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GENERAL ANTI-AVOIDANCE RULES AND THE RULE OF LAW

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A. Introduction

The *Prima Facie* Breach

General Anti-Avoidance Rules ("GAARs") constitute a *prima facie* breach of the Rule of Law. The retrospective effect and lack of certainty generated by GAARs raises particular concerns.

The Justifications

- However, GAARs are necessary to protect the tax base.
- Rawls, Nozick and Finnis support a duty to pay tax and corollary duty not to avoid tax.
 - Even if GAARs *prima facie* breach the Rule of Law, there can be some justifications for them.
 - Funding: In cases of extreme tax avoidance, a lack of funds may result in the legal system ceasing to function
 - The "Thin Ice" Principle: Taxpayers exploit the law's adherence to formality and certainty and undertake a risk that the law may look through the artificiality

The Moral Limits of GAARs

In accordance with the Rule of Law and Distributive and Corrective Justice:

- 1) A subjective test for avoidance
- 2) Effect of GAAR limited to offending taxpayer (in accordance with corrective justice, excepting special situations)
- 3) Penalties are permitted

Explanations and Effects

GAARs vary considerably, but essentially allow tax authorities to disregard schemes that have little or no economic purpose other than the avoidance of tax.

- Most modern GAARs also empower tax authorities to reconstruct a transaction to reflect economic reality and tax on this basis.

Justifications for a GAAR include:

- 1) simplifying tax laws;
- 2) deterring attempts to avoid tax;
- 3) better utilisation of skill and human resources; and
- 4) maintaining the integrity of the tax base.

For GAARs to be effective, they have to be broad enough to capture all imaginable ways in which one could conceivably avoid tax.

GAARs are retrospective in effect, notwithstanding the fact that taxpayers would have organised their affairs to comply with the existing legislation by that time.

C. Duty to Pay Tax

Rawls: All citizens under the veil of ignorance would regard it just for taxation to be sufficient to fund redistributive programmes that enable equality of opportunity for all (human reciprocity as that from which legitimate law may spring).

Nozick: Taxation should only be enacted to the minimal extent that allows for the sustenance of political institutions that can, *inter alia*, protect the life, liberty and property of citizens through the enforcement of positive law and adjudication of disputes (the "night watchman").

Moral Duty to Not Avoid Tax

Finnis: In the "seamless web" of law, a moral duty to not avoid paying tax arises in order to encourage people to follow the law at large – independent of the intrinsic justness of the tax.

- Even if the tax is unjust, a taxpayer, having benefited from the efficacious operation of the legal system at large (E.g. protection of life and liberty) should still follow the regime and pay tax.

Some hold the assumption that taxpayers "not only have the legal right to avoid tax liability, but also a corresponding moral entitlement to do so".

Prebble points out that this is based on four flawed assumptions:

- 1) As taxpayers are morally entitled to their pre-tax incomes, taxation is an unjustified governmental incursion on to [their] property rights;
- 2) Tax evasion and avoidance are not especially harmful and are therefore not immoral;
- 3) The crime of tax evasion is *malum prohibitum* rather than *malum in se*; and
- 4) Existence of morality independently of the law".

Leading Conceptions

Prebble and Prebble: "Taxpayers exploiting rules that were designed to reduce unfairness in the tax system or using existing legal structures in enterprising ways that the legislature, had it thought about the matter, would not have approved."

- Features include artificiality, lack of business or economic reality, lack of true business risk, and exploitation of statutory loopholes

Ebersohn: A diversion from the economic substance of a transaction or arrangement towards its legal form that generates a tax advantage

- Analytically, tax avoidance can be understood as necessarily an artificial transaction or arrangement for the purpose of gaining a tax advantage.
- Such a transaction or arrangement would be exactly that which is circumscribed by the GAAR, in accordance with legislative intent.

D. Tax Avoidance

E. Justifications

While the use of GAARs does breach certainty and the Rule of Law, the Rule of Law is not an unqualified good and can be outweighed by competing considerations

Funding (Preservation of the Integrity of the Legal System)

- For the Rule of Law to work, there must first be a functioning legal system, which is sufficiently funded (through taxation)
- Preserving system integrity, conceivably, would only justify the application of GAARs in cases of extreme tax avoidance. This could happen in situations where the amount of tax revenue lost is enormous or where tax avoidance is so frequent, both of which threaten the very legal framework itself.

The "Thin Ice" Principle

Prebble and Prebble: The uniqueness of Tax Law lies in the fact that tax avoidance takes advantage of the very nature of law itself – by exploiting the law's adherence to formality.

- In exploiting the formality of the law, tax avoidance exploits the values of the Rule of Law which pretending to honour them.
- The "Thin Ice" Principle: The origins of this quote are found in criminal law where Lord Morris remarked that "those who skate on thin ice can hardly expect to find a sign which will denote the precise spot where they may fall in".
- If taxpayers attempt to flout GAARs by engaging in artificial transactions to avoid tax, they are exploiting the law's adherence to formality and certainty.
- They undertake a risk that the law may look through the artificiality and cannot complain if the tax effects of these transactions are subsequently negated under the GAARs.

Distributive and Corrective Justice and the Effects of GAARs

The effects of GAARs on the impugned transaction should be limited to changing the tax consequences of a transaction.

- Distributive Justice: Avoidance is committed against society at large and the effect of the GAAR should be to correct the interaction between the taxpayer and society (a tax matter)
- Corrective Justice: Avoidance does not affect the relationship between the parties to a transaction and all other non-tax effects should remain undisturbed

F. Issues

Knock-On Effects

Generally, the effect of a GAAR should be limited to affecting the tax liability of only the company it is applied against. Only that company and not its business partners should be affected by the GAAR.

- Companies in Collusion: But an appropriate rule is needed to ensure that in situations where multiple companies are involved, separate corporate personalities do not serve as artificial impediments to the application of GAARs where the substance of the matter would suggest that the companies were acting as a collective whole.
- Third Parties: Special rules may be necessary to govern situations where the tax liability of a third party is contingent on the tax liability of the offending company. E.g. Contractual Provisions, VAT Registration Thresholds, Balancing Charges in Capital Allowances Claims.

Penalties

A system without penalties encourages tax avoidance, since there are potential benefits but no disadvantages from attempting avoidance. This may lead to a decline in tax compliance and morality over time.

- It would appear that the *prima facie* breaches of the Rule of Law in the form of uncertainty and retrospective effect can generally only be justified on the grounds of the "Thin Ice" principle.
- If the basis of imposing a GAAR lies in the exploitation of the law's adherence to formality and certainty, the test for imposing a GAAR must necessarily hinge on the mental state of the taxpayer (i.e. a subjective test)
- This creates a moral baseline for arguing that the test for tax avoidance has to be subjective in nature and not objective. If there are any difficulties in ascertaining the intentions of the taxpayer, they must be so fundamental that the consequences of failing to do so will destroy or threaten to destroy the whole legal system, otherwise, breaches to the Rule of Law cannot be justified.

G. Moral Limits

A Subjective Test

- The taxpayer must have entered into the impugned transaction with the sole or main purpose of obtaining a tax advantage.
- If one of the main motivating reasons was to gain a tax advantage by exploiting the ambiguity inherent in the legislation, the taxpayer would have engaged in tax avoidance under the proposed test.
- Ironically, attempting to increase legal certainty by devising more complex tax rules has the opposite effect; the more complex the legal rule, the "less constant and less predictable" it will be.
- GAARs can provide relatively more certainty if combined with a subjective test to determine when they will apply.

The Moral Limit of GAARs

- 1) A subjective test for avoidance
- 2) Effect of GAAR limited to offending taxpayer (in accordance with corrective justice, excepting special situations)
- 3) Penalties are permitted