

Comparing the Canadian and Australian GAARs

John Tretola

Lecturer- Adelaide University, Law School

Abstract

This paper seeks to compare and contrast the Australian and Canadian general anti-avoidance rules (GAAR) with the aim to highlight how each respective GAAR works and also to determine if aspects of the Canadian GAASR can be incorporated into the Australian GAAR.

Introduction- What is Tax Avoidance?

Many jurisdictions have introduced a statutory general anti-avoidance rule (GAAR) as a primary method to tackle tax avoidance. Australia has had a GAAR for many years, although the current version has only been in operation since May 1981, whereas Canada has only had a GAAR since 1988. Before 1988 Canadian tax law relied on a system of specific anti-avoidance rules, however, these specific rules were regarded as ineffectual as the Canadian Department of Finance made clear when it commented that “we no sooner get the stuff out and the ink gets dry than there is a way to beat the rules”.¹ Krishna also commented that the specific anti-avoidance rules were practically useless as he stated that these specific anti avoidance rules were aimed at “specific transactions close to the barn door only after the horses have bolted”.²

Tax avoidance is not a statutory defined concept and to date defining the concept of ‘tax avoidance’ has been elusive. Tax avoidance is not tax evasion. Tax evasion, in contrast to tax avoidance, usually requires an element of culpability and involves some degree of illegality. Tax avoidance activities reduce government revenue and attack the integrity and equity of the tax system.³

¹ Minutes of the Commons Standing Committee on Finance and Economic Affairs June 29 1987 in Krishna *Tax Avoidance The General Anti Avoidance Rule* (1990) 21.

² Krishna, V., *The Fundamentals of Canadian Income Tax* (2002) 7th ed. Thomson-Carswell: Toronto at 860.

³ Chris Atkinson, ‘General anti-avoidance rules: exploring the balance between the taxpayer’s need for certainty and the government’s need to prevent tax avoidance’, *Journal of Australian Taxation* Volume 14, Issue 1, 1 referring to the Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) 7.

Tax avoidance has been defined as “*a course of action designed to conflict with or defeat the evident intention of Parliament.*”⁴ It has also been stated that “*tax avoidance reduces the incidence of tax borne by an individual taxpayer contrary to the intentions of Parliament.*”⁵ Tax avoidance is likely to involve artificial or contrived arrangements with little or no real underlying business activity or purpose and a substantial removal of any risk to the taxpayer. Tax avoidance therefore encompasses all actions that have the effect of reducing, eliminating or deferring tax liability that are not illegal but these actions give the illusion that the transaction somehow complies with the letter of the law, however the tax advantage is not one intended by the law and so is clearly against the intention of Parliament.⁶

Despite the difficulty in defining tax avoidance it is certainly possible to explain the characteristics of tax avoidance arrangements as they exhibit such qualities as ‘artificiality’, ‘undue complexity’ and ‘circularity’ or ‘lack of business reality’.⁷ It seems therefore as the Privy Council pointed out in *Newton’s case* in 1958 that it is possible to know tax avoidance when it occurs but it has to be seen first before it can be properly identified.⁸

The issue that then confronts taxpayers is what is acceptable tax behaviour “according to the intention of Parliament” which is more correctly referred to as tax planning or tax mitigation and what is unacceptable tax behaviour, which is regarded as tax avoidance?⁹ Working out where to draw this line between arrangements which are acceptable as tax planning and those which are not and are therefore regarded as tax avoidance and what principles are relevant to enable this line to be drawn is still very much a valid question and for which there is still uncertainty in the context of both the Australian and the Canadian GAARs (and indeed all GAARs).¹⁰

⁴ [1997] S.T.C. 995, 1004c.

⁵ Lord Templeman in ‘Tax Avoidance and the Law’, (Adrian Shipwright (ed), Key Haven, London, 1997) at 1.

⁶ Judith Freeman, ‘Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle’ [2004] *British Tax Review* 332.

⁷ *Barclays Mercantile Business Finance Limited v Mawson (Inspector of Taxes)* [2005] STC 1, paragraph 24 citing Park J in the High Court.

⁸ *Newton v Commissioner of Taxation* [1958] AC 450, 466.

⁹ Lord Templeman first used terms such as acceptable tax mitigation and unacceptable tax avoidance in *CIR (NZ) v Challenge Corporation* [1987] AC 155.

¹⁰ M Cashmere, ‘Part IVA after Hart’ (2005) 24 AT Rev 131 at 145.

The Australian approach to tackling tax avoidance involves using the GAAR (contained in Part IVA of the *Income Tax Assessment Act 1936*) but only when other provisions have failed to apply in the way in which it was somehow assumed that they ought to have applied. Keith Kendall writes that the Part IVA provisions are intended to be invoked only as a measure of last resort.¹¹ Kendall notes that Part IVA only applies after it has been determined that the transaction in question has given rise to a tax benefit and there is no specific anti-avoidance rule that would deny or limit that tax benefit. If there is no specific anti-avoidance provision then, and only then, pursuant to s177B (3) of the *Income Tax Assessment Act 1936* can the application of Part IVA be considered.¹²

The Australian GAAR in subsection 177D(2) of the *Income Tax Assessment Act 1936* does contain eight relevant factors to be considered in this context in determining whether the taxpayer had the sole or dominant purpose of engaging in tax avoidance. The Canadian GAAR has an additional factor of abuse and misuse. This is a point of difference that I will discuss later on in this paper.

Whether or not tax avoidance exists can be to some extent explained by the dictum of Lord Nolan who treated tax avoidance as conduct that reduces or eliminates a tax liability by using provisions of the tax law to achieve outcomes that were not intended.¹³

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. The hallmark of tax mitigation (tax planning), on the other hand, is that the taxpayer takes advantage of fiscally attractive options afforded to him by the legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. Where the taxpayer's chosen course is seen upon examination to involve tax avoidance (as opposed to tax mitigation), it follows that tax avoidance must be at least one of the taxpayer's purposes in adopting that course, whether or not the taxpayer has formed the subjective motive of avoiding tax.

¹¹ K Kendall, 'The structural approach to tax avoidance in Australia', *The Tax Specialist*, Volume 9 No 5 June 2006 at 290-91.

¹² K Kendall, 'The structural approach to tax avoidance in Australia', *The Tax Specialist*, Volume 9 No 5 June 2006 at 290 referring to section 177B (3) and (4).

¹³ *Inland Revenue Commissioners v Willoughby* [1997] 4 All ER 65, 73.

