistance or advice of tax professionals such as accountants or attorneys. Therefore, disclosure requirements are only effective if there are provisions governing tax professionals. All "material advisors"[234] must file information returns with respect to reportable transactions that identify the transaction and describe the potential tax benefits.[235] They also face penalties of $50,000 for failing to file or filing false or incomplete returns.[236] The penalties rise to $200,000 if the tax shelter is a listed transaction (or 50 percent of the gross income derived from the aid or assistance provided with regard to the transaction if greater).[237] Finally, if the failure of the material advisor to file a correct informational return is intentional, the potential penalty is increased to 75 percent of the gross income derived from the transaction.[238] The 2004 Jobs Act also eliminated the "reasonable cause" exception that had previously existed to abate these penalties,[239] but the penalties can still be rescinded in certain cases.[240]

Promoters of any potentially abusive tax shelter are also required to maintain a list of investors for 7 years and to provide the list to the IRS

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[232] Internal Revenue Service, Merck Agrees to Pay IRS $2.3 Billion, http://www.irs.gov/newsroom/article/0,,id=167773,00.html (last visited June 17, 2011). The settlement was reached using the IRS's Fast Track Settlement program. Rev. Proc. 2003-40, 2003-1 C.B. 1044.

[233] *See* Blank, *supra* note 230, at 559 (concluding that shaming sanctions are ineffective to deter corporate tax abuse); *see generally* Stephen W. Mazza, *Taxpayer Privacy and Tax Compliance*, 51 KAN. L. REV. 1065 (2003).

[234] I.R.C. § 6111(b)(1)(A) (2011) ("In general. The term 'material advisor' means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.").

[235] I.R.C. § 6111(a). The designated form is Form 8918. I.R.S. Form 8918, Material Advisor Disclosure Statement (2007), *available at* http://www.irs.gov/pub/irs-pdf/f8918.pdf.

[236] I.R.C. § 6707(b)(1) (2011).

[237] I.R.C. § 6707(b)(2) (2011); *see also* Soled, *supra* note 183, at 309.

[238] I.R.C. § 6707(b)(2) (2011); *see also* Soled, *supra* note 183, at 309.

[239] I.R.C. § 6707 (2011), as enacted by 2004 Jobs Act, *supra* note 182, § 816.

[240] I.R.C. § 6707(c) (2011). Section 6707A(d) allows the Commissioner to rescind a part or the entirety of an assessed penalty if "the violation is with respect to a reportable transaction ... and rescinding the penalty would promote compliance with the requirements of ... effective tax administration." *See also* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 7B.16[4][b][i] (rev. 2d ed. Supp. 2010) [hereinafter SALTZMAN SUPPLEMENT].

upon request.[241] The material advisor faces a penalty of $10,000 per day for not making the list available within twenty business days after the IRS request.[242] Furthermore, tax shelter promoters face exposure to a penalty equal to 50 percent of the gross income derived from the abusive transaction if fraudulent statements are made for the purpose of receiving tax benefits.[243] There is also a 100 percent penalty on gross valuation overstatements made in connection with tax shelter transactions.[244] However, the penalties based on gross valuation overstatements can be waived by the Service if a reasonable basis for the valuation is established and it is shown that the valuation was made in good faith.[245]

Furthermore, district courts have found that neither taxpayers nor tax shelter organizers may avoid disclosure by asserting an identity privilege through section 7525.[246] A district court noted that while a taxpayer's relationship to a tax practitioner was similar to the relationship between a client and attorney with respect to confidentiality, "a client's identity generally is not privileged unless revealing the client's name would inevitably result in revealing the client's motivation for seeking representation[.]"[247] The clients at issue here had been accused of participating in abusive tax shelters, which was "information ordinarily subject to full disclosure under the tax law" and the clients were therefore precluded from "establishing an expectation of confidentiality."[248]

A tax return preparer[249] is subject to sanction when there is an understatement of the taxpayer's liability resulting from either an unreasonable position or willful or reckless conduct.[250] The preparer will be responsible for paying the greater of $1,000 or 50 percent of the income derived from a transaction when the understatement results from an unreasonable position of which the preparer was aware or should have been aware.[251] The preparer can avoid the penalty if the position was disclosed and a

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[241] I.R.C. § 6112 (2011).

[242] I.R.C. § 6708(a)(1) (2011).

[243] I.R.C. § 6700(a)(2)(B) (2011).

[244] I.R.C. § 6700(a)(2)(B) (2011).

[245] I.R.C. § 6700(b)(2) (2011).

[246] United States v. Arthur Andersen, LLP, 2003 U.S. Dist. LEXIS 14228, at *19–20 (N.D. Ill. 2003) (citing United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003)).

[247] *Id*. at *17.

[248] *Id.* at *20.

[249] A tax return preparer is "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title." I.R.C. §§ 6694(f) (2011), 7701(a)(36) (2011).

[250] I.R.C. § 6694.

