

UNIVERSITY OF NAIROBI

PARKLANDS CAMPUS

ACADEMIC YEAR: 2009/2010.

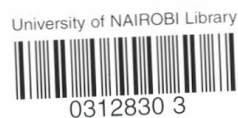
THESIS SUBMITTED FOR PARTIAL FULFILLMENT
OF NAIROBI UNIVERSITY AWARD OF MASTER OF LAWS
(LL.M.) DEGREE IN LAW.

TOPIC OF THESIS:

TAX AVOIDANCE IN KENYA: A CASE FOR ADOPTION OF
GENERAL ANTI-AVOIDANCE RULES (GAAR).

SUPERVISOR: MR. Y.R. VYAS


STUDENT: GAULKE M. OBBAYI



REGN. NO: G62 / 76669/ 2009

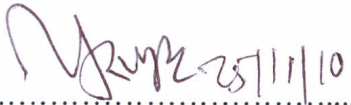
DECLARATION

I, **GAULKE MICAH OBBAYI** do hereby declare that this is my original work and I have not submitted it before and it is not currently being submitted for a degree in another University.

Signed:  25/11/10

GAULKE MICAH OBBAYI

This thesis is submitted for examination with my approval as University Supervisor.

Signed:  25/11/10

MR. YASHWANT RAI VYAS

ACKNOWLEDGMENT

Much credit goes to my devoted supervisor Mr. Yashwant Rai Vyas for his focused, patient and tireless efforts towards guiding me in carrying out the enquiry into the issues researched upon in this thesis.

To my former boss, Mr. Michael G. Waweru, Commissioner General, Kenya Revenue Authority who motivated me to pursue a Masters degree in Law.

To Mrs. Savita Vyas who was very receptive to me at all times I visited their house to consult with her husband, Mr. Vyas, my supervisor.

To my wife and children who always gave me encouragement in my endeavours.

To our devoted secretary, Ms. Nada Elia at Tax Experts and Advisory Services Limited who tirelessly worked with me even during odd hours to ensure the project paper was ready in time, and my son David who assisted in the typing of the project.

DEDICATION

To my wife and children, particularly David and Gertrude who were patient with me and understood my plight of being unable to spend quality time with them.

TABLE OF CONTENTS

<i>Cover page</i>	<i>i</i>
<i>Declaration</i>	<i>ii</i>
<i>Acknowledgment</i>	<i>iii</i>
<i>Dedication</i>	<i>iv</i>
<i>Table of contents</i>	<i>v</i>
<i>Table of cases</i>	<i>xi</i>
<i>Table of statutes</i>	<i>xiv</i>
<i>Abbreviations</i>	<i>xv</i>

CHAPTER ONE - INTRODUCTION

1.0. INTRODUCTION	1
1.1. BACKGROUND TO THE STUDY	1
1.2. STATEMENT OF THE PROBLEM	3
1.3. JUSTIFICATION FOR THE STUDY	4
1.4. THEORETICAL BACKGROUND	5
1.5. LITERATURE REVIEW	7
1.6. QUESTIONS THE RESEARCH WILL SEEK TO BE ANSWERED	13
1.7. RESEARCH METHODOLOGY	13
1.7.1 Primary and Secondary sourcing	13
1.7.2 Research Objectives	14
1.7.3 Hypotheses	14
1.8. SCOPE AND LIMITATIONS	15
1.9. CHAPTER BREAKDOWN	16

CHAPTER TWO - TAX AVOIDANCE, EVASION, AND THE NEED FOR

ADOPTION OF GAAR.

2.0 DISTINCTION BETWEEN TAX AVOIDANCE AND TAX EVASION

2.0.1 TAX AVOIDANCE	19
2.0.1.1 Why Tax avoidance as opposed to tax evasion is attractive	21
2.0.1.2 Goals of tax avoidance	23
2.0.1.3 The techniques of tax avoidance	24
2.0.1.4 The key features of tax avoidance	25
2.0.1.5 Why tax avoidance has become more prevalent	27
2.0.1.6 Consequences of tax avoidance	29
2.0.1.7 Other consequences of tax avoidance	30
2.0.1.8 How Governments deal with tax avoidance – Enactments of GAAR	33
2.0.2 TAX EVASION	38
2.0.2.1 How Governments deal with Tax Evasion	39
2.0.3 CONCLUSION	41

CHAPTER THREE – ANTI AVOIDANCE MEASURES IN KENYA –

CURRENT POSITION.

3.1.0. KENYA’S INCOME TAX LEGAL FRAMEWORK	43
3.1.1 INTRODUCTION	43
3.1.2 GENERAL ANTI-AVOIDANCE PROVISIONS (GAAP)	45
3.1.2.1 Section 23 – Transactions designed to avoid Tax	45

3.1.2.2 Section 24 – Avoidance of Tax	48
3.1.2.3 History of the existence of sections 23 and 24	50
3.1.2.3.1 Under the Kenya Income Tax Act (KITA) – 1973	50
3.1.2.3.2 Under the East African Income Tax (Management) Act of 1970 (EAIT (M) A -1970)	50
3.1.2.4 Interview with 4 big firms of accountants/ Tax practitioners in Kenya on application of sections 23 and 24	51
3.1.2.5 Forum for appeal	52
3.1.2.5.1 Appeal to Income Tax Local Committee	52
3.1.2.5.2 Appeals to Income Tax Tribunal	53
3.1.3 SPECIFIC ANTI-AVOIDANCE RULES (SAAR)	55
3.1.3.1 Thin Capitalization	56
3.1.3.2 Exchange gains and losses	59
3.1.3.3 Specified sources of Income	61
3.1.3.4 Other SAAR	63
3.1.4 CONCLUSION	63

CHAPTER FOUR— APPLICATION OF SAAR, GAAR AND ANTI-AVOIDANCE DOCTRINES IN ABSENCE OF GAAR.

4.1 INTRODUCTION	64
4.2 KENYA – APPLICATION OF GAAP AND ENACTMENT OF SAAR – THE <i>UNILEVER</i> CASE.	66
4.2.1 Introduction	66
4.2.2 Transfer pricing	66
4.2.1.1 Meaning of Transfer pricing	67

4.2.1.2 The <i>Unilever</i> Case	68
4.2.1.3 The Rules	71
4.2.3 Conclusion	74
4.3 COUNTRIES WITH GAAR– APPLICATION OF GAAR	74
4.3.1 AUSTRALIA	74
4.3.1.1 INTRODUCTION	74
4.3.1.2 Part IVA of the Australian Income Tax Act – The GAAR	76
4.3.1.2.1 Federal Commissioner of Taxation v Peabody	78
4.3.1.2.2 Federal Commissioner of Taxation v. Spotless Services Ltd	84
4.3.2 SOUTH AFRICA	87
4.3.2.1 INTRODUCTION – THE OLD SOUTH AFRICA GAAR	87
4.3.2.2. THE NEW SOUTH AFRICA GAAR	89
4.3.2.2.1. Definitions and new components in South Africa GAAR	89
4.3.2.2.2. Avoidance arrangement	90
4.3.2.2.3. Sole or main purpose test	91
4.3.2.2.4 Tax benefit	91
4.3.2.2.5. Presumption of purpose	92
4.3.2.2.6. Requirements of “tainted elements”	93
4.3.3 NEW ZEALAND	94
4.3.3.1 INTRODUCTION	94
4.3.3.2. INTERPRETATION OF SECTION BG 1	95
4.3.3.2.1 Form and substance: the basis of two dichotomies	96
4.3.3.2.2 Legal form and legal substance	96
4.3.3.2.3 Legal substance and economic substance	97
4.3.3.2.4 The “tax avoidance purpose” test	97

