Tax Avoidance Revisited

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1. The purpose of this note is to discuss the definition, objectives and nature of avoidance rules by focussing on the following questions:

   1.1. Is there a generally accepted concept of tax avoidance that enables a determination of whether tax avoidance should be regulated?

   1.2. How harmful is tax avoidance to the public interest?

   1.3. How effective or defective are the current rules?

   1.4. How can the current rules be improved?

2. A generally accepted starting definition of tax avoidance is any lawful behaviour designed to avoid tax. Illegal behaviour constitutes tax evasion. In my opinion, this unrefined starting definition is sufficient to determine whether tax avoidance should be the subject of specific regulation, involving the refinement of its application to particular taxes.

3. It is generally accepted amongst welfare economists that tax avoidance is harmful to the public interest. First, the government seeks to raise taxes to achieve its national welfare objectives, and tax avoidance undermines that objective. Secondly, tax avoidance is characterised by an excessive degree of tax influence in decisionmaking, which magnifies the dead-weight loss of the tax system. There are also equity arguments against tax avoidance. First, if government is to achieve its revenue target, unwanted tax avoidance results in a redistribution of the tax burden. Secondly, excessive tax avoidance will undermine the public's confidence in the tax system which will affect their willingness to comply with tax laws and procedures.

4. I am unaware of any scientific study of the economic costs of avoidance in New Zealand. There are related measures however. The Report of the Committee of Experts, starting at page 152, provides some statistics on the black economy (a proxy for evasion), which shows that it hovers around 9% of GDP (c$9 billion), having a tax effect of around $3 billion, being c10% of taxes collected (c$31 billion). The second observation is that the economic definition of tax avoidance is likely to include any adverse tax induced behaviour, which would incorporate dead-weight losses. [I note however that I do not support such a broad legal definition of tax avoidance on the basis that much of the behaviour causing these economic costs cannot be avoided by avoidance provisions]. A 1994 New Zealand Business Roundtable study estimated deadweight losses to be 18% in respect of labour income. Given that the dead-weight loss on capital income would be higher (as capital is a more elastic factor), we can therefore say the Report estimates the minimum overall dead-weight loss in New Zealand from tax avoidance at $18 billion.

5. The next question concerns the effectiveness of current tax avoidance rules. Tax avoidance is usually discussed in an income tax context, whereas such rules do exist outside the income tax, such as section 76 of the Goods and Services Act 1985. Indeed, avoidance legislation is sometimes enacted in non-tax legislation. For example the definition of a credit contract in the Credit Contracts Act 1981 includes the following limb: *(4) Where, by virtue of any contract or contracts (none of which by itself constitutes a credit contract) or any arrangement, there is a transaction that is in substance or effect a credit contract, the contract, contracts, or arrangement shall for the purposes of this Act be deemed to be a credit contract made at the time when the contract, or the last of those contracts, or the arrangement, was made, as the case may be.* A further example is section 68 of the Electricity Industry Reform Act 1998 that states that: *No person may at any time do anything to defeat the purposes of Parts 1 to 5.* I have also reproduced in the attached Appendix, the present anti-avoidance provisions contained in the Income Tax Act 1994 and the Goods and Services Act 1985.

6. There appears to be a lack of consensus in New Zealand about whether exsiting rules and approaches are effective. For example, the Valabh Committee was keen to revise the income tax avoidance rules, whereas, the Committee of Experts preferred they remain largely unaltered. Some commentators prefer that there be no general income tax avoidance provision, whereas others such provisions. And finally, there is a diversity of judicial approach across time and place to defining and applying avoidance provisions. Unfortunately, this cleavage of opinion contributes to an uncertain and unstable tax avoidance law.

7. I consider that the test for adequacy of the existing rules turns on their ability to enable persons to predict that an anticipated arrangement, or determine that an actual arrangement, constitutes tax avoidance. A contrary argument is that an uncertain tax avoidance law increases the cost of tax avoidance transactions. In other words, risk averse taxpayers are more likely to engage in less tax avoidance around an uncertain boundary. I consider that an uncertain definition is more costly because it kills off legitimate transactions and complicates dispute resolution.

8. Income tax legislation contains the most extensive range of specific avoidance provisions ("SAP's") in addition to a general avoidance provision ("GAP"). I consider that these provisions largely do not meet the test set out in the above paragraph. In particular, they do not specify the relationship between SAP's, the GAP and non-avoidance legislation. Furthermore, the GAP is incomplete. It defines tax avoidance in terms of avoidance of a liability to tax, but fails to specify when a normative liability has been avoided. This requires the Court to first determine whether the liability asserted by the taxpayer, the Commissioner, or some other liability, was the tax liability intended by the Legislature. This matter is not answered by the provision dealing with purpose or effect, because that provision relies on a starting definition of tax avoidance.

