

Beyond Boundaries

Developing Approaches to
Tax Avoidance and Tax Risk Management

Edited by **Judith Freedman**

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Freedman



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OXFORD UNIVERSITY CENTRE FOR BUSINESS TAXATION

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The Centre for Business Taxation is an independent research centre of Oxford University, based in the Saïd Business School, with close links to the Faculty of Law and the Department of Economics.

The Centre's primary aim is to promote effective policies for the taxation of business. It undertakes and publishes multidisciplinary research into the aims, practice, and consequences of taxes which affect business. Although it engages in debate on specific policy issues, the main focus of the Centre's research is on long-term, fundamental issues in business taxation. The Centre provides analysis independent of government, political party, or any other vested interest. The Centre has no corporate views: publications of the Centre are the responsibility of named authors.

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I

Introduction

1 Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management

It is the task of the law to draw boundaries. The need for practical solutions and applications of rules demands that our legislation and courts give binary answers on questions regarding legal definition, status, and liability. The complex facts that arise in reality rarely lend themselves to straightforward yes and no answers. In drawing such boundaries, therefore, pragmatic decisions have to be made and hard cases have to be dealt with. Tax law is no different from any other area of law in this respect, except that the resources available to test the boundaries are often very great, given the large amounts of money involved. The most obvious issues arise over the geographical boundaries which, under our current tax law, determine the allocation of revenue between different jurisdictions. But there is another set of boundaries that is of major significance in any discussion of taxation: this consists of the boundary between illegal evasion and 'legal' avoidance and the boundary between what is sometimes termed 'acceptable' and 'unacceptable' avoidance.

The Centre for Business Taxation (CBT) organized a conference in the summer of 2007 entitled '*Corporation Tax: Battling with the Boundaries*', with a view to discussing both sets of boundaries. Excellent papers were given on all aspects of our topic. It was decided to publish the papers on the issues of avoidance and tax risk management as a book because they brought together an immense amount of experience, information, and analysis from across the globe in a form not readily available elsewhere. Developments are taking place in different jurisdictions and despite the different starting points, arguably the attempted solutions are converging; there is a remarkable similarity across jurisdictions, as **Weisbach** puts it in his chapter.¹ These papers are collected together here to inform the ongoing debate.

It will be noted, however, that we have not entitled this volume '*Battling with the Boundaries*' but rather '*Beyond Boundaries*'. We do not deny the continuing importance of the boundaries we have outlined, but we consider whether the time has come to go

1. See also J Freedman, 'Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance' (2005) 53 Canadian Tax Journal 1038.

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beyond the concerns about line-drawing. A precise boundary is clearly impossible and even undesirable, given that any such boundary would be an instant target for tax 'planning' activity. Could it be that what matters now is not whether the boundary lines are clear but how we deal with the inevitable lack of clarity? As **Liptak** points out in his chapter, 'uncertainty is a reality'. What we need to do is to manage that uncertainty within a legitimate and practical framework with minimal interference with commercial or family arrangements but giving revenue authorities (and thus the generality of taxpayers) defences against the more excessive activities of the tax avoidance industry.

Terminology has beset this debate, however, and we cannot escape it completely. It is very much open to question whether the distinction between 'acceptable' and 'unacceptable' avoidance is a tenable one. Another, perhaps preferable, way of attempting to draw the line is to distinguish that which is intended to be within the legislation and that which is not, but then the debate simply shifts to how one defines what the legislature intended to cover and the extent to which it is possible to look outside the specific legislation for guidance on this point. **Part II** of this book contains chapters that discuss the way in which different jurisdictions attempt to deal with this set of problems. Whether the approach is to have a statutory general anti-avoidance rule (GAAR) or to rely on judicial approaches, the question is the same. Does the judicial rule, or the GAAR, go beyond the application of normal principles of purposive interpretation of legislation to provide an overarching principle? If it does not do so, what is the value of the additional legislative or judicial rule? And if there is an overarching principle, how can it be contained so as to be a legitimate reflection of parliamentary intention rather than giving free rein to administrative or judicial discretion? Furthermore, will the courts be prepared to give full effect to a provision that has no clear limits? At what point does such a provision offend the rule of law? Can we talk sensibly about 'economic substance' in a tax system which is not always based on economic substance and sometimes not even upon any discernible principles at all?²

A valuable survey of various approaches is provided by **Pickup**, based on a study conducted on behalf of the UK's revenue authority (HMRC) and HM Treasury (HMT). He shows the difficulties that have been encountered with GAARs in Australia, Canada, South Africa, and New Zealand. The story does not suggest that GAARs have provided an easy solution: there have been many false starts. It is worth noting, however, that not one of the jurisdictions that has introduced a GAAR has shown any sign of wanting to dispense with it. Rather, they have introduced new and stronger versions where their original attempts have been thwarted, as in Australia and South Africa. **Liptak** describes what (admittedly from a revenue service perspective) he considers to be a positive experience following the revamping of the South African GAAR which has been designed to provide some objective

2. For a further discussion of the views of the editor on these points see J Freedman, 'Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle' [2004] BTR 332; J Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 LQR 53.

standards. **Evans** criticizes the lack of certainty surrounding the Australian GAAR, and there are many commentators who consider that this GAAR may have gone too far. In addition, **Evans** shows how GAARs cannot operate in a vacuum and must be backed up by other measures in order to be effective. Nevertheless, in his view, the Australian GAAR plays an important role and will continue to do so. It is worth noting here that both the Canadian and New Zealand revenue authorities have experienced defeat in recent litigation relying upon GAARs, but neither has given up. In Canada, the case of *Earl Lipson et al v Her Majesty the Queen et al* was heard in April 2008 and its outcome is awaited at the time of going to press: it might just revive the Canadian GAAR, which **Arnold** tells us is not dead, despite its effectiveness being undermined by the *Canada Trustco* case. In New Zealand, as **Pickup** points out, there is great interest in cases now coming through to the newly created Supreme Court in the course of the next year. In Hong Kong, meanwhile, Lord Hoffmann has shown recently how a GAAR can be given substance in the cases of *Commissioner of Inland Revenue v HIT Finance Limited*³ and *Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Limited*.⁴

Ideas developed in one jurisdiction will clearly have an important impact elsewhere in the current climate. As **Tiley**'s discussion reveals, the UK has been strongly influenced by what have been widely perceived here as the difficulties arising in jurisdictions with a GAAR but also by the apparent success of the disclosure regime in the US, described in this volume by **Weisbach**. **Evans** and **Schön** both also show the importance of this development: an equivalent disclosure regime has not yet been adopted in either Australia or Germany, but it has clearly entered the picture as a possibility in both countries. Germany's GAAR has also been tightened up in the recent past, but the changes were limited as a result of opposition and may not have made a substantial difference to the scope of the law. **Tiley**, like most UK commentators, rejects the adoption of a GAAR for the UK in favour of 'letting the judges do their work'—but he agrees this requires legislation that they can construe and it might be reasonably maintained that so far this has not been forthcoming. Nevertheless, **Tiley** argues that the UK system is working well. In one sense, the development of the disclosure regime and the introduction of many targeted anti-avoidance rules (TAARs) have reduced the need for a GAAR in the UK, and **Bowler** is clearly correct when she argues that a GAAR would not provide all the answers or be capable of replacing all the specific provisions. On the other hand, the ever-increasing number of anti-avoidance provisions is hardly sustainable and the number of TAARs on the statute book now must make for at least as wide an anti-avoidance regime and as much potential uncertainty as any GAAR. Is the UK not close to having a GAAR through the back door and without any proper discussion of the constitutional implications of these developments or the introduction of the full clearance system that might have been the

3. FACV Nos 8 and 16 of 2007.

4. FACV No 2 of 2007.

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corollary of a full GAAR? HMRC/HMT proposals for simplification of avoidance provisions⁵ and for principle-based drafting,⁶ coupled with the complaints of taxpayers—not least those of large businesses—that the complexity of the UK system is making it less competitive, suggest that the current situation is not ideal.

As **Weisbach** states, ‘it seems clear that no country is able to live with a purely rules-based, literal interpretation regime’. He argues that an overlay of anti-avoidance provisions actually allows the rules to be simpler, notwithstanding the complexity and uncertainty that anti-avoidance rules can impose.

Given these continuing difficulties in drawing a line between the acceptable and the unacceptable, the impermissible and the permissible, and the effective and the ineffective, **Part III** of the book explores some other approaches to the problems: ‘beyond boundaries’. The scene is set by a summary of a report of a small scale survey undertaken by researchers at CBT (**Freedman, Loomer, and Vella**) to investigate the response to the *2006 Review of Links with Large Business in the UK* (the *Varney Report*). The *Varney Report* puts forward a plan for a new relationship between HMRC and large firms: one based on trust, transparency, consultation, and accountability (the *Varney Delivery Plan*). At its core is a risk-based approach to resource allocation by the authorities in their investigation of tax risks. It might be hoped that this approach would move beyond the old boundary debates but the **Freedman, Loomer, and Vella** report raises some questions about the benefits of the risk rating system established under the *Varney Delivery Plan* and argues that one problem is that the boundary between acceptable and unacceptable tax avoidance appears to remain important and problematic under this system. This can create tensions between the objectives of the *Plan*. The *Varney Delivery Plan* has much to offer in terms of efficiency and improved relationships and, as it beds down it may indeed improve management of the uncertainty that remains around this line, especially for large companies with Customer Relationship Managers. However, more work is needed to assess the impact of the new approach on the behaviour of corporate taxpayers and HMRC on how this behaviour is to be assessed and rewarded. These empirical observations are supported by the theoretical work of **Ulph**, who applies economic analysis to conclude that the *Varney Delivery Plan* may not have the impact on behaviour that HMRC anticipates and that, even where the behaviour is of the kind that HMRC might have anticipated, it is not obvious that this will necessarily reduce the tax gap.

The *Varney Delivery Plan* identifies strong corporate governance and transparency as a key to reducing tax risk. One aspect of this is the disclosure of accurate information. **Desai** puts forward the arguments for increased alignment of financial and tax accounting

5. See HMRC, ‘Simplifying anti-avoidance legislation: A progress report on the anti-avoidance simplification review’ (12 March 2008). Available at <<http://www.hmrc.gov.uk/budget2008/aa-simplification.pdf>>.

6. HMRC, ‘Financial products avoidance: consultation on principles-based legislation’ (December 2007). Now withdrawn and to be replaced by a new consultation in May 2008.

to improve corporate governance, whilst at the same time reducing costs. In his view, tax avoidance could be reduced by this route. **Hanlon** reports on a paper written with Joel Slemrod which investigates the response of the market to tax aggressiveness; a vital question when considering whether tax avoidance could be controlled by concerns about reputational risk. They find that the news that a firm is tax aggressive is viewed negatively by the market, especially where the firms are poorly governed, but that the reaction is small and does not seem to be predominantly due to harm to the firm's reputation. **Macdonald** raises some queries about the results put forward by **Desai** and **Hanlon**, and suggests that tax avoidance is more problematic, in the sense of actually losing tax revenues, from the state's point of view in the case of well-governed firms.

Another route to dealing with aggressive or 'unacceptable' tax avoidance might be to put the onus on the taxpayer to determine what is unacceptable and to refrain from 'pushing at the boundaries'. **Avi-Yonah** draws on the Corporate Social Responsibility (CSR) literature to argue the case for this in an argument that involves investigation of the nature of the corporation. **Fraser** responds to **Avi-Yonah**, considering his view of the corporation and commenting on the duties of directors under the UK's Companies Act 2006. Much depends here on whether CSR is considered to require altruism, which is hard to justify as a matter of company law or practicality in a capitalist system, or whether it is purely a manifestation of concerns about longer term issues such as reputational damage, in which case it may be considered to be perfectly consistent with shareholder interests to refrain from tax avoidance which may create costs for the company in the future.⁷ The discussion by **Self** reveals very clearly the difficulty of a CSR route: given that some tax planning is justified by taxpayers on the basis of the complexity and 'unfairness' of the tax system itself, leaving the line-drawing to the taxpayer and attempting to rely on some abstract concept of fairness or acceptability leaves many questions open to different interpretations and arguably does not help to solve the boundary problem.

Happé takes the discussion back to risk management and the Dutch approach to dealing with this problem: a focus on the idea of cooperation based on trust, which the *Varney Delivery Plan* emulates. Like **Avi-Yonah**, **Happé** considers that CSR has a major role to play in this formula and notes that many multinationals now regard the society in which they operate as an important stakeholder. **Happé** contrasts the Dutch enforcement covenants, under which multinationals undertake to report all actions that involve tax risk, including their views about the legal consequences of such actions, with the more legally-based Australian Forward Compliance Arrangements. Despite the sophistication of the Dutch scheme, he comments on the need for 'tax risks' to be defined more clearly. Even in this context, it is hard to escape from boundaries. **Happé** concludes that for this

7. For further discussion of these points by the editor see J Freedman, 'The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility' in J Holder and C O'Connell (eds), *Current Legal Problems* (Oxford University Press, Oxford 2007).

6 Beyond Boundaries

approach to work, enterprises must feel obliged to pay their fair share of tax; he proposes comparative evaluations of the Dutch and Australian systems. A review of the Varney approach in the UK might usefully be included in such an evaluation.

Wise, in **Part IV** of the book, reports on the OECD Study into the Role of Tax Intermediaries, which puts forward the notion of an ‘enhanced relationship’ between tax administrators, large corporate taxpayers, and their advisers to encourage greater transparency and disclosure. This clearly builds on experiences such as those in the Netherlands and the UK, and no doubt there will be continued assessment of progress under these approaches. **Hartnett**, now Acting Chairman of HMRC, takes up the theme with a description of the new kind of relationship HMRC aims to forge with business following Varney, whilst **Hickey**, continuing with this general line of thought, calls for a Code of Conduct to which taxpayers, tax authorities, and tax advisers could be signatories. The theme is one of collaborative behaviour rather than sole reliance on tax legislation to regulate behaviour, albeit with a foundation in law.

Whilst enhanced relationships may be developed in a variety of ways, no one doubts that legislation will continue to be needed, and attention is now turning to different methods of delivering such legislation. In addition to the debate about the value of GAARs, TAARs, and specific anti-avoidance legislation, the question of principle-based drafting has emerged in the UK⁸ and in Australia. **Krever** discusses the prospects of such an approach towards reducing complexity, and contrasts principle-based drafting (which might assist) with purposive drafting, which he contends is guaranteed to increase complexity. **Duff’s** chapter completes the book, with a review of the role of GAARs in the light of the foregoing debate. He notes the prevalence of general anti-avoidance rules as a ‘recognition of the comparative institutional competence of the courts over legislatures in addressing unforeseen (and often unforeseeable) implications of ordinary tax provisions’. In his view, and that of **Tiley**, however, GAARs should be a measure of ‘last resort’; nevertheless, **Duff** considers that the UK should enact a GAAR in order to support HMRC’s administrative practices.

This points to a need for better legislation, giving clearer signals to taxpayers, better tools to the judiciary and an improved basis for enhanced cooperation between taxpayers, their advisers, and the tax authorities. Further work is clearly needed on forms of drafting, both at the specific and at the meta levels. Such work should try to move beyond boundaries and towards tackling the underlying issues. The only true solution to avoidance is to have a much more principle-based tax system—but this requires more than merely changes to wording. It seems that only a combination of approaches can work, but they must all have a foundation in a sensible underlying tax system to work well.

*Judith Freedman, Editor
Oxford, June 2008*

8. See (n 6) above.

II

Statutory Anti-Avoidance Provisions—Old and New

2 In Relation to General Anti-Avoidance Provisions: A Comparative Study of the Legal Frameworks Used by Different Countries to Protect Their Tax Revenues

David Pickup

The Study, which was conducted by David Pickup (at the time of the Study, of HM Revenue & Customs—HMRC), Lisa Wise (HMRC), and Katherine Green (HM Treasury) started in March 2006 and was completed in November of that year. The purpose of the Study was not to make recommendations as to the future direction of UK anti-avoidance policy, but rather to record what we were told in the countries we visited, the discussions we had, and any lessons that came out of the experiences of the countries visited, so that better informed advice could be given to UK Ministers when revenue protection measures are put forward to them in future.

There are two general comments to be made at the outset. Firstly, the tax landscape of each country we visited was a product of that country's own history and culture, and in particular, how its economy had developed. The factors that had influenced the development and current shape of each country's anti-avoidance framework were many and diverse. It follows from that observation that in reality, there is no one perfect answer to what the ideal legal framework should be. Moreover, it does not follow that because one technique works for one country it can simply be transported to a different country with equal prospects of success.

Secondly, it was clear from our visits that a vital issue in the effectiveness of anti-avoidance measures was the approach of the judiciary to tax cases in general and avoidance in particular. In some countries it seemed that the judges had formed a collective view that their task was simply to give effect to legislation passed by the legislature. Those judges adopted a black-letter approach to the interpretation of tax statutes with the emphasis on the language rather than the purpose of the legislation. This contrasted with the position

taken in other countries such as the US where the courts have taken a more proactive approach, developing common law doctrines such as economic substance which are now central to the avoidance debate. In other countries, the approach taken has varied between individual judges.

The recent history of the Australian general anti-avoidance rule (GAAR) is an interesting example of the influence of particular judges and of changing judicial approaches to avoidance and anti-avoidance legislation. Australia has had a GAAR since the 19th century. Prior to 1981 it was found in section 260 of the Income Tax Act 1936. That section initially worked well, until Sir Garfield Barwick became Chief Justice. He subjected section 260 to what was described to us as ‘judicial castration’. This led to increasingly aggressive tax avoidance schemes being developed, and to a number of tax scandals, including the infamous ‘Bottom of the Harbour’ schemes. This led to a general consensus within the Australian tax community (and from the public) that the excesses could not be allowed to continue, and following his retirement as Chief Justice, there was a recognition by the judiciary that the approach of the Barwick court had brought it into disrepute. The outcome was action by the legislature to significantly toughen the GAAR, which has been given strong support by the judiciary. Indeed, so successful has the tax authority been in applying the GAAR (see as an example the *Hart* case, which is referred to later in this chapter) that there is serious concern in many quarters, including public statements by some of the most influential judges, that legitimate business and personal transactions are being wrongly caught by the GAAR. It may only be a matter of time before the judiciary begins to adopt a more pro-taxpayer approach.

Another general observation that came out of our study is the importance of recognizing that the impact of any particular anti-avoidance measure is reliant on the interaction of all the components of a compliance regime. It is an end-to-end process and taxpayers and their advisers are astute to identify any weak links in a fiscal authority’s approach to compliance. For example, there is little point having a well-drafted GAAR with significant sanctions attached if there is no real danger that an avoidance scheme will be detected, either when marketed, or when a return is submitted, or when the tax authority lacks the will or the ability to successfully litigate avoidance cases. Let us turn now to the current position in the UK and then to some of the countries we visited, in the hope that this will assist in our debate.

UK

We will not dwell long on the position in the UK, which is well known. The fascinating evolution of the courts’ approach to tax avoidance from the *Duke of Westminster*¹ in 1936 via *Ramsay*² in 1982 to *Barclays Mercantile*³ in 2004 is a topic that has been considered many times before. But for present purposes it is worth setting out the current position as

1. [1936] AC 1.
2. [1982] AC 300.
3. [2004] UKHL 51.

set out by the House of Lords in the *Barclays* case—to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply, and then to decide whether the actual transaction answered to the statutory description. It is an approach that is difficult to disagree with, but very difficult to apply in practice to predicting the likely outcome in a particular case. As John Tiley has put it, the *Barclays* case could be described as bringing ‘less chaos, more uncertainty’. The UK does not have a GAAR, instead relying on specific provisions and on more targeted anti-avoidance rules (TAARs) that can be highly complex, and have attracted much criticism from many quarters, including practitioners and academics. An important recent development in the value-added tax (VAT) area is that we now have the concept of abusive practice as part of UK law, arising from the European Court of Justice (ECJ) decision in *Halifax*.⁴ In that case, the ECJ decided that the VAT Directive had to be interpreted as precluding any right of a taxable person to deduct input tax where the transactions from which that right derives constitute an abusive practice. This involves two tests:

- The transaction concerned, notwithstanding formal application of the conditions laid down by the Directive and national legislation transposing it, results in the accrual of a tax advantage, the grant of which would be contrary to the purpose of those provisions.
- It is apparent from a number of objective factors that the essential aim of the transaction is to obtain a tax advantage.

It will be apparent that the decision raises many questions as to its scope and application, and whilst HMRC is confident that *Halifax* represents a very important addition to its anti-avoidance armoury, it will be for future litigation to determine how significant a decision it is in reality.

Canada

The Canadian GAAR was introduced in 1987 following a Supreme Court case which expressly rejected the adoption of a judicially developed business purpose test in considering avoidance cases. The explosion of avoidance activity which followed led to the introduction of the GAAR. The GAAR, in section 245 of the Canadian Income Tax Act (CITA) involves the following tests:

- Is there a tax benefit?
- Is the primary purpose of the transaction an avoidance transaction?
- Is the avoidance transaction abusive: would it result directly or indirectly in a misuse of the provisions of the CITA, or abuse having regard to those provisions, read as a whole?
- If yes to all these tests, the tax benefit is denied.

4. [2006] STC 919.

The first GAAR case to reach the Supreme Court was *Canada Trustco*⁵ in 2005. The case was decided in favour of the taxpayer, even though it involved a purchase/leaseback with no real risks to the company, but with an entitlement to deduct capital cost allowance in computing its profits. Some quotes to illustrate the Court's reasoning:

The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The Income Tax Act is a compendium of highly detailed and often complex provisions. 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 Income Tax Act would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act? Notwithstanding the interpretive challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretive norms was Parliament's intent. Second, to search for an overriding policy of the Income Tax Act 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.

Parliament intends taxpayers to take full advantage of the provisions of the Act that confer tax benefits. Parliament did not intend the GAAR to undermine this basic tenet of tax law.

And to indicate they did not expect to have another GAAR case before them for some time:

Where the tax court judge has proceeded on a proper construction of the Income Tax Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.

The outcome of the case, and the basis for the Supreme Court's decision, would seem to represent a significant victory for taxpayers. But it should be noted that at the same time as it heard *Canada Trustco*, the Supreme Court also heard the *Mathew*⁶ case. In that case, losses in an insolvent company were transferred into a partnership, purchased by another partnership, and used by individuals in that partnership to offset against income. Applying

5. [2005] SCC 54.

6. [2005] SCC 55.

the *Canada Trustco* case, the Court found in *Mathew* that Parliament had never intended such broad loss sharing to be permitted, and applied the GAAR to deny the tax benefit. In some ways this decision made it even harder to determine the likely impact of *Canada Trustco* on future GAAR cases.

Clearly it would have been open to the Canada Revenue Agency (CRA) to have sought legislation to reformulate the GAAR, and this was a course urged on it by a number of commentators who were disappointed by the Supreme Court's decision in *Canada Trustco*, including Brian Arnold, who described the outcome of the case as 'confusion worse confounded'. But instead, the CRA decided on an alternative strategy: to litigate GAAR cases so it could determine the real impact of *Canada Trustco* in practice. Some 12 cases have now been litigated, and the picture that arises from an analysis of the cases is one of complete confusion. The 12 cases involve six issues, and on each issue, the CRA have won one case and lost another.

Some quotes from some of the cases might illustrate the problems.

In *XCO Investments* (a loss transfer case): 'Anti-avoidance sections are not intended as a means of punishment for offending the Minister's olfactory sense . . .'

In *Evans* (a surplus strips case): 'I do not think that it can be said that there is an abuse of the provisions of the Act where each section operates exactly the way it is supposed to. The Crown's position seems to be predicated on the view that since everything worked like clockwork there must have been an abuse. The answer to this position is, of course, that if everything had not worked like clockwork, we would not be here.' And: 'The only basis upon which I could uphold the Minister's application of section 245 would be to find that there is some overarching principle of Canadian tax law that requires that corporate distributions to shareholders must be taxed as dividends, and where they are not the Minister is permitted to ignore half a dozen specific sections of the Act. This is precisely what the Supreme Court of Canada has said we cannot do.'

In *Lipson* (an interest case): 'The case is an obvious example of abusive tax avoidance' and 'If there was ever a case at which section 245 was aimed, it is this one' and finally 'If section 245 is to serve any purpose it must be applied to the very sort of contrived transactions as this one at which it is obviously aimed'.

Interestingly, all three cases were heard by the same judge!

So confused is the situation that in a recent case, *McKay*, the CRA lost the very issue on which it had won in the *Mathew* case before the Supreme Court. The difficulties for

practitioners and the CRA in these circumstances are obvious. One practitioner described his task of finding the line as to what was acceptable and what would be caught by the GAAR as being a Herculean task.

South Africa

For anyone interested in the GAAR debate, a consideration of the recent history of the South African GAAR as set out in the Discussion Paper on Tax Avoidance published by the South African Revenue Service (SARS) in November 2005 is strongly recommended. The analysis of the problems and the proposed solutions as set out in that Paper, how these were developed (following the consultations that then took place) in subsequent SARS papers, and the terms of the revised GAAR that was ultimately enacted at the end of 2006, are all required reading and contain many insights that have wide application in considering general GAAR issues. Much of the work was conducted for SARS by Ed Liptak, whose very valuable insights appear in this volume.

In brief, South Africa has had a GAAR since 1941. However by 2005 it had lost confidence in the then current text, and its ability to successfully litigate GAAR cases. Its key problem was that it was for SARS to prove that a transaction had been entered into in an abnormal manner. Since most schemes utilize techniques that were developed for bona fide business purposes, and have at least some purported business purpose, how was abnormality to be demonstrated? In addition, if a particular scheme is being widely used, can what is being done be described as abnormal? A second major concern was that the purpose test (the sole or main purpose was to obtain a tax benefit) was a subjective, not an objective, test. These and other technical difficulties were compounded by SARS being outgunned on the expert evidence needed for litigation, since most experts in South Africa were already committed to the taxpayer's cause.

The new GAAR had effect from 2 November 2006. In the context of a business, an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and:

- it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or
- it lacks commercial substance, in whole or in part, as defined, or after taking into account the provisions of the Act which set out characteristics of a lack of commercial substance, such as the insertion of elements that cancel each other; or
- it has created rights or obligations that would not normally be created between persons dealing at arms length; or
- it would result directly or indirectly in the misuse of the provisions of the Act (including the GAAR provision itself).

The burden of proof is reversed, so that it is for the taxpayer to prove that obtaining a tax benefit was not the sole or main purpose of the arrangement, and this is now an objective test to be considered in the light of the relevant facts and circumstances.

New Zealand

There is a long history of GAARs in New Zealand. The first was enacted in 1891. The current provisions date from 1994, and are to be found in sections BG1 and GB1 of the Income Tax Act.

The New Zealand GAAR is notable for being relatively short and broadly drafted, and is often contrasted with the much longer and more detailed Australian GAAR. BG1(1) sets out that a tax avoidance arrangement is void against the Commissioner for income tax purposes. BG1(2) allows the Commissioner to counteract a tax advantage obtained under a tax avoidance arrangement. How this is done is set out in GB1.

The key to the GAAR is in the definition of ‘tax avoidance arrangement’ which is found with other relevant definitions in QB1 of the Act.

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

‘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 or prospective liability to future income tax.

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

- has tax avoidance as its purpose or effect; or
- 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.

Cases have made it clear that ‘purpose or effect’ is to be determined objectively. The GAAR has had mixed success. Two recent cases illustrate this. In *Accent Management Ltd v CIR*,⁷ the taxpayer had invested in a Douglas fir forest, by acquiring a 50-year licence to use the land for forestry purposes. Whilst payment for the investment was largely deferred to the end of the 50-year period, immediate deductions were claimed by the taxpayer in the first

7. (2005) 22 NZTC 19027.

year of the scheme. The judge had no doubt that the taxpayer had entered into the arrangements to achieve the taxation benefits, and confirmed both the application of the GAAR and the imposition of an abusive tax position shortfall penalty.

A decision that went the other way was *Peterson v CIR*,⁸ a deeply unsatisfactory decision of the Privy Council allowing appeals (by a 3:2 majority) against the decision of the Court of Appeal of New Zealand, which applied the 1976 version of the GAAR to counteract the tax advantage obtained by the taxpayer from his investment in two film schemes. The dissenting judgments from Lord Bingham and Lord Scott are particularly noteworthy, and make plain their disbelief at the decision reached by the majority, describing themselves as not being willing to be a party to the emasculation of the GAAR that the decision of the majority involved. It is noteworthy that since the *Peterson* decision was given, the New Zealand Parliament has passed legislation establishing the New Zealand Supreme Court as the final Court of Appeal in New Zealand. The Supreme Court has yet to hear its first tax avoidance case, and the approach it takes to BG1 is keenly awaited by the New Zealand tax community.

Australia

Australia has had a GAAR since the 19th century. Prior to 1981 it was found in section 260 of the ICTA 1936, which had antecedents dating back to 1915. Section 260 was a very broad provision, similar to the New Zealand GAAR. We have referred above to the judicial castration of section 260 by Barwick CJ and to the impact this had. The replacement GAAR in Part IVA of the ITA was intended (according to the Explanatory Memorandum to the Bill) to provide an effective general measure against tax avoidance arrangements that were 'blatant, artificial or contrived'. Part IVA is a complex provision but essentially has three requirements:

- The arrangement is a scheme.
- The taxpayer has derived a tax benefit from that scheme which would not have been available if the scheme had not been entered into.
- The scheme must have been entered into for the sole or dominant purpose of obtaining a tax benefit. This requires an objective determination founded on an analysis of eight matters specified in section 177D:
 - the manner in which the scheme was implemented
 - its form and substance
 - the timing of the scheme
 - the result that would be achieved by the scheme, but for Part IVA
 - any change in the financial position of the relevant taxpayer arising out of the scheme
 - any change in the financial position of any other person

8. [2005] UKPC 5.

- any other consequences for the relevant taxpayer or any other person connected with the scheme
- the nature of the connection between or amongst parties to the scheme.

The determination of the ‘tax benefit’ and of the ‘sole or dominant purpose’ both require consideration of the tax consequences, but for the operation of Part IVA, of an alternative hypothesis, or alternative postulate—what would have happened if the scheme had not been entered into—known as the ‘counterfactual’.

Where Part IVA applies, section 177F gives the Commissioner discretion to make a determination cancelling the tax benefit that has been obtained. As well as Part IVA, there are also GAARs which apply to fringe benefits and sales tax.

After Part IVA came into force there was a deliberate policy by the Commissioner not to litigate the GAAR, so as not to risk lessening its deterrent effect. The first case did not come before the High Court until 1994, and that case resulted in a win for the taxpayer. After this false start the GAAR has proved to be a significant weapon for the Commissioner in combating tax avoidance. Consideration of the cases of *Spotless*,⁹ *Hart*,¹⁰ and *Macquarie Finance*,¹¹ illustrate the current position on the interpretation of Part IVA. For the purposes of this chapter, we will just refer to the *Hart* decision.

Mr and Mrs Hart borrowed money to buy a house in Canberra and to pay off a mortgage on their existing home to keep as an investment property. They obtained what was known as a split loan, which was applied to both transactions. Under the terms of this split loan, all the repayments went to the new home part of the loan, leaving compound interest to accrue on the investment part of the loan, which the taxpayers then claimed as a tax deduction.

The Commissioner argued that the scheme was one to which the GAAR applied. The trial judge found that the obtaining of the tax advantage was central to the adoption of the scheme by the taxpayers. This was reversed on appeal, the court concluding that the dominant purpose was the obtaining of the loan and thus refinancing and investing, over the taxation purpose. On the Commissioner’s further appeal, the appeal was allowed, and the GAAR was applied. The judges disagreed on the reasons for this, but the majority concluded that having regard to the eight identified matters in section 177D, the dominant purpose of the taxpayers was to obtain a tax benefit—the larger interest deduction that was possible under the scheme than if separate loans had been taken out. In so deciding the judges made it clear they were not concerned with the subjective motives of the taxpayer, saying that section 177D ‘requires the drawing of a conclusion and purpose from the eight

9. 96 ATC 5201.

10. 2004 ATC 4599.

11. 2005 ATC 4829.

identified objective matters; it does not require, or even permit, any enquiry into the subjective motives of the relevant parties’.

The fact that the split loan scheme was called the ‘wealth optimiser’ cannot have helped the taxpayer’s case!

USA

In the US, the terms tax shelter and avoidance are used interchangeably. Whilst the US courts have developed a number of common law doctrines to combat avoidance, the US tax code contains both broad mini GAAR statutory rules as well as targeted anti-avoidance legislative fixes. But the Internal Revenue Service’s (IRS) preferred route for tackling avoidance transactions is to apply the common law doctrines. Amongst these doctrines are:

- sham in fact
- sham in substance
- economic substance
- business purpose
- substance over form
- step transactions.

The borders between these doctrines are, at least from a UK perspective, uncertain, and they seem to be used interchangeably by the IRS, commentators, and the courts. They are sometimes presented as stand-alone concepts, sometimes as subcategories of a wider single doctrine; but even then it is unclear whether economic substance or substance over form is the dominant doctrine.

But it is economic substance on which we will concentrate for the purposes of this chapter. The authority from which this doctrine derives is the decision of the Supreme Court in *Gregory v Helvering*.¹² In that case a sale of shares was made tax free utilizing corporate reorganization provisions within the US tax code. The Supreme Court decided that the test was whether what was done, apart from the tax motive, was what the statute intended. It held that the transaction was ‘simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of the business, but to transfer a parcel of corporate shares’ to the taxpayer.

A recent example of the application of the economic substance doctrine can be seen in the *Coltec*¹³ case. In that case, the US Court of Appeal reversed a decision of the trial

12. 293 US 465 (1935).

13. 454 F 3d 1340 (Fed Cir 2006).

judge¹⁴ that the economic substance doctrine was unconstitutional as a violation of the separation of powers, and that it had no application in any event in the *Coltec* case because the transaction had a bona fide business purpose.

Coltec was a publicly traded company. It sold one of its businesses for a gain of \$241 m. Seeking to avoid tax on that gain, Coltec adopted an off-the-shelf tax shelter scheme which was designed to create an offsetting tax loss. The IRS disallowed the loss, relying in part on the economic substance doctrine, and Coltec took the matter to court. The Court of Appeal said that ‘Over the last 70 years, the economic substance doctrine has required disregarding for tax purposes, transactions that comply with the literal terms of the tax rule but lack economic reality’.

It continued that ‘The economic substance doctrine represents a judicial effort to enforce the statutory purposes of the tax code. 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’.

The Court set out its understanding that the doctrine had five principles:

- Although the taxpayer has an unquestioned right to decrease his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality.
- The taxpayer has the burden of showing that the transaction has economic substance.
- The economic substance of a transaction must be viewed objectively.
- The transaction to be analysed is the one that gave rise to the alleged tax benefit.
- Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

That all looks relatively straightforward, but there is some disagreement between the Courts of Appeal in the different US circuits as to what the test for economic substance is. Some circuits use a two-pronged test:

- The subjective intent of the taxpayer entering into the transaction.
- The objective economic substance of the transaction.

They disagree as to whether this is a disjunctive or conjunctive test. Other circuits simply ask whether the transaction had any practical economic effects other than the creation of the income tax losses.

This difference of view, and the apparent reluctance of the Supreme Court to hear an appeal on economic substance (it refused to review the Court of Appeal’s decision in

14. 62 Fed Cl 716 (2004).

Coltec), has given rise to growing concerns that the judicial doctrines are being undermined and that their effectiveness as a tool for tackling avoidance is being reduced. This has led to moves to codify the doctrines in statute. California, New York, and Illinois have done so at state level, and the Senate Finance Committee has consistently backed codification proposals in federal tax bills. The House of Representatives has been resistant to this, and codification legislation has not been enacted. The debate continues.

Europe

Reference has already been made above to the *Halifax* case and to the abuse concept applied by the ECJ in that case. Abuse of law or its equivalent is a feature of many Continental legal systems. For the purposes of this chapter, we will refer to the position in the Netherlands and Spain.

Netherlands

The Netherlands is interesting because it has both a statute-based anti-avoidance rule known as *richtige beffing*, and a judicially-based principle known as *fraus legis*. Since 1987, only *fraus legis* has been used by the tax authority to combat avoidance. The *richtige beffing* rule is set out in Article 31 of the General Law on Taxation, and dates from the 1930s. It can be translated as meaning 'correct assessment'. It has two strands:

- The transaction must have no other purpose than to save tax.
- The transaction must be in conflict with the purpose and spirit of the law.

If these conditions are satisfied, the transaction can be neglected for tax purposes. *Fraus legis* is a Roman law concept. According to the Roman lawyer Paulus, it concerns the act of someone who, without infringing the words of the law, deceives the purpose thereof.

Fraus legis is an ultimate remedy, and can only be applied if all other methods of interpretation have been exhausted, so issues such as the application of the sham doctrine and other interpretation techniques must be considered first. Only if these do not result in justice being done, can *fraus legis* be turned to. Two criteria must be met for *fraus legis* to apply:

- That avoidance of tax is the only, or paramount, motive for the transaction. Whilst this is a subjective test, it falls to be determined from a consideration of objective circumstances. The burden of proof is on the tax authority, but if the transaction would foreseeably result in a loss from an economic point of view if the tax effect is left out of consideration, and if the transaction does not have any other significant economic consequence, the burden reverses and it is for the taxpayer to provide evidence that the avoidance of tax was not the only, or paramount, motive for the transaction.
- That there is a conflict with the intention and purpose of the law. This is an objective test, and a consideration of the legal history of the provision, as found in the record

of the parliamentary proceedings, is an important source for the court's decision-making. But many other sources can be considered by the court in determining the intention and purpose.

If *fraus legis* applies, the tax avoidance transaction can either be ignored for tax purposes, or can be replaced by another transaction, depending on which option gives the best expression to the intention and purpose of the law. Clearly *richtige beffing* and *fraus legis* are similar, but it is understood that the decision to rely exclusively on *fraus legis* was based on *fraus legis* being easier to apply, and giving the judges much greater flexibility, particularly in enabling the transaction to be reconstructed to enable the right fiscal outcome to be achieved.

Spain

Spain amended its legislation relating to tax avoidance in 2004. Prior to 2004, it had relied for the previous 20 years on legislation based on the concept of *fraude de ley*. This concept was found to have a number of difficulties, and as a result, was relied on by the tax authority in no more than three to four cases a year. It was replaced by a new provision, which appears at section 15 of the General Tax Law.

Section 15 is essentially a dispute resolution provision that allows the tax administration to challenge transactions more consistently through a consultative committee. It also contains a favourite description of abusive behaviour of any of the provisions we have seen around the world:

Where, taken individually or as a whole, the acts or transactions are notoriously crafty or improper for achieving the result obtained.

It will be interesting to see how this test is interpreted by the Spanish Courts.

3 Battling with Boundaries: The South African GAAR Experience

Ed Liptak

Background

The South African general anti-avoidance rule (GAAR) was introduced in 1941. Since the 1950s it has involved a four-prong test: (1) there must be an ‘arrangement’; (2) the arrangement must have a ‘tax effect’; (3) the arrangement must be ‘abnormal’ or create non-arm’s length rights and obligations; and (4) tax avoidance must be the arrangement’s sole or main purpose. The purpose test was a subjective one.

In practice, the ‘abnormality’ requirement had proven to be the ‘Achilles’ Heel’ of the old GAAR. To remedy this problem, Parliament passed certain amendments to the legislation in 1995. Before these amendments could be tested, however, the Supreme Court of Appeal handed down a judgment on the other provisions of the GAAR that ‘effectively emasculated’ the legislation. Of more concern following the decision was whether a business purpose for an overall scheme could be used to insulate all of its steps from challenge.

The situation remained unchanged for the next ten years—no further amendments were made and there was only one court challenge that resulted in an unpublished opinion unfavourable to the South African Revenue Service (‘SARS’).

The General Environment and Attitudes

Prior to 1996, tax compliance in South Africa was extremely poor. The current Commissioner, Pravin Gordhan, has done a tremendous job during the last ten years of building a culture of compliance. Nonetheless, abusive tax avoidance remained a serious problem, and in some ways, was a problem that was growing more and more difficult.

There were several reasons contributing to the growing difficulty of this problem, such as: South Africa’s growing integration into the global economy following the fall of the Apartheid regime; the rapid changes in the financial markets, including the continuing evolution of ever more complex financial instruments; and the equally rapid improvement in information technology.

The weak GAAR and practitioner attitudes were equally to blame. It was not unusual to see tax opinions on abusive arrangements dismiss the GAAR in one or two paragraphs. This was the case, for example, in connection with the abusive film scheme that was included as Annexure A in the SARS Discussion Paper on Tax Avoidance.

Practitioner attitudes may have been an even more serious problem. The legal community remained wedded to the *Duke of Westminster* principle in its most unadulterated form. In addition, there was virtually no academic debate on the topic of abusive arrangements. By and large it was an unchallenged view.

One side effect of practitioner attitudes was that, in the minds of tax advisers, there was little if any room for the GAAR to operate. As one commentator noted following the enactment of the 1995 amendments, the GAAR could only be applied to the most blatantly abusive schemes. Indeed, during the last year's debate over the new GAAR, the Tax Section of the Law Society argued, in essence, that there were only two categories of arrangements: permissible tax avoidance and 'sham transactions'.

The Amendment Process and Its Goals

The amendment process lasted a full year, from the introduction of a Discussion Paper in November 2005, to the enactment of the new GAAR in November 2006.

There was extensive consultation with the public, involving:

- the Discussion Paper¹
- a three-month comment period
- an Interim Response, together with a further comment period
- public hearings before Parliament
- numerous public presentations and discussions
- the release of revised proposals and a detailed Background Note
- informal consultations with senior practitioners and international experts
- enactment of the final legislation.

The Goals of the Discussion Paper: Text and Subtext

Text:

- place the issue of impermissible tax avoidance in a broader context
- emphasize that the GAAR is intended to protect the tax base, not expand it
- establish the need both for a GAAR and for changes to the existing provisions
- provide an overview of abusive schemes currently in the market

1. The Discussion Paper may be found on the SARS website under Legislation > Policy Documents > Discussion Paper on Tax Avoidance available at <http://www.sars.gov.za/home.asp?pid=5981#Discussion%20Paper%20on%20Tax%20Avoidance>.

- highlight the weaknesses in the existing legislation
- provide a brief overview of the international situation
- acknowledge countervailing concerns; in particular, the risk of increased uncertainty
- introduce and explain the proposed amendments.

Subtext:

- initiate a debate
- tie the approach to the mainstream of international thinking
- make it clear that the government was dead serious
- link the issue to broader tax reform
- embed the term ‘impermissible tax avoidance’ in the tax lexicon
- perhaps begin to change some attitudes on the issue.

A final goal was to elicit at least some support on the need for change—and break the ‘monolithic’ opposition.

The overall assessment of the process was positive. Practitioners and taxpayers rose to the occasion to participate in a constructive and professional dialogue, even if heated at times. A major disappointment in this process was the Tax Section of the Law Society, whose attitudes were described by one practitioner as ‘Neanderthal’. In addition, they failed to engage on the concerns and issues raised during the process.

Tax Morality

This issue raises two questions:

- Is avoidance best viewed as complex technical issues which have serious economic and social implications, or as a moral issue with technical aspects?
- If it is to be viewed as a moral issue, are there reciprocal obligations of government?

Uncertainty and Broader Tax Reform

Without question, uncertainty is a major and legitimate concern, and one which is likely to be the major ‘barrier’ for companies.

SARS sought to address this issue in four major ways, with the: (1) concomitant introduction of an advance tax ruling system; (2) introduction of a new notice requirement; (3) establishment of a central committee; and (4) issuance of a detailed Practice Note.

The other major ‘barrier’ for companies is bad tax legislation. Some of the serious deficiencies in the South African income tax system exist in the form of: lack of group relief; treatment of interest expenses; capital allowances; and just plain bad legislation. Deadweight loss attributable to these issues may well equal the deadweight loss attributable to impermissible tax avoidance.

Much of what SARS has considered impermissible tax avoidance could be seen as self-help remedies to overcome these deficiencies. On the other hand, these deficiencies could and often did provide both the impetus and the excuse for many evils.

The Major Amendments

Two of the major amendments made to the new GAAR include:

- A commercial substance test, including statutory indicia such as round-trip financing and tax-indifferent parties. The most powerful tool may be the authority to treat connected persons and tax-indifferent parties as one and the same person.
- A ‘misuse or abuse test’.

Taxpayers are still free to structure their affairs in a tax-efficient way, provided that those structures do not include one or more of the ‘tainted elements’ identified by Parliament.

The Reasons for the South African Approach

In an international review of GAARs, the traditional GAARs have been hit-or-miss affairs. Their open-endedness may well have contributed to uncertainty about boundaries.

There has been some academic debate over the proper basis for a GAAR—should it be ‘business purpose’, ‘legislative intent’ (determined using a purposive construction), or the ‘artificial and contrived’ nature of arrangements? These bases are often presented as mutually exclusive options. The amendments to the South African GAAR sought to recognize that impermissible tax avoidance takes many forms and that each of these tests plays a role depending upon the circumstances.

Do we really know ‘impermissible tax avoidance’ when we see it? Particularly in South Africa, the answer seemed to be ‘no’. Not only was there disagreement between SARS and practitioners, but there was widespread disagreement among practitioners themselves.

Similarly, there was a failure to recognize, let alone be troubled by, some of the basic building blocks and features of most abusive schemes—circular cash flows, tax-indifferent parties, composite transactions, a lack of commercial substance, and a reliance on an extremely literal statutory construction. The amendments try to address these issues through more explicit/objective standards.

Despite the drafting difficulties, the proposed amendments sought to provide some objective standards and to put ‘impermissible tax avoidance’ into a broader conceptual context. Taxpayers can still arrange their affairs in tax-efficient ways, provided that they do not employ any ‘tainted elements’ to obtain the desired tax benefits.

Another aspect is the use of an 80/20 approach, which is aimed more toward deterring ‘bad behaviour’, in conjunction with other measures, including a revamped reportable arrangements regime.

A final reason for the South African approach: politics!

Experience So Far

The experience so far is generally positive—clients have backed away from schemes involving the indicia of a lack of commercial substance. The battle has shifted to ‘business purpose’. This shift may require a tougher stance in respect of avoidance arrangements that lack commercial substance or involve a misuse or abuse of the underlying tax legislation. One query is why a taxpayer in a business setting should be allowed significant tax benefits in either of these situations.

Some weaknesses/mistakes have already been identified and amendments are under consideration to fix the problems. A recent private equity deal could be considered a shot across the bow.

Conclusion—Barrier or Safe Harbour?

Throughout the process, SARS emphasized that the new GAAR was intended to be a foundation for a better tax system for all. A higher barrier on the outside—lower barriers within. Positive changes are already on the way.

A final word about uncertainty: uncertainty is a reality. The question is whether a stronger GAAR (and a more purposive approach to statutory construction) will increase or decrease that uncertainty for the majority of taxpayers who do not seek to push the envelope.

4 The Canadian Experience with a General Anti-Avoidance Rule

Brian Arnold

Introduction

The Canadian general anti-avoidance rule (GAAR—section 245 of the Income Tax Act) was introduced in 1987 in response to the Supreme Court decision in the *Stuart Investments* case,¹ which rejected a broad judicial business purpose test. The GAAR has been considered by the courts in approximately 30 cases to date. In October 2005 the Supreme Court decided its first two GAAR cases, *Canada Trustco Mortgage Company v The Queen* [2005] SCC 54 and *Mathew v The Queen* [2005] SCC 55. Since those cases (the taxpayer was successful in *Canada Trustco* and the tax authorities won in *Mathew*) the Tax Court of Canada has decided several cases in which no clear pattern emerges; two cases have been decided by the Federal Court of Appeal, with the results split between the government and the taxpayer.

The GAAR was amended in several respects in 2005. The amendments are retroactive to 1987 when the GAAR was enacted. They clarify that the GAAR applies to the abuse of tax treaties as well as statutes related to the Income Tax Act. They also revised the wording of section 245(4), the misuse and abuse test, although it is questionable whether the change has any substantive effect on the meaning of the provision.