A GAAR is an important weapon in the armoury of tax authorities but a GAAR also adds to uncertainty as a general anti-avoidance provision by its very nature cannot definitively distinguish between acceptable and unacceptable activities. Certainty is considered to be an important feature of a fair tax system¹⁴. And this point was recently reinforced by the OECD Committee on Fiscal Affairs which recently stated that taxpayers have a right to a high degree of certainty as to the taxation consequences of their actions.¹⁵

The Canadian GAAR

The Canadian GAAR is found in section 245 of the *Income Tax Act* (Canada) 1985 (ITA85) and is based primarily on misuse or abuse as an indicator of impermissible tax avoidance and it was introduced shortly after the release of the decision in the *Stuart Investments Ltd. v The Queen*¹⁶ case which held that the business purpose test did not apply in Canada. In the *Stuart* case the Supreme Court stated that “a transaction cannot be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose”.¹⁷

The Canadian Supreme Court stated in *Stuart Investments*:

*The presence of a provision of general application to control avoidance schemes looms large in the judicial approach to the taxpayer's right to adjust his sails to the winds of taxation unless he thereby navigates into legislatively forbidden waters. The legislature has provided the standards of unacceptable avoidance procedures and there being no other limit imposed by the Act, the court found itself under no duty, nor indeed possessed of any authority, to legislate new limits.*¹⁸

¹⁴ Adam Smith outlined his four canons of taxation: equality, certainty, convenience and economy in his work, *An Inquiry into the nature and causes of the Wealth of Nations*, first published 1776 and reproduced in 1990 at pages 405-6, cited in *British Columbia Railway Company v The Queen* (1979) 79 DTC 5020, 5025 (with a particular focus on the importance of certainty). The Henry Report also noted that simplicity and policy consistency were desirable features of a tax and transfer system, *Australia's Future Tax System*, Henry review at page 2 of the Final report Overview, accessed on 10th March 2015 through http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/Publications/Papers/Final_Report_Part_1/index.htm Simplicity and fairness were also seen as desirable characteristics of a tax system by the Asprey Report published by the Taxation Review Committee on January 31 1975 accessed through a digital text provided by the University of Sydney Library 2001 at pages 39-46 of the Report.

¹⁵ OECD, *Taxpayer's Rights and Obligations: A Survey of the Legal Situation in the OECD Countries* (OECD, 1990) [2.21].

¹⁶ 1984 1 SCR 536.

¹⁷ Per Beetz, Estey and McIntyre JJ at 536-537.

¹⁸ Ibid at 557.

The Supreme Court in the *Stuart* case referred specifically to the comment in *Produits LDG Products Inc. v The Queen*, where the court stated:

*There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible.*¹⁹

The decision in *Stuart* has been criticised by some Canadian tax commentators but one, Arnold, noted that the decision rightly recognised the relationship between statutory interpretation and the control of tax avoidance and that therefore a purposive approach rather than a literal approach is the favoured approach to interpreting tax legislation.²⁰ The purposive approach to interpreting tax legislation is now set out in sub-section 245 (2) of ITA85 which provides that where a transaction is an avoidance transaction the tax consequences to the taxpayer are to be determined as is reasonable in the circumstances to deny the tax benefit that results directly or indirectly from the transaction.²¹ If the transaction is found to be an avoidance transaction then the whole or part of any tax benefit obtained can be disallowed to any taxpayer affected by the transaction.²²

Sub-section 245 (1) provides that a tax benefit is widely defined to mean a reduction, avoidance or deferral of tax or other amount payable under the Act or an increase in a refund of tax or other amount under the Act that arises from a particular transaction or series of transactions. In determining a tax benefit there is first a factual determination made of the tax benefit and second whether or not the tax benefit is material is not relevant (although due to the costs of litigation cases that appear before the courts would inevitably have large tax benefits at stake). Third, where reduction of taxable income is not an issue, a tax benefit can be determined by reference to an alternative arrangement that the taxpayer could have carried out.

¹⁹ *Produits LDG Products Inc. v The Queen* 76 DTC 6344 at 6349.

²⁰ Arnold, B.J., 'The Canadian General Anti-Avoidance Rule', in Cooper (de) *Tax Avoidance and the Rule of Law* (1997) 223.

²¹ Inf. Cir. 88-2. 88-2S1.

²² Sub-section 245(5).

In *Canada Trustco* it was noted that “the existence of a tax benefit might only be established upon a comparison between alternative arrangements”.²³ In *Univar Canada Ltd v R.* it was noted that this comparison must be made to the alternative transaction that the taxpayer may have actually entered into even if this alternative transaction amounts to nothing.²⁴ The case *OSFC Holdings Ltd*²⁵ made it clear that it is not a requirement that the tax benefit has to be enjoyed by the party entering into the avoidance transactions.

Subsection 245(3) of ITA85 provides that an ‘avoidance transaction’ includes an arrangement or event and any transaction including a transaction that is part of a series of transactions that results directly or indirectly in a tax benefit unless the transaction may be reasonably considered to have undertaken for bona fide purposes other than to obtain the tax benefit.²⁶ Sub-section 248(10) provides that a series of transactions includes any related transactions or events completed with the series in mind. This indicates that the step must not be independent and must be related to the bigger transaction and must achieve the objective of the series.

In *Canada Trustco* it was held that:

*If at least one transaction in a series of transactions is an ‘avoidance transaction’, then the tax benefit that results from the series may be denied under the GAAR. Conversely, if each transaction in a series was carried out primarily for non-tax purposes, the GAAR cannot be applied to deny the tax benefit.*²⁷

The Canadian GAAR contained in section 245 does distinguish between avoidance and planning and tests whether a transaction was undertaken or arranged primarily for ‘bona fide purposes’ other than securing tax benefits. The Canadian GAAR looks to see what the primary purpose was of any transaction entered into and if that primary purpose, after weighing up all the relevant tax and non-tax purposes is mainly for tax reasons then the transaction will be made void.

²³ *Canada Trustco Mortgage Company v Canada* 2005 SCC 54 at para. 20.

²⁴ *Univar Canada Ltd v R.* 2005 DTC 1478.

²⁵ *OSFC Holdings Ltd.* 2001 DTC 5471.

²⁶ Sub-section 245 (3).

²⁷ *Canada Trustco Mortgage Company v Canada* 2005 SCC 54 at para. 34.

The term bona-fide means that the non-tax purpose must be real and not contrived to create an impression of a non-tax purpose. Therefore, even if tax is a significant but not the main purpose of the transaction then the transaction will not be caught by section 245. In so doing the section applies a step transaction approach taken by the judiciary in England in the *WT Ramsay Case*.²⁸ As such each step in the transaction or series of transactions must be carried out primarily for bona fide non-tax purposes. However, with the decision in *Stuart Investments v R*²⁹ the Canadian Supreme Court has now clearly stated that the *Ramsay* approach did not apply to Canada due to the existence of the Canadian GAAR.

Sub-section 245(4) of ITA85 plays a central role in the operation of the Canadian GAAR as it provides that the GAAR does not apply to any transaction where it may be reasonably concluded that the transaction would not result in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole. The Canadian Supreme Court accepted in the *Lipson case*³⁰ that a consideration of the entire series of transactions is appropriate in determining whether a particular transaction in the series results in an abuse or misuse. The Supreme Court concluded in the *Lipson* case there was an abuse as the attribution rules were used to shift an interest deduction and resulting loss from the wife to the husband taxpayer.