9. The second general inadequacy concerns an unsettling of a traditional approach to the construction of taxing statutes. A number of English tax decisions have moved towards the North American tradition of relaxing the focus on a formal analysis of the facts and the statute, bearing in mind that the English judges still dominate our highest appellate Court. For example, in the House of Lords decision in *IRC v McGuckian* [1997] 3 All ER 817, Lord Steyn made the following remarks:

   It is necessary to distinguish between two separate questions of law. The first is whether there is a special rule applicable to the construction of fiscal legislation. The second question is whether there is a rule precluding the court from examining the substance of a composite tax avoidance scheme. I consider first the construction of tax statutes.

Towards the end of the last century Pollock characterised the approach of judges to statutory construction as follows: "Parliament generally changes the law for the worse, and that the business of judges is to keep the mischief of its interference within the narrowest possible bounds": Essays on Jurisprudence and Ethics (1882), 85. Whatever the merits of this observation may have been when it was made, or even earlier in this century, it is demonstrably no longer true. During the last 30 years there has been a shift away from literalist to purposive methods of construction. Where there is no obvious meaning of a statutory provision the modern emphasis is on a contextual approach designed to identify the purpose of a statute and to give effect to it. But under the influence of the narrow Duke of Westminster doctrine tax law remained remarkably resistant to the new non formalist methods of interpretation. It was said that the taxpayer was entitled to stand on a literal construction of the words used regardless of the purpose of the statute: Pryce v Monmouthshire Canal and Railway Cos (1879) 4 App Cas 197, 202-203 ; Cape Brandy Syndicate v IRC [1921] 1 KB 64, 71 ; IRC v Plummer [1980] AC 896 . Tax law was by and large left behind as some island of literal interpretation. The second problem was that in regard to tax avoidance schemes the courts regarded themselves as compelled to adopt a step by step analysis of such schemes, treating each step as a distinct transaction producing its own tax consequences. It was thought that if the steps were genuine, ie not sham or simulated documents or arrangements, the court was not entitled to go behind the form of the individual transactions. In combination those two features - literal interpretation of tax statutes and the formalistic insistence on examining steps in a composite scheme separately - allowed tax avoidance schemes to flourish to the detriment of the general body of taxpayers. The result was that the court appeared to be relegated to the role of a spectator concentrating on the individual moves in a highly skilled game: the court was mesmerised by the moves in the game and paid no regard to the strategy of the participants or the end result. The courts became habituated to this narrow view of their role.

On both fronts the intellectual breakthrough came in 1981 in Ramsay, and notably in Lord Wilberforce's seminal speech which carried the agreement of Lord Russell of Killowen, Lord Roskill and Lord Bridge of Harwich. Lord Wilberforce restated the principle of statutory construction that a subject is only to be taxed upon clear words at [1982] AC 300, 323C-D. To the question "what are clear words?" he gave the answer that the court is not confined to a literal interpretation. He added "There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded." This sentence was critical. It marked the rejection by the House of pure literalism in the interpretation of tax statutes.

But that left the problem of the courts' self denying ordinance of not examining the true nature of a composite transaction. Lord Wilberforce observed, at p. 323H that the Duke of Westminster case did not compel the court to look at documents or transactions in blinkers, isolated from the context in which they properly belong. Lord Wilberforce concluded, at p. 326C-D:

"... While the techniques of tax avoidance progress and are technically improved, the courts are not obliged to stand still. Such immobility must result either in loss of tax, to the prejudice of other taxpayers, or to Parliamentary congestion or (most likely) to both. To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made: legislation cannot be required or even be desirable to enable the courts to arrive at a conclusion which corresponds with the parties' own intentions."

In other words, if it was shown that a scheme was intended to be implemented as a whole, legal analysis permitted the court in deciding a fiscal question to take into account the composite transaction.

While Lord Tomlin's observations in the Duke of Westminster case [1936] AC I still point to a material consideration, namely the general liberty of the citizen to arrange his financial affairs as he thinks fits, they have ceased to be canonical as to the consequence of a tax avoidance scheme. Indeed, as Lord Diplock observed, Lord Tomlin's observations tells us little or nothing as to what method of ordering one's affairs will be recognised by the courts as effective to lessen the tax that would otherwise be payable: RC v Burmah Oil Co Ltd (1981) TC 200, 214-215 .