[251] I.R.C. § 6694(a)(1). In 2007, this penalty was increased from a penalty of $250. SALTZMAN SUPPLEMENT, *supra* note 240, ¶ 4.06.

reasonable basis for the position existed,[252] or if there was substantial authority for the position.[253] However, if the position is with respect to a tax shelter[254] or a reportable transaction, there must be a reasonable belief that the position will more likely than not be sustained on the merits.[255] Moreover, if the understatement results from the reckless disregard of rules or a willful attempt[256] to understate the tax liability, the preparer will face a penalty of the greater of $5,000 or 50 percent of the income derived from the preparation of the return.[257]

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[252] I.R.C. § 6694(a)(2)(B); *see generally* COLLINS AND ROBBINS, JR., *supra* note 159, at § 12:18. Disclosure of the position is satisfactory when made in accordance with section 6662(d)(2)(B)(ii)(I). I.R.C. § 6694(a)(2)(B).

[253] I.R.C. § 6694(a)(2)(A). Substantial authority is a lower standard than the more likely than not standard and is more stringent than the reasonable basis standard. SALTZMAN SUPPLEMENT, *supra* note 240, ¶ 4.06[2][a]. From May 25, 2007 onward, tax return preparers need only meet the "substantial authority" standard for undisclosed positions. Emergency Economic Stabilization – Energy Improvement and Extension – Tax Extenders and Alternative Minimum Tax Relief Act, Pub. L. No. 110-343, § 506, 122 Stat. 3765, 3880 (2008); *see also* Brian C. Bernhardt, *The New Rules of § 6694, Part I*, 23 PROBATE and PROPERTY 62, 64 (2009) (noting that except for tax shelters and reportable transactions, taxpayers can avoid an underpayment penalty for an undisclosed position if there is substantial authority for the position); Bret Wells, *Voluntary Compliance: This Return Might Be Right But Probably Isn't*, 29 VA. TAX. REV. 645, 665, 667 (2010) (discussing the current standards that must be met by taxpayers, tax advisors, and tax return preparers to avoid understatement penalties).

[254] For purposes of this section, tax shelter is defined as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. §§ 6694(a)(2)(C), 6662(d)(2)(C)(ii).

[255] I.R.C. § 6694(a)(2)(C). For purposes of this section, the "reasonable to believe that more likely than not" standard can be satisfied if, after the tax return preparer analyzes all of the pertinent facts and authorities, the preparer reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. Treas. Reg. § 1.6694-2(b)(1) (2009). For penalties imposed under this section, the reasonable cause and good faith exception under § 6694(a)(3) is also available. *See* SALTZMAN SUPPLEMENT, *supra* note 240, ¶ 4.06[2][a].

[256] "[A] preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons." Treas. Reg. § 1.6694-3(b) (2009). A tax preparer is "considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return ... that is contrary to a rule or regulation ... and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. A preparer is reckless ... if the preparer makes little or no effort to determine whether a rule or regulation exists ... demonstrat[ing] a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation." Treas. Reg. § 1.6694-3(c) (2009).

[257] I.R.C. § 6694(b). This penalty is reduced by any penalty paid with respect to an underpayment resulting from an unreasonable position under section 6694(a). I.R.C. § 6694(b)(3). Prior to 2007, the penalty imposed for understatements resulting from willful or reckless conduct was $1,000. SALTZMAN SUPPLEMENT, *supra* note 240, ¶ 4.06.

Disclosure requirements aimed at limiting tax shelter activity have undergone various amendments throughout the years.[258] One of the earliest attempts to identify tax shelter activity was enacted as a part of the Deficit Reduction Act of 1984 ("DEFRA 1984") and required registration of tax shelters with the IRS.[259] The Secretary of the Treasury was authorized to issue identification numbers to the person registering the tax shelter[260] and any person receiving a benefit from a tax shelter was required to include the assigned identification number on the tax return.[261] Additionally, organizers and sellers of abusive tax shelters "were required to maintain a list of investors in such shelters."[262] DEFRA 1984 was the first step towards effective disclosure requirements, and thus effective governance over tax shelters in the United States.[263]

In the late 1990s, there was heightened interest in Congress, the Treasury, and the IRS in preventing tax shelter participation.[264] In 1997, the Taxpayer Relief Act extended registration requirements to include "corporate tax shelters promoted under conditions of confidentiality"[265] when the transaction's significant purpose was "tax avoidance or evasion" and promoter fees exceeded $100,000.[266] This effort was supplemented by the creation of the Office of Tax Shelter Analysis ("OTSA") in 2000 "to identify potentially improper tax shelters and the taxpayers who participate in those shelters."[267] The OTSA also provides a centralized place for the analysis of tax shelters that are disclosed or exposed by field personnel.[268]

In 2007, the Treasury Department issued amended and final regulations requiring taxpayers to disclose participation in transactions that were described in these regulations.[269] These final regulations divide reportable

[258] *See generally* Collins and Robbins, Jr., *supra* note 159, § 12:6.

[259] U.S. Dep't of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals 60 (1999), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/ctswhite.pdf [hereinafter Treasury White Paper] (citing I.R.C. § 6111(b)(2) (1984)). On August 13, 1984, the IRS released News Release IR-84-88 providing general rules on tax shelter registration using Form 8264. *See* I.R.S. News Release IR-84-88 (Aug. 13, 1984).

[260] Staff of Joint Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 479 (Comm. Print 1984).

[261] Treasury White Paper, *supra* note 259, at 61 (citing I.R.C. § 6111(b)(2) (1984)).

[262] *Id*. at 60.

[263] *Id*.

[264] *See* Collins and Robbins, Jr., *supra* note 159, § 12:6.