Arnold notes that the term ‘reasonably considered’ indicates that an objective test is applied with reference to what the taxpayer did and the legal, commercial and tax consequences of their actions as opposed to the subjective motive and intentions.³¹

In summary then, three conditions must be satisfied before section 245 can be applied:

1. There must exist an avoidance transaction;
2. A tax benefit arises from the avoidance transaction; and
3. The avoidance transaction must be abusive and so directly or indirectly result in the misuse or abuse of any provision of the ITA 1985.

²⁸ *WT. Ramsay Ltd.* [1982] A.C. 300 (House of Lords).

²⁹ [1984] 1 SCR 536; (1984) CTC 294.

³⁰ *Lipson* 2009 DTC 5015.

³¹ Arnold, B.J., ‘The Canadian General Anti-Avoidance Rule’, in Cooper (de) *Tax Avoidance and the Rule of Law* (1997) 231.

In *Canada Trustco*³² the Supreme Court found that the term ‘abuse’ was broad enough to encompass ‘misuse’.³³ The Supreme Court stated that it was not possible to abuse the Act as a whole without also misusing the specific provisions of the Act and that therefore subsection 245(4) does involve a two-stage test. The first stage involves a contextual, textual and purposive interpretation of the provisions that the taxpayer relies on to obtain the tax benefit. This is a question of law. The second step then involves a determination of whether the facts of the transaction fit in the purposive analysis of the relevant provisions. If they do not an abuse of the provisions has occurred and the GAAR can be used to strike down the ‘abusive’ transaction. This second step involves a factual inquiry.

The Supreme Court stated in *Canada Trustco*:

*Section 245(4) imposes a two part inquiry. First, the courts must conduct a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act. Second, the court must examine the factual context of the case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance.*³⁴

The purposive interpretation of ITA85 as required by this abuse and misuse approach does not necessarily extend to the policy underlying the provisions because the policy justification behind the legislation is often impossible for taxpayers and the revenue authorities alike to ascertain.

³² *Canada Trustco Mortgage Co v Canada* [2005] 2 SCR 601, 619 [38].

³³ *Ibid* at paragraph 39.

³⁴ *Ibid* at paragraph 44.

In highlighting this difficulty in ascertaining the policy behind legislation the Supreme Court stated in *Canada Trustco* that:

*To search for an overarching policy 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. Although Parliament's general purpose in enacting the GAAR was to preserve legitimate tax minimisation schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law. These three latter purposes would be frustrated if the Minister and/or the courts overrode the provisions of the Income Tax Act without any basis in a textual, contextual and purposive interpretation of those provisions.*³⁵

The purposive interpretation provided for by 245(4) allows for a transaction to be disregarded even if it complies with a literal interpretation of the provisions. This aspect of the Canadian GAAR therefore allows the GAAR to save the ITA85 from self-destruction.³⁶ This is not to say that a literal interpretation of the legislative provisions is not required as the literal meaning of the provision in question is still important to the inquiry and if the words of the provision are clear and unambiguous then their ordinary meaning will play a more dominant role in their interpretation.³⁷

The Supreme Court stated in *Canada Trustco* that the lack of economic substance in a transaction is not a necessary pre-condition to an abusive transaction and is by itself of limited importance in determining tax avoidance.³⁸ Despite this observation the court in *Matthew* held that “the abusive nature of the transactions is confirmed by the vacuity and artificiality”.³⁹

³⁵ *Canada Trustco Mortgage Co v Canada* at paragraph 42.

³⁶ And in this way the Canadian GAAR is far superior to the former Australian GAAR found in section 260 of the *Income Tax Assessment Act* 1936 which because it was applied in such a literal and formalistic way resulted in it being practically useless in its effect as the period of the Barwick High Court demonstrated.

³⁷ *Canada Trustco* *ibid* at paragraph 10.

³⁸ *Ibid* at paragraphs 57-58.

³⁹ *Mathew v Canada* 2005 SCC 55 at paragraph 62.

The 'abuse' test uses the 'object and spirit' approach followed by the Canadian Supreme Court and draws on the 'abuse of rights' doctrine that applies in some jurisdictions to defeat schemes that attempt to abuse tax legislation.⁴⁰ This 'object and spirit' approach recognises that a number of provisions of the Act contemplate or encourage transactions that may seem to be primarily tax motivated and so if transactions are carried out within the object and spirit of the Act taken as a whole then they will not fall foul of the GAAR. However, where a taxpayer carries out a transaction primarily to obtain a tax benefit that was not intended, when looking at the Act as a whole, by any specific provisions sought to be applied then the GAAR will apply. This outcome occurs even when the words of the specific provision are strictly applied. For example, in *Pieces Automobiles Lecavalier Inc.*⁴¹ a debt restructuring transaction despite having been undertaken for bona fide non-tax purposes was ruled as having been a misuse of the debt forgiveness rules and was made void by the operation of the GAAR rules.

Section 245 includes an additional positive requirement that is not found in the Australian or New Zealand GAARs. This additional requirement is found in subsection 245(4) and must be fulfilled before the GAAR will operate. This additional requirement provides that a unified textual, contextual and purposive analysis of the provisions giving the tax benefit should be undertaken to determine why they were put in place and why the benefit was conferred. The purposive interpretation of the provisions of the Act that confer the tax benefit consequently means that the GAAR will only apply to a transaction if it may reasonably be considered that the transaction would result in a 'misuse' of any provision of the income tax legislation or an 'abuse' of the legislation read as a whole. Whilst the inclusion of this additional requirement does appear to be aimed at attacking the more aggressive of the avoidance arrangements it does not provide any more specific guidance about exactly the type of arrangement that may amount to a misuse of a provision or the legislation taken as a whole. Much like the New Zealand GAAR, this is a task that has been left to the courts to decide.⁴²

⁴⁰ *Stuart* 84 DTC 6305.

⁴¹ *Pieces Automobiles Lecavalier Inc.* 2013 DTC 1245 (TCC).

⁴² The New Zealand GAAR is found in sections BG 1, GA 1 and YA 1 of the *Income Tax Act 2007* (NZ).

Per section 246 of ITA85 a tax benefit will not be found to be subject to the GAAR in any transaction if the transaction meets the following four conditions⁴³:

- (a) Was entered into at arm's length;
- (b) Is bona fide;
- (c) Is not pursuant to or part of any other transaction; and
- (d) Did not affect the payment or partial payment of any existing or future obligation.

In *Indalex Ltd*⁴⁴ a tax benefit was found subject to the GAAR where aluminium was purchased from a Canadian company indirectly through a Bermuda corporation that was part of the same corporate group at inflated prices. Similarly in *Kieboom*⁴⁵ a tax benefit was found subject to the GAAR where a taxpayer issued shares to his spouse and children with the result that the value of the taxpayer's shares was diminished with this decrease in value effectively given to related family members.