Problems in the Case Law Dealing with the GAAR

Several serious problems with the GAAR emerge from the case law, and, in particular, the Supreme Court's decision in the *Canada Trustco* case. The major problems are described briefly here.²

The Abuse Test

- a. The Supreme Court adopted a two-stage test to determine if a transaction abuses the tax system: a court must determine, first, the purpose of the statutory provisions

1. *Stuart Investments Limited v The Queen* [1984] CTC 294 (SCC).

2. For a more detailed analysis of these issues, see B Arnold, 'Confusion Worse Confounded: The Supreme Court's GAAR Decisions' (2006) 54 Canadian Tax Journal 167–209, and B Arnold, 'The Long, Slow, Steady Demise of the General Anti-Avoidance Rule' (2004) 52 Canadian Tax Journal 488–511.

(by reference to the wording of the provision, the context of the Act as a whole, and extrinsic aids) that confer the tax benefit, and second, whether the avoidance transaction abuses or frustrates that purpose. According to the Supreme Court, the first stage is a question of law and the second is one of fact. The effect of treating the second state as a question of fact is that the responsibility for deciding such questions rests with the Tax Court and the Supreme Court cautions appeal courts not to interfere with the Tax Court's factual findings 'absent a palpable and overriding error'. Although it may seem clear from this that the Supreme Court does not wish to hear additional GAAR cases, it has given leave to appeal in a case involving a series of transactions to convert nondeductible interest in respect of a personal residence into deductible interest.³

b. The question of whether a particular transaction is abusive is a quintessential legal question. Moreover, it is inappropriate for the appeal courts to defer to the Tax Court with respect to the GAAR. Although some Tax Court judges are knowledgeable about the tax system, some are not, and Tax Court decisions with respect to the application of the GAAR should be carefully scrutinized by more senior courts.

c. According to the Supreme Court, abuse exists:

where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit, or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.

This test of abuse is sadly deficient. It is tautological (when does a transaction lack a 'proper basis'?—when it is abusive, of course) and provides no guidance to taxpayers or the tax authorities. Also, the GAAR does not refer to 'relationships' so it is unclear why the Supreme Court refers to relationships and not just to transactions. Finally, if a transaction is wholly dissimilar to the transactions contemplated by the relevant provisions, one wonders how, even in the absence of the GAAR, the transaction could have qualified for the benefits conferred by those provisions.

d. Under section 245(4), the abuse test applies to a particular avoidance transaction, not the entire series of transactions of which the particular transaction is a part. It should apply to both. The courts seem to have applied the abuse test to the entire series. As a result, it is possible to identify an emerging pattern in the case law that the GAAR applies in cases where the series as a whole is abusive and does not apply where the series as a whole has a legitimate purpose. This approach renders the GAAR ineffective against abusive steps inserted into otherwise legitimate commercial transactions, which is a common tax planning technique. This issue arises in the *Lipson* case, which was heard by the Supreme Court in April.

3. *Lipson v The Queen* [2007] FCA 113. The case was argued in April, 2008.

Economic Substance

Any GAAR or general anti-avoidance doctrine must consider the economic substance of transactions if it is to be effective. However, vague references to economic substance are a poor substitute for a rigorous analysis of transactions on the basis of objective criteria such as a comparison of the pre-tax profit and the tax benefits. In the hands of Canadian courts, there is a serious risk that economic substance may degenerate into an unprincipled smell test.

Despite clear statements in the Explanatory Notes that the GAAR is intended to ensure that the provisions of the Act apply to transactions with real economic substance, the Supreme Court held that economic substance is relevant under the GAAR only if the provisions in question contemplate or refer to economic substance. Even if they do, the lack of economic substance is only one factor to be considered and is insufficient by itself to establish abusive tax avoidance. Very few statutory provisions explicitly refer to economic substance; therefore, if the Supreme Court's approach is adhered to strictly by the lower courts, economic substance is unlikely to be an important factor in the application of the GAAR.

The Relationship between Statutory Interpretation and the GAAR

The Supreme Court's approach to the interpretation of tax statutes is confused. Sometimes the Court suggests that, like all statutes, tax statutes should be interpreted textually, contextually, and purposively. At other times it indicates that, because tax statutes are detailed and particular, they must be given a literal interpretation or the literal meaning of the text must be given more weight than other relevant factors. This confused approach has been repeated in recent Supreme Court cases.⁴

The confusion is exacerbated by the Supreme Court's approach to the interpretation of the GAAR and, in particular, section 245(4), the misuse and abuse test. According to the Court, the question of abuse (the first step in the two-stage process referred to above) is to be determined on the basis of a textual, contextual, and purposive analysis of the relevant provisions. If, however, the provisions of a tax statute, like all statutes, are interpreted textually, contextually, and purposively in the first place, then performing the same analysis under the GAAR is redundant and the GAAR is unnecessary. Transactions that are not in accordance with such an interpretation of the relevant provisions will fail without the need for the GAAR. The alternative is that provisions of tax statutes must be interpreted literally, and a broader interpretive approach becomes relevant only in terms of the application of the GAAR. However, this result is inconsistent with several unequivocal statements by the Supreme Court that all statutes must be given a textual, contextual, and purposive interpretation.

4. See B Arnold, 'The Supreme Court and the Interpretation of Tax Statutes—Again' (2006) 54 Canadian Tax Journal 677–84.

Determining the Purpose of Steps in a Series

Determining whether a transaction is an avoidance transaction is based on the primary purpose of the transaction. Although it seems clear from the definition of avoidance transaction that each transaction forming part of a series must be considered separately, there is case law authority to the effect that any transaction forming part of a series has the same purpose as the series as a whole. If so, it will be relatively easy for purely tax-motivated steps to be inserted into a series of transactions that, as a whole, has a legitimate non-tax commercial purpose.

Conclusions

The Canadian GAAR is obviously not dead. After all, it was applied in one of the two cases heard by the Supreme Court. Moreover, its application has been upheld in several lower court decisions since the Supreme Court's GAAR cases, including two Federal Court of Appeal decisions.

Although the GAAR is not dead, its effectiveness is questionable as a result of the problems identified above. The cases in which the GAAR has been applied, including the *Mathew* case, in this author's opinion, could have been decided in favour of the tax authorities without the need for the GAAR. Thus, there is a serious risk that the GAAR will apply only in obvious cases and, as a result, it will not be effective in protecting the tax base against sophisticated tax avoidance schemes.

Amendments to the GAAR are necessary to eliminate the major deficiencies in the case law. In particular, the GAAR should be amended to require the courts to consider the economic substance of the transaction in question and should provide some guidance to the courts as to the meaning of economic substance.

In the final analysis, we need judges at all levels with a better understanding of the structure and policy of the tax system and commercial transactions. Perhaps a separate final court of appeal for tax cases is an idea worth consideration.

Appendix

Canada, Income Tax Act, Part XVI (Section 245)

Tax Avoidance

245

(1) **Definitions.** In this section and in subsection 152(1.11):

‘tax benefit’—‘tax benefit’ means a reduction, avoidance, or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance, or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty.

‘tax consequences’—‘tax consequences’ to a person means the amount of income, taxable income, or taxable income earned in Canada or, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount.

‘transaction’—‘transaction’ includes an arrangement or event.

(2) **General anti-avoidance provision.** Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) **Avoidance transaction.** An avoidance transaction means any transaction:

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

(4) **Provision not applicable.** Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction:

(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of:

- i. this Act,
- ii. the Income Tax Regulations,
- iii. the Income Tax Application Rules,
- iv. a tax treaty, or
- v. any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or

(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

(5) Determination of tax consequences. Without restricting the generality of subsection (2), and notwithstanding any other enactment:

(a) any deduction, exemption, or exclusion in computing income, taxable income, taxable income earned in Canada, or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(b) any such deduction, exemption or exclusion, any income, loss, or other amount or part thereof may be allocated to any person,

(c) the nature of any payment or other amount may be recharacterized, and

(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

(6) Request for adjustments. Where with respect to a transaction:

(a) a notice of assessment, reassessment, or additional assessment involving the application of subsection (2) with respect to the transaction has been sent to a person, or

(b) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction,

any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 180 days after the day of mailing of the notice, to request in writing that the Minister make an assessment, reassessment, or additional

assessment applying subsection (2) or make a determination applying subsection 152(1.11) with respect to that transaction.

(7) **Exception.** Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment, or determination pursuant to subsection 152(1.11) involving the application of this section.

(8) **Duties of Minister.** Upon receipt of a request by a person under subsection (6), the Minister shall, with all due dispatch, consider the request and notwithstanding subsection 152(4), assess, reassess, or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, except that an assessment, reassessment, additional assessment, or determination may be made under this subsection only to the extent that it may reasonably be regarded as relating to the transaction referred to in subsection (6).

Coming-into-force: Section 245 is applicable with respect to transactions entered into on or after September 13, 1988 other than:

(a) transactions that are part of a series of transactions, determined without reference to subsection 248(10), commencing before September 13, 1988 and completed before 1989, or

(b) any one or more transactions, one of which was entered into before April 13, 1988, that were entered into by a taxpayer in the course of an arrangement and in respect of which the taxpayer received from the Department of National Revenue, before April 13, 1988, a confirmation or opinion in writing with respect to the tax consequences thereof.

5 The Battle Continues: Recent Australian Experience with Statutory Avoidance and Disclosure Rules

Chris Evans

At a 1995 conference held in Sydney, Jeffrey Waincymer noted that ‘the importance of avoidance in the history of Australian taxation law cannot be overestimated.’¹ Recent developments in Australia serve to confirm the relevance and accuracy of that statement. Australian taxation law, and developments in the Australian tax landscape more generally, continue to be shaped in large part by the ongoing tension between the protectors of the fisc and those who would seek to legitimately reduce the tax liabilities of themselves or their clients. This tension is not limited, as might historically have been the case, to high wealth individuals or those at the ‘top end of town’. The growth in the mid to late 1990s of mass-marketed tax avoidance schemes pedalled by the ‘white shoe brigade’² to high income blue collar workers operating in the resources sectors in the remoter parts of Australia has shown that tax avoidance activity is now a much more comprehensive and extensive phenomenon than was the case in earlier years.

The General Anti-Avoidance Rule (GAAR) constituted by Part IVA of the Income Tax Assessment Act 1936,³ which has operated since 1981, has continued to be a principal weapon in the anti-avoidance armoury. But there have also been developments, distractions, and digressions in a number of other areas. The Australian Government has shown itself to be willing to enact Specific Anti-Avoidance Rules (SAARs) where it feels the need. It has also

1. J Waincymer, ‘The Australian Tax Avoidance Experience and Responses: A Critical Review’ in G Cooper (ed), *Tax Avoidance and the Rule of Law* (IBFD Publications, Amsterdam 1997) 247. The conference upon which the edited book was based (The Rule of Law and Anti-Avoidance Rules: Tax Administration in a Constitutional Democracy) was held in Sydney in 1995.
2. A derisive term originally coined to describe the property developers who worked with Sir Joh Bjelke-Petersen, Premier of Queensland, in a number of suspicious deals in the 1960s, 1970s, and 1980s.
3. Note that there are also separate GAARs that apply to the operation of the Australian Goods and Services Tax (Division 165 of the A New Tax System (Goods and Services Tax) Act 1999) and the Fringe Benefits Tax (Section 67 of the Fringe Benefits Tax Assessment Act 1986). Developments in these provisions are not considered in this chapter.

recently enacted legislation designed to rein in the promoters of ‘tax exploitation schemes’, and the Australian Taxation Office (ATO) continues to refine its meta-risk management framework which governs the relationship between itself and other key stakeholders.

In short, the weapons technology continues to develop, some of the illicit arms dealers are under siege, and the protocols or rules of engagement for the combatants continue to be fine-tuned. Key developments in each of these separate battleground areas are examined in turn.

Part IVA: Maintaining the Nuclear Deterrent

Australian governments have traditionally used a variety of GAARs to combat what are perceived to be abusive avoidance activities. These include Part IVA of the Income Tax Assessment Act 1936, Section 67 of the Fringe Benefits Tax Assessment Act 1986 and Division 165 of the A New Tax System (Goods and Services Tax) Act 1999. The income tax GAAR is by far the best known of these rules, with a substantial amount of case law already developed—this chapter focuses upon this provision.⁴

For Part IVA to apply there must be a ‘scheme’, which is very broadly defined; a taxpayer must obtain a ‘tax benefit’ (also defined) in connection with the scheme; and, having regard to eight factors listed in the legislation, it would be concluded that the sole or dominant purpose of any person who entered into or carried out the scheme (or any part of the scheme) did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme. When these separate elements are satisfied the Commissioner may make a determination to cancel the tax benefit.

In this volume, David Pickup⁵ mentions the ‘judicial castration’ of Section 260,⁶ the predecessor to Australia’s current income tax GAAR, which was brought in by the Barwick High Court of the 1960s and 1970s. There were initial fears that Part IVA would suffer the same fate. For example, after the decision in the *Peabody*⁷ case (the first Part IVA case heard by the High Court) went against the Commissioner in 1994, Graeme Cooper noted that: ‘[t]he inauspicious inauguration of [Part IVA] may be the portent of its imminent emasculation’.⁸

4. In passing, it should be noted that the first case considering the Goods and Services Tax GAAR, legislated with effect from transactions entered into on or after 2 December 1998, was heard by the Administrative Appeals Tribunal in 2006. The case of *Re VCE v FCT* [2006] AATA 821 resulted in an entirely expected victory for the Commissioner.

5. See Ch 2, this volume.

6. Section 260 Income Tax Assessment Act 1936.

7. *FCT v Peabody* (1994) 181 CLR 359; 94 ATC 4663.

8. G Cooper, ‘Conflicts, Challenges, and Choices: The Rule of Law and Anti-Avoidance Rules’ in G Cooper (ed), *Tax Avoidance and the Rule of Law* (IBFD Publications, Amsterdam 1997) 42.

But these initial fears for the future of Part IVA have not proved to be well founded. After *Peabody*, the High Court has subsequently heard three cases (*Spotless*, *Consolidated Press Holdings*, and *Hart*⁹) relating to the application of Part IVA. In addition there have been many cases on Part IVA heard in the lower Federal and Full Federal Courts.¹⁰ The Commissioner has enjoyed success in most of these Part IVA cases. In particular, outright High Court victory in *Spotless* and in *Hart*, and partial success in *Consolidated Press Holdings*, has provided the Commissioner with a weapon of mass destruction that is not only perceived to be a potent threat, but which actually is powerful when used.

There is therefore a sense that the Commissioner's faith in the approach of using a GAAR as a principal weapon in the anti-avoidance crusade has been vindicated. Part IVA is seen as effective and plans to strengthen it have been left on the shelf. In 1999 the Government had announced,¹¹ in response to the Review of Business Taxation that took place in that year, that Part IVA would be strengthened by expanding the concept of 'tax benefit',¹² tightening the 'reasonable expectation' test,¹³ and giving the Commissioner wider powers to cancel benefits.¹⁴ In fact, eight years later, none of these changes has been legislated, suggesting that there is general satisfaction, so far as the Government is concerned, with the way that Part IVA is currently operating.

But the Commissioner's apparent success has come at something of a cost. The abundance of jurisprudence relating to Part IVA has not provided any greater certainty of outcome as to when, or why, Part IVA will apply in particular circumstances. Recent commentators¹⁵ have noted that there are a large number of unresolved issues and continuing uncertainty in the application of Part IVA, and one such commentator¹⁶ has argued that 'the more things change the more they remain the same, in that the issues

9. *FCT v Spotless Services Ltd* (1996) 186 CLR 404; *FCT v Consolidated Press Holdings Ltd* [2001] HCA 32; *FCT v Hart* [2004] HCA 26.

10. These include *Eastern Nitrogen v FCT*, 50 (2001) 108 FCR 27; 2001 ATC 4164; *Howland-Rose and Others v FCT* [2002] FCA 246; 2002 ATC 4200; *Vincent v FCT* 2002 ATC 4742; *Puzey v FCT* 2003 ATC 4782; *FCT v Sleight* [2004] FCAFC 94; 2004 ATC 4477; *FCT v Cooke & Jamieson* [2004] FCAFC 75; *Macquarie Finance Limited v FCT* [2005] FCAFC 205; 2005 ATC 4829.

11. The Treasurer, Commonwealth of Australia, New Business Tax System: Stage 2 Response No 74 (1999).

12. The government announced that the concept of 'tax benefit' would be expanded so that it would apply in a generic way to any reduction or deferral of tax payable, including through tax rebates and credits or losses.

13. This proposed amendment was designed to counter arguments by taxpayers that if the scheme had not been entered into, no action at all would have been taken.

14. The government announced that the Commissioner would be given the power to issue a single determination covering every participating member of a scheme.

15. See, for example: M Cashmere, 'Towards an Appropriate Interpretative Approach to Australia's General Tax Avoidance Rule—Part IVA' (2006) 35 Australian Tax Review 4; T Pagone, 'Part IVA—The Voyage Continues' (2006) 10 The Tax Specialist 1; W Thomson, 'Applying Part IVA' (2007) 10 The Tax Specialist 4; C Evans, 'Barriers to Avoidance: Recent Legislative and Judicial Developments in Common Law Jurisdictions' (2007) 37 Hong Kong Law Journal 103.

16. Pagone (n 15) 36.

about Part IVA which still appear to be in doubt or contention frequently seem to be the same as they were before the disputes were, supposedly, resolved by the High Court’.

Tony Pagone goes on to list eight specific areas where the law is still uncertain or unresolved. These are:

- the role of a purpose of obtaining a tax benefit;
- the relevance of a tax adviser’s purpose and whether it can be imputed to the taxpayer;
- the identification of a scheme;
- the identification of a tax benefit;
- the role of legislatively permitted choices and the extent to which a tax benefit may be attributable to the making of a choice;
- the question of whether a scheme may be entered into for the purpose of enabling a particular choice to be made;
- the use of roll-overs; and
- the time at which the sole or dominant purpose is to be tested.

Maurice Cashmere goes further and argues that Part IVA ‘is drafted so widely as to be capable of enabling the Commissioner of Taxation to annihilate any transaction which provides a tax advantage’.¹⁷ It is his contention that ‘[w]hile certainty relating to the application of legal principles (including tax principles) cannot be assumed, it is important that there be certainty relating to the principles which are to be applied. The High Court has yet to provide that certainty in relation to the interpretation of Part IVA’.

As is noted later in this chapter, ‘certainty’ is a concept that is being heavily promoted by the ATO as part of its broader risk management strategy. To promote such certainty the Commissioner of Taxation released—in December 2005—a series of publications designed to outline the ATO approach to the application of the general anti-avoidance rules, with a particular focus on the application of Part IVA. The package¹⁸ includes a two-page statement outlining how the ATO will refocus its test case program on the application of Part IVA to income-splitting arrangements; an eight-page practical guide outlining the basic principles of how and when Part IVA applies to tax schemes;¹⁹ and an ATO Practice Statement Law Administration (PS LA 2005/24) comprising nearly 100 pages which updates advice to ATO staff on the application of Part IVA and other broadly equivalent general anti-avoidance rules of other tax laws. The practice statement provides extensive detail on the operation of these provisions and the processes leading to a decision on their application.

The ATO, like all revenue authorities, is between a rock and a hard place when it comes to the publication of such information. On the one hand the tax advising

17. Cashmere (n 15) 4.

18. Australian Taxation Office Media Release Nat—2005/70, 13 December 2005.

19. *Part IVA: The General Anti-Avoidance Rule for Income Tax* (Australian Taxation Office, Canberra 2005).

profession welcomes any light that can be thrown on how these general anti-avoidance rules apply in practice. For example, the statement outlining how the ATO will refocus its test case program on the application of Part IVA to income-splitting arrangements makes it very clear that ‘genuine’ husband and wife partnerships that derive personal services income and share equally in profits and losses (notwithstanding that only one spouse performs the bulk of the work), will not be subjected to challenge under Part IVA (absent unusual features). A cynic might suggest that this decision owes more to a pragmatic acceptance that there are simply too many such partnerships to challenge rather than the application of a principled approach to the issue, but there can be no doubt that the approach provides practitioners with the certainty of outcome they crave in that particular instance.

But on the other hand, practitioners will still need to be conscious that these publications merely express the Commissioner’s view on the potential application of Part IVA or one of the other general anti-avoidance rules—they are not a substitute for the law itself, nor do their arguments and discussions necessarily hold any particular sway with the judges who must ultimately arbitrate in the cases that come before the courts. The assiduous practitioner or commentator will be able to pick any number of holes in the ATO guidelines, and the need for a careful review of the potential application of the general anti-avoidance rules will not go away as a result of the publication of this information.

In summary, therefore, the Australian GAAR has continued to maintain a pivotal role in the anti-avoidance provisions available to the Commissioner. The Commissioner has not been profligate in its application, fearing that overuse may diminish its potency. Where it has been used, appropriately and as a provision of last resort, the Commissioner has enjoyed success more often than not. But the emerging jurisprudence has revealed something of a divergence in the views of the more commercially biased Federal and Full Federal Courts and a High Court necessarily concerned with a purposive legal interpretation of a complex provision. As a result, and despite attempts by the Commissioner to provide some certainty, there are large areas of application that remain uncertain and a large number of issues relating to Part IVA that are still unresolved.

SAARs: Snipers and Shotguns

While the GAAR has maintained its central role, the Australian Government has not eschewed the opportunity to introduce more targeted and specific anti-avoidance provisions where the need has arisen.

In the 1960s, the Canadian Carter Commission identified and distinguished two approaches to specific anti-avoidance provisions: the ‘sniper’ and the ‘shotgun’.²⁰ It was noted that the sniper approach contemplates the enactment of specific provisions

20. See J Tiley, *Revenue Law* (5th edn Hart Publishing, Oxford 2005) 96.

identifying, with precision, the type of transaction to be dealt with and prescribing, with precision, the tax consequences of such a transaction. In contrast, the shotgun approach contemplates the enactment of some general provision imposing tax on transactions which are defined in a general way. The difference between this and the sniper approach lies in its conscious rejection of certainty.

Australia has recognized the usefulness of both, and recent legislative initiatives reflect sniper and shotgun approaches. The sniper approach, for example, is evident in the denial of losses or outgoings in furtherance of illegal activities—legislation enacted in late 2005 (almost as a knee-jerk ‘moral panic’ reaction) in sections 26–54 ITAA97 in response to an Australian tax case in which a drug dealer successfully claimed tax deductions for losses incurred in his criminal activities.²¹

The shotgun approach has been used in the enactment, for example, of general value shifting rules in 2002,²² which were themselves a delayed legislative response to the adverse outcomes of the Part IVA *Peabody* case in 1994, and in the alienation of personal services income (PSI) rules enacted in 2000.²³ The purpose of these rules, as set out in section 86-10, is to ensure that individuals cannot reduce or defer their income tax (and other liabilities) by alienating their personal services income through companies, partnerships, or trusts that are not conducting personal services businesses. The rules ensure income for the provision of personal services, whether paid directly to an individual or channelled through an interposed entity, will be treated for taxation purposes in the same way, and also clarify the deductions available (both for individuals and other entities) in the gaining of personal services income.

SAARs of both types have therefore continued to be used, and have generally been effective, in Australia in recent years, but they have also suffered certain problems and disadvantages. For example:

- they have contributed enormously to the length and complexity of the Australian taxation legislation, which is considered to be amongst the most tortuous in the world;
- they are often reactive rather than proactive in that they are there to plug a gap that the revenue authority has become aware of, and as a result the revenue authority is always playing ‘catch up’;
- they can lead to legislative layering which can itself facilitate more avoidance possibilities (what Lord Walker has referred to as ‘avoidance karate’²⁴).

21. *La Rosa v Commissioner of Taxation* [2004] FCA 1799.

22. Divisions 723 to 729 Income Tax Assessment Act 1997.

23. Divisions 84 to 87 Income Tax Assessment Act 1997.

24. Lord Walker of Gestingthorpe, ‘*Ramsay* 25 Years On: Some Reflections on Tax Avoidance’ (2004) LQR 412 at 416.

Promoter Penalties: Dealing with the Arms Dealers²⁵

In Australia in recent years there has been some emphasis upon the enactment of legislation designed to impose penalties upon the promoters of what have been labelled 'tax exploitation schemes'.

In late 2003, the Australian Government announced²⁶ its intention to introduce measures, including a new civil penalty regime, to deter the promotion of tax avoidance and tax evasion schemes. Exposure draft legislation to give effect to this announcement was introduced in August 2005. The explanatory material noted that there were (at that time) no administrative penalties that could be imposed on the promoters of tax exploitation schemes. By way of contrast, taxpayers found to have participated in tax exploitation schemes might be subject to scheme penalties. The amendments, therefore, sought to address this inequity, and to create a deterrent to the promotion of tax exploitation schemes.

Legislation²⁷ designed to deter the promotion of tax exploitation schemes in Australia received the Royal Assent in early 2006. The legislative provisions seek to deter:

- the promotion of tax avoidance and evasion schemes (collectively referred to in the legislation as tax exploitation schemes); and
- the implementation of schemes that have been promoted on the basis of conformity with a product ruling, in a way that is materially different to that described in the product ruling.

In summary²⁸ the provisions enable the Commissioner to:

- request the Federal Court of Australia to impose a civil penalty on a scheme promoter or implementer. The maximum penalty the Federal Court can impose is the greater of 5,000 penalty units (currently equal to AUD\$550,000) for an individual, or 25,000 penalty units (currently equal to AUD\$2.75 million) for a body corporate, and twice the consideration received or receivable, directly or indirectly, by the entity or its associates in respect of the scheme;
- seek an injunction to stop the promotion of a scheme or implementation of a scheme not in conformity to its product ruling; and
- enter into voluntary undertakings with promoters or implementers about the way in which schemes are being promoted or implemented.

25. This section is based upon material contained in C Evans, 'Barriers to Avoidance: Recent Legislative and Judicial Developments in Common Law Jurisdictions' (2007) 37 Hong Kong Law Journal 103.

26. Assistant Treasurer's Press Release C117/03 (Treasury, Canberra December 2003).

27. Division 290 of Tax Administration Act 1953.

28. Chapter 3 Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 1) Act 2006.

In deciding what penalty is appropriate, the Federal Court can have regard to all matters it considers relevant, including the amount of loss or damage incurred by scheme participants and the honesty and deliberateness of the promoter's conduct.

The Explanatory Memorandum notes²⁹ that the civil penalty regime is not intended to inhibit the provision of independent and objective tax advice, including advice regarding tax planning. Some commentators have, however, expressed serious reservations about the potential impact on tax advisers providing tax planning advice, as well as expressing concerns about many other aspects of the promoter penalty provisions.³⁰

Meta-risk Management: Refining the Rules of Engagement³¹

Legislative initiatives and judicial responses have been very important anti-avoidance developments in Australia. But they have also been accompanied by ATO administrative initiatives designed to successfully manage the risk to the revenue constituted by avoidance activity.

So far as the 'big end of town' is concerned, the approach of the ATO has most recently been spelled out in a speech by the Commissioner to Financial Executives International of Australia entitled 'Creating the Right Environment: Transparency, Cooperation, and Certainty in Tax'.³² In that speech the Commissioner notes that 'the challenge for large business and the Tax Office is to create certainty through transparency and cooperation', and emphasizes the current ATO mantra of 'consultation, collaboration, and co-design'. Mention is also made of two 'Forward Compliance Arrangements' made with the ANZ bank and BP in the areas of Goods and Services Tax (GST) and Excise, which were designed to promote governance arrangements that reduce the company's risk of audits, tax litigation, penalties, and interest, and also streamline access to support and advice.

Earlier in 2007 the Commissioner issued guidance to CEOs and company boards recommending that:

- there is a sound framework in place for managing tax issues and complying with tax obligations;
- there is a well-resourced, skilled, and experienced in-house capability in place to support the management of tax issues;

29. Paragraph 3.50 Explanatory Memorandum to Tax Laws Amendment (2006 Measures No. 1) Act 2006.

30. For example, J King, 'New Measures Deterring the Promotion of Tax Exploitation Schemes' (2006) Australian Tax Review 35, 3.

31. This section is based upon material contained in C Evans, 'Barriers to Avoidance: Recent Legislative and Judicial Developments in Common Law Jurisdictions' (2007) 37 Hong Kong Law Journal 103.

32. Delivered by Michael D'Ascenzo on 19 June 2007 at the Intercontinental Hotel, Sydney and available at <<http://www.ato.gov.au/corporate/content.asp?doc=/content/85792.htm>>.

- appropriate reporting systems are in place so that significant tax risks are escalated to the board or decision-makers in a timely fashion;
- the appropriate review and sign-off for material transactions are in place and that tax impacts are considered as part of this process;
- the company has a clearly articulated approach to managing tax risk (for example, seeking rulings in relation to complex and novel transactions); and
- that these systems and processes are audited regularly to ensure that they are operating effectively.

The ATO also publishes a comprehensive annual compliance program³³ which describes the tax compliance risks it is most concerned about and what it is doing to address them. 'Aggressive tax planning', which the ATO defines as 'the use of transactions or arrangements that have little or no economic substance and are created predominantly to obtain a tax benefit that is not intended by the law',³⁴ features as a prominent part of that annual program. The program identifies the ATO's general approach to aggressive tax planning, certain headline issues, and its current focus and priorities, as well as actions taken and successes achieved in the preceding year.

As Braithwaite has noted,³⁵ the ATO's response to aggressive tax planning has moved beyond the 'command and control' framework that typified the 1970s and 1980s to one of 'responsive regulation' and 'meta risk management' from the 1990s onwards. Braithwaite explains that under the command and control approach '[t]axpayers lodged their returns, the ATO assessed them and decided how much tax was due. Audits were conducted to detect the provision of false information on returns, which, when detected, typically resulted in the imposition of modest penalties'.³⁶ That command and control mentality involved the see-saw of 'carrot and stick' approaches, oscillating between a customer service focus and one which relied on punitive legal action, depending on whichever particular philosophy happened to be in the ascendant at a particular time within the organization.

Responsive regulation involves an enforcement pyramid (now encapsulated in the ATO's Compliance Model) in which the bulk of taxpayers engaged in cooperative compliance are situated at the base of the pyramid, while a small hard core of recalcitrant offenders are at the apex. Little enforcement activity is required for those at the base of the pyramid; essentially they require only the positive encouragement to comply. On the other hand, the revenue authority possesses a credible capacity to escalate up the pyramid to progressively more severe sanctions in the face of persistently aggressive non-compliance.

33. See <<http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/88713.htm&pc=001/005/008/009/002&mnu=&mfp=&st=&cy=1>> for the latest version (Compliance Program 2007–08).

34. *Ibid.*

35. J Braithwaite, *Markets in Vice: Markets in Virtue* (Federation Press, Leichardt 2005).

36. *Ibid.*, p 68.

In Braithwaite's terms, responsive regulation involves 'sending clear signals through concrete enforcement actions that the agency is willing to escalate in order to create a culture where systemic preventive solutions and good relationships with taxpayers will do most of the compliance work'.³⁷ As part of this responsive regulation, meta risk management simply refers to the 'risk management of risk management'.³⁸ It entails the ATO monitoring of the tax community's self-monitoring and self-regulation.

Conclusions

GAARs have always played an important role in Australian anti-avoidance regimes, and continue to do so. The Commissioner can probably take some pleasure from the outcomes of the various cases that have been litigated under Part IVA to date, although the emerging jurisprudence might be characterized more for the uncertainty than for the clarity of its outcomes. That uncertainty generally works in the Commissioner's favour, and does not always sit comfortably with the Commissioner's apparent concern for certainty in tax that is so manifest in the broader risk management strategy adopted by the ATO.

But the GAARs do not operate in a vacuum, and there is clearly recognition that both tightly targeted and more general SAARs also have an important role to play in maintaining the integrity of the Australian tax system. These provisions are not as prolific in Australia as they are in other jurisdictions (and particularly the UK), but they are significant.

In addition the Government has responded to the debacle of the ATO's handling of the proliferation of mass-marketed tax avoidance schemes in the mid to late 1990s with the enactment of the promoter penalty regime. The ATO has also extended its administrative discretion by introducing formal systems of product and class rulings designed to give prior approval to investments in managed investment and similar schemes.

Hence there is a reliance in Australia on a combination of GAARs, SAARs, and promoter penalty regimes, all bound together in a carefully crafted risk management strategy. Australia has not yet identified the need to implement a formal tax scheme disclosure regime of the kind introduced in the UK in 2004 (and in the USA and Canada earlier). But concern about tax avoidance and tax evasion is rife, as evidenced by current media coverage of Project Wickenby.³⁹ It is perhaps merely a question of time before the ATO manages to persuade the Australian Government of the absolute necessity for the wide-reaching provisions of a scheme disclosure regime to be enacted in Australia.

37. *Ibid*, p 178.

38. *Ibid*, p 85.

39. Project Wickenby is a multi-agency taskforce set up in 2004, with funding of AUD\$305.1 million over seven years, to investigate internationally promoted tax arrangements that allegedly involve tax avoidance or evasion, and in some cases, large-scale money-laundering. The five agencies involved are the ATO, the Australian Crime Commission (ACC), the Australian Federal Police (AFP), the Australian Securities and Investments Commission (ASIC), and the Commonwealth Director of Public Prosecutions (CDPP).

6 Statutory Avoidance and Disclosure Rules in Germany

Wolfgang Schön

Introduction

Germany introduced its general statutory anti-avoidance rule (German GAAR) in 1919 when § 5 of the *Reichsabgabenordnung* (Imperial Order on Levies) came into force. While the *locus* of this provision has changed several times in the following decades (it moved to § 6 of the *Steueranpassungsgesetz* (Tax Adjustment Act) in 1934 and was later transferred to § 42 *Abgabenordnung* (Order on Levies) in 1977), its wording has remained virtually unchanged over many years. Yet in summer 2007, the German Government expressed the need to extend the scope of this provision substantially.¹ In addition to this move, the Ministry of Finance launched a plan to introduce statutory disclosure rules for international tax avoidance schemes along the lines of US and UK predecessor provisions.² The autumn of 2007 saw a lively public debate on the merits of these high-flying proposals. When the German Bundestag passed the *Jahressteuergesetz 2008* (Finance Act 2008) in November 2007, the relevant change in the law had boiled down to a moderate amendment of § 42 *Abgabenordnung*, and no additional provisions on tax shelter disclosure were enacted.³

The political debate which accompanied these legislative developments has shown that the formerly unspectacular fate of Germany's statutory anti-avoidance provision belongs to the past. The concept and the consequences of abuse in the area of tax law are now regarded as constituting one of the paramount topics for German tax legislation, jurisprudence, and doctrine. Against this background, the *Deutsche Steuerjuristische Gesellschaft* (German Tax Lawyers' Association) will devote its 2009 conference to this subject-matter. As such, it might be useful for academics and practitioners from other jurisdictions to cast an eye on the German situation as it stands today.

1. Finance Bill 2008, Bundestags-Drucksache 16/6290 available at <<http://dip21.bundestag.de/dip21/btd/16/062/1606290.pdf>>.
2. Gesetzentwurf zur Anzeigepflicht von Steuergestaltungen v. 25.6.2007 available at <http://rsw.beck.de/rsw/upload/FDMA/StGestAnzPflG_RefEntw.pdf>.
3. Bundestags-Drucksache 16/7036 available at <<http://dip21.bundestag.de/dip21/btd/16/070/1607036.pdf>> 80.

Content and Impact of § 42 *Abgabenordnung*

The current version of § 42 para 1 *Abgabenordnung* reads as follows:

The tax law cannot be circumvented by abusive constructions. In case of an abuse the tax claim arises in the same way as it would have if a reasonable/adequate legal construction reflecting the true economic nature of the event would have been executed.⁴

GAAR and General Rules of Tax Law Interpretation

This provision has given rise to several—partly interdependent—issues. The first and, from a methodological standpoint, the most important, question refers to the relevance of such a statutory rule in the first place. A substantial group of academic writers is of the opinion that the same result as can be achieved under a general anti-avoidance provision can be reached by way of purposive construction of the relevant substantive tax law.⁵ In their view, any artificial ‘construction’ aiming at the same economic effect as a ‘reasonable’ measure can be dealt with by simple purposive application of the specific tax provisions of income tax, corporate tax, and so on. The wording of § 42 *Abgabenordnung* (‘. . . cannot be circumvented . . .’) is held to be of a declaratory nature. In other words: according to these writers, the existence of § 42 *Abgabenordnung* simply does not make a difference for the application of substantial tax law in Germany. The majority opinion,⁶ on the other hand, still seems to see § 42 *Abgabenordnung* as a meaningful instrument which is necessary in order to disregard abusive behaviour which otherwise would have to be accepted by the administration and the courts.

In order to assess the full implications of this debate, it has to be understood that these different views on § 42 *Abgabenordnung* do not concern an isolated issue but reflect a far-reaching divide among German tax lawyers (academics and practitioners alike) with respect to taxation law.⁷

4. „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 rechtlichen Gestaltung entsteht.“

5. P Fischer, ‘Commentary on Section 42 *Abgabenordnung*’ in Hübschmann, Hepp, and Spitaler (eds), „*Abgabenordnung und Finanzgerichtsordnung*“ (2007) para 10 et seq; P Kirchhof, „*Steuerumgehung und Auslegungsmethoden*“ (1983) 60 *Steuer und Wirtschaft* 173 et seq; K Tipke, „*Die Steuerrechtsordnung*“ vol III, 1 edn (1993) § 29 para 4.12; H Weber-Grellet, „*Steuern im modernen Verfassungsstaat*“ (2001) 222 et seq.

6. A Hensel, „*Zur Dogmatik des Begriffs „Steuerumgehung“*“ in „*Bonner Festgabe für Ernst Zitelmann*“ (1923) 217 et seq; E Reimer, C Waldhoff (eds), „*Albert Hensel: System des Familiensteuerrechts und andere Schriften*“ (2000) 303 et seq.; H Wilhelm Kruse, „*Lehrbuch des Steuerrechts*“ vol I (1991) § 6 V; J Lang in Tipke, and Lang, „*Steuerrecht*“ 18 edn (2006) § 9 para 96.

7. See W Schön, ‘*Interpretation of Tax Statutes in Germany*’ in K Vogel (ed), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany* (Kluwer Law International, Amsterdam 1998) 69 et seq; for a monographic analysis see S Sieker, *Umgebungsgeschäfte* (2001).

One group⁸ pleads for a restrictive application of tax law and insists on legal certainty and limited powers of the tax administration and the tax courts. They take the following view: tax law has to be interpreted narrowly and should—as a rule—refer to the traditional civil law meaning of terms used by the tax legislator. Moreover, there should be no general ‘substance over form’ rule when it comes to the application of tax provisions to economic events. Thirdly, tax provisions should not be extended by way of analogy to situations not covered by the existing provisions. And last, but not least, § 42 *Abgabenordnung* should not be used to extend the scope of tax law systematically (and to mend deficiencies of existing legislation), but its application should be restricted to outright artificial constructions which were put into place with the single (or paramount) goal of saving tax.

The opposing group⁹ of writers tries to strengthen the equitable treatment of taxpayers and to enforce an even-handed taxation according to the ‘ability-to-pay’ principle. They propose to loosen the link between civil law and tax law in order to extend the meaning of tax provisions to all sorts of economic events resembling the case originally covered by a tax provision. Moreover, they plead for a broad ‘substance over form’ perspective and a purposive interpretation of tax rules which would ensure that all situations representing the same economic power are covered by a provision. It is quite evident that this group of writers also sees no fundamental limits to extending the scope of a tax provision by way of analogy. In the context of the German GAAR they show a mixed attitude: on the one hand, they plead for a broad interpretation of this rule, while on the other hand, they regard it to be superfluous as the same results can be achieved by way of interpretation.

In the end, it should be clear that the ‘philosophies’ behind these schools of thought are quite different. While the first group believes that there is no taxation if the legislator has not said so explicitly, and that the taxpayer’s right to legal certainty has to be protected, the other group puts equity first and accepts willingly that the scope of a tax provision is extended in a way which was not and could not easily be foreseen by the taxpayer. Even within the Federal Tax Court, the respective Senates seem to adhere to different lines of thinking. While the First Senate (competent for corporate and international tax) promotes a narrow understanding of ‘abuse’, other Senates use this concept more often to prevent taxpayers from reaping ‘unjustified’ tax benefits.

8. W Flume, „Steuerrechtsprechung und Steuerrecht“ in (1985/86) 37 *Steuerberater-Jahrbuch* 277 et seq; Wilhelm Kruse (n 6) § 6 IV; Schön (n 7) 69 et seq.
9. Tipke (n 5) §§ 28, 29; P Fischer, „Geltungsanspruch des Steuergesetzes, Steuerumgehung und „wirtschaftlich oder sonst beachtliche Gründe““(2001) 83 *Finanz-Rundschau* 1212 et seq.; P Kirchhof, „Die Steuern“ in Isensee, and Kirchhof (eds), „*Handbuch des Staatsrechts*“ vol 5, 3 edn (2007) § 118 para 34; P Kirchhof, „Der Vertrag—ein Instrument zur Begründung steuerlicher Ungleichheit?“ in Crezelius, Hirte, and Vieweg (eds), „*Festschrift für Volker Röhrich*“ (2006) 919 et seq.

The 'Adequateness' of a Legal Construction

The basic requirement for an 'abusive' construction is—according to § 42 *Abgabenordnung*—its missing 'adequateness' in terms of economic sense. While it has often been stressed by the courts that this verdict aims only at 'unusual' constructions, it is equally accepted that the taxpayers are not bound to stick to traditional legal forms, ie they are allowed under tax law to move on to more innovative contractual arrangements. Therefore, it is not so much the 'unusual' as the 'unreasonable' which would be attacked under the German anti-avoidance provision.¹⁰ This requires an appraisal of the merits of a contractual arrangement, and in particular, the economic background of a particular construction. The courts have to ask whether 'reasonable parties', having the same economic goal in mind, would have chosen this structure. In this context, it is regarded to be decisive whether the taxpayer can bring forward any non-tax justification for his or her choice of legal instrument. The Federal Court of Justice has disregarded several machinations along these lines in recent judicature. Some of the best-known examples include:

- The sale of real estate between related persons, when the consideration is immediately donated back to the buyer.¹¹
- The interposition of a limited company by a real estate owner in order to avoid the classification of the resulting capital gains as 'business income'.¹²
- The suspension of a right to use a dwelling which is replaced by mutually offsetting obligations to pay a rent and to pay an annuity.¹³

The Motive Test

An important point, where the aforementioned and basically divergent views clash, concerns the relevance of a 'motive test', when it comes to the application of § 42 *Abgabenordnung*. The traditional narrow view of this provision has it that only constructions which have been executed specifically in order to save taxes would be reconstructed by the tax administration and the courts.¹⁴ This seems to be a sensible approach, because only a person who intentionally uses a tax planning device in order to save taxes and without any other economic purpose should lose the protection of the principle of legal certainty. Writers who plead for a broader application of this rule refer to the argument that taxation should not be dependent on subjective elements like 'motives'

10. H Wilhelm Kruse, 'Commentary on Section 42 *Abgabenordnung*' in Tipke, and Kruse (eds), *Abgabenordnung und Finanzgerichtsordnung* (1999) para 30 et seq.

11. Federal Tax Court, judgment of 27 October 2005 IX R 76/03, available at <<http://www.bundesfinanzhof.de>>.

12. Federal Tax Court, judgment of 18 March 2004 III R 25/02, available at <<http://www.bundesfinanzhof.de>>.

13. Federal Tax Court, judgment of 17 December 2005 IX R 56/03, available at <<http://www.bundesfinanzhof.de>>.

14. Federal Tax Court, judgment of 8 May 2005 IV R 54/01, available at <<http://www.bundesfinanzhof.de>>; this issue was left open in: Federal Tax Court, judgment of 18 March 2004 (n 12) para 79.

and should simply look at the economic reality of the taxpayer's behaviour and the economic effects brought about by this behaviour.¹⁵ Others point to the fact that the 'tax motive' is taken into account anyway when it is tested whether 'reasonable parties' would have embarked on this transaction in order to pursue their economic goals.¹⁶ Again, the final word in this debate has not yet been spoken.

Step Transactions

From a UK point of view, it should be noted that the 'step transaction doctrine' which has been applied by British courts in recent years has found its way into German court decisions as well. A dissertation¹⁷ comparing the UK and German notion of 'abuse of law' in the context of tax law in 1994 was well received and even reviewed by a leading German tax judge.¹⁸ In the same vein, several Senates of the Federal Tax Court in Munich have made clear in a series of judgments that 'rotating schemes' which lead the taxpayer after a series of transactional steps 'back to square one' will not be accepted and will be regarded as abusive.¹⁹ According to their view, it is the 'overall design' (*Gesamtplan*) which has to be assessed by the courts.²⁰ Yet some academic writers hold the view that this inclusion of 'subjective elements' into the application of the tax law will give rise to increasing uncertainty and hidden analogies, thus damaging legitimate tax planning in the future.²¹ The First Senate of the Federal Tax Court, which is in charge of corporate and international taxation, has recently decided that even an outrageously artificial scheme could not be attacked by the tax administration under § 42 *Abgabenordnung* if the individual steps taken by the taxpayer were not abusive on their own—isolated—merits.²² It is this judgment which has given rise to the current legislative extension of § 42 that will be discussed below.

Tax Benefit and Tax System

One of the most important features of § 42 *Abgabenordnung* under the interpretation given by the Federal Tax Court refers to an 'unwritten' requirement of abusive

15. U Koenig, „Commentary on § 42 Abgabenordnung“ in: Pahlke/Koenig (ed), „Abgabenordnung“ (2004) para 35.

16. Wilhelm Kruse (n 10) para 44.

17. K Nevermann, „Justiz und Steuerumgehung—Ein kritischer Vergleich der Haltung der Dritten Gewalt zu kreativer steuerlicher Gestaltung in Großbritannien und Deutschland“ (1994).

18. P Fischer, „Substanz und Form—oder: „Das Steuergesetz kann nicht umgangen werden““ (1995) 72 *Steuer und Wirtschaft* 87 et seq.; see also: G Förster, and D Schmidtman, „Die Gesamtplanrechtsprechung im Steuerrecht—mit einem Vergleich der sog. „Step Transaction Doctrine“ im amerikanischen, britischen und belgischen Steuerrecht“ (2003) 80 *Steuer und Wirtschaft* 114 et seq.

19. Federal Tax Court, judgment of 8 May 2005 (n 14); Federal Tax Court, judgment of 4 October 2006 VIII R 7/03, available at <<http://www.bundesfinanzhof.de>>.

20. Federal Tax Court, judgment of 27 October 2005 (n 11), paras 15–19.

21. G Crezelius, 'Das Argumentationsmuster des sogenannten Gesamtplans' (2003) 85 *Finanz-Rundschau* 537.

22. Federal Tax Court, judgment of 28 June 2006 I R 97/05, para 29, available at <<http://www.bundesfinanzhof.de>>.

constructions in the field of tax law. According to the Court—most eminently to the First Senate of the Federal Tax Court—even an artificial construction intended to produce favourable tax treatment will not be regarded as abusive if the tax benefit derived from the construction complies with the systematic framework of tax law in general.²³ Only if and so far as the basic design of the relevant tax law is distorted by the taxpayer's action, is the borderline between legitimate tax planning and illegitimate tax avoidance transgressed. The most evident example concerns the choice of legal form (partnership vs limited company) which may naturally take into account preferential tax treatment of one legal form over the other. Another case in point which was adjudicated by the Court referred to the so-called 'distribute-contribute' scheme under the former German corporate tax imputation system. If the shareholders decide to distribute corporate profits in the first place (in order to enjoy the benefit of the imputation rules) and to recontribute the same monies to the company immediately afterwards instead of simply retaining the profits within the sphere of the corporation, this construction will not be disregarded. This is due to the argument that the tax effect of this transaction (ie the definite application of the taxpayer's personal income tax rate to the distributed profits) has been envisaged by the legislator when the imputation system was introduced.²⁴

Reform of the German GAAR

It has been in particular the restrictive approach of the First Senate of the Federal Tax Court in matters of corporate and international taxation which has moved the German Government to launch a bill which was meant to fundamentally extend the scope of § 42 *Abgabenordnung*.²⁵ According to the draft which was presented to the German parliament in August 2007, any 'unusual' transaction chosen by the taxpayer would be disregarded if the taxpayer did not prove legitimate non-tax reasons for the transaction. Moreover, any structure which does not match the picture which the legislator had in mind when a tax provision was enacted in the past, would be regarded as 'unusual' under this new rule.