[265] Treasury White Paper, *supra* note 259, at 74.

[266] *Id*.

[267] Collins and Robbins, Jr., *supra* note 159, § 12:6:1:A.

[268] *Id*. § 12:6:1:A.

[269] Saltzman Supplement, *supra* note 240, ¶ 7B.16[3][b1].

transactions into five categories,[270] which include: (1) transactions that are the same or substantially similar to a transaction that the Treasury has deemed a tax avoidance transaction or "listed transaction;"[271] (2) transactions offered under condition of confidentiality;[272] (3) transactions with contractual protection;[273] (4) transactions involving large losses;[274] and (5) transactions that are the same or substantially similar to a transaction that the Treasury has deemed a "transaction of interest."[275]

Under the final regulations, taxpayers are required to file a special disclosure form with the IRS Office of Tax Shelter Analysis upon participation in any of these reportable transactions.[276] The designated form is IRS Form

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[270] Treas. Reg. §1.6011-4(b)(2)–(6). Reportable transactions include the "listed transactions" that have been specifically identified by the IRS as having a tax avoidance purpose and "transactions of interest" that the IRS designates as potential tax avoidance schemes every year through notices and published guidance. LEDERMAN and MAZZA, *supra* note 41, at 502. *See, e.g.,* I.R.S. Notice 2009–7, 2009–3 I.R.B. 312 (marking a domestic partnership which prevents the inclusion of subpart F income as suspect); I.R.S. Notice 2007–57, 2007–29 I.R.B. 87 (describing the loss importation transaction). The regulations under § 6011 were intended to work in conjunction with § 6111 and § 6112, which require the promoters and material advisors to register transactions and maintain lists of investors, respectively. I.R.C. §§ 6111; 6112 (2003); *see also* COLLINS AND ROBBINS, JR., *supra* note 159, § 12:6:1.

[271] A listed transaction is defined as "a transaction that is the same as or substantially similar to one of the types of transactions that the [IRS] has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance." Treas. Reg. § 1.6011–4(b)(2) (2010). For example, "listed" transactions involve the sale of assets through the use of an intermediary, the mischaracterization of losses or liability, or contributions to pensions. I.R.S. Notice 2009-59, 2009-31 I.R.B. 170, § 2 (11) (citing I.R.S. Notice 2001–16, 2001–9 I.R.B. 730).

[272] A confidential transaction is one offered to the taxpayer under conditions of confidentiality by an advisor who receives a minimum fee. Treas. Reg. § 1.6011–4(b)(3) (2010). The minimum fee amount is $250,000 for corporate taxpayers. Treas. Reg. § 1.6011–4(b)(3)(iii) (2010).

[273] Transactions with contractual protection are transactions for which the taxpayer or a related party is entitled to a full or partial refund of fees paid if the intended tax consequences are not achieved. Treas. Reg. § 1.6011–4(b)(4) (2010). This may also be a transaction where fees are "contingent on the taxpayer's realization of tax benefits from the transaction." *Id*.

[274] A loss transaction is one that involves the corporate taxpayer claiming a loss under § 165 for $10 million for a single taxable year or $20 million for any combination of years. Treas. Reg. § 1.6011–4(b)(5) (2010).

[275] "Transactions of interest" encompass "transactions that the IRS has identified by notice or other pronouncement as having the potential for tax avoidance or evasion." LEDERMAN and MAZZA, *supra* note 41, at 502; *see also* Treas. Reg. § 1.6011-4(b)(6) (2010).

[276] Treas. Reg. § 1.6011–4(a) (2010); *see also* SALTZMAN SUPPLEMENT, *supra* note 240, ¶ 7B.16[3][b1]; Joshua Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection,* 56 UCLA L. REV. 1629, 1637 (2008–2009) [hereinafter Blank, *Overcoming Overdisclosure*].

8886, Reportable Transaction Disclosure Statement.[277] Form 8886 must include such information as an identification and description of the transaction, the parties involved and the tax structure, the tax benefits, and the expected tax treatment.[278] If a transaction becomes a listed or reportable transaction after the taxpayer has filed the return and before the end of the statute of limitation period for that return, the disclosure statement must be filed with the Office of Tax Shelter Analysis within ninety calendar days after the time when the transaction became a listed or reportable transaction.[279] There are significant penalties for failure to disclose a reportable transaction.[280]

In 2009, the IRS updated the set of "listed transactions" to offer more guidance to taxpayers and tax planners.[281] There are currently thirty-four listed transactions identified by IRS notices and revenue rulings.[282] The IRS has also published revenue procedures that limit the scope of these Treasury Regulations by providing lists of acceptable transactions that are not considered reportable transactions for certain disclosure rules.[283] The lists contained in these revenue procedures are referred to as "angel lists" and typically apply to one category of reportable transactions.[284]

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[277] I.R.S. Form 8886, *supra* 195; *see also* COLLINS AND ROBBINS, JR., *supra* note 159, § 12:6:4:E.

[278] *See* McMahon, *Living With the Codified ESD*, *supra* note 125, at 731.