The new Ramsay principle was not invented on a juristic basis independent of statute. That would have been indefensible since a court has no power to amend a tax statute. The principle was developed as a matter of statutory construction. That was made clear by Lord Wilberforce in Ramsay and is also made clear in subsequent decisions in this line of authority: see the review in the dissenting speech of Lord Goff of Chieveley in Craven v White [1989] AC 398, 520C-521E . The new development was not based on a linguistic analysis of the meaning of particular words in a statute. It was founded on a broad purposive interpretation, giving effect to the intention of Parliament. The principle enunciated in Ramsay was therefore based on an orthodox form of statutory interpretation. And in asserting the power to examine the substance of a composite transaction the House of Lords was simply rejecting formalism in fiscal matters and choosing a more realistic legal analysis. Given the reasoning underlying the new approach it is wrong to regard the decisions of the House of Lords since Ramsay as necessarily marking the limit of the law on tax avoidance schemes.

10. I do not believe the above approach has been traditional in New Zealand. For example, in *Mills v Dowdall* [1983] NZLR 154 (CA), Richardson J summarised the position:

The legal principles governing the ascertainment of the true legal character of a transaction are now well settled and for recent discussions in this Court it is sufficient to refer to Re Securitibank Ltd (No 2) [1978] 2 NZLR 136 Buckley & Young Ltd v Commissioner of Inland Revenue [1978] 2 NZLR 485; (1978) 3 NZTC 61,271; (1978) 2 TRNZ 485, Marac Finance Ltd v Virtue [1981] 1 NZLR 586 and Commissioner of Inland Revenue v Smythe [1981] 1 NZLR 673. It frequently happens that the same result in a business sense can be attained by two different legal transactions. The parties are free to choose whatever lawful arrangements will suit their purposes. The true nature of their transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. Not on an assessment of the broad substance of the transaction measured by the results intended and achieved; or of the overall economic consequences to the parties; or of the legal consequences which would follow from an alternative course which they could have adopted had they chosen to do so. The forms adopted cannot be dismissed as mere machinery for effecting the purposes of the parties. It is the legal character of the transaction that is actually entered into and the legal steps which are followed which are decisive. That requires consideration of the whole of the contractual arrangement and if the transaction is embodied in a series of inter-related agreements they must be considered together and one may be read to explain the others. In characterising the transaction regard is had to surrounding circumstances: not to deny or contradict the written agreement but in order to understand the setting in which it was made and to construe it against that factual background having regard to the genesis and objectively the aim of the transaction. The only exceptions to the principle that the legal consequences of a transaction turn on the terms of the legal arrangements actually entered into and carried out are:

(i) where the essential genuineness of the transaction is challenged and sham is established; and

(ii) where there is a statutory provision, such as s 99 of the Income Tax Act 1976,

mandating a broader or different approach which applies in the circumstances of the particular case. A document may be brushed aside if an to the extent that it is a sham in two situations:

(a) where the documents does not reflect the true agreement between the parties in which case the cloak is removed and recognition given to their common intentions (as happened in Marac Finance Ltd v Virtue); and

(b) where the document was bona fide in inception but the parties have departed from their initial agreement while leaving the original documentation to stand unaltered.

The reason why the Courts have adopted the approach I have been discussing is obvious enough. Commercial men are entitled to order their affairs to achieve the legal and lawful results which they intend. If they deliberately enter into a genuine transaction intended to operate according to its tenor, those intentions should be recognised. It is what they choose to do that counts and their rights and obligations should be determined on that basis except where the legislation has itself directed otherwise.

11. I consider that the principles of statutory interpretation enunciated in *McGuckian* move tax law further away from the goals outlined in paragraph 7. The development of this line of cases in the United Kingdom occurred in the context of tax legislation that lacked a GAP. My crude observation is that the English House of Lords got fed up with tax schemes that flourished on the basis of more certain tax laws based on a formal and traditional analysis of transactions and statutes.

12. I prefer the use of legislative avoidance provisions alongside a formal approach to tax legislation in general. I suspect that this particular issue would be highly controversial amongst lawyers, economists and accountants. Again, I would test the various approaches by assessing their impact on the overall certainty of the tax law.

13. The final question for consideration is how existing tax avoidance law could be improved. The most difficult practical problem with such provisions is how to determine whether the arrangement undertaken is in accordance with legislative intent. I recommend a 2-tier approach. First, focus only on those arrangements in which a tax objective is dominant. Secondly, save those arrangements in which the Legislature can reasonably be regarded as condoning the tax consequence sought by the taxpayer. This second test is necessary to save those commercial decisions in which tax factors must predominate, such as an election to be a consolidated company for tax purposes.