This reform bill was heavily criticized both in academic circles and among tax practitioners.²⁶ There were two main points raised against the legislative project. The first point concerned the 'presumption' that any structure which is not in line with the original intent of the tax legislation should be regarded as unusual. It is well known that no legislator in the world knows in advance all future situations which might fall under the scope of a provision. It is the task of the courts to decide which situations are covered and

23. Federal Tax Court, judgment of 28 June 2006 (n 22), paras 28–32.

24. Federal Tax Court, judgment of 8 August 2001 I R 25/00 Bundessteuerblatt, part 2, 2003, p 923; Federal Tax Court, judgment of 19 August 1999 I R 77/96 Bundessteuerblatt, part 2, 2001, p 43.

25. See (n 1).

26. H Bernhard Brockmeyer, „Bedenkliche Neufassung des § 42 Abs.1 AO im Referentenentwurf des Jahressteuergesetzes 2008“ (2007) 45 Deutsches Steuerrecht 1325; G Crezelius, „Vom Missbrauch zum Misstrauen: Geplante Änderungen des § 42 AO“ (2007) 60 Der Betrieb 1428.

which are not. The new bill, however, seemed to grant a power to the tax authorities to limit the field of application of a tax rule to those situations which have been expressly addressed by the original legislator (ie which have been foreseen by the tax administration which advises the legislator in nearly all matters of tax law). The taxpayer would not be in the position to rely on the wording of a tax provision according to state-of-the-art interpretation; he would have to listen to the tax authorities who would explain whether they regard their own original intention to cover a certain situation or not. Legal certainty would be missing and the interpretation of a tax rule in a new case would run systematically against the taxpayer.

The second point which was raised referred to the burden of proof. The new bill provided that in the case of an ‘unusual’ transaction the taxpayer had to prove a reasonable non-tax motive behind the chosen path. Taken together with the aforementioned presumption that any transaction which was not covered by the original intent of the tax legislation, this rule on the burden of proof would have meant that the taxpayer would have to defend himself against the reproach of ‘abuse’ in any case, which deviates from the narrow understanding of a provision put forward by the tax authorities. In other words: the taxpayer would be bound to arrange his affairs according to the picture of ‘real life’ which the tax administration had in mind when they advised the parliament in matters of tax legislation. This would lead to a petrification of existing business models. Any ‘new’ situation would have to be justified in the light of the original intent of legislation.

The wording of the final—enacted—version does not refer to the ‘unusual’ but to the ‘unreasonable’ or the ‘inadequate’ transaction. It leaves § 42 para 1 sent 1 *Abgabenordnung* unchanged and only tries to describe the ‘abusive’ character of a given transaction as follows:

Abuse does exist when an inadequate construction has been chosen which—unlike an adequate construction—confers upon the taxpayer or a third person a tax benefit which is not intended by the law. This rule does not apply if the taxpayer proves non-tax motives for the chosen construction which appear to be relevant in the light of the overall situation.²⁷

This language is much more in line with the traditional understanding of the German GAAR. Insofar as the application of the provision basically requires the ‘inadequateness’ or ‘unreasonableness’ of a certain transaction this is in line with existing jurisprudence. According to the Finance Committee of the German Parliament, the ‘adequateness’ or ‘reasonableness’ would be tested following the above-mentioned judicature of the Federal

27. „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.“

Tax Court.²⁸ Therefore, the courts have to evaluate whether reasonable parties would have chosen the same transaction in order to achieve the same economic effect. In international cases, according to the Finance Committee, one has to follow the very restrictive line of thinking put forward by the European Court of Justice.

According to the Finance Committee,²⁹ the tax authorities and the courts have to apply the new rule in three steps. At the first stage, it has to be established whether the chosen transaction does lead to a tax benefit which would not be generated by an ‘adequate’ construction and which is not intended by the relevant legislation. As such, there still seems to be a basic underlying notion of how an ‘adequate’ transaction should be. Thus, the courts will in the future have the task of not only defining what an ‘inadequate’ construction is but also what an ‘adequate’ construction should look like. In particular, the enjoyment of explicit ‘tax incentives’ would not be prevented by the new rule. At the second stage, one has to establish whether the chosen transaction was regarded to be ‘inadequate’. This is the case if reasonable parties would not have embarked upon the same transaction if not for tax reasons. At the third stage, the taxpayer would be in the position to prove that the ‘inadequate’ transaction was actually motivated by non-tax reasons.

Note that the ‘tax motive’ shows up twice in this examination: it has to be taken into account when the ‘unreasonableness’ of a transaction is tested, and it has to be looked at when the taxpayer tries to defend the true economic nature of his transaction. Yet this does not amount to a simple duplication of the same test. The rationale seems to be as follows: the first ‘tax motive’ test tries to answer the question of whether a reasonable third party would have chosen the relevant transaction if not for tax reasons. If this is not the case, the construction is presumed to be of an abusive nature. The second ‘tax motive’ test looks at the individual decision of the taxpayer who would be entitled to prove that he or she did not have a tax goal in mind when the construction was chosen. In this way, the taxpayer is granted two different lines of defence.

Against this background it is assumed that the new wording does not amount to a substantial extension of the scope of application of the German GAAR.

Tax Shelter Disclosure

While the debate on the envisaged extension of the German GAAR raged on in summer and autumn 2007, the tax authorities put forward a second proposal in order to strengthen their position in the fight against tax shelters. A new section 138a *Abgabenordnung* was drafted which was meant to introduce the first explicit set of tax shelter disclosure rules into German legislation.³⁰ The draft only concerned cross-border constructions, and in

28. See (n 3), p 33.

29. See (n 3), p 33.

30. See (n 2).

particular, transactions which have a ‘double dipping’ or ‘white income’ effect, but it seemed to be clear that a successful application of this new provision would, in the long-run, lead to an extension of its scope to domestic tax shelters as well.

The draft largely followed US and UK predecessors.³¹ The promoters of a ‘tax scheme’ which was meant to be sold systematically to taxpayers would have been required to file their ‘scheme’ with the tax authorities from the start. Moreover, they were meant to inform their clients about this listing, so that the taxpayers should include in their tax return a note on the use of a listed tax shelter. This provision was meant to inform the tax authorities as soon as possible about the latest developments in the tax shelter world and to give them the opportunity to act at an early stage—either by introducing administrative regulations or by advising the legislator to change the relevant tax law. Moreover, it should have a preventive effect on the tax shelter industry. German business (and academics) did not accept this move.³² It was made clear that in Germany the tax authorities are widely aware of existing tax schemes anyway, either by examining tax returns in the first place or, in the business sector, by the traditionally extensive field audits.³³ In the end, the proposal was dropped (but nobody knows whether it will pop up some time later).

Perspective

While no one expects any new legislative proposals in the near future, it seems to be clear that jurisprudence and academic writing will devote a lot of time to a further examination of the concept of ‘abuse of law’ in the field of taxation. Of course, arguments about the borderline between legitimate tax planning and illegitimate tax avoidance will likely rage on forever, but the public would like the Federal Tax Court to put forward a more coherent framework for the application of § 42 *Abgabenordnung*. It is the task of academia to support the courts in this respect.

31. M Wienbrocke, „Anzeigepflicht von Steuergestaltungen: Britisches Modell als Vorbild für deutsche Regelungen?“ (2007) 95 Deutsche Steuer-Zeitung 664.

32. C Flämig, „Der Steuerstaat auf dem Weg in den Überwachungsstaat“ (2007) Appendix to issue 44 of 45 Deutsches Steuerrecht; W Schön, „Grauzonen und Drohgebärden“ (Handelsblatt 27, 28, 29 July 2007) 8.

33. R Seer, ‘Tax Shelter Disclosure and Civil Penalty Rules—Comment on the Paper by Daniel Shaviro’ in W Schön (ed), *Tax and Corporate Governance* (Springer-Verlag Berlin and Heidelberg GmbH & Co KG 2008) 261 et seq.

7 Comments on Recent Developments on Tax Shelters in the US

David Weisbach

Introduction

In the last decade, the US government has made a number of changes to the tax law to combat tax shelters. This chapter summarizes the most significant changes and gives a brief evaluation of their overall impact.

We can divide the changes into four basic categories:

- merits-based challenges to tax shelters, primarily through litigation;
- disclosure rules;
- penalties; and
- regulation of tax advisers.

Merits-based Challenges: Litigation on Existing Shelters

The direct and most obvious way to attack tax shelters is to structure the substantive law to minimize shelters. To the extent the substantive law has been changed in the US, it has primarily been through piecemeal changes that address particular transactions. Some of these changes are long overdue improvements to the law, but most are complicated patches aimed at particular deals. There has been little movement toward overall reform (and tax shelters would likely play a small role in overall reform in any event). More important, there has been only limited movement toward strengthening anti-abuse rules. The government's primary approach has been to assert the economic substance of sham doctrine in litigation. In the last several years, it has had a remarkable string of successes. The government takes this string of successes as evidence that its strategy is working and that legislative changes to the economic substance doctrine are not needed.

It is hard to know how to evaluate the string of successes, however. The problem is that there is an endogeneity problem with the selection of cases for trial. Studying this problem is complicated because the Internal Revenue Service (IRS) is a repeat player and each draw from a court is not independent of prior draws. As far as is known, we do not know the

optimal equilibrium strategies for the IRS and taxpayers and how this is likely to affect the selection of cases for trial. Without this information, we cannot know what to make of a series of government wins. For example, the likelihood of the government winning a case may be 50 per cent and the string of wins nothing more than chance.

Congress seems likely to codify the economic substance doctrine later this year, if only because of the large revenue estimate associated with codification. The revenue estimate, however, appears to come almost entirely from the associated penalty provisions rather than a change in the law—the codification at best makes only marginal changes and, in many jurisdictions, will have no effect whatsoever. The Bush Treasury and the tax bar oppose codification, for reasons that are difficult to make sense of. (The Clinton Treasury supported codification.)

Disclosure

In contrast to the reluctance to change the substantive law, there have been a large number of changes to the disclosure rules. These changes are premised on the idea that the audit lottery played a significant role in the decision to engage in a shelter. The expectation of a good outcome for the taxpayer is simply the (one minus) probability of the shelter being found in an audit multiplied by the chance if it being disallowed. Changing either variable, the chance of being found and the chance of disallowance, will have similar effects. It is not obvious that changing audit probabilities alone is the desired response. The preference for changing audit probabilities seems to come from a concern for so-called 'legitimate' tax planning: disclosure rules are thought to impose less of a burden on legitimate tax planning than is the greater uncertainty about success in court. There have been a large number of changes to the disclosure rules. The following lists some of the major changes:

- Reportable transaction disclosure:
 - There are a number of reportable transactions that have to be separately disclosed to the IRS. The most important of these are the listed transactions, which are basically any transactions described in a notice issued by the government. In addition, a new category, 'transactions of interest' seems likely to become important in the future.
 - There are new penalties for failure to report (direct penalties for noncompliance regardless of the merits of the transaction—there are additional penalties if you lose a case regarding a reportable transaction and neglected to comply with the reporting requirements).
 - Material advisers to a reportable transaction must disclose this to the IRS.
 - Tax shelter promoters must keep lists of clients and give those lists to the IRS. This includes names of clients when those names would be traditionally protected by the attorney client privilege.

- Work papers:
 - Work papers used to analyse a transaction may now have to be turned over to the IRS, which makes the costs of an IRS challenge to a transaction much lower. One of the reasons for having to turn over work papers is that accountants regularly require tax opinions or memos that justify a tax result before they are willing to give accounting credit. Once these are turned over to the accountant, there is no longer attorney-client privilege and the IRS can demand them during an audit. The IRS does not regularly exercise this right, but the possibility that it might hinders communications and makes it more difficult to get accounting credit.

Increase in Penalties

There have been a number of changes to the penalty provisions as well as an increase in the likelihood that the IRS will assert penalties. These include a special 20 per cent penalty for reportable transactions (30 per cent if there was inadequate disclosure), and rules that make it more difficult to get out of significant understatement penalties because of reliance on tax advice.

Regulation of Tax Advice

Tax advisers are not part of standard economic models of tax avoidance, but they play an important role (as does the entire institutional structure of the market, which is often ignored in simple models). Tax advisers are often given a formal role in the legal structure in the sense that tax advice can provide a basis for good faith behaviour to avoid penalties. In addition, tax advisers have specialized knowledge of the law which can be used to find and market shelters. The regulation of tax advisers, therefore, is likely to play a significant part of any systematic attack on shelters. The changes in the US rules for tax advisers include the following:

- Insurance opinions
 - Changes to the penalty rules make it more difficult to rely on opinions to avoid penalties. In particular, taxpayers cannot rely on opinions from material advisers, which means that opinions must come from advisers who did not play a role in structuring the transaction. This raises the cost (and may reduce the quality) of opinions. In addition, there are stricter standards for opinions.
- Circular 230 tax shelter opinions
 - The Treasury Department has the ability to regulate tax advisers directly, with sanctions such as disbarment or fines. The section of these regulations on tax shelter opinions, Circular 230 section 10.35, was significantly revised. The opinions are now much more difficult to give and therefore, are more expensive.

- Criminal indictments
 - There have been a number of indictments of tax professionals. While none of the cases have yet been tried, there have been at least two guilty pleas, and an indictment alone is sufficient to ruin a career. The indictments go largely to the willingness of the tax advisers to accept representations regarding facts that they knew were false.
 - Therefore, they do not go directly toward the merits of the opinions or deals created by these advisers. At least one law firm was shut down because of shelters that it marketed, while KPMG and Ernst & Young have both paid significant fines.
- Regulation of accountants in giving credit for shelters: FIN 48
 - The role of accountants in corporate governance has increased dramatically in recent years following the Enron scandals and the passage of the Sarbanes-Oxley reforms. This trend has moved into the tax law, most forcefully with FIN 48. Because of their fear of liability (or perhaps just because they can), accountants are now much more reluctant to give credit for a tax transaction. Moreover, they often demand to see the tax opinion, which destroys attorney-client privilege. FIN 48 requires a more-likely-than-not conclusion to get any credit. Accountants have required extensive documentation to satisfy FIN 48.
- Preparer penalty
 - Congress has recently strengthened the penalty on tax return preparers.

Overall effects

It is very difficult to evaluate the overall effects of these changes. There is no question that they have increased the cost of sheltering, so we should expect some decline. We were never able to measure the size of the tax shelter market previously and still cannot, making any reasonable estimate of the effects, or even a wild and crazy guess, impossible. There seems to be a consensus that the large-scale retail marketing of tax shelters has slowed significantly. The major accounting firms, for example, no longer appear to be in the business to any great extent. Corporate shelters are more expensive due to all of the regulations, but there is no reason to believe that aggressive tax advice of the sort offered previously is not available to those who seek it. We do not, however, understand the dynamics of the tax shelter market, so it is hard to determine which, if any, of the changes to the laws, have had the largest effects.

Evaluation

The interesting question about the US reforms is the strong preference for procedural changes instead of changes to the economic substance/anti-abuse rules. Even the proposed codification of the economic substance doctrine purports not to change current

law, or at least not by much. Instead, the revenue estimated to be raised by the codification comes from the enhanced penalties.

We do not have a clear understanding of this preference. One explanation is that changes to procedures will not make anything illegal that currently works and also that there are vested interests in protecting transactions that currently work. Additional procedures, however, impose burdens on these transactions, so the distinction is not entirely clear. That is, if, for some reason, we are trying to protect some category of existing deals, changing procedures and changing substantive law both burden existing deals, although perhaps procedural changes burden them less.

Changing procedures is also easier to model from an economic perspective. We can simply change the payoffs used when taking expectations. Changing substantive law is difficult to model. By making sheltering more expensive through economic substance requirements, we reduce sheltering to some extent but also make the shelters that remain worse—taxpayers will needlessly take risks or change their economic positions to get tax benefits. Understanding this trade-off is considerably more difficult.

Finally, the Pickup¹ summary of anti-avoidance provisions around the globe is one of remarkable similarity. Although the details vary across countries, it seems clear that no country is able to live with a purely rules-based, literal interpretation regime. In the author's view, as argued elsewhere, this is so because an overlay of anti-avoidance provisions allows the rules to be overall simpler, notwithstanding the complexity and uncertainty that anti-avoidance rules impose on the system.²

1. See Ch 2, this volume.

2. See D Weisbach, 'Formalism in the Tax Law' (1999) 66 Chicago L Rev 860. The Pickup summary (n 1) reinforces this view.

8 Tackling Tax Avoidance in the UK

Tracey Bowler

The Tax Law Review Committee (TLRC) of the Institute for Fiscal Studies is currently considering potential approaches to countering tax avoidance in the UK. This chapter summarizes the work the author has undertaken for that project and indicates some of the conclusions reached so far. **This note has not been approved by the TLRC and does not reflect the views of the TLRC.**

Background

In 1998, the Government published a consultation document on the introduction of a General Anti-Avoidance Rule (GAAR).¹ This followed a TLRC paper which considered the possible drafting of such a provision and resulted in a further paper from the TLRC in response to the Government's proposals.² However, no further steps have been taken by the Government down this route.

Over the past ten years, the Government has used various methods to counter tax avoidance with varying degrees of success, but the Government has recognized that the complexity of the law has increased to the point where the burden for customers in complying with the law has become a real issue. The anti-avoidance legislation plays a large part in contributing to this complexity. In addition, it has been clear that highly complex legislation does not achieve the purpose of stopping avoidance: the more detailed the rules, the more likely it is that loopholes will be found by those wishing to do. In response, more complexity is added and so the process continues. This has resulted in a tax system which many would say is so complex and unstable that it is impacting on the competitiveness of the UK as a location for business. As a result, the Chancellor of the Exchequer announced in the November 2007 Pre-Budget Report that there would be a review designed to find out how anti-avoidance legislation can best meet the aims of simplicity and revenue protection.

1. Inland Revenue, *A General Anti-Avoidance Rule for Direct Taxes: Consultative Document* (Inland Revenue, London 1998) <http://www.hmrc.gov.uk/consult/consult_1.htm>.
2. TLRC Institute for Fiscal Studies, *Tax Avoidance* (Tax Law Review Committee, London 1997) <http://www.ifs.org.uk/tlrc/publications.php?publication_id=1908>; TLRC *A General Anti-Avoidance Rule for Direct Taxes: A Response to the Inland Revenue's Consultative Document* (Institute for Fiscal Studies, London 1999) <<http://www.ifs.org.uk/comms/comm77.pdf>>.

Current TLRC Work

Current work has focused on various issues with regard to tackling tax avoidance in the UK. One such issue has been to consider whether introducing a GAAR in the form suggested by the TLRC in 1998 would have prevented much of the complexity which has since been introduced in Finance Bills. The anti-avoidance measures introduced in Finance Bills over the past ten years have been reviewed, with a view to establishing whether they would have been necessary if a GAAR was in place. While the Targeted Anti-Avoidance Rules (TAARs) (of which there are more than 40) may have been unnecessary if a GAAR was in place, much of the anti-avoidance legislation does not take this form, and it would seem that much of that legislation would still have been introduced even if a GAAR had been in place. The forms of TAAR used in the legislation have also been reviewed, and a most surprising finding is the number of different forms they take—no doubt providing fertile ground for litigators to argue the significance of the inclusion or exclusion of particular words or phrases.

An alternative approach may be to consider the use of GAAR alongside tackling areas in tax law which are currently structured in such a way as to give rise to, rather than minimize, opportunities for tax avoidance. One way of doing this is to consider whether provisions are driven by an underlying structural feature of the tax system. In this chapter, these features are referred to as the ‘source’ of the tax provision. For example, the source of a piece of legislation may be the capital/income distinction, or the source may be the way in which that area of tax law has been approached in drafting terms, such as the list type approach of the Pay As You Earn (PAYE) regulations. In this way it may be clearer as to what combination of changes could be the most effective. In some cases, the source of the avoidance may be something which Government is not prepared to alter, but the analysis may help to draw out where the tensions that give rise to avoidance lie. For example, if a tax is imposed with different rates for different types of transactions, as is the case with stamp duty, it must be expected that taxpayers will seek to structure their transactions to fall into a lower rate category. This is a cost of having these boundaries, and to the extent boundaries are maintained or increased in the tax system, that cost needs to be recognized.

Assuming that the boundaries remain, which to some extent they always will, the work then considers how the boundaries can most clearly be identified for the taxpayer, HMRC, and the courts in order to enable the tax system to be operated on a clear and efficient basis, and at the same time, minimize tax avoidance. With this aim, we have, to date, reviewed changes to the employee shares legislation over the past ten years to consider where the legislation has worked and where it has not. The main problem evident in this area of tax legislation is that legislation has been reactive and not proactive: change after change was introduced in an attempt to counter avoidance in this area, and culminated in an announcement by the Paymaster General in December 2004 that

any future schemes would be dealt with by retrospective legislation. This type of reactive approach only adds to the complexity of anti-avoidance legislation and often limits its effectiveness.

Work is now being carried out to consider what other ways of tackling avoidance may be used in the UK, including addressing the Governments' proposals for tax simplification.

9 The Avoidance Problem: Some UK Reflections

John Tiley

Introduction

This chapter will say a few provocative general things about a general anti-avoidance rule (GAAR) from a UK perspective and, in a related way, talk about the UK notification rules introduced in 2004 and widened in 2006.¹ The author is indebted to Tracey Bowler of the Institute for Fiscal Studies' Tax Law Review Committee for some fact-based research (a preliminary note of which appears in this volume). It is still a work in progress but it supports one of the more interesting points made here.

There are links between the GAAR issue and the notification powers:

- a. One effect of the notifications has been to increase the number of detailed rules—following the terminology of the Canadian Royal Commission of 1966, some 'sniper', some 'shotgun'—introduced to counter avoidance.² This impact on the statute book may be unfortunate, but it cannot be ignored.
 - b. It has been interesting to see that as the enthusiasm for the GAAR has begun to wane—as people see it may not be quite the cure-all some hoped it would be, exterminating all avoidance schemes (and only avoidance schemes) with Dalek-like precision—so interest in the notification rules has waxed. More simply, it may be that notification rules are the 'new kids on the block' and everyone wants to decide whether they want to befriend them. Notification rules are not a complete solution for our problem, but they are an entirely legitimate part of HM Revenue & Customs' (HMRC's) armoury.
1. Some of this material was first used in the Melbourne University Annual Tax Lecture for 2007, April 2007. The author is grateful to that university for the invitation and the opportunity to spend time there. As in that lecture, the author is indebted for thoughts on the information powers to Keith Gordon for a talk given to the IFA last autumn, to Lakshmi Narain for an article in *Tax Adviser* (September 2006) 4, and to Rachel Tooma for an article in *Journal of Australasian Tax Teachers Association* 2 (2006) 158–177. The author would also like to mention the invaluable notes by Ross Fraser in (2004) *BTR* 282–96 and 451–59.
 2. Canadian Royal Commission of 1966, Vol 3 pp 552 et seq.

Ways of Dealing with Avoidance

Other legitimate parts of the HMRC armoury include vigorous administration, a refusal to compromise litigation on terms advantageous to the taxpayer just because litigation has dragged on a long time, and a willingness to litigate where tax is due. The list also includes a willingness to accept settlement on a basis which includes full-tax interest and either no penalty or nominal penalties, on the promise that after a certain date, the offer is withdrawn and full penalties are sought. There is also the idea of retroactive/retrospective legislation which was passed and threatened in 2004.³ At least at this micro level, the more thoroughly retrospective legislation on commodity straddles from 1978 which applied to transactions since March 1976, has ‘at a stroke’ as we used to say, stopped many others. We may be clear that the 2004 model meets the Human Rights Act requirements, but we have to acknowledge that the 1978 change does not.⁴

We can be less happy about the treatment of people like Mr and Mrs Jones of *Jones v Garnett*—we either need to introduce the individual equivalent of a group litigation order, or follow the precedent of *Smith v Schofield*⁵ where the profession subsidized the litigation. It is also inconsistent of the government to say it encourages people to run their business through a company, only to ‘zap’ them with a claim for back tax. In *Jones v Garnett*, the Revenue issued assessment in 2000 dating back to 1996–97. When the case finally came before the Commissioners in June 2004, the Revenue cancelled the assessments for 1996–97, 97–8, and 98–99 and so did not proceed with the first three years that were originally assessed (whereupon the taxpayer sought costs on the basis that HMRC had behaved ‘wholly unreasonably’). Sadly, the cancellation was not because of an onset of reason on the part of the Revenue, but because the assessing officer came to learn that the taxpayers had actually made a full and complete disclosure of all the facts and so he could no longer claim to have made the ‘discovery’ which would have opened the earlier years (Case Stated 150 and 151); costs were duly awarded.⁶

3. See (n 4).

4. The 1978 change alters the tax effect of transactions entered into after March 1978 and before March 1978 and imposes charge where there was none before. The 2004 changes are more subtle. The first change, the introduction of the pre-owned asset rules, changes the tax effects of a transaction entered into before March by imposing an income tax charge but only with effect from 6th April 2005. The second change was the threat made in December 2004 by the Financial Secretary to the Treasury to legislate retrospectively if people tried to create yet further schemes to get around the new rules for employment securities, which seems to come within the margin of appreciation allowed by the ECHR in the *Woolwich* case (and assumes that the UK courts would draw that margin in the same place). The area of law was narrowly defined; the schemes involved abuse of law, and the intentions of Parliament which had tried introduced further rules in 2003 were crystal clear.

5. [1993] STC 268.

6. On the House of Lords decision see [2007] UKHL 2007 35, [2007] STC 1536. For the Special Commissioner’s decision see [2004] STC (SCD) 9.

The GAAR as a Particular Way of Dealing with Avoidance

The Change over Time

How does the GAAR rate as a way of dealing with avoidance? Many have long regarded it as a measure of last resort, a confession of failure—this does not mean that it is the wrong thing to do—failure must sometimes be owned up to (especially if we can say it is the failure of others—viz, usually the judges). However, this simply may not be the time to adopt a GAAR. One does not have to be a friend of avoidance to hold such a view—there was a debate at the Tax Faculty at Cambridge some ten years ago when two very senior Revenue people found themselves on opposite sides. If there were an obvious answer, we would not still be discussing the problem. There are prices to be paid whichever solution we adopt, and we can always find a reason for preferring one change over another.

Looking back over 40 years of looking at these issues, our views on the subject have ‘developed’ or, at least, it has been necessary to place a possible GAAR against the background of a tax system which has also ‘developed’. The answer to the question ‘what do we gain by having a GAAR?’ has also changed.

Gains from a GAAR

We can consider the question of gain on two levels. The first is the micro level where we don our hats as tax specialists. Assuming that we can agree on what we mean by avoidance, we gain a rule which helps us stop avoidance schemes.

Cases Decided Differently?

We might test this by asking which of our Revenue defeats before the House of Lords would be decided differently. The list for consideration includes *Craven v White* (1988),⁷ *MacNiven v Westmoreland* (2001),⁸ *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* (2005)⁹ and *Jones v Garnett* (2007).¹⁰

Price

One price is a new layer of administration with bureaucratic uncertainty replacing legal uncertainty.

Clearance

Those proposing a GAAR usually propose a clearance mechanism, but it is not clear that this would be included. An interesting comment on this came from HMRC’s Dave Hartnett before the House of Lords Select Committee:

7. [1988] STC 476.

8. [2001] STC 237.

9. [2005] STC 1.

10. See (n 6).

I think there is a very significant issue that arises there: how sensible would it be to offer pre-transaction clearances for what were very clearly tax avoidance arrangements? Again, how sensible is it to offer arrangements like that which then enable planners to refine their product again and again and again, as we have seen with some of our existing clearance measures, until they have got something that they think works.¹¹

This is a fair point—it raises new issues, but in a way, it is the same point as can be made about the statute book—the endless changes seem to make the statute book a guide for tax planners.

Effect on the Statute Book—General

Another issue or price is the problem of the interaction of the GAAR with the existing statute law. Some will remember the fuss over the Finance Act 1960 section 28, later section 460 (1970), later section 603 (1988), and now re-enacted—for income tax and not (yet) for corporation tax—as ITA 2007 Part 13 Chapter 1 (sections 682 et seq). That fuss meant that a GAAR would not have got through in 1960, but it might have formed part of the 1964 changes, and it would have been very convenient to have had it in the 1970s when the tax avoidance industry got going. But whether the judges of the time would have gone down the route taken by the current Canadian Supreme Court or by the current Australian High Court is open to question. However, we can suspect that the Canadian example would have provided the model, because purposive construction was not the norm.¹²

Since then, we have had countless provisions introduced to protect the tax base without a GAAR. Introducing a GAAR at this point is not so much closing the stable door after the horse has bolted, as much as putting an extra door on while the horse is—or at least a reasonable number of the horses are—still inside.

Effect on the Statute Book—Particular: The IFS Work in Progress

It would be very helpful if someone could do a systematic survey of the 200 or so changes made since 1998 which purport to be dealing with avoidance in order to ask whether the changes required could have been dealt with by a GAAR. Fortunately, someone has been doing just that. Tracey Bowler has written a draft paper for the Tax Law Review Committee (TLRC) of the Institute for Fiscal Studies (IFS) and what follows here, with her and their permission to make—and hopefully not misrepresent what is a highly sophisticated analysis—are a few of the points from that survey.¹³

11. Mr Hartnett (Q 283) quoted in Report on Finance Bill 2006 para 62.

12. See further [2004] BTR 304 and [2005] STC 273.

13. See Ch 8, this volume.

Bowler notes that while a GAAR may assist with countering some transactions it will not always provide the answer for all transactions. A more effective approach may be to consider the use of GAAR alongside tackling areas in tax law which are structured in such a way as to maximize rather than minimize opportunities for tax avoidance. One way of doing this is to consider whether provisions are driven by an underlying structural feature of the tax system. An example might be capital/income distinction. In this way it may be clearer as to what combination of changes could be the most effective. In some cases the source of the avoidance may be something which politicians would not like to alter, but the analysis may help to draw out where the tensions that give rise to avoidance lie.

She concludes that a GAAR could replace the targeted or mini anti-avoidance rules (though she notes that some, eg what was FA 2007 clause 70, are actually wider than a GAAR).

Of 195 or so provisions or groups of provisions, she notes 35 targeted anti-avoidance rules (TAARs). Replacing these specific anti-avoidance rules would not necessarily help—some are carefully drafted. She then identifies a further 30 or so provisions which could have been dealt with by a GAAR (and a further 13 GAARs with question marks). However this still leaves 120 or so provisions or sets of provisions where a GAAR would not achieve what the provision achieves: the legislation is usually highly technical and has no purpose provision. It is difficult to see how a GAAR could deal with avoidance structured around these specific rules and definitions.

To quote her final paragraph:

Whenever economically the same result can be achieved but it can be structured in different ways with differing tax consequences, then taxpayers can be expected to structure their transactions to incur less cost, taking into account tax and non-tax costs. If that activity is considered ‘avoidance’ then a GAAR will always be limited in how it deals with such a situation. To the extent it is possible to do so, a cleaner way of tackling the issue is to ensure that transactions with the same economic effect incur the same tax costs. A GAAR will not enable HMRC to maximize the tax payable by taxpayers.

Note ‘to the extent that it is possible’! If we abolished trusts and companies, perhaps we might achieve it.

The Doctrine of Unripe Time

With all the activity, legislative and administrative, and with an objective of what HMRC would see as raising the level of taxpayer behaviour by informal means, it may not be the right time to make the dramatic and politically demanding switch to a GAAR. It must be acknowledged that, insofar as this activity is legislative, the effects on the length of our statute book have been dire. The question is not whether that is a bad thing but whether it is better than any relevant alternative. This clearly is a point at which our debate can take off.

The author's present view, reinforced by Tracey Bowler's masterful survey work, is that the GAAR cannot be seen as a way of shortening the statute book to the extent that we would wish. We can do at least as well—and probably better—with our existing approach, especially as it seems to mesh well with the schedular approach to the definition of income. We have neither a general definition of income, nor a general system of deductions, and we are systematically mean on loss reliefs across the schedules. The fact that the Capital Gains Tax (CGT) is not schedular may explain some of our problems.¹⁴

Yet we have to acknowledge that there comes a point at which the ever-lengthening statute book is too great a problem. In part this is a change of style. Can we make the book shorter without losing comprehensibility? The Tax Law Rewrite Committee seems to believe that the more words the better is a good policy.

The Judges

We are prepared to leave the judges to do their work—as long as they are given tasks they can do, which means legislation which they can construe and apply. The rules have to be workable or, if you prefer such words, 'justiciable'. If you give the judges too many words with either abstract or little content they may react as the judges have done in Canada and sit down and simply interpret the words.

The Revenue have had a quite a run of success in our senior tribunal. They may not have expected to win *Macdonald v Dextra Accessories* on deduction¹⁵ or the CGT case of *West v Trennery*.¹⁶ They may also have been surprised by their success in the *Scottish Provident* case.¹⁷ To agree with David Pickup, one can have hopes for the abuse doctrine stemming from *Halifax* and *Cadbury Schweppes*. However, the words as presently formulated seem to place the point at which the taxpayer escapes from the doctrine rather low. One response may be for us to try to understand better how these things will work in a civil law and multilingual context. The controlled foreign companies (CFC) group litigation cases could be expected to solve that issue.

A last word on the judges. What is going to happen will depend not just on the judges but on how HMRC choose to argue their cases. The composite transaction argument advanced in *Ramsay* in 1981 was a new departure for the Revenue, but it was advanced in the context of a particularly outrageous scheme.

Macro Level

And now, a brief word on the macro level. In the rush to get the most successful GAAR with all its bells and whistles we should not forget what we are about. The American writer

14. The author is indebted for this point to a conversation with a leading Australian practitioner.

15. [2005] STC 1111.

16. [2005] STC 214.

17. [2005] STC 15.

Groves once described tax as the most pervasive and privileged exercise of the police power of the state; it determined the directions in which people may become wealthy by determining the directions in which they may not. Leaving aside arguments from economic efficiency, the task of the tax system is to provide a balance between the state and the taxpayer and to ensure that the system is fair or, perhaps more realistically, minimally unfair. Allowing taxpayers who arranged their affairs as they did in *Ramsay* to succeed would have created gross unfairness between those who paid their advisers and those who paid the Revenue. On the other hand, some tax rules are still ‘arbitrary’ and ‘capricious’ to use Robert Venables’ phrase on the discretionary trusts regime extended in 2006.¹⁸ He suggests that the effect of the 2006 change is to make tax planning much easier for those who are well-advised. It will be left to others to wonder whether they think the tax system is sufficiently fair in other aspects. Will a move to an exemption system for foreign income and gains make it more arbitrary?

Notification

The Regimes

We now have four separate regimes and so four separate bits of legislation, one each for the direct taxes, stamp duties, value added tax (VAT), and having just come into force on May 2007, National Insurance Contributions.¹⁹ The stamp duty rules apply if the property is not wholly residential and the applicable value is at least £5 million.²⁰

Direct Taxes—Elements

We will concentrate here on the direct taxes. The rules require a promoter (P)²¹ and sometimes the taxpayer (or client) to provide the Revenue with information about: (a) notifiable arrangements, and (b) proposals for notifiable arrangements.²² For a scheme to be notifiable it must enable, or might be expected to enable, any person to obtain a tax advantage in relation to any tax so prescribed in relation to the arrangements. It is also necessary that the main benefit, or one of the main benefits that might be expected to arise from the arrangements, is the obtaining of that advantage.

Is the tax advantage a ‘main benefit’? HMRC Guidance says (and note para 5.2 makes the following general points):

In our experience those who plan tax arrangements fully understand the tax advantage such schemes are intended to achieve. Therefore we expect it

18. R Venables, *The Taxation of Trusts Post Finance Act 2006*, (Key Havens Publications Plc, Oxford 2006) para 2.3.3.

19. On the scope of HMRC powers re direct taxes see s 318(1) ‘tax’.

20. Stamp Duty Land Tax (Prescribed Description of Arrangements) Regulations 2005 SI 2005/1868.

21. Defined s 307.

22. Defined s 306.

will be obvious (with or without detailed explanation) to any potential client what they are buying and the relationship between the tax advantage and any other financial benefits. The test is objective and considers the value of the expected tax advantage compared to the value of any other benefits likely to be enjoyed.

The fact that the people planning these schemes ‘fully understand’ the tax advantages has not stopped some people from alleging innocence—as we shall see below.

Who Notifies—and When?

In the direct tax area, the obligation to notify generally falls upon the promoter of the scheme. It falls on the user of the scheme if the promoter is resident outside the UK and no promoter is resident within the UK.²³ If there is no promoter (ie the scheme is designed ‘in-house’), the duty to notify falls on those entering into any transaction which is part of the notifiable arrangements.²⁴ The same applies where the promoter is prevented by legal professional privilege (LPP) from making a full disclosure.²⁵

Legal Professional Privilege

The privilege question is an important one. In Australia, the notification rules are aimed at those who market the schemes, rather than at those who devise them, and the reason for this was over concern for legal professional privilege (LPP). In the UK, we have gone wider but have provided protection for LPP. It would be interesting to know whether the UK LPP rules work in the way hoped for—are they wide enough in terms of people covered and are they wide enough in terms of transactions? The legislation containing these provisions can be extremely hard to make sense of, in that the actual words are hard to understand, and if the words mean what we think they mean, they must be in breach of the human rights legislation.

Here P must inform the Revenue when the notifiable proposal is made available for implementation or, if earlier, when P becomes aware of any transaction forming part of the proposed arrangements.²⁶ P does not have to notify the Revenue if someone else has already done so.²⁷ Once the Board has been informed, they may give the arrangements a reference number while further provisions deal with the obligations of promoters and parties to pass the number around.²⁸ The normal time limits by which a promoter must

23. S 309.

24. S 310.

25. SI 2004/1864 reg 4 (5A)

26. On multiple promoters and multiple proposals see 308(4) and (5).

27. S 308(3).

28. Ss 311–13.

disclose a scheme are within five days of first making the scheme available for implementation, or within five days of first becoming aware of a transaction implementing the scheme, whichever is the earlier.

Penalties

Those who fail to comply with a statutory obligation to disclose a scheme—or to advise a client of a scheme reference number issued by HMRC—are liable to penalties. Our approach is different from that in Australia—we want compliance. There is an initial fine (£5,000) and then a daily fine (£600) until the failure is remedied.

House of Lords Committees' Favourable Assessment

How well are they working? In 2006, the House of Lords Select Committee were pleased to note a broad consensus among witnesses from the private sector that the rules were working well, in particular by excluding unnecessary disclosures. 'Setting up the necessary reviewing machinery has created more work for tax professionals and the burden is ultimately passed on to their clients in costs. *However, judged by the results described to us by HMT and HMRC, we concluded that this compliance burden was proportionate and justified by the outcome in terms of reducing the tax gap.*'²⁹

At the risk of appearing a touch cynical, what this shows is that the sort of people who provide evidence to House of Lords Committees are generally content. We should note that the Committee were then considering only the scheme as enacted in 2004. In that first flush they were aimed only at certain types of arrangements connected with employment (especially employment-related securities) and with financial products. There were also conditions or hallmarks with regard to premium fees and confidentiality.³⁰

Purpose

What were the 2004 rules trying to do? They were designed to improve transparency in the system and to enable the Revenue Departments to counter 'sophisticated and aggressive avoidance schemes [that] thrive on concealment and secrecy'. They were 'aimed at those marketing and using certain tax avoidance schemes and arrangements [and] will allow early detection of such schemes and enable more effective targeting of avoiders'. Our rules are not aimed at mass-marketed schemes—they are wider than that. What the rules were after was not direct blocking, though that might follow, but speed of response. (During the 1970s, in the Ramsay era, it was often a condition of buying a scheme that claims for the relevant relief should be delayed until the last possible moment.) By 2004, it was apparent

29. Author's emphasis. See *Select Committee on Economic Affairs Sixth Report*, para 24. Available at <<http://www.publications.parliament.uk/pa/ld200506/ldselect/ldeconaf/204/20405.htm>>.

30. SI 2004/1863 Regs 5A and 8 (now repealed).

that the Revenue needed to know about schemes earlier.³¹ In relation to employment-related securities, the evidence is that this has been achieved.

2006 Widening

The 2006 scheme widens the net for direct taxes.³² The obligation to notify now arises not where there are those two types of arrangements, but with any arrangements when there are ‘hallmarks’. The HMRC Guidance includes a useful flowchart.³³ In theory, a person can implement a scheme within the time frame but there is no evidence that HMRC is concerned about this—at present. The hallmarks include tests such as confidentiality, a premium fee, the presence of off-market terms, and being a standardized tax product. There are also distinct hallmarks for schemes involving losses and, separately, leases. Most apply for income tax, capital gains tax, corporation tax, and National Insurance contributions (NICs). Unfortunately one has to dig through each rule to find that in most cases, they do not apply to small and medium size enterprises defined in EC law terms, as in the Commission Recommendation of 6 May 2003, and that only rarely do they apply to individuals.

Returns: Numbers

One fear was that there would be too many returns; another that there would be too few. So how many have there been? The statistics are released every six months for the periods ending 30 September and 31 March. The figures to 31 March 2007 showed that in the eight months of the new hallmark regime, 125 schemes were notified. The very provisional total reported since 1 August 2004 came to 1,456 of which: financial provided 463, employment 198, and Stamp Duty Land Tax (SDLT) 670; the advent of the total of hallmarks has meant that only 12 have been reported under financial, and none under employment, since 1 August 2006.

Who provided those returns? A survey last year, thus relating to fewer notifications but which illustrates the balance quite nicely, showed: Big Four 353, other accounting 194, legal 434, financial institutions and others 166. Most (399/434) of the disclosures by legal practices related to Stamp Duty Land Tax.³⁴

Original System Found to Be ‘Self Regulatory’: 2007 Changes Give HMRC Wider Powers

The Finance Act 2007 contains clauses improving the scheme. Until now the Revenue have been limited in what they can do to investigate non-compliance. There are rumoured to be two penalty cases pending, but what the department ideally wants is earlier

31. For comment, see R Fraser [2004] BTR 282–96 and 451–59.

32. 2006/1543 Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006.

33. *Guidance on Disclosure of Tax Avoidance Schemes* (HMRC June 2006) 18. Available at <<http://www.hmcr.eu/ria/disclosure-guidance.pdf>>.

34. L Narain, ‘Tax Avoidance Disclosure: An Update’ (September 2006) Tax Adviser 4.

information. As the department admitted in their note in the 2006 consultation document, disclosure is, for the moment, effectively a self-regulatory regime.³⁵ Non-compliance not only undermines the purpose of the disclosure regime (to provide early information about avoidance schemes); it also creates distortions and puts those promoters who comply at a competitive disadvantage.

How do HMRC find out about non-compliance? They monitor disclosures received and developments in the marketplace for tax schemes through published material, intelligence received, and feedback from promoters. Increasingly, they also obtain evidence from enquiries into the tax returns of companies and individuals who have used schemes.³⁶

Some defaulters tell HMRC nothing more than that they have systems in place to identify whether or not their products are notifiable and that they are satisfied that the particular scheme is not. Such promoters will generally refer to Counsel's opinion—they hold that the scheme is not notifiable, but do not explain why the scheme is not notifiable. The proposed new rules are designed to resolve disputes about what is notifiable. They may well include a power to get more information and a pre-disclosure enquiry to help HMRC get clearer reasons why P thinks the scheme is not notifiable. Where there is a doubt about notifiability, there may be a procedure by which HMRC can ask the Tribunal to order that the scheme be treated as if it were notifiable—you can imagine the problems of the burden of proof here. Even more dramatically, where there is such a doubt, there may be a procedure by which HMRC can ask the Tribunal to determine that the scheme is notifiable.³⁷

Conclusion

So there we are. This author has not counted the number of rule changes made in Finance Acts 2005, 2006, and 2007 which can be traced to the new powers, but there are probably more than 20 each year. The impression is that the system is working and working well, but it will be interesting to learn if that view is not shared.

35. See (n 20).

36. Notes to Draft Clauses Pre Budget Report (HMRC December 2006) 6. Available at <<http://www.hmrc.gov.uk/pbr2006/pbrn-all.pdf>>.

37. The enacted sections: 308A, 313A, 306A, and 314A.

III

Tax Risk and Relationships between Taxpayers, Revenue Authorities, and Other Stakeholders

10 Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC

Judith Freedman, Geoffrey Loomer, John Vella

Introduction

The problem of drawing a boundary between tax planning and tax avoidance, or ‘unacceptable’ and ‘acceptable’ taxpayer behaviour, is one that besets all tax jurisdictions. It raises fundamental questions about the nature of tax legislation, the role of the tax system, and the relationship between taxpayers, intermediaries, the administration, and government.

In the UK there has been an intense focus recently on the last of these questions, specifically the relationship between large businesses and HM Revenue & Customs (HMRC). Concerns about this relationship have led to surveys, reports, and proposals from various sources.¹ The Government response is encapsulated in the *2006 Review of Links with Large Business (Varney Report)*² and the papers that followed it in March 2007, *Making a Difference: Delivering the Review of Links with Large Business (Delivery Plan)* and *HMRC Approach to Compliance Risk Management for Large Business (Risk Management Report)*, which are called here collectively the *Varney Delivery Plan*.³ These documents endorse a new approach to tax risk management and tax compliance by large businesses.

This article is a summary of a report (Full Report)⁴ on the findings of a small scale pilot survey undertaken by the Oxford University Centre for Business Taxation (OUCBT) in early 2007, which investigated attitudes and opinions of some large businesses and HMRC respondents, regarding issues arising from the *Varney Report* and *Varney Delivery Plan*. Where relevant, the conclusions contained in this article also draw comparisons with the

1. For a selection of the literature see p 5 of the Full Report (n 4).
2. HMRC (November 2006).
3. HMRC (March 2007).
4. J Freedman, G Loomer, and J Vella, *Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC* (Report of the Oxford University Centre for Business Taxation, Oxford June 2007), available at <<http://www.sbs.ox.ac.uk/Tax/publications/reports/Reports.htm>>.

more recent HMRC publication on implementation of the *Varney Delivery Plan*, entitled *Making a Difference: Clarity and Certainty (Clarity & Certainty Report)*.⁵

Central to the *Varney Delivery Plan* is the desire from both sides for a relationship based on mutual trust. Evidently this agenda deals with issues much wider than the nature of tax avoidance. It focuses on certainty, an efficient risk-based approach to resource allocation, speedy resolution of issues, clarity through consultation, and clear accountability for delivery. Nevertheless, the *Varney Report* emphasizes ‘the need to establish more common ground in what constitutes unacceptable tax planning and behaviours’.

It might be thought that the agenda has moved beyond the well-known problems of distinguishing acceptable tax avoidance (sometimes known as tax ‘planning’ or tax ‘mitigation’) from unacceptable tax avoidance—a debate which is muddled by inconsistent terminology.⁶ Arguably, the extension of the disclosure regime in 2006 has made the issues about the boundary between acceptable and unacceptable avoidance less relevant. The UK Courts have rejected a formulaic judicial anti-avoidance doctrine, apparently in favour of a form of purposive construction of statutory provisions.⁷ If we have moved on from a debate about where to draw the line, to a more rewarding way forward based on trust, risk assessment, transparency, and certainty, is there still a need to establish more common ground on what is ‘unacceptable’?

The results of the pilot survey suggest that, despite attempts to shift the debate, the problem of agreeing which side of the boundary behaviour falls is still central. The survey investigated how far a common understanding has been reached and what might assist in this process. It also extended to a series of other topics that are broadly relevant to the *Varney Delivery Plan*.