[279] COLLINS AND ROBBINS, JR., *supra* note 159, § 12:6:4:E:1. This requirement applies even if the transaction did not become a listed or reportable transaction in the year in which the taxpayer was a participant. *Id.*

[280] *See* I.R.C. § 6707A(a) (2011) (imposing a separate penalty for failing to disclose reportable transactions); I.R.C. § 6662A(a)-(b)(2) (2011) (imposing an accuracy-related penalty for understatements of tax arising from listed and reportable avoidance transactions). These reportable transactions are also subject to registration and list maintenance requirements. I.R.C. §§ 6111(a), 6112(a) (2011).

[281] I.R.S. Notice 2009–59, 2009–2 C.B. 170. This represented an expansion of the listed transactions, which had not been updated since 2004. *See* I.R.S. Notice 2004–67, 2004–41 I.R.B. 600 (providing thirty listed transactions subject to disclosure requirements).

[282] Notice 2009–59, *supra* note 281 (providing thirty listed transactions subject to disclosure requirements). The listed transactions apply to taxpayers who participate in potential tax shelters, as well as "material advisors." *Id*. "The term 'material advisor' means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who directly or indirectly derives gross income in excess of the threshold amount . . . for such aid, assistance or advice." I.R.C. § 6111(b)(1)(A) (2011).

[283] Susan Simmonds, *IRS Issues Guidance on Shelter Registration Rules*, 105 TAX NOTES 1093, 1093 (2004) ("Each revenue procedure contains a caveat that the transactions may nonetheless be reportable under other provisions of reg. section 1.6011–4(b)."); *see generally* Rev. Proc. 2004–65, 2004–50 I.R.B. 965; Rev. Proc. 2004–66, 2004–50 I.R.B. 966; Rev. Proc. 2004–67, 2004–50 I.R.B. 967; Rev. Proc. 2007–20, 2007–7 I.R.B. 517.

[284] Simmonds, *supra* note 283, at 1093.

For example, in Rev. Proc. 2007-20,[285] the IRS issued an "angel list" of transactions with contractual protections that are not required to be disclosed.[286] There are four "angel lists" pertaining to the current reportable transactions.[287]

17.5 Professional Conduct and Ethics

In general, the guidelines governing attorney practice are promulgated by the American Bar Association and are administered by state bar disciplinary boards.[288] These guidelines are derived from the ABA Model Rules of Professional Conduct, the ABA Model Code of Professional Responsibility (the ethical standards for lawyers in all practice areas),[289] as well as in the formal opinions authored by the ABA Committee on Professional Ethics interpreting the Model Code and the Model Rules.[290] Specifically, the rules with respect to tax return positions are found in three ABA ethical opinions.[291] With respect to tax avoidance transactions, ABA Revised Formal Opinion 346 states that an attorney "functions more as an advisor than as an advocate" when providing a tax shelter opinion that "he knows will be relied upon by third" parties.[292] Thus, the attorney must render a "more

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[285] Rev. Proc. 2007–20, *supra* note 283.

[286] *Id*. (finding that these transactions are not reportable under §1.6011–4(b)(4), but may be reportable under §1.6011–4(b)(2), (b)(3), (b)(5), (b)(6), or (b)(7)); *see also* Blank, *Overcoming Overdisclosure*, *supra* note 276, at 1674.

[287] *See generally* Rev. Proc. 2004–65, *supra* note 283; Rev. Proc. 2004–66, *supra* note 283; Rev. Proc. 2004–67, *supra* note 283; Rev. Proc. 2007–20, *supra* note 283.

[288] Soled, *supra* note 183, at 290–91 (2008-2009) (citing BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 103.2 (6th ed. 2004))*; see also* MODEL CODE OF PROF'L RESPONSIBILITY Preliminary Statement ("The [Model] Code is designed to be adopted by appropriate agencies both as an inspirational guide to the members of the profession and as a basis for disciplinary action when the conduct of a lawyer falls below the required minimum standards stated in the Disciplinary Rules.").

[289] The ABA Model Code of Professional Responsibility was replaced by the ABA Model Rules of Professional Conduct as the ABA's formal position on legal ethical matters in 1983. STEPHEN GILLERS ET AL., REGULATION OF LAWYERS: STATUTES AND STANDARDS 591 (2010). The Model Rules of Professional Conduct have not been adopted unedited by any state. However, forty-nine states and the District of Columbia closely adhere to the language of the Model Rules. California is the only state to have its own system of ethical standards. *Id.* at 3.

[290] Soled, *supra* note 183, at 290–291.

[291] ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982) [hereinafter Formal Op. 346]; ABA Comm. on Prof'l Ethics and Grievances, Formal Op. 314 (1965).

[292] Formal Op. 346, *supra* note 291, at 2.

likely than not" opinion that the transaction in question would succeed if it were challenged by the Service.[293]

The AICPA is "the professional organization that promulgates the ethical responsibilities of accountants" with eight "Statements on Standards for Tax Services."[294] In addition to the AICPA and the ABA standards, Congress has authorized the Treasury Department to issue guidelines for tax practitioners and to regulate the practice of tax professionals before the IRS.[295] Treasury Department Circular No. 230 ("Circular 230") lays out the ethical rules for tax "practitioners"[296] who "practice before" the IRS, a group that can include practicing attorneys, certified public accountants ("CPAs"), enrolled agents, enrolled actuaries, and enrolled retirement plan agents. This means the individual "render[s] written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion."[297]