4.3.3.2.5	Scheme and purpose of the Income Tax Act 2007	98
4.3.3.2.6	Uncertainty and general anti-avoidance rules	99
4.3.4	CANADA	99
4.3.4.1	INTRODUCTION	99
4.3.4.2	<i>CANADA TRUSTCO V. CANADA</i>	101
4.3.4.3	<i>MATHEW V. CANADA</i>	103
4.3.4.4	THE COURT'S APPROACH TO TAX AVOIDANCE AND THE GAAR.	107
4.3.4.4.1	Tax benefit	107
4.3.4.4.2	Avoidance transaction	108
4.3.4.4.3	Misuse or abuse	108
4.4	COUNTRIES WITHOUT GAAR – APPLICATION OF ANTI- AVOIDANCE JUDICIAL DOCTRINES.	109
4.4.1	UNITED STATES OF AMERICA (USA)	109
4.4.1.1	Introduction	109
4.4.1.2	What did American Courts consider?	110
4.4.1.3	The <i>Compaq case</i>	112
4.4.1.4	America enacts GAAR	114
4.4.2	UNITED KINGDOM (U.K)	115
4.4.2.1	Introduction	115
4.4.2.2	Sham doctrine	116
4.4.2.3	The Ramsay case	118
4.4.2.4	Furniss v. Dawson	120
4.4.2.5	Commissioner of Inland Revenue v. McGuckian	121
4.5	ILLUSTRATION BY USE OF A CASE	125

4.6 CONCLUSION	127
----------------	-----

CHAPTER FIVE— CONCLUSION AND RECOMMENDATIONS

5.0. CONCLUSION	129
5.0.1 Introduction	129
5.0.2 Problem with SAAR	129
5.0.3 Kenya’s ineffective GAAP	130
5.0.4 Why Kenya should adopt GAAR	131
5.1 RECOMMENDATION	134
5.1.1 Introduction	134
5.1.2 Statutory Framework	135
5.1.3 Administrative Framework	137

TABLE OF CASES

1. **ACM Partnership v. Commissioner of Internal Revenue** 157 F.3d 231, 247 (3d Cir. 1998)...111.
2. **Ayrshire Pullman Services & Ritchie v. CIR** (1929) 14TC 754...117.
3. **Barclays Mercantile Business Finance (BMBF) v. HM Inspector of Taxes** (2007) STC 1 at 14...125.
4. **Black and Decker Corporation v. United States** 436 F. 2d 431 (4th Cir 2006)...111.
5. **Bowater Property Development Ltd v. Inland Revenue Commissioner** (Reported sub nom Craven v. White (1989) A.C 398; (1988) 3 ALL ER 395; (1988) 2 WLR 423; (1988) STC 476; 62 TCI (HL))...125, 126.
6. **Canada Trustco Mortgage Company v. Canada** ...100, 101, 105.
7. **Case V20** (2002), 20 NZTC 10, 233 (TRA)...97, 98
8. **Case W33** (2004) 21NTC 11,321 (TRA)...98.
9. **Chandler v Director of Public Prosecutions** (1962) AER 142 (HL)...93
10. **C.I.R v. Conhage (Pty) Ltd (Formerly TYcon (Pty) Ltd**, 19988 (4) SA 1149 (SCA), 1999 173, 1999 (12) JTLR 337...88.
11. **Coltec Industries Inc v. United States** 91. 62 Fed Cl 716 (2004)...112.
12. **Commissioners of Inland Revenue v. McGuckian** (1997) 1 W.L.R 991...121.
13. **Commissioner of Inland Revenue v. Wattie** (1998) 18 NZTC 13,991 (PC)...97.
14. **Compaq Computer Corp v. Federal Commissioner of Taxation** 277 F. 3d 778 (5th Cir 2001)...111, 112, 114, 115
15. **Ensign Tankers (Leasing) Limited v. Stokes** (HM Inspectors of Taxes (1992) BTC (HC)...96.

16. **Europa Oil (NZ) Limited v. Commissioner of Inland Revenue** (1976) 1WLR 464,475...95, 96.
17. **Federal Commissioner of Taxation v. Peabody** 94 ATC 4663...78,79, 80, 84.
18. **Federal Commissioner of Taxation v. Purcell**1920-1921) 29 CLR 464...75.
19. **Federal Commissioner of Taxation v. Spotless Services Ltd** 95 ATC 5201...84, 85.
20. **Furniss v. Dawson A.C** (1984) A.C 474...120, 121, 123.
21. **Gregory v. Helvering** 293 U.S 465 (1935)...36, 109.
22. **Inc v. United States** 253 F. 3d 350 (8th Cir..111.
23. **Inland Revenue Commissioner v. Duke of Westminster** (1936) AC 1...93, 96, 107, 116, 117, 131.
24. **Inland Revenue Commissioner v. Scottish Provident Institution** (2005) STC ...125.
25. **IRC v Burmah Oil Ltd** (1982) STC 30, HL (Sc)...119, 121.
26. **IRC v. Plummer** ((1979) STC 793)... 118.
27. **Macniven v. Westmoreland Investments Ltd** (2001) 2 W.L.R 377...121
28. **Mathew v. Canada** (Mathew v. Canada)...100, 103, 104, 105.
29. **Newton v. Federal Commissioner of Taxation** (1958) 98 CLR 1...76, 83.
30. **Ovenstone v SIR** (1980) (2) SA 721 (A), 42 SATC 55, 1980 Taxpayer 166...93.
31. **Piggott v. Staines Investments Ltd** (1995) STC 114 255(58)...133.
32. **Salomon v. A Salomon & Co Ltd** (1897) AC 22 (HL)... 131.
33. **TIFD III-E v. United States** 342 F.Supp 2d 94 (D Conn 2004)...112.
34. **Unilever Kenya Ltd v. Commissioner of Income Tax** (2005) High Court, Income Tax Appeal No. 753 of 2003...5, 17, 52, 65, 66, 67, 68.
35. **United Parcel Service of America Inc v. Commissioner** 254 F.3d 1014 (11th Cir. 06/20/2001)...111

36. **W.T. Ramsay v. IRC ((1981))** STC 174...10, 24, 36, 118, 120, 123, 124, 131, 133.

37. **Yaya Towers Ltd (Republic v. KRA Ex-parte)** High Court Misc. Civil Appli 374
of (2006)...131.

TABLE OF STATUTES

1. Australian Income Tax Assessment Act.
2. Canadian Income Tax Act.
3. Kenya Finance Bill 2010.
4. Income and Corporation Taxes Act. (United Kingdom)
5. Internal Revenue Code (USA).
6. Kenya Income Tax Act.
7. Newzealand Income Tax Act.
8. South African Income Tax Act.

Abbreviations

Descriptions and explanations of some terms and abbreviations used in this thesis are listed below. They serve to clarify some terms used in the thesis and are not intended to be authoritative.

Name	Description
ALP	Arm's Length Principle.
ATC	Australian Tax Case.
AITAA	Income Tax Assessment Act (Australia).
ATO	Australian Tax Office.
CIR	Commissioner of Inland Revenue (New Zealand).
CITA	Canadian Income Tax Act.
Europa	Europa Oil (N2) v. Federal Commissioner of Taxation.
FCT	Federal Commissioner of Taxation (Australia).
GAAR	General Anti-Avoidance Rules.
GAAP	General Anti-Avoidance Provisions.
HMRC	Her Majesty's Revenue and Customs.
IT	Income Tax.
ICTA	Income and Corporations Taxes Act (United States).
IRC	Internal Revenue Commissioner (United States).
IRS	Inland Revenue Services (United Kingdom).
IR	Inland Revenue (United Kingdom).

IRC	Inland Revenue Code of 1986 (U.S.A).
KRA	Kenya Revenue Authority.
NZITA	New Zealand Income Tax Act.
OECD	The Organization for Economic Co-operation and Development.
PAYE	Pay As You Earn.
Ramsay	W.T Ramsay v Inland Revenue Commissioner.
RC	Revenue Canada.
SAAR	Specific Anti-Avoidance Rules.
SARS	South African Revenue Services.
SAITA	South African Income Tax Act.
SCA	South African Court of Appeal.
TP	Transfer Pricing.
UKL	Unilever Kenya Limited.
VAT	Value Added Tax.
Unilever Case	Commissioner of Income Tax v. Unilever Kenya Limited.
ULL	Unilever Uganda limited.
WLR	Weekly Law Reports
Westminster	Duke of Westminster v Inland Revenue Commissioner.

TAX AVOIDANCE IN KENYA: A CASE FOR ADOPTION OF GENERAL ANTI-AVOIDANCE RULES (GAAR)

CHAPTER ONE

1.0 INTRODUCTION

1.1. BACKGROUND TO THE STUDY

Few taxpayers like paying taxes, although many regard it as a public duty to pay their fair share of the money required by the Government, much of which comes back to them in the form of social services. Some citizens admit this duty, but do not take the same view as Parliament as to what is their fair share; others have the simple philosophy that the tax collector is public enemy No. 1, to be outwitted by fair means or foul.¹

Taxes are imposed by governments and consist of direct and indirect taxes. A tax may be defined as a pecuniary burden laid upon individuals, firms or property owners to support the government and are exacted by legislative authority². A tax is not a voluntary payment but an enforced contribution, exacted pursuant to a legislative authority and is any contribution imposed by the government.³

Taxes are used by governments to carry out many functions some of which include expenditure on the enforcement of law and public order, to pay salaries for public servants, to finance public works, social engineering, economic infrastructure and the operation of the government itself and to provide services such as education, health care, pensions, energy, water and waste services.

¹ Whiteman P.G., **Whiteman and Wheatcroft on Income Tax**; (London, Sweet & Maxwell, 2nd Edition) (1976)) p. 9.

² Public Finance – Wikipedia.

³ Ibid.

Despite this, some taxpayers resent paying taxes. Although many people recognize the duty to file the most accurate returns possible and to pay the appropriate share of tax to the government, a sizeable number however consider that their primary goal is to minimize taxes and some of these attempts at minimizing taxes take the form of avoidance.

One of the reasons for this resentment is because people feel that they put a lot of effort to earn the income on which they are taxed and this effort is usually “taxing” in itself, that anything exacting tax from them seems painful. For this reason, people always look for a way to avoid this pain by avoiding to pay them.

Tax avoidance is a problem for all tax systems. Whenever there are tax laws, people will find ways of manipulating the rules to reduce or defer their tax liability through tax avoidance schemes. In order to combat tax avoidance many countries have statutory general anti avoidance rules (GAAR) that allow tax authorities to disregard these schemes that have the purpose and effect of avoidance of tax.

GAAR enable tax authorities to collect the amount of tax that would have been payable but for the existence of avoidance arrangements. GAAR therefore allow and facilitate the collection of a considerable amount of tax that would otherwise not be collected. Governments use GAAR as legal means to collect taxes that would not be collectable from taxpayers who are engaged in tax avoidance. Tax avoidance may also be a problem in Kenya as it is in many countries all over the world and it is for this reason that this thesis seeks to research on whether Kenya needs a statutory GAAR in its tax statutes to combat the tax avoidance.

1.2. STATEMENT OF THE PROBLEM

In many ways, tax authorities bother themselves with tax evasion and this is what is mainly targeted by the authorities when dealing with taxpayers because tax evasion is an illegal means of reducing or evading tax liability. Little attention is paid to tax avoidance whenever taxpayers engage into it, the reason being that it is a legal means by which people do everything possible to reduce their tax liability, yet it will be shown that tax avoidance digs inroads in tax revenues and as a result drain national revenues. Where attempts have been made to deal with avoidance, the laws that are drafted are drafted in such a manner that they do not give clear directions on how to discern such avoidance precisely and to deal with it as candidly as the laws that deal with tax evasion do, in order to counter the non commercial transactions entered into by taxpayers whose purpose is to avoid tax.

Tax avoidance is normally planned by professionals in the tax planning field who come up with complex and sophisticated schemes by providing tax avoidance products to the market resulting in global financial melting. Countries therefore make laws to counter the advantage that is obtained by taxpayers who use lawful avoidance schemes which in turn drain national revenues. Such laws come in the form of General Anti-Avoidance Rules (GAAR), enacted in tax statutes.

The problem considered in this thesis is that although tax avoidance issues raise a major worry for all nations as a result of which many countries enact GAAR, there are no GAAR which have been enacted in Kenya under the Kenya Income Tax Act to deal with the problem. It is for this reason that a study was carried out to determine whether Kenya should enact GAAR. It may be added here that apart from making inroads and draining national revenues, tax avoidance also affects the efficiency and equity of tax systems, siphoning off

resources from more productive ventures, redistribute and threaten to undermine compliance.⁴ The Organization for Economic Cooperation and Development (OECD) has noted that any avoidance proliferation of arbitrary and entrenched systems leads to a perception that the tax system is unfair and this can discourage compliance even by tax payers that had not previously engaged in tax avoidance⁵. In view of this, a study was carried out to determine whether Kenya should adopt GAAR with a view to countering tax avoidance.

1.3. JUSTIFICATION FOR THE STUDY.

Kenya is a fast growing economy in Africa, south of the Sahara, perhaps next to South Africa, which introduced its GAAR in 1998⁶. In the same manner as there is tax avoidance in Kenya, South Africa introduced GAAR as a result of an increase in supply of tax avoidance products due to the fact that the market place had been fuelled by the availability of talented human resources prepared to work in the area and by rapid advances in computer and telecommunications technology, which had greatly enhanced the activity of accounting firms and tax advisors to create sophisticated tax and financial models to market to multiple taxpayers⁷. The abundance of supply has in turn created a demand for aggressive tax planning or tax avoidance opportunities for a large group of taxpayers who may feel that they should not miss out on what other people enjoy⁸.

An example of the existence of tax avoidance in Kenya may be discerned from a recent case involving transfer pricing. This was a case involving sale of goods by a Kenyan Company, *Unilever Kenya Limited* to a related party *Unilever Uganda Ltd* at a price lower than it was

⁴ Evans, Chris, "Containing Tax Avoidance: Anti-Avoidance strategies", (December 2008) 40, University of New South Wales Faculty of Law Research series, p.8.

⁵ Ibid

⁶ Tax avoidance rules were initially introduced under Section 103 of the South African Income Tax Act and are now contained at Section 80A-L of the Act.

⁷ Evans Chris, *supra* note 4 at p.8.

⁸ Ibid

selling to un-related parties. The Kenyan tax authorities sought to adjust the prices charged by the Company to the related party to be in line with prices charged to independent unrelated parties, and therefore increase the Company's Kenyan taxable profits. The High Court however ruled that the Kenyan Income Tax Act did not have such guidelines empowering the authorities to make such adjustments. The result was that the Kenya government reacted by promulgating specific anti-avoidance rules (SAAR) to deal with transfer pricing avoidance schemes.

Although the Kenya Income Tax system and other international tax systems recognize that transfer pricing requires specific rules to counter transfer pricing avoidance schemes only, on the contrary GAAR, as a rule are used to counter any unforeseeable avoidance schemes that taxpayers engage into which fall within the GAAR. Thus whereas specific anti rules are enacted after an event has occurred to seal such future loopholes in the specific area targeted by such specific rules, properly promulgated GAAR are drafted in such a manner that they are enacted to counter unforeseen and unanticipated avoidance schemes. It is for this reason that there is a justification for a study on the possibility of enacting a statutory GAAR in Kenya to counter such avoidance schemes, without having to wait for an event to occur, following which SAAR would be made to counter it. It must however be noted that not all avoidance is illegal as in the case of evasion. The rationale for the concern is because sometimes people go too far by taking advantage of its legality to create avoidance schemes that have no commercial value other than tax avoidance which then gives rise to national and global impact on revenues.

1.4. THEORETICAL BACKGROUND.

In order to appreciate general anti- avoidance rules, one should have a theoretical understanding of taxation. Governments impose taxes in order to raise revenues to enable

them provide services. Taxes are also imposed in order to re-distribute wealth. In addition the other purposes of taxation apart from being financial are for purposes of social welfare as well as regulatory in that it has the effect of inducing or preventing some action which may be done by some businessmen.⁹

From a jurisprudential point of view as summarized by one philosopher Adam Smith in his writings "*Wealth of Nations*"¹⁰ who while writing on "*Justice in Taxation*", adhered to four maxims which a good tax system should conform to:-

- (a) The subject of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
- (b) The tax each individual ought to pay ought to be certain, not arbitrary. The time of payment, the manner of payment, and the quantity to be paid ought to be clear and plain to the contributor and to every other person.
- (c) Every tax ought to be levied at the time, or in the manner in which it is convenient for the contributor to pay it.
- (d) Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

Adam Smith sums up the theoretical framework, about the obligation of every subject to pay taxes according to the ability as laid down by the law, where taxes are certain and not

⁹ Verma, Kumar Sushil, "Taxation as a Technique to Regulate Private Enterprises", in 1971 **Edition Government Regulation of Private Enterprises** (Bombay, 1971) p. 291.

¹⁰ Weiner Nadia, **Adam Smith's Recommendation on Taxation**, available at e-book<<
<http://www.progress.org/banneker/adam.html> >>

arbitrary, and in the manner that is convenient according to the law. Tax avoidance therefore goes against Adam Smith's maxims and hence the need for GAAR to counter it.

1.5. LITERATURE REVIEW

There is a significant amount of literature on tax avoidance which supports the need to promulgate general anti-avoidance rules. There is also significant amount of case law on general anti-avoidance rules from jurisdictions which have embraced the rules in their statutes, notably common law countries like Australia, New Zealand and Canada.

Although United Kingdom and United States of America (until recently) do not have general anti-avoidance rules, there is also significant amount of literature on case law and judicial doctrines. Kenya does not have general anti-avoidance rules and it is probably for this reason that the researcher has not come across any literature on the subject on Kenya but Kenya has a number of specific anti-avoidance rules. The legal framework of countries which have embraced general anti avoidance rules has also been studied.

In her book "*Legislating Against Tax Avoidance*",¹¹ Rachel Anne Tooma expresses the view that tax avoidance has a number of negative consequences. Tooma has indicated several of these. According to Tooma, the negative consequences for governments are that less tax is collected. She gives an example of Australia where it was estimated that during the 1990's an estimated \$4 B in tax revenue was lost when 42,000 Australians were involved in aggressive mass marketed avoidance schemes. Further scheme related deductions are estimated to have increased from \$54 million in 1994 to over 1 billion in 1998.

¹¹ Tooma, Rachel, *Legislating Against Tax Avoidance*, (Amsterdam, IBFD publishing, August 2008) p. 24.

Such revenue loss attributable to tax avoidance schemes has direct consequences for the level of government expenditure, and the size of government debt¹². She also says there is a direct consequence to taxpayers not engaging in avoidance because they are made to bear the tax burden of tax avoiders causing a redistribution of the burden with the consequences that there will be a deterioration of taxpayer morale¹³. As to the economy, the effects of tax avoidance are economic in that taxpayers will alter their employment and investment choices in order to take advantage of tax avoidance, and in doing so, they make unproductive decisions from a social point of view. There could also be an indirect effect. For example if wage earners believe that non-wage earners are able to avoid tax, this belief will lead them to demand greater wage rises, which if met will lead to higher levels of inflation. Governments typically respond to inflation by acting to dampen demand, which in turn produces unemployment and unemployment will need to be kept high in order to prevent the rate of inflation from rising again¹⁴.

According to Tooma however, tax avoidance is justified because the people who engage in avoidance do so, because they believe that other taxpayers are engaged in avoidance schemes. Where tax avoidance is perceived to be wide spread, taxpayer morale can be expected to deteriorate, as taxpayers will feel less inclined to pay when they believe that other tax payers are engaged in tax avoidance schemes, which in turn leads to further avoidance. This particular consequence of tax avoidance is especially important in support of statutory GAAR. An effective statutory GAAR may lead taxpayers to consider that other taxpayers are not able to avoid tax which will in turn improve taxpayers' morale, and therefore reduce tax avoidance¹⁵.

¹² Ibid.

¹³ Ibid.

¹⁴ Ibid p. 25.

¹⁵ Ibid

Tax avoidance and tax evasion are sometimes confused and it is important that the two should be distinguished since the discussion in the thesis is on tax avoidance. The importance of the distinction arises because whereas tax avoidance is generally the legal exploitation of the tax regime to one's advantage to attempt to reduce the amount of tax payable by means that are within the law, by contrast, tax evasion is the general term for efforts by firms, individuals, trusts and other activities to evade the payment of taxes by illegal means. This distinction has been commented upon by **Richard Salmon** in *Capitalism Magazine*¹⁶ who quoted the Economist, which had recognized the crucial distinction:

As almost everybody knows, there are two ways of cutting your tax bill. Tax avoidance is doing what you can within the law. Tax evasion is what happens outside the law. There may be a thin line between the two, but one sense it is a solid one. As Denis Healey, a former British Chancellor put it, "The difference between tax avoidance and tax evasion is the thickness of a wall".

According to Salmon¹⁷, the distinction was also made clear in a 1934 ruling by U.S. District Judge, Leenard Hand:

There is nothing sinister in arranging in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich and poor. Nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. Anyone may arrange his affairs that his taxes shall be as low as possible, he is bound to choose pattern which will best pay the Treasury. There is not even a patriotic duty to increase ones taxes.

¹⁶ Salmon, "Treasury Secretary Paul O'Neil confuses tax avoidance versus tax evasion", accessed at << <http://www.capitalmagazine.com/politics/taxation/1856-Treasury-Secretary-Paul-Neil--8/1/2010> >> on 27th July 2010

¹⁷ Ibid

Statutory general anti-avoidance rules are therefore promulgated to counteract tax avoidance whereas for the tax evasion many countries have both civil and criminal sanctions in the statutes. In order to combat tax avoidance, many countries have statutory general anti-avoidance rules that require tax authorities to disregard arrangements that have the purpose and effect of tax avoidance.

In its article titled “*A 1998 General Anti-Avoidance Rule for direct taxes document*”¹⁸ the UK government summarized as follows when it proposed to introduce GAAR:

When individuals and businesses develop schemes to avoid paying taxes or defer or reduce their liability, it leads to higher burdens following on the majority of taxpayers. The Government is committed to countering abuses and avoidance whilst recognizing that businesses and individuals may operate in a tax efficient way.

The Financial Secretary to Treasury, Dawn Primarolo was of the view that the GAAR were under consideration because, while courts had managed to use the principles in *T.M. Ramsay V. CIR*¹⁹ (discussed in chapter 4) to cover much tax avoidance, a further much more drastic step (GAAR) was required to achieve a level playing field. The difference between having a GAAR and the current system based on case law is that legislation targeted at tax avoidance schemes or arrangements stops them from the future²⁰.

¹⁸ Fisher, Philip, “1936, a good year for tax” accessed at << http://www.co.uk/taxation/articles/2005/08/25/3425/1936-good_year_tax >> on 4th July 2010

¹⁹ (1981) STC 174.

²⁰ Fisher, Philip *supra note* 18.

Rebecca Prebble and John Prebble in their article titled “*Does the use of General Anti-Avoidance Rules to combat Tax Avoidance breach Principles of the Rule of law?*”²¹ while commenting on the GAAR are of the view that legislators decide that they need the rules in situations where the rules may be needed may not be defined in advance. This is because if legislation could foresee all varieties of tax avoidance, they would pass specifically targeted rules to frustrate the endeavors. The fact that general anti-avoidance rules exist at all is evidence that policy-makers and legislators themselves cannot predict the structures taxpayers will eventually contrive.

In an article by Hammonds titled “*United Kingdom: General Anti-Avoidance Rule- A new dawn for tax planning*”,²² the author argues the introduction of GAAR should satisfy revenue authorities who have been frustrated by the inventiveness of the tax profession in detecting and utilizing tax loopholes, sometimes implementing complex and artificial tax avoidance schemes. The introduction of GAAR enables the Inland Revenue to challenge tax avoidance without the uncertainty of litigating tax driven transactions through the courts.²³ He however argues that while the GAAR if enacted could deter the implementation of artificial tax avoidance schemes, it may be an unacceptable cost of uncertainty for the majority of companies undertaking legitimate tax planning in commercial transactions.

In an information circular from Revenue Canada titled “*General Anti-Avoidance Rule Section 245 of the Income Tax Act*”,²⁴ it is explained that an avoidance transaction does not include a transaction that may reasonably be considered to have been undertaken or arranged for *bona fide* purposes other than to obtain the tax benefit. The purposes of a transaction are determined not only from the taxpayer’s statement of intention but also from the

²¹ Accessed at << http://papers.ssrn.com/so12/papers.cfm?abstract_id=1523043>> page 9 on 24th July 2010.

²² Ibid

²³ Accessed at <<http://www.mondaq.com/article.asp?article_id=6758>> on 25th July 2010.

²⁴ Accessed at << <http://www.cra-arc.gc.ca/E/pub/tp/ic88-2/ic88-2-e.txt>>> on 21st July 2010.

circumstances of the transaction or transactions. If it can be determined that the primary or principal purpose in undertaking the transaction is other than to obtain tax benefit, then the transaction is not an avoidance transaction.

In *the 1996 May Report of the Auditor General of Canada*,²⁵ an observation was made that the volume of business and financial transactions and the pace at which new species of avoidance schemes are created do not allow the government to devise a specific legislative or administrative provision that can counter all abusive transactions that may be developed in the future. So in 1988 the government of Canada introduced GAAR to cope better with a wide variety of abusive schemes and to reduce the number of anti-avoidance provisions in the Income Tax Act that contribute to its complexity.

In a *circular from the Australian government* explaining the effects of GAAR the Commissioner explains that the fact that a tax benefit exists does not mean that Part IVA²⁶ will apply. He however explains that the effects of the scheme can contribute to a determination of the purpose of a person in entering into the scheme. The absence of any genuine change in a person's overall financial legal or economic position is likely to add weight to the dominance of the tax purpose²⁷.

With regard to Kenya, there is no literature on GAAR and no writer has given his opinion on whether Kenya needs to have general anti-avoidance rules in its Income Tax Act. This is not to say that because there is no literature on Kenya there is no tax avoidance and no need to introduce GAAR. Tax avoidance is inherent in every human being, including Kenyans and

²⁵ Accessed at << www.oag-bug.gc.ca/internet/English/part-oag-199605-11-e-5042.htm >> on 9th July 2010

²⁶ Part IVA of the Australian Income Tax Assessment Act 1936 is the part of the Act that deals with general anti-avoidance rules. It replaced Section 260 of the same Act which was criticized for being too narrow.

²⁷ The circular was accessed at: << <http://www.ato.gov.au/contact/downloads> >> page 9 on 24 July 2010.

other people who do business here which if not checked has the effect of negative consequences on the economy as well as government expenditure and on the morale of taxpayers not engaged in it.

1.6. QUESTIONS THE RESEARCH WILL SEEK TO BE ANSWERED.

1. What is the effect of tax avoidance on a country?
2. Why does the modern taxpayer prefer tax avoidance to tax evasion, and why is tax avoidance flourishing?
3. What provisions exist in the Kenya Income Tax Act to counter tax avoidance and how often have they been applied?
4. What legal provisions and measures have other jurisdictions put in place to counter tax avoidance?
5. Should Kenya adopt a statutory general anti-avoidance rule (GAAR) or rely on anti-avoidance judicial doctrines?
6. What are the advantages of adopting GAAR to other anti-tax avoidance measures?

1.7. RESEARCH METHODOLOGY

1.7.1 Primary and Secondary sourcing

The study was conducted by the use of both primary and secondary sourcing. For secondary sourcing, information was gathered from the available literary material obtained from articles and books maintained at the University of Nairobi library and from articles posted on the internet. Case law and statute law from jurisdictions that have embraced GAAR was also accessed from the internet as well as case law from countries with no GAAR.

No questionnaire was prepared for use in this study since this kind of sourcing was not found to be appropriate. However the researcher conducted telephone interviews with some staff and partners in the 4 large accounting firms as well as an interview with a partner in an upcoming middle level firm of accountants. The purpose of the interviews with the accounting firms was to find out how often, from their experience the anti-avoidance provisions at Section 23 and 24 are applied. The study was therefore mainly literary based.

1.7.2 Research Objectives

- a) Since a study on this subject has not been carried out before on Kenya's GAAR, the study has sought to explore the GAAR legal framework that can be used by KRA to deal with taxpayer avoidance schemes.
- b) To critique the current anti-avoidance provisions under the Income Tax Act.
- c) To show that if general anti-avoidance rules (GAAR) are promulgated in Kenya they can greatly reduce tax avoidance, if accompanied by the requisite guidelines issued by the government detailing how the rules shall apply, including the nature of disclosure that taxpayers may be required to make.

1.7.3 Hypotheses

- (a) In order to counteract and cope better with a wide range of non-permissible avoidance schemes and transactions that may be entered into by taxpayers, Kenya needs to enact GAAR which are catch all provisions in addition to specific anti-avoidance rules (SAAR) which are enacted to counteract a specific event after it has occurred.
- (b) Some taxpayers create pre-arranged complex schemes which are commercially artificial and carry very little financial risks, with almost military precision, whose whole purpose is the avoidance of tax and subversion of tax laws.

- (c) The general anti-avoidance provisions in the Kenyan law are inadequate to deal with avoidance schemes.
- (d) Some anti-tax avoidance measures such as judicial doctrines are not that effective.

1.8 SCOPE OF LIMITATIONS.

The study was limited by a number of factors. There is little literature on general anti-avoidance provisions on Kenya Income Tax Act and there are absolutely no comments which the researcher has come across on general anti-avoidance rules (GAAR) in the same Act. This constrained the author as he did not find anything to comment on.

Another constraint in the study was the unwillingness of tax practitioners and accounting firms to disclose the fact that some of their clients are involved in tax avoidance schemes which Kenyan tax authorities have not unraveled. The researcher may not have obtained all the facts to assist him confirm whether avoidance schemes, which are known to exist in Kenya actually exist.

The University of Nairobi library has very few books on tax law. The few books available on tax law which the author looked at: Davies, Davies: Principles of Tax Law; Whiteman and Wheatcroft on Income Tax; Simon, Simon's Income Tax and Pinson, Pinsons Revenue Law. These books deal with all aspects of income Tax whilst the author's thesis is based on a small component of tax – GAAR. The author was therefore constrained and therefore relied heavily on articles from the internet, as these books were found to be inadequate for the study.

1.9. CHAPTER BREAKDOWN

The purpose of this section is to briefly analyze the arrangement of chapters that are contained in this dissertation:

1.9.1. Chapter 1 - Introduction

This is a background chapter which introduces the concept of general anti-avoidance rules (GAAR). It begins by discussing why taxes are imposed and the importance of taxes and why governments need to put in place rules and laws, specifically tax avoidance rules in the form of general anti-avoidance rules. It then discusses the statement of the problem which seeks to interrogate if adequate, statutory laws and rules have been enacted and promulgated to counter avoidance activities. It looks at some of the available literature review on general anti-avoidance rules and doctrines which is the basis of this dissertation. It then looks at the justification for the study, the questions that the research will seek to answer, the theoretical background, the assumptions, the scope and limitations of the study and the research methodology.

1.9.2. Chapter 2 – Tax avoidance, evasion, and the consequences of tax avoidance

Chapter two has examined the meaning of the term tax avoidance and distinguished it from tax evasion. The chapter has examined the possible causes of tax avoidance, and why people prefer it to tax evasion. It has also examined tax evasion, not only in relation to personal and corporate income tax but also looked at withholding taxes, P.A.Y.E. and Value Added Tax (VAT). It has also examined then discussed the penalties prescribed in Kenya for tax evasion in relation to income tax.

The chapter has examined the consequences of tax avoidance to a country as a whole, to the economy, to taxpayers and to further tax avoidance. The chapter has then proceeded to

discuss the reasons why countries enact laws and rules to counteract tax avoidance in the form of statutory general anti-avoidance rules (GAAR).

1.9.3. Absence of GAAR in Kenya Income Tax Act

Chapter three has looked at the Kenya Income Act (KITA) and reviewed some aspects of the Act. It has examined the general anti-avoidance provisions (GAAP) at Section 23 and 24 and noted that these provisions do not serve as substitute for GAAR, and that the provisions at Section 23 which have not been applied since their enactment are not adequately framed to combat tax avoidance. The chapter has also looked at three specific anti-avoidance rules (SAAR) in the Act which are specific rules designed to deal with specific issues, which do not also serve as substitutes for GAAR.

1.9.4. Chapter 4 – Comparing countries with and without GAAR

This chapter has examined Kenya's specific anti-avoidance rule with specific reference to the *Unilever* case, where a general anti-avoidance provision (GAAP) at Section 18(3) was found to be wanting to deal with transfer pricing tax avoidance schemes, consequently resulting into the enactment of Transfer Pricing Rules that are specific anti-avoidance rules in nature (SAAR.)

The chapter has then proceeded to examine a number of countries that have enacted GAAR and their experiences with statutory GAAR. It has considered the provisions contained in the statutes of some of these countries as well as Court decisions on appeals raised by taxpayers against assessments raised by revenue authorities based on GAAR. It is also concerned with countries, which rely on judicial doctrines notably United States of America (until recently) and United Kingdom. Finally the chapter is concerned with whether similar decisions can be

reached by countries that do not have GAAR with those that have GAAR even though different routes are taken and has considered whether GAAR are more effective than judicial doctrines and therefore the rationale for adoption of GAAR in Kenya as opposed to maintaining reliance on SAAR.

1.9.5. Chapter 5 – Conclusion and Recommendation

This chapter has summarized the findings of this dissertation by looking at Kenya's SAAR and GAAP. It has found that the GAAP contained at Sections 23 and 24 of the KITA are ineffective in combating tax avoidance. It has then commented on GAAR vis-à-vis judicial doctrines applied and made conclusions on the effectiveness of having GAAR as contrasted to judicial doctrines applied in combating tax avoidance. It has then made a recommendation for the enactment of GAAR in Kenya.

CHAPTER TWO

2.0 DISTINCTION BETWEEN TAX AVOIDANCE AND TAX EVASION

2.0.1 Tax avoidance

What is tax avoidance?

Tax avoidance comes under many labels. In Australia it is often referred to (particularly by the Australian Tax Office – “ATO”) as “aggressive tax planning”; in South Africa as “impermissible or abusive tax avoidance”; in New Zealand and the United Kingdom as “unacceptable tax avoidance”; and in the US terms such as “tax abusive shelters” are often used. Whichever term is used, tax avoidance is often contrasted with tax evasion.²⁸ These meanings of the words “tax avoidance” are used interchangeably in this thesis.

In general terms the word tax avoidance means doing everything possible within the law to reduce ones tax liability. Many jurisdictions have not defined what tax avoidance is but several meanings have been given to it. The free dictionary by Farlex has defined it as the process by which one plans his or her finances so as to apply all exemptions and deductions provided by the law to reduce taxable income. Through tax avoidance, an individual takes advantages of all legal opportunities to minimize his or her income tax.

An individual may for example avoid tax by investing a large sum of money in treasury bonds, since the interest on such bonds is not considered as taxable, but interest on the same amount invested in banks is taxable. Others have defined it as a method by which a taxpayer legally reduces his tax liability, for example by investing in a tax shelter.

²⁸ Evans, Chris, *supra* note 4 p.3.

According to A.J. Easson, tax avoidance is the art of dodging tax without actually breaking the law and the lawfully carrying out of a transaction which was either entered into, or which took a particular form, for the purpose of minimizing taxes.²⁹

Other definitions have been given as the practice of avoiding paying too much tax by taking advantage of legal means. It is finding loopholes where one can use existing laws to ones advantage.³⁰ Tax avoidance is generally the legal exploitation of the tax regime to ones advantage, to attempt to reduce the amount of tax that is payable by means that are within the law whilst making a full disclosure of the material information to tax authorities. Examples of tax avoidance involve using tax deductions, changing ones business structure and through incorporation or establishing an off shore company in a tax haven.³¹

There is no definition of tax avoidance when GAAR are used in statutes and for these reasons government enquiries tend to formulate their own definitions. For example, the Commission on Taxation of Profits and Income, UK (Radcliffe Commission) noted that avoidance was³²

“Some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is largely in the right...”

In 1966, the Royal Commission on Taxation Canada (Carter Commission) described tax avoidance as³³

²⁹ Easson, E.J, **Cases and Materials in Revenue Law**, (London, Sweet and Maxwell, 1973).

³⁰ Murray, Jean “Tax Avoidance v. Tax Evasion”, (May 2008), Jean’s Business Law/ Taxes accessed at <<<http://biztaxlaw.about.com/b/2008/05/07/tax-avoidance-vs-tax-evasion.htm>>>

³¹ Ibid.

³² Tooma, Rachel, *supra* note 11 p. 13.

³³ Ibid.

“Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred by taking advantage of some provision or lack of a provision in the law...it presupposes with existence of alternatives, one of which would result in less tax than the other.”

Tax avoidance is generally accepted as lawful as it uses the law and jurisdictional loopholes. It can be argued that the avoidance of tax constitutes a legitimate responsibility of corporate management in safeguarding a company's assets. Consequently those who succeed in avoiding taxes are likely to be big businesses and high net worth individuals who have resources to hire sophisticated professional accountants and lawyers to discover tax loopholes and to stretch them far beyond their immediate scope through creative legal engineering. There is no transaction hidden, no fraudulent claims or misrepresentations and therefore no law is broken.³⁴

2.0.1.1 Why Tax avoidance as opposed to tax evasion is attractive.

As indicated above tax avoidance is a legal means of reducing the tax payable, and involves issues where taxpayers are carrying on commercial transactions but choose to do so in a way to minimize tax. It is for this reason that many jurisdictions do not impose both civil and criminal penalties to taxpayers who engage in tax avoidance. It is recognized that often taxpayers enter into tax avoidance transactions knowing that they have little to lose: the potential tax saving just needs to be set against any additional costs of the structure of the transaction. If he or she fails to avoid tax, the taxpayer will only have suffered those transaction costs since the tax paid will be the same as it would have been without the

³⁴ Mo, Lai Lan Phyllis, – *Tax avoidance and Anti-avoidance measures in major developing countries*, (Praeger Publisher, 2003).

structure and there would be no penalties or interest.³⁵ It is for this reason that taxpayers would rather engage in tax avoidance than tax evasion discussed below. There has been an argument that if the penalties for tax avoidance are high or if there is some form of penalty, that would be a deterrent. Nevertheless, many jurisdictions do not impose a penalty or interest on amounts that are incurred as a result of tax avoidance transactions entered into by taxpayers.³⁶

One often used criterion for tax avoidance is disclosure that is, if all relevant information is disclosed to tax authorities the attempt to escape tax, though not acceptable is not illegal.³⁷ Some lawyers and accountants use the technique of “irrelevant disclosure” to ensure that they disclose enough to be dependable, but present the information that obscures its relevance. One alternative is to bury key information in a big document, leaving tax inspectors to spot it if they can.

The provision of non diagnostic evidence has the impact of diluting the inspector’s attention to relevant information. Thus full disclosure can in fact hide, rather than reveal. Other approaches include directing attention from a big issue to a little one, leaving something for the tax inspector to find, or presenting key information in one of the footnotes or appendixes of a big document. The disclosure in law is not breached, but it is complied with in a way that does not disclose relevant information. Thus we observe that the differentiation between the tax evasion and avoidance is tenuous at best in practice.³⁸

³⁵ Evans, Chris, *supra* note 4 p.

³⁶ *Ibid* p. 4.

³⁷ *Ibid*.

³⁸ Mo, Lai Lan Phyllis, *supra* note 35 p.3.

2.0.1.2 Goals of tax avoidance

It is possible to characterize tax avoidance activity in any number of ways. For example, one can consider avoidance in relation to its goals, to the nature of its activities, or by reference to its key features.³⁹ Getting to the essence of tax avoidance perhaps requires an understanding of its goals – what tax avoidance sets out to achieve. At the end of it all, the goal of tax avoidance is a reduction of tax liability, but that can take a number of forms. It is possible to identify four possible goals that underpin tax avoidance activity: elimination; deferral; re-characterization; and/or shifting.⁴⁰ The first goal – the permanent elimination of a tax liability needs no further explanation, and is presumably the tax avoider's desire. Deferral involves the postponement of the payment of a tax liability, and relies on the concept of the time value of money for its effectiveness. Re-characterization is simply the conversion of the character of an item or transaction – for example from a taxed or a highly taxed item like revenue to a tax exempt or less heavily taxed item like capital. The fourth possible goal – shifting – can relate to income or profit shifting (as in shifting a liability from a highly taxed entity to a less heavily taxed or even exempt entity as well as value shifting where value is shifted between assets).⁴¹

Achievement of any or all of these goals is only possible because of the potential for tax leverage or tax arbitrage that arises as a result of the so-called inconsistencies and discontinuities that exist within national tax jurisdictions and across international tax borders. The inconsistencies and discontinuities that are evident within and between tax systems are not likely to disappear – they exist for very good reasons. Distinctions between, for example, debt and equity, or capital and revenue, or between the assessability of different sorts of entities and different levels of income are fundamental parts of national tax systems, and they

³⁹ Evans Chris, *supra* note 4 p.4.

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

exist for both policy and political reasons. But we have to be aware of the consequences. As Jeff Waincymer points out: “progressive rates of taxation encourage income-splitting techniques; tax expenditures in favour of activities deemed worthy of encouragement lead to the creation of tax-inspired shelters; ...administrative necessities such as limiting the taxing exercise to a particular period encourage manipulations of the timing of deductions and receipts of income streams”.⁴²

2.0.1.3 The techniques of tax avoidance

From the foregoing goals, and appreciating that these goals are achieved through manipulation of the mismatches within and between tax systems, identifying the various contemporary techniques for tax avoidance is not a difficult task – although that is not in any way to under-estimate the ingenuity of their design or the complexity of their construct that is so often a feature of such schemes.⁴³

Lord Walker⁴⁴ of Gestingthorpe, in an unpublished paper presented shortly after the decision in the *Ramsay*⁴⁵ case was handed down by the House of Lords, recently identified “seven types of tax avoidance”, proceeding from the simplest case to the increasingly complex (and to most observers, increasingly objectionable). These were: 1) using a relief; 2) finding a gap; 3) exploiting (or abusing) a relief; 3) anti-avoidance “karate” (by which he meant the capacity for taxpayers to turn to their own advantage statutory provisions designed to prevent tax avoidance); 4) unnatural assets or transactions; 5) pre-ordained transactions; and 6) dodgy offshore schemes.

⁴² Ibid.

⁴³ Ibid.

⁴⁴ Head John, Kiever Richard, “Tax Reform in the 21st Century: a volume in the memory of Richard Musgrave,” (The Netherland, Kluwer Law International, 2009) p. 533.

⁴⁵ (1981) STC 174.

2.0.1.4 The key features of tax avoidance.

Many techniques share a series of common characteristics, most of which are summarized in the paper on tax avoidance prepared in late 2005 by the South African Revenue Service.⁴⁶ In the view of that revenue authority the “badges” or “hall marks” of avoidance typically include any or all of the following features:⁴⁷

- i. the lack of economic substance (usually resulting from pre-arranged circular or self-cancelling arrangements), with the result that an apparently significant investment proves ultimately to be illusory, and, through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary;
- ii. the use of tax-indifferent accommodating parties or special purpose entities, often referred to in the jargon as “washing machines”;
- iii. unnecessary steps and complexity, often inserted to prop up a claim of business purpose, or to disguise the true nature of a scheme or “as a device to cloak the tax shelter transaction from detection”;
- iv. inconsistent treatment for tax and financial accounting purposes;
- v. high transaction costs;
- vi. fee variation clauses or contingent fee provisions;
- vii. the use of new, complex financial instruments such as derivatives, hybrids and synthetic instruments which have made it possible for promoters to mimic almost perfectly the risks and returns attributable to more traditional financial instruments such as equity shares or “plain vanilla” debt without incurring, at least in theory, the tax consequences typically associated with them; and

⁴⁶ Evans Chris, “Barriers to avoidance. Recent Legislative and Judicial development in common law jurisdictions”, (1 November) 2006 p.13.

⁴⁷ SARS, “Discussion paper on Tax Avoidance” (Law Administration, South African Revenue Service, November 2005) p.16.

viii. The use of tax havens, particularly in the context of captive insurance companies, captive finance subsidiaries and intangible property holding companies.

The above hallmarks do not to suggest that the existence of these characteristics, either alone or in combination, *must* necessarily point to the existence of tax avoidance activity. That conclusion can only be drawn after a careful consideration of all of the facts. But it is to suggest that, *prima facie*, the existence of these features, alone or in combination, *may* indicate avoidance activity.⁴⁸ The Anti-Avoidance Group (“AAG”)⁴⁹ in the UK has developed a similar list of “signposts”, identifying the factors that it considers may indicate avoidance.

These include:

- (a) Transactions or arrangements which have little or no economic substance or which
- (b) have tax consequences not commensurate with the change in a taxpayer’s (or group of related taxpayers’) economic position. For example, forex matching abuse where the position is flat in economic substance but the benefit of hindsight can be used to choose which of two equal and opposite positions is taxed.
- (c) Transactions or arrangements bearing little or no pre-tax profit which rely wholly or substantially on anticipated tax reduction for significant post tax profit. For example dividend buying where the value of foreign tax credit more than offsets a pre-tax loss; and contrived gilt strip losses counterbalanced by gains on exempt assets such as options.⁵⁰
- (d) Transactions or arrangements that result in a mismatch such as: between the legal form or accounting treatment and the economic substance; or between the tax treatment for different parties or entities; or between the tax treatment in different

⁴⁸ Evans, Chris, *supra* note 4 p.4.

⁴⁹ HM Revenue a Customs, Guidance from Anti-Avoidance Group: “Risk assessing factors which may indicate tax avoidance”, accessed at, <<<http://www.hmrc.gov.uk/avoidance/aag-risk-assessing.htm>>>. on 20th July, 2010.

⁵⁰ Braithwaite, “Markets in vice: Markets in Virtue,” (Leichardt Federation Press 2005).

jurisdictions. For example a transaction where a payment is treated as an expense in one jurisdiction but the corresponding receipt is not taxable income in another jurisdiction.

- (e) Transactions or arrangements exhibiting little or no business, commercial or non-tax driver. For example film schemes which create tax losses in excess of the genuine commercial investment.
- (f) Transactions or arrangements involving contrived, artificial, transitory, pre-ordained or commercially unnecessary steps or transactions. For example the use of artificial arrangements designed to take assets out of the inheritance tax regime while allowing the former owner to continue to enjoy the benefits of ownership.
- (g) Transactions or arrangements where the income, gains, expenditure or losses falling within the UK tax net are not proportionate to the economic activity taking place or the value added in the UK - especially where the transactions or arrangements are between associates within the same economic entity and would not have occurred between parties acting at arm's length and/or add no value to the economic entity as a whole. For example the transfer of ownership of an income stream from a UK resident company to an associated company resident in a low/no tax jurisdiction in circumstances where the economic activity giving rise to the income does not accompany the transfer of ownership and/or where no economic benefit accrues to the economic entity as a whole.

2.0.1.5 Why tax avoidance has become more prevalent

Many reasons for the growth of avoidance activity in the latter part of the twentieth century and early part of this have been advanced in some literature. Braithwaite⁵¹ has identified globalization, increasing deregulation and changes in market forces as principal causes.

⁵¹ Braithwaite, "Markets in vice: Markets in Virtue," (Leichardt Federation Press 2005).

Braithwaite positions his work squarely within a broader market context. He shows how the waves of aggressive tax planning in Australia and elsewhere have initially been supply driven. It is his contention that a relatively small group of promoters, including some acting out of major financial institutions and more latterly the (now) Big Four accounting firms, have been the driving force behind many of the schemes that have been adopted by taxpayers in Australia and elsewhere. According to Chris Evans, much the same point is made by Richards, who notes “the conventional wisdom is that most of the planning and mass marketing emanates from the accounting firms”.⁵² There is also little doubt that the supply of tax avoidance products in the market place has been fuelled by the availability of talented human resources prepared to work in the area and by “rapid advances in computer and telecommunications technology (which have) greatly enhanced the ability of investment banks, accounting firms and other tax advisers to create sophisticated tax and financial models...to market...to multiple taxpayers”.⁵³

This abundance of supply has, in turn, created a demand for aggressive tax planning and avoidance opportunities from a much larger group of taxpayers, who feel that they should not miss out on what the ‘big end of town’ is able to enjoy. Chris Evans points out that as Pederick had noted many years ago: “cynicism grows apace and a race not to be left out of the tax minimization derby, by hook or by crook, infects the body politic”.⁵⁴ The US Treasury⁵⁵ has also noted that changing attitudes may play a large part in the growth in corporate tax shelters in recent decades. It is simply a reflection “of more accepting attitudes of tax advisers and corporate executives toward aggressive tax planning”. And the demand is not merely now restricted to those at the top end of town. For example, the growth in the mid

⁵² Evans, Chris, *supra* note 4 p. 7.

⁵³ *Ibid* p.8.

⁵⁴ *Ibid* p.7.

⁵⁵ U.S Treasury, “The problem of Corporate tax shelters’-discussion, analysis and legislative proposals”, (Washington Dc: United States State Department, 1999) p.19.

to late 1990s of mass-marketed tax avoidance schemes pedaled by the “white shoe brigade” to high income blue collar workers operating in the resources sectors in the remote parts of Australia has shown that tax avoidance activity is now a much more comprehensive and extensive phenomenon than was the case in earlier years. That observation is not confined to Australia.⁵⁶

2.0.1.6 Consequences of tax avoidance.

The growth of tax avoidance activities is a matter of concern. In the first place, and perhaps most importantly, it impacts negatively on the capacity of national tax jurisdictions to collect the revenue needed for the proper discharge of governmental functions. Revenue collection is the primary function of any tax system, and systematic and widespread avoidance activity will clearly have an adverse impact on that function. There are no reliable estimates on the losses to national treasuries as a result of avoidance activity, but the amounts are likely to be very significant.⁵⁷

For example, one estimate has suggested that tax haven activity alone has resulted in annual revenue losses to other countries in excess of US\$50 billion.⁵⁸ In the UK, the tax loss from avoidance is estimated to run into several billion pounds across both direct and indirect taxes.⁵⁹ When tax revenues do not flow as anticipated, or when large amounts of expected revenue are diverted by successful avoidance activity, cuts in government expenditure will follow, “with the resulting social and political difficulties that such cuts may bring”.⁶⁰

⁵⁶ Evans Chris, *supra* note 4 p.7.

⁵⁷ Ibid.

⁵⁸ Ibid.

⁵⁹ Ibid.

⁶⁰ Ibid.

But the harmful effects of tax avoidance activity go well beyond their impact on revenue collections. They also significantly affect the efficiency and equity of tax systems. According to Chris Evans these impacts are encapsulated by Bankman where he notes that “tax shelters siphon off resources from more productive ventures, redistribute the tax burden and threaten to undermine compliance”.⁶¹ As the OECD has also noted, any “proliferation of arbitrary and contrived schemes...leads to a perception that the system is unfair which can discourage compliance, even by taxpayers that had not previously engaged in tax avoidance”.⁶² It should also not be forgotten that much of the complexity of modern tax systems is a direct result of the introduction of specific integrity measures, involving convoluted anti-avoidance legislation designed to counter real and perceived avoidance abuses.⁶³ It can, therefore, safely be concluded that the growth in tax avoidance activity is a matter of grave concern, as it can reduce revenue collections, introduce economic inefficiencies by distorting economic behaviour, undermine the integrity of national tax systems and introduce a host of additional and unwanted complexities to those systems.⁶⁴

2.0.1.7 Other consequences of tax avoidance.

(a) Consequences of tax avoidance for Governments

The direct effect of tax avoidance for government is ultimately that less revenue is collected. The loss to revenue each year as a result of tax avoidance is difficult to estimate and to budget for. It has been estimated that during 1990's. \$ 4 billion in tax revenue was lost with 42,000 Australians becoming involved in aggressive mass marketed schemes and scheme related deductions are estimated to have increased from \$ 54 million in 1994 to over \$ 1

⁶¹ Ibid.

⁶² Ibid.

⁶³ Ibid.

⁶⁴ Ibid.

billion in 1998. Such revenue loss obviously has direct consequence for the level of government expenditure, and the size of government debt.⁶⁵

(b) Consequences of tax avoidance for Taxpayers

The direct effect of tax avoidance for taxpayers is that there is a revenue gain for tax avoiders, and ultimately an increasing tax burden falls on those taxpayers not engaged in tax avoidance. This redistribution of the tax burden will inevitably lead to a deterioration of taxpayer.⁶⁶ Other interest effects of tax avoidance may include: increasing complexity in tax laws, including the possible erosion of civil rights and legal professional privilege as governments amend tax statutes for the purpose of countering tax avoidance.⁶⁷

(c) Consequences of tax avoidance for Economy