Specifically, this article and the Full Report consider the responses of our interviewees regarding the following six topics: (1) the risk rating approach; (2) the continuing importance of the ‘boundary of the law’; (3) formal and informal disclosure; (4) clearances and rulings; (5) corporate governance and relationships with HMRC; and (6) corporate governance and relationships with other stakeholders.

5. HMRC (October 2007).

6. There is a large literature on the nature of acceptable and unacceptable tax avoidance and the various approaches to identifying and addressing unacceptable tax avoidance. In addition to the articles contained in the present volume, see for example: M Gammie, ‘The Implications of *Furniss v Dawson*’ (1985) *Fiscal Studies* 52; J Tiley, ‘Judicial Anti-avoidance Doctrines: The US Alternatives’ (Pts I and II) [1987] *BTR* 180 and 220; *Special Issue on Tax Avoidance* [1998] *BTR* No 2; the Rt Hon Lord Templeman, ‘Tax and the Taxpayer’ (2001) 117 *LQR* 575; the Rt Hon Lord Walker, ‘*Ramsay* 25 Years On: Some Reflections on Tax Avoidance’ (2004) 120 *LQR* 412; *Special Issue on Tax Avoidance* [2004] *BTR* No 4; the Rt Hon Lord Hoffmann, ‘Tax Avoidance’ [2005] *BTR* 197; J Freedman, ‘Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament’ (2007) 123 *LQR* 53.

7. *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51; [2005] 1 AC 684.

The survey was small in scale, engaging with the tax directors of nine very large businesses, all of whom volunteered to be interviewed following an initial approach by letter from OUCBT to all its corporate sponsors (members of the 100 Group of companies). The nine participating businesses were spread across sectors and revealed a spectrum of opinions, but given the limits in terms of numbers and scope and possible response bias it is not claimed that the views set out here are necessarily representative and the conclusions put forward are accordingly tentative. Further, the work was undertaken at a time when the *Varney Delivery Plan* was still bedding down. Further work building on this pilot survey is now under way with a wider range of participating companies selected using a random sampling methodology, although this subsequent survey is also qualitative rather than quantitative in nature.

The survey was designed with the assistance of two practitioners (a lawyer and an accountant) and two tax directors not included in the subsequent survey. The interviews were not highly structured, allowing tax directors to focus on matters of importance to their companies. All interviewees were guaranteed anonymity. The OUCBT survey was differentiated from other similar surveys by its in-depth nature, the fact that it was conducted by qualified tax experts, and by its use of detailed tax-planning scenarios.

In addition to the interviews with corporate taxpayers, information was obtained through interviews and written opinions from a small number of HMRC employees from the avoidance team and the Large Business Service. Due to time constraints we were unable to interview other stakeholders and analysts but note that further work on the views of these parties would be valuable.

OUCBT is very grateful for the time and cooperation of all the interviewees.

The Risk Rating Approach

One of the four desired outcomes of the *Varney Report* is ‘an efficient risk based approach to dealing with tax matters’.⁸ Under this approach, the volume of HMRC’s interventions in a company’s affairs and the nature of the working relationship between the two depend on a risk assessment given to the company by HMRC. Apart from producing a more efficient allocation of resources, however, HMRC also seem to view this approach as a means of enticing firms into altering their behaviour in terms of transparency, governance, and tax planning.

Whilst agreeing with the risk rating approach in principle, a majority of our interviewees raised serious questions about its details and practical operation. In particular, at the time of the survey there appeared to be uncertainty as to what criteria HMRC were employing in establishing a company’s risk assessment, their relative weight, and the benefits of being considered low risk.

8. *Varney Report*, para 1.7.

Risk Assessment Criteria

The *Risk Management Report* explains the criteria HMRC will employ in assessing tax risk, the process by which this will be done, and the meaning of the different risk ratings in practice. The risk dealt with here is ‘compliance risk’, which HMRC define as ‘the likelihood of failure to pay the right tax at the right time, or of not understanding what the right position might be’.⁹ HMRC observe that compliance risk can arise from structural factors (such as the complexity of international business) as well as behavioural factors (such as corporate tax strategies and the level of cooperation with tax authorities).

As a number of our interviewees pointed out, this approach is not entirely novel. The *Varney Report* in fact builds upon the report *Working with Large Business: Providing High Quality Service—Improving Tax Compliance*,¹⁰ which provided for a risk assessment process.

The following risk assessment criteria are set out in the *Risk Management Report*:

We will make an assessment of the level of tax risk each customer presents. Our evaluation will be based on the extent to which we can be assured there is:

- strong **corporate governance** including transparency in its relations with HMRC;
- effective **delivery** (eg, whether systems and internal processes are sufficient for the business to meet its obligations); and
- successful **management** of inherent risk, ie:

change (eg, mergers, acquisitions, strategic, financial and organizational restructuring),

complexity (eg, complex commercial, legal and financial structures, large numbers of group companies, employees, VAT groups or tax and duty regimes to which the business is subject), and

boundary issues (eg, extent of a business’ global exposure and level of cross-border and connected party transactions).

And we will want to see how each of these factors affects the tax contribution a customer makes and take a view of whether this meets what we might expect from the level of its economic activity.

The last item on the list appears relatively straightforward in stating that HMRC will consider the extent to which a company successfully manages risk arising from change,

9. *Risk Management Report*, para 3.2.

10. HMRC (April 2006).

complexity, and boundary issues. Accordingly, it is the management of these issues and not their existence per se which HMRC will consider. This appears to be different from the approach under the previous regime, where the mere existence of these issues was a factor contributing to a high risk rating. It was not entirely clear, however, whether the difference is one of approach or merely rhetorical. The majority of our interviewees assumed that the criteria are unchanged, which obviously coloured their views on the risk rating approach.

Weight of the Different Criteria

The criteria mentioned above can be divided into two general groups: structural (eg, extent of a business' global exposure) and behavioural (eg, transparency). Our interviews revealed that there is considerable uncertainty as to what weight will be given to the various criteria. In particular, most of our interviewees were sceptical as to whether a company that has a high score on structural criteria can reduce its overall rating by having a low score on behavioural criteria.

The majority of our interviewees assumed that it is the existence of the structural issues and not their management which is most relevant. We were told by these interviewees that their companies are large, run a complex business, pay substantial tax, and thus, 'with the best will in the world', could never become low risk on the basis of HMRC's criteria. The relevance of tax planning as a risk criterion was also highlighted.¹¹ The list of criteria quoted above does not include tax planning, yet other parts of the Varney literature indicate that a company's attitude to tax planning is one of the most important factors in assessing risk.

These concerns were broadly supported by our interviewees' actual experience. Only one of our interviewees said they were considered low to moderate risk. The remainder indicated they were considered high risk under either the current or previous regime, apart from one whose risk assessment had not yet been completed.

The conversations we had with two sources from HMRC did not dispel these uncertainties. It was said that HMRC will need a lot of convincing to believe that a large company running a complex business and having overseas interests is low risk, even if it is very open about its tax affairs. On the other hand, we were also told that 'there may be FTSE 100 companies that are low risk' and that if a company is very transparent it could be treated as low risk despite its size.

Subsequently we were informed that low risk companies do exist amongst FTSE 100 companies, so the fact that some large companies thought they could never obtain a low risk rating might have been a problem of perception rather than reality. This is a matter for further investigation as the *Varney Delivery Plan* develops.

As things stood at the time of the interviews, however, a majority of our interviewees expressed a lack of enthusiasm regarding the risk rating criteria. They thought that risk

11. As discussed in more detail below.

should be assessed based on a firm's openness and transparency with HMRC and not on its size, complexity, or attitude to tax planning and they were not clear that this was the case.

Lack of Clarity on Benefits

The other area of concern for a majority of our interviewees was the perceived lack of clear benefits of being low risk as opposed to moderate or high risk.

HMRC set out the consequences of being low and high risk in the *Risk Management Report*, particularly in Chapter 5. Low risk companies are to benefit from a light touch approach, whilst high risk companies will be the subject of 'more intensive scrutiny'.¹²

A majority of our interviewees could not see the benefits of being low as opposed to high risk. One interviewee said that at a recent meeting of tax directors, the general view was that it makes no difference whether a company is rated as high, moderate, or low risk. Another explained that certain companies' size and complexity necessarily mean that they will be subject to constant audit review and regular interventions, whatever their risk rating may be. Interestingly, a number of interviewees were clearly not displeased with regular interventions as they thought that the complexity and size of their business requires it. One interviewee, whose company is considered high risk, welcomed having more resources allocated to it as he thought that that would result in more certainty.

The majority view appeared to receive broad confirmation from one HMRC employee who told us that he does not think the risk rating approach will have a considerable impact on a Customer Relationship Manager's (CRM's) day-to-day work. Another HMRC employee suggested that there is a tension between the desire to apply a light touch approach to low risk companies and the desire for companies to be open with HMRC, disclosing everything they are doing, preferably in 'real time'.

A minority of interviewees had different views to those expressed above. They thought that HMRC could adopt a light or lighter touch with regard to their business and that this would result in clear benefits. The benefits they identified were fewer interventions, more focused questions, more flexibility with deadlines, and even forgiveness of penalties.

Whilst a majority of our interviewees could not easily identify the benefits of being low risk, they had no difficulty identifying a particular negative of being high risk. A majority of interviewees said that HMRC can make life difficult, especially by asking for excessive information. When elaborating on this 'hassle factor', a common complaint was that HMRC are often indiscriminate, demanding voluminous documentation in areas where the risk is low and perhaps the amount of tax in question is also low. The value of this approach appears questionable, as it might lead no further than frustrating and antagonizing companies. One interviewee told us that, whilst they found the hassle factor hugely

12. *Risk Management Report*, para 1.10.

frustrating, they do not see the benefit of changing their business or behaviour for the sake of reducing it. On the other hand, those who felt that there are advantages to being lower risk highlighted the particular benefit of reduced and better-focused HMRC enquiries.

A source within HMRC did not dispute the existence of the hassle factor. Another confirmed that the hassle factor existed in the past, but said that it will not be carried forward into the future. The *Risk Management Report* confirms this intention, as HMRC have made a commitment to respond to risk in a proportionate manner and not to take up relatively insignificant risks.¹³

A number of our interviewees also noted that it was not clear, from a shareholders' perspective, whether being low risk was even desirable. Having a low risk rating might be positive if it means that the company can carry on business more easily, but if the relationship with HMRC is too 'cosy' that might indicate that shareholder value is not being maximized.

The Continuing Importance of the 'Boundary of the Law'

One issue that emerged quite clearly from our discussions was the continuing practical importance, when actually allocating resources to risk, of the distinction between what most of our interviewees referred to as 'acceptable' and 'unacceptable' tax avoidance. Whatever other factors may be identified in the *Varney Delivery Plan*, a company's 'behaviour' with respect to tax planning or tax avoidance seems to be critical to its risk profile. The *Varney Delivery Plan* eschews the word 'avoidance' and instead adopts the term 'boundary of the law', which seems to imply a boundary between acceptable and unacceptable avoidance, whatever that may mean.¹⁴ Thus we find ourselves in a situation where most people want to move beyond the debate about what distinguishes acceptable tax avoidance from unacceptable tax avoidance; nonetheless, the distinction remains central to a company's risk rating and thus its future relationship with HMRC.

Structural Risk, Behavioural Risk, and Tax Avoidance

As discussed above, most companies we interviewed would welcome a shift away from structural factors towards behavioural factors in assessing tax risk. HMRC respondents agreed that a risk assessment must give substantial consideration to the latter. The difficulty lies in determining what behaviour comprises.

13. *Ibid*, para 5.11.

14. In current parlance, the term 'tax avoidance' is sometimes used to denote *unacceptable* or *ineffective* avoidance only, that is, arrangements which a court would ultimately hold to be inconsistent with the text, context, and purpose of the relevant statutory provisions. Similarly, the term 'tax planning' is often used to describe *acceptable* or *effective* avoidance. However, the terminology is used inconsistently. The difficulty with using words like 'acceptable' and 'unacceptable' is that one must ask: acceptable to whom? Lord Hoffmann states in *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6, para 62: '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.' Others might take a wider view of what is unacceptable. For further discussion see the literature cited at (n 6).

Several companies argued that low risk behaviour consists of strong corporate governance systems, transparency about tax risks, and openness with HMRC, not the particular transactions that a business does or does not undertake. It was felt that HMRC should assess behaviour by focusing on a firm's internal decision-making systems, compliance with information requests, and speed and fullness of disclosure. Accordingly, most companies believed that a lower risk rating is indicated if a business is very open regarding the transactions it undertakes—even if HMRC disagrees with the taxpayer's interpretation of the law as applied to those transactions. The general opinion among the companies interviewed was that HMRC is unlikely to approach 'behaviour' in this way. One moderate to high risk company said that, from HMRC's perspective, responsible behaviour comprises transparency, openness, and 'not doing planning that HMRC don't like'.

The above comments were generally consistent with what HMRC respondents told us about how they undertake, or expect to undertake, risk assessments under the Varney approach. We were unable to determine from the answers given whether a firm's approach to tax planning would be a more or less important factor than its governance systems, compliance with information requests, and disclosure. HMRC respondents indicated that all of these factors should be considered in determining a taxpayer's risk profile.

Assessing Behavioural Risk Based on the 'Spirit of the Law'

The *Varney Delivery Plan* states that HMRC intend to reduce interventions with low risk customers and to investigate intensively those companies that repeatedly push at the 'boundary of the law'. This could have a range of meanings but HMRC have suggested elsewhere that determining the acceptability of tax planning behaviour requires looking at the spirit rather than merely the letter of the law.¹⁵ This clearly requires a non-literal reading of legislation but whether it is intended to go further than purposive interpretation as it would be applied by the Courts is not discussed. We asked a series of questions about the feasibility of this approach and, assuming the approach were feasible, how a firm should determine if a tax planning arrangement is within the 'boundary of the law' or consistent with the 'spirit of the law'.

There was little disagreement from the businesses and HMRC respondents we interviewed that most companies want to pay the 'right amount' of tax and thereby 'comply with the law', as the *Varney Delivery Plan* suggests they do.¹⁶ However, one could

15. See for example HMRC, *International Tax Handbook* ITH103, available at <http://www.hmrc.gov.uk/manuals/ithmanual/html/1ithcont/01_0001_ITHCONT.htm>. For further discussion see J Freedman, 'The Tax Avoidance Culture: Who is Responsible? Governmental Influences and Corporate Social Responsibility' in J Holder and C O'Conneide (eds), (2006) 59 *Current Legal Problems* (OUP) 359.

16. *Delivery Plan*, para 3.2; *Risk Management Report*, para 1.3.

reasonably question whether these statements convey any meaning, as the ‘right amount’ of tax often depends, in the absence of judicial determination, on a person’s own view of the text and purpose of legislation. Is the right amount of tax dependent upon what the *Varney Delivery Plan* calls the ‘boundary of the law’?

None of the respondents disagreed that tax laws have a boundary, but the majority felt that this boundary can only be what Parliament and the Courts say it is. Some respondents felt that this requires a predominantly textual/technical interpretation of the law, perhaps with reference to purpose as expressed in Hansard or legislative notes. One tax director stated that it was appropriate to apply an ‘abuse of law’ test to determine whether tax avoidance is acceptable or unacceptable, suggesting that judges implicitly use a test that goes beyond pure interpretation when deciding tax avoidance disputes. However, this was an isolated view. Most tax directors asserted that behaviour cannot be measured on some undefined spirit of the law. Various interviewees suggested that it is ‘ridiculous’ or ‘offensive’ to expect firms to look beyond legislative text and purpose in order to decide what the spirit of the law is. Others were more moderate in their responses, saying that it is often ‘unclear’ where the boundary of the law lies or what the spirit of the law is. There was some consensus that it would be useful for businesses to know what the spirit of the law was, but that knowledge could only be derived from direct statements by Parliament or decisions of the Courts. Several companies argued that the boundary of the law or the spirit of the law cannot simply be what HMRC personnel say they are.

Operating within Areas of Uncertainty—Where is the Boundary of the Law?

One objective of this survey was to move beyond the broad statements often made in the debate about ‘responsible behaviour’ and ‘avoidance’ by trying to establish more precisely where a common understanding exists and where it does not. A common understanding of unacceptable tax avoidance would, of course, lend legitimacy to any risk assessment based on HMRC’s view of a firm’s tax planning decisions.

It is perhaps not surprising that most of the disagreement in this area related to the importance of commercial purpose in a transaction and the degree to which purposive interpretation of taxing statutes takes us beyond a literal interpretation thereof. In order to elucidate these admittedly vague concepts, we asked a series of questions about two hypothetical tax-planning arrangements.

The arrangements which we discussed are described in detail in Appendix A to the Full Report. Very briefly, the first example involved an intra-group reorganization designed to allow the shares in certain operating companies to be transferred to a third party purchaser without realizing the latent capital gain on those shares. The second example involved a multinational enterprise centralizing its main financing activities in a controlled company located in Ireland. We also welcomed interviewees to draw on their own experiences with similar transactions or arrangements.

Comments on the Importance of Commercial Purpose

Opinions varied widely with respect to the importance (or relevance) of commercial purpose. Several commentators from both business and HMRC noted that the approach to tax avoidance articulated in *Barclays Mercantile (BMBF)* does not incorporate any ‘commercial purpose’ or ‘economic substance’ requirement. It would nevertheless seem that, from a practical perspective, HMRC personnel and many large businesses see commercial purpose as a relevant consideration in assessing whether a transaction is within or beyond the boundary of the law.

Some interviewees said that it was ‘essential’ that any transaction they enter should have a commercial purpose. However, all of these respondents agreed that it was acceptable for a taxpayer to implement a business-led transaction in the most tax effective manner. The remaining companies stated that it is always preferable to have a strong commercial purpose in any transaction as a practical matter, but in fact were prepared to consider transactions with a limited underlying commercial purpose provided it satisfied the technical requirements of the legislation. Some noted that corporation tax is a significant cost against business profits; reducing that cost in order to maintain competitive position or enhance shareholder value was seen as a valid commercial objective *in itself*.

The *Varney Delivery Plan* suggests that an absence of commercial purpose is a key indicator of high-risk transactions or arrangements. Paragraph 5.12 of the *Risk Management Report* highlights, among other things, transactions or arrangements ‘which have little or no economic substance’, ‘exhibiting little or no business driver’, or ‘involving contrived, artificial, transitory, pre-ordained, or commercially unnecessary steps’. HMRC respondents confirmed that the absence of a commercial motivation is indicative of unacceptable tax avoidance, stating that judges will have regard to this factor when interpreting and applying statutory provisions.

Comments on Purposive Interpretation

Opinions also varied regarding what is involved in ‘purposive’ statutory interpretation. The approach from *BMBF*, which involves purposive statutory construction and an investigation into whether a transaction meets the statutory description, appears to mean different things to different people.

Some respondents believe that the *BMBF* approach requires a predominantly textual/technical interpretation of the law, perhaps with reference to purpose as expressed in Hansard or legislative notes. One tax director told us that a purposive interpretation entailed applying an ‘abuse of law’ test, although it was not entirely clear how far, if at all, that provided an overlay to the statute. The HMRC personnel we met seemed content to rely on purposive interpretation of legislation in order to discern the law’s spirit, but the discussion was very general. A number of respondents from both

business and HMRC stated that the incredible complexity of some statutory provisions (eg, the Controlled Foreign Companies (CFC) regime) leaves no room for any discernible spirit.

Comments on the Example Transactions

Of the business respondents who believed that a commercial objective is a necessary feature of any transaction, only one suggested that there might be a good commercial reason for the first example. The others amongst that group felt that the transaction was 'ineffective' or 'unacceptable', although some of them thought there might have been technically correct methods of achieving the same result. Opinions among the firms less concerned with an underlying commercial purpose were substantially in favour of this transaction. For example, some pointed out that the validity of deferring capital gains in such situations was subsequently affirmed by the introduction of the substantial shareholdings exemption to prevent double taxation in such situations. That is, they took the view that this device was simply a way of achieving a 'fair' result, but most interviewees did not appear to evaluate the transaction by reference to the purpose of the existing relevant statutory provisions. Not surprisingly, HMRC respondents tended to agree with the former group of firms, stating that this transaction was technically ineffective for reasons given in HMRC's published guidance or that the entire arrangement was unacceptably tax-motivated.

Opinions regarding the second example were generally more positive. Only one firm suggested that there was no obvious commercial reason for moving the treasury functions to Ireland. The remaining business respondents each said that there could be a variety of good commercial reasons for doing so, including better access to funds, reduced regulatory fees, and, in some respondents' opinions, reducing the group's overseas tax burden. HMRC respondents expressed a balance of views with respect to this arrangement, again focusing on the presence or absence of business reasons for the relocation. It was suggested that the use of CFCs, including financing companies and captive insurance companies, inevitably raises suspicion about unacceptable tax avoidance.

Moderating Behaviour in Exchange for HMRC Commitments

The *Varney Delivery Plan* commits HMRC to building a relationship of trust with large businesses. HMRC expects a form of quid pro quo from business, expressed both in terms of 'partnership' and 'bargain'.¹⁷

In other forums HMRC officials have referred expressly to a 'bargain' between HMRC and business: HMRC commits to delivering greater certainty, enhanced clarity and consultation, speedier resolution, and improved resourcing to risk, while business commits to enhanced tax governance, transparency about tax risks, and openness with HMRC. But these commitments are said to carry a further obligation regarding a firm's actual tax planning strategy. It appears that HMRC believes there is a strong association

17. *Delivery Plan*, paras 3.3 and 3.7; *Risk Management Report*, paras 1.4 and 1.8.

between tax planning and a company's governance systems and transparency, as indicated by the fact that 'tax planning' is included in the 'governance' component identified in Annexes A and B of the *Risk Management Report*. According to this view, a business that is more aggressive in its tax planning will tend to have deficiencies in its decision-making systems and tend to be less transparent in its dealings with HMRC.

The businesses we interviewed welcomed HMRC's plans for greater certainty, clarity, consultation, and resolution. In particular, most of the respondents praised HMRC's commitment to streamline the process for resolving contentious issues, including unsettled historic issues. Yet they did not feel that these commitments compelled any change in their approach to tax planning. Most companies agreed that HMRC should be devoting resources to investigating, and perhaps challenging, transactions which it feels are near the boundary of the law. Those companies said that they would be open and candid with HMRC about such transactions, hoping to resolve any disputes in a professional manner. Two of the companies we spoke with suggested that, under the new risk regime, a company will have incentive to be more aggressive with its tax planning because there will be more HMRC resources devoted to resolving the contentious issues. In other words, having a higher risk rating is seen by some to imply speedier resolutions and improved certainty, while potentially achieving a lower effective tax rate. Finally, the view of the tax directors was that it is unreasonable for HMRC to draw a connection between tax planning behaviour and the quality of a firm's compliance.

Formal and Informal Disclosure

A key theme of the *Varney Delivery Plan* is the expectation that large businesses will endeavour to provide full and contemporaneous disclosure of their tax affairs. The proposed relationship of trust between HMRC and large business includes a commitment to transparency about a firm's 'approach to tax risk management' and 'disclosure of any areas of legal uncertainty'. Several of our respondents described this approach as 'real-time interaction' or 'real-time disclosure', which is consistent with the terminology used in the *Risk Management Report*.

We asked interviewees to comment on how their practices have evolved in light of the amendments to the formal (obligatory) disclosure regime and the renewed attention on informal (voluntary) disclosure.

Formal Disclosure of Tax Arrangements

Most respondents agreed that the legislated disclosure regime is working as intended, because the Government is now getting early notice of the more aggressive tax arrangements. Parliament can and will amend legislation, perhaps retrospectively, to 'shut down' schemes that are seen as unacceptable. Opinions among HMRC respondents differed as to whether the disclosure regime has affected the attitudes of more aggressive taxpayers.

Among business representatives, only one stated unequivocally that the disclosure regime had changed attitudes about marketed tax arrangements. Two others, both of whom have a practice or policy of not using tax-led schemes, said that they saw no change of attitude in the marketplace. The remaining business respondents each said that the disclosure regime has prompted a change in 'approach' or 'emphasis' rather than a change of attitude; the schemes that are marketed currently tend to be tailored for specific sectors or companies and are designed to operate more quickly, thus minimizing the risk that legislation will be introduced to override them, at least not before they have taken effect. A common perception was that there is less mass-marketing of schemes, which has had a greater effect on the high net worth individual sector than it has on large corporations.

Informal Disclosure of Tax Planning

The real-time disclosure envisioned in the *Varney Delivery Plan* obviously goes beyond statutorily mandated disclosure of marketed schemes. There was general agreement amongst our interviewees that it is appropriate for businesses to disclose their tax affairs to HMRC, but opinions about the timing and quantity of disclosure varied. The usual practice of most of the companies we interviewed is to disclose transactions only upon filing the tax return. The HMRC respondents we interviewed agreed that this is the most common practice, with the extent of the disclosure sometimes being minimal. Some of these companies said that they might alert HMRC to major issues, such as a change of corporate structure, after the end of the fiscal year but before filing their returns. Three other companies stated that they have a practice of disclosing all significant tax planning issues to HMRC immediately after the end of the fiscal year. Only one company stated that their practice is to disclose their tax affairs in real time.

Clearances and Rulings

Part of the business case for moving to early and full disclosure of a firm's tax affairs is the ability to obtain commercial certainty in advance of filing tax returns. Related to this goal is the *Varney Delivery Plan's* commitment to enhance commercial certainty by extending the current system of clearances and advance rulings. More detailed proposals regarding how such a system might operate were set out in a Consultation Document published in June 2007.¹⁸ Following a period of consultation, HMRC published its responses as Annex A to the *Clarity & Certainty Report* and issued a Statement of Practice on advance agreements as Annex C to that report.¹⁹ We asked interviewees in what situations they would find an expanded system of clearances most useful.

18. HMRC, *Giving Certainty to Business through Clearances and Advance Agreements*, Consultation Document (June 2007). See also House of Lords, Select Committee on Economic Affairs, *4th Report of Session 2006–07* (June 2007) paras 23–32, 284–85, available at <<http://www.publications.parliament.uk/pa/ld200607/ldselect/ldeconaf/121/12102.htm>> (placing a high priority on the development of the clearances system).

19. Statement of Practice 02/07: Advance Agreements Unit.

The Utility of Clearances in General

The general view of business respondents was that clearances can be useful in some contexts, and thus an expanded system of clearances is obviously welcome. It was noted that advance rulings appear to be restricted to the context of inward investment. Most respondents added the important caveat that they would apply for HMRC approval only in respect of 'highly commercial' transactions, perhaps involving an unrelated third party. In such situations a clearance or ruling might be sought in order to provide an additional level of certainty, after obtaining comfort from internal or external opinions. Consistent with this theme, some business respondents and one HMRC respondent suggested that clearance procedures would be more useful to small and medium-sized businesses, which are unlikely to have internal tax departments or the resources for external tax opinions.

Clearances and Tax Planning

There was a consensus that clearances and rulings will not be sought or given in respect of arrangements which push at the 'boundary of the law'. HMRC respondents stated quite clearly that, while clearances would be available for a wider range of transactions than is currently the case, they have no intention to vet tax planning arrangements. Similarly, the tax directors interviewed were almost unanimous in saying that they would not apply for a statutory clearance in any case involving 'pure' tax planning. Two companies suggested that they might apply for HMRC clearance with respect to the second example transaction; none said that they would for the first example. Accordingly, these procedures will remain relevant to business only insofar as the transaction being considered is 'highly commercial'.

Tax, Corporate Governance, and Relationships with HMRC

As noted above, corporate governance in tax matters is one of the issues HMRC will consider when assessing compliance risk. HMRC's views on what constitutes good corporate governance have been expounded in prior documents²⁰ and are repeated in the *Risk Management Report*. It is said that a business that is successfully managing tax risk will have 'strong governance, with a clear tax strategy and principles set by its Board, and well-defined accountabilities, roles, and responsibilities that are understood throughout the business.'²¹

Tax Policies

In its guidance, HMRC recommends that companies put in place a board-approved formal tax policy 'that sets out their high level tax strategy, operating principles, and guidelines'. Five out of our nine interviewees have formal tax policies, all approved by their board. Only

20. HMRC, *Tax in the Boardroom* (2006); HMRC, Partnership Enhancement Programme, *Tax in the Boardroom Agenda: The Views of Business* (2006).

21. *Risk Management Report*, para 3.2.

one has shared it with HMRC; none have shared it with their shareholders. We did not have access to these tax policies but we were left with the impression that they are formulated in general terms, such as policies of being transparent with HMRC, of complying with the law, and of not entering into tax-driven schemes.

The remaining four interviewees do not have formal tax policies, instead relying on more general risk policies. Interestingly, high-ranking HMRC officials approached the boards of two of these companies asking them to sign letters which would, it seems, act as proxy tax policies. One declined to do so; they felt that it was not sufficiently clear what behaviour HMRC was expecting them to commit to. The second company explained that, whilst in the process of settling a large number of disputed issues, their finance director was asked by HMRC to provide a tax policy 'conduct letter'; although it was not a formal condition of settlement they felt they could not refuse. It was suggested, however, that HMRC and the company might interpret the letter differently.

Decision-Making and Review Processes

Our survey could not, of its nature, reveal the extent to which boards are aware of their firms' tax departments' behaviour, although some of our interviewees were adamant that (contrary to what HMRC appeared to believe) their boards are fully aware. All but one interviewee spoke of board, board committee, or CFO participation during the tax decision-making process. This participation, however, usually came about only when the most 'major' or 'structural' issues were involved. Participation came in different forms, ranging from informal conversation with board members to formal sign-off by the CFO. Apart from differences in board-level participation, the companies differed in the rest of the decision-making process, although it always involved a mixture of processes within the tax group and the participation of outside counsel, solicitors, or auditors when deemed necessary.

A majority of our interviewees also spoke of review processes related to the decisions of their respective tax departments. These processes seem to vary in detail, formality, and even rigour, but usually include board or board-member participation at some level.

Tax, Corporate Governance, and Relationships with Other Stakeholders

The themes of the *Varney Delivery Plan* are consistent with recent efforts to highlight the role of business taxation in corporate governance and corporate social responsibility (CSR). A number of recent reports have elaborated the way in which efforts by companies to understand and manage tax risk might enhance shareholder value.²² Looking beyond

22. K Lee and N Antill, Citigroup, *Generation (Ta)X – An Investors' Guide To Analysing Tax Risk* (Citigroup Global Markets, London, September 2005) ('*Citigroup Report*'). This report is proprietary and is referred to herein with the authors' permission); Henderson Global Investors, *Tax, Risk and Corporate Governance* (February 2005); Henderson Global Investors, *Responsible Tax* (October 2005).

the investment community to other stakeholders, there have also been suggestions that a company's approach to tax planning is relevant to its broader corporate responsibility.²³

We therefore asked interviewees for their opinions on the relevance of a firm's tax planning strategy in the minds of shareholders, analysts, and the wider community.

Relationship with Investors and Analysts

Corporation tax, and planning around corporation tax, can obviously affect a company's profits and thus may affect its share value. However, interviewees were unanimous in observing that shareholders and analysts do not seem to pay attention to corporation tax, whether due to a lack of comprehension or a lack of concern.

All of the companies interviewed stated that the investment community rarely raises concerns about a firm's tax policies or planning decisions. Many respondents said that shareholders simply want their investments to have consistent and stable returns, leading analysts to focus on such criteria as well. Others noted that shareholders and analysts do not want to see volatility in share value. We were told that the investment community places an inordinate value on stability, often failing to recognize a firm's successes in reducing its effective tax rate (ETR). A few interviewees noted that shareholders and analysts might ask questions about widely publicized tax disputes that carry a huge financial risk for the company.

HMRC respondents agreed that shareholders seem indifferent about tax, although one respondent noted that shareholders could become concerned if a firm was aggressive *and* unsuccessful in its tax planning.

Relationship with the Wider Community

While most companies are mindful of their reputation in the wider community, few of our respondents were apprehensive about the public's perception of their tax policies and planning decisions. About half of the interviewees observed that it was important to avoid damage to their public reputation or 'brand'. We assume that the remaining respondents would agree with this as a general principle. However, only three respondents said that they would be concerned about negative press coverage regarding avoidance of corporation tax. The remaining respondents, including HMRC respondents, believed that corporation tax issues seem to be too complex or obscure for the media and the public to understand.²⁴

23. For example D McBarnet, 'Corporate Social Responsibility Beyond Law, Through Law, For Law: The New Corporate Accountability' in D McBarnet, A Voiculescu, and T Campbell (eds), *The New Corporate Accountability: Corporate Social Responsibility and the Law* (Cambridge University Press, Cambridge 2007); R Avi-Yonah in Ch 15, this volume; SustainAbility, *Taxing Issues—Responsible Business and Tax* (2006); DF Williams, KPMG's Tax Business School, *Developing the Concept of Tax Governance* (2007). For further discussion see Freedman (n 15).

Consistent with the above views, interviewees were unanimous in saying that the payment of corporation tax is not as yet a 'social' issue relevant to CSR. Even the companies with the most conservative approaches to tax planning within our sample agreed with this view. All of the businesses we met had developed or were in the process of developing a CSR policy. Only two companies said that their board had considered including corporation tax as an aspect of their CSR policy—both rejected it. Among the remaining firms, a recurring observation was that paying corporation tax is not a 'moral' or 'social' issue and thus is not a factor in the CSR agenda. One HMRC representative and two business respondents acknowledged that it is *possible* tax will become important to CSR in the future. They thought this would happen only if the media and the public begin to focus on tax-paying and tax planning as important social issues.

Conclusions

Each section of the Full Report contains its own analysis and conclusions. Here we highlight some of our key preliminary conclusions and suggestions for further research. It is important to remember that these are tentative as they are based so far only on a small sample.

The Risk Rating Approach

In terms of facilitating an efficient allocation of resources, the risk rating approach should be useful for HMRC. It will be less so, of course, if companies of a certain size and complexity cannot be low risk, due to their structure and regardless of their behaviour. The *Clarity & Certainty Report* makes the claim that 'early indications are that 40 per cent of our largest businesses could be classified as "low risk" by October 2008, reducing their compliance burden'. The responses of our interviewees suggest that this claim is open to question, but follow-up will be interesting.

The utility of the risk rating approach as a tool to bring about a change in behaviour is questionable. The benefits of a low risk rating need to be made clearer to large companies if they are to find it attractive. If the benefits are spelt out more carefully they could, perhaps, suffice to improve transparency, the management of structural risk, and corporate governance. Indeed, most of our interviewees appeared credibly committed to these issues as things stand. Perhaps such benefits can never be strong enough, however, for companies which are more reluctant to change, such that real change can be obtained only by resorting to legislative intervention.

The decision to allocate resources to areas of high risk cannot be faulted. It follows that if HMRC believe that engaging in tax planning is conducive to companies being high risk, it

24. Subsequent events may make this easier to test in future: on the one hand, there has been widespread media coverage of 'tax avoidance schemes' such as *The Guardian's* contested coverage of Tesco's activities; and on the other, we have many large firms openly using the threat of leaving the UK for tax purposes to try to persuade the Government to reform tax law in a direction favourable to large firms.

may be reasonable to allocate more resources to companies that engage in such planning. However, this simply takes us back to the acceptable/unacceptable tax planning debate. If there is not common ground as to where the line should be drawn between acceptable and unacceptable tax planning, companies can legitimately have a different opinion to that of HMRC. This is why many interviewees considered it would be fairer and more efficient if HMRC were to focus on governance and transparency in reaching their risk rating.

At present, a company's risk rating is confidential. Issues for the future might include the extent to which a high risk rating should be disclosed under general corporate disclosure requirements, and whether, if some companies were to voluntarily disclose their risk rating, this might put pressure on others to do the same. It is not clear, however, what the reaction of shareholders would be to different risk ratings.

The Boundary of the Law

It is not surprising to find that most businesses would prefer a definition of 'behaviour' that depends solely on governance, transparency, and openness, leaving them to engage in whatever tax planning they deem appropriate without affecting their relationships with HMRC. There was a strongly held view that it is unhelpful to assess behaviour based on undefined concepts including 'boundary of the law' and 'spirit of the law'. The distinction between 'acceptable' and 'unacceptable' behaviour continues to be significant, despite the new approach to risk and relationships in the *Varney Report* and other developments such as the disclosure regime.

There is some evidence that company tax directors do accept commercial purpose as a test which they use to self-regulate, despite the fact that its basis in case law is unclear. There was a difference of opinion over the presence of commercial purpose in relation to our scenarios, but it does at least seem to be a starting point in that both tax directors and HMRC respondents used it as a rule of thumb. Some sort of commercial purpose requirement might be a way of reaching towards the common ground referred to in the *Varney Report*. Since it is not based firmly in the case law, however, legislative backing for this as a starting point could be helpful.²⁵

Large businesses do not seem intent on altering their approach to tax planning as a quid pro quo for HMRC providing greater certainty, enhanced consultation, or speedier resolution of disputes. Whilst it is sometimes implied that being more 'aggressive' in tax planning decisions is equivalent to 'non-compliant' behaviour, large businesses may disagree that such a connection can fairly be drawn. If the *Varney Delivery Plan* represents a partnership or bargain between HMRC and large business, the businesses we interviewed see their side of that relationship as a commitment to be open, transparent, and professional, not a commitment to curtail tax planning.

25. For further discussion see Freedman (n 6) and other chapters in this book.

Disclosure

The responses of our interviewees suggest that that real-time voluntary disclosure will not happen by consensus. Without additional legal requirements, some taxpayers will continue to provide the minimum amount of information at the latest time possible. Also, HMRC will certainly need greater resources if it is to deal with information in real time. Therefore, while it appears that some large businesses are keen to move to real-time interaction with HMRC, there is work to be done to make that goal legally and practically feasible.

Clearances and Rulings

Our interviews suggest that clearances and rulings will be useful in a limited range of circumstances but not in the areas of most uncertainty. The distinction between 'acceptable' and 'unacceptable' behaviour is central to the new clearances regime since clearances will not be available where HMRC believe that the arrangement seems to be included primarily in order to obtain a tax advantage. If this distinction is left simply to HMRC, this could give rise to difficulty and the clearance regime might not be seen to be as useful as some are now suggesting.

Corporate Governance and Relationships with HMRC

Tax policies drawn up by corporates obviously differ greatly, but the general nature of the language they usually contain seems to undermine their value. One certainly cannot tell whether a company is aggressive in its tax planning on the basis of these tax policies alone.

Our survey could not, of its nature, reveal the extent to which boards are aware of tax departments' behaviour. Decision-making and review processes of the companies with which we engaged vary, but usually do include board or board-member participation at some level. This seems to indicate that the impact of bringing tax into the boardroom will not be very great. Also, whilst boards can be approached directly by HMRC, they can always turn to their tax departments to explain concerns away.

Furthermore, some of the companies considered to be amongst the most aggressive tax planners appear to have very rigorous decision-making and review processes. This indicates that good governance in terms of processes might not inevitably lead to less, or less aggressive, tax planning.

Corporate Governance and Relationships with Other Stakeholders

A major problem in deciding the relevance of CSR to tax is that this label is used in different ways. Proponents of CSR in the tax context often seem to be making a business case requiring corporate directors to consider the risk that a tax scheme will not be effective and/or cause reputational damage, in which case this does not go beyond normal tax risk management. We believe more work is needed to assess the actual reputational impact of companies entering into tax planning schemes but care needs to be taken not to overstate

this case without evidence. Whilst our interviewees would consider the business case if they thought tax planning might be relevant to risk and reputation, they rejected any wider notion of CSR. In any event, even where our interviewees thought CSR might become significant in the future, this appeared to be linked to the reputational risk issue rather than a 'purer' form of CSR.

It is interesting to note that some proponents of CSR intuitively gravitate towards a commercial purpose test in their formulations when discussing CSR.²⁶ Working on the agreement of some extended, principle-based but contained legal test might be more successful in attaining this than arguing for unconstrained CSR in view of the uncertainty about its scope.

There is still more that can and should be done to reach the commendable aim of the *Varney Report*; that is, to establish more common ground in what constitutes unacceptable tax planning and behaviours, and to use risk rating to improve efficiency and relations between HMRC and large business. The authors aim to explore this further in future research.

26. Eg, SustainAbility, *Taxing Issues—Responsible Business and Tax* (2006) p 20; RS Avi-Yonah, 'Corporate Social Responsibility and Strategic Tax Behavior' in W Schön (ed), *Tax and Corporate Governance* (Springer-Verlag Berlin and Heidelberg GmbH & Co KG 2008).

11 Managing Tax Risks

David Ulph

Introduction

In the recent *Varney Review* of links with large business,¹ two of the key proposals that were made were:

- a. To give business ‘earlier certainty of the tax treatment of transactions’ which would be achieved through:
 - i. ‘the introduction of a system of advance rulings to give UK and international business certainty about the tax consequences of significant investments and corporate reconstructions’; and
 - ii. ‘the extension of existing clearances so that as normal business practice HMRC will provide businesses with their view of the tax consequences of significant commercial issues whenever there is uncertainty’.
- b. To use a more ‘cost effective use of resources and efficient resolution of issues through the implementation of an audit approach which is focused on key risks’. As a result ‘a low-risk business might expect to receive a risk-based enquiry only every three years, subject to a review of specific high risk issues as necessary’.

The hope behind all of this is to bring about a change of behaviour by business that results in real welfare gains to the UK through (a) a reduction in the amount of non-compliance and the welfare losses to which it gives rise; and (b) a more effective deployment of resources within and across the public sector.

The aim of this chapter is to subject these proposals to critical scrutiny by examining them through the lens of an analytical framework for understanding taxpayer behaviour which sets out the complex tax risks that have to be faced and managed by both business and HMRC, and which highlights the fact that some of the risks that each party faces are affected by the behaviour of the other. The key conclusion is that the two proposals may not fully achieve their intended outcome—a finding that is consistent with the results of

1. HMRC, *2006 Review of Links with Large Business* at <<http://www.hmrc.gov.uk/large-business/review-report.pdf>>.

the survey Freedman et al reported elsewhere in this volume. The implication is that policies need to be developed with a fuller understanding of the richness of the behaviours that are at work.

The structure of this chapter is as follows. The next section sets out the basic framework and identifies the various risks that companies face in deciding how to organize their tax affairs. In the following section, this framework is used to set out the predictions about company behaviour—which types of company will arrange their tax affairs in which type of way. Finally in the third section, we will use the framework to predict the effects of the two key Varney proposals set out above.

The Analytical Framework

To understand the impact of the Varney proposals, it is necessary to first set out briefly the basic framework of taxpayer behaviour that we have in mind.² This framework is very general and is applicable to both companies and individuals and to any type of taxation. However since the issue under consideration is how companies will respond to new initiatives particularly around corporation tax, we will develop the analysis in this specific context.

Consider a typical company with a corporate profits tax base, Y . The company has available to it a number of different ways of arranging its tax affairs which could allow it to get some reduction in the effective rate of corporation tax that it pays on these profits. These various arrangements could be available to it through a variety of sources:

- in-house tax advice;
- bespoke advice or schemes obtained from a range of external suppliers;
- marketed schemes that could be acquired from a variety of sellers.

In what follows we will talk about companies acquiring a scheme but this is to be understood as a shorthand for the very wide range of means by which various ways of arranging its tax affairs come to its attention.

Schemes will differ in general in both the extent of a variety of different types of risk to which they expose the company—about which we will say more below—and the reduction in the effective tax rate that they enable the company to obtain. Since we want to focus on the issue of risk management, we will confine attention to the case where all the various schemes available to the company produce the same reduction $\Delta t > 0$ in the effective corporate tax rate that the company will pay but differ solely in the risks to which they expose the company.

In general the various arrangements available to a company can be thought of as ranging across the spectrum from tax planning: from complying with both the letter and

2. A more formal and detailed analysis is set out in D Ulph, 'Avoidance Policies—A New Conceptual Framework' (University of St Andrews Discussion Paper, 2007).

the spirit of the law, to tax avoidance, and from complying with the letter but not the spirit of the law, to tax evasion and misrepresentation. However an important feature of the framework we will now set out is that by focusing on risks, it bypasses the issue of what particular labels one puts on various types of scheme.

There are four types of risk a company needs to think about in considering any particular scheme that it might potentially acquire.

Legal Effectiveness

The first is whether or not the scheme works in law. Let us assume that this is something on which the company can get advice—both from the supplier of the scheme but also from independent legal experts—so that it can form an accurate view as to the true probability that the scheme/arrangement is effective.³

Change in the Law

Even if an arrangement works in law there is the possibility that Parliament and Ministers, advised by HM Revenue & Customs (HMRC), will deem it to contravene their intentions or otherwise challenge the integrity of the tax system, and so will change some piece of legislation on which the arrangement depends for its effectiveness. Effectively the scheme is closed.⁴

There are two dimensions to this risk: the likelihood that the law is changed and the speed with which this happens if it is.

The former will depend on a variety of factors: how many others adopt the scheme (or one similar), the consequences for tax revenue, and attitudes of HMRC, Ministers, and Parliament. Since companies essentially have to second-guess how Parliament, Ministers, and HMRC are going to behave, they will often find it hard to accurately assess how likely it is that legislation will be changed. We presume that they will have a good idea of when a scheme lines up either very well or very badly with the intentions of the law and so there is a very low (resp. high) chance of legislative change. However we assume that in between these extremes, they find it very hard to gauge the true probability of legislative change. They may overestimate the likelihood of legislative change in cases where this is, in fact, unlikely, but underestimate the probability that a scheme will be closed in cases where this is, in fact, very likely. It is precisely in this area that companies have the potential to benefit from early advice from HMRC about their views on certain arrangements.

3. It could be argued that in some circumstances there is no such thing as the 'true' probability, and that there could be genuinely different views as to whether or not the arrangement is effective, in which case what really matters is whether HMRC thinks the scheme works in law. This could be an area where greater clarity of HMRC's views could be valuable. This could be an interesting extension of the framework developed here.
4. An alternative interpretation is that the scheme becomes ineffective for sure, and while the taxpayer might continue to use it, doing so incurs risks of detection, and the imposition of penalties.

The speed with which any legislative change is introduced will depend on how quickly HMRC becomes aware of the scheme and its effects, and on the date from which any change in legislation can be deemed to take effect. Recent disclosure powers by HMRC will have considerably reduced the effective length of time for which certain types of scheme will be operable.

Effective Challenge

If a scheme fails to work in law there is a risk that it will be successfully challenged by HMRC and the company will have to repay the tax (plus interest) and, possibly, a penalty.

The risk of effective challenge is the product of a number of other risks:

- The risk that the company's affairs will be investigated. This will depend in turn on the amount of resources devoted to investigation relative to the population of companies (*the coverage rate*) and the nature and quality of the risk rule that HMRC uses for selecting cases for investigation. In particular, for reasons that will become clear below, the larger the size of their tax base, the higher a company's perceived risk of investigation.
- The probability that, if investigated, the scheme will be detected and successfully challenged. This will depend on the quality of staff deployed on investigations by HMRC—not only their understanding of tax law but also their personal effectiveness in defending their position under counter-challenge by the company.

We assume that through personal experience and interaction with other companies, a company can form an accurate view of the probability of successful challenge before it acquires any given scheme.

In the third section we will analyse the potential effect on company behaviour if HMRC deploys a more effective risk rule such as the second of the Varney proposals.

We will also assume that if a company is effectively challenged it may suffer a *reputational cost* from being perceived as having done something that contravenes the law.⁵ We assume that this reputational cost is proportional to the size of the company⁶—and hence to the tax base Y but allow for this factor of proportionality—which is denoted by r to vary across companies. For some companies r may be zero, while for others it could be very large. The value of r will depend on a variety of factors—the nature of the business that the company is in, the company's mission, whether it is largely UK-owned or foreign-

5. An alternative assumption is that a company only suffers a reputational cost if it is not just successfully challenged but is also required to pay a penalty. This would make no difference to the qualitative conclusions of the analysis.
6. Let us have in mind that if a company is perceived to have cut legal corners in one aspect of its business, customers may start to question whether it is cutting corners in other aspects and so consider switching business to rival companies.

owned etc. For the purposes of the analysis being conducted here we do not need to make any further assumptions about how r is distributed across the population.⁷

Penalty Imposition

Finally, before acquiring a scheme, a company has to bear in mind the likely financial penalty it will have to pay (in addition to repaying the tax) if the scheme is ineffective and is successfully challenged by HMRC. Even if there is a clearly specified penalty rate—for example, 100 per cent of the tax underpaid—it may be that in some cases no penalty is paid, or, even if it is, the precise amount is subject to negotiation and is just a fraction of the rate at which it could theoretically be imposed. Let us assume that again, by experience, the true fraction of the statutory rate that is likely to be imposed if any given scheme is deemed to be ineffective and is successfully challenged is well understood by companies before they acquire it.