These practitioners must file written declarations with the IRS stating that they are qualified in their position as well as authorized to practice their professions.[298] Declarations and information regarding qualification must be provided to and is kept track of by the Office of Professional Responsibility ("OPR").[299] Therefore, in addition to meeting the standards laid out in Circular 230, lawyers, CPAs, and enrolled actuaries are required to adhere to the professional and ethical standards of their own professions and cannot be "under suspension or disbarment from practice."[300] Furthermore, failure to adhere to the requirements of Circular 230 can lead to discipline by the OPR.[301] Circular 230 parallels the ABA

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[293] Soled, *supra* note 183, at 291. The attorney must satisfy a confidence level of "reasonable basis" (a 10 to 20 percent likelihood of success on the merits), when advising a client with respect to a tax-controversy representation as well as negotiation and settlement proceedings and a slightly higher level of confidence, a "realistic possibility of success," (a 33 percent likelihood of success) for tax reporting positions. *Id.* at 291.

[294] For example, Statement on Standards for Tax Services Number 1 requires that accountants "only advocate tax return positions that meet a 'realistic possibility' of success standard (which is very similar in nature to the ABA 'realistic possibility of success' return position standard)." Soled, *supra* note 183, at 291.

[295] *See* 31 C.F.R. Pt. 10 (2008) [hereinafter Circular 230].

[296] Circular 230, *supra* note 295, § 10.2(a)(5).

[297] *Id.* § 10.2(a)(4).

[298] *Id.* § 10.3(a)–(e). The requisite written declaration for tax practitioners reflects the Treasury's high standard of qualification set for those who practice before the IRS.

[299] *Id.* § 10.1.

[300] *Id.* § 10.3(a), (b), (d).

[301] Audio tape: Hot Topics and Current Developments in Circular 230, sponsored by ABA Tax Section (June 2, 2010) (on file with author) [hereinafter Hot Topics in Circular 230]. The sanctions available for imposition by OPR include: disbarment, suspension, censure, and monetary sanctions. *Id.* Notably, "the IRS Office of Professional Responsibility may now levy steep monetary sanctions (that can amount to double the expected fees charged for advising reportable transaction) either in addition to or in lieu of other sanctions

Model Rules of Professional Conduct.[302] Consequently, violation of Circular 230's requirements and subsequent discipline by the OPR may be accompanied by discipline by state professional organizations, whether for lawyers, CPAs, or actuaries.[303] Nevertheless, disciplinary action by the OPR is unlikely to occur without prompting by a client complaint or a high profile tax case involving ethical violations.[304]

Subpart B of Circular 230 delineates duties related to practice before IRS, involving all matters of tax practice. One significant standard of professional responsibility that tax practitioners are held to is transparency, including the furnishing of information both to the IRS and to the OPR.[305] Upon request of the IRS, practitioners are required to promptly surrender records and any information related to a matter before the IRS unless he "believes in good faith and on reasonable grounds that the" requested information is privileged.[306] Tax practitioners are also obligated to be thorough, accurate, and efficient as well as to exercise due diligence in their tax services in order to ensure accuracy.[307] A practitioner must promptly advise a client upon knowledge of an instance of error, omission, or noncompliance in order to rectify it and inform the client of the consequences of noncompliance.[308]

A broader demand Circular 230 makes on tax practitioners is that they employ the recommended "best practices."[309] This obligation is met by: (1) clearly communicating terms of the tax assistance provided; (2) competently arriving at conclusions based on careful deliberation of law and facts; (3) informing clients of the significance of conclusions made; and (4) demonstrating integrity and fairness in practice before the IRS.[310] Firms

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that may be levied, including censure, suspension or disbarment." Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 449-50 (2008).

[302] BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE: CIRCULAR 230 AND SHELTER-RELATED DEVELOPMENTS 3 (2006 Supplement) [hereinafter STANDARDS 2006 SUPPLEMENT].

[303] *See* Michael B. Lang, *Patented Tax Strategies, Ethics and Circular 230: Protecting Yourself and Your Client*, 50 TAX MGMT. MEMORANDUM 275, 3 (2009). Similarly, conduct resulting in discipline by another licensing body may result in the inability to practice before the IRS. *See* Hot Topics in Circular 230, *supra* note 301.

[304] Lang, *supra* note 303, at 3.

[305] Circular 230, *supra* note 295, § 10.20.

[306] *Id.* § 10.20(a)(1). Similarly, upon request of the OPR, practitioners are required to promptly surrender records and any information related to an alleged ethical violation by any person, as well as to testify in relation to such information unless he has a good faith, reasonable belief that the requested information is privileged. *Id*. § 10.20(b).

[307] *Id*. § 10.22. A tax advisor should acquire reasonably sufficient skill and knowledge in order to competently advise his client.

[308] *Id*. § 10.21.

[309] *Id.* § 10.33.