Subsection 245(2) of ITA85 empowers the Minister to recharacterise the tax consequences of an avoidance transaction by disregarding them. The tax consequences are determined as is reasonable in all the circumstances and what is reasonable in all the circumstances is a question of fact.⁴⁶ The term 'reasonable in all the circumstances' does clearly allow the Minister some flexibility in recharacterising transactions that are found to be abusive and this flexibility is seen as important given the ever-changing transactions and tax avoidance methods that taxpayers are developing.

*Rousseau-Houle*⁴⁷ held that the GAAR did not apply to the Income Tax Regulations and as such the GAAR was retroactively amended back to 12 September 1988 to extend its application to the Income Tax Regulations; the Income Tax Application Rules and also to Canada's international treaty obligations.

⁴³ Sub-sections 246(1) and (2).

⁴⁴ *Indalex Ltd*. 88 DTC 6053.

⁴⁵ *Kieboom* 92 DTC 6382.

⁴⁶ Krishna, V., *The Fundamentals of Canadian Income Tax* (2002) 7th ed. Thomson-Carswell: Toronto at 866.

⁴⁷ *Rousseau-Houle* 2001 DTC 250.

Different approaches have been taken to applying the Canadian GAAR. In *Jabs Construction Limited v Canada*⁴⁸ the GAAR was noted as a harsh measure which can only be applied as a measure of last resort and the court noted that the GAAR is an “extreme sanction that is not be used when the Minister is upset by an avoidance transaction.”⁴⁹ Similarly in *Hill v The Queen*⁵⁰ the GAAR was described as the ultimate weapon but which did not end up applying to the transaction in question. In *Canada Trustco* the GAAR was described as “tax legislation to be applied with utmost caution”.⁵¹

In *Fredette*⁵² it was stated that:

When it passed section 245 of the Act, parliament’s aim was to put a stop to schemes put in place to create an undue tax benefit for taxpayers. Parliament’s intent was not, however, to enable the Minister to force taxpayers to structure their transactions so as to give rise to the greatest possible tax liability. In his explanatory notes on the new section 245 accompanying the Bill to amend the Act, the Minister of Finance acknowledged that a taxpayer is entitled to arrange his affairs so as to pay the least tax possible. Section 245 is a powerful tool for discouraging and preventing flagrant abuses of the Act. It cannot serve as a tool for the Minister to force taxpayers to structure their transactions in the manner most favourable to the tax authorities.

Arnold acknowledges that the GAAR is a provision of last resort but it is not an extreme sanction as even if abusive tax avoidance is found no penalties apply and it has to date been applied responsibly as GAAR cases are first reviewed by the GAAR Committee.⁵³ Nevertheless the Canadian Supreme Court has stated that it considers the GAAR in section 245 to be uncertain as it does not clarify the boundary between permissible and impermissible tax avoidance. In this regard the court stated:

The GAAR draws a line between legitimate tax minimisation and abusive tax avoidance. The line is far from bright.

⁴⁸ *Jabs Construction Limited v Canada* 99 DTC 729

⁴⁹ *Ibid* at paragraph 48.

⁵⁰ *Hill v The Queen* [2003] 4 CTC 2548.

⁵¹ *Canada Trustco Mortgage Co v Canada* [2003] 4 CTC 2009 at paragraph 77.

⁵² *Fredette v The Queen* [2001] 3 CTC 2468 at paragraph 76.

⁵³ Arnold, B.J., ‘The Long, Slow, Steady Demise of the General Anti-Avoidance Rule (2004) 52 2 *Canadian Tax Journal* 488 at 492.

The GAAR's purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act. But precisely what constitutes abusive tax avoidance is the subject of debate.⁵⁴

In *Lipson* it was stated:

To the extent that it may not always be obvious whether the purpose of a provision is frustrated by an avoidance transaction, the GAAR may introduce a degree of uncertainty into tax planning but such uncertainty is inherent in all situations in which the law must be applied to unique facts. The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed, in the context of the ITA, to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved.⁵⁵

Problems with applying the misuse or abuse concept

In *OSFC Holdings Ltd* Rothstein J stated the following:⁵⁶

It is also necessary to bear in mind the context in which the misuse and abuse analysis is conducted. The avoidance transaction has complied with the letter of the applicable provisions of the Act. Nonetheless, the tax benefit will be denied if there has been a misuse or abuse. This is not an exercise of trying to divine Parliament's intention by using a purposive analysis where the words used in a statute are ambiguous. Rather, it is an invoking of a policy to override the words Parliament has used. I think, therefore, that to deny a tax benefit where there has been strict compliance with the Act, on the grounds that the avoidance transaction constitutes a misuse or abuse, requires that the relevant policy be clear and unambiguous. The court will proceed cautiously in carrying out the unusual duty imposed upon it under section 245(4). The court must be confident that although the words used by Parliament allow the avoidance transaction, the policy relevant provisions of the Act as a whole is sufficiently clear that the court may safely conclude that the use made of the provision or provisions by the taxpayer constituted a misuse or abuse.

⁵⁴ *Canada Trustco* at paragraph 16.

⁵⁵ *Lipson v Canada* 2009 SCC 1 at paragraph 52.

⁵⁶ *OSFC Holdings Ltd* 2001 4 CTC 82 paragraph 67.

This policy approach advanced in the *OFSC Holdings* case made it extremely difficult for the Minister to prove misuse or abuse because there was no ‘clear and unambiguous’ policy document that accompanied the Canadian *Income Tax Act 1985*.⁵⁷

In *Hill v The Queen* the misuse and abuse approach was taken further to require the Minister to actually produce a document containing policy reasons behind the statutory provisions and this argument formed the basis of the taxpayer’s defence and not on whether the transaction in question was legitimate.⁵⁸

The difficulty in taking this policy approach to this extent was conceded by Miller J in *Canada Trustco Mortgage Company* where His Honour stated:

*What this analysis highlights is the difficulty and risk in determining tax issues based on policy. Certainly the GAAR invites such an approach, and the Federal Court of Appeal has made it clear that the only way to determine if there has been a misuse or abuse is to start with the identification of a clear and unambiguous policy. No clear and unambiguous policy-no application of GAAR. But at what level do we seek policy? And, as previously mentioned, do ‘policy’, ‘object’ and ‘spirit’ all mean the same thing? Is there a policy behind each particular provision, a policy behind a scheme involving several provisions, a policy behind the Act itself? Is the policy fiscal? Is the policy economic? Is the policy simply a regurgitation of the rules? Does the identification of policy require a deeper delving into the raison d’être of those rules? How deep do we dig? The success or failure of the application of the GAAR left to the Court’s finding of a clear and unambiguous policy inevitably invites uncertainty. This is simply the nature of the GAAR legislation in relying upon such terms as misuse and abuse. As many have said before, this is tax legislation to be applied with utmost caution as it directs the Court to ascertain the Government’s intention and then rely on that ascertainment to override legislation. This is quite a different kettle of fish from the accepted approach to statutory interpretation where policy might be sought to assist in understanding legislation. Under GAAR policy can displace legislation.*⁵⁹

⁵⁷ Arnold, B.J., ‘The Long, Slow, Steady Demise of the General Anti-Avoidance Rule (2004) 52 2 *Canadian Tax Journal* 488 at 499. Arnold suggests that it would have been fairer for the court in *OSFC Holdings Ltd* to interpret the misuse and abuse concept as entailing the use of some words used by Parliament to override other words used by Parliament instead of trying to use policy to override the words Parliament actually used.