Any given scheme is therefore characterized by the following risk characteristics:

- the probability that it works in law;
- if it does work, the probability that some piece of legislation on which it depends will be changed;
- if legislation is to be changed, the likely speed of this response;
- if the scheme does not work in law, the likelihood of effective legal challenge;
- if it is effectively challenged, the likely fraction of any statutory penalty that will actually be imposed.

These risks will generally vary across schemes depending on their specific characteristics, and in particular, on where they lie on the spectrum between tax planning through avoidance to evasion. This implies that these risks will be highly correlated across schemes. Thus:

- pure tax planning will certainly work in law and the legislation on which it depends is very unlikely to be changed;
- pure avoidance will also work in law but there is a higher chance that the underlying legislation will be altered;
- there will also be avoidance schemes that are less likely to be legally effective, and rather more likely to have the legislation on which they depend quickly changed if they are, or face a risk of effective challenge if they are not;
- there is finally, pure evasion, which is definitely illegal and is very likely to be effectively challenged and incur a significant penalty.

7. An interesting topic for future research would be to try to assess companies' reputational costs—using, for example, the types of well-tried techniques used to establish environmental attitudes—and to examine what factors caused these costs to vary across firms.

These risks determine the expected gain in the form of tax saving that a company will obtain from acquiring any given scheme, and also the expected loss in terms of penalties and reputation. Taken together, these will determine *expected net gain*, G , from any given scheme. Given the assumptions made so far, G will be directly proportional to the size of the relevant tax base, Y , of the company that is acquiring it. Indeed we can write:

$$G = \Delta t.Y.(1 - p) \quad (1)$$

where $p \geq 0$ is what we can call the *risk factor* that a company associates with any given scheme. This will depend on all the risks identified above.

For any given company this *risk factor* will vary across schemes. If a scheme is pure tax planning $p = 0$ but for other types of scheme we will have $p > 0$, since there will be some risk that a company will not achieve the full tax savings. Other things being equal, the *risk factor* will be lower for schemes that are closer to pure tax planning and higher for schemes that are closer to tax evasion. However, nothing depends on what label we attach to schemes—all that matters is their risk characteristics as summarized in the *risk factor*.

For any scheme that has some chance of being ineffective the *risk factor* will also vary across companies, with companies with high reputational costs attaching a higher *risk factor* to the scheme than companies with lower reputational costs.

Costs and the Market for Schemes

There will be two types of costs involved in acquiring and implementing a scheme.

Acquisition Costs

If the scheme is developed in-house then there will be resource costs incurred in its development. These are upfront costs that will depend on the complexity of the scheme, and the care that is taken in ensuring that it is effective and will survive legal challenge etc. We assume that these costs are independent of the amount of tax saved by the scheme.

If the scheme is acquired from an external supplier then there will be a fee to be paid. In general this is likely to be a combination of a flat fee, plus a percentage of any tax saved, and there may in addition be provision for sharing legal and penalty costs if the scheme turns out to be ineffective and is successfully challenged.⁸

Given the focus of this chapter, we will avoid an analysis of the pricing policies of the suppliers of schemes and of the decisions by companies as to whether to develop a scheme in-house or acquire it externally—and if so, whether to acquire a bespoke scheme or some off-the-shelf package.

8. The difference between an in-house scheme and an acquired scheme is therefore that with an in-house scheme, the acquirer incurs all the costs and bears all the risks, while with an externally-supplied scheme, some of the costs, benefits, and risks may be shared with the supplier, but there may also be some margin in the pricing for profit.

So in what follows we will assume that:

- all schemes can be developed at a constant marginal and average cost that is independent of the number of schemes provided by a supplier;⁹
- schemes that are marketed are sold at a flat fee;
- there is perfect competition in the market for schemes, so the fee for any scheme will equal the lowest cost for providing that scheme.

This guarantees that essentially, companies bear the full costs, benefits, and risks of developing a scheme whether it is developed in-house or bought from an independent supplier.

Notice that these acquisition costs are independent of the amount of tax saved by scheme (ie of the tax base), though, as mentioned above, we allow costs to vary across schemes depending on the complexity of the scheme and the care with which it has been developed.

Implementation Costs

Once a firm has acquired a scheme there will typically be costs involved in arranging its affairs so as to implement it. These could take a variety of forms but a significant element will be the extent to which a company has to undertake changes in the real organization of its affairs¹⁰ and the extent to which the scheme allows the company to undertake largely paper transactions. Again, we assume that these implementation costs are independent of the size of the tax base to which it is going to be applied.

Taken together, these factors suggest that the total cost of a scheme,¹¹ C , is likely to vary across different schemes in a complex way. In particular, the costs may vary in a complex way depending on where they are in the spectrum between planning, avoidance, and evasion. For example, pure tax planning may have high acquisition costs—because it may be expensive to ensure that it is fully effective—but it may still be less expensive to develop and acquire than a complex avoidance scheme. However, pure tax planning may have higher implementation costs because it involves a reallocation of real resources.

The Market for Schemes

Taken together, we can think of there being a market that provides a wide range of different schemes that vary in both their risk characteristics (as summarized by the *risk factor*) and their total costs of acquisition and implementation. While costs can in principle vary in a complex way across schemes, notice that, **in equilibrium**, it must be the case that

9. Effectively, all schemes are bespoke.

10. What products it produces and sells, what factors of production are employed, where all this activity takes place, and in what organizational form.

11. Acquisition plus implementation costs.

if one scheme has a higher total cost than another it must also have a lower *risk factor*—otherwise it would not be bought and so would disappear from the market. In what follows, we will assume without loss of generality that the total cost of acquiring and implementing a scheme is negatively correlated with its risk factor.

This completes the description of the model. In the next section, we will analyse which companies will acquire which types of scheme.

Company Behaviour

Given the array of schemes/products available on the market, companies will manage the risks they face in part through first seeking advice, but mainly through the choice of scheme they acquire. They can choose between more expensive low-risk schemes or cheaper schemes that carry higher risk or, alternatively, choose none at all and so gain no reduction in their effective tax rate.

Recall that the expected net gain, G , from acquiring a scheme is proportional to the size of the company's tax base, Y , while the total cost, C , of acquiring and implementing a scheme is independent of the size of the company's tax base.

We will take that the decision on whether or not to acquire a scheme and, if so, which one to acquire is made in the following way:

- a company will first identify the scheme that gives it the highest total net benefit $G - C$;
- it will then acquire this scheme if the total net benefit is positive.

Companies are therefore maximizing the expected net benefit arising from the decision they make.

There are two immediate implications of this decision-making approach:

- companies will not necessarily minimize risk—they may be willing to take some element of risk if they judge that the additional cost of further reducing their risk by choosing a safer product is not worth the gain;
- even companies with high reputational concerns may be willing to take some degree of risk if the gain is sufficiently large.

In general, companies will spread themselves across the large spectrum of schemes available on the market, depending on their two key characteristics—the size of their tax base, Y , and their reputational concern, r . However to see more clearly which companies will acquire which type of scheme, we want to simplify the analysis by assuming that there are just two schemes available on the market: a low-risk scheme, L , that has a low probability of being ineffective, and a high-risk scheme, H , that has a higher chance of being ineffective.

It is possible to show that the predictions of the model as to which scheme, if any, is bought by which type of company, are given by the following diagram in Figure 1:

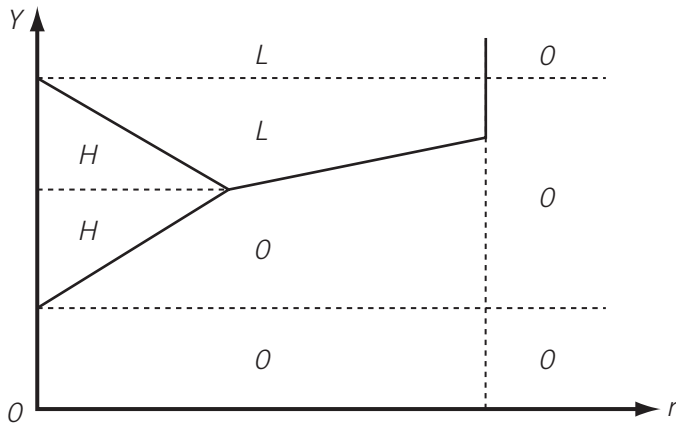


Figure 1

The predictions are therefore as follows:

- There is a critical level of reputational concern such that companies with a higher degree of concern will acquire neither of the two schemes—however large their tax base. This is because the high reputational concern means that the net benefit of even the low-risk scheme is negative.
- There is a critical size of the tax base such that companies with a smaller tax base will acquire neither of the two schemes, however low their reputational concerns. This is because the fixed cost of acquiring even the relatively cheap high-risk scheme is too high given the low tax base on which the scheme will generate benefits.
- Companies with tax bases just above this critical level will acquire the high-risk scheme provided their reputational concern is not too high. If their reputational concern is too high, they acquire nothing. The higher the tax base, the greater the range of reputational concerns for which it is desirable to acquire a scheme. Again the intuition is that these companies can now afford the relatively cheap high-risk scheme, but not the more expensive low-risk scheme.
- Once a company's tax base becomes sufficiently large, they can start to afford the low-risk scheme—though they will still prefer the high-risk scheme if they are not too concerned about their reputation. As the size of the tax base increases, more and more companies will acquire a scheme, though fewer and fewer will acquire the high-risk scheme.

- Finally, there is a high critical threshold of the tax base such that companies with higher tax bases than this will acquire only the low-risk scheme if they acquire anything at all.

This gives us a rich crop of predictions as to what we might expect to see in the data:

- There will be a group of companies of varying size who do not undertake any non-compliance. However, there will be a cluster of very small companies in this group.
- Companies who undertake some form of non-compliance will be above a certain size. Put another way, if non-compliance occurs at all, it will be done above some minimal scale.
- The larger the company (as measured by the tax base), the more likely that company is to engage in some form of non-compliance.
- Large companies avoid tax, small companies come closer to evasion, and medium-sized companies do a bit of both.

Drivers of Behaviour

Notice that behaviour in this model—and indeed in real life—is driven by the following four factors.

Opportunity

The opportunity for non-compliance depends on two things. The first is the design of the tax system. The more the tax system tries to tax at different rates activities/income sources that are very close substitutes, the greater is the opportunity for non-compliance. This is captured in the model by Δt . The second is the ease with which schemes can be devised and implemented. This depends on the availability of knowledge and expertise to the industry devising tax schemes, and is captured by the costs, C , of acquiring and implementing schemes.

Incentive

The incentive to engage in non-compliance depends on the size of the net gains from doing so, and is captured in this model by the size of the tax base, Y .

Attitude

Incentives alone do not explain behaviour. One also needs to recognize that there are social norms and attitudes that can affect behaviour. In general these are quite complex, but in this model they are captured by the reputational concern, r . A richer theory would allow for various different facets of attitude.

Belief

Behaviour depends on the taxpayers' perceptions of the various risks they face by indulging in certain types of behaviour. This is captured by the perceived value of the *risk factors* p attached to various schemes.

To manage the risks that it faces, a tax authority such as HMRC has to change the behaviour of taxpayers, and so has to operate on one or more of these drivers. The two key proposals in the *Varney Review* which were referred to in the introduction are essentially aimed at changing companies' beliefs about the consequences of their behaviour, so we can use the framework developed here to assess their potential effectiveness. We turn to this in the next section.

Changing Company Behaviour

Let us consider in turn the potential effectiveness of each of the Varney proposals.

Greater Certainty

As noted above, a key risk that companies face is that they do not always have a clear understanding of the potential reaction of HMRC, Ministers, and Parliament to their use of some new scheme that has been introduced. They probably have a pretty good idea of the end-points: certain schemes are almost certainly consistent with the intentions of Parliament and so the legislation on which they depend is very unlikely to be changed, while others sail so close to the wind that they are almost certainly going to be stopped. However in between these points, they may have a very poor understanding of the likelihood of a scheme's being closed. The Varney proposal is to give greater certainty before a company makes its decision. Within the framework of the model this can be interpreted as raising the risk factor on high-risk schemes and lowering the risk factor on low-risk schemes. The effect of this on behaviour is illustrated in Figure 2 below where, as in Figure 1 above, the thick line gives the boundary between the different regions of behaviour before the introduction of rulings, while the dashed line gives the boundary after the introduction of rulings.

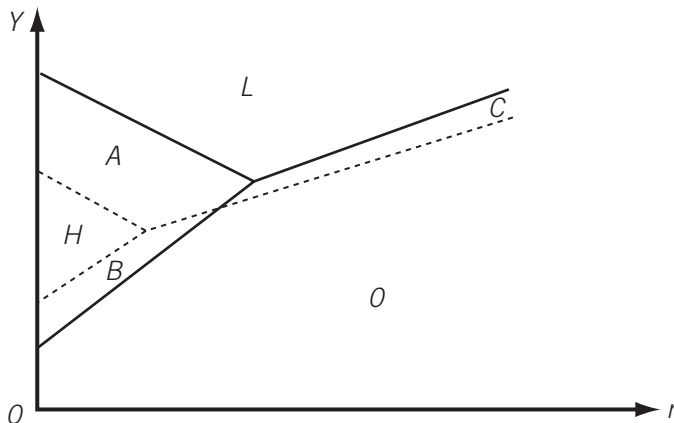


Figure 2

As we can see, and as is intuitively obvious, the provision of advice has three effects:

- Some companies with a moderately sized tax base and low reputational concern—ie those in region A of the figure—who previously used a high-risk scheme will switch to using a low-risk scheme, since this is now relatively more attractive.
- Some companies with smaller tax bases and low reputational concern—ie those in region B of the figure—who previously used a high-risk scheme will now use no scheme at all, and so end up paying more tax. This is because the high-risk scheme is now perceived as too risky but their tax base is too small to make it worthwhile to acquire an expensive low-risk scheme.
- Some companies with low tax bases and moderate reputational concerns—ie those in region C of the figure—that previously did not use any scheme to lower their tax liabilities, will now find it attractive to use the low-risk scheme, and so reduce the amount of tax they pay.

In terms of the overall level of non-compliance—ie the **number** of companies that choose to buy a scheme—the second and third effects go in opposite directions, and the overall effect will depend on the number of companies in regions B and C.

However, HMRC is not only interested in the number of compliant and non-compliant companies, but also in the amount of tax that it raises, or, conversely, the amount of the tax it doesn't raise—the tax gap. Notice that the average amount of tax lost for every company in category C that now buys a scheme will be greater than the average amount of tax gained from every company in category B that now decides to stop using a scheme. This is for two reasons:

- Companies in category C have larger tax bases than those in category B.
- Companies in category C will use the low-risk scheme, while companies in category B were previously using the high-risk scheme, and by definition, the low-risk scheme generates more tax savings for a company than the high-risk scheme. Put differently, HMRC will be less likely to be able to recover lost tax from companies using the low-risk scheme.

For precisely the same reason, the first effect identified above—while it has no effect on the **number** of companies that are compliant—will definitely increase the tax gap.

Even if the number of companies choosing to use a scheme is unaffected by this policy, the policy will still have the effect of increasing the tax gap.

In terms of the type of non-compliance that is being undertaken, this policy will shift this behaviour towards the tax-planning end of the spectrum. It is not obvious from the point of view of social welfare that this is desirable. In part this is because, as just pointed out, in itself this will tend to increase the tax gap, but it is also because more resources are used up in devising these types of schemes.

When the potential effects of this policy are examined more carefully, it is far from obvious that it is attractive.

Better Risk-based Deployment of Resources

The second proposal made by Varney was for a more cost-effective use of resources through the implementation of an audit approach that is focused on key risks.

Auditing is strictly only relevant to closing the tax gap to the extent that a company employs an ineffective tax scheme, since it is only in this case that tax can be recovered.

As we saw above, company behaviour depends in part on the probability of successful challenge if the scheme it uses is ineffective. This risk is in turn the product of two risks:

- the risk of being audited;
- the risk that if audited, HMRC will be able to successfully detect and challenge the scheme.

So if the Varney proposal is to bring about a change in behaviour, it would have to be the case that companies believe that changes in their current behaviour are likely to have a significant impact on their future risks of facing an effective challenge.

It is to the first of these risks that the Varney proposal is directed. The issue is how an improvement in HMRC's risk rules will affect the actual and perceived risk of being audited, and hence, company behaviour.

One obvious problem in trying to address this question is that one has to first understand what sort of risk rule HMRC is currently operating and then specify how it might be improved.

In thinking about how HMRC should most effectively deploy its resources to key risks, then what matters in terms of closing the tax gap is the extent of the *tax risk*, TR , that different companies pose to it, where the *tax risk* posed by company k , TR_k ,¹² is:

$$TR_k = \Delta t \cdot Y_k \cdot p_k \quad (2)$$

Here, as before, Δt is the reduction in its tax rate that a company will be able to bring about by acquiring a scheme; Y_k is company k 's tax base; and p_k is the probability that company k will acquire an ineffective scheme—call this the *behavioural risk* posed by company k . This is the product of two risks:

- the risk that the company acquires a scheme;
- the probability that this scheme is ineffective.

12. The assumptions here are that (i) large companies are sufficiently idiosyncratic that deploying more resources to investigate one company has no indirect effect of persuading other companies that they too face a higher audit risk; and (ii) any correctional effect—the impact on future behaviour by a company of an increase in its audit probability—is the same (in percentage terms) across companies.

The *behavioural risk* that a company poses will depend on a number of features of that company—the size of its tax base, its reputational concern, as well as its beliefs about the various risks that it, in turn, faces. Moreover, the relationship between a company's *behavioural risk* and these underlying features can be quite complex. For example, we saw that the first component of *behavioural risk* is an increasing function of the company's tax base, while the second is a decreasing function so the overall relation between *behavioural risk* and the tax base is likely to be non-monotonic.

While it is reasonable to suppose that HMRC will know the tax base of various companies, it will not know the behavioural risk, but will need to form estimates of this based on:

- the current tax return by company k ;
- past behaviour of company k ;
- behaviour of other similar companies.

Given the complexity of the link between *behavioural risk* and the underlying features of the company there will certainly be scope for HMRC to improve its understanding of *behavioural risk*. However since many of the underlying features of the company that affect *behavioural risk*—beliefs, reputational concerns—are not directly observable by HMRC, the scope for improvement is limited.

However, what matters for changing behaviour is how improvements in HMRC's understanding of *behavioural risk* affects its perception of tax risk, and how this, in turn, affects the actual and perceived audit probabilities of companies. Given the above discussion the following three points follow:

- HMRC's developing a better risk understanding of the *behavioural risks* posed by different companies could cause the *behavioural risk* and hence *tax risk* of any given company to rise or fall. So there is unlikely to be a simple prediction of how company behaviour changes.
- In the absence of any clear specification of the methods HMRC uses to determine *behavioural risk*, companies may reasonably believe that current behaviour should not and will not play a major role in determining *behavioural risk*, hence *tax risk* and hence *audit probability*, so changes in current behaviour may not greatly change their audit risk.
- Although it is potentially possible that for large companies (ie those with large tax bases, Y) even quite small changes in their *behavioural risk* could bring about large changes in their *tax risk*. Companies might equally believe that if HMRC uses a rather simple classification of *tax risks* and hence audit rates into, Low, Medium, and High, for example, then, given their size, they will always be in the High Risk/High Audit category and so will see little advantage in changing their behaviour. The empirical

evidence cited by Freedman et al suggests that this is precisely the calculation that some companies undertake.

Overall then, it is very hard to be convinced that, by itself, adopting a better risk-based approach to audit decisions will bring about a significant change in behaviour.

Finally, let us suppose that the proposed improvement of risk rules has the effect of making companies feel that if they choose an ineffective scheme then it is more likely to be effectively challenged by HMRC. This will have two effects:

- It will induce some companies with low reputational concerns and moderate tax bases who would have chosen a high-risk scheme not to acquire any scheme, which will reduce the tax gap.
- It will cause some companies with higher tax bases who also acquired high-risk schemes to now switch to a lower risk scheme—which, for reasons discussed above, could raise the tax gap.

In conclusion, this policy may not bring about a significant change in behaviour because, in the absence of knowing exactly how HMRC assesses risk and how this will change under the new procedures, companies may reasonably conjecture that their risk status in HMRC's eyes and hence their audit probabilities are virtually unaffected. Moreover, even if behaviour changes, this may not necessarily reduce the tax gap.

Conclusion

In this chapter, we have sketched a framework for thinking about how both HMRC and companies manage the risks that they each face. The risks that each party faces are largely determined by the behaviour of the other, so to change the way companies behave, HMRC has to change its own policies/behaviour. Using this framework, we have subjected two of the key proposals in the *Varney Report* to critical analysis and shown that (a) they may not have the impact on behaviour that HMRC anticipates; and (b) even when the behaviour is of the kind that HMRC might have anticipated, it is not obvious that this will necessarily achieve the ultimate objective, which is to reduce the tax gap.

By developing a better understanding of company behaviour, HMRC may be able to better devise policies that will achieve its objectives.

12 Corporate Governance and Taxation: The Implications for Financial Reporting¹

Mihir Desai

Introduction

Several significant tax changes in the US initiated a diffusion of stock ownership in the early twentieth century and motivated Adolf Berle and Gardiner Means² to launch the study of the agency problem.³ For nearly a century since this pioneering work, this link between corporate governance and taxation has been neglected as the study of these two important features of an economy became segregated. Corporate finance scholars have treated taxes only as market imperfections that influence capital structure and dividend policies, while public finance scholars have not incorporated the possibility of agency problems in their analyses. This divergence is all the more surprising given that the state, by way of the corporate tax, is typically the largest claimant on pretax cash flows, and thereby the largest shareholder, in most corporations.

An emerging literature suggests that revisiting this link can generate new insights into the real effects of tax policies and the workings of corporate governance. In particular, as this contribution notes, this link suggests a reconsideration of the nature of the information requirements associated with the corporate tax in the US and elsewhere.

The basic intuition for how corporate governance and taxation interact is that tax avoidance demands complexity and obfuscation to prevent detection. These characteristics,

1. These comments draw on M Desai, 'The Degradation of Reported Corporate Profits' (2005) 19 *Journal of Economic Perspectives* 171–192; M Desai, 'Aligning the Accounting and Tax Treatment of Stock Options' (25 June 2007) *Tax Notes* 1–20; and M Desai and D Dharmapala, 'Corporate Governance and Taxation: An Economic Approach' in W Schön (ed), *Tax and Corporate Governance* (Springer-Verlag Berlin and Heidelberg GmbH & Co KG 2008).
2. A Berle, and GC Means, *The Modern Corporation and Private Property* (Macmillan, New York 1932).
3. For a discussion of the Berle-Means (1932) argument, see M Desai, D Dharmapala, and W Fung, 'Taxation and the Evolution of Aggregate Corporate Ownership Concentration' A Auerbach, JR Hines Jr, and J Slemrod (eds), *Taxing Corporate Income in the 21st Century* (Cambridge University Press, Cambridge 2007).

in turn, can become a shield for managerial opportunism. This logic is perhaps best understood by example. Suppose that managers of a firm begin creating several special purpose entities (SPEs) in tax havens. These entities are rationalized as providing the means for reducing tax obligations. The details of the structures and transactions cannot be explicated fully or widely, explains management, due to the likelihood of detection by the tax system and the revocation of those benefits. Such structures and secrecy may also allow managers the ability to engage in various activities that may be harmful to shareholders. More specifically, such entities may facilitate earnings manipulation (by creating vehicles that can manufacture earnings without enabling investors to understand their source), the concealment of obligations (by taking on debt that is not fully consolidated), or outright diversion (by allowing for insider transactions that are not reported widely). The secrecy laws of tax havens may well assist managers in obscuring these actions, all of which are rationalized as tax avoidance undertaken for the shareholders' benefit.

More formally, the technologies of tax avoidance and managerial diversion can be thought to be complementary. That is, undertaking tax avoidance can reduce the costs of managerial diversion or, alternatively, reduce the likelihood of detection. This complementarity is modeled in Desai, Dyck, and Zingales⁴ as creating an interaction between resources diverted by managers and the amount of tax savings created by shelters. Another form of this complementarity is modeled in Desai and Dharmapala⁵ as creating an interaction between the ability to reduce taxable income and inflate book income in a setting of dual reporting. This view can be thought of as, narrowly, an 'agency perspective on tax avoidance' or, more broadly, as the 'corporate governance view of taxation'.

The corporate governance view of taxation yields three distinct predictions that have been tested in various settings. First, characteristics of a tax system—such as the structure of rates and the nature of enforcement—will influence managerial actions and hence the extent of the agency problem. Second, the nature of the corporate governance environment—eg the protections afforded dispersed outside investors and the laws that regulate self-dealing—will influence the workings of the tax system. Third, tax avoidance need not represent a simple transfer of resources from the state to shareholders; rather, managers may capture a share of the benefits of tax avoidance. The first two of these predictions have found empirical support in the international setting (with particular emphasis on developing countries) while the third has found empirical support using US data.⁶

4. M Desai, A Dyck, and L Zingales, 'Theft and Taxes' (2007) 84 *Journal of Financial Economics* 591–623.

5. M Desai and D Dharmapala, 'Corporate Tax Avoidance and High Powered Incentives' (2006) 79 *Journal of Financial Economics* 145–179.

6. See Desai, Dyck, and Zingales (n 4) for international evidence and Desai and Dharmapala (n 5); M Desai and D Dharmapala, 'Earnings Management and Corporate Tax Shelters' (2006) Harvard Business School Finance Working Paper 884812; and M Desai and D Dharmapala, 'Corporate Tax Avoidance and Firm Value' (2006) Working Paper for evidence in the US. M Hanlon and J Slemrod, 'What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Aggressiveness' (2007) Working Paper; M Erickson,

Financial Reporting for Tax Authorities and Capital Markets

These recent results supporting the corporate governance view of taxation recommend a reconsideration of the information environment of the corporate tax. Accounting systems play a crucial role in producing information for both an audience of investors and for the tax authorities. While the design of information systems for investors has received much attention in the accounting literature, the information system embodied in tax regimes has received limited attention. If one views the state as a shareholder because of the tax system, then the question of the optimal design of information systems for both the state and investors becomes central.⁷

The dual reporting system employed in the US allows firms to keep two sets of financial statements: a financial statement that reports 'book profits' to the capital markets and a separate financial statement that reports 'tax profits' to the government. These two profit reports can bear little resemblance to each other and each follow distinct rules. Conceptually, the many differences between book and tax profits largely center on differing treatments associated with the *timing* and *location* of income. With respect to timing, accountants have developed a variety of rules to ensure that income is measured when earned and associated expenses are incurred in parallel, through the system of accrual accounting. In contrast, tax authorities emphasize the actual receipt of proceeds and the actual payment of expenses. In a related vein, book profits reflect subjective, probabilistic assessments of expenses, such as contingent liabilities, while tax authorities are reluctant to provide deductions for anything but actual payments.

With respect to location, book profits measure the worldwide income of firms, which is increasingly comprised of earnings from overseas operations. In contrast, the international tax regime for US multinationals considers the repatriation of earnings to the US to be the recognition event for tax purposes. As a consequence, profit reports differ given the differing definitions of worldwide income. More generally with respect to location, the rules differ markedly with respect to entity definition and consolidation rules creating myriad differences in how a tax entity is defined relative to an accounting entity.

The dual reporting system is also accompanied by asymmetric sharing of information on profit reports. Tax authorities have access to reports to capital markets while investors

M Hanlon, and EL Maydew, 'How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings' (2004) 79 *Accounting Review* 387–408; O Guedhami and J Pittman, 'The Importance of IRS Monitoring to Debt Pricing in Private Firms' (2007) Working Paper; and M Desai and JR Hines Jr, 'Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions' (2002) 55 *National Tax Journal* 409–40 also have related results.

7. For a review of the history of the dual information system, see D Lenter, J Slemrod, and DA Shackelford, 'Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives' (2003) 56 *National Tax Journal* 803–30; AD Knott and JD Rosenfeld, 'Book and Tax: A Selective Exploration of Two Parallel Universes, Parts One and Two' (2003) 99 (6) *Tax Notes* 865–97 and 99 (7) *Tax Notes* 1043–80; and Desai (n 1) 'The Degradation of Reported Corporate Profits'.

cannot access confidential tax returns. The confidentiality of tax returns, which prevents explicit comparisons of the two profit reports by capital market participants, is usually defended on the grounds that competitors could glean useful information from tax returns.

Supporters of the dual reporting system rely on the intuition that the two books serve two distinct purposes. The Supreme Court decision usually cited, *Thor Power Tool Co v Commissioner* (439 US 522 [1979]), states that:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistent with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This intuition that two different functions are being served by the two reports continues to be the primary argument for sustaining dual reporting.

Defenders of the current dual reporting system also tend to emphasize that reconciliation of the two profit reports is possible in two ways. First, the accounting standards that guide reporting of tax expenses on public financial reports are meant to provide sufficient information to infer a firm's tax position. While income statements typically keep tax information to a minimum, more detailed footnotes provided in public registration statements are meant to provide further information on the nature of a firm's tax position. Second, corporations must explicitly reconcile book profits and tax profits on their tax returns. This reconciliation, which begins with aggregate book profits and is designed to categorize the discrepancies with tax profits, is part of a corporation's returns and, as such, is only available to tax authorities.

The debate on the merits of the dual reporting system has been somewhat heated.⁸ As such, it is useful to begin with the relatively unambiguous conclusions that have emerged from recent work on the dual reporting system.

8. Critics of increased conformity have labeled it a 'naïve proposal' with 'dangerous' consequences. For a particularly eloquent statement for maintaining the status quo, see DA Shackelford, 'Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means' (9 May 2006) available at <<http://waysandmeans.house.gov/hearings.asp?formmode=view&id=144>>.

Public Financial Reports Tell Us Little or Nothing about What a Firm Pays in Taxes

As discussed above, proponents of the current system suggest that information about taxes paid is available to investors so it is not clear that increased conformity would serve a meaningful purpose. Indeed, given that thirty-five cents of every pretax dollar is supposed to go the government, one would think that such a large cost figure would be easily deduced or that it would be clearly reported. In fact, research has shown that the amount corporations pay in taxes is impossible to decipher from annual reports. Leading accounting scholars have reviewed the intricacies of tax footnotes of leading companies and cannot answer a simple question: how much did this company pay in taxes? Specifically, Hanlon⁹ reviews the tax footnotes of several major corporations and demonstrates that several contradictory conclusions regarding their tax positions, depending on the information used, are entirely feasible.¹⁰

The Argument That Tax and Financial Reporting Have Different Purposes is a New Argument

The 1979 *Thor* decision has led various supporters of the status quo to assert that financial and tax reporters serve two distinct purposes and should therefore not be conformed. Revisiting the history of the corporate income tax clarifies that this view is a decidedly modern notion and also reveals just how curious the current state of affairs is. With respect to the measurement of income, accountants, economists, and firms all argued at the onset of the corporate tax that accounting income should be employed for assessing tax burdens. When the income tax was first devised, Robert Haig, the Columbia University economist who helped devise the Haig-Simons definition of income, stated that ‘it goes without saying that taxable income under an income tax law should approximate as nearly as practicable the true net income as defined by the analysis of the economist and the accountant’.¹¹ Indeed, accountants and firms vigorously argued that accounting income was the only correct basis for taxing corporate profits, arguing that differing definitions would require ‘duplicating the present cost of the accounting department, serving no useful purpose whatever’.¹² Through the middle of the last century, firms continued to argue for greater conformity toward accounting standards given the costs of dual reporting.

9. M Hanlon, ‘What Can We Infer About a Firm’s Taxable Income from its Financial Statements?’ (2003) 56 National Tax Journal 831–63.

10. Large sample evidence that compares tax returns to public financial statements yields a contradictory set of conclusions on the degree to which public financial statements, on average, can yield meaningful information on tax payments (JR Graham and LF Mills, ‘Using Tax Return Data to Simulate Corporate Marginal Tax Rates’ (2007) Working Paper, available at <<http://ssrn.com/abstract=959245>>; and GA Plesko, ‘Corporate Tax Avoidance and the Properties of Corporate Earnings’ (2006) 5 National Tax Journal 729–37). Recent reforms in tax reporting (as advanced in LF Mills and GA Plesko, ‘Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income’ (2003) 56 National Tax Journal 865–93) have led to an increased ability to match public financial statements to tax returns for tax authorities without any increased access to this information for shareholders.

11. RM Haig, ‘The Concept of Income—Economic and Legal Aspects’ in RM Haig (ed) *The Federal Income Tax* (Cambridge University Press, New York 1921).

12. M Robinson, ‘The Federal Corporation Tax’ (1911) 1 American Economic Review 691–723.

A historical review of the motivations for the corporate tax also makes clear that the sponsors viewed the tax as advancing the efforts to control corporations through dissemination of additional information of their activities. As contemporaneously profiled by Robinson,¹³ the corporate income tax should not 'be judged primarily upon its capacity to produce revenue or to distribute the fiscal burdens equitably. Its important function in the view of its sponsors was to give publicity and to furnish the basis of government supervision of corporations'. This intuition for the intent of the tax seems to accord well with the idea that a corporate income tax should be viewed as part and parcel of the system of monitoring corporate activity for various corporate shareholders, a goal presumably impeded by the maintenance of a confidential, distinct set of profit reports.

Up through the middle of the last century, many firms continued to argue for greater conformity between tax profits and accounting standards, given the costs of dual reporting. But over time, as Knott and Rosenfeld¹⁴ describe it, the two accounting systems have evolved into 'parallel universes' with innumerable differences in treatment. The evolution of two distinct accounting systems is largely the story of the refinement of accounting science in addressing issues like the timing and location of income, combined with stagnation in the ways in which tax authorities measure income. In contrast to their historical positions, firms and accountants now generally argue against conformity between the two sets of accounts and disclosure of corporate tax returns. Given the costs involved in maintaining two books, firms presumably have come to value the opportunity to characterize their profits in distinct ways to the capital markets and tax authorities.

In the Aggregate, Deviations between Profit Reports to Tax Authorities and Capital Markets Have Become Large and Difficult to Understand

Over the last decade, the connection between aggregate financial accounting income and tax income has become more tenuous. A variety of commentators have tried to reconcile the two values, in aggregate, with limited success based on accepted differences between the two profit reports. Estimates of the overall difference for the years prior to the advent of the M-3 reconciliation form were as high as \$150 billion annually with differences arising from stock options constituting a significant fraction of that amount.¹⁵

Thanks to the implementation of the M-3 reconciliation form, as advanced in Mills and Plesko,¹⁶ it is possible for researchers with access to this confidential data to tell us more

13. See Robinson (n 12).

14. See Knott and Rosenfeld (n 7).

15. See, for example, M Desai, 'The Divergence Between Book Income and Tax Income' in J Poterba (ed) *Tax Policy and the Economy 17* (MIT Press, Cambridge MA 2003) 169–206, and Hanlon and Shevlin 'Accounting for Tax Benefits of Employee Stock Options and Implications for Research' in T Shevlin (ed) (2002) 16 Accounting Horizons 1–16; and M Hanlon, SK LaPlante, and T Shevlin, 'Evidence on the Information Loss of Conforming Book Income and Taxable Income' (2005) 48 *The Journal of Law and Economics* 407–42.

16. See Mills and Plesko (n 10).

about this gap. More recent analysis using this data, as in Boynton, DeFilippes, and Legel¹⁷ and Weiner¹⁸ confirms many of the findings from previous studies. The distinction continues to be large (on the order of \$140 billion) and stock options constitute a sizable fraction of that gap for 2004, the first year for which M-3 data is available.

The M-3 has been very useful for providing a broad characterization of the differences between the two profit reports. It is worth noting that the usefulness of the M-3 has been limited by its confidential nature. Data are accessible only to researchers granted explicit access, and then only with a lag of several years. And, obviously, investors cannot access information about their specific firms. Moreover, the fundamental differences between the two reporting systems remain large and permit a decomposition of the overall gap only into broad categories.

Part of the argument for greater conformity rests on the three fairly uncontroversial facts above. First, investors should be able to infer what a firm pays in taxes and the dual reporting system currently does not permit that. Second, investors and the government have a common interest in understanding what economic profits are and there is no reason to have two systems as there is a common goal. Finally, the large deviations that have arisen between the profits reported to capital markets and tax authorities are confusing and cloud the interpretation of corporate profits at the aggregate and corporate level.

While these facts relate to the difficulties created by the dual book system, the corporate governance view of taxation suggests potential distinct advantages associated with adopting a greater degree of conformity. First, a system characterized by greater conformity allows for an additional monitor, the IRS, to review the same profit reports that financial investors receive. Second, managers cannot use the distinction between book and tax reports to manufacture profits or reduce tax obligations, as the examples and evidence above suggest they do. Finally, the taxes paid by firms become automatically observable to shareholders thereby making the overall economic performance of firms more transparent.¹⁹

The case for conformity is strengthened by the fact that operating two parallel reporting systems creates an obvious redundancy in operating costs for firms. These costs are compounded by employing two groups of people with the particular expertise associated with each distinctive system. Slemrod²⁰ reviews existing evidence on the compliance costs of taxing large businesses. Estimates of the ratio of compliance costs to revenues raised ranges widely from three to 30 per cent. Regardless of the range of these estimates, these

17. C Boynton, P DeFilippes, and E Legel, 'A First Look at 2004 Schedule M-3 Reporting by Large Corporations' (2006) 112 Tax Notes 943–82.

18. JM Weiner, 'Closing the Other Tax Gap: The Book-Tax Income Gap' (2007) 115 Tax Notes 849–61.

19. An example of this is the recent debate over uncertain tax positions and their accounting. See G Morgenson, 'A Tax Secret Emerges from the Murk' *The New York Times* (14 January 2007) section 3.

20. J Slemrod, 'The (Compliance) Cost of Taxing Business' (2006) University of Michigan Working Paper.

costs are thought to be highly regressive, across firm size. And, of course, these costs do not contain estimates of the costs to the US government of enforcing a tax reporting system that is distinct from the reports to capital markets. Compliance costs would not be eliminated in a system with more conformity but clearly some reduction in costs would result. Unfortunately, no reliable estimates exist for such savings.²¹

Efficient tax policies are characterized by lower rates on a broader base rather than high rates on a narrow base. Lower rates and broader bases allow for reduced behavioural responses to taxes and, consequently, lower deadweight losses associated with raising government revenue. Currently, we appear to have a high marginal tax rate, by global standards, on a relatively narrow base and firms responding, as one might expect, by reducing their tax obligations in other ways. Coupling a move toward greater conformity on the broader base of financial accounting profits with a significantly lower rate could reduce these significant efficiency costs and reduce the efforts by firms to engage in such activities.

Understanding the precise magnitude of the feasible tax cut requires much more analysis. Rough estimates, elaborated on in Desai,²² suggest that a 15 per cent tax on reported profits could generate the same revenues as the corporate tax does now. Emphasizing the experience of US multinational firms, Erickson, Hanlon, and Maydew²³ estimate that conformity could result in revenue-neutral corporate tax reductions to a statutory rate of 26 per cent. These initial efforts to understand what reductions in tax rates could accompany a broadening of the base could usefully be expanded on by government researchers that have tax information available to them.

There are two primary concerns about greater conformity that arise repeatedly in current debates. The primary difficulty with advancing toward greater conformity is the political dimension. There are two possible political consequences that are concerning. First, the government might lose some freedom over tax policy in a totally conformed system. In particular, the ability to change depreciation schedules to provide investment incentives may not exist in a totally conformed system. This concern is mitigated by the fact that few advocate a completely conformed system but instead the use of financial accounting measures as a default, with then accepted departures dictated by policy makers.

21. The remarkable magnitude of deferred tax assets and liabilities (see J Poterba, N Rao, and J Seidman, 'The Significance and Composition of Deferred Tax Assets and Liabilities' (2007) NBER Working Paper 12923) also places increasing pressure on firms to explain the valuation of these accounts to rating agencies and investors. While the costs associated with this are unclear, the pervasive nature of these accounts and their growing values are presumably associated with costs that could be limited in a system characterized by greater alignment.

22. See Desai (n 1).

23. See Erickson, Hanlon, and Maydew (n 6).

The second, and more severe, concern is that accounting bodies would face more lobbying and political pressure from legislative bodies about accounting definitions if taxes were associated with financial accounting definitions. As Zeff²⁴ elaborates, financial accounting standard setting bodies have been subject to, and have sometimes accommodated, intense pressure by legislators and firms. Indeed, one such example relates to the treatment of option expensing. With greater conformity, the incidence of such lobbying could increase, particularly as legislators became concerned about the definitions of accounting items that could influence tax policy. A system of absolute conformity would be subject to such concerns, although a reasonable system where financial accounting was the default and exceptions were allowed would seem to be less subject to this concern. Finally, the convergence of accounting systems toward international accounting standards, as described below, might also limit this political pressure as the relevant bodies may be somewhat insulated from political influence through the acknowledgement of supranational standards.

Critics of conformity also emphasize the loss of information to investors from a potential conformed system. This loss of information is purported to arise because of a manager's willingness to sacrifice the accuracy of reports to investors and accounting profits in order to save taxes. Evidence for this point of view draws on studies of several countries with conformity as well as analyses of the imposition of conformity in particular parts of the reporting environment.²⁵

The cross-country evidence, unfortunately, is limited by the handful of countries that are analysed and by the fact that this evidence is most properly interpreted as indicating that a cluster of institutions—concentrated ownership, bank-based systems and book-tax conformed income—are associated with less informative earnings.²⁶ Indeed, studies by scholars in countries with conformity experiences (such as Schön²⁷) suggest that many of the concerns over conformity are overstated.

More generally, examining a narrow change to reporting rules toward conformity may also not be informative about a wholesale change toward conformity—much as narrow tax

24. SA Zeff, "'Political' Lobbying of Proposed Standards: A Challenge to the IASB' (2002) 16 *Accounting Horizons* 43–54.

25. See for example Hanlon, LaPlante, and Shevlin (n 15).

26. The few studies of this issue include R Ball, S P Kothari, and A Robin, 'The Effect of International Institutional Factors on Properties of Accounting Earnings' (2000) 29 *Journal of Accounting and Economics* 1–51; R Ball, A Robin, and J Shuang Wu, 'Incentives Versus Standards: Properties of Accounting Income in Four East Asian Countries' (2003) 36 *Journal of Accounting and Economics* 235–70; and DA Guenther and D Young, 'The Association between Financial Accounting Measures and Real Economic Activity: A Multinational Study' (2000) 29 *Journal of Accounting and Economics* 53–72, who consider the effects of reporting environments on the quality of information in a handful of countries.

27. W Schön, 'The Odd Couple: A Common Future for Financial and Tax Accounting' (2005) 58 *Tax Law Review* 111–48.

reforms may lead to misleading implications about the consequences of wholesale tax reforms. In short, very little is known about the imposition of conformity from an empirical perspective. As suggested below, recent movements toward conformity in various parts of the world may offer a promising empirical setting for considering these questions. More generally, there is limited theoretical work on the merits or costs of dual reporting systems. Given the centrality of information systems to both tax systems and investor rights, much greater empirical and theoretical work is warranted prior to making any conclusions about the loss of information associated with conformity.²⁸

The international experience with conformity is rapidly changing and many countries are now experimenting with greater levels of conformity. These changes have been triggered by the widespread growth of the International Financial Reporting Standards (IFRS) via the International Accounting Standards Board. In short, many large countries have adopted or mimicked IFRS and many others, including the US, have embarked on convergence projects that target the same endpoint.²⁹

The EU's mandated use of IFRS has triggered a reevaluation of the degree to which tax accounting should also use IFRS. The advent of IFRS has led commentators to call for the use of IFRS as the logical starting point for tax accounting, creating a potentially sizable degree of conformity. See, for example, Schön.³⁰ The current state of play is summarized in Endres, Köhler, Oestreicher, Scheffler, and Spengel³¹ which documents how European Union countries reflect IFRS principles and practices to varying degrees in their tax laws. As described in detail there, considerable overlap exists between IFRS and tax accounting rules. Indeed, the European Union is now considering using the IFRS as the starting point for a Common Consolidated Tax Base. See Norberg³² for a discussion of this proposal, a rich set of examples of countries reacting to IFRS and the issues associated with such transitions.

One example of particular note is the United Kingdom. The recent experience in the UK is summarized in Freedman,³³ who details how the advent of IFRS has led to greater,

28. This concern, while historically relevant, also seems less pressing for the case of public corporations today that prioritize investor perception. These concerns would be even less relevant with lower rates of corporate taxation. It is possible that firms would respond to conformity with a changed emphasis on different definitions of income—so called *pro forma* earnings, for example—to facilitate tax avoidance while preserving positive impressions with investors.

29. For more on the evolution of IFRS, see C Armstrong, ME Barth, A Jagolinzer, and EJ Riedl, 'Market Reaction to the Adoption of IFRS in Europe' (2007) Stanford University Graduate School of Business Working Paper.

30. W Schön, 'International Accounting Standards—A Starting Point for a Common European Tax Base?' (2004) 44 *European Taxation* 426–40, and Schön (n 27).

31. D Endres, S Köhler, A Oestreicher, W Scheffler, and C Spengel (eds), *The Determination of Corporate Taxable Income in the EU Member States* (Kluwer Law International, Amsterdam 2006).

32. C Norberg, 'Kara Tikka Memorial Lecture: Accounting and Taxation' (2007) Working Paper.

33. J Freedman, 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges' (2004) 2 *eJournal of Tax Research* 71–99.

but not complete, conformity in the UK. Specifically, legislative efforts to make IFRS the default definition of income for tax purposes have been followed by case law developments and the actions of standard setters to modify IFRS to accommodate the necessities of tax law. While a complicated transition requiring effort by legislators, standard setters and judges, these efforts and subsequent development appear to have been successful and have been met with acceptance by companies and investors. There certainly has not been the doomsday outcome suggested by critics of conformity.

Oversimplifying the international experience into countries with and without conformity is not accurate. Accounts of some countries as being hampered by conformity and no longer abiding by it are similarly inaccurate.³⁴ The advent of IFRS has stimulated many changes in this arena with many countries employing it as an opportunity to advance conformity, with apparently salutary effects. Other countries, such as Germany, are in the midst of reconsidering traditional conformity measures in the world of IFRS. Much more research could be done in the international arena to further understand the effects of conformity, as evidenced by the case examples provided in Freedman, Norberg, Schön, and Endres, Köhler, Oestreicher, Scheffler, and Spengel.³⁵ The IRS could also benefit from looking to the experiences of other countries with greater conformity to further understand the potential effects in the US setting.

Conclusion

Revisiting the links between corporate governance and taxation offers some lessons for the design of the information systems employed by tax authorities and capital markets. In short, the corporate governance view of taxation recommends a reconsideration of the dual reporting system and an increased reliance on alignment of financial and tax accounting whenever possible. In addition, such an alignment can have significant benefits in terms of lowered compliance costs and holds the promise of lower tax rates on a broader tax base. The recent experiences of several countries offer the promise of furthering our understanding of how corporate governance and taxation interact and are influenced by the information environment.

34. Indeed, some commentators have suggested that the dominant trend is toward alignment.

35. See Freedman (n 33), Norberg (n 32), Schön (n 30 & n 27), and Endres et al (n 31).

13 Analysing the Impact of Tax Avoidance

Michelle Hanlon

This chapter is based on a paper which was co-authored with Joel Slemrod entitled ‘What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News about Tax Aggressiveness’.¹ In this paper, we investigate the stock market reaction to the first mention in the news media (press or newswires) that a firm was involved in a tax shelter. We have a sample of 108 observations consisting of the first time a firm was mentioned in the press for being in a particular tax shelter (the same firm can be included multiple times in this sample if they are in the press for being in more than one shelter). We do not make an *ex ante* prediction regarding the sign of the overall reaction because there are competing hypotheses.