[310] *Id.* § 10.33(a)(1)–(4).

must dedicate resources to ensure adherence to these standards because failure to follow "best practices" could increase the risk of malpractice liability.[311]

Circular 230 also lays out specific standards of practice for practitioners who advise clients seeking to engage in transactions that have as their significant purpose the evasion or avoidance of tax.[312] As part of the government effort to minimize the use of tax shelters, Circular 230 was amended to include detailed requirements for these tax opinions known as "covered opinions."[313] Covered opinions are the written advice from a practitioner to a client relating to Federal tax issues[314] arising from: (1) a transaction deemed to be the "same as or substantially similar" to a listed transaction;[315] (2) a plan or arrangement with the "principal purpose" of evading or avoiding taxes;[316] (3) a plan or arrangement with a "significant purpose" of evading or avoiding taxes if the covered opinion is a reliance opinion,[317] a marketed opinion,[318] confidential, or contractually protected.[319]

A *reliance opinion* is written advice that "concludes at a confidence level of at least more likely than not (greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's

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[311] STANDARDS 2006 SUPPLEMENT, *supra* note 302, at 4; *see also* Susan T. Edlavitch and Brian S. Masterson, *Circular 230 "Best Practices" and Written Advice Standards*, in REPRESENTING THE GROWING BUSINESS: TAX, CORPORATE, SECURITIES, AND ACCOUNTING ISSUES 775 (ALI-ABA 2007); Edward M. Manigault and Steve R. Akers, *Circular 230 – How It Changed Our Lives (or at Least Our Practices)*, PROB. & PROP., May-June 2006, at 32.

[312] LEDERMAN and MAZZA, *supra* note 41, at 717.

[313] Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Standards*, 25 VA. TAX REV. 583, 618–19 (2005-2006).

[314] Circular 230, *supra* note 295, § 10.35(b)(2)(i).

[315] *Id.* § 10.35(b)(2)(i)(A). Listed transactions are defined in Treas. Reg. § 1.6011-4(b)(2).

[316] Circular 230, *supra* note 295, § 10.35(b)(2)(i)(B).

[317] A *reliance opinion* is written advice that "concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor." *Id*. § 10.35(b)(4).

[318] A *marketed opinion* is written advice that a practitioner "knows or has reason to know . . . will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s)." *Id*. § 10.35(b)(5)(i).

[319] *Id*. § 10.35(b)(2)(i)(C)(1)–(4). Covered opinions do not include written advice provided with the reasonable expectation that a covered opinion will follow, written advice concerning qualification of a qualified plan, a state and local bond opinion, written advice included with required documents to be filed with the SEC, and advice rendered after a taxpayer has already filed a return with the IRS that includes the tax benefit. *Id*. § 10.35 (b)(2)(ii)(A)–(E).

favor."[320] The rules relating to reliance opinions are considered to be "the most controversial aspect of the new regulations because of their potential breadth and the cumbersome requirements that they impose."[321] There is, however, an important exception to the reliance definition. Written advice will not be treated as a reliance opinion if it prominently discloses that it was not intended to be used by the taxpayer to avoid penalties.[322] A similar disclosure will serve to remove a marketed opinion from the covered opinion rules.[323] Most law and accounting firms now routinely affix this disclaimer legend on all written advice that they provide including email correspondence.[324]

In covered opinions, tax practitioners are required to employ "reasonable efforts" to obtain and consider all facts relevant to the transaction in question, without basing the opinion on any unreasonable factual assumptions, "representations, statements or findings."[325] The covered opinion should apply law to the relevant facts, without assuming a favorable resolution or inconsistent legal conclusions.[326] Instead, the opinion should provide and describe the reasons for the conclusions that the practitioner draws "as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue."[327] It should also offer an overall conclusion and reasons as to whether the treatment of the avoidance transaction is likely the proper treatment.[328]

Similar to other IRS tax shelter disclosure requirements, covered opinions must disclose the relationship between a tax practitioner and the client or promoter of the tax avoidance transaction including any compensation or referral arrangements.[329] Marketed opinions are further required to disclose that they were "written to support the promotion or marketing of

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[320] *Id*. § 10.35(b)(4).

[321] STANDARDS 2006 SUPPLEMENT, *supra* note 302, at 8.

[322] Circular 230, *supra* note 295, § 10.35(b)(4)(ii).

[323] STANDARDS 2006 SUPPLEMENT, *supra* note 302, at 10. The disclaimer must contain additional language disclosing that the opinion was written to support the marketing of the transaction and that the taxpayer should seek individualized tax advice from an independent tax advisor. *Id.*

[324] *See id.* at 9. For example, tax practitioners now use a "no penalty reliance legend," tagged to all written and electronic correspondence with clients. The legend warns the client against reliance on the communication for "the ultimate validity of the benefits or for purposes of avoiding tax penalties." Soled, *supra* note 183, at 269–70, n. 7 (citing Sheryl Stratton, *Circular 230 E-Mails, T-Shirts Attain Legendary' Status*, TAX NOTES TODAY, July 5, 2005, *available at* 2005 TNT 127-1).

[325] Circular 230, *supra* note 295, § 10.35(c)(1)(i)–(iii).

[326] *Id.* § 10.35(c)(2)(i)–(iii).

[327] *Id.* § 10.35(c)(3)(ii).

[328] *Id.* § 10.35(c)(4)(i). If it is a *marketed opinion*, the confidence level is raised to "at least more likely than not." *Id.* § 10.35(c)(4)(ii).

