Prebble welcomes the US Treasury and IRS to the ranks of GAAR-empowered fiscs

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An American GAAR

President Barack Obama signed sec. 7701(o) of the Internal Revenue Code 1986, the United States's first statutory general anti-avoidance rule, or "GAAR", into effect on 30 March 2010. In most countries, and ordinarily in the United States, such a move would have come as a concretization of a major development in tax enforcement policy, but in the odd circumstances of the President's health reform legislation the birth of the American GAAR was buried in sec. 1409 (a) of the Health Care and Education Reconciliation Act of 2010 (H.R. 4872, 111th Cong., §1409).

Why enact a GAAR now? Why not decades ago? America usually adopts new ideas very fast. Within months of Richard Pearse's heavier-than-air flight at Waitohi, Timaru, New Zealand, on 31 March 1903, Orville Wright was airborne at Kitty Hawk NC. But 132 years elapsed between what is thought to be the world's first GAAR, sec. 62 of the New Zealand Land Tax Act 1878 (NZ), and its US counterpart.

There appear to be two main reasons that delayed the introduction of a GAAR for so long. First, it seemed that the US could manage without a GAAR. America takes a more substantive, less formalistic, approach to statutory interpretation than do other common law countries; so the IRS was generally able to get by with various forms of the economic substance doctrine. But since about 2000, the IRS has found the economic substance doctrine increasingly ineffective, as

[1] For references and amplification see Zoë Prebble and John Prebble "Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law" (2008) Bulletin for International Taxation 151 – 170 (go) and Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?" forthcoming, Saint Louis University Law Journal (2010) (go).

seen in cases like *Compaq Computer Corp v. Commissioner*, 277 F.3d 778 (5th Cir. 2001).

GAARS and the Rule of Law

Secondly, the public institutions of the USA, which is the home both of the world's most famous constitution and of the canonical work of Lon L. Fuller, have always had a healthy respect for the rule of law. New Zealand, on the other hand, does not yet have a codified constitution and takes a pragmatic approach to legislation: if something needs attention we legislate.

Consider GAARs in the light of the principles of the rule of law. In its essentials, the archetypal GAAR simply says that tax avoidance arrangements are void for tax purposes. On analysis, the circularity of this form of rule differs little in structure from that of the notorious Article 386 of the Criminal Code of the Qing dynasty of China, which made it an offence to "[Do] that which ought not to be done".

No one would suggest that the Qing rule comes close to satisfying modern legislative standards in general, let alone the principles of the rule of law as Fuller expounded them. A GAAR is hardly more principled. Nevertheless, the unusual nature of tax law and Rawls's argument that sometimes in law a bad thing is justified as the lesser of two evils have combined to encourage increasing numbers of jurisdictions to enact GAARS. (In the present context the two evils are, respectively, a breach of the rule of law and unaddressed tax avoidance by rich people.) The muster of common law jurisdictions that remain without GAARS is dwindling; India and the United Kingdom are the most prominent. Civil law countries follow the same route. Disconcertingly, the most prominent civil law GAAR, Art. L 64 of the French *Livre de Procédure Fiscale*, originated in a Vichy provision that authorized the tax administration (a) to disregard a legal act aimed to dissimulate income or profit and (b) to recharacterize the transaction according to its genuine character, terms that are uncannily similar to those of modern GAARS in New Zealand and other common law countries.

Drafting of the American GAAR

On its face, the US sec. 7701(o) is different from GAARs as we know them. It claims to codify, but instead of codifying it incorporates judge-made law by reference. It applies to "any transaction to which the economic substance doctrine is relevant", but should the taxpayer inquire further sec. 7701(o)(5)(A) offers only the illumination of a circular definition: the economic substance doctrine is the doctrine that applies to a transaction that "does not have economic substance or [that] lacks a business purpose".

This sort of drafting is rare in tax legislation and almost unheard of elsewhere. But the overall effect is familiar. A standard GAAR tells the Commissioner that an avoidance transaction is void against him and authorizes him to reconstruct the transaction and to tax that notional reconstruction instead. Similarly, the economic substance doctrine tells the Commissioner to disregard the parties' legal transactions and instead to tax the economic substance that lies behind those transactions.

The Relative Benefits Rule

In short, sec. 7701(o) is a true GAAR, but it is a GAAR with extra bite, in that sec 7701(o)(1) and (2) contain rules that sharpen its focus. The most important is a relative benefits rule, which strikes down a transaction where the economic profit is not "substantial" in relation to its net tax benefits. This rule shares its philosophy of economic substance with a test to determine whether a GAAR applies that Lord Templeman enunciated in the Privy Council in London in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513, 561 line 41. His Lordship said that the GAAR "does not apply to tax mitigation [that is, a reduction of tax] 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."

The relative benefits rule was presumably intended to reverse the result in a case like *Compaq Computer Corp v. Commissioner*, and it probably has that effect. But the drafting of sec. 7701(o) betrays all sorts of compromises. Notably, paragraph (5)(C) says that "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." Was (I) the economic substance doctrine relevant to the *Compaq* case because (a) informed observers would conclude that there was at least an issue as to whether the doctrine applied and (b) counsel and the court spent many words discussing the doctrine? Or was (II) the doctrine not relevant because the court decided that the transaction should be taxed according to its legal form and that the doctrine did not authorize the Commissioner to ignore legal form and to assess according to underlying economic substance?

Resolving the Internal Contradiction in Section 7701(o)

Answer (II) should be rejected, since it makes nonsense of the drafting of sec. 7701(o). If answer (II) were correct the effect would be that Congress wasted its time in enacting the relative benefits rule in paragraph (2)(A) and in passing paragraph 2(B) to authorize the Secretary of the Treasury to issue regulations about the treatment of foreign taxes when the Commissioner calculates relative benefits. Neither rule existed before the President signed sec. 7701(o) into law, which means that the rules can have no effect if "determination of whether the economic substance doctrine is relevant" is interpreted to mean that courts must decide cases according to judge-made law as it stood before 30 March 2010. In short, answer (I) appears to be correct, but the position is not free from doubt.

Penalties

In addition to the conceptual rules discussed above, sec. 1409 (b) of the Health Care and Education Reconciliation Act of 2010 amended sec. 6662 of the Internal Revenue Code to increase the penalty for a "non-disclosed noneconomic substance transaction" to 40 per cent of any underpayment of tax that results from the transaction. The increase is interesting from a policy point of view, but does not appear to give rise to problems of interpretation or of application.

Conclusion: an Effective Weapon for the Commissioner?

Just as the economic substance rule has waxed and waned in the hands of American judges, so the reach of statutory GAARs varies over time in their jurisdictions. In the 1960s the Australian High Court virtually emasculated the GAAR in that country, and the Supreme Court of Canada, where the experience of a GAAR is relatively short, has issued judgments that are close to directly contradicting one another. Nevertheless, the general experience of GAARs is that they are powerful weapons in the hands of Commissioners of taxation. Moreover, once the major philosophical decision has been taken and a GAAR is in place, most legislatures become willing to amend and to improve it as litigation reveals loopholes or shortcomings.

As has been explained above, a possible interpretation of sec. 7701(o)(5)(C) is that Congress is saying, “It may appear that in the sec. 7701(o)(1) to (4), above, we have armed the Commissioner with a GAAR. But we don’t really mean it. Everyone carry on as before”. In the opinion of the present writer this interpretation is too bizarre to be tenable. On the contrary, sec. 7701(o) is a true GAAR that will prove a powerful weapon in the hands of the Commissioner. Notwithstanding its novel drafting, it will operate much as GAARs in other common law jurisdictions.