One hypothesis is that the market reaction could be negative for at least one of the following reasons. First, if the shelter were disallowed the firm might be subject to additional taxes, penalties, and interest and if these were not previously accounted for it would mean the firm’s earnings were not as high as previously reported and the market would likely react negatively. Second, if a firm is identified as a low taxpayer or tax avoider the firm may bear political or reputation costs of being labelled a ‘poor corporate citizen’ for not paying their fair share of taxes. Third, is that investors might interpret news about a firm’s tax aggressiveness as evidence that the firm is not only willing and/or adept at being aggressive with the tax authority, but that the firm is willing and capable of being aggressive with investors as well.

However, the alternative hypothesis is that the market reaction could be positive. In order to maximize the value of the firm, shareholders would like to minimize corporate tax payments net of the private costs of doing so. In other words, shareholders want a company they own to be optimally aggressive in their tax reporting. As stated by Alan Murray in a *Wall Street Journal* article in 2002, ‘Lying to the IRS doesn’t generate the same public outrage as lying to shareholders. In some quarters of the country, it is almost seen as a patriotic act’.² Learning that a firm is in aggressive tax positions may make owning its shares more attractive and thus, information that the firm was in a tax shelter may be positive news to the market.

1. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975252>.

2. A Murray, ‘Inflated Profits in Corporate Books is Half the Story’ *The Wall Street Journal* (New York 2 July 2002).

Thus, because there are reasons why the market reaction to news that a firm is tax aggressive may be negative or positive we make no *ex ante* prediction. Testing the market reaction over the three-day window surrounding the first mention of the firm's involvement in the shelter, we find that the market's reaction is negative, but fairly small. For the entire sample, the reaction is -0.44 per cent (and insignificant at conventional levels). For a sub-sample of observations (70 observations) where the press mention is in a 'major' press source (ie, *The Wall Street Journal*, *The Washington Post*, or the major newswires), we find that the market reaction over the three-day window surrounding the event is -1.16 per cent on average, which is statistically significantly different than zero.

Although we do not have an overall directional prediction for the market reaction to news of tax aggressiveness, we make several cross-sectional predictions and find evidence generally consistent with these predictions. First, we find that the stock price reaction is smaller for firms that have better governance (as measured using the governance score developed by Gompers, Ishii, and Metrick (2003)—an index of shareholder rights from 0–24 where a lower score indicates better governance). For example, the average market reaction for well-governed firms (those with a governance score below the median in our sample) is -0.20 per cent and the average market reaction for the poorly-governed firms is -0.86 per cent. The returns for the poorly-governed firms are statistically significantly negative using three out of four of our test statistics, while the returns for the well-governed firms are not statistically different from zero. Thus, there is some support for the hypothesis that poorly-governed firms will have a more negative response to news of tax aggressiveness.³

We also test other cross-sectional predictions. For example, we examine whether firms in the retail sector have a more negative reaction because these firms are more subject to consumer backlash. We find some limited evidence consistent with this prediction. Finally, we investigate whether the market reaction varies with the market's perception of how tax-aggressive the firm is, using the firm's current effective tax rate (current tax expense/total pre-tax book income) as a proxy for the market's beliefs. We find mixed results with respect to the tests of this prediction.

We also explore the stock price reaction to reports of current effective tax rate calculations released by Citizens for Tax Justice. We hypothesize that these reports signal tax aggressiveness without implications for tax penalties or illegal behavior that tax shelter news carries, and therefore any market reaction represents a pure reputation effect. We find no statistically significant stock price reaction to the report, suggesting that the negative reaction to the tax shelter news is not predominantly a reputation effect.

3. The returns for the well-governed and poorly-governed firms are not statistically different from each other, however. In tests on the sub-sample of firms with mentions of tax shelter involvement in the major news sources, we find that the market reaction for the well-governed firms is -0.55 per cent on average and -1.69 per cent on average for the poorly-governed firms. These reactions are significantly different from each other (one-tailed p-value of 0.085).

Overall, we conclude that the news that a firm is tax aggressive is viewed negatively by the market, but the reaction is small and does not seem to be predominantly due to harm to the firm's reputation.

14 Analysing the Impact of Tax Avoidance: A Response

Graeme Macdonald

In his work, Mihir Desai challenges the traditional assumption that tax avoidance represents a transfer of value from the state to shareholders. His thesis is tested by asking whether tax avoided is captured in share values. Michelle Hanlon's work is similarly concerned with the reflection of tax avoidance in share values, but concentrates on the announcement effect on share prices following media reports of tax shelter involvement.

Before commenting further it has to be noted that none of this research can be taken to suggest that tax avoidance is *not* a transfer of value from the state (or perhaps, more correctly that it is not the avoidance of transferring wealth *to* the state). Tax avoidance, if successful, always represents a loss of tax revenues to the state;¹ the question that the research mentioned above raises is who benefits from tax avoidance.

Share values reflect expectations about future outcomes; reported profits broadly reflect completed transactions, subject to the usual discretionary spreading of costs and revenues across accounting periods under conventional accrual accounting on which generally accepted accounting principles (GAAP) are based. Tax that has been avoided is irrelevant to the future except insofar as it is a predictor of tax avoidance in the future,² but the tax information given in accounts is usually an amalgam of unconfirmed provisions for some periods, and differences between prior provisions and confirmed liabilities for other periods. It is therefore inherently difficult to establish the exact level of avoidance for any period.

If tax avoidance is predicted for the future we might expect it to be valued differently from other predicted gains: it will almost certainly be considered more risky³ than other future inflows, and the benefits might be considered to be of shorter duration. This assessment of risk by investors is different from the avoidance 'risk' that concerns HMRC, which is about identifying the behavioural propensity to undertake tax avoidance, though this will be reflected in the avoidance outcomes evaluated by investors. An expected low

1. Unless there is some incentive effect which results in an increase in the tax base above that which would have prevailed in the absence of avoidance.
2. For example, because ongoing avoidance structures or strategies shelter future income streams.
3. The tax saved must be as risky as the underlying income flows which are taxed; the possibility that those flows may not be reduced by tax is an additional risk (unless the savings are considered certain).

propensity to engage in avoidance, if correct, will mean low tax savings being incorporated in share valuations, and a higher propensity, high tax savings; but the risk that the investor attaches to those savings being realized will depend on the assessment of likely success in avoidance. There is also a further distinction to be made between these risks and the amount of tax 'at risk'. This latter term is a function of the absolute size of the tax base of a company together with the assessed probability of it failing to comply with tax rules or of it engaging in avoidance.

The announcements observed by Michelle Hanlon will either have represented new information or confirmation of prior expectations. The finding that the market reaction (in terms of share value) is not positive suggests either:

- a. that the predicted net income after tax is riskier or shorter term than was previously thought because it relies on tax avoidance (new information); or
- b. that future after-tax incomes are likely to be lower because the tax avoidance activity is now in the public domain making it more likely that:
 - i. the loophole will be closed down;
 - ii. there will be political or reputation costs (confirmatory information).

What is not known is whether the market value would be higher if there were no tax avoidance.

Michelle Hanlon's research provides some support for Mihir Desai's hypothesis that the share price of poorly-governed firms reflects tax avoidance less positively or even negatively as compared with well-governed companies. Both researchers suggest that tax avoidance in poorly-governed companies is correlated in investor expectations, with managers acting in their own interests at the expense of investors. Desai specifically suggests that this means that managers will engage in tax avoidance if the scheme enables them, the managers, to profit thereby, but otherwise will not bother. The loss to the state is either wholly or partly to the benefit of the managers.

It could be, of course, that investors would regard tax avoidance undertaken by poorly-governed firms as being riskier (less likely to be successful) than tax avoidance undertaken by well-governed firms, though Desai argues that this is not the case. It may be that the secrecy and obfuscation that he refers to is in fact more closely allied to tax evasion than avoidance, or to inherently doubtful, and so risky, avoidance, all of which may be characteristic of poorly-governed firms. However, whatever the cause of differential valuation as between types of companies, there seems to be no conclusive evidence as to the level of tax avoidance in either type. That the effect on the share values of well-governed firms is positive could suggest that investors consider the avoidance activities of those firms likely to be successful. Arguably, therefore, tax avoidance is more problematic, in the sense of actually losing tax revenues, from the state's point of view in the case of well-governed firms.

In all the research it is acknowledged that the measurement of the extent of tax avoidance is difficult,⁴ and the use of the 'book-tax' gaps are used as proxies for tax avoidance activity. There are now requirements in the US⁵ to disclose more fully the basis of tax provisions, and it remains to be seen whether this has any impact on share valuation. If it could be shown that engagement in tax avoidance really does reduce firm values below that which would apply in the absence of tax avoidance, then, assuming that managers are influenced by share value, a requirement to reconcile the reported tax liability with a nominal tax liability based on reported income and statutory tax rates might be a useful way of publicizing tax avoidance. However, intuitively it remains difficult to see why tax avoidance should reduce a firm's value below that which it otherwise would be, unless there are significant costs to reputation resulting in expectations of net of tax income streams being lower than otherwise would be the case, or penalties which mean that failed schemes have actual costs for a firm.

4. See discussion above.

5. FIN 48.

15 Aggressive Tax Behaviour and Corporate Social Responsibility

Reuven Avi-Yonah¹

The boundary between acceptable and unacceptable corporate tax behaviour is difficult to draw from the perspective of the legislator, the tax administrator, or the judge. However, it may be easier to draw this line from the perspective of the corporate tax planner. This raises the question of what is the appropriate response for a corporate executive confronted with a plan that may pass legal muster in a court of law, but that the executive knows is purely tax motivated and has no business purpose other than tax reduction.

This chapter will draw on the corporate social responsibility (CSR) literature to argue that the appropriate response is not to implement the transaction.² This is relatively easy to establish if one views the corporation primarily as a creature of the state or as a free-standing entity similar to an individual, because both of these attitudes legitimize CSR and the refusal to engage in aggressive tax planning can be conceived as a form of CSR. However, the interesting point is that aggressive tax planning may not be appropriate even if one adopts the academically dominant nexus of contracts theory of the corporation, with its concomitant delegitimization of CSR, and if one assumes that aggressive tax planning increases returns to shareholders. The reason is that if all CSR is illegitimate, the entire responsibility for addressing social issues devolves on the state, but the state may not have adequate resources to deal with these issues if aggressive tax planning is allowed. It is not likely that supporters of the nexus of contracts view would advocate a situation in which nobody is able to address social problems.³

It will immediately be argued that this scenario is unrealistic: since in OECD member countries the corporate tax amounts to less than 10 per cent of total tax revenue, the state can replace the lost revenue from corporate tax avoidance by raising other taxes. But even if one sets aside issues of distribution and fairness (lowering taxes on capital usually means

1. This chapter appears in a longer form as 'Corporate Social Responsibility and Strategic Tax Behavior' in W Schön (ed), *Tax and Corporate Governance* (Springer-Verlag Berlin and Heidelberg GmbH & Co KG 2008) 183. It is reprinted here with permission of the editor, W Schön, on behalf of the publishers.
2. Strange as it may seem today, this was in fact the common response of most corporate executives to such transactions before the tax function became a 'profit centre' around the mid 1990s.
3. Shifting the burden to the charitable sector is not a solution because corporations are barred by the nexus of contracts view from donating to charities as well.

higher taxes on labour), this answer is inadequate for three reasons. First, there may be political constraints to raising other taxes; especially in the US context it seems glib to say that politicians could respond to a decline in the corporate tax by raising individual tax rates. Second, individual tax rates may already be set so high that it becomes highly inefficient and potentially counter-productive to raise them further. If individual rates are set very high, there will be an impact on both the labour/leisure trade-off and on the willingness of individuals to pay taxes, on which the system depends. Finally, in many non-OECD countries, as well as in some OECD members like Japan, the corporate tax amounts to a far higher percentage of total revenues. It has been shown that tax competition, which is itself a form of strategic tax behaviour, has resulted in significant declines in tax revenues in developing countries, which have not been offset by tax increases elsewhere.

It can also be argued that aggressive tax behaviour by corporations is positive in situations where the government is ineffective or corrupt, and therefore the funds can be put to better use in the private sector. This is precisely the reason that under the real entity view of corporations CSR is acceptable, because in many situations corporations are better situated than the government to address social problems. But this argument cannot be made under the nexus of contracts view, because under that view almost all CSR is illegitimate and solving social problems is the exclusive responsibility of the government.

16 ‘Aggressive Tax Behaviour’ and Corporate Social Responsibility: A Response

Ross Fraser

This note is a response to the previous chapter by Reuven Avi-Yonah, with further consideration of his longer published paper.¹

Preliminary Issues

Is There an Ethical Dimension?

In relation to fiscal dishonesty there is a plain ethical dimension—it is wrong to steal from or defraud other people and it makes no difference whether the victim of the theft or fraud is the Government (economically, the aggregate of the perpetrator’s fellow taxpayers) or a corporation or natural person. However, most lawyers (at any rate) would see a sharp distinction between the assertion of one’s property rights (in competition with the Government), without any element of dishonesty, on the one hand, and dishonest behaviour on the other. One can therefore confidently omit consideration of dishonest conduct from this debate.

Judicial statements can however be found in UK tax jurisprudence to the effect that (well short of dishonesty) there is something ethically unacceptable about tax avoidance—arranging one’s affairs to produce a beneficial fiscal result. So we find Lord Templeman in *Ensign Tankers v Stokes* remarking of a particular tax saving arrangement:

The scheme is one of many; it reflects no credit on Guinness Mahon, the merchant bank that invented it, or on the appellant and the other industrial companies which purchased it for many hundreds of thousands of pounds.²

However, in analysing the scheme (and concluding that it did not work, essentially on the basis of construction of the private law documents by which it was carried into effect³) Lord Templeman said this (which one could argue is what he really meant):

1. RS Avi-Yonah, ‘Corporate Social Responsibility and Strategic Tax Behavior’ in W Schön (ed), *Tax and Corporate Governance* (Springer-Verlag Berlin and Heidelberg GmbH & Co KG 2008) 183.
2. [1992] 1 AC 655 (HL) 667 G.
3. [1992] 1 AC 655, 682 D–683 G, esp 683 B–D.

But there is no morality in a tax and no illegality or immorality in a tax avoidance scheme.⁴

Another occasional feature of the UK judicial rhetoric is that deliberately created arrangements designed to reduce tax are open to the ethical objection that those who embark on them are thereby deliberately shifting the burden of tax from their own shoulders onto the shoulders of others. A recent illustration is found in the judgment of Lightman J in *John Lewis Properties plc v IRC*:

I reach th[e] conclusion [that the tax planning arrangement ‘worked’] with reluctance . . . The approach [of the Revenue, in the case] has the attraction that it will strike down attempts to exploit devices to exempt from income tax which can only have the effect of transferring the tax burden on to others.⁵

There are two problems with this ‘watered down’ ethical approach (which, if we have followed his argument, is not espoused by Avi-Yonah). First, it assumes that total Government expenditure is fixed, which is not so far as is known in accordance with the facts—and indeed Avi-Yonah’s concern is that aggressive tax planning may deprive the state of adequate resources to deal with social issues, implying that such planning is liable to reduce the tax of the planners without increasing that payable by others. Secondly, this potential ethical objection cannot be evaluated without an investigation of where the burden was intended by the legislature to fall in the first place. This is not always self-evident. Simply sharing out Government expenditure on a simple basis (eg, per capita) is most unlikely to be workable or acceptable in a modern state, and once the division depends on more or less elaborate rules the (possibly ethical) debate about shifting the burden is heavily influenced by (if not virtually subsumed within) the technical debate about whether the scheme ‘works’.

It is therefore counterproductive to attempt to conduct the debate about the propriety of aggressive tax planning on an ethical basis. That is not to say that a radical and wholehearted application of corporate social responsibility (CSR) is not to be commended on ethical grounds—that may well be so. But even if it is so, it could be argued that if CSR is to be adopted or encouraged or even demanded by current corporate law that can only be because of some quality inherent in CSR, and not because of its ethical effect (which could be characterized in this context as a ‘side’ effect). For completeness, we should add one point. It does not automatically follow from the fact that a course of conduct is ethical that the directors and officers causing the company to follow it are not in breach of their duties. In other words it is at least theoretically possible that the discharge of duties may require unethical conduct.

4. [1992] 1 AC 655, 668 B–C.

5. *IRC v John Lewis Properties plc* [2001] STC 1118 (Ch) [39] (Lightman J).

Boundaries (and 'Pushing at' Them⁶)

The equator is the boundary between the northern and southern hemispheres. However it corresponds with no physical features. It can exist only in the human intellect even if there is wide consensus as to where it lies. Pushing at something has no effect unless the 'something' moves. Likewise, the line between that which is taxable and that which is not is an intellectual boundary, though in the absence of a relevant judicial decision there may be no consensus as to where it lies. Not only is it pointless to push at such a boundary—there is nothing to push at, in this author's view. It is suggested that this notion also does not assist the debate much and that it should be seen as a possibly justified expression of frustration by the sponsor of UK fiscal legislation that the legislation does not always produce the result intended by the sponsor either 'first time' or, possibly, at all.

The Three Theories of Corporate Existence Referred to by Reuven

We can unhesitatingly say that the principle underlying UK corporate law is that of the 'nexus of contracts' described by Avi-Yonah, rather than the alternative artificial entity/creature of the state theory, or the 'real entity' theory, and it is noteworthy that, despite a wide-ranging review of company law (including directors' duties) culminating in the Companies Act 2006, there has been no detectable shift to the artificial entity or 'real entity' theory.⁷ The consequence is, as Avi-Yonah remarks, that CSR in relation to tax is not per se legitimate but has to be justified on some other basis, which, he suggests, is the danger that the state will be deprived of the resources it needs to carry out its social agenda. This is the nub of the argument, to which we will now turn.

Is the Exchequer Really at Risk of Being Deprived, by Aggressive Tax Planning, of the Resources to Pursue its Social Agenda?

Practical Experience So Far

So far as the UK is concerned, we could argue that there is no substantial danger of the kind to which Avi-Yonah refers.⁸ Junior politicians have, it is true, been known to make

6. This concept has been put forward by Her Majesty's Revenue & Customs ('HMRC'), the UK taxing authority, in their paper 'Making a difference: delivering the review of links with large business' (March 2007) [3.3]. It is suggested by HMRC that interventions (audits) will be more rapid and frequent for taxpayers who 'repeatedly [push] at the boundaries of the law'.

7. It is true that the Companies Act 2006 requires a director to 'have regard to . . . the impact of the company's operations on the community'. But this is plainly subsidiary to his duty 'to act in the way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole' (emphasis added)—see s 172. Section 172 also requires directors to have regard to 'the need to foster the company's business relationships with suppliers, customers and others' and 'the desirability of the company maintaining a reputation for high standards of business conduct' (emphasis added). It is doubtful whether 'business' in that context refers to relationships with, or conduct in relation to, HMRC, since the payment of tax is not in strictness part of the company's 'business'. If it were otherwise, it would seem to follow that corporation tax would be a tax deductible expense of management for an investment company.

8. See Ch 15, this volume, Reuven Avi-Yonah, 'Aggressive Tax Behaviour and Corporate Social Responsibility' para 2.

remarks (in relation to tax avoidance) to the effect that tax avoidance limits the ability of the state to pursue its social agenda (the ‘schools and hospitals’ rhetoric). However governmental actions speak louder than words. In the late 1950s, a form of tax planning was developed which would have resulted in a refund to companies of tax which had never reached the Exchequer and the amounts were very large. The then Government—which might have been expected to be sympathetic to ‘big business’—dealt with the threat (after a ‘misfire’⁹) by introducing provisions¹⁰ which were (by the standards of the time) of draconian severity, capable of extending to numerous ordinary transactions not involving the so-called ‘refunds’ and conferring an unusually wide discretion on the taxing authority. The Courts, it should be noted, were wholeheartedly supportive of the Government, both in striking down transactions carried out before enactment of the new provisions¹¹ (again after a ‘misfire’¹²) and later in applying the new provisions.¹³

Much more recently, concern grew about avoidance of liability to personal income tax and social security contributions by apparently artificial devices. The amounts potentially at stake were (in line with the tendency Reuven notes in other OECD countries¹⁴) much higher than the amounts involved in planning to reduce corporate taxes. Part of the Government’s response was to give notice that *retrospective* legislation—otherwise unthinkable—would be introduced to counter the devices.

It is also necessary to notice the disclosure regime introduced in 2004. We could suggest that this is in part at least an attempt to improve the effectiveness (if not the quality) of tax legislation by drawing on private resources¹⁵ to enable the Government to increase its understanding of how the tax code applies to business operations and the interaction of

9. F (No. 2) A 1955, s 4 and Sched. 3.

10. FA 1960, s 28, now ICTA 1988, s 703 et seq (for companies); Income Tax Act 2007 (‘ITA’), s 682 et seq (for individuals).

11. See for instance *Lupton v FA & AB Limited* (1971) 42 TC 86 (where Mr S Templeman QC, as he then was, appeared for the taxpayer).

12. *Harrison (JP) (Watford) Limited v Griffiths* (1962) 40 TC 281 (HL).

13. See for instance *IRC v Cleary* (1967) 44 TC 399 (HL), *Greenberg v IRC* (1971) 47 TC 240 (HL) where Lord Reid said (at 272): ‘We seem to have travelled a long way from the general and salutary [and now—2007—probably obsolete] rule that the [taxpayer] is not to be taxed except by plain words. *But I must recognise that plain words are seldom adequate to anticipate and forestall the multiplicity of ingenious schemes which are constantly being devised to evade* [sic] *taxation. Parliament is very properly determined to prevent this kind of evasion* [sic] *and if the Courts find it impossible to give very wide meanings to general phrases the only alternative may be for Parliament to do as some other countries have done and introduce legislation of a more sweeping character* [than ICTA 1988, s. 703 et seq; ITA 2007, s.682 et seq] *which will put the ordinary well-intentioned person at much greater risk than is created by a wide interpretation of [the] provisions of* [ICTA 1988, s 703 et seq; ITA 2007, s 682 et seq]’ (author’s emphasis). In the passage cited, Lord Reid (who was Scottish) uses ‘evade’ and ‘evasion’ in a sense that is no longer customary in England. Today, ‘evade’ means (in England) ‘dishonestly escape liability for’.

14. See Avi-Yonah (n 1) text to (n 13) in W Schön (ed).

15. Without payment.

commercial law and tax law. Legislation of this kind was unprecedented. It may have given (or may, in due course, give) the legislator sufficient material accurately to draw the boundary between what he wants to tax and what he does not, though, as in the case of the threat of retrospective legislation just mentioned, it is probably too early to tell whether the regime is completely efficacious.

The Courts' Attitude

It is not clear that Avi-Yonah's phrase 'passing legal muster'¹⁶ would accurately encapsulate the UK Courts' current attitude to aggressive tax planning. It is certainly not the case that such planning enjoys widespread unvarying judicial support.¹⁷ Judicial rhetoric and the Courts' traditional diffidence about explicitly acknowledging that they legislate are apt to mislead and to widen the 'do-say' gap.¹⁸ Although the 'glory days' of distorting the facts so as to deny the taxpayer a tax advantage he sought may be over,¹⁹ 'purposive construction' of tax legislation—more accurately 'strained and purposive' construction—is now general and it is now clear, for instance, that the general desideratum of taxpayer certainty may need to be subordinated to the furtherance of the purpose of the legislation by such construction.²⁰

Expectations of the Tax Gatherer, Where These Are More Onerous for the Taxpayer than the Law

The present position is clear—save to the extent that such expectations can be justified by strained and purposive construction (based on *Parliament's* presumed intentions) they are, broadly, legally irrelevant. In the area of administrative law *legitimate* expectation is generally and increasingly regarded as worthy of legal protection.

16. See Avi-Yonah (n 8), third sentence.

17. See for instance *IRC v Scottish Provident Institution* [2005] STC 15 (HL) [22], [23]. This case and contemporary judicial attitudes are discussed by J Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 LQR 53–90.

18. By which is meant the gap between what judges say and what they do, including the gap between the real reason for a decision and the reasons given for it.

19. See *IRC v Ramsay* [1981] STC 174, *Burmah Oil v IRC* [1982] STC 30, *Furniss v Dawson* [1984] STC 153 (all HL). This approach is not quite dead—more recently Ribeiro PJ spoke in the Court of Final Appeal in Hong Kong of 'the purposive interpretation of statutes *applied to the facts viewed realistically*' (author's emphasis)—*Collector of Stamp Duties v Arrowtown Assets* [2003] HKCFA 46 at [39].

20. See *Carreras Group Limited v Stamp Commissioner* [2004] STC 1377 (Judicial Committee of the Privy Council [Jamaica]) [16]. Lord Hoffmann (who delivered the judgment of their Lordships in that case) has suggested extra-judicially (and rhetorically) that tax avoidance is now impossible (see Leonard Hoffmann, 'Tax Avoidance' (2005) 2 BTR 197–206). If tax avoidance consists in flouting the intention of the legislature and a strained and purposive construction will be given (if necessary) to the words to give effect to that intention, the logic is as immaculate as it is inescapable. The practical flaws seem to lie in the facts that (i) not all tax disputes reach the higher appellate Courts and taxpayers, tax authorities and the lower Courts' interpretation of 'strained and purposive construction' may risk falling short of the true doctrine and (ii) (as experience and the facts of the decided cases selected by HMRC for litigation suggest) that HMRC are not yet fully attuned to the need to seek out the presumed intention of Parliament, as distinct from the intention of HMRC either at the time of enactment or later.

However in the tax field:

the taxpayer's only legitimate expectation is, *prima facie*, that he will be taxed according to statute, not . . . a wrong view of the law.²¹

Accepted notions of the rule of law suggest that what is sauce for the taxpaying goose should be sauce for the tax-gathering gander—indeed a *fortiori*, since the latter, unlike the former, is a public authority. Why then should the expectations of the taxing authority be relevant to directors' behaviour, to the point where the disappointment of such expectations might be regarded as giving rise to some kind of sanction? Changing the current position in this respect would seem to involve revisiting not just the machinery by which tax legislation is produced and the manner of its drafting (which, it is suggested, are overdue for reconsideration), but also constitutional issues settled several hundred years ago, and to involve issues far larger than we have space for.

Conclusions—Do We Need Mandatory CSR?

Perhaps we need a careful investigation of the place which CSR ought to play in our company law. Such an investigation need not, and in this author's view should not, be restricted to tax planning. Unless and until such a review takes place and the law is changed, it is suggested that CSR plays as such no part in directors' duties so far as tax planning is concerned. Indeed the relentless pursuit of CSR to a degree not justified by the company's true business interests may (as has been suggested) itself evidence a breach of duty. It should also not be forgotten that in some respects society may (in the long run) benefit more from a company's continued existence and prosperity²² than from the immediate application of its assets to social ends.

That is not to say that directors observe their duties by (for instance) insisting on litigating a tax dispute when a compromise or even surrender is an option, or that any tax device (however bizarre in the context of the company's normal business or however devoid of prospects of success) must be adopted on pain of a breach of duty.²³ Such decisions, like all business decisions, must be taken in good faith and against a proper and skilful appreciation of the risks and costs involved. The Courts are likely to be influenced, if and when issues related to directors' duties in this area come before them, by the directors' appreciation of the long-term effects of the proposed tax strategy or scheme on the company's business. These effects are not restricted to the amount of one year's tax provision in the financial statements but would (it is suggested) comprehend the effect on

21. See *R v IRC ex p MFK Underwriting Agencies Limited* [1989] STC 873 (CA) per Bingham LJ (as he then was) at 892d.

22. Meaning that it expands, and employs more staff and pays more tax.

23. One effect of the Companies Act 2006 (when it is in force) may be to clarify that compromise or abandonment of tax disputes is not a breach of duty.

the perceptions of other stakeholders (besides shareholders)—customers, suppliers, potential investors, and employees—of 'tax aggressiveness', and hence the indirect effect (if any) of 'tax aggressiveness' on the company's business. (Here, we have deliberately omitted the state (including the taxing authority) from the 'other stakeholders'.²⁴ To do otherwise would seem to substitute an 'artificial entity/creature of the state' philosophy for the current 'nexus of contracts' theory which we have taken as the starting point.) It may indeed be the case that research needs to be done in relation to the impact of 'tax aggressiveness' on these other stakeholders' perceptions, and in the context of a nexus of contracts philosophy, we can consider that it is appropriate to address the matter in the light of those perceptions rather than abstract principles. So far as is known, there is no general prejudice on the part of 'other stakeholders' against companies which pursue an aggressive tax policy.²⁵

One thing that is abundantly clear is that, apart from the exceptional case of apprehended insolvency—which need not concern us here—directors' duties are enforceable at the suit of the company and no one else (not even the 'other stakeholders' we have identified).²⁶ Of course it is open to any stakeholder in his capacity of customer or supplier to obtain whatever terms he can negotiate and if his negotiating position is strong enough, that might include a requirement to observe CSR. If the *Government as a whole* is fully committed to the imposition of CSR (which we can take leave to doubt, given the absence of any explicit CSR provisions in the Companies Act 2006) we might therefore see attempts to introduce such terms into government contracts, for the benefit of the taxing authority. However, in the context of aggressive tax planning, given the nebulous concepts involved, there would be substantial technical challenges in terms of drafting the relevant contractual provision and assessing remedies for breach²⁷ would also be problematic.

24. In making that deliberate omission the author does not intend to suggest that the creation or maintenance of a good relationship with the taxing authority and other organs of government is not a legitimate corporate goal which it may be the duty of the directors to secure, so far as that is consistent with other legitimate goals, such as the preservation of the company's property. However, here we risk straying into the difficult and controversial area, thrown up by recent 'risk assessment' material emanating from HMRC, of equal treatment of taxpayers, which there is no space to discuss here.

25. Recent research has been carried out by Michelle Hanlon, who participated in the Conference for which this chapter was originally prepared, and Joel Slemrod on the effect of 'tax aggressiveness' on the perceptions of investors in US companies (see Ch 13, this volume). The conclusions do not seem inconsistent with personal experience as stated in the text. Statistical work has also been carried out, cited by Hanlon and Slemrod, about the stock-market effect of US federal indictments for price-fixing, which suggests that the main link is between the indictment and financial factors such as the anticipated loss of 'monopoly profits', rather than reputational issues. See Bosch and Eckard, 'The Profitability of Price Fixing: Evidence from Stock Market Reaction to Federal Indictments' (1991) *Review of Economics and Statistics* 309–317.

26. This principle, long established by case law, will become statutory when s 170(1) comes into force.

27. Loss of tax due to aggressive tax planning would be suffered by the Government, not in its capacity of contracting party, but in its capacity of tax-gatherer. One might argue that the former capacity is 'beneficial', the latter, 'fiduciary' and that this may make a difference to the assessment of any damages.

These two points seem to place the idea of imposing CSR by contract firmly in the realms of fantasy.

If we are right in saying that CSR plays no part in directors' duties under existing law (save in the rather indirect sense based on stakeholder perceptions outlined in the last-but-one paragraph) that begs the question whether that is a desirable state of affairs and whether explicit statutory requirements on directors to view tax planning proposals in CSR terms would be a necessary or useful tool to improve our tax system. There is currently uncertainty about the long-term effect of the disclosure regime and the declaration regarding retrospective legislation on employee earnings, and this clouds the issue. But (in view of the absence of any general CSR provision in company law) it is suggested that it is for those who advocate CSR in relation to aggressive tax planning to make the case for its explicit inclusion as such in director's duties, and that the case would have to be a strong one. The judicial armoury, as outlined, is far from bare. It is to the Courts (upon whom ultimately the function of construing and applying any anti-avoidance or other tax provision devolves) that we must look for reliably effective action against unacceptable tax avoidance, for we must recognize that the profound reforms to legislative machinery necessary to produce legislation that produces the right result first time are a distant prospect. It is doubtful whether the power of strained and purposive construction to ascertain the true 'intention of Parliament' has yet been fully appreciated by our taxing authorities. It may be that until the purposive principle has been absorbed into the day-to-day 'vocabulary' of Revenue officials in negotiating tax liabilities, and it is clear what the effect is of other initiatives, such as the disclosure regime and the retrospective outlawing of employment income tax planning, it is too soon to set sail on the uncharted sea of mandatory CSR.

Some Scenarios

The Appendix sets out a few scenarios, suggested analyses and remarks intended to aid discussion.

Appendix

Some Scenarios

Scenario A

Out of the blue, a company receives an amendment to its self-assessment return for a prior year, showing that extra tax is due and the amount is material.

Suggested Analysis

The directors and officers of the company ought to take steps to investigate the legal basis for the amendment. This may involve taking professional advice. Depending on the results of that investigation, the directors and officers may form the reasonable view in good faith that the amendment is unjustified, in which case they may be under a duty to appeal (though this prima facie duty may be qualified by less clear-cut or longer-term effects, such as potential damage to reputation).²⁸ It would probably be a breach of duty to pay the extra tax sought by HMRC without investigation, and in this respect, liability to tax does not differ from the liability asserted by any other claimant.

Remarks

Only the most extreme view of CSR would require the claim to be paid without investigation. That view would seem to render nugatory the appeals process deliberately created by the legislator.

Scenario B

A company (Alpha) embarks on a course of corporate activity, such as a merger with another company (Beta). Directors' duties may require that advice is taken—anyhow advice is in the event taken—and it emerges that there are two ways of carrying out the transaction.²⁹ It is found that there is a substantial difference in the tax position depending on which way of effecting the transaction is adopted.

Suggested Analysis

If, on a proper appreciation of the long-term and short-term effects of the two possible ways of carrying out the transaction, and other collateral effects—such as effect on reputation—there is a clear advantage of the one way as opposed to the other, directors' duties require that the more advantageous way be adopted.

28. In the UK, tax litigation can only be conducted without publicity at the first level of the appeal process.

29. The difference between the two ways may be no more than that Alpha acquires the shares of Beta in exchange for the issue of Alpha shares to the shareholders of Beta, as compared with Beta acquiring the shares of Alpha in exchange for the issue of Beta shares to the shareholders of Alpha.

Remarks

It is doubtful that even the staunchest advocate of CSR would claim that the less advantageous way of implementing the transaction must be adopted. CSR surely does not require the making of what would be gifts to the taxing authorities, any more in this Scenario than in Scenario A.

Scenario C

A company needs cash of 25 monetary units ('MU'). It decides that the amount is best raised by means of a cash advance from a financial institution of that amount, in return for which it pays 6MU p.a. for five years to the financial institution (a total of 30MU, economically representing the 25MU advanced plus an income return to the financial institution of 5MU over the five years). It emerges that there are two ways of implementing the proposal. The legal substance of the one ('Method 1') is a borrowing, in which case the 5MU income return to the institution, only, is deductible for tax purposes. The other way ('Method 2') relates to an income-producing asset which the company owns and which produces (prima facie taxable) income of 6MU p.a. The legal substance of Method 2 is that five years' income from the asset is sold by the company to the financial institution for a price of 25MU and it is assumed that the circumstances are such that a sale of this kind would give rise to no capital gain. The tax result of Method 2 is that no part of the aggregate 30MU of income sold is taxable on the company³⁰ and therefore the company (by adopting Method 2) will have achieved its commercial objective and obtained a more favourable tax treatment than if Method 1 had been chosen.³¹

Suggested Analysis

Subject to any adverse long-term and collateral effects, directors' duties require that Method 2 is chosen. This scenario is not quite the same as Scenario B because it is much more common for companies to need cash than for them to merge with other companies. However, from the point of view of directors' duties, this scenario should be looked at in the same way as scenario B. Any mandatory CSR would seem to have no effect.

Remarks

Similar comments apply to those made in relation to Scenario B. UK tax law operates by reference to the legal substance of transactions, not their economic effect. A tax system which distinguishes between income and capital (as the UK system does) has to 'make up

30. Though it may be taxable on the recipient, the buyer of the income. However the recipient may not be subject to tax on it by reason of some exemption or may not be fully subject to tax on it because the recipient is subject to some special tax treatment.

31. Owing to recent changes in UK tax law, Method 2 is no longer fiscally effective. However the basic facts are derived from the litigation in *IRC v John Lewis Properties plc*, in relation to which the Court of Appeal held, by a majority, that arrangements like Method 2 did work.

its mind' at a fundamental level and at an early stage in its development whether it is going to treat the proceeds of sale of income as income or capital, in the same way that a system of traffic regulation needs to make up its mind whether people should drive on the left or the right. The UK tax system had made up its mind on the point by 1938,³² in favour of treating the proceeds as capital. The main distinctions between this scenario and Scenario B are that noted in 'Suggested analysis' above and that the arrangements are more elaborate and 'deliberate' (and arguably 'artificial') than those of Scenario B. It is suggested that these are distinctions without a difference. It may be that in terms of EU law there would be a difference—since the ECJ seems to be influenced by 'artificiality' in applying VAT law and the provisions of the EU treaty to national domestic tax laws. But this is a purely domestic UK case, and EU law has nothing to do with it.

Scenario D

Same facts as in Scenario C except that:

- (a) the company happens to owe 25MU or more to some third party, and
- (b) there is a special tax rule designed to apply to Scenario C such as to eliminate the tax difference between Method 1 and Method 2. The special tax rule is not completely clear and may only apply where the company receives cash or some other asset in the amount of or to the value of 25MU.

A modified Method 2 is suggested, which involves the financial institution assuming 25MU of the company's debt to the third party (in return for 6MU p.a. paid to the institution for five years as before).

Suggested Analysis

This is the same (as regards directors' duties) as for Scenario C except that the reputational risk may sharpen³³ and the prospects of success may weaken (see under Remarks, below).

Remarks

Modified Method 2 is *prima facie* vulnerable to a strained and purposive construction of the special rule (the taxing authority's prospects of success would depend on a careful examination of the terms of the special rule and its context and legislative history). If the taxing authority fails on this point, a contention that CSR should be mandatory and would have required that the plan not be adopted is disturbing in the context of a democratic

32. According to the majority in the Court of Appeal in *IRC v John Lewis Properties plc*. Of course, in accordance with the declaratory theory of judicial utterance the principle had existed *ab initio*, it was merely revealed in 1938.

33. In the perception of some there will be an analogy between the company's actions and the hypothetical case of a speeding motorist who, on seeing the flashing blue light of a following police car in his mirror (analogous to the special rule), puts his foot down in an endeavour to escape apprehension. See also however note 7 and the text thereto as regards the position under the statutory rules in the Companies Act 2006 and the text between notes 22 and 24 as regards the general position.

society, since the effect of the contention would be to deprive the taxpayer of an advantage which the law allows. (If the taxing authority succeeds, CSR considerations would probably be beside the point.)

17 Acceptable Tax Avoidance?¹

Heather Self

It was 6 February 1984 and, as a recently qualified accountant, I was polishing off my last audit before being allowed to escape to the tax department. The phone rang and a colleague who had been a tax senior for six months told me that the taxpayer had lost in the House of Lords in *Furniss v Dawson*.² Was this the end of tax planning? Had I made a suicidal career move into an area which would be moribund within weeks?

More than 20 years later, we are still debating the question of tax avoidance. We do not yet have a general anti-avoidance rule but Professor Judith Freedman has suggested we should have a general anti-avoidance principle, although perhaps we would have to find another acronym than GAAP. We do of course already have extensive disclosure rules. From HM Revenue & Custom's (HMRC) corner there is much sabre-rattling and talk of 'unacceptable tax avoidance', with the Acting Chairman, Dave Hartnett, promising to stamp this out (whatever it is) by 2008. In the other corner tax advisers keep returning to the crucial distinction between avoidance (legal, whether HMRC likes it or not) and evasion (definitely illegal). Neither side seems prepared to engage constructively on the question of just how tax avoidance should be defined and we seem to be in danger of adopting the Humpty Dumpty definition: 'It means what I say it means, no more and no less'. But if we cannot all agree on what avoidance is, how will we make progress on stamping it out (from HMRC's perspective), or in ensuring that legitimate tax planning is not tied up in endless red tape, to the detriment of UK competitiveness?

I think it would be useful to start by trying to work out what 'acceptable tax avoidance' might look like. I realize I am not the first to do this, nor do I expect my definition to be perfect—but I think it is time we started somewhere.

The Two Elements

In my opinion there are two elements to acceptable tax avoidance. Firstly, the tax planning must relate to a business transaction, such as the sale of a business or a wish to hedge a financial risk. Secondly, the way in which the tax planning is carried out must be commercial. So my hypothesis is that commercial tax planning, related to business transactions, should be considered to be acceptable tax avoidance.

1. This chapter originally appeared as 'In My Opinion: Acceptable Tax Avoidance?' (5 February 2007) *The Tax Journal* 9–10. It is reprinted here with permission of the editor, A Lovejoy, on behalf of the publishers.
2. [1984] STC 153.

The first leg is probably the easier one to define. If there is no business transaction and the taxpayer is simply trying to recognize a tax benefit, I do not have a problem with HMRC outlawing wholly artificial structures. Examples would include loss-selling (capital or income), or any transaction which is only entered into because there appears to be a tax benefit to be gained. It seems to me that case law, perhaps particularly *Burmab Oil*,³ deals reasonably well with this area—if a transaction has no economic effect, it is unlikely to be effective for tax purposes. Conversely, if there is a real business transaction, a taxpayer should still be entitled to plan his affairs so as to pay the minimum amount of tax legally due on that transaction.

Thus, for example, a taxpayer may choose to sell shares rather than assets, in order to benefit from the substantial shareholding exemption rather than paying tax on a capital gain on goodwill. There is a business transaction (the sale of a business) and the taxpayer is at liberty to choose between different forms of the transaction, which may have different tax consequences.

The question of whether the tax planning is deemed to be commercial is a harder one to answer. However, it is worth the effort. In considering this from the perspective of a business, the question to be asked is whether the steps taken are within the normal course of that company's activities. So, for example, if the group treasurer habitually uses financial instruments to hedge interest rate risk, that is commercial behaviour, but if he suddenly decides to take out (say) a weather derivative instead, that may not be commercial.

I am aware of at least one example of what I consider to be perfectly commercial behaviour being classified as avoidance by legislation. Where Company A has surplus cash, it will wish to invest this in a way which delivers an acceptable return, taking into account the treasurer's normal risk parameters. Within these parameters, investing in Company B's preference shares may be considered to be a normal commercial investment. If Company B happens to have surplus losses, it will offer a slightly higher post-tax return, since it is happy to pay a (non-deductible) preference share dividend rather than pay interest, in respect of which it cannot use the tax deduction. For example, if a commercial interest rate were 5 per cent, Company B might offer to pay a preference dividend of 4 per cent, since its total cost is less than an interest cost of 5 per cent. This is attractive to Company A, which receives a post-tax return of 4 per cent rather than 3.5 per cent (on taxable interest of 5 per cent). Both companies have behaved in a wholly commercial, arm's-length manner and I do not consider that this should be classed as 'unacceptable' tax avoidance. Unfortunately, the shares are likely to be within FA 1996, s 91D and so will be taxed as if they were a loan relationship.

In this case I accept that arbitrage exists but it is due to commercial decisions so that both companies—operating at arm's length—optimize their financing costs. The

3. [1982] STC 30.

underlying problem is that Company B has suffered a real economic loss, for which it cannot get immediate tax relief. The better solution, in economic terms, would be for the Government to make current payments for tax losses—which would be efficient since the Government’s cost of capital is almost always lower than that of an individual business—but even I recognize that it would be optimistic to hope for this solution to come to pass.

This does, however, highlight what I think is one of the main causes of behaviour which HMRC may regard as avoidance. The tax system is undeniably complex and taxpayers can end up being taxed twice, or being unable to gain relief for real economic losses. This leads to a perception of unfairness, so taxpayers may enter into complex arrangements to try to achieve a ‘fairer’ result. For example, companies with capital losses may try to generate receipts in a capital rather than an income form, in order to use the capital losses. From HMRC’s view, trying to turn an economic income return into something which is classed as capital for tax purposes is likely to be viewed as avoidance. A better approach would be to identify these tensions and either remove the artificial barriers (such as the Schedules system—a complete anachronism in corporate tax), or accept that behaviour designed to circumvent such a barrier, in order to get relief for a real loss, is not ‘unacceptable’ tax avoidance.

The Intention of Parliament

HMRC will tend to argue that, once legislation has been enacted, its role is to give effect to the intention of Parliament, which can usually only be discerned from the words of the law. This view was given support by Lord Nolan in *IRC v Willoughby*:⁴

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.

This seems to me to work reasonably as a test where there is a clearly expected economic consequence of a transaction—the once-popular gold bullion schemes come to mind. The amounts looked like remuneration, they felt like remuneration and passed what has often been called the ‘duck test’—if it looks like a duck, walks like a duck and quacks like a duck then it is reasonable to assume that it is a duck. So choosing to receive something which was very like remuneration, without the tax consequences of its being taxed as remuneration, was regarded by HMRC as tax avoidance. Would it pass my test of acceptable tax avoidance? No, because although there is a business transaction (payment of a bonus to a valued employee), paying it in gold bullion is not commercial unless the employee has particular expertise in, or commercial need for, gold bullion.

4. [1997] STC 995, at pages 1003–4.

But Lord Nolan's test is more difficult to apply in circumstances where there is highly technical legislation and it is not at all clear what 'economic benefits' are expected to arise. This is often the case in the structured finance area, where, frankly, a competent bank can structure an instrument to give whatever overall commercial effect is required, but often two very similar instruments will have very different tax consequences. In this case the taxpayer is still, in my view, at liberty to choose the one which gives him the better tax answer and the onus is on HMRC (and its masters, Government Ministers) to decide as a matter of policy how they want to tax those instruments and to ensure that the law is properly drafted to achieve that policy.

Acceptable Behaviour

The example I usually quote here is the 'TOMS' structure, or to give it its full name 'The Off-Market Swap'. This was an idea which purported to give a tax deduction for a premium paid to enter into a swap at uncommercial rates. The theory was that the net commercial effect was the same as a swap at normal rates but the tax treatment was more favourable. I make no comment on whether the structure was effective⁵ and note that it was stopped with effect from 30 September 2002, so it is now of historic interest only—but it illustrates some interesting points.

To bring it down to a simpler level, suppose you were going on a holiday to the US and had a choice of two bureaux at which to buy your US\$. Bureau A would give you \$190 for £100 and charge \$20 commission; Bureau B would give you \$220 but charge \$50 commission. As the net proceeds of \$170 are the same in both cases, you would be indifferent and would probably choose the bureau with the shorter queue—unless you thought that you could get an additional tax break on the commission paid, in which case you would choose Bureau B.

The first question in deciding whether this is acceptable avoidance, using my definition, is to see whether there is a genuine business transaction. Provided that you need the US dollars for real expenditure, this is satisfied; however, if you intend to go round the corner and exchange them back into pounds, so that you can keep repeating the transaction, you would fail this part of the test. The second question is whether the behaviour is commercial—and, in the circumstances I have described, it looks perfectly commercial.

So under my definition, this would be acceptable tax avoidance. The snag is that, to HMRC, it may be unacceptable—not on any moral grounds but simply on grounds of cost. The real problem is that the tax legislation gives a result that no one thought of when it was being drafted: the solution here is surely to change the particular piece of legislation and to try to achieve better quality next time.

5. See now *Prudential plc v HMRC* [2007] UKSPC SPC00636.

What Next?

In conclusion, I believe it would be helpful to have a focused and constructive dialogue between HMRC and the profession, to seek to reach common ground on the definition of tax avoidance. In my view, trying to agree what behaviour is acceptable would be a good starting point.

