

**Does the Use of General Anti-Avoidance Rules to Combat Tax
Avoidance Breach the Rule of Law?¹**

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¹ The authors gratefully acknowledge the support of the Henry Lang Fellowship, Institute of Policy Studies, Wellington, towards the writing of this paper.

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1. Introduction

1.1 The rule of law and tax avoidance

“The rule of law” is a compendious term for a number of related values that people generally think good laws should adhere to. Dicey’s familiar formulation held that the rule of law requires “the absolute supremacy or predominance of regular law as opposed to the influence of arbitrary power.”⁴ It is theoretically possible to interpret this condition as requiring merely that there should be laws, as opposed to a series of isolated commands. Nevertheless, theorists writing since Dicey have supplemented Dicey’s basic formulation with a number of additional requirements that the basic formulation logically entails if it is to be of any value. The most important additional requirement for present purposes is that the law should be capable of guiding people. In order to guide people, laws must be relatively clear and their application relatively certain; otherwise people will not know exactly what is permitted and what is forbidden.

That laws should be relatively certain seems at first to be a reasonable thing to require. Indeed, governments generally do manage to pass laws that adequately satisfy this condition. However, governments find this criterion difficult to satisfy in the sphere of tax avoidance, specifically when they try to formulate rules to combat that activity.

Tax avoidance is a problem for every country. Avoidance is not evasion. Evasion means lying about one’s income, for example, a cash business under-stating its takings. Avoidance is not mitigation. “Mitigation” is not a term of art, but in this article, and generally in the present context, it means reducing one’s tax in ways that the statute clearly encourages or permits; for example, taking a deduction for a gift to charity.⁵

Avoidance is between the two. Avoidance means, approximately, contriving artificial transactions to reduce tax that is otherwise payable. This is a description rather than a definition. Terminology in the area is controversial. Some people deny that we can draw a meaningful distinction between avoidance and mitigation. Some people deny that the word mitigation has any right to exist as a meaningful term in this context.⁶

As a general rule, the law does not demand that people arrange their affairs so that they incur the greatest possible tax liability. When faced with two possible ways in which to organise their money, taxpayers are legitimately entitled to choose the option that requires them to pay the lesser amount of tax. There comes a point, however, where governments begin to think that taxpayers are going too far in their attempts to decrease their tax liability: at this point, taxpayers cease to be engaging in legitimate tax mitigation and begin to be engaging in unacceptable tax avoidance.

⁴ A V Dicey *Introduction to the Study of the Law of the Constitution* (10 ed, Macmillan, London, 1960) 202.

⁵ Judith Freedman “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle [2004] BTR 332, 350.

⁶ See, eg, *Miller v CIR* [2001] 3 NZLR 316, 326 Lord Hoffman (PC).

Analytic definitions of the point at which tax mitigation becomes tax avoidance are elusive. Lord Denning has said that for an arrangement to constitute tax avoidance, “you must be able to predicate ... that [the arrangement] was implemented in that particular way so as to avoid tax.”⁷ This definition brings us no closer to knowing what constitutes tax avoidance, because all it says is “tax avoidance arrangements are those arrangements that look like tax avoidance arrangements.” Nevertheless, the definition highlights the difficulty of exhaustively defining tax avoidance, or, indeed, the difficulty of defining tax avoidance in terms of legal rules at all.

Tax avoidance is perhaps best defined by ostensibly, rather than by analysis. That is, the best way to understand tax avoidance is simply to be shown some examples. This exercise proves to be an easier task than exhaustive definition. Tax avoidance transactions tend to have a number of identifiable features, for example, artificiality,⁸ lack of business or economic reality,⁹ lack of true business risk,¹⁰ and the exploitation of statutory loopholes.¹¹ Avoidance often involves taxpayers exploiting rules that were designed to reduce unfairness in the tax system¹² or using existing legal structures in enterprising ways.¹³

To help to recognise avoidance, take, for example, *Inland Revenue Commissioners v Bowater Property Developments Ltd*,¹⁴ which the House of Lords decided in 1988. That case involved development land tax, a kind of capital gains tax that applied to land sales if the development value component was more than £50,000. Bowater proposed to sell land, in a transaction potentially caught by the tax, for more than £250,000 to a company called Milton Pipes Ltd.

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

⁷ *Newton v FCT* (1958) 98 CLR 1, 8, [1958] 2 All ER 759, 764 (PC).

⁸ *FCT v Gulland* (1985) 160 CLR 55, 109 Dawson J; *FCT v Spotless Services Ltd* (1996) 186 CLR 404, 425 McHugh J.

⁹ *Mangin v CIR* [1971] NZLR 591, 596-598 Lord Donovan (PC), quoting Turner J in the court below.

¹⁰ *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, 561 Lord Templeman (PC).

¹¹ See generally Nabil Orow *General Anti-Avoidance Rules: A Comparative International Analysis* (Jordan Publishing Ltd, Bristol, 2000) 18.

¹² Eg *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513 (PC) involved a corporate group taking advantage of rules that allowed it to consolidate the affairs of its members and to pay tax only on the net profit. The group tried to minimise tax by buying an outside company that had suffered a loss and subtracting that loss from the profits of the original group.

¹³ Eg, *Mangin v CIR* [1971] NZLR 591 (PC) involved an arrangement whereby the taxpayer each year leased the profitable part of his farm, which was a different section each year, to a family trust. The trust would then pay out the income from the section of the land to its beneficiaries, who were the taxpayer’s wife and children. The artificial element in this arrangement was that the part of the farm leased to the trust changed year by year, with the trust always receiving almost all of the farm’s income for that year. The result of the arrangement was that each beneficiary received a fraction of the farm’s income. The income was therefore taxed at a lower rate than it would have been had it been entirely incurred by the taxpayer.

¹⁴ [1989] AC 398 (HL).

The five companies then sold their undivided shares to Milton Pipes for £50,000 each. That is, each company bought for £36,000 and sold for £50,000, making a profit of £14,000, well under the threshold.

Legally, there were five separate sales from Bowater and five more sales to Milton Pipes. Economically there was one sale from Bowater to Milton Pipes. The House of Lords, however, held that the transactions genuine. Bowater escaped development land tax.

1.2 General anti-avoidance rules

Typically, governments combat avoidance by adding rules to tax legislation that frustrate one kind of avoidance transaction or another. For instance, jurisdictions might allow taxpayer companies to carry losses forward and to set them off against the profits of future years. As an anti-avoidance measure, such jurisdictions tend to require certain minimum continuity of ownership between the loss year and the profit year.¹⁵ Tax statutes are replete with such rules. However, specific anti-avoidance rules cannot combat the more creative forms of tax avoidance that employ transactions that employers cannot predict. Consequently, many tax systems feature general anti-avoidance rules in addition to specific ones.

There is considerable variation in the form that general anti-avoidance rules take in different countries. Nevertheless, the various forms have roughly the same effect, at least in theory. General anti-avoidance rules allow tax authorities to disregard schemes that would otherwise reduce tax liability. The transactions to which they apply are void for tax purposes transactions that it captures. The transaction being void, the tax lies where it falls, though modern general anti-avoidance rules often allow the tax authorities to reconstruct a transaction to reflect the economic reality of the circumstances and tax the taxpayer on the basis of the reconstructed transaction.

An example of a typical general anti-avoidance rule is section 99 of New Zealand's Income Tax Act 1976 (New Zealand's current rule is not so readily quotable because it is disaggregated into several elements,¹⁶ but it has roughly the same meaning and effect). Section 99 relevantly read:

Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes if and to the extent that, directly or indirectly,—

(a) Its purpose or effect is tax avoidance; or

(b) Where it has 2 or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings,—

whether or not any person affected by that arrangement is a party thereto.

Countries that have anti-avoidance rules broadly similar in form to New Zealand's include Australia,¹⁷ Canada,¹⁸ South Africa¹⁹ and Hong Kong.²⁰ The United

¹⁵ New Zealand, for example, requires companies to have a minimum continuity of ownership of 49 per cent between loss year and profit year, Income Tax Act 2004, s IE 1(1)(b).

¹⁶ Income Tax Act 2004, section BG 1, incorporating section GB 1 and certain definitions in section OB 1.

¹⁷ Income Tax Assessment Act 1936 (Aust.), Part IV A, ss 177A-177G.

States and the United Kingdom do not have statutory general anti-avoidance rules, but they both have judicially developed anti-avoidance rules that can sometimes have roughly the same effect. The United Kingdom common law anti-avoidance doctrine was first propounded by the House of Lords in *W T Ramsay Ltd v IRC*.²¹ The United States approach was established by the Supreme Court in *Gregory v Helvering*.²² Both approaches essentially allow the court to look at a series of transactions and to determine whether the transactions have any economic purpose other than the avoidance of tax. In both countries there have been suggestions that that common law anti-avoidance doctrines are insufficient to combat tax avoidance and should be replaced by general anti-avoidance rules.²³ Civil law countries tend to rely on the “abuse of rights” concept, which forbids the use of rights for improper purposes.²⁴ The different forms that general anti-avoidance rules take do not affect the associated rule of law issues; the problems and justifications that concern general anti-avoidance rules are equally relevant to all of them.

1.3 How do general anti-avoidance rules breach the rule of law?

The exact content of the rule of law is the focus of an ongoing debate among legal theorists.²⁵ Nevertheless, as far as certainty is concerned there is close to unanimity: most, presumably all, legal philosophers consider that a law must be relatively certain in order to conform to the principles of the rule of law.²⁶ It is this requirement of certainty that general anti-avoidance rules offend. Although a number of countries have statutory general anti-avoidance rules, the legislation adds little to the common understanding of what constitutes tax avoidance. By the same token, there is uncertainty in most jurisdictions as to what transactions fall inside and what outside the general anti-avoidance rule.

The uncertainty surrounding tax avoidance stems from the fine line that separates tax avoidance from acceptable tax mitigation. Lord Templeman in *Challenge Corporation Ltd v CIR*²⁷ considered the two concepts with reference to section 99 of the Income Tax Act 1976, the then New Zealand general anti-avoidance rule:

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply to tax mitigation because the taxpayer's tax advantage is not derived from an "arrangement" but from the reduction of income which he accepts or the expenditure which he incurs.

¹⁸ Income Tax Act 1988 (Can.), s 245.

¹⁹ Income Tax Act (SA), s 103.

²⁰ Inland Revenue Ordinance (HK), s 61.

²¹ [1982] AC 300.

²² (1935) 293 US 465.

²³ See, eg, Judith Freedman “Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle [2004] BTR 332. There is also a bill before the United States House of Representatives that proposes to codify the anti-avoidance doctrine, see H R 1555, “Abusive Tax Shelter and Taxpayer Accountability Act of 2003.

²⁴ Nabil Orow General Anti-Avoidance Rules: A Comparative International Analysis, (Jordan Publishing Ltd, Bristol, 2000) 373.

²⁵ See further, Jeremy Waldron “Is the Rule of Law an Essentially Contested Concept (in Florida)”? (2002) 21 Law and Philosophy 137.

²⁶ There is abundant support for this proposition, in particular see F A Hayek *The Constitution of Liberty* (Routledge, London, 1960) 144; John Rawls *A Theory of Justice* (The Belknap Press of Harvard University Press, Cambridge (Mass.), 1971), 235.

²⁷ *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, 562.

Thus when a taxpayer executes a covenant and makes a payment under the covenant he reduces his income. If the covenant exceeds six years and satisfies certain other conditions the reduction in income reduces the assessable income of the taxpayer. The tax advantage results from the payment under the covenant.

...

Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.

Section 99 does apply to tax avoidance. Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

Although it is generally accepted that general anti-avoidance rules apply to tax avoidance and not to tax mitigation, drawing the line between the two is often problematic. A literal application of general anti-avoidance rules would catch many legitimate transactions.²⁸ General anti-avoidance rules therefore mean something more than their bare words.

Probably, there are two meanings of avoidance: first, the ordinary meaning, and secondly the meaning of the words in most statutory general anti-avoidance rules. The second meaning may be a subset of the first. That is, there are perhaps some transactions that people might call avoidance but that are not "avoidance" in the statutory sense. Statutory general anti-avoidance rules do not simply codify ordinary language.

1.4 Why are general anti-avoidance rules especially bad?

The preceding sections of this article have demonstrated that general anti-avoidance rules are vague. However, all legislation is vague to some extent. The most specific rules will always have borderline cases. Why do people single general anti-avoidance rules out as particularly egregious breaches of the rule of law? This paper focuses on general anti-avoidance rules because their vagueness is more systematic than the vagueness of other laws. Drafters of most laws cannot foresee all relevant fact situations. As Hart pointed out, all laws admit of "core" situations, where the law will definitely apply, and "penumbra", where it is less certain whether the law will apply.²⁹ To criticise general anti-avoidance rules because it is not clear whether they apply in some situations appears to subject them to a higher standard than we demand of law in general.

The difference is that general anti-avoidance rules have far larger penumbras than most laws. Arguably, general anti-avoidance rules are nothing but penumbra. The reason why legislators decide that they need general anti-avoidance rules is that situations where general anti-avoidance rules might be needed cannot be defined in advance. If legislators could foresee all varieties of tax avoidance, they would pass

²⁸ See, eg, Richardson J in *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, 546 (CA) alludes to the somewhat paradoxical consequence situation of a literal interpretation of a general anti-avoidance rule being quite obviously not what Parliament intended.

²⁹ HLA Hart "Positivism and the Separation of Law and Morals" in HLA Hart *Essays in Jurisprudence and Philosophy* (Clarendon Press, Oxford, 1983) 49, 63.

specifically targeted rules to frustrate those endeavours. No doubt, most tax policy makers could give examples of the sorts of arrangement that might be caught by general anti-avoidance rules, but these examples would be cases that have been found to constitute avoidance in the past. The fact that general anti-avoidance rules exist at all is evidence that legislators themselves cannot predict what structures taxpayers will eventually contribute.

2. The underlying values of the rule of law

2.1 Guidance

The rule of law requires that the law must be certain so that it can provide guidance.³⁰ Do vagueness and uncertainty offend the rule of law principle that the law should be such that people are able to be guided by it?

This paper examines the deeper values that the requirement of certainty seeks to preserve, and considers whether general anti-avoidance rules truly offend those values. If they do so, are there situations in which the rule of law must give way to countervailing considerations, and is tax avoidance one of those situations? An important factor is the general public tolerance of general anti-avoidance rules. It appears that the rule of law is seen as more important in some areas of law than in others. This paper examines why this is so.

Generally, laws that are as vague as general anti-avoidance rules attract considerable criticism. For example, in 1935 an amendment to the Danzig Penal Code was passed that criminalised acts “deserving of penalty according to the fundamental conceptions of a penal law and sound popular feeling.”³¹ In an uncomfortable common law echo, the House of Lords in the English case of *Shaw v Director of Public Prosecutions* decided that it had jurisdiction to create new offences in order to punish acts that were contrary to public morals, but that had not previously been held to be illegal.³²

Both of these examples of uncertainty in the law have been heavily criticised. For example, the Permanent Court of International Justice delivered an opinion condemning the amendment to the Danzig Penal Code.³³ People criticise *Shaw* for similar reasons.³⁴ Should we be concerned that the reasons that make the Danzig Decree and the decision in *Shaw* objectionable appear to apply equally to general anti-avoidance rules?

It is difficult to know what effect general anti-avoidance rules have on people’s actions. It has been suggested that they act in *terrorem*, in that people are discouraged from constructing tax avoidance schemes because of the ever-present risk of being caught by the general anti-avoidance rule.³⁵ While this consequence is presumably

³⁰ See, eg, Joseph Raz “The Rule of Law and its Virtue” in Joseph Raz *The Authority of Law: Essays on Law and Morality* (Oxford University Press, Oxford, 1979), 210, 213.

³¹ Decree of the Senate of the Free City of Danzig, 29 August 1935, Article 2.

³² *Shaw v Director of Public Prosecutions* [1962] AC 220 (HL).

³³ Permanent Court of International Justice Advisory Opinion of 4 December 1935

³⁴ Eg, C C Turpin “Criminal Law – Conspiracy to Corrupt Public Morals” [1961] *Cambridge Law Journal* 144, 144-146.

³⁵ See, eg, Michael O’Grady “Acceptable Limits of Tax Planning: A Revenue Perspective” KPMG Tax Conference, Ireland, November 2003, 6.

exactly what governments hope for when they resort to general anti-avoidance rules, this effect is not what scholars mean when they argue that the law should be capable of guiding people. However, to demonstrate that general anti-avoidance rules offend the rule of law it is not sufficient simply to show that they do not guide people's actions. To see what is so objectionable about general anti-avoidance rules it is necessary to examine the underlying values of the rule of law, and to reveal why it is important that people should be able to rely on the law to guide them.

2.2 Liberty

The relationship between liberty and laws that can be relied upon is a key part in many theorists' conceptions of the rule of law. For Rawls, people must know exactly what legal rights they can claim because, "If the bases of these claims are unsure, so are the boundaries of men's liberties."³⁶ An essential part of being free, then, is knowing exactly how free one is. This argument has particular resonance when we look at general anti-avoidance rules. The argument is that general anti-avoidance rules' truly objectionable aspect is that no one really knows how far their reach extends. People are prevented from taking action that might be allowed, the argument continues, because they do not want to take the risk of their action being disallowed.

The argument in the preceding paragraph appears to support the proposition that general anti-avoidance rules offend the rule of law as Rawls sets out that doctrine. But when tax professionals make this argument they are likely to put it in more specific terms, viz, that the existence of a general anti-avoidance rule has a chilling effect on legitimate tax planning, and that fear of general anti-avoidance rules prevents investors and businesses from utilising effective business structures that appear to be economically sensible.

There may be some truth in this claim, but it is not borne out by reported cases. All cases known to the present writers where the Commissioner has attacked an arrangement using a general anti-avoidance rule involve arrangements that an informed but objective bystander would predicate entail tax avoidance. From another perspective, at meetings of tax professionals one of the writers has frequently asked for examples of transactions or structures that could reasonably be predicated to be legitimate, but that taxpayers have rejected because of fear of a general anti-avoidance rule. Examples have not been forthcoming.

Hayek is another philosopher who stresses the connection between the rule of law and liberty, but his conception of liberty is slightly different from that of Rawls. Where Rawls would describe knowledge of the degree of liberty that the law allows as an essential component of liberty itself,³⁷ Hayek simply sees liberty as the absence of coercion. If people know what the law is in advance, they can choose to put themselves in the position of being subject to it. Subjection to the law is therefore a wilful act.³⁸ This argument is particularly relevant to general anti-avoidance rules. Since no one knows exactly when general anti-avoidance rules will apply, people who are caught by them have not made a conscious decision to be subject to them, and are therefore coerced.

³⁶ John Rawls *A Theory of Justice* (The Belknap Press of Harvard University Press, Cambridge (Mass.), 1971), 235.

³⁷ *Idem.*

³⁸ F A Hayek *The Constitution of Liberty* (Routledge, London, 1960) 144 -145.

2.3 Human dignity

For Raz, the criterion that the law should be capable of guiding action is closely linked to human dignity. The law must assume that people are capable of rational thought, and that they therefore want to plan their lives with the knowledge of what the law is.³⁹ For Raz, this factor is even more important than the rule of law's connection with freedom.⁴⁰ Laws that do not conform to the rule of law, then, are an affront to human dignity, because the law "encourages autonomous action only to frustrate its purpose."⁴¹ Raz might well charge general anti-avoidance rules with such an offence. The detailed formality of tax law encourages people to find ways to circumvent it, but general anti-avoidance rules may frustrate their efforts.

2.4 Effective law and Fuller

It is unlikely that Lon Fuller would disagree with Rawls's argument that the rule of law protects liberty or Raz's proposition that it protects dignity. Fuller, however, focuses his argument on the theory that certain formal criteria of the rule of law must all be sufficiently satisfied in order for law properly so called to exist.⁴² Laws must be public, prospective, understandable, non-contradictory, possible to conform to, relatively stable, there must be congruence between how the rules are written down and how they are enforced, and laws must be rules as opposed to ad hoc decisions.⁴³

In order to demonstrate how continuous breaches of the rule of law reduce the effectiveness of legal systems, Fuller gives us the example of King Rex. King Rex is a ruler who tries but fails to make law on eight separate occasions. Each time that Rex attempts to make law, he manages to breach one of these eight criteria. For example, on one occasion Rex publishes a legal code that is so convoluted that no one can understand it and on another occasion he announces that all cases will be decided retrospectively.

Naturally, Rex's subjects are dismayed at their king's disregard for the rule of law, and are annoyed at the way the consequences of that disregard affect them.⁴⁴ For present purposes, however, the interesting point is the consequences for Rex. Rex is unable to rule effectively because his rules are incapable of being followed. There is really no point in Rex having laws at all, because his laws do not guide the behaviour of his subjects.⁴⁵ However much his subjects might want to obey Rex's laws, they cannot. Fuller's examples show that laws that do not conform to the rule of law can therefore be just as frustrating to law-makers as they are to law-followers.

2.5 Are general anti-avoidance rules effective?

General anti-avoidance rules tend to be counterexamples to Fuller's general theory of effective law. They are frustrating to the citizen, but they are useful to governments. When general anti-avoidance rules work they are undeniably effective, because they

³⁹ Joseph Raz "The Rule of Law and its Virtue" in Joseph Raz *The Authority of Law: Essays on Law and Morality* (Oxford University Press, Oxford, 1979) 210, 221.

⁴⁰ *Idem.*

⁴¹ *Id.* 222.

⁴² Lon Fuller *The Morality of Law* (2 ed, New Haven (CT) Yale University Press, 1964) 168.

⁴³ *Idem.*

⁴⁴ *Id.* 167.

⁴⁵ *Id.* 168.

allow governments to collect tax that they would otherwise lose. Nevertheless, the experience of some countries with general anti-avoidance rules reveals that they can sometimes be ineffective for reasons very similar to those that plagued King Rex.

For example, when Sir Garfield Barwick was Chief Justice of Australia the Commissioner was seldom successful in litigation where he deployed the general anti-avoidance rule.⁴⁶ Barwick CJ felt very strongly that “[i]t is for Parliament to specify, ... with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax.”⁴⁷ The Chief Justice had little time for the vagueness of the general anti-avoidance rule, and tended to find for the taxpayer even in cases of the most blatant tax avoidance.⁴⁸

Barwick CJ’s pro-taxpayer stance reached its apogee in the cases of *Slutzkin v FCT*⁴⁹ and *Cridland v FCT*.⁵⁰ *Slutzkin* was a case of dividend-stripping. The taxpayer was a shareholder in FR Holdings Pty Ltd, a company that was pregnant with profits. Had the company distributed the profits as a dividend they would then have been taxable in the hands of Slutzkin and his fellow shareholders. The same result would have obtained had the shareholders put the company into liquidation and distributed the proceeds.

Instead, the shareholders cashed the company up by liquidating its assets. They then sold their shares to Cadiz Corporation, which was a trader in shares. Cadiz Corporation caused FR Holdings Pty Limited to distribute its retained profits as a dividend. Without its retained profits the company was now worth very little. Cadiz Corporation sold the shares in FR Holdings Pty for nearly all the price that Cadiz Corporation had paid for the shares.

For *Slutzkin*, the fiscal effect of these transactions was that he sold his shares for a non-taxable capital receipt. Cadiz Corporation Limited, on the other hand, derived a taxable profit from the dividend, but sustained a deductible loss in selling the shares. The loss neatly cancelled the gain from the dividend and left Cadiz Corporation Limited with, in effect, a fee for its trouble. The fee was taxable, but was a very small fraction of the income that Slutzkin and his fellow shareholders had stood to derive from either a profit distribution or a liquidation.

Arguing that the only reason that Slutzkin and his fellows sold their shares was to avoid tax on profits that would otherwise have been distributed, the Commissioner submitted that the price of the shares was economically the same thing as a dividend and that the general anti-avoidance rule applied. Barwick CJ rejected this argument, holding that the sale of the shares was "no more than a realisation by them of the benefit of their shareholding in a way which would not attract tax."

⁴⁶ At the time, Australia’s general anti-avoidance rule was contained in s 260 of the Income Tax Assessment Act (Cth) 1936.

⁴⁷ *FCT v Westradars Pty Ltd* (1980) 54 ALJR 406, 461 Barwick CJ.

⁴⁸ See further, G Lehman, “The income tax judgements of Sir Garfield Barwick: A study in the failure of the new legalism” (1983) 9 Monash ULR 115, 135. Lehman argues Sir Garfield Barwick did not deprive Australia’s general anti-avoidance rule of all effect, because to do so would invite speedy law reform. Barwick CJ allowed the former section 260 to continue to operate where an “antecedent transaction” was involved, see *Mullins v FCT* (1976) 135 CLR 290, 302.

⁴⁹ *Slutzkin v FCT* (1977) 140 CLR 314.

⁵⁰ *Cridland v FCT* (1977) 140 CLR 330.

Cridland involved a scheme designed to take advantage of a rule that allowed primary producers to average their incomes over a number of years and to pay tax on that average. The rule was intended to make the tax system fairer for people like farmers, whose income often varies considerably from one year to the next. Pursuant to the scheme, Cridland, a university student, bought a share in a unit trust. The trust was a primary producer. Cridland's interest as a beneficiary of the trust was only one dollar a year. The years in which he was a beneficiary straddled his time as a student and also time as a salaried graduate, when his income was much higher. Cridland claimed to average his income as a primary producer. Despite the general anti-avoidance rule, the Barwick court upheld the claim, with Mason J delivering the leading judgment. Both *Slutzkin* and *Cridland* were almost certainly situations where Australia's general anti-avoidance rule should have applied, but Barwick CJ's High Court found in both cases that the taxpayers had not avoided tax.

In response to this judicial attitude, which rendered Australia's general anti-avoidance rule almost useless, the Australian Parliament in 1981 enacted a new type of general anti-avoidance rule that attempts to attain more precision of detail. It is certainly more prolix.⁵¹ In hindsight, Parliament's action was possibly not necessary: following Sir Garfield Barwick's retirement, the High Court was able to re-inject some force into section 260, Australia's then general anti-avoidance rule.⁵² The history of how section 260 fared during Sir Garfield Barwick's term as Chief Justice is an interesting example of how the rule of law defects of general anti-avoidance rules can make them ineffective.⁵³

It is interesting to note that when general anti-avoidance rules are ineffective, this ineffectiveness is not due primarily to taxpayers being inadequately guided. Rather, when general anti-avoidance rules are ineffective it is because the judiciary do not know what to make of them. To return to general anti-avoidance rules' sinister counterpoint, the amendment to the Danzig Penal Code, it seems that the Nazis had a similar experience. The same rule applied in Germany, as well as in Danzig, but it ultimately led to very few prosecutions in either jurisdiction, because its terms were too vague for the compliant judges of the Nazi era to make much sense of them.⁵⁴ As far as tax avoidance is concerned, however, situations where statutory general anti-avoidance rules are ineffective are relative rarities. The majority of jurisdictions that have general anti-avoidance rules find them to be a reasonably effective tool of frustrating tax avoidance.

It is difficult to know what conclusion to draw from the fact that general anti-avoidance rules can be relatively effective. Fuller's argument that laws are more effective when people know what they require certainly seems uncontroversial and likely to be true in most situations. While Fuller does not demand that legal systems must satisfy each of his criteria perfectly in order to conform to the rule of law;⁵⁵ it is

⁵¹ Income Tax Assessment Act 1936 (Aust), ss 177A-177G.

⁵² See *FCT v Gulland* (1984) 160 CLR 55.

⁵³ The United Kingdom's experience with a judicially developed anti-avoidance doctrine might be used to illustrate the same point. The doctrine, as developed from its original formulation by Lord Wilberforce in *WT Ramsey Ltd v IRC* [1982] AC 300, 323-326, is so vague that no one seems to be certain whether it even exists. Its application can therefore appear somewhat haphazard, see further, The Right Honorable Lord Walker of Gestinghope "Ramsay 25 Years On" (2004) 120 LQR 412.

⁵⁴ Martin Broszat *The Hitler State* (Longman, London 1981) 339.

⁵⁵ Lon Fuller *The Morality of Law* (2 ed, New Haven (CT) Yale University Press, 1964) 170.

unlikely that Fuller would approve of the protracted and unapologetic breaches that accompany general anti-avoidance rules.

This point is even clearer if we use Fuller's framework to assess individual laws, as opposed to entire legal systems. A state with some laws that offend Fuller's criteria may still be able to be governed effectively, but, according to Fuller's thesis, an individual rule that continuously breaches many criteria ought not to be effective. It is an interesting feature of general anti-avoidance rules that their criteria for effectiveness are almost the exact opposite of the effectiveness criteria of any other law.

3. Are general anti-avoidance rules nevertheless justified?

3.1 Problems of income taxation

The intuitive alternative to a general anti-avoidance rule is a system of very many specific rules that detail exactly what is and is not subject to income tax. Of course, all tax systems already have such specific rules in at least some areas of economic activity, whether or not they also have general anti-avoidance rules. Unfortunately however, the more specific and detailed a system's rules become, the more ways people will find to circumvent those rules.⁵⁶ Tax law is unusual in two key respects. First, there are very few other areas of law that people so aggressively try to avoid. Secondly, the nature of tax law means that tax legislation contains a large number of potential loopholes.⁵⁷ The result is that in the absence of a general anti-avoidance rule, there is apt to be a great deal of tax avoidance that the government is powerless to stop.

It is tempting to suggest that if legislators cannot frame a tax avoidance rule that conforms to the rule of law they should not have an anti-avoidance rule at all. Governments should just put up with the adverse consequences. However, this suggestion overlooks the fact that tax avoidance is not a problem for governments alone, it is a problem for society generally. Avoidance undermines two key purposes of a tax system. First, the principle of horizontal equity states that people in the same economic position should be taxed at the same rate.⁵⁸ Tax avoidance makes horizontal equity difficult to achieve, because successful tax avoidance results in some people being taxed less than others who are in the same economic position. In other words, people who avoid tax are not paying their fair share as measured by their wealth.

Secondly, tax avoidance makes it more difficult for tax systems to be economically neutral. Economic neutrality demands that tax systems should distort the normal workings of the market as little as possible; that is, that people should not make decisions for purely (or even partially) tax reasons. The existence of opportunities for tax avoidance frustrates this goal. To illustrate, consider the case of

⁵⁶ Judith Freedman "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle [2004] BTR 332, 346.

⁵⁷ For an explanation of why tax law is more susceptible to loopholes than other areas of law, see Ross Parsons "Income Taxation – An Institution in Decay" (1986) 3 Australian Tax Forum 233, as developed in John Prebble "Income Taxation: a Structure Built on Sand" (2002) 24 Sydney Law Review 303.

⁵⁸ See, eg, Richard E Krever "Structure and Policy of Australian Income Taxation" in Richard E Krever (ed) Australian Taxation: Principles and Practice, Longman Cheshire Pty Ltd, Melbourne, 1987, 1, 11.

Peterson v CIR,⁵⁹ which the Privy Council decided in 2005. Peterson was a case in which films were funded principally by non-recourse loans. Pursuant to a scheme, Mr Peterson and others invested in films and deducted their investment from their other income. They were able to depreciate the value of the films to zero over two years.

The promoters of the film told the investors that the cost of the film was (say) \$2,000, while in fact it was only (say) \$1,000. To fund their investment in the films, Mr Peterson and his co-investors borrowed. The borrowing was in the form of non-recourse loans, that is, loans that were repayable only if the films were successful. Interest was not charged. Loans on such favourable terms naturally attract questions, and indeed it was found as a fact that the money was never borrowed at all.⁶⁰ The fact that the extra money from investors was not available did not bother the film's promoters, because they had overstated the cost of the film anyway.

The reason for the overstatement of the cost of the films was the tax saving that it led to. Instead of being able to write off \$1,000 over two years, investors were able to write off \$2,000, even though they had never actually spent the second \$1,000 (and, except on paper, had not even borrowed it). Whether or not the films were successful, the investors would gain a tax advantage. This tax advantage meant that a scheme that would not ordinarily be attractive to investors was in fact attractive.

This situation is a clear example of the tax system creating market distortions: the transactions in *Peterson* were not attractive for their intrinsic merits; they were attractive because of tax advantages. Jurisdictions that have general anti-avoidance rules are able to counteract the effect of this distortion to some extent: to the extent that investors see the tax advantages of a particular scheme as unlikely to stand up to close scrutiny and therefore refrain from investing in it and the market will not be distorted.

The aims of the tax system are related the more general point about the purpose of tax systems. Governments do not tax people only for the sake of amassing wealth. Rather, tax is necessary to keep states functioning. Governments must provide public services such as defence and education. Furthermore, most societies use tax to redistribute wealth to some extent. Tax avoidance reduces the effectiveness of welfare systems,⁶¹ a matter that is particularly important in the light of the public perception (that is probably accurate) that most tax avoidance is perpetrated by the rich or by people who are relatively well off. Though few people have reasoned the issue through to a sufficient depth to put it this way, the wide spread of general anti-avoidance rules, either statutory or judge-made, indicates that most countries consider that the negative results from not having a general anti-avoidance rule outweigh the breaches of the rule of law that general anti-avoidance rules entail.

This balancing exercise reveals much about the nature of the rule of law and its values. Adherence the rule of law can often interfere with a society's other goals. Some philosophers insist that the rule of law must be preserved without compromise.⁶² Other writers, such as Raz, stress than the rule of law is only one

⁵⁹ *Peterson v CIR* [2005] UKPC 5 (PC). The Privy Council in fact found that New Zealand's general anti-avoidance rule did not apply to this scheme.

⁶⁰ *Case U32* (2000) 19 NZTC 9,302 [80].

⁶¹ RA McLeod "Tax Avoidance Revisited" (2000) 6 NZJTL 103, 103.

⁶² See, eg, F A Hayek *The Constitution of Liberty* (Routledge, London, 1960).

yardstick against which a legal system may be measured.⁶³ Just as a society's conformity to the rule of law does not ensure that the society is good, a breach of the rule of law does not make that society bad.⁶⁴ Rawls expands on this point, saying that a breach of the rule of law may be "the lesser of two evils."⁶⁵ Tax avoidance is a very real evil for society: a breach of the rule of law seems to be a necessary remedy.

In modern days, at least in democracies that follow a Western model, it is seldom that there is anything sinister about legislators breaching the rule of law. As Fuller observes, laws tend to be most effective when they conform to the rule of law;⁶⁶ so governments have a vested interest in making sure their laws conform to its values. In situations where laws offend the rule of law, it will often be the case that the alternative is even less desirable. Tax law is by no means the only situation where the rule of law must be sacrificed to the common good. It is easy to imagine situations where the preservation of human rights or the fulfilment of justice requires a breach of the rule of law. For example, a retrospective law may be necessary to fully compensate for a human rights breach. In such situations, most people would think that breaching the rule of law is justified.

3.2 The importance of certainty

Certainty is clearly an important rule of law value. Usually certainty is important for both the law-follower and the law-maker. Most laws are more effective when people can be certain what they are meant to do or not do. That is, in most cases the rule of law helps to promote effective law. General anti-avoidance rules are therefore an aberration: it is their very vagueness that makes them effective. If they were not vague, they would not be effective.⁶⁷ This characteristic, together with the fundamental problems of tax law plus what many see as the dubious moral standing of tax avoiders, prompts some commentators to argue that certainty is simply an inappropriate value for general anti-avoidance rules to strive for.⁶⁸

*Challenge Corporation Ltd v CIR*⁶⁹ is an example of the negative effect that certainty can have on the utility of an anti-avoidance rule. Challenge Corporation, the taxpayer company, acquired a subsidiary that had suffered heavy losses. Challenge Corporation then purported to set the subsidiary's losses off against its own profits.

At the time, the provisions that allowed intra-group loss consolidation did not require any continuity of shareholding between loss year and profit year. Challenge Corporation had therefore complied with the letter of the law. Without a general anti-avoidance rule, companies in the situation of Challenge Corporation would be able to take deductions despite having suffered no economic loss.

⁶³ Joseph Raz "The Rule of Law and its Virtue" in Joseph Raz *The Authority of Law: Essays on Law and Morality* (Oxford University Press, Oxford, 1979), 210, 211.

⁶⁴ Even Fuller, who is strongly committed to the rule of law, accepts that isolated breaches do not automatically condemn a legal system. See Lon Fuller *The Morality of Law* (2 ed, New Haven (CT) Yale University Press, 1964), 170.

⁶⁵ John Rawls *A Theory of Justice* (The Belknap Press of Harvard University Press, Cambridge (Mass.), 1971) 242.

⁶⁶ Lon Fuller *The Morality of Law* (2 ed, New Haven (CT) Yale University Press, 1964) 168.

⁶⁷ As mentioned in 1.1 above, there are some cases that are definitely tax avoidance (although these cases are mainly ones that have been judicially decided to be tax avoidance); so general anti-avoidance rules' sphere of application is not entirely unknown. Nevertheless, it is true to say that general anti-avoidance rules depend on their vagueness for their effectiveness.

⁶⁸ Eg, Judith Freedman "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] BTR 332, 346.

⁶⁹ [1986] 2 NZLR 513.

Where the principles of the rule of law negatively influence a law's effectiveness, it is necessary to weigh the consequences of not having the law in question against the possibility that some people will be surprised by the manner in which the law operates. Certainty and related rule of law values are therefore extremely important where criminal sanctions are imposed, but are less important where the issue is tax avoidance.⁷⁰

3.3 The morality of tax avoidance

In the face of such an obvious breach of the rule of law, the fact that so many countries have general anti-avoidance rules seems difficult to account for. The idiosyncrasies of tax law no doubt make general anti-avoidance rules necessary, but it is unlikely that the public tolerance of general anti-avoidance rules is caused by knowledge of these idiosyncrasies. Tax law is extraordinarily complicated, but it is unrealistic to suppose that most people see it as different in kind from other branches of the law. How, then, can we account for the lack of public condemnation of general anti-avoidance rules? The explanation may be a perception of tax avoidance as being questionable from a moral perspective.

The moral status of tax avoidance is contentious. There have been a number of cases that hold that since people have the right to arrange their money in such a way as to pay as little tax as possible, even holding that there nothing immoral about tax avoidance.⁷¹ Relying on such decisions, lawyers tend to assume that as a matter of law tax avoidance is morally unimpeachable. However, it is a logical error to say that because tax avoidance is not immoral as a matter of law, it is not immoral in any sense. Whether a certain act is moral must be determined according to ordinary principles of ethics, not by reference to statements in judgments. It is possible that judges who say that there is nothing immoral about tax avoidance are correct, but if that is so it must be because tax avoidance is moral according to ethical principles. As a matter of logic, a judge saying that a particular act is moral as a matter of law cannot determine whether the act is in fact moral.⁷²

According to basic ethical principles, then, what is the moral status of tax avoidance? As a matter of morality untainted by law, people know that they have a duty to pay tax; so seeking to pay less tax than they otherwise might can appear to be shirking that duty.⁷³ Furthermore, despite the complexity of tax laws, most people have a reasonably clear idea of what the policy of the law would require them to pay. General anti-avoidance rules do not set out to catch individual taxpayers trying earnestly to comply with complex tax laws. Rather, they tend to catch instances of tax

⁷⁰ While taxpayers are usually extremely annoyed if their tax avoidance schemes are disallowed because of the operation of general anti-avoidance rules, general anti-avoidance rules do not impose *criminal* penalties, although some penalties are involved. It is arguable that it is more important for laws that impose criminal penalties to conform to the rule of law, see, John Rawls *A Theory of Justice* (The Belknap Press of Harvard University Press, Cambridge (Mass.), 1971) 241.

⁷¹ Probably the most famous statement on the morality of tax avoidance comes from Lord Tomlin in *CIR v Duke of Westminster* [1936] AC 1, 19-20 (HL), where his Lordship stated that "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be."

⁷² See further, Zoe Prebble and John Prebble "The Morality of Tax Avoidance: Why the Legal difference Between Evasion and Avoidance is Insufficient to Ground a Moral Distinction" Legal Ethics: Professional Ethics and Personal Integrity Conference, University of Auckland, 23-25 June 2006.

⁷³ Nevertheless, the exact amount of tax the each individual should pay is open to debate. It is questionable whether taxpayers who have paid the amount of tax specified by black-letter law can really be shirking a duty. See further, Judith Freedman "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] BTR 332, 337.

planning that is at least relatively aggressive. People who are ultimately caught by general anti-avoidance rules almost always know that they have engaged in something that they would at least concede to be “tax planning” – usually aggressive tax planning - even if they do not expect to be called to account. Taxpayers who engage in tax avoidance schemes are consciously putting other taxpayers at a relative disadvantage and may be criticised on moral grounds.⁷⁴

If the arguably dubious moral status of tax avoidance partially explains the conspicuous lack of public outcry over general anti-avoidance rules, what can we deduce about the relationship between the rule of law and morality? It cannot be correct that people lose their right to rely on the law when they act immorally.⁷⁵ No one would suggest that the rule of law is unnecessary in the field of criminal law, which typically involves far more obvious immorality than tax avoidance. Possibly the real explanation is that the rule of law itself, as a strict formalist doctrine, inevitably allows people to some extent to circumvent the laws that conform to it to some extent. As far as criminal law is concerned, this shortcoming of the rule of law is far outweighed by the benefits that the rule of law offers. In contrast, when it comes to tax avoidance, the benefits to society of legal certainty are outweighed by its detriments.

The argument that the detriments of the rule of law in a particular area outweigh its benefits is nevertheless unsatisfactory. At least, it would not satisfy Hayek, although it might satisfy Rawls or Raz. Hayek would argue that the merits of the rule of law should not be evaluated on a case-by-case basis, leaving us free to disregard its principles where those principles are inconvenient. Rather, one of the reasons why societies value the rule of law is that it applies despite its resulting in a net societal detriment from time to time. Societies commit to adherence to the rule of law for the very reason that there will be instances where it is tempting to allow breaches of it.

This argument echoes David Cole's criticism of Richard Posner's *Not a Suicide Pact: The Constitution in a Time of National Emergency*.⁷⁶ In his book, Posner argues that the protections offered by the United States' Constitution should be interpreted flexibly in order to allow the government to address the threat of terrorism. Posner argues, for example, that the United States' administration's wiretapping of international telephone calls should be considered a "reasonable" search in the context of the threat of terrorism. Cole, however, points out that allowing the provisions of the Constitution to be interpreted more strictly or less strictly according to administrative convenience misses the point of having a constitution in the first place.⁷⁷ A constitution like that of the United States, and the rule of law, should be adhered to notwithstanding that doing so is not beneficial to society in every case. Any kind of cost-benefit analysis is simply inappropriate where the Constitution is concerned. The same considerations apply in respect of the rule of law.

It follows, therefore, that the disbenefit to society at large that can accompany adherence to the rule of law when it is a matter of tax avoidance cannot explain the apparent public acceptance of general anti-avoidance rules. What, then, may be the

⁷⁴ See further, The Right Honourable Lord Templeman “Tax and the Taxpayer” 2001 117 LQR 575, 575.

⁷⁵ But see S Munzer (1982) “A Theory of Retroactive Legislation” 61 Tex L Rev 424. Munzer argues that people have no right to rely on their immoral acts not being retrospectively criminalised.

⁷⁶ 2006, Oxford University Press.

⁷⁷ David Cole, "How to Skip the Constitution" review of Richard Posner *Not a Suicide Pact: The Constitution in a Time of National Emergency*, New York Review of Books, 53:18, November 16 2006.

explanation? The most likely answer is that tax avoiders are seen as fundamentally different to criminals. When criminals break the law, they simply break it; they do not try to find ways of circumventing the law in order to avoid technical breaches. In contrast, there is an entire industry devoted to manipulating fiscal laws with a view to obtaining tax advantages without incurring any corresponding economic loss. In the light of this difference, the fact that the informed public appears to accept general anti-avoidance rules⁷⁸ despite their shortcomings as far as the rule of law is concerned is not surprising.

4. Conclusion

General anti-avoidance rules demonstrate that the rule of law is not an unqualified good. As with all principles, the rule of law can be outweighed by competing considerations. General anti-avoidance rules give an example of what those competing considerations might be. Furthermore, while general anti-avoidance rules themselves are justified, they are useful in showing exactly why we value the rule of law. Most societies with developed legal systems tend not to breach the rule of law very often. As a rare example of a breach, general anti-avoidance rules are a useful reminder of why values such as certainty are important.

⁷⁸ People who move in the same circles as tax advisors may dispute this statement. But who has heard of a mainstream political party campaigning for support to repeal a general anti-avoidance rule?