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A comparison of statutory general anti-avoidance rules and judicial general anti-avoidance doctrines as a means of controlling tax avoidance: Which is better? (What would John Tiley think?)

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Introduction

There is an inverse relationship between quantity and quality with respect to many things, including writing about tax avoidance. Everyone working in the tax area has views about tax avoidance and almost everyone, it seems, feels an irresistible urge to inflict these views on others. Most of the writing on tax avoidance is in the nature of fast food: quickly prepared, consumed, digested and forgotten – and, if consumed in excessive quantities, dangerous to your (mental) health. In a fast-food world, master chefs are revered and celebrated. Professor John Tiley is a master chef with respect to offerings about tax avoidance. His writings about controlling tax avoidance constitute the fine-dining experience, the Michelin three-star restaurant in a world of greasy spoons, chains and all-you-can-eat buffets. It is fitting that we celebrate his contributions.

The subject of my paper is a comparison of a statutory general anti-avoidance rule and judicial general anti-avoidance doctrines as methods of controlling tax avoidance. The paper assumes, fairly I think, that specific statutory anti-avoidance rules and limited judicial anti-avoidance doctrines such as sham are necessary but not even nearly sufficient to deal effectively with tax avoidance. The issue can be framed in a number of ways. Often in the context of a particular country, it takes the form of the question: is a statutory GAAR necessary? The issue was put this way in Canada in the mid-1980s when the GAAR was adopted and it has been put that way in the UK since the *Ramsay* case in 1981.

Other people, especially Tiley, are much more qualified than me to opine about whether the UK should adopt a GAAR. Instead, in this paper

I want to emulate Tiley and approach the issue from a comparative perspective. Comparative analysis has been a prominent feature of Tiley's writing on tax avoidance over his career. The subject lends itself to comparative treatment because some countries (notably the UK and the US) have vigorous judicial anti-avoidance doctrines and no statutory GAAR, while other countries with similar legal traditions (Australia, Canada, New Zealand and South Africa) have enacted statutory GAARs.

The organisation of the paper is straightforward. It commences with a background section dealing with some preliminary issues relating to the broader context in which anti-avoidance rules operate that are essential to an understanding of both judicial doctrines and statutory GAARs. The two following sections describe statutory GAARs and judicial anti-avoidance doctrines from a general perspective. I have avoided detailed descriptions and analysis of the anti-avoidance measures of specific countries because of space restrictions and the availability of this material elsewhere. These two sections are followed by an assessment of the two methods of controlling tax avoidance and a brief comparison of the seemingly similar situations in Canada under its statutory GAAR and the UK with its judicial approach.

1.1 Background – preliminary matters

Introduction

One typical aspect of Tiley's writings on tax avoidance that I especially value is the care with which he situates the discussion of the most recent case or statutory provision in a broader context – and for him that context is very broad indeed.

In a short article published in 1985,[1] soon after the *Ramsay*[2] and *Furniss v Dawson*[3] cases, Tiley reminds everyone, but in particular, panicking practitioners, that –

> these decisions represent a classic example of legal development; there is nothing unusual about the way the need for change has come about nor about the way in which the change was made and it is suggested that history may also warn us to avoid jumping to solutions.[4]

[1] Tiley (1985a). [2] *Ramsay v IRC* [1982] AC 300 (HL).
[3] *Furniss v Dawson* [1984] AC 474 (HL). [4] Tiley (1985a, p. 19).

He placed the decisions in the broader context of the law generally;[5] in the historical context of parallel developments in the law of negligence and the rule against perpetuities; and in the comparative context.[6] In a 2004 article, he wisely advises us to 'bypass the judicial rhetoric in particular cases and ask what the judges have actually done'.[7] At the same time, he admonishes the judges for forgetting that '[t]heir words are pored over not just for the fun of gazing at entrails but in order to give advice about what those very judges might do next.'[8]

In the chapter of his textbook[9] dealing with 'The Control of Tax Avoidance', before discussing the UK case law, which is the central focus of the chapter, he usefully sets the stage by identifying eleven ways in which legislatures can control tax avoidance and discussing the advantages and disadvantages of anti-avoidance legislation. That chapter also discusses the experience of several countries (European, Commonwealth and the US) with statutory general anti-avoidance rules and the aspects of a tax system related to the need for and structure of a GAAR (information disclosure rules and the availability of a clearance or advance rulings procedure). It also demonstrates an appreciation of history, with references to statutory GAARs in the UK excess profits tax during the Second World War. Thus, anti-avoidance rules and doctrines are always portrayed by Tiley as an integral part of the tax system.