⁵⁸ *Hill v The Queen* [2003] 4 CTC 2548 at paragraph 62.

⁵⁹ *Canada Trustco Mortgage v the Queen* [2003] 4 CTC 2009 at paragraph 91.

The policy approach was used in *Canada v Jabin Investments Ltd*⁶⁰ where the Court rejected the Minister's reference to the 1966 *Report of the Royal Commission on Taxation* chaired by Kenneth Carter to establish policy. The Court held that the *Report* was not a policy document as some of its proposals were not adopted in their entirety. The Court stated: "because the policy invoked by the Minister is to override the words that Parliament has used, the policy must be clear and unambiguous if it is to be applied".⁶¹

However, as noted earlier the Supreme Court in *Canada Trustco* did away with this policy approach and replaced it with a purposive approach.

*There is no doubt today that all statutes, including the Income Tax Act, must be interpreted in a textual, contextual and purposive way. However, the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation.*⁶²

Therefore, although the Supreme Court in *Canada Trustco* replaced the policy approach with the purposive approach, the Supreme Court is not unequivocal in requiring the application of the purposive approach as a literal interpretation of some taxing provisions is still required when these are clear and where these have been followed precisely by the taxpayer.

In *Geransky*, Bowman ACJ stated:⁶³

What is misuse or abuse is in some instances in the eye of the beholder. The Minister seems to be of the view that any use of a provision is a misuse or abuse if the provision is not used in a manner that maximises the tax resulting from the transactions.

The most recent Canadian Supreme Court case concerning the Canadian GAAR is the case of *Copthorne Holdings Ltd v The Queen* where the Court affirmed that the two-stage approach in *Canada Trustco* could be justified in the following instances:

⁶⁰ *Canada v Jabin Investments Ltd* [2003] 2 CTC 25.

⁶¹ *Ibid* at paragraph 3.

⁶² *Canada Trustco Mortgage v the Queen* [2003] 4 CTC 2009 at paragraph 11.

⁶³ *Geransky* at paragraph 40.

1. Where the taxpayer relies upon specific provisions of the Canadian *Income Tax Act* 1985 for tax consequences that the provisions do not seek;
2. Where a transaction defeats the underlying rationale of the provisions relied upon by the taxpayer; and
3. Where a transaction avoids the application of anti-avoidance provisions in the Canadian *Income Tax Act* 1985 in a manner that frustrates the object, spirit and purpose of those provisions.

In dismissing the taxpayer's appeal the Supreme Court noted that establishing the misuse and abuse test is the most difficult part of applying the GAAR. This difficulty the Court noted emanates from the fact that the GAAR is a "legal mechanism whereby Parliament has conferred on the court the unusual duty of going behind the words of the legislation to determine the object, spirit or purpose of the provisions relied upon by the taxpayer".⁶⁴ The Supreme Court also reiterated the views in *Canada Trustco* that the GAAR is a provision of last resort with the burden of proof regarding the abusive nature of a transaction lying with the Minister and that the GAAR should only be applied when there is no doubt about the abusiveness of the transaction.⁶⁵ The Court also explained the analysis required under the misuse or abuse indicator that in determining the object, spirit and purpose of the provisions it is necessary to consider the purpose of the provisions by undertaking a unified textual, contextual and purposive analysis.

The Supreme Court noted that usual purposive statutory interpretation required the meaning of the provisions to be determined whereas the purposive analysis under the GAAR is different as the aim is to find the rationale of the provisions that is absent in the actual words.⁶⁶

In *Lipson* the Court noted that:

⁶⁴ *Copthorne Holdings Ltd v The Queen* 2011 SCC 63 at paragraph 66.

⁶⁵ *Ibid* at paragraphs 65 and 68.

⁶⁶ *Ibid* at paragraph 70.

*The Duke of Westminster has never been absolute and Parliament enacted section 245 of the Income Tax Act, known as the GAAR, to limit the scope of allowable avoidance transactions while maintaining certainty for taxpayers.*⁶⁷

Whilst the nature of the GAAR creates some uncertainty it has been applied successfully in a number of cases in Canada such as *Mathew, Lipson and Cophorne* and so has been proven to be more than capable of curbing impermissible tax avoidance in Canada.

Australia's GAAR (Part IVA)

On 27 May 1981 Part IVA was introduced into the *Income Tax Assessment Act 1936* (ITAA36) and in his Second Reading Speech to then Bill, the then Treasurer, the Hon. John Howard stated what he saw as the purpose of this new part of the legislation:

*"The proposed provisions embodied in a new Part IVA seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs".*⁶⁸

*"In order to confine the scope of the proposed provisions to schemes of the "blatant" or "paper" variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and an objective examination, having regard to the scheme itself and to its surrounding circumstances and practical results, leads to the conclusion that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit"*⁶⁹

The views of the Treasurer are also then supported by the Explanatory memorandum (EM) which accompanied the Bill.

⁶⁷ *Lipson v Canada* 2009 SCC 1 at paragraph 21.

⁶⁸ Second Reading Speech, *Income-tax laws Amendment Bill (No. 2) 1981*, *Hansard*, House of Representatives, 27th May 1981.

⁶⁹ Second Reading Speech, *Income-tax laws Amendment Bill (No. 2) 1981*, *Hansard*, House of Representatives, 27th May 1981.

The explanation in the EM stated that the aim of the Bill “was to restore the anti-avoidance rule to the position as it was understood immediately after the decision of the Privy Council in *Newton*.”⁷⁰

Justice Pagone, writing extra-judicially suggests that the drafters of Part IVA reverted back to *Newton’s case*⁷¹ so that tax avoidance was found when by looking at the overt acts by which it was implemented you were able to predicate that it was done in that particular way so as to avoid tax. This was to be contrasted to a transaction that was capable of explanation by reference to ordinary business or family dealings.⁷²

Pre-conditions for operation of Part IVA

Section 177F of ITAA36 makes it clear that Part IVA is not a self-operating provision as it requires the Commissioner to exercise his discretion to cancel a tax benefit that has been obtained, or would, but for section 177F, be obtained, by a taxpayer in connection with a scheme to which Part IVA applies.

For Part IVA to apply three elements must be satisfied which must each be considered individually but the Part IVA provision must be interpreted as a whole.⁷³ The three elements that are required to be established are that:

- there must be a ‘scheme’;
- a taxpayer must obtain a ‘tax benefit’ in connection with that scheme; and
- it would be concluded that the scheme was carried out for the dominant purpose of enabling the taxpayer to obtain a tax benefit in connection with that scheme.

Scheme

Section 177A of ITAA36 defines the term ‘scheme’ in very broad language as:

(a) “any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

⁷⁰ The Treasurer, *Income Tax Laws Amendment Bill (No. 2) 1981: Explanatory Memorandum* (Canberra AGPS, 1981).

⁷¹ *Newton v FCT* (1958) 98 CLR 1 (Privy Council).

⁷² G T Pagone, *Tax Avoidance in Australia* (Federation Press, 2010) at page vi.

⁷³ *FCT v Peabody* 94 ATC 4,663.

(b) any scheme, plan, proposal, action, course of action or course of conduct”.

Due to this broad definition of ‘scheme’ in s177A (1), almost any activity, even if taken out unilaterally would appear to amount to a scheme. However, the Full Federal Court in *FCT v Peabody*⁷⁴ held that where a scheme consists of a series of steps or a course of action, the Commissioner cannot just isolate one step out of the course of action and classify that one step as a scheme. In that same case, Hill J stated that: “[I]n a case where a series of steps constitutes a scheme, that whole series of steps is to be considered, the individual steps being seen as parts of the scheme rather than each step being capable of being seen as a scheme in itself.”⁷⁵ Although in *Peabody* the High Court accepted on appeal that it is possible to have a narrower scheme within a broader scheme the High Court made it clear that “the scheme must still be capable of standing on its own without being robbed of all practical meaning.”⁷⁶

Cooper J in *Spotless Services Ltd* asserted that the definition of scheme “requires that the parties to the scheme, insofar as they are known, must be identified and the terms or content of any agreement, arrangement, understanding, promise or undertaking and the steps or stages of any course of action or proposal insofar as they are relevant, be identified.”⁷⁷ This therefore means that the relevant facts must be included in the relevant formulation of the scheme as identified.

Tax Benefit

Section 177C of ITAA36 defines the kind of tax outcomes that a participant in the scheme must have had in connection with the scheme. Accordingly it provides that a tax benefit can be any one of the following:

- An amount not included in assessable income;
- A deduction being allowed;
- A capital loss being incurred; and
- A foreign income tax offset being allowed.

⁷⁴ (1994) 28 ATR 344.

⁷⁵ (1993) 93 ATC 4104, 4111.

⁷⁶ *Peabody v Commissioner of Taxation* (1994) 94 ATC 4663, 4670.

⁷⁷ (1995) 95 ATC 4775, 4805.

Finding a tax benefit is not by itself a sufficient condition for the operation of Part IVA for which there is also required the critical additional condition that the taxpayer entered into the scheme for the sole or dominant purpose or objective of tax avoidance. The Commissioner can put his case in relation to the scheme and tax benefit in alternative ways. However, the existence of a scheme and a tax benefit must be established as matters of objective fact and are not affected by the Commissioner exercising his opinion or satisfaction that there is a tax benefit that was obtained in connection with a scheme.⁷⁸

In determining whether a tax benefit exists may at first glance be an easy thing to identify but as Domenic Carbone has pointed out in determining whether a tax benefit exists also requires considering the taxpayer's actual state of mind and all the known circumstances in determining what the taxpayer's subjective intention is likely to have been. Carbone notes that "subjective intention can therefore be drawn from direct evidence given by a person, as well as by inference from the known circumstances" but that a taxpayer's testimony must always "be examined against and judged in light of the known circumstances of a case" or to put it another way subjective intention is determined objectively.⁷⁹

A Part IVA inquiry requires a comparison between the scheme in question and an alternative postulate or so called 'counter-factual'.⁸⁰ A counterfactual scenario can be described as an alternative hypothesis or what would have happened or might reasonably be expected to have happened if the particular scheme had not been entered into or carried out. The reasonable expectation test requires more than a possibility and involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.⁸¹

Such a comparison can be undertaken in two ways:

⁷⁸ *Peabody v Commissioner of Taxation* (1994) 181 CLR 359 at 382-384

⁷⁹ D Carbone, 'Part IVA & the Relevance of Subjective Intention- the Second Instalment', paper presented at the 20th annual ATTA conference in Hobart in January 2008 at pages 1-2.

⁸⁰ *FCT v Hart* (2004) 217 CLR 216 at [66].

⁸¹ *FCT v Peabody* 94 ATC 4,663 at 4,671.

- First, comparisons between the tax consequences of the scheme and the tax consequences of the alternative postulates provide a basis for identifying (and quantifying) any tax advantages obtained from the scheme;
- Second, a consideration of alternative postulates may assist in reaching a conclusion about the purposes of the participants in the scheme to help reach a conclusion about the eight matters as set out in s177D (b) of ITAA36.

In order to quantify the tax benefit it is necessary to compare the tax consequences of the scheme in question with the tax consequences that either would have arisen, or might reasonably be expected to have arisen, if the scheme had not been carried out.

An alternative postulate could merely be that the scheme did not happen or that it did not happen but that something else did happen.

Subsection 177C (2) was recently amended (in 2012) and which now provides that an amount is not a tax benefit and is excluded from the operation of Part IVA if the benefit is expressly provided for in the Act and:

- (i) ... is attributable to the making of a declaration, agreement, election, selection or choice, the giving of a notice or the exercise of an option by any person, being a declaration, agreement, election, selection, choice, notice expressly provided for by this Act...; and
- (ii) the scheme was not entered into or carried out by any person for the purpose of creating any circumstance or state of affairs the existence of which is necessary to enable the declaration, agreement, election, selection, choice, notice or option to be made, given or exercised.

On 29 June 2013 Part IVA was further amended⁸² with effect from 16 November 2012 with the insertion of new sections 177CB and 177D which repealed the old sections 177CA and 177D of the *Income Tax Assessment Act 1936*.

⁸² These amendments were contained in the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013*.

Whilst section 177C has still been preserved to retain the alternative postulate of assessing “what would have” or “might reasonably be expected to have” been included in income or allowed as a deduction, the new provision of s177CB(4)(a) requires having regard to:

1. The substance of the scheme; and
2. Any result or consequences for the taxpayer that is or would be achieved by the scheme (other than a result in relation to the operation of this Act).

In effect the new provision limits the range of alternative postulates to be considered to only those with the same objective as the scheme identified and which provide the same commercial result. Notwithstanding this, section 177CB notes that these factors are not an exhaustive list and so other factors which may impact on a taxpayer’s facts and circumstances in deciding upon a particular transaction may still be relevant in terms of the alternative postulate enquiry.

Section 177CB of ITAA36 now provides that any alternative postulate result that takes into account federal income taxation is to be disregarded. This does it seem still allow a consideration of foreign and/or state taxes in determining whether a tax benefit exists apart from the scheme.⁸³ Section 177CB now also expressly provides for two bases for the identification of a tax benefit with the first basis being as to what ‘would’ have resulted if the scheme had not been entered into (this approach is referred to as the annihilation approach and is stated in 177CB(2)). The second basis being to compare the tax consequences of the scheme with the tax consequences that ‘might reasonably be expected to have’ resulted if the scheme was not entered into (this approach is known as the reconstruction approach and is stated in subsections 177CB (3) and (4)).

Purpose of entering into the scheme

The mere fact that the taxpayer has obtained a tax benefit in connection with a scheme does not of itself mean that Part IVA will apply. Part IVA will only apply to a tax benefit if a person or persons who participated in the scheme did so for the sole or dominant purpose of enabling the taxpayer to obtain the tax benefit.

⁸³ *PwC Tax Talk Monthly* 1 August 2013 at page 1.

This purpose of the taxpayer must be established objectively based on applying paragraph 177D (b) of ITAA36 which lists eight factors which must be taken into account in determining the purpose of the taxpayer entering into the scheme.

This requires an analysis of how the scheme was implemented, what the scheme actually achieved as a matter of substance or reality (as distinct from legal form) and the nature of any connection between the taxpayer and other parties. These eight factors, which were included in ITAA36 at subparagraphs 177D (b) (i) to (viii) were amended in 2013 and are now included in subsection 177D (2).⁸⁴

In considering whether Part IVA applies these eight criteria need to be applied separately but they are not mutually exclusive and so must also be considered together.

The eight factors listed in sub-section 177D (2) are:

- The manner in which the scheme was entered into or carried out;
- The form and substance of the scheme;
- The time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- The result in relation to the operation of the Tax Act, but for Part IVA, would be achieved by the scheme;
- Any change in the financial position of any person who has any connection (whether of a business, family or other nature) with the relevant taxpayer from the scheme;
- Any consequences for the relevant taxpayer or other connected person of the scheme having been entered into or carried out;
- The nature of the connection (whether of a business, family or other nature) between the relevant taxpayer and that other connected person; and
- Any changes in the financial position of the taxpayer.

A former Commissioner of Taxation (Michael Carmody) in a speech to the Taxation Institute of Australia in 1997 referred to the application of these eight criteria as the application of a kind of 'smell test' suggesting that if the taxpayer's arrangements 'smell' like tax avoidance then they probably do amount to tax avoidance.⁸⁵

⁸⁴ *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013.*

⁸⁵ Michael Carmody (Federal Commissioner of Taxation), 'Part IVA- Where to Draw the Line' (Address presented at the 13th National Convention of the Taxation Institute of Australia, Melbourne, 19 March 1997).

In practical terms the Commissioner was suggesting that the degree of artificiality or contrivance present is a key factor in assessing which side of the tax planning/avoidance line the taxpayers is on.

A sole purpose is clear enough to establish as sole denotes the only purpose but a dominant purpose is more problematic. The meaning of the term ‘dominant’ purpose was clarified by the High Court in *Peabody* where all 7 judges stated unanimously that:

*Much turns upon the identification, among various purposes, of that which is ‘dominant’. In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose.*⁸⁶

Hill J in the Full Federal Court stated in *Peabody v FCT* that Part IVA would “seldom if ever [apply] where the overall transaction is in every way commercial, although containing some element which has been selected to reduce the tax payable”.⁸⁷ In *Mochkin v FCT*⁸⁸ Part IVA was found not to apply as the court concluded that a reasonable person would not conclude that the taxpayer entered into the scheme for the dominant purpose of obtaining the tax benefit as the tax advantages from the scheme in that case were held to be secondary to the commercial objectives of gaining limited liability.

Gleeson CJ and McHugh J in the High Court in *Hart* stated “a transaction may take such a form that there is a particular scheme in respect of which a conclusion of the kind described in section 177D is required, even though the particular scheme also advances a wider commercial objective.”⁸⁹ In reaching this conclusion their Honours gave special emphasis to the former s 177D (b) (i) which requires consideration of the manner in which the scheme was entered into and that this allowed reference to be made to how the transaction was structured and as such placed emphasis on the ‘wealth optimiser’ aspect of the borrowing at issue rather than the mere borrowing itself.⁹⁰

⁸⁶ *FCT v Peabody* 94 ATC 4,663 at 5,206.

⁸⁷ *FCT v Peabody* 93 ATC 4104, 4110 and 4118.

⁸⁸ *Mochkin v FCT* (2002) 2002 ATC 4465.

⁸⁹ *FCT v Hart* (2004) 2004 ATC 4599, 4604.

⁹⁰ *FCT v Hart* (2004) 2004 ATC 4599, 4605.

Reconstruction

Where the three elements are found and it is concluded that the sole or dominant purpose of entering into the scheme was to obtain a tax benefit, s177F of ITAA36 allows the Commissioner the power to reconstruct the taxpayer's affairs. With this reconstruction the tax benefit is removed (so either an amount is included in assessable income or a deduction or capital loss or foreign tax credit is disallowed) and this thereby gives rise to a tax shortfall amount. Penalties can then also be applied to this tax shortfall amount based on the degree of culpability involved and these penalties can range from 25% (for lack of reasonable care) to 75% (for intentional disregard) of the tax shortfall amount.

Comparing the Canadian and Australian GAARs

Both GAARs require the identification of a course of action that gives rise to the tax advantage obtained. The Australian GAAR uses the concept of 'scheme'⁹¹ whereas the Canadian GAAR uses that of 'avoidance transaction'.⁹² How broadly or narrowly the arrangement is defined is critical to the operation of both GAARs. The broader an arrangement is defined, the more likely that it will be found to have an overall non-tax purpose. Conversely, the narrower a scheme is defined, the more likely a GAAR will be found to apply to the arrangement. In recognition of this issue of the identification of a scheme or arrangement, courts have sought to limit the way in which a scheme or arrangement can be defined. For example, the High Court in *Hart* took a narrow view of the scheme in question (although it did accept that a broad approach was also possible).⁹³

Both the Australian and Canadian GAARs use a very similar definition of 'tax benefit' which has been obtained in connection with the scheme or avoidance transaction as the required second element to the application of the GAAR.

⁹¹ As defined in section 177A of the *Income Tax Assessment Act 1936*.

⁹² *Income Tax Act (Canada) 1985* section 245.

⁹³ *FCT v Hart* (2004) 2004 CLR 216 per Gummow and Hayne JJ at paras. [48]-[55].

The Australian GAAR refers to a 'tax benefit' in section 177C of ITAA36 whereas the Canadian GAAR refers to 'tax benefit' in section 245 of ITA85.⁹⁴ However, there is no real practical difference in these terms as both relevant terms are defined broadly enough to ensure that any arrangement that reduces tax payable or provides a timing advantage through deferring the derivation of income or bringing forward a deduction can potentially be caught by either GAAR. As such the aim of both GAARs is to ensure that all forms of tax benefit, whether acceptable or not, are potentially caught.

As part of identifying the tax benefit it is also necessary to show that the 'scheme' or 'avoidance transaction' as identified actually produced the 'tax benefit'. The tax benefit in question is identified by comparing the actual amount of tax payable under the arrangement as defined to a hypothetical determination of the amount of tax that would have been payable in the absence of the arrangement. The difference between these two amounts is the tax benefit. In *Peabody* the High Court stated that to identify the tax benefit that it must be 'reasonably expected' to have been obtained without the scheme and that this requires a certain state of affairs be determined as likely to apply if the tax benefit was not obtained and this state of affairs must amount to more than a mere possibility and so must be sufficiently likely to have happened and so reliable.⁹⁵ Justice Pagone, writing extra-judicially, has noted that the purpose of this comparison between what occurred and a hypothetical alternative scenario (the so called 'counterfactual' or 'alternative postulate') is to ensure that it was the scheme itself which caused the tax benefit.⁹⁶

In Canada, s 245 (1) of ITA85 provides that a tax benefit is widely defined to mean a reduction, avoidance or deferral of tax or other amount payable under the Act or an increase in a refund of tax or other amount under the Act that arises from a particular transaction or series of transactions. In determining the tax benefit under the Canadian GAAR there is first a factual determination made of the tax benefit and in this whether or not the tax benefit is material is not relevant (although due to the costs of litigation cases that appear before the courts would inevitably have large tax benefits at stake).

⁹⁴ Section 177C of the *Income Tax Assessment Act* 1936 and section 245 of the *Income Tax Act* 1985 (Can.).

⁹⁵ *Peabody v Federal Commissioner of Taxation* (1993) 181 CLR 359, 385.

⁹⁶ G T Pagone, *Tax Avoidance in Australia* (Federation Press, 2010) at page 49.

Next, where reduction of taxable income is not an issue, a tax benefit can be determined by reference to an alternative arrangement that the taxpayer could have carried out.

In respect to the third and final element of both the Australian and Canadian GAARs with respect to the requisite purpose there is a very significant difference between the Australian and Canadian GAARs. The Australian GAAR considers the intention of the taxpayer as determined objectively by reference to the eight factors in s177D of ITAA36. The Canadian GAAR, on the other hand, in s245(4) involves the application of a two-stage test to determine and strike down avoidance transactions that amount to an abuse or misuse of the provisions of the Canadian ITA85. The first stage involves a contextual, textual and purposive interpretation of the provisions that the taxpayer relies on to obtain the tax benefit. This is a question of law. The second step then involves a determination of whether the facts of the transaction fit in the purposive analysis of the relevant provisions. If they do not an abuse of the provisions has occurred and the GAAR can be used to strike down the 'abusive' transaction. This second step involves a factual inquiry.

The Australian GAAR operates where a taxpayer obtains a tax benefit in connection with a scheme in circumstances where it is concluded that the taxpayer, having regard to the eight factors listed in section 177D (b) of ITAA36, entered into or carried out the scheme for the 'sole or dominant purpose' of enabling the taxpayer to obtain a tax benefit.⁹⁷ A sole purpose implies there is no other purpose present whereas a 'dominant purpose' has been interpreted by Australian courts as the 'ruling, prevailing or most influential' purpose.⁹⁸

Both the Australian and Canadian GAARS contain a similar reconstructive element which imposes taxation by reference to a hypothetical state of affairs that it is reasonably considered that the taxpayer would have entered into in the absence of the arrangement.⁹⁹

⁹⁷ These eight factors are set out in section 177D (b) of the *Income Tax Assessment Act 1936* and are explained in more detail later in this paper.

⁹⁸ *Federal Commissioner of Taxation v Spotless Services Ltd* (1996) 186 CLR 404 at 416.

⁹⁹ Australia: section 177F *Income Tax Assessment Act 1936* and New Zealand: section GA 1 of the *Income Tax Act 2007* (NZ).

However, one other point of difference is that penalties are not imposed under the Canadian GAAR even to highly abusive transactions whereas administrative penalties¹⁰⁰ are nearly always imposed in Australian GAAR cases.

Which GAAR is better the Australian or Canadian GAAR?

The Australian GAAR has the eight criteria found in s177D of ITAA36 to determine purpose whereas the Canadian GAAR has the abuse and misuse criteria as its critical requirement. Both GAARs do lead a court to focus on the degree of artificiality and complexity involved in determining the purpose of the taxpayer but the Canadian GAAR in having this abuse or misuse test leaves more to the Canadian courts to determine whether ultimately the GAAR applies. This is arguably preferable as judges, with their greater jurisprudential skills, are perhaps better suited than Parliament to resolve the issue of where the line is to be drawn between tax planning and tax avoidance.

A review of the definitional elements of tax avoidance in the *Income Tax Assessment Act 1936* or in the *Income Tax Assessment Act 1997* in Australia reveals that the elements in the legislation cannot definitively distinguish between tax avoidance and tax planning. One commentator, Chris Atkinson, has suggested one way to overcome this limitation is by including the additional positive requirement, as currently used in the Canadian GAAR, of a 'misuse or abuse' provision supported by clear and coherent standards placed in the legislation which are then capable of being applied consistently would then provide the best possible guide to taxpayer conduct.¹⁰¹

Conclusion

There are many similarities in the wording and operation of both the Australian and Canadian GAAR provisions. The Canadian GAAR contains the abuse or misuse test, which is not present in the Australian GAAR, and this arguably leaves more work for the Canadian courts to do to interpret and apply the GAAR. This results, as recent Canadian jurisprudence has shown, in an effective and efficient application of the GAAR.

¹⁰⁰ These range from 0% to 75% of the tax shortfall amount depending upon the degree of culpability of the taxpayer with the 75% penalty reserved for cases involving a taxpayer showing an intentional disregard for the law.

¹⁰¹ Chris Atkinson, 'General anti-avoidance rules: exploring the balance between the taxpayer's need for certainty and the government's need to prevent tax avoidance', *Journal of Australian Taxation* Volume 14, Issue 1, 32.

Both GAARs have been interpreted in a purposive way (in Australia at least since the early 1980s)¹⁰² and this had led to more decisions favourable to the revenue authorities in both jurisdictions (*Spotless Services; Consolidated Press Holdings and Hart* in Australia and *Mathew, Lipson and Copthorne* in Canada, among other decisions). By applying techniques of statutory interpretation which look at Parliamentary intention and then at whether or not the particular transaction has been carried out and the specific tax rules applied in accordance with this intention of Parliament is a welcome and desirable outcome which has enabled both the Australian and Canadian courts to allow the GAAR provisions to do their work in a balanced and effective way.

The Australian GAAR has undergone some very recent changes in 2012 and 2013 for which it is still too early to tell in the absence of any relevant cases on their application as to whether or not they have improved the application of the Australian GAAR. Australian courts since the Barwick High Court era have applied on the whole successfully the eight criteria set out in section 177D (b) of ITAA36 to strike out artificial and contrived arrangements.

It is the author's conclusion that Australian GAAR could still be modified further to allow courts to look specifically at the purpose and effect of the tax law being applied in order to determine, in the harder cases, whether the spirit of the GAAR has been breached. In this much can be learned from the Canadian abuse and misuse approach.

¹⁰² Due to two factors, the departure of Barwick CJ from the High Court and also due to the passing of sections 15AA and 15AB of the *Acts Interpretation Act 1915* (Cwlth) which require a purposive interpretation to be applied and also allow the use of extrinsic materials in seeking to determine what that purposive interpretation should be.