[329] *Id*. 10.35(e)(1)(i)-(ii).

the transaction(s)" and recommend that the client seek independent advice based on the client's individual circumstances.[330] A tax practitioner is prohibited from rendering advice to a client that is inconsistent with the disclosure required by Circular 230.[331] Firms must have procedures in place to ensure compliance with the covered opinion requirements.[332]

Many provisions of the Code reflect the professional standards delineated in Circular 230. Code section 6111 for example, requires that a tax adviser to a client engaging in a reportable transaction must file a return with information regarding the transaction with the IRS.[333] Other Code sections regulate the advice a practitioner may give to a client. Tax practitioners are limited in advising clients to take positions, in that they may only make a recommendation that meets one of the section 6694(a) standards.[334] This provision requires that a practitioner have a reasonable belief that the recommended course of action regarding a reportable transaction "would more likely than not be sustained on its merits."[335] For other transactions, the practitioner must support his advice with "substantial authority" or the recommended position must be fully disclosed and have a "reasonable basis."[336]

Tax practitioners have responded to these standards of professional responsibility by implementing stringent governance and internal control procedures.[337] These procedures include the regulation of issued opinions on tax avoidance strategies, in addition to strict oversight of adherence to new ethical standards within firms.[338] Motivation for these actions stems not only from the threat of professional sanctions, but also from the threat of liability. Successful tax shelter malpractice suits provide a strong incentive for practitioners to meet disclosure requirements and provide the government with requested taxpayer information.[339] Adherence to high ethical standards is a prudent method of deterring such law suits.[340]

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[330] *Id.* § 10.35(e)(2)(i)–(ii).

[331] *Id.* § 10.35(e)(5).

[332] *Id.* § 10.36; *see also* Standards 2006 Supplement, *supra* note 302, at 18.

[333] I.R.C. § 6111(a) (2011).

[334] I.R.C. § 6694*; see also* Lang*, supra* note 303, at 10.

[335] I.R.C. § 6694(a)(2)(C).

[336] I.R.C. § 6694(a)(2)(A)–(B); *see also* Lang, *supra* note 303, at 10.

[337] Soled, *supra* note 183, at 269.

[338] *Id.*

[339] *Id.* at 301–03, 307.

[340] Novella N. Clevenger, *Ethical Issues for the Tax Practitioner*, The Nat'l Pub. Acct. (Nov. 1, 1995), *available at* http://www.allbusiness.com/accounting/methods-standards-generall-accepted-accounting/531017-1.html.

The professional standards for tax advisers are continually revised and updated.[341] In September 2010, the Department of the Treasury finalized regulations that tighten qualification requirements for tax practitioners by requiring paid tax return preparers to obtain a Preparer Tax Identification Number ("PTIN") and pay a registration fee, instituting qualification exams, and allowing for the possibility of future guidance that would require continuing education.[342] Proposed recommendations would also expand the scope of Circular 230 to apply to both signing and non-signing preparers of tax returns in order to ensure competence and integrity in the tax system.[343]

17.6 Conclusion

The war on corporate tax shelters has been described as the government's version of the "Whack-a-Mole" game.[344] However, over the past decade, the war has become much more sophisticated with the government attacking the problem on many fronts. In the judicial arena, the courts appear to be more willing to apply judicial doctrines to deny various tax losses to taxpayers as demonstrated by the many corporate tax shelter decisions finding in the government's favor. The codification of the economic substance doctrine should reinforce this trend particularly with respect to courts that preferred to take a literary approach to statutory interpretation.

Congress can continue to enact targeted statutory changes to eradicate specific tax shelter transactions as they become known, particularly in

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[341] As evidence, ethical standards of tax avoidance transactions and schemes have been a recurring topic at ABA Tax Section meetings, as well as those of state bar and accounting organizations, over the last several years. *See, e.g.,* Linda Beale, *Tax Patents: At the Crossroads of Tax and Patent Law*, 2008 U. ILL. J.L. TECH. & POL'Y 107, 110 n.19 (2008) ("Tax patents were a significant topic of discussion at the ABA Tax Section Annual Meeting in Washington, D.C. in May 2007, the Fall Joint CLE Meeting in Vancouver, BC in September 2007, and the Mid-Year Meeting in January 2008 in Lake Las Vegas, Nevada.").

[342] *See generally* Treas. Reg. § 1.6109-2 (2010) (as amended by T.D. 9501, 2010-2 C.B. 651). Prior to this, there had been a 6-month study by the IRS of paid preparers that concluded in December 2009. Internal Revenue Service, *Return Preparer Review* (2009), *available at* http://www.irs.gov/pub/irs-pdf/p4832.pdf [hereinafter *Return Preparer Review*]; *see also* Jeremiah Coder, *IRS Recommends Registration, Testing for Paid Return Preparers*, 126 TAX NOTES 149 (2010). Licensed attorneys and CPAs will be exempted from the testing and continuing education requirements. *See* Hot Topics in Circular 230, *supra* note 301.

[343] Internal Revenue Service, *IRS Proposes New Registration, Testing and Continuing Education Requirements for Tax Return Preparers Not Already Subject to Oversight*, *available at* http://www.irs.gov/newsroom/article/0,,id=217781,00.html (last visited June 17, 2011); *Return Preparer Review*, *supra* note 342, at 34.

[344] Roin, *supra* note 11, at 182.

the international arena. It is likely that the more stringent penalties have deterred some questionable taxpayer behavior. The IRS is somewhat successfully ferreting out shelters before they become too widespread because of the increased disclosure required of aggressive transactions. It is too early to tell whether the new Schedule UTP will be an effective source of information, but the IRS is hopeful.

It is important to continue the debate on the successes and failures of each of these strategies and to constantly make modifications and adjustments. Moles do not hibernate.[345] Somewhere in America at a tax boutique firm, creative tax advisors are putting together new tax shelters waiting for Corporate America to earn profits that need sheltering.

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[345] Internet Center for Wildlife Damage Management, Mole Control and Management Information, http://icwdm.org/wildlife/mole.asp (last visited May 9, 2011).

Appendix

K.B. Brown (ed.), *A Comparative Look at Regulation of Corporate Tax Avoidance*, Ius Gentium: Comparative Perspectives on Law and Justice 12,
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	Type of legal system	Branch responsible for enforcement	Does the country acknowledge tax evasion, tax mitigation, and tax avoidance?	Is there a judicial economic substance doctrine?	Is there a GAAR?	When was a GAAR adopted or considered?	Is there an anti-tax shelter program?	Are there special penalties for tax shelters?	Are there disclosure requirements for tax shelters?
Australia	Common Law	Executive	The Code only distinguishes between tax avoidance and tax evasion	No	Yes; There are three component elements of the GAAR: a scheme, a tax benefit and the dominant purpose of obtaining the tax benefit.	1936 (as modified in 1981)	No	No	No
Austria	Civil Law	Executive	Yes (evasion = illegal; mitigation = legal; avoidance is proscribed by generally applicable laws)	Yes: The courts utilize a substance over form approach	Yes	—	No	No	No
Canada	Quebec follows civil law, the rest of Canada follows common law	Canadian Revenue Agency	(not mentioned in report)	Courts are reluctant to develop judicial economic substance doctrine	Yes	1988	Yes	Yes	Yes
China	Civil Law	State Administration of Taxation	Tax mitigation is not recognized; Tax evasion and avoidance are	No: The SAT is responsible for regulating tax avoidance	Yes	2007, effective 2008	No	No	No
Croatia	Civil Law	Executive	Not as such, but the differences are understood by scholars	Yes	No	N/A	No	No	No
France	Civil Law	French Tax Administration	Abuse of law	Yes: Substance over form	Yes, Art. L64	2008	No	Yes	No
Germany	Civil Law	Federal Ministry of Finance	Yes	Yes	Yes	1919, revised in 2008	Yes	Yes	No
Greece	Civil Law	Executive	Tax commentators make similar distinctions	No - but substance over form (tax legal realism)	No	N/A	No	No	For offshore activities
Hungary	Civil Law	Cabinet (HMRC)	Yes: Tax avoidance and evasion	No	Yes	1991	No	No	No
Italy	Civil Law	Tax Authorities	Yes	Valid business purpose test	Yes, but the GAAR only applies with respect to a specific, but extremely broad array of transactions	1990	No	No	No
Japan	Civil Law	Executive	Yes	Yes: Substance over form	No	1950's	Yes	No	No

	Type of legal system	Branch responsible for enforcement	Does the country acknowledge tax evasion, tax mitigation, and tax avoidance?	Is there a judicial economic substance doctrine?	Is there a GAAR?	When was a GAAR adopted or considered?	Is there an anti-tax shelter program?	Are there special penalties for tax shelters?	Are there disclosure requirements for tax shelters?
Netherlands	Civil Law	Tax Administration	There are no general definitions of these terms	Yes, but not styled as such	Yes, although it has largely been superseded by judicial doctrine and special anti-avoidance rules	First enacted in 1925, but the government ceased using the provision in 1987	No	No	No
New Zealand	Common Law	Inland Revenue Department	These are no terms of art, but tax avoidance is defined for purposes of the GAAR	Yes	Yes	1878, but not in regular use until 1960's	No	No	No
Poland	Civil Law	Tax Administration	Not defined by law	Business Purpose is addressed seldomly	No	A GAAR was enacted in 2003, but found unconstitutional in 2005	No	No	No
Russia	Civil Law	Federal Tax Service	Tax evasion is proscribed by law	Substance over form approach is utilized by the arbitration courts	(not mentioned in report)	—	Yes	No	No
Slovenia	Civil Law	Organ under Ministry of Finance	Acknowledges difference between evasion and avoidance	anti-avoidance, anti-abuse approach is codified	General anti-abuse rule short of GAAR	N/A	No	No	No
South Africa	Common Law	South African Revenue Service	Yes	Yes	Yes	1941, amended in 2006 and 2008	No	No	Yes, if covered by GAAR
Sweden	Civil Law	Swedish Tax Agency	Avoidance and evasion	Yes	Yes	1980	No	No	No
Taiwan	Civil	Executive Yuan	Acknowledged, but only "tax evasion" appears in the code	Yes, similar to substance over form criteria in the US	There is a new provision similar to GAAR	GAAR-like statute adopted in 2009	No	No	No
United Kingdom	England and Wales are common law; Scotland is a mix of common and civil law	HMRC	Tax evasion is distinguished on the basis that it is illegal (tax avoidance is not per se prohibited)	This is sometimes considered when judiciary employs purposive approach to statutory interpretation	No	Currently under consideration	No	No	Yes: Required of promoter and sometimes user
United States	Common Law	Executive	Yes	Yes	Yes	2010	Yes	Yes	Yes