14. Finally, I would emphasise that avoidance provisions are a blunt instrument, and they should not be relied on to substantially mitigate the economic costs of avoidance activity. Tax systems should be designed in ways that reduce the returns to avoidance activities, the key design elements being:

    14.1. a broad tax base and a broad mix of bases;

    14.2. low tax rates;

    14.3. effective penalty and interest systems;

    14.4. effective disclosure and rulings regimes;

    14.5. effective policy formation and implementation;

    14.6. effective detection, audit, and dispute (including Court) resolution.

APPENDIX

General Avoidance Provisions

Income Tax Act 1994

SECT OB 1 "TAX AVOIDANCE ARRANGEMENT"

In this Act, unless the context otherwise requires, -

Tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly -

(2) Has tax avoidance as its purpose or effect; or

(2) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental:

SECT OB 1 "TAX AVOIDANCE",

In this Act, unless the context otherwise requires, -

Tax avoidance in sections BG 1, EH 1, [EH 42,] GB 1, and GC 12, includes -

(2) Directly or indirectly altering the incidence of any income tax:

(2) Directly or indirectly relieving any person from liability to pay income tax:

(c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax:

SECT OB 1 "LIABILITY"

In this Act, unless the context otherwise requires, -

Liability in the definition of "tax avoidance", includes a potential or prospective liability to future income tax:

SECT OB 1 "ARRANGEMENT"

In this Act, unless the context otherwise requires, -

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

SECT BB 3. OVERRIDING EFFECT OF CERTAIN MATTERS

Tax avoidance arrangement - Subpart BG

(2) If a person is affected by a tax avoidance arrangement, the person may not have satisfied an obligation under this Act if the satisfaction is dependent on the arrangement being valid for income tax purposes.

SECT BG 1. AVOIDANCE

Arrangement void

(2) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

Enforcement

(2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement.

SECT GB 1. AGREEMENTS PURPORTING TO ALTER INCIDENCE OF TAX TO BE VOID -

(2) Where an arrangement is void in accordance with section BG 1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement may be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, the Commissioner may have regard to -

(2) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or

(2) Such amounts of gross income and allowable deductions as, in the Commissioner's opinion, that person would have had, if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.

(2) Where any amount of gross income or allowable deduction is included in the calculation of taxable income of any person under subsection (1), then, for the purposes of this Act, that amount will not be included in the calculation of the taxable income of any other person.

Section 76 of the Goods and Services Act 1985

76. AGREEMENT TO DEFEAT THE INTENTION AND APPLICATION OF ACT TO BE VOID--

(1) Notwithstanding anything in this Act, where the Commissioner is satisfied that an arrangement has been entered into between persons to defeat the intent and application of this Act, or of any provision of this Act, the Commissioner shall treat the arrangement as void for the purposes of this Act and shall adjust the the { sic } amount of tax payable by any registered person (or refundable to that person by the Commissioner) who is affected by the arrangement, whether or not that registered person is a party to it, in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained by that registered person from or under that arrangement.

(2) The Commissioner may, for the purposes of this section, deem--

(a) Any person (not being, apart from this subsection, a registered person) who is a party to or has participated in any way in any arrangement, to be a registered person:

(b) Any supply of goods and services, whether or not a taxable supply, that is affected by or is part of any arrangement, to be both made to and made by any registered person:

(c) Any supply of goods and services to occur in any taxable period that, but for any arrangement affected by this section, would have been the taxable period in which the supply was made:

(d) Any supply of goods and services to have been made, or consideration for such supply to be given, at open market value.

(3) Where--

(a) Any person (in this subsection hereafter referred to as the original person) enters into any arrangement on or after the 22nd day of August 1985 whereby any taxable activity formerly carried on by the original person is carried on, in whole or in part, by any other person or other persons; and

(b) The original person and the other person or other persons are associated persons,--

for the purposes of sections [15 (3), 15 (4)], [19A (1)], and 51 (1) of this Act, the value of the supplies made in the course of carrying on all taxable activities in any period of 12 months commencing on the first day of any month by the original person and by the other person or, as the case may be, by the other persons shall, so far as the value relates to those supplies arising from the taxable activity formerly carried on by the original person, each be deemed to be equal to the aggregate of the value of the taxable supplies made by all of them for that period:

Provided that the Commissioner may, having regard to the circumstances of the case and if the Commissioner thinks it equitable to do so, determine in any particular case that this subsection shall not apply to all or any of the original person and that other person or, as the case may be, those other persons.

(4) For the purposes of this section--

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

"Tax advantage" includes--

(a) Any reduction in the liability of any registered person to pay tax:

(b) Any increase in the entitlement of any registered person to a refund of tax:

(c) Any reduction in the total consideration payable by any person in respect of any supply of goods and services.