18 Multinationals, Enforcement Covenants, and Fair Share

Richard Happé

Introduction

In the twenty-first century taxes will never be levied as they were in the previous century. In 2000 Vito Tanzi, Vice President of the IMF, published a working paper entitled 'Globalization, Technological Developments, and the Work of Fiscal Termites'.¹ Tanzi noted that the globalization of the economy had a significant effect on the tax revenue of national governments. He said this was caused by fiscal termites, which gnaw at and impact on the foundations of tax systems. These termites are referred to in particular as 'off-shore financial centers and tax havens', 'intra-company trade', 'electronic commerce and transactions', and 'derivatives and hedge funds'. He concluded his paper with the question of how these fiscal termites should be tackled. In short: what is the response of tax authorities to the tax effects of globalization?

This chapter² examines a typically Dutch response to fiscal globalization: the enforcement covenants that the Dutch Tax and Customs Administration (*Belastingdienst* (TCA)) concluded with multinationals at the end of 2005.³ The conclusion of these agreements is part of a long tradition of consultation in Dutch tax practice, and in that sense is a modern example of the unique Dutch consensus or *polder* model. Although it is still too early to say whether these agreements have been a success, they are an unconventional, almost revolutionary method of exerting a positive effect on and supporting multinational compliance, entailing horizontal supervision embedded in a vertical supervision framework. In essence they are an invitation to mutual trust.

1. V Tanzi, 'Globalization, Technological Developments, and the Work of Fiscal Termites' (2000) IMF Working Paper, WP/00/181 <<http://www.imf.org/external/pubs/ft/wp/2000/wp00181.pdf>>.
2. A Dutch version was also previously published in J Sprenger et al (eds), *Per saldo. Overheidsfinanciën en fiscaliteit na twaalf jaar minister Zalm* (Den Haag, Sdu uitgevers 2007) 57–77. It is reprinted here with permission of the property owner, R Happé. The chapter is reprinted from R Happé, 'Multinationals, Enforcement Covenants, and Fair Share' (2007) 35 *Intertax* 537 with permission from the editor, F de Hosson, on behalf of the publishers.
3. The TCA itself refers to listed or very large enterprises. See inter alia *Bedrijfsplan Belastingdienst 2006–2010* ('Business plan of the Dutch Tax and Customs Administration') (The Hague) 20. For the sake of simplicity we will generally refer to these enterprises as multinationals.

Before discussing the enforcement covenants, we will first sketch two major developments behind them. First of all there is globalization itself and the impact this has had on tax planning. The great accounting scandals of Worldcom, Enron, and other multinationals subsequently brought about a fundamental shift in the practice of tax consultancy.

Multinationals are no longer able to escape tax risk management. The fiscal behaviour of an enterprise is irrevocably tied up with corporate governance and corporate social responsibility. The second major development concerns the approach taken by tax authorities. In the second half of the last century it became clear throughout the western world that the classical manner of levying tax was becoming a thing of the past. The Dutch 100 per cent philosophy, whereby every return was assessed against every aspect of tax legislation, had become a complete fiction. Starting in the early 1990s the TCA introduced a number of radical new methods. Management philosophy has now become compliance strategy: each taxpayer category gets the attention appropriate to it.

Although these two developments can obviously be distinguished from one another, the tax reality is that they cannot be separated. There is close interaction between the two sides: in fiscal matters, tax authorities and multinationals along with their tax advisers are the chief actors and are forced to engage with one another. It is interesting in this regard that an enforcement covenant tries to do justice to the occasionally opposing interests of the two actors. Given the fact that the Australian tax authorities recently concluded agreements with multinationals (Forward Compliance Arrangements), we will compare the Dutch and Australian approaches. The emphasis in the Australian agreements is on their legal character, while the Dutch tend rather to focus on the idea of cooperation based on trust.

In conclusion we will examine the *conditio sine qua non* for such agreements: enterprises must feel obliged to pay their fair share of tax. An invitation to mutual trust by national tax authorities must be counterbalanced by a willingness on the part of the private sector to acknowledge its fair share. If both tax authorities and the business community can agree on this point, then a foundation for cooperation exists in which both sides respect each others' interests. In order to provide a better grip on the matter we will further operationalize the fair share idea in two ways. Here the Aristotelian 'virtue' ethic of choosing the 'appropriate' mean could prove useful.

Globalization and Taxes as Cost Items

Since the 1980s 'globalization' has become a widely used term in both economic and political parlance.⁴ Stiglitz describes globalization as 'the closer integration of the countries and peoples of the world which has been brought about by the enormous reduction of costs of transportation and communication, and the breaking down of artificial barriers to the flows

4. See for example 'Globalization: Threat or Opportunity' at <http://www.imf.org/external/np/exr/ib/2000/041200to.htm>.

of goods, services, capital, knowledge, and (to a lesser extent) people across borders'.⁵ Multinationals play a crucial part in this process. Not only production is transferred to countries where manufacturing costs are lower, the service sector too has discovered that so-called outsourcing is cheaper and sometimes even necessary. This development has radical consequences for tax consultancy. Here we are not referring so much to the fact that some major tax firms in English-speaking countries have shifted their simple tax return departments to cheaper countries,⁶ the fact is in this connection that international tax planning is crucial in the operation of a multinational. In taking decisions, a multinational must also take into account their tax consequences. The reason seems obvious: from an economic perspective, taxes are a significant cost item for businesses.

Tax planning practice has undergone explosive development since the 1970s. International tax consultancy has seen an impressive growth of expertise in the field of multinational tax planning. Keeping tax costs to a minimum is a major objective. John Braithwaite has pointed out that for years some of the largest enterprises in the United States paid little or no corporation tax.⁷ Too high taxes are a sign that a company is performing poorly in this area.⁸

Partly as a result of market pressures, tax planning is gradually becoming a form of engineering. The arsenal used to reduce tax burdens concentrates on three main areas of attack. First of all there are the *fraus legis*-type devices that push the limits of legislation. Their inventors adhere to an ideology of legal positivism, which allows anything as long as a taxpayer complies with the letter of the law. The spirit of the law is less important. Tax inspectors frequently fail to recognize these devices. Time and again complexity and lack of transparency of these devices pose insurmountable obstacles. If an inspector does succeed in unearthing and opposing a device of this sort, it is the Supreme Court that ultimately decides whether or not it is allowable. If it declares it to be a case of *fraus legis*, ie it ignores the spirit of the law, only from that moment is the scope of the law clear. The only risk the taxpayer takes is that it then has to pay the tax it owes by law anyway.⁹

5. J Stiglitz, *Globalization and its Discontents* (Penguin, London 2002) 9.

6. See TL Friedman, *The World is Flat, A Brief History of the Twenty-first Century* (Farrar, Straus and Giroux, New York 2005) 13.

7. J Braithwaite, *Markets in Vice, Markets in Virtue* (Oxford University Press, Oxford 2005) 20, 161. See also J Pender, 'Counting the Cost of Globalization: How Companies Keep Tax Low and Stay Within the Law' *Financial Times* (21 and 22 July 2004). Based on annual management reports, he demonstrates that the big multinationals in fact pay little to no tax on profit.

8. An example is Google, whose share price dropped 10 per cent at the beginning of 2006 because its tax bill was higher than was targeted, and also higher than was predicted by financial analysts. See *De Volkskrant* (2 February 2006) at <<http://www.volkskrant.nl/>>.

9. In this regard see D McBarnet, 'When Compliance is not the Solution but the Problem: From Changes in Law to Changes in Attitude' in V Braithwaite (ed) *Taxing Democracy, Understanding Tax Avoidance and Evasion* (Ashgate Publishing, Aldershot 2003) 232, as well as JE Stiglitz, *The Roaring Nineties: A New History of the World's Most Prosperous Decade* (Norton, New York 2003) 230.

Secondly, corporations often make use of tax havens.¹⁰ The trick is to shift deductions to countries with relatively high tax rates and drop profits in countries where rates are low. For tax inspectors it is often extremely difficult to prove the inappropriateness of such shifts within a group.

Finally, the phenomenon of tax arbitrage, especially the search for so-called mismatches between the various tax systems has become a leading ploy.¹¹ Well-known examples are the 'double dip' and 'triple dip' devices, ie deducting the same commercial loss in two or more countries, and 'double dip leases', which take advantage of the fact that leases are governed in one country by legal ownership while in another beneficial ownership is the case, the result being that both countries offer possibilities for deduction.¹²

The implicit idea underlying such practices is that tax law amounts to nothing more than a collection of miscellaneous rules, ie a 'bunch of rules' used for 'gaming the system'. As Doreen McBarnet so aptly puts it, '[a] mindset in which to comply with the letter but defeat the spirit of the law is deemed clever and legitimate'.¹³ It goes without saying that such trends in tax planning practice have also become visible in the Dutch legal system. Starting in the 1990s, the TCA has with increasing frequency brought 'advanced' tax devices before the courts.¹⁴

This is a global phenomenon. In many countries battle lines between tax authorities and the corporate sector are hardening. Referring to the United States situation in his book *The Roaring Nineties* Stiglitz observes: 'The ethos at the time was to avoid as many taxes as possible'. As for international business, he points out that tax devices have become increasingly complicated and opaque: 'In succeeding years, ever more complicated devices were invented, partly to take advantage of different tax laws in different countries'.¹⁵ John Braithwaite discusses the same trend. Covering a longer period of time, his investigation focuses primarily on Australia and the United States, concluding that the various tax systems are in a state of crisis. For him the crux of the matter is the phenomenon of aggressive tax

10. In 1984 the Dutch State Secretary of Finance set up the Coordination Group for Tax Havens (the CGT) to provide support to inspectors in tackling Dutch taxpayers who were using tax havens to avoid paying tax. See V-N 1986/1314.

11. See HD Rosenbloom, 'The David R Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"' (2000) 53 *Tax Law Review* 137.

12. Other examples of exotic tax planning devices are: 'double-non-taxation', 'dual resident entities', 'hybrid entities', 'hybrid financial instruments' and 'single-dip-no-pick-up'.

13. D McBarnet, 'After Enron: Will "Whiter Than White Collar Crime" Still Wash?' (2006) 46 *British Journal of Criminology* 1091.

14. See for example HR (Supreme Court) 21 September 1988, BNB (Decisions on Dutch Tax Law) 1988/311 and 13 November 1996, BNB 1998/47, as well as HR 23 August and 6, 20 and 27 September 1995, BNB 1996/3-6.

15. Stiglitz (n 9) at 129 and 130. For a Dutch example regarding a Belgian coordination centre see HR 14 October 2005, BNB 2006/79.

planning. This he defines as 'a scheme or arrangement put in place with the dominant purpose of avoiding tax'.¹⁶ Research in the United States has shown that huge financial interests are involved: 'Subsidiaries in the top 11 tax havens accounted for 23 per cent of foreign profits of US companies in 1988, 38 per cent in 1999 and 46 percent in 2001'.¹⁷

From Accounting Scandals to Tax Risk Management

It was in 2002 that the Enron accounting scandal unfolded, leading to the fall of both Enron and Arthur Andersen, then the world's biggest accounting and tax consultancy firm. Enron had employed one accounting dodge after another. These dodges were closely tied up with aggressive tax devices. What distinguished them from 'normal' ones was the element of fraud.¹⁸ Enron had breached the line between tax avoidance and tax evasion.

Enron is not the only giant corporation to have got into trouble in this way. Worldcom and Parmalat and even Ahold have trodden similar paths. The result has been a major crisis of confidence in the financial world. In order to restore trust the United States Government intervened with the introduction of the Sarbanes-Oxley Act.¹⁹ Corporate governance became the focal issue: how should large corporations be managed well, ie efficiently and responsibly? In the Netherlands the Tabaksblat Commission established a code, the aim of which was to help restore confidence in listed companies, in their conduct of business in an honest, scrupulous and transparent manner. A strengthening of the 'checks and balances' mechanism was required in the corporate sector.²⁰

The tax consultancy world has also been in the firing line. Other large consultancy firms have earned discredit for resorting to highly aggressive, sometimes fraudulent tax devices. KPMG-US, for instance, narrowly escaped the same lot that befell Arthur Andersen.²¹ But this process of 'moral erosion' also resulted in a process of heightened awareness and reflection. Following on the heels of corporate governance was the debate about tax risk management. KPMG published a paper discussing 'Tax in the Boardroom', while PwC, Deloitte, and Ernst & Young issued papers about tax risk management.²² Tax risk

16. Braithwaite (n 7) 16.

17. Braithwaite (n 7) 23. See also The Department of the Treasury's report 'The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals' (July 1999) <http://www.taxpolicycenter.org/taxfacts/papers/corp_shelter.pdf>.

18. See inter alia Stiglitz (n 5) 242.

19. Since 1 January 2005 annual reports of all listed funds in the European Union have had to comply with the IFRS rules.

20. See <<http://www.commissiecorporategovernance.nl/2004>>.

21. See for example R H Happé, 'Between Persuasion and Deterrence: Some Legal Aspects of Compliance in Taxation' in H Elffers et al (eds) *Managing and Maintaining Compliance* (Boom Legal Publishers, The Hague 2006) 139.

22. See for example <<http://www.kpmg.com.au/aci/docs/tax-boardroom.pdf>>; <http://www.businessweek.com/adsections/2006/pdf/us_tax_trm_point-of-view_061605.pdf>; <[http://www.pwc.com/extweb/pwcpublications.nsf/docid/8182FE7283B0D21C85257036000C64B8/\\$File/trmc.pdf](http://www.pwc.com/extweb/pwcpublications.nsf/docid/8182FE7283B0D21C85257036000C64B8/$File/trmc.pdf)>.

management means that a company recognizes its tax risks in good time and controls them adequately, ie effectively and where possible pro-actively. This is also referred to as the 'tax control framework' of a company. An essential element is that a company consciously decides on the level of tax risk it wishes to take. Tax directors of large corporations claim that tax risk management is a critical factor of corporate governance.²³

What are the principal features of tax risk management? First of all a company must have an explicit tax strategy. Its Management Board must also take responsibility for the company's tax operations. Good communication and exchange of information between the Management Board and tax director or tax department are essential. Finally, tax operations must be subject to independent review. It is important that the various publications acknowledge the public demand that multinationals pay their fair share of tax in the countries in which they operate.²⁴ Companies that employ aggressive tax planning devices to keep their effective tax burdens to a minimum risk damaging their reputations if stakeholders or the public at large find out about their shady conduct. This brings us to the field of corporate social responsibility. A company bears responsibility to the society in which it is established and operates. This responsibility extends beyond mere economics. It also touches on the legal and ethical expectations that the society has of it. A company that recognizes its responsibility in this sense aims 'to make profit, obey the law, be ethical, and be a good corporate citizen'.²⁵

Payment of tax is an important element of this, or in the words of Oliver Wendell Holmes Jr.: 'Tax is the price we pay for a civilised society'. Every company must decide whether and to what extent it wishes to pay its fair share of tax.

From the 100 Per Cent Philosophy to Compliance Strategy

Governments have the task of ensuring that citizens obey the law. Until the 1980s the TCA's '100 per cent philosophy' stamped the relation between government and citizens as regards the levy of tax. This philosophy holds that the taxpayer must file a return; the inspector then assesses the return against the law and corrects it if he or she notices that it departs in any way from the law. According to this philosophy every taxpayer pays the tax that he or she owes by law. In Anglo-Saxon countries this was referred to as a 'command and control' approach.

In the final decade of the twentieth century the realization began to dawn on the TCA that its stance on tax returns was doomed to fail. A new method was needed to replace the 'one size fits all' approach. The Dutch tax authorities were losing their grip on taxpayers.

23. Research by Ernst & Young in 2004 demonstrates that almost 70 per cent of tax directors of large corporations subscribe to this view. See <<http://www.ey.com/global/download.nsf>>.

24. See for example PwC (n 22) 'Tax Risk Management & Compliance' 10, and KPMG (n 23) 'Tax in the Boardroom' 16.

25. AB Carroll, 'Corporate Social Responsibility' (1999) 3 *Business & Society* 283, 289.

A major cause of this was the aim of multinationals to keep their tax burden to a minimum, as described above. A particular problem for the tax inspector was—and still is—not merely the legal battle against tax devices, but rather against their inherent and actual lack of transparency. The national perspective of an inspector means that he or she has only a limited view of both the whole and the details of any such device and its effects. Stiglitz refers to the problem of ‘asymmetric information’ or, put briefly, a lack of information.²⁶ Just before the turn of the millennium the TCA adopted an entirely new course.²⁷ Embracing risk management, it decided to focus on controlling the tax and financial risks attached to levying tax, ie only intervening in the event of an actual risk.²⁸ Shortly afterwards it defined this change of direction more sharply with the introduction of compliance strategy, meaning the support for and strengthening of the willingness of taxpayers to observe their statutory obligations.²⁹ To this end various categories of taxpayers, each having their own risk profile, were distinguished from one another. A major element of this strategy is that the intensity of supervision is determined principally by the degree of observed compliance or non-compliance on the part of the taxpayer. Taxpayers who voluntarily comply with their obligations require little attention, while those who display avoidance or evasion tendencies need all the more.³⁰

The Netherlands was not alone in taking this new approach. Interesting trends of this sort were also observed within the Australian Taxation Office (ATO). There too risk management and compliance have become key concepts of the new approach. The ATO has a compliance pyramid.³¹ At its base are taxpayers who display compliant behaviour. It is important that the ATO support and strengthen their willingness to pay tax. Cooperation is a key concept.

At the apex of the pyramid are the tax fraudsters, who are subject to tough criminal litigation.³² The ATO also draws on publicity to show compliant taxpayers that the government is serious about tackling non-compliance. Reputational damage is a way of

26. See Stiglitz (n 5) 154.

27. For comparable trends in other countries see J Job, A Stout, and R Smith, ‘Culture change in regulatory institutions: from command-and-control to responsive regulation in taxation administration’ in H Elffers et al (eds) (n 21) 147.

28. *Annual Report of the Tax and Customs Administration* (Tax and Customs Administration, The Hague 1998) 8.

29. See *Control Report of the Tax and Customs Administration* (Tax and Customs Administration, The Hague 2000) 2, and the *Annual Report of the Tax and Customs Administration* (Tax and Customs Administration, The Hague 2002) 26.

30. Business plan of the Tax Customs Administration 2006–2010 at <<http://www.itdweb.org/documents/public/Business%20Plan%202006-2010.pdf>> 5, 19.

31. See for example ‘Improving Tax Compliance in the Cash Economy, Canberra’ (ATO Cash Economy Task Force 1998) at <<http://www.ato.gov.au/businesses/content.asp?doc=/content/39073.htm>>.

32. See inter alia V Braithwaite, ‘A New Approach to Tax Compliance’ in Braithwaite (ed) (n 9) 1–11, and J Braithwaite, ‘Large Business and the Compliance Model’ *ibid* 194.

achieving this. This corresponds strikingly with the recent Dutch Report, 'Settlement and Prosecution Guidelines', which also recognizes the public effect of settling important cases under criminal law.³³

The crux of compliance strategy is thus that compliant behaviour is rewarded while non-compliant behaviour is punished. An essential element of the strategy pursued is that it is flexible. Taxpayers must consistently be invited to behave compliantly. This also goes for those who are less compliant or even not compliant at all. On several occasions in the United States for example, a distinction has been made regarding multinationals suspected of serious fraud between the natural persons who were actually presumed to have committed the fraud and the organizations to which they belonged. A recent case involved KPMG-US. Criminal charges were pressed against the natural persons in question, while an agreement—a kind of settlement—was reached with the corporation. In addition to the payment of an enormous fine, this settlement entailed the appointment for a number of years of a supervisor with far-reaching powers. In addition to a fine a corporation is forced to introduce a 'compliance and ethics' programme.³⁴ This gives it the opportunity to resume compliant behaviour.³⁵ At the same time, the damage suffered by stakeholders, such as shareholders, employees, and the public, is kept to a minimum.

Finally, it is important to look at the public context of compliance strategy. This strategy is aligned to the concept of society as 'a cooperative venture for mutual advantage'.³⁶ This view implies that it may be expected of all taxpayers that they in principle display cooperative behaviour towards the tax authorities.

The fact is that in the absence of taxes no form of organized society is possible. This has important consequences for the attitude of the tax authorities. They must take into account the degree of cooperation of individual categories of taxpayers, from salaried employees to multinationals. Compliance strategy is the expression of this. Compliant behaviour by taxpayers thus requires a different response from the tax authorities than non-compliant behaviour. In this connection the enforcement covenants between the TCA

33. ATV-richtlijnen voor fiscale delicten and douanedelicten 2006 ('Report, Settlement and Prosecution Guidelines for Tax and Customs Offences') 12 December 2005, DGB2005/6956M, Stcrt. (Government Gazette, Netherlands 2005) 247. In this regard see R H Happé in Elffers et al (eds) (n 21) 137.

34. See 'Prepared remarks' by Attorney General Alberto R. Gonzales at the 'Press Conference Regarding KPMG Corporate Fraud Case' at <<http://www.ojp.usdoj.gov.com>>. Other well-known examples are WorldCom and, very recently, the J Paul Getty Trust. The management of the Dutch Central Government's TCA does not have this authority. Nor was it granted it even after the legislative proposal regarding the punishment order ('strafbeschikking') was accepted (Kamerstukken II (Parliamentary Papers) 29 849). Article 76 of the General Taxes Act (Algemene Wet inzake Rijksbelastingen) does not allow the possibility for imposing such a condition. Regarding this missed opportunity see also R H Happé in Elffers et al (eds) (n 21) 143.

35. The theory of shame management refers to 'reintegration'. See inter alia J Braithwaite and V Braithwaite, 'Shame, Shame Management and Regulation' in E Ahmed, N Harris, J Braithwaite, and V Braithwaite, *Shame Management through Reintegration* (Cambridge University Press, Cambridge 2001) 39.

36. J Rawls, *A Theory of Justice* (Oxford University Press, Oxford 1973) 4.

and a number of multinationals are a significant operationalization of compliance strategy: they are arrangements that take into account the interests of both parties. They are also in harmony with corporations who place a high priority on compliance. In this sense enforcement covenants provide a meeting point for two parties that strive for compliance, each from their own points of view.

Tax Version of the *polder* Model: Enforcement Covenants

The Netherlands is known for its culture of consultation. The Dutch *polder* model, or dialogue between government and major civil society organizations that is aimed at consensus, has acquired international renown. The Dutch Government and its citizens are well aware of the fact that they depend on each other to accomplish great things. The underlying culture of consultation runs in the blood of the Dutch. And this certainly applies to taxes. One of the strengths of the TCA is its willingness to conduct a dialogue with taxpayers and make arrangements in advance about the tax consequences of their actions, particularly those of corporations. Such arrangements are also binding upon the tax inspector and are thus enforceable by the taxpayer.³⁷ The fact that such arrangements can be made enables multinationals to cover tax risks. They obtain certainty in advance about the tax consequences of their commercial operations. Known as ruling practice, it has since the Second World War provided multinationals with an important means of controlling the tax aspects of their Dutch operations.³⁸ Essential to such arrangements is that they remain within the bounds of the law. Nevertheless, around the turn of the millennium ruling practice became a subject of debate both within the European Union and the OECD.³⁹ Following the criticism then expressed, ruling practice in the Netherlands was drastically modified and formalized.⁴⁰ Where ruling practice is primarily characterized by concrete arrangements—providing multinationals with certainty on how the law applies to them—the TCA's compliance strategy has recently come to include making entirely different kinds of arrangements with multinationals. These are the enforcement covenants, the essence of which is the relationship they define between the TCA and a multinational. In mid-2005 the State Secretary of Finance made his aim clear: he wanted horizontal supervision. He reported to the Lower House that this entailed mutual trust between the taxpayer and the TCA, clearer articulation of each others' responsibilities and means for enforcing the law,

37. Such arrangements are in the form either of an undertaking by the inspector or of an advance tax ruling.

38. See for example C Romano, *Advance Tax Rulings and Principles of Law: Towards a European Tax Rulings System?* (IBFD, Amsterdam 2002) 22–49.

39. See the Primarolo report published in 2000 at <http://www.ec.europa.eu/taxation_customs/resources/documents/primarolo_en.pdf>, and the OECD report 'Towards Global Cooperation: Progress in Identifying and Eliminating Harmful Tax Practices, 2000' at <<http://www.oecd.org>>.

40. It is now referred to as APA/ATR practice. See for example the Order of 30 March 2001, no. BOB2001/698M, BNB 2001/287, in which the State Secretary of Finance says that no certainty is given in advance if it violates the good faith that is due to treaty partners and/or required in the international context.

and the establishment of and compliance with reciprocal arrangements. This would put underlying relations and communication between government and citizens on a more equal footing. The State Secretary was clearest about very large corporations. He announced a pilot scheme with about 20 enterprises, most of them listed. His idea was to have Management Boards and tax inspectors conclude individual enforcement covenants on a voluntary basis.⁴¹ In this way he envisaged increasing legal certainty for the corporations and—with the TCA implicitly placing trust in them—avoiding devices normally combated through vertical supervision. At the end of 2006 the Minister of Finance reported that covenants had been concluded with nearly all 20 corporations, and that the pilot scheme had been extended to include another 20.⁴² What do these enforcement covenants actually entail? On this subject the State Secretary reported the following:

Upon concluding a covenant, arrangements are made about settling the past, thus increasing legal certainty. One aim of the covenants is to significantly limit the TCA's vertical supervision activities, thus reducing corporate burdens. Another aim is to have tax inspectors take a stance on corporations' future actions and their tax consequences. This is also possible because as yet unsettled 'problems of past years' no longer constitute an impediment to taking a stance. This is based on the premise that the law is applied and that no more or less favourable stances are taken. Another premise is that corporations report actions that have a bearing on tax openly and in good time. It is this mutual trust that is after all the basis of horizontal supervision.⁴³

Around the same time the State Secretary published an anonymized enforcement covenant.⁴⁴ What is clear therefore is that mutual trust is an essential element of these covenants. Based on it both parties take heed of each others' interests. Conditional upon their cooperation with one another is reciprocity. The interests of the multinational lie first and foremost in reducing vertical supervision. Less far-reaching audits mean reduced administrative burdens. Another interest lies in the prospect of rapid action on the part of the tax inspector. Past tax disputes are settled, while matters of the present can be put to the inspector so that he or she can take a stance on them. The tax inspector's interests are in part a mirror image of those of the multinational: reduced vertical supervision means that available capacity can be deployed to deal with other, less compliant, taxpayers. These enforcement covenants are thus clearly distinct from the

41. Kamerstukken II, 2003–2004, 29 643, no 4.

42. Letter from the Minister of Finance dated 29 October 2006, Kamerstukken II, 2006–2007, 30 800, IXB, no 13 p 2. See a previous letter from the State Secretary of Finance, Kamerstukken II, 2005–2006, 30 306 and 30 307, no 74.

43. Kamerstukken II, 2005–2006, 30 300 IXB, no 40 p 13.

44. See Kamerstukken II, 2005–2006, 30 306 and 30 307, no 74.

abovementioned rulings. They do not contain any obligation to have substantive provisions of tax law applied in a specific manner.

They deal primarily with the inspector's discretionary powers: the degree to which he or she draws upon his or her powers of control and the pace at which he or she tackles the implementation of tax legislation. It goes without saying that multinationals which have concluded a covenant will also enter regularly into rulings with the tax inspector about substantive aspects of legislation.⁴⁵

Transparency of Information and Voluntary Reporting of Tax Risks

One of the biggest problems faced by the tax authorities in trying to implement tax legislation properly is a lack of transparency of the taxpayer's information. Vertical supervision in the form of audits is therefore an essential means of obtaining the information required. However, audits often entail extensive operations, resulting in considerable administrative burdens for the multinational. It is here that an enforcement covenant aims to do justice to the interests of both parties: transparency of information for the TCA and reduced administrative burdens for the multinational. This is achieved because the TCA offers prospects of reduced vertical supervision, and in return the multinational undertakes to provide transparency. The covenant is explicitly based on transparency. The parties to it agree to be open about their dealings.⁴⁶

In conformity with the published covenant the multinational undertakes not only to report all actions that involve tax risks, it also consents to disclose its views about the legal consequences of such actions and the positions taken by it. This goes beyond its actual statutory obligations. Based on the Dutch General Taxes Act (*Algemene Wet inzake Rijksbelastingen*), the taxpayer is only obliged to provide factual information.

The covenant therefore entails voluntary reporting of tax devices, regarding which the United States and United Kingdom, for example, have increasingly introduced statutory disclosure obligations.⁴⁷ The question is whether the term 'tax risks' referred to in the covenant is not too vague. There is no doubt that this term includes abuse of law practices. Nevertheless, an assessment margin always applies here: one person's idea of aggressive tax planning is not necessarily another's. Where, for instance, does the search for the most favourable tax arrangement end in the evasion twilight zone?⁴⁸ Another

45. Neither in rulings nor in enforcement covenants is there in any question of tolerance, ie non-enforcement on the part of the inspector. Regarding the term tolerance, see the policy document *Tolerance in the Netherlands*, Kamerstukken II, 1996-1997, 25 085, nos 1-2 p 16.

46. Openness on the part of the TCA is limited by its statutory obligation of confidentiality.

47. See for example the HM Revenue & Customs publication 'Guidance Disclosure of Tax Avoidance Schemes' (June 2006) at <<http://www.hmrc.gov.uk/ria/disclosure-guidance.pdf>>.

48. In this regard see for example P F E M Merks, 'Tax Evasion, Tax Avoidance and Tax Planning' (2006) 34 *Intertax* 272.

difficult question is whether the term also covers tax arbitrage. For instance, should 'double dip leases' and 'dual resident companies' actively be put to the assessment of the inspector? From the isolated national perspectives of both countries in question, a multinational complies with the legislation of each country if, for example, it deducts the same costs from the profit in both countries. From the joint perspective of the two countries, there is a considerable interest in remaining informed about the particular details of the device.⁴⁹

In brief: the obligation to report 'relevant tax actions' is inherently too diffuse to be left simply to the multinational. The mutual financial interests at stake are too great. Finally, there is always the risk of some corporations being unable to resist the universal, age-old temptation to 'play the audit lottery'. This would obviously jeopardize the continued existence of the enforcement covenant. It would also have undoubted consequences for actual vertical supervision of the multinational in question. The fact is that '[r]egulatory agencies have maximum capacity to lever cooperation when they can escalate deterrence in a way that is responsive to the degree of uncooperativeness of the firm'.⁵⁰ The Dutch Minister of Finance seems to go a step further: 'If having concluded a covenant with the TCA you are subsequently caught doing something you should not, you will be dealt with more severely than in other situations'.⁵¹ It is not entirely clear what he means by this. In any case the fact remains that in such a situation the TCA may be expected to respond carefully and proportionately, within the boundaries of the law.⁵²

Furthermore, this last point again underlines the fact that given such a situation the TCA should lay down a clearer definition of the term 'tax risks' before concluding an enforcement covenant. Right now it seems that its definition is left too much to the multinationals.

In summary it is justifiable to say that the TCA should define the term 'tax risks' more clearly. The term should also cover cases of tax arbitrage. It is also necessary that compliance with the undertaking to report tax risks is subject to vertical supervision. In this sense the omission of vertical supervision makes meta-vertical supervision of horizontal supervision necessary. In turn the assessment of such meta-supervision can finally clarify whether voluntary reporting works satisfactorily, thus rendering superfluous a statutory obligation to report.

49. This interest may lie in the exchange of information, or the implementation of measures to end the 'double dip'. See also for example DN Shaviro, *Corporate Tax Shelters in a Global Economy* (The AEI Press, Washington 2004) 40.

50. V Braithwaite and J Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in N Shover and JP Wright (eds), *Crimes in Privilege: Readings in White-Collar Crime* (Oxford University Press, New York, Oxford 2001) 409.

51. Kamerstukken II, 2006–2007, 30 572, no 13 p 50.

52. He was possibly referring to fraudulent conduct. Legal safeguards obviously apply to this too.

Australian Enforcement Agreements: Forward Compliance Arrangements

The Netherlands is not the only country that is experimenting in this area. Recently, an interesting parallel has emerged in Australia. In 2006 the ATO issued a comprehensive brochure entitled *Large Business and Tax Compliance*,⁵³ which introduces a new compliance tool, ie the 'Forward Compliance Arrangement' (FCA). The ATO describes the FCA as a viable alternative to traditional compliance approaches.⁵⁴ It entails a voluntary arrangement between a large corporation and the ATO for future cooperation. Premises on which the FCA is based are transparency and real time collaboration. The intended effect is fewer surprises for the tax authorities and a reduction in the number of audits. Striking in this connection is the fact that the brochure also refers to concessions in relation to administrative penalties and interest that apply in the event of tax shortfalls. This element is rightly absent from Dutch enforcement covenants. Tax authorities are entitled to impose fines as part of their statutory powers.⁵⁵ It is inappropriate to reduce fines in violation of legislation or legal precedents.⁵⁶

The ATO also emphasizes the fact that corporations must maintain continuous disclosure. This factor also emerged in the enforcement covenants and, in my opinion, is a requisite condition for concluding a covenant. It is notable that the ATO also stipulates a due diligence verification as a condition for entering into an FCA. The multinational in question must also make a significant investment in its tax risk management processes. As a result not every corporation is eligible for an FCA. The TCA does not impose such requirements in concluding enforcement covenants.⁵⁷ We will return to this important difference later.

FCAs have a narrower scope of application than enforcement covenants. An FCA can relate to corporation tax as well as to the Goods and Services Tax (GST)⁵⁸ and excise duties. It is also possible to conclude an FCA for one of these areas and later to extend it to cover the other forms of taxation. The Dutch covenants deal with all forms of taxation as well as its collection.⁵⁹

Recently two press releases have been published in which the ATO and two multinationals, ANZ, a large financial enterprise, and BP Australia, announced that they had

53. See <http://www.ato.gov.au/content/downloads/77898_N8675-08-2006_w.pdf>.

54. See 'From the 100 per cent philosophy to compliance strategy' above.

55. In imposing fines the inspector is also bound to the principles governing the proper imposition of fines, such as the principles of equality and proportionality.

56. The same applies to statutory interest.

57. In any case the published documents make no mention of any such requirements.

58. This GST is a turnover tax of 10 per cent on added value.

59. The TCA also makes horizontal supervision arrangements for customs matters. Following investigation companies can be issued with a certificate. This means they can accelerate their logistical processes. See Kamerstukken II, 29 643, no 4 p 4, as well as the Annual Report of the Tax and Customs Administration 2005 35.

concluded FCAs.⁶⁰ Two things are notable in this connection. First of all both agreements relate to GST and, in the case of BP, excise duties as well as a 'fuel tax credit system'. The agreements do not therefore have any bearing on corporation tax. Part of the reason for this may be that GST and excise duties relate to goods and services, and corporations have a significant interest in a deliverance of goods without interference by the ATO later on. Another reason could be that precisely in the area of corporation tax much advanced tax planning takes place. A second point is the publicity accorded to these first two agreements, which underlines their public context and forms a stark contrast with the secrecy surrounding the covenants concluded in the Netherlands. It is thus to be recommended that Dutch enforcement agreements are announced publicly by means of a press release.

However the fact remains that, in general, enforcement covenants and FCAs are based on the same premises. The TCA and the ATO on the one hand and the multinationals on the other reach agreement because they take heed of each others' interests, such as transparency, reducing administrative burdens, and working in the here and now. Both are in the vanguard of a modern interpretation of compliance: cooperation based on mutual interest. An essential ingredient of such cooperation is mutual trust.

Enforcement Covenants and FCAs: The Basis is Mutual Trust

When can mutual trust be said to exist? Under what circumstances is a tax authority prepared to reduce its vertical supervision significantly? An important factor in answering these questions is the trends sketched above, both among tax authorities and multinationals.

In any case a number of multinationals have realized, more than previously, that tax risk management forms a crucial part of their corporate governance policy. Tax risk management thus implies that the multi-national is expressly aware whether and to what degree it behaves as a compliant taxpayer. Some multinationals even go a step further, incorporating such management into their policy on corporate social responsibility. As we have seen the assumption of this responsibility means that the issue of contributing a fair share of tax is one that keeps surfacing.⁶¹

Over the last two decades tax authorities have also undergone a major development. Their actions are currently shaped to a large extent by risk management and compliance strategy. This means in particular that tax authorities adopt an approach that corresponds to the degree of compliance on the part of the taxpayer. Multinationals who behave compliantly are entitled to expect the tax authorities to behave as befits a proper government. Valerie Braithwaite uses the word integrity in this connection, commenting:

60. See media releases 2006/39 and 50 of the ATO at <<http://www.ato.gov.au>>.

61. See 'From accounting scandals to tax risk management' above.

'If taxpayers offer compliance, the tax office, as part of government, should reciprocate with integrity'.⁶² What makes tax authorities and multinationals conclude cooperation pacts with one another? A prerequisite is that the multinational behaves as a compliant taxpayer and that the tax authorities recognize this behaviour as such. A further requirement is that the multinational subscribes to the idea of fair share, and practices it as well. Acknowledging this necessity is, in this author's opinion, the *conditio sine qua non* for concluding an enforcement agreement or FCA. Only if both conditions, which are linked to each other, are satisfied is there room for mutual trust and can the parties really take heed of each others' interests. And only on the basis of such trust can there be, as John Rawls puts it, a 'cooperative venture for mutual advantage'. If the TCA does not have this fundamental trust in the willingness of a particular multinational to pay its fair share of tax, then no covenant should be concluded. Likewise, a covenant or arrangement should be terminated if this fundamental trust is violated.

The Dutch enforcement covenant and the Australian FCA presuppose this fundamental idea of cooperation with taxpayers based on trust. Either can only be a meaningful compliance instrument if the taxpayers in question feel their obligation towards society to pay their fair share of tax. An important touchstone for them is actual transparency. Taxpayers agree to be open about their tax planning for commercial operations, while the tax authorities are transparent in taking stances on those operations.

This brings up a very important matter: are the TCA and ATO not too trusting? Both cut back their vertical supervision, trusting the multinationals to take their interests seriously as well. Both explicitly place their trust in the other party. The critical factor here is that if a multinational's effective tax burden is low, its financial interests are very high.⁶³ In this regard there is a significant difference between the TCA and the ATO. The nature of the ATO's FCA is clearly more that of a hard, legal agreement containing specific conditions that must be met. Before concluding an FCA, a due diligence verification must be carried out to determine the tax risks, while security of the multinational's tax risk management is also investigated within the corporation itself.⁶⁴ No such conditions are imposed in the enforcement covenant. The emphasis is far more on trust. No due diligence verification is performed, while other arrangements deal primarily with the parties' expectations of one another. The enforcement covenant is a cooperation pact rather than a legal agreement. While an Australian multinational that fails to comply with the arrangements laid down does not fulfil the agreement, a Dutch multinational that does so violates the fundamental trust placed in it. In this regard the Dutch TCA takes a greater risk than the ATO, although

62. V Braithwaite, 'Tax System Integrity and Compliance: The Democratic Management of the Tax System', in Braithwaite (ed) (n 9) 271.

63. See 'Globalization and taxes as cost items' above.

64. *Large Business and Tax Compliance* (2006) 38 at <http://www.ato.gov.au/content/downloads/77898_N8675-08-2006_w.pdf>.

the latter also works on a basis of trust. This makes it all the more important how the multinationals in question deal with the issue of their fair share.

Fair Share and Aristotle's Doctrine of the Mean

Is it possible to provide more substance to the idea of fair share? In order to do so we must first of all point out the intrinsic relation between a modern society and the payment of tax. This also goes for multinationals. The success of a market is wholly dependent on the degree to which the legal system, financed by taxes, provides effective legal protection.⁶⁵ Murphy and Nagel point out that 'the modern economy . . . would be impossible without the framework provided by the government supported by taxes'.⁶⁶

The idea of a just society is also important here. Citizens of a just society are entitled to equal fundamental rights. In many countries, the obvious expression of this is the Constitution, which lays down fundamental rights. In this context the obligation to pay tax qualifies as a fundamental duty of every citizen. Stiglitz remarks: 'Every tax system is an expression of a country's basic values—and its politics. It translates into hard cash what might otherwise be simple high-flown rhetoric'.⁶⁷ This view is allied to the idea that everyone pays his or her fair share for the costs incurred by society. In that sense everyone's tax contribution is an expression of respect for society and fellow citizens. The multinational that acknowledges this and thus respects and performs its fundamental duty to pay tax occupies common ground with the TCA in concluding an enforcement covenant. An outlook of this sort justifies a tax inspector reducing his or her vertical supervision and, based on mutual trust, making arrangements for the benefit of both parties. The voluntary compliance thus envisaged is the expression of the multinational's serious acceptance of its social responsibility.

What does this mean for the multinational's actual tax behaviour, for its tax risk management? Here Aristotle's doctrine of the mean may be useful. Following serious reflection, virtue in terms of taxation is a matter of making a properly considered decision about one's own tax behaviour.⁶⁸ This means that the wise multinational chooses the mean between two extremes: on the one hand the unadulterated pursuit of its own interests by means of aggressive tax planning and, on the other, giving absolute priority to the interests of the community in which the company operates.

Neither extreme shows evidence of practical wisdom. This implies on the one hand that there is a limit to the tax adage that everyone is free to opt for the cheapest solution. After all, virtually anything is possible under tax law. In this respect aggressive tax planning is

65. See for example Friedman (n 6) 245.

66. L Murphy and T Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford University Press, Oxford 2002) 8.

67. Stiglitz (n 5) 177.

68. See Aristotle, *Ethica Nicomachea* 1111 b 5.

often akin to engineering science: using the minimum amount of substance, how can the tax burden of a device be kept as low as possible without collapsing? Escaping tax altogether or, if this is not possible, postponing it, sometimes seems to be the only motive. This concept of tax as a mere tool deprives tax law of its legal character, its purpose and its justness. After all, membership of a society means not only that everyone gets his or her own allotted share,⁶⁹ but also that everyone does his or own bit. Good tax judgement thus entails a certain amount of restraint regarding that which is technically possible. A guide to employing tax devices should thus be that one should not only adhere to the letter of the law, but also feel bound at all times to its spirit.⁷⁰ Daniel Shaviro put it as follows:

The management and shareholders should act in the interest of taxpayers generally by confining their pursuit of self-interest in tax minimisation to strategies and reporting positions that are reasonably within in the spirit of the law.⁷¹

A more general perspective for determining whether a multinational takes the fair share idea seriously is offered by examining the effective tax burden it bears. This may give a first clue about the degree to which the multinational actually observes the fair share idea. In other words, it is also the effective tax burden that indicates to what extent the multinational chooses the correct mean. This is not the case, for example, with multinationals that have reduced their tax burden to nil or very nearly nil.⁷² Some publications by tax firms take the view that in judging whether a multinational contributes its fair share, its other taxes and social contributions must be taken into account.⁷³ This view holds that a low corporation tax burden must not be seen in isolation. In other words, the avoidance of corporation tax may be compensated by other tax contributions. In the social context, however, such compensation is not relevant as a ground for justification.⁷⁴ But on the other hand it is not necessary to put aside one's own interests entirely and pursue a tax policy that is most beneficial to the government. The fact is that corporations aim to maximize profit.⁷⁵

69. Aristotle, *Ethica Nicomachea* V. See also *Digesta* 1.1.10 (Weidmann, Dublin/Zurich 1966).

70. Compare also The OECD Guidelines for Multinational Enterprises: Text, Commentary and Clarifications, 2001, X Taxation: 'Enterprises should comply with the tax law and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and the spirit of those laws and regulations'.

71. Shaviro (n 49) 25.

72. Here we leave aside the matter that the effects of tax arbitrage on the tax burden are not always visible from a strictly national perspective.

73. See U Landolf, 'Tax and corporate responsibility' 29 *International Tax Review* 9 (also at <<http://www.internationaltaxreview.com>>).

74. A part presumably played here is that tax law as such as wage and turnover tax are not nearly so susceptible to tax devices as corporation tax, and therefore create a relatively heavy tax burden.

75. See M Friedman, 'The Social Responsibility of Business is to Increase Its Profits' (13 September 1970) *The New York Times Magazine*, which rejects any notion of social responsibility on the part of corporations, as long as they adhere to the law.

The matter at issue is that they also take into account their social responsibility. John Braithwaite rightly remarks that '[t]ax integrity means paying the right, the just, amount of tax, not the maximum amount'.⁷⁶ Enforcement covenants envisage 'a cooperative venture for mutual advantage' between tax authority and multinational.⁷⁷ Nothing more and nothing less.

If a multinational employs aggressive tax planning or endeavours to minimize its effective tax burden, then intensive vertical supervision is necessary. This leaves no room for an enforcement covenant. A condition for an enforcement covenant is after all the willingness of the multinational to observe tax restraint and contribute its fair share to society. This fair share notion serves as a corrective to the unbridled pursuit of a multinational's own interests. To quote Aristotle, '[a] temperate human being . . . holds a position between these things'.⁷⁸

Summary and Proposal for Evaluation

In summing up let us repeat some of the most important conclusions above and make a recommendation regarding evaluation. In recent decades the taxing of multinationals has been undergoing radical changes. The reason is obvious: from an economic perspective, tax is a very significant cost item for corporations. Tax planning plays an important part in this. International tax planning has evolved into an engineering science, a development seen particularly in the closing decades of the twentieth century. As a result tax legislation was viewed as a collection of miscellaneous rules which one could draw upon to compile any imaginable device. The spirit of the rules, as well as the social meaning of tax law, were gradually lost sight of. The great accounting scandals led to a major break in this trend. Corporate governance and corporate social responsibility have become more pressing issues than ever before. This development has also touched on taxation. For many multinationals and big tax consultancy firms, tax risk management has become a very serious matter. Many multinationals now regard the society in which they operate as an important stakeholder. Multinationals have become increasingly aware that they must decide on how far they want to go with tax planning. In this connection the notion of fair share is an important factor.

In the 1980s tax authorities started realizing that with their traditional approach to taxation they were losing their grip on the wild proliferation of tax complexities. This also called for risk management: government operations needed to be geared to relevant financial tax risks. Compliance strategy is an expression of this. Compliant behaviour requires support, while non-compliant behaviour must be dealt with severely. Against the background that a society can be described as a cooperative venture, tax authorities view

76. Braithwaite (n 7) 203.

77. Rawls (n 36) 4.

78. Aristotle, *Ethica Nicomachea* 1119 a 10. See also Aristotle, *Ethics* (Penguin, London 1955) 106.

the degree of cooperation or non-cooperation on the part of taxpayers as a strategic factor. In 2005 the TCA extended a remarkable invitation to mutual trust, in the form of the enforcement covenant. It thereby demonstrated its willingness to make arrangements with multinationals reducing its vertical supervision and undertaking to work in the here and now. In return multinationals are required to operate transparently and report tax risks openly and in good time. Based on mutual trust, the parties pay heed to each others' interests. A crucial factor is the duty to report 'tax risks'. In recent years a number of other countries have introduced a statutory obligation to report. In the Netherlands, multinationals report voluntarily within the framework of a covenant. In this context vertical supervision is still indispensable. The term 'tax risk' is too vague to have its application left entirely to the multinational. A clearer definition is required from the TCA. It also creates a responsibility on the part of the TCA for the proper legal application of 'meta-supervision' of covenant compliance. In the second half of 2006 the Australian tax authorities launched a comparable initiative. This was the FCA, which is based on the same premises as the enforcement covenant, ie transparency of information and the reduction of administrative burdens. There are, however, striking differences, such as the 'harder', more legal nature of the agreement, the condition of a prior due diligence verification, and the accounting requirements. In this regard the enforcement covenant is more 'horizontal' in nature than the FCA. The fundamental trust upon which both the enforcement covenant and the FCA is based is more dominant in the case of the former. An Australian multinational that fails to comply with the arrangements laid down does not fulfil the agreement, while a Dutch multinational that does so violates the fundamental trust placed in it. Enforcement covenants and FCAs are a modern manifestation of the compliance strategy. In a certain sense they replace mistrust with trust. Both parties undertake to cooperate with each other with a view to each others' interests. This involves a fundamental step on the part of the tax authorities, which to a large extent substitute trust for vertical supervision. For this to happen, two conditions must be met: not only must the multinationals in question be compliant, they must also subscribe to the notion of contributing their fair share of tax and actually do so in practice. This element can be seen as a *conditio sine qua non* for such arrangements.

Whether the TCA—and also the ATO—are too trusting is irretrievably bound up with the way in which multinationals put the notion of fair share into practice. The contribution of a fair share of tax can be further operationalized on two levels. Here the Aristotelian doctrine of the mean is useful. On the level of actual tax devices, wisdom dictates a certain amount of restraint in exploring what is possible under tax legislation. Not only the letter of the law but also its spirit must remain recognizable. The second level is that of the effective tax burden. A multinational that succeeds in reducing its effective tax burden to nil or nearly nil cannot be viewed as a suitable party to an enforcement covenant. On both levels aggressive planning must be avoided. The point is to maintain a balance, Aristotle's mean.

Finally, with the enforcement covenant the TCA has taken a ground-breaking initiative. It involves an unusual, innovative form of supervision. It provides both the TCA and multinationals with the opportunity to take into account each others' interests on a basis of mutual trust.

Partly for this reason this compliance instrument should be thoroughly evaluated in, say, three years. It is extremely important that such an evaluation be independent and scientifically sound. Very recently, the TCA sent the results of a first enquiry to Parliament. This enquiry was held by the TCA itself. The general impression is that both the tax directors of the large companies and the tax inspectors involved are satisfied with the enforcement covenants concluded and with the initial implementation experiences.⁷⁹

It would also be advisable to exchange experiences with the ATO. This could help establish where the correct mean lies between the harder conditions of the ATO's offer of trust and the TCA's solution, which is more inviting of cooperation.

79. See letter of 12 April 2007, DGB 2007-1685M to the Dutch Upper House.

IV

Directions for the Future

19 Boundaries, Behaviour, and Relationships: The Future

Dave Hartnett

Boundaries are an inevitable feature of tax systems: boundaries between the taxing rights of different fiscs, and boundaries within tax systems (debt/equity, income/capital). There are also behavioural boundaries—for example, acceptable versus unacceptable tax planning (relevant for an increasing number of corporates and featuring increasingly in corporate responsibility statements).

This chapter will focus on behaviour around the boundaries—the behaviour of tax administrators, business, and tax advisers—and the way it shapes the relationships between these three participants in the tax system.

A caricature of the old relationship is the game-keeper/poacher analogy: with tax inspectors viewing themselves as game-keepers, and judging their success by how many poachers or unwary trespassers they catch. This was probably never an entirely justified view but it underlies some of the perceptions.

Following the recent *Review of Links with Large Business*,¹ HMRC wants to forge a new kind of relationship, requiring different behaviours from each of the parties:

HMRC Behaviour

- We will consult—with business and with their advisers—on precisely where the boundaries should lie.
- We will map out the boundary territory clearly in guidance—consulting with business and advisers to make sure that guidance is helpful.
- We will give advance clearances so that boundaries are clear and certain for individual transactions.
- We will not start from the assumption that every business is a potential poacher. Instead we will be more trusting and look at their behavioural track record: do they have appropriate governance systems in place to police the legislative boundaries

1. Available at <<http://www.hmrc.gov.uk/large-business/review-report.pdf>>.

themselves, and do they have policies to reassure us on their behavioural boundaries? Perhaps most importantly, are they transparent?

- We will recognize that intermediaries are generally the front line of compliance and that they play an important and constructive role in tax systems.
- We will acknowledge that for tax advisers, clients' interests are paramount and cannot be compromised in case resolution, though HMRC cannot be expected to accept that delivering a client's wishes can justify aggressive or abusive planning.
- By consulting tax advisers, we will give them a voice on changes in the operation of the tax system with sufficient engagement to allow their unique knowledge to influence final decisions.
- We will ensure an alignment between top management in tax administration and field agents. So if, for example, disclosure of tax schemes and arrangements is an important strategic goal of tax administrators, it should not be seen as a trigger for in-depth, far-reaching investigation without good reason.
- We will be proportionate in the enquiries we make and learn to bring enquiries to an end at the earliest appropriate time.

Business Behaviour

- HMRC is looking to business for good governance, an actively managed tax policy, disclosure, and transparency.
- We want business to alert us when they are in difficult or disputed territory. We would not necessarily expect them always to agree with us on where the boundary lies—but if they flag up potential areas of disagreement we can have a sensible discussion and try to resolve the issue.
- This is 'low-risk' behaviour: however large and complex their affairs, and however many boundary issues may arise, we would expect these businesses to need a minimum of active intervention from HMRC.
- We also expect an alignment of tax with underlying business.
- We want senior leaders in business to take ownership of the behaviour of advisers who represent them.

Tax Advisers—Where Do They Stand in the New Relationship?

- HMRC will look for behaviour that will help to foster the new relationship: guiding clients by giving them a clear view of what HMRC expects and what will be the likely consequences of the choices open to the client—again, this doesn't necessarily mean agreeing with HMRC on every issue. Most importantly, it means working in partnership with HMRC in the client's best interests.
- There should be an end to artificial schemes and arrangements that are hidden from tax administrators and exposed only through heavyweight enforcement action.

- Advisers should help tax administrators better understand business and how companies operate in domestic and global markets. Tax administrators want help in getting to grips with corporate governance, the dynamics of competition, and the responsibilities of financial reporting.
- Tax administrators want advisers' help in gaining better knowledge of industries and best practice, and help in understanding risk management strategies and appetite for risk in relation to tax.
- HMRC will seek out behaviour that will not help to foster the new relationship: deliberately seeking out uncharted or disputed territory, and constructing tortuous paths that penetrate deeper into such behaviour or burrow beneath the fences. Similarly, tax intermediaries should not be advising clients to ask for clearance from HMRC even when the boundary is obvious, thereby swamping our capacity to support those who are genuinely in doubt.

None of this is easy—for HMRC, for business, or for advisers—and it will take time for trust to grow. But it does require cooperative behaviour from all three participants if the new relationship is to be successful.

Do we need a code of conduct governing the way in which we work together? Perhaps. But HMRC has taken a first step in setting out the basis of the relationship in the *Review of Links with Business* and is now committed to making that a reality.

HMRC's Watchwords in Promoting New Behaviours:

- disclosure
- transparency
- cooperation
- proportionality

20 Relationships and Boundaries: The Future

Loughlin Hickey

Future Assumptions

In thinking about relationships and boundaries going forward, it is necessary to make some assumptions or predictions about the future. We will assume a world of commerce as follows:

- Continued globalization and mobility—meaning that more corporates will trade across borders, and more infrastructure investment—telecommunications, power, transport and education—will increase the choices of location for people and assets (both tangible and intangible).
- New ways of doing business will emerge which will mean different ways of creating value and profit and managing risk.
- Global consolidation of industries will continue—for example in energy and natural resources, financial services, and telecommunications.
- The new global investors—China, Russia, India, and private equity will remain important and increase their global influence.
- There will be pressure to converge standards to enable better comparisons between global companies and locations for investment.

Hybrid System

In this world there is likely to be a dislocation between the sophistication of activities being carried on within a country by domestic and foreign enterprises, and the ability/capacity of legal and tax systems to cope with them. To deal with this dislocation, a 'hybrid' system of administering tax needs to emerge.

This hybrid could be:

- a. A foundation in law. Tax legislation would evolve in collaboration with business but would be directed towards introducing law in areas not adequately covered by existing law (for example, financial instruments) rather than having to legislate for every possible nuance of business transactions.

- b. A standard of collaborative behaviour ('a code of conduct') that taxpayers, tax authorities, and tax advisers would be able to 'sign up to'. A common theme in this world is to promote collaborative behaviour rather than use tax legislation to regulate behaviour.

If a code of conduct is to be credible it needs to be administered by an independent body with benefits (such as market or customer confidence and approval) and proportionate and appropriate sanctions available against any or all of the 'signatories'. This means that the tax authorities would not rely on powers to regulate taxpayers and tax advisers, but rather open themselves up equally to the same supervision. This could be a difficult but necessary mindset shift equivalent to making central banks independent of government.

If convergence is to be credible then China, India, and Russia need to be enabled and assisted to transition their tax systems and practices to shape and meet global standards. Also, listed and unlisted corporates (in particular, large private companies and private equity 'conglomerates') should be encouraged to adopt the same standards of collaboration and transparency.

Equally it means global tax 'entities' such as global companies, the Forum on Tax Administration, and global professional services firms need to commit investment funds and assistance to change their behaviours and learn together (for example through joint training and greater mobility between them) to enable global standards to work in practice.

21 OECD Study into the Role of Tax Intermediaries

Lisa Wise

Background

In January 2008 the heads and deputy heads of revenue bodies from over forty countries attended the fourth meeting of the Organization for Economic Cooperation and Development (OECD) Forum on Tax Administration (FTA) in Cape Town, South Africa. The meeting culminated in the publication of the ‘Cape Town Communiqué’,¹ which sets out the FTA’s ambitions for working more closely with business and assisting capacity building in African revenue bodies, and the publication of the key findings of the Study into the Role of Tax Intermediaries.

The study was undertaken by an international team—led by HM Revenue & Customs (HMRC), but closely supported by the OECD secretariat and representatives from FTA countries. It took 15 months to complete and involved extensive, global consultation with tax intermediaries (accountants, lawyers, banks, and other financial institutions) and business representatives. It was set up following the FTA’s previous meeting in Seoul, Korea—but has evolved considerably since its inception—moving from a focus on the role of tax intermediaries in aggressive tax planning to a broader consideration of how tax administrators can work more effectively with large corporate taxpayers and their advisers to encourage greater transparency and disclosure.

The Study’s Findings—Executive Summary

The study’s executive summary sets out the Study Team’s key findings . . .

While tax intermediaries are vital to tax systems, helping taxpayers understand and comply with their obligations, the concerns set out in Seoul were borne out by the study’s findings: that some tax intermediaries continue to develop and promote aggressive tax planning, presenting a key risk revenue bodies have to manage.

1. The Communiqué can be found at http://www.oecd.org/document/39/0,3343,en_2649_37427_39886055_1_1_1_37427,00.html along with the Study Team’s report.

The study team concluded that to understand the role of tax intermediaries, and more importantly, to influence their behaviour, it needed to take a broader view. Tax intermediaries represent the supply side of aggressive tax planning, but large corporate taxpayers, tax intermediaries' clients, set their own strategies for tax-risk management and determine their own appetites for tax risk. They are the ones who decide whether to adopt particular planning opportunities. Taxpayers represent the demand side of aggressive tax planning.

The report therefore considers the tripartite relationship between revenue bodies, taxpayers, and tax intermediaries. The Study Team concludes that there is significant scope to influence the demand side—at least in relation to large corporate taxpayers, the taxpayer segment that is the principal focus of the study.

In addressing the demand side, risk management is an essential tool for revenue bodies, assisting with the identification and treatment of risks. It allows revenue bodies to assess the risk presented by taxpayers or groups of taxpayers and then allocate resources to respond to those risks.

Risk management relies on information, which makes it important to encourage disclosure from taxpayers. This means revenue bodies need to operate using the following five attributes when dealing with all taxpayers: understanding based on commercial awareness; impartiality; proportionality; openness (disclosure and transparency); and responsiveness.

If revenue bodies demonstrate these five attributes and have effective risk management processes in place, this should encourage large corporate taxpayers to engage in a relationship based on cooperation and trust, with both parties going beyond their statutory obligations. This 'enhanced relationship' is central to the report.

As well as benefiting revenue bodies, the enhanced relationship will also benefit many taxpayers. For example, taxpayers who represent lower risks can reasonably expect a cooperative relationship with revenue bodies and therefore lower compliance costs, with increased certainty at an earlier stage.

The Study Team recognizes that the demand for aggressive tax planning will not disappear completely, and some large corporate taxpayers may choose not to adopt the enhanced relationship. Revenue bodies will need to have effective risk-management processes in place to identify these taxpayers and allocate the necessary levels of resources to deal with them.

The report's recommendations have the potential, if fully implemented, to reduce the demand for aggressive tax planning and to give revenue bodies much better information about aggressive tax planning and therefore the opportunity to devise more effective responses. If the demand can be reduced, the supply of aggressive tax planning would also fall. In this way, the Study Team believes revenue bodies can best respond to the development and promotion of aggressive tax planning by tax intermediaries. More generally, the implementation of the Study Team's recommendations should lead to a more constructive relationship between revenue bodies, taxpayers, and tax intermediaries.

Next Stages

The response to the study has been overwhelmingly positive, with business and tax intermediaries publicly welcoming the study's focus on building positive cooperative relationships and a risk-based approach to compliance. So what are its implications for the FTA and tax administration more generally?

For the FTA, the study has started a dialogue with business that Commissioners are keen to build on—this process has already started with business leaders attending the Cape Town meeting and the Cape Town Communique, setting out hopes for taking this forward:

In addition, we will continue to encourage a global dialogue with large corporate taxpayers and their advisers. We have seen how, through working together with them, we are able to influence and learn from the global environment within which national tax systems operate.

The study has also helped shape the FTA's forward work plan with further studies into high-net-worth individuals and banks already being actively taken forward.

For FTA countries the report deliberately does not set out a prescriptive approach and each country must decide how to apply the recommendations in their particular context—it will therefore mean different things in different countries.

Some countries, for example Ireland, the Netherlands, and the USA, already have initiatives that look quite like an 'enhanced relationship'—with a focus on a risk-based, cooperative approach to compliance. For such countries the report supports the further development of these early experiences.

For HMRC the study's findings complement the *2006 Review of Links with Business*—which similarly advocates the need for greater trust and cooperation between HMRC and business. What is new is the increased focus on the tax intermediary role within this relationship and the need for all three parties to contribute to the effectiveness of the

tax system. HMRC are currently considering how to bring this focus into the *Review of Links* model.

For other countries the report may simply provide the opportunity to open up dialogue with business and tax intermediaries and to use this dialogue to influence compliance strategies.

For all countries the study has shown that by working together, revenue bodies, tax intermediaries, and business can seek to find solutions that benefit all. As Dave Hartnett, Acting HMRC Chairman commented:

A more cooperative, trust-based tax environment will result in greater certainty, more timely resolutions, and reduced compliance costs for taxpayers and their representatives.

This is groundbreaking work by OECD, led by HMRC, which can be drawn-upon by revenue bodies throughout the world as a template in constructing a better working relationship with intermediaries and corporate clients.

22 Plain English Drafting, Purposive Drafting, Principle-based Drafting: Does Any of it Matter?

Richard Krever

In the early decades of the 20th century, the income tax emerged as the preferred broad-based tax on gains, fending off a strong assault from the closest alternative, the expenditure tax. The income tax adopted in all western economies turned out to be far different from the theoretical neutral and equitable benchmark, however, measuring nominal gains only, generally ignoring or badly executing the task of measuring imputed rents, using a realization base with no compensating charge for the benefits of deferral, and imposing the tax on a base that waxes and wanes in response to political pressures. The resulting inequities and inefficiencies were exacerbated by the exploitation of arbitrage opportunities created by overlaps and lacunae, narrow ‘black-letter’ interpretation by the courts, and a pattern of piecemeal and ad hoc responses to the most costly problems. The narrowly targeted legislative responses inevitably acted as signposts to more avoidance opportunities, prompting never-ending rounds of knee-jerk reactions yielding new avoidance possibilities.

Somehow, despite the obvious flaws and fragility, the tax keeps working, generating the bulk of revenues in all developed countries. In most cases, a significant proportion of the income is paid by labour, particularly employees, with a disproportionately small percentage of revenue generated by the taxation of returns to capital, at least measured in terms of the churning and multiplicity of rules applying to that source of income.

What is clear to all players is that the legislative complexity embedded in the tax generates enormous deadweight losses in terms of compliance and administration costs. Talk of ‘reform’ and ‘simplification’ is as old as the tax itself. Somehow, more than half a century of ‘reforms’ aimed in part at simplification have yielded only increased complexity and confusion. The chair of a recent reform commission in Australia noted that if the pattern of exponential growth in legislative changes in that country were to continue, before too long the nation would have an infinite number of pages in its income tax law.

Increasing complexity in tax law has generated a growing business in investigating the causes of and possible solutions to the phenomenon. Finding the principal culprits has not been that difficult; solutions are proving more elusive. In the past decade, much of the focus has been on drafting techniques as a possible solution to the problem of complexity. At various times, advocates of drafting techniques as the solution to complexity have spoken of ‘plain English’ drafting, ‘purposive’ drafting, and ‘principle-based’ drafting as preferred options. Some of these techniques may be counter-productive, actually increasing complexity; while none is a panacea for the problems of the income tax, principle-based drafting may go some way to alleviating the problem.

What Causes Complexity?

Studies in tax law complexity suggest a number of causes of complexity in tax law. For the most part, however, the studies fail to identify correctly the principal causes, as they either start with economic theory rather than actual experience or they are based on highly subjective surveys. Analyses based on objective data such as the subject matter of private ruling requests reveals four key causes of complexity: the use of tax expenditures, the effect of transplanted categories, the consequences of judicial inclinations, and the impact of rigid legislation.

Tax Expenditures

Almost all studies of complexity suggest tax expenditures are a major cause, if not *the* major cause, of complexity. The propensity of governments of all political persuasions to use the tax law as a spending tool is universal and the complexity it yields is the stuff legends are made of—what practitioner doesn’t dream of retiring on the proceeds of an argument before the House of Lords on the meaning of a biscuit for VAT purposes? But is it really the case that tax expenditures are inherently complex? The problem appears not to be one of complexity, but rather, a failure of the legislative designers and drafters to apply the same rigorous definitions and limitations to tax expenditures as they do for direct expenditures. Consider the Australian VAT zero-rating concession for infant beverages:

Beverages that are [zero-rated]:

beverages, and ingredients for beverages, of a kind marketed principally as food for infants or invalids.

What is an infant—someone under 18? Who knows what the target market is—the manufacturer, the retailer, the ad agency? Does ‘principally’ mean most time (daytime TV) or most money (prime time spots)? How generic is the ‘kind’ that might include the targeted drink?

If there are answers to these questions, they are not to be found in the law. Nor does the law provide guidance to taxpayers, tax administrators, or tax adjudicators on the

principles that could be used to interpret the terms. The section is confusing and thus complex, leading to ruling requests and litigation, and imposing high compliance costs on taxpayers and high administrative costs on the tax authority.

Time and again critics argue that tax expenditures are inevitably complex—the Treasury and Inland Revenue by definition cannot know how to design and monitor spending programs as well as the line agencies. This observation is probably true, but it doesn't necessarily follow that all tax expenditures are inherently complex. If we can design precise and administrable spending programs for implementation by line ministries, surely we can insert similar provisions into the income tax law. Failure to do so is not because it can't be done; it is because the government does not want it to be done. Tax expenditures are used more often than not because the government does not want to be seen explicitly to be favouring beneficiaries of the expenditures. Fuzzy drafting delegates the task of being the bad guys to Inland Revenue, leaving the politicians in the clear.

Transplanted Categories

The second most important cause of complexity is the inherent uncertainty of key concepts in tax legislation resulting from the propensity of Anglo judges (apart from US judges) to use 'transplanted categories' when interpreting tax legislation. The phenomenon derives from a misapplication of the doctrine of precedent. For example, when interpreting the meaning of 'employee' in income tax law, common law judges rely on tests that were developed a century earlier to identify employees for vicarious liability purposes. When interpreting the terms 'income' or 'capital', they turn to trust law concepts. When deciding who derives gain, they look to property law concepts. And when deciding whether a corporate taxpayer is 'in' the jurisdiction when a tax event takes place, they look at civil procedure service *ex-juris*, service *in-juris* cases. Any coincidence of the purpose of the transplanted concept in its original application and the purpose of the concept in tax law is just that—pure coincidence.

Judicial reliance on transplanted doctrines rather than interpreting terms in light of the objectives of tax laws yields complexity in two respects. Initially, it causes confusion as taxpayers and tax administrators struggle to apply inherently uncertain notions to very certain economic transactions. The legislature's attempts to redraft legislation to overcome the most egregious departures from sound tax policy caused by the transplanted categories regularly leads to further fragmentation of tax concepts. More often than not, the process commences with an initial *ex post facto* endorsement of judicial characterizations by the legislature, thus cementing the causes of complexity and then compounding them.

Judicial Inclinations

A third significant cause of tax complexity lies in the tendency of many Anglo judges to construe taxation laws narrowly, resolving ambiguity in favour of the taxpayer and,

significantly, favouring form over substance. With few exceptions, the most significant being the relatively limited fiscal nullity jurisprudence, Anglo judges other than those of US courts are quite content to apply tax law to dissected elements of multi-stage arrangements without considering the effect of the elements working together. Thus, for example, in the absence of specific legislative direction to the contrary, an Anglo court will accept a taxpayer's dissection of a secured repo loan into separate sale, put option, and repurchase obligations. By way of contrast, a US judge looking at the same repo arrangement would simply consider all the pieces of the transaction as a whole and conclude the purchaser/reseller's profits on the repo transaction was income for tax purposes.

Rigid Legislation

An income tax, particularly a realization-basis income tax, is based on a limited number of relatively simple concepts. Taxable income is the difference between gross receipts and expenditures incurred to derive those receipts. On the income side, some accounting rules are needed to ensure receipts are not recorded before they are actually earned and the taxpayer's entitlement to the amounts crystallize. Parallel rules are needed on the outgoing side to ensure expenses for long-term benefits (including wasting assets) are not deducted before the benefits are actually consumed. A few more rules are needed to include receipts that courts, relying on judicial notions of income, would otherwise exclude from the tax base and, of course, rules are needed for tax expenditures and tax administration.

There is little evidence of the simple principles of an income tax in the legislation. To the contrary, the current construction almost seems designed to obscure principles. For example, a concept fundamental to any income tax system is that capital expenses—that is, expenses that yield benefits that last over several accounting periods—should be deducted over the effective life of the benefits acquired. The income tax law includes a proviso that prevents taxpayers from deducting immediately capital expenses but it contains no general fall-back rule for the recognition of these outgoings over the life of wasting assets, or when the assets are sold in the case of non-wasting assets. Instead, it has a series of distinct amortization rules for different types of wasting assets and a separate capital gains tax to recognize the cost of non-wasting assets. Expenses that fall between the rules are never recognized for tax purposes—they are 'nothings' in the tax world. In the absence of any general rule, the legislature must respond to pressure for expense recognition with separate measures for each new allowance or cost recognition measure. The indeterminate borders between categories generate new complexities.

Solutions

Scholars, practitioners, and revenue and Treasury officials have proposed a wide range of responses to the problem of complexity in tax law. The pragmatic solutions, which recognize the inevitability of tax expenditures remaining in the tax law, the continued use

of transplanted categories, and the inclination of judges to construe legislation narrowly and in favour of taxpayers, fall into three main camps: plain English drafting, purposive drafting, and principle-based drafting. The first two are destined to fail; the third may provide a solution.

Plain English Drafting

In a wide range of English-speaking countries at least, the initial proposed solution to complexity in income tax law was the adoption of ‘plain language’ drafting or, as it is known in the Anglo countries, ‘plain English’ drafting. It was always a fantasy at best to believe that rewriting confusing and bad law in clearer language could address any of the underlying causes of its complexity. The enduring legacy, perhaps, of experiments in plain English tax law drafting is the exposure to laypersons and legislatures of the complexity built into tax law by making obvious the wholly inconsistent treatment provided for economically identical but legally different forms of transactions, as well as revealing plainly the countless overlaps and gaps throughout the law.

Purposive Drafting

Following the failure of plain English drafting to solve the problem of tax law complexity, many advocated the use of ‘purposive drafting’ as a solution. If the law explained the purpose of a provision, it was thought, the courts would have to interpret the words of the provision appropriately, thus sweeping away one of the principal causes of complexity.

An example of purposive drafting may be found in Schedule 13 of the UK Finance Act 2007:

Purpose of Schedule

1(1) The purpose of this Schedule is to secure that in the case of an arrangement—

- (a) which involves the sale of securities and the subsequent purchase of securities, and
- (b) which equates, in substance, to a transaction for the lending of money at interest from or to a company (with the securities which were sold as collateral for the loan),

the charge to corporation tax in that case reflects the fact that the arrangement equates, in substance, to such a transaction.

The provision makes it clear what the provisions that follow are intended to achieve—they treat the sale and guaranteed repurchase of ‘securities’ as a secured loan. But it does nothing to address the problems of complexity. To the contrary, it is guaranteed to substantially increase complexity. The fundamental problem is the refusal of Anglo judges (outside the US) to look at the three elements of a multi-step transaction—a sale, a put

option, and a repurchase—as a single transaction. If the elements were considered together, it would be clear the transaction in its entirety is a loan.

The initial repo loan schemes that prompted a legislative response involved the sale and repurchase of securities. The legislation is directed at this narrow class of arrangements. By focusing on one particular type of asset—securities—the legislation invites taxpayers to avoid the rule by engaging in the same transaction but substituting other assets. The result will no doubt be further legislation, a series of ad hoc and narrow provisions that serially address each type of asset used as the different cases emerge one by one. And each narrow response will add layers of complexity to the law, however clearly the narrow purpose of the anti-avoidance provisions may be stated.

Principle-based Drafting

The most recent proposal to address the problem of complex tax legislation is the use of principle-based drafting. Principle-based drafting structures legislation in a ‘pyramid’ form, starting with fundamental principles and then carving out exceptions to the basic fall-back rule. This approach stands in stark contrast to current practice which is based on the use of multiple separate provisions dealing with specific instances, devoid of principle. For example, rather than a series of measures that first state arrangements involving the sale, put option, and repurchase of securities amounts are deemed to be a loan, followed by another provision deeming the sale, put option, and repurchase of real property to be a loan, and a third deeming the sale, put option, and repurchase of commodities to be a loan, and so forth, principle-based drafting will establish one principle that applies to all sales, put options, and repurchases of an asset or substitute asset. Concessions or exceptions would then be carved out of the fall-back position—if a transaction does not fall into a carve-out, it should unambiguously be caught by the fall-back rule.

The general provision for recognition of wasting capital assets in the US is often held out as an example of principle-based drafting.

Internal Revenue Code section 167.

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

- (1) of property used in the trade or business, or
- (2) of property held for the production of income.

While there may be factual disputes as to the effective life of an asset, the general principle set out in the section leaves no room for disputes as to whether a deduction should be allowed. There is no artificial distinction between airport runways and airport hangars or between tangible property, intangible intellectual property, or even intangible rights such

as contractual rights. If the asset wastes, the cost is deductible over the life of the asset. The principle is clear. Separately, the revenue authority can establish guidelines for what is a reasonable allowance for different types of assets. Courts will accept the revenue authority's rulings as reasonable estimates so long as the estimates allow taxpayers to recognize the cost in a fair manner over the lives of the assets.

23 Relationships, Boundaries, and Corporate Taxation: Compliance and Avoidance in an Era of Globalization

David Duff

In its *2006 Review of Links with Large Business*,¹ and subsequent reports in March 2007,² Her Majesty's Revenue and Customs (HMRC) affirms two approaches to its relationship with large businesses.³ First, through reduced complexity, greater certainty, increased communication and clarity, and the speedy resolution of contentious tax issues, HMRC intends to facilitate tax compliance by large businesses—'making it as easy as possible for business to get their tax affairs right' and 'helping them to meet their obligations'.⁴ Second, HMRC maintains it is 'also committed to deal firmly with those who intentionally fail to meet their responsibilities'⁵ through a risk-based approach to tax administration that will direct increased resources to high-risk businesses, including those which do not adequately manage their 'tax compliance risks' or 'repeatedly push . . . at the boundary of the law'.⁶

This chapter reflects on HMRC's dual approach to its relationship with large businesses, considering questions of tax compliance and tax avoidance in the context of increased globalization and cross-border activity. Beginning with a brief discussion of tax compliance

1. HMRC, '2006 Review of Links with Large Business' (November 2006) <<http://www.hmrc.gov.uk/large-business/review-report.pdf>>.
2. HMRC, 'Making a Difference: Delivering the Review of Links with Large Business' (March 2007) <<http://www.hmrc.gov.uk/budget2007/large-business-plan07.pdf>>; and HMRC, 'HMRC Approach to Compliance Risk Management for Large Business' (March 2007) <<http://www.hmrc.gov.uk/budget2007/large-business-riskman.pdf>>.
3. For a comprehensive review of these reports and the response to these reports by large businesses in the UK, see J Freedman, G Loomer, and J Vella, *Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC* (Report of the Oxford University Centre for Business Taxation, Oxford June 2007), available at <<http://www.sbs.ox.ac.uk/Tax/publications/reports/Reports.htm>>. See also Ch 10, this volume.
4. *2006 Review* (n 1) para 1.2.
5. *Ibid.*
6. *Approach to Compliance Risk Management* (n 2) para 1.4.

and risk-based regulation, we then consider the questions of legal clarity and taxpayer certainty, before concluding with a short evaluation of general and specific anti-avoidance rules.

Tax Compliance and Risk-based Regulation

According to HMRC, the heart of its approach to tax compliance is the belief that the majority of large businesses ‘want to pay the right amount of tax at the right time’.⁷ On this basis, it explains, it seeks to ‘build a relationship of trust and openness with our large business customers’—promising ‘open dialogue’ about its approach to risk assessment and ‘greater clarity and certainty’ through a proposed system of clearances and advance rulings, in exchange for ‘transparency from our business customers about their approach to tax risk management and disclosure of any areas of legal uncertainty’.⁸

This approach to tax compliance differs markedly from traditional models of tax administration, which assume that taxpayers are generally non-compliant and are induced to comply only through the combined operation of detection and sanctions.⁹ Although it would be naïve to suggest that the probability of enforcement and the severity of penalties have no effect on tax compliance,¹⁰ several studies indicate that attitudes toward legal compliance are also shaped by social norms as well as institutional and procedural arrangements that build trust about the fairness of the tax system and the legitimacy of government more generally.¹¹ These expanded theories of legal compliance underlie a fundamental transformation in regulatory strategies over the last 10–20 years away from traditional conceptions based on ‘command and control’ in favour of more flexible approaches described as ‘responsive regulation’.¹²

7. *Ibid.*, para 1.3.

8. *Ibid.*, para 1.8. See also *Making a Difference* (n 2) para 3.7.

9. See, eg, MG Allingham and A Sandmo, ‘Income Tax Evasion: A Theoretical Analysis’ (1972) 1 J Pub Econ 323.

10. On the contrary, evidence suggests that voluntary compliance is greatest where the probability of detection is highest due to third party reporting. L Lederman, ‘Tax Compliance and the Reformed IRS’ (2003) 51 Kan L Rev 971, 974–8. In contrast to the probability of detection, there is less evidence that the severity of penalties has a significant impact on compliance. S Leviner, ‘A New Era of Tax Enforcement: From “Big Stick” to Responsive Regulation’ (November 2006) University of Michigan Law School Public Law and Legal Theory Working Paper Series, Working Paper No. 68 22.

11. See, eg, M Blumenthal, C Christian, and J Slemrod, ‘The Determinants of Income Tax Compliance: Evidence from a Controlled Experiment in Minnesota’ (2001) 79 J Pub Econ 455; M Blumenthal, C Christian, and J Slemrod, ‘Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota’ (2001) 54 Nat Tax J 125; L Lederman, ‘The Interplay Between Norms and Enforcement in Tax Compliance’ (2003) 64 Ohio St L J 1453; and M Wenzel, ‘The Multiplicity of Taxpayer Identities and Their Implications for Tax Ethics’ (2007) 29 Law & Policy 31. For a more general discussion, see T Tyler, *Why People Obey the Law* (Yale University Press, New Haven 1990).

12. See, eg, I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, New York 1992); and J Braithwaite, *Restorative Justice and Responsive Regulation* (Oxford University Press, Oxford 2002). For a recent symposium on responsive regulation and taxation, see (2007) 29 Law & Policy 1–158.

According to a recent explanation by Valerie Braithwaite, responsive regulation refers to the practice of:

- (a) influencing the flow of events (b) through systematic, fairly directed, and fully explained disapproval (c) that is respectful of regulatees, helpful in filling information gaps, and attentive to opposing or resisting arguments, (d) yet firm in administering sanctions (e) that will escalate in intensity in response to the absence of genuine effort on the part of the regulatee to meet the required standards.¹³

Among the insights of this responsive approach to tax administration is the idea of a 'regulatory pyramid' which comprises a series of regulatory responses that a tax authority might employ to promote compliance, commencing with the least intrusive for the majority of complying taxpayers at the bottom of the pyramid to the most intrusive for a minority of consistent non-compliers at the top of the pyramid.¹⁴ Another insight is that the most effective and efficient way to promote tax compliance is to share the regulatory function not only with taxpayers themselves (through disclosure and self-regulation) but also with other constituencies with an interest in tax compliance.¹⁵ To the extent that weak corporate governance facilitates tax non-compliance as well as the diversion of corporate resources by corporate managers,¹⁶ for example, corporate shareholders may share the revenue authorities' interest in increased transparency.

Emphasizing trust, communication, and transparency, as well as risk-based regulation, HMRC's twofold approach to its relationship with large businesses is firmly rooted in the theory of responsive regulation. Assuming that most large businesses seek to comply with the law,¹⁷ HMRC's initial regulatory approach is to help businesses to comply,¹⁸ by reducing complexity, improving certainty, increasing communication and clarity, and ensuring the speedy resolution of contentious tax issues.¹⁹ Where HMRC believes that the business is 'not managing its compliance risks adequately, or is repeatedly pushing at the boundary of the law', on the other hand, it promises to 'intervene quickly and intensively'.²⁰ In order to distinguish

13. V Braithwaite, 'Responsive Regulation and Taxation: Introduction' (2007) 29 *Law & Policy* 3, 5.

14. *Ibid* at 4–5.

15. On the role of public interest groups in responsive regulation, see Ayres and Braithwaite, *Responsive Regulation* (n 12) 57–8.

16. See M Desai, A Dyck, and L Zingales, 'Theft and Taxes' (2007) 84 *J Fin Econ* 591; and M Desai and D Dharmapala, 'Corporate Tax Avoidance and Firm Value' (2005) NBER Working Paper No. 11241 <<http://www.nber.org/papers/w11241.pdf>>. See also M Desai, Ch 12, this volume.

17. *Approach to Compliance Risk Management* (n 2) para 1.3 ('our large business customers have the same core objective in managing tax risk as HMRC—to ensure compliance with the law').

18. *Ibid*, para 1.7.

19. *2006 Review* (n 1) para 1.2.

20. *Approach to Compliance Risk Management* (n 2) para 1.4.

between low and high-risk businesses, moreover, HMRC will consider among other factors 'strong corporate governance, including transparency in its relations with HMRC'.²¹

Notwithstanding the merits of this responsive approach to regulation, there are two concerns about the HMRC approach that should be noted. First, since corporations tend to be less motivated than individuals by social norms and institutional and procedural arrangements that might otherwise encourage tax compliance,²² corporate behaviour is apt to be influenced more by traditional deterrence strategies emphasizing detection and sanctions, than by regulatory approaches emphasizing communication and trust.²³ This is particularly so in an era in which corporations are increasingly multinational in character, lacking any strong allegiance to any particular state.²⁴ Indeed, research suggests that the pattern of compliance for corporate taxation is shaped more like an oval than a pyramid.²⁵

Second, and more importantly, by basing its regulatory response on its assessment that a business is 'repeatedly pushing at the boundary of the law', HMRC assumes a shared understanding of the content and boundaries of the law that may not exist.²⁶ To the extent that the law is not clear, therefore, HMRC's approach may undermine the rule of law—allowing the revenue authority to insist on a particular interpretation or approach to interpretation through the threat of heightened administrative scrutiny, notwithstanding that the specific interpretation or interpretive approach has not been adopted by the courts. Although it seems reasonable to conclude, as the House of Lords has effectively done,²⁷ that the content of the law includes its object or purpose as well as the statutory text, this object or purpose is not always obvious—especially if legislation is drafted in a detailed technical style that eschews more general statements of purpose. Nor are the boundaries of UK tax law necessarily clear where a taxpayer engages in transactions that have little or no economic substance or are motivated solely or primarily by tax considerations—two considerations which HMRC considers relevant to the categorization

21. *Ibid.*, para 4.4.

22. See, eg, R Avi-Yonah, 'Corporate Social Responsibility and Strategic Behavior' (December 2006) University of Michigan Law School Public Law and Legal Theory Working Paper Series, Working Paper No. 69 (arguing that corporations should, but generally do not, act in accordance with notions of social responsibility).

23. This conclusion is supported by evidence that shareholders do not regard corporate tax avoidance as a significant corporate governance issue. See, eg, M Hanlon and J Slemrod, 'What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Aggressiveness' (23 January 2007) <http://www.americantaxpolicyinstitute.org/pdf/HS_012407.pdf>. See also Freedman, et al, *Moving Beyond Avoidance?* (n 3) 38–40.

24. This point is made by W Schön in Ch 6, this volume.

25. J Braithwaite, 'Large Business and the Compliance Model,' in V Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion*, (Aldershot, Ashgate 2003) 177 at 180.

26. For a more general critique of responsive regulation on this basis, see M Burton, 'Responsive Regulation and the Uncertainty of Tax Law—Time to Reconsider the Commissioner's Model of Cooperative Compliance?' (July 2007) 5 *eJournal of Tax Research* 71.

27. *Barclays Mercantile Business Finance Ltd. v HM Inspector of Taxes* [2004] HL 51, [2005] STC 1.

of ‘high-risk’ businesses.²⁸ For both of these reasons, therefore, risk-based regulation should not function as a substitute for clear and certain laws.

Legal Clarity and Taxpayer Certainty

Legal clarity and certainty are central to the rule of law, allowing legal subjects to comply with the law, and maximizing their scope for freedom of action within the bounds that are established by the law.²⁹ In practice, however, legal clarity and certainty are necessarily limited, as there is always some uncertainty in the application of general laws to specific circumstances.³⁰ This is particularly true when the assumptions on which legislation was initially enacted no longer apply due to social or economic changes.³¹ A good example of this phenomenon in the tax area is the impact of globalization on the bilateral tax treaty network, which has increased rapidly over the last 40 years, and has resulted in new tax avoidance strategies involving transfer pricing, treaty shopping, the use of conduit companies, and international tax arbitrage.

Income tax legislation in particular is notoriously complicated, not only because legislatures often complicate these statutes with special incentives or tax expenditures, but more generally because the transactions and relationships to which the legislation must apply are often complicated themselves and detailed rules are frequently required in order to ensure equity or fairness. In addition to these factors, narrow and literal judicial decisions have often contributed to the complexity of tax statutes, as legislatures have had to enact detailed specific provisions in order to address judge-made anomalies.³²

In its approach to large business, HMRC proposes to improve clarity and increase certainty by consulting with business on the application of the law,³³ by extending existing clearances to cover ‘the tax consequences of significant commercial issues whenever there is uncertainty’,³⁴ and by introducing ‘a system of advance rulings to give UK and international business certainty about the tax consequences of significant investments and corporate reconstructions’.³⁵ A more recent document explains how HMRC will administer these clearances and advance rulings,³⁶ explaining that these arrangements will provide

28. *Approach to Compliance Risk Management* (n 2) para 5.12.

29. J Raz, ‘The Rule of Law and its Virtue’ (1977) 33 LQR 195, 204.

30. Even Friedrich Hayek acknowledges this limitation, insisting on ‘fair certainty’ regarding legal rules. FA Hayek, *The Road to Serfdom* (University of Chicago Press, Chicago 1994) 80.

31. This point is made by D Ulph in Ch 11, this volume.

32. See, eg, S Bowman, ‘Interpretation of Tax Legislation: The Evolution of Purposive Analysis’ (1995) 43 Can Tax J 1167, 1184.

33. *Approach to Compliance Risk Management* (n 2) para 3.11 (‘Wherever possible we want to rely on a customer’s own understanding of how the law applies to their business, and on their systems and governance.’).

34. *2006 Review* (n 1) para 1.11 (‘Key proposal 2’).

35. *Ibid*, para 1.10 (‘Key proposal 1’).

36. HMRC, *Giving Certainty to Business through Clearances and Advance Agreements*, 20 June 2007.

business with much-needed certainty on ‘the tax consequences of a particular transaction’ in the case of clearances,³⁷ and binding rulings across all relevant taxes for businesses contemplating a ‘major inward investment’.³⁸ In each case, HMRC explains that the clearance or ruling will be binding only if the applicant has ‘set out all the relevant facts and drawn attention to all of the issues’.³⁹ Here too, therefore, trust and transparency are central to HMRC’s administrative approach.⁴⁰

Although clearances and advance rulings can ensure a measure of certainty for businesses which require this assurance before proceeding with a transaction or major investment, it is important to recognize that these arrangements—like risk-based regulation—are not a substitute for clear and certain laws. To the extent that HMRC will not grant a clearance or advance ruling where ‘the arrangement seems to be included primarily in order to obtain a tax advantage’,⁴¹ therefore, HMRC may be using its administrative authority to advance an interpretive approach that is neither stipulated by legislation nor clearly adopted by the courts. In practice, of course, as Freedman et al report, businesses are unlikely to seek a clearance or advance ruling where the arrangements that they propose to undertake are primarily tax-motivated or ‘push . . . at the boundary of the law’.⁴²

The Role of Anti-avoidance Rules: General and Specific

This brings us back to the subject of tax law itself—both the ordinary provisions that define a taxpayer’s basic tax obligations and anti-avoidance doctrines and rules (general as well as specific) that limit the scope of permissible avoidance.

As David Pickup’s survey demonstrates, all major English-speaking countries except the United Kingdom have devised general anti-avoidance doctrines (GAARs) and rules that attempt to preclude abusive tax avoidance.⁴³ Without considering the merits of different approaches, this record suggests that each of these countries has concluded that some kind of general anti-avoidance regime is a valuable component of any tax system in order to prevent tax-motivated arrangements that contradict the object or purpose of the relevant provisions or statutory scheme. Although various justifications for these general anti-avoidance regimes might be advanced,⁴⁴ they are best explained as a recognition of the

37. *Ibid*, para 2.3.

38. *Ibid*, para 4.2.

39. *Ibid*, para 3.23.

40. *Ibid*, para 2.4.

41. *Ibid*, para 3.27.

42. Freedman et al, *Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC*, at 33.

43. See Ch 2, this volume.

44. See, eg, D Weisbach, ‘Formalism in the Tax Law’ (1999) 66 *Chi L Rev* 860 (arguing that anti-avoidance provisions allow ordinary rules to be simpler overall).

comparative institutional competence of courts over legislatures in addressing unforeseen (and often unforeseeable) implications of ordinary tax provisions.⁴⁵

So understood, general anti-avoidance regimes obviously have a limited and residual role in preventing unacceptable tax avoidance—functioning, as John Tiley rightly emphasizes,⁴⁶ as ‘a measure of last resort’ when ordinary provisions and specific anti-avoidance rules fail to prevent a tax benefit that is not consistent with the object or purpose of the relevant provision or statutory scheme. Although these general anti-avoidance regimes are inevitably open-ended and imprecise, and therefore decried by some as contrary to the rule of law,⁴⁷ it is also arguable that they uphold the rule of law by invalidating deliberate arrangements that are designed to defeat the object or purpose of the law.⁴⁸

As measures of last resort, however, general anti-avoidance regimes should not be generally relied upon to address reasonably foreseeable methods of tax avoidance occasioned by statutory differences in the tax treatment of similar transactions or relationships.⁴⁹ In these circumstances, to the extent that the avoidance is considered unacceptable, the preferred response is for the legislature either to amend the specific provisions at issue or to introduce a specific anti-avoidance to preclude their use for unacceptable tax avoidance.⁵⁰

Returning to the international context, in which globalization and the expansion of the tax treaty network has created new opportunities for international tax avoidance in the form of transfer pricing, treaty shopping, conduit companies, and international tax arbitrage, one might ask whether the most effective response to these strategies involves specific anti-avoidance rules like those for transfer pricing, or more general anti-avoidance principles such as the limitation of benefit articles included in US tax treaties, or the concept of tax treaty abuse expressed in the commentary to Article 1 of the OECD Model Treaty. Although the decision of the French Conseil d’État in the 2006 *Bank of Scotland* case suggests that a general principle of tax treaty abuse may be successfully employed to limit the availability of tax benefits from treaty shopping,⁵¹ Canadian experience in *MIL*

45. See the section on ‘Statutory Interpretation, Tax Avoidance, and Institutional Competence’ in DG Duff, ‘Justice Iacobucci and the “Golden and Straight Metwand” of Canadian Tax Law’ (2007) 57 UTLJ 525, 576–78.

46. See Ch 9, this volume.

47. See, eg, J Nitikman, ‘Is GAAR Void for Vagueness?’ (1989) 37 Can Tax J 1409.

48. Duff (n 45) 575.

49. T Edgar, ‘Designing and Implementing a Target-Effective General Anti-Avoidance Rule’ in DG Duff and H Erlichman, *Tax Avoidance in Canada after Canada Trustco and Mathew* (Irwin Law, Toronto 2007) 221 (arguing that general anti-avoidance rules should not apply to ‘transactional substitutes’).

50. To the extent that these amendments are not retroactive, it may be necessary to rely on more general anti-avoidance regimes to prevent unacceptable avoidance. Once identified, however, clarity and certainty can be enhanced by amendments to the ordinary tax provisions or the enactment of a specific anti-avoidance rule.

51. CE 20 December 2006, No. 283314.

Investments v The Queen is much less encouraging, as the Tax Court of Canada and the Federal Court of Appeal refused to apply the Canadian GAAR to a tax-motivated series of transactions in which the taxpayer continued into Luxembourg in order to obtain a treaty exemption (and non-taxation in Luxembourg) on the disposition of shares in a Canadian mining enterprise that were worth over \$500 million.⁵²

In contrast to the undefined concept of tax treaty abuse, several countries have developed detailed transfer pricing rules to govern transactions among associated enterprises.⁵³ Although these rules are extremely difficult to apply in practice, they have at least established a common understanding of the relevant legal standard in light of which businesses and revenue authorities increasingly negotiate advance pricing agreements (APAs) to govern transactions among associated enterprises. Based on trust and disclosure, these APAs reflect a similar strategy for promoting legal clarity and certainty as HMRC's proposal for clearances and advance rulings. Unlike HMRC's proposal for clearances and advance rulings, however, APAs are negotiated on the basis of a shared understanding by taxpayers and revenue authorities that transactions among associated enterprises are properly governed by the arm's-length principle expressed in Article 9 of the OECD Model Treaty. Absent judicial or legislative clarification on the boundaries of UK tax law, however, a shared understanding of the legal background against which HMRC will issue clearances and advance rulings seems unlikely.

Conclusion

While HMRC's new approach to corporate tax compliance and administration reflects a welcome recognition of risk-based regulation as a more effective and efficient method of enforcement than traditional approaches, it may suffer from two deficiencies. First, to the extent that corporate tax compliance differs from individual tax compliance, it may be unrealistic to assume that trust, communication, and transparency will produce meaningful changes in the relationship between HRMC and the corporate sector. Second, and more importantly, by promising to 'deal firmly' with corporations which 'repeatedly push . . . at the boundary of the law', HRMC may be using risk-based regulation as an administrative substitute for judicial or statutory anti-avoidance rules. The same may also be said of HMRC's policy on clearances and advance rulings, which it will not grant for arrangements which appear to be entered into 'primarily in order to obtain a tax advantage'.

In a society that respects the rule of law, administrative practice should not operate as a substitute for law. In order to support HRMC's administrative practices, therefore, the UK should follow the practice of most other developed countries by enacting a general

52. [2006] 5 CTC 2552, 2006 DTC 3307 (TCC), aff'd [2007] 4 CTC 235, 2007 DTC 5437 (FCA).

53. See, eg, R Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (1995) 15 Va Tax Rev 89.

anti-avoidance rule. As well, since a general anti-avoidance rule necessarily serves only a limited and residual role in preventing unacceptable tax avoidance, this rule should be supported by specific anti-avoidance rules and other legislative amendments designed to encourage legal clarity and certainty. As experience with international transfer pricing and APAs suggests, only with relatively clear legal standards and rules in place can taxpayers and revenue authorities have a shared understanding of when a transaction or arrangement may reasonably be considered to have crossed the boundary of the law.