The starting point: the Duke of Westminster

As noted above, Tiley is especially sensitive to the influence of history on tax law.[10] It is no surprise, therefore, that his analysis of anti-avoidance doctrines in the UK and other Commonwealth countries usually commences with the seminal *Duke of Westminster* case.[11] He cites the case not only for the obvious point that the House of Lords affirmed the right of taxpayers to arrange their affairs to minimise tax, but also for the more subtle and arguably more influential point that the courts cannot tax on

[5] 'New tax cases represent tax law joining this mainstream of judicial thinking not departing from it.' *Ibid*.
[6] 'The United Kingdom is now closer to the mainstream of legal experience in other countries.' *Ibid*.
[7] Tiley (2004a, p. 328). [8] Tiley (2001, p. 158). [9] Tiley (2005b).
[10] See, for example, his lecture reproduced in Tiley (1998a), which describes developments in the UK personal income tax since 1968.
[11] *IRC v Duke of Westminster* [1936] AC 1 (HL). For example, see Tiley (2005b, pp. 105–7) and Tiley (2004b, p. 133).

the basis of economic substance but must respect the legal rights and obligations created by the parties:

> The doctrine emerging from the *Westminster* case is that taxpayers and the Revenue are bound by the legal results which the parties have achieved – even though this may be inconvenient for the Revenue. The court cannot disregard those facts just because of the tax avoidance purpose which may have led the parties to create those facts in the first place.[12]

However, the *Duke of Westminster* principle does not mean, as some have suggested, that the legal form of a transaction is conclusive. A court is not bound by the labels that the parties have attached to their transactions; it is entitled to examine all of the facts 'to discover the true character in tax law of the transaction entered into'.[13] This fundamental principle emerging from the *Duke of Westminster* case is not just trotted out in the interests of tradition. According to Tiley, it helps to explain the recent House of Lords jurisprudence on tax avoidance: 'All the cases in which the Revenue have succeeded under the Ramsay composite transaction rule . . . can be seen as examples of this rule.'[14] Moreover, the *Duke of Westminster* case is still 'absolutely correct' based on a rigorous legal analysis of the contractual relations between the Duke and his gardener.[15] Only by applying an economic substance approach such as the US business purpose test, is it possible to conclude that the gardener continued to receive his full wages after the Duke executed the deed to provide the gardener with an annuity equal to a portion of his wages.[16]

Questions of fact or rules of law?

One of the fundamental difficulties with judicial anti-avoidance doctrines is differentiating between those that relate merely to the ascertainment of the facts and those that establish rules of law applicable to the facts. Students of tax avoidance owe a debt to Tiley for illuminating this issue over twenty years ago, and it is worthwhile recapping his analysis here.

[12] Tiley (2005b, p. 106). [13] *Ibid.* [14] *Ibid.*, p. 107. [15] Tiley (1988a, p. 81).
[16] An alternative possibility would be to treat the annuity as a sham because it was never intended that the contractual arrangements between the Duke and his gardener would be acted upon. It was understood that the gardener would not sue the Duke to obtain his full wages. And it is significant in this regard that the Duke entered into these arrangements only with long-term loyal employees.

In a section of a 1987 article[17] entitled 'Anatomy of a Tax Case', Tiley identifies nine levels of reasoning to explain how tax cases are decided. The first four levels relate to the determination of the facts:

- The basic facts or events (who did what to whom? when? etc.).
- The classification of the basic facts in terms of the private law (was a contract entered into? was the property sold? etc.).
- The classification of the private law results for tax purposes (for example, if employment income is a recognised category for tax purposes, is the private law contract one of employment or of service?).
- The rearrangement of the facts as determined under the previous three steps (the application of the step transaction doctrine: can transfers from A to B and B to C be treated as a transfer from A to C?).

The following levels of reasoning relate to the interpretation of the tax law and its application to the facts as determined under the first four levels:

- The interpretation of the words of the tax legislation (according to Tiley, this is where the US business purpose test becomes relevant: do the terms of the particular statutory provision require a transaction to be carried out with a business purpose in order to come within its terms?).
- The application of the provisions of the tax law as interpreted to the facts as determined (this issue is often treated as a question of fact in terms of reviewability by an appeal court, whereas issues of statutory construction are reviewable questions of law).
- The application of overarching principles of tax law, such as the principle that all income must have a source, and the distinction between capital and income.
- The application of anti-avoidance doctrines, which, unlike the general principles, occurs spasmodically and whose limits are difficult to define.
- Finally, the application of broad principles 'floating about in the legal ether'[18] which reflect notions about what the law should be and which often conflict (for example, everyone is entitled to arrange his or her affairs to minimise tax, and everyone should pay his or her fair share of tax).

One may quibble with Tiley's classification of these nine levels of reasoning.[19] But such quibbles miss the point. The purpose of the

[17] Tiley (1987, pp. 190–5). [18] Tiley (1987, p. 194).
[19] There is some obvious overlap between some of the categories and the ordering of the various levels may not reflect how courts actually decide tax cases.

identification of the various levels of reasoning is not important in itself but as a means of obtaining a deeper understanding of judicial anti-avoidance rules and how they fit into legal reasoning about tax issues. In the absence of this understanding, commentary about the rules is condemned to be emotional ranting based on gut feelings about what is right or wrong. Tiley forces us – tax practitioners, scholars, students and judges – seriously to consider our thinking about judicial anti-avoidance doctrines so that they have intellectual coherence and credibility. He is fond of quoting Justice Learned Hand in dissent in the *Gilbert* case:

> To say it [the test] is whether the transaction has a 'substantive economic reality' or 'is in reality as it appears to be in form,' or is a 'sham' or a 'masquerade' or 'depends on the substance of the transaction'; all of them appear to me to leave the test undefined because they do not state the facts which are determinative.[20]

And as he puts it himself:

> What is vital is that the courts should be honest in their reasoning; invoking the will of the wisp of substance or reality is simply not intellectually sustainable.[21]

Interpretation and application

As Tiley often reminds us, it is important to distinguish between the judicial functions of interpretation and application.[22] Judicial decisions about the meaning of statutory provisions should be justified on the basis of prior case law, the purpose of the provisions or the consequences of competing interpretations. They should be internally consistent and capable of being followed in subsequent cases. Application, however, involves deciding whether the facts of the particular case in front of the court are within or outside the meaning of the relevant provisions as interpreted by the court. For this purpose, how the court determines or characterises the facts is critical. As discussed earlier, in determining the facts, the actual legal rights and obligations created by the parties must be respected, subject to narrow exceptions for sham and legal substance. Perhaps the best brief summary of the twofold challenge for courts was provided by Judge Ribeiro in the *Arrowtown*[23] case:

[20] *Gilbert v CIR* (1957) 248 F 2d 399 (2d Cir.) at p. 411.
[21] Tiley (1988a, p. 89).
[22] Tiley (2004a, p. 308).
[23] *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2004] 1 HKLRD 77 (HKCA), quoted by Lord Nicholls in the House of Lords in *Barclays Mercantile v Mawson* [2004] UKHL 51 (HL) at para. 36.

> The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.

As the foregoing summary of Tiley's 'Anatomy of a Tax Case' shows, it is simplistic to differentiate only between the judicial functions of interpretation and application. And yet at times the courts of many countries seem to mix them up. As Tiley says, in his straightforward way, a court must 'determine the facts, interpret the law and apply that interpretation to the facts'.[24] He argues that much of the judicial confusion comes from the courts' framing their task in terms of determining 'the true character of the transactions'.[25] According to Tiley, 'the characterization of the facts in the case must come before the interpretation' and in this regard he and Lord Hoffmann (who delivered one of the major speeches in *MacNiven v Westmoreland*[26]) disagree 'on which is the cart and which is the horse'.[27] Extending the metaphor in typical witty fashion, he suggests that 'much time will have to be spent mucking out this particular stable yard'.[28]

The confusion between interpretation and application is evident in the *Westmoreland* case. Recognising that *Ramsay* is a principle of construction, Lord Hoffmann attempted to introduce a distinction between statutory language referring to legal concepts and commercial concepts and to limit the *Ramsay* principle to the latter. This distinction has since been resoundingly rejected by the House of Lords; quite rightly, because the distinction is unclear and diverts attention from the important issue – did Parliament intend the transaction in question to be covered by the statutory language used? In contrast, Lord Hutton considered that *Ramsay* required an element of artificiality. As a result, under this approach it would be necessary for the courts to distinguish between real amounts and contrived, unreal amounts. Once again, this distinction is unhelpful because it does not provide any test to distinguish between real and unreal amounts. To me, the issue in *Westmoreland* that the House of Lords

[24] Tiley (1987, p. 191). [25] Tiley (2001, p. 158).
[26] *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6 (HL).
[27] Tiley (2001, p. 157).
[28] *Ibid.* My own view is that, while Tiley is generally correct that the facts come first in tax avoidance cases, the characterisation of the facts and the interpretation of the legislation are more integrated than separate in the analytical process. Judges do not interpret legislation in the abstract; they confront questions concerning the application of the legislation to a particular transaction or set of facts. The House of Lords recognised this in *Barclays Mercantile v Mawson* [2004] UKHL 51 at para. 32: 'Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute.'

did not confront was: did Parliament intend that payment of an amount which, in the circumstances, did not have to be made and which had no financial or commercial consequences for the parties, should generate tax consequences?

Tiley's prediction about the need to sort out the confusion between interpretation and application is equally accurate with respect to the Canadian GAAR. In the *Canada Trustco* case,[29] the Supreme Court of Canada adopted a two-stage approach to the application of s. 245(4) of the general anti-avoidance rule. Section 245(4) provides that an avoidance transaction is subject to the GAAR only if it constitutes a misuse or an abuse of the provisions of the Income Tax Act or other relevant tax legislation. According to the Supreme Court, a court must determine: first, the purpose of the statutory provisions that confer the tax benefit; and second, whether the avoidance transaction abuses or frustrates that purpose. According to the court, the first issue is a question of law but the second is a question of fact, with the result that the factual findings of the trial court should be accepted unless there is a palpable and overriding error.[30] The first issue involves the interpretation of the statute; the second issue involves the application of the statute to the transaction. The striking point is that the Supreme Court's approach to the issue of abuse under the GAAR is virtually identical to the House of Lords' approach in tax avoidance cases, despite the absence of a GAAR in the UK.[31]

The relationship between statutory interpretation and tax avoidance

Since all taxes are imposed by statute, all questions of tax are ultimately ones that involve the interpretation and application of the statute. The result in the *Duke of Westminster* case was as much a product of the literal interpretation of taxing statutes that prevailed at the time in the UK and Commonwealth countries as the result in the contemporary US case, *Gregory v Helvering*,[32] was a product of a more purposive approach to interpretation. It is not mere coincidence that the adoption of the *Ramsay* approach by the House of Lords in the 1980s was accompanied

[29] *The Queen v Canada Trustco Mortgage Company* [2005] SCC 54 (SCC).
[30] The second issue is clearly a mixed question of fact and law. Indeed, the question of whether a transaction is abusive is quintessentially a legal question, not a factual one. For a more detailed analysis see Arnold (2006a).
[31] This point is explored in more detail below.
[32] *Gregory v Helvering* (1934) 69 F 2d 809 (2d Cir.), affirmed (1935) 293 US 465 (USSC).

by a gradual shift to a more purposive approach to the interpretation of statutes in the UK. As Lord Steyn wrote in the *McGuckian* case:

> 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 the judges is to keep the mischief of its interference within the narrowest possible bounds' (see Pollock *Essays in Jurisprudence and Ethics* (1882) p 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 (see *Pryce v Monmouthshire Canal and Rly Cos* (1879) 4 App Cas 197 at 202–203, *Cape Brandy Syndicate v IRC* [1921] 2 KB 64 at 71 and *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.
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> On both fronts the intellectual breakthrough came in 1981 in the *Ramsay* case, 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 ([1982] AC 300 at 323). 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.[33]

Tiley's appreciation of the tax case law in a broader historical context of the development of legal principles generally allowed him to anticipate by many years the statutory interpretation underpinnings of the *Ramsay* case law recognised by Lord Steyn in 1997. In 1985 he wrote in response to the criticism of tax practitioners that the House of Lords did not interpret the statute in the *Ramsay* and *Furniss v Dawson* cases:

> To take the criticism on a more substantial level, it can be said that the courts *are* interpreting the statutes but are doing so in a more adventurous way. As one reads the speeches in *Ramsay* one expects at any moment to come across a paraphrase of Lord McNaughten's famous dictum on income tax, 'My Lords, capital gains tax is, if I may be pardoned for saying so, a tax on capital gains.' What one detects in the speeches is not just an exasperated impatience with avoidance schemes or oversubtle arguments but an increasing confidence in handling the relatively new capital gains tax and an invocation of overriding concepts such as gain. If it is so, we are at the start of an era of strong tax jurisprudence . . .[34]

As discussed in the next section, Tiley recognised early on that there are two intimately related things going on in tax avoidance cases. One is factual: the search for the relevant transaction. The other is interpretive: what does the statute require? In the UK, the US, and most of the other countries considered here, the interpretation of tax statutes is supposed to take account of the purpose of the relevant provisions. Although good in theory, a purposive approach raises several issues: how is the purpose of tax legislation to be determined, what is the role of legislative history and other extrinsic material, and what is the competence of non-specialist judges to determine the purpose of complex tax statutes? Where do judicial anti-avoidance doctrines fit into this matrix of determining the facts and interpreting the statute? In Tiley's seminal analysis of judicial anti-avoidance doctrines,[35] he identifies the UK sham doctrine as essentially factual: the label that the parties attach to a transaction will not be conclusive in determining the legal rights and obligations created by the parties. On the other hand, the US business purpose doctrine is

[33] *IRC v McGuckian* [1997] 3 All ER 817 (HL) at p. 824.
[34] Tiley (1985a, p. 24). [35] Tiley (1987a), Tiley (1987b) and Tiley (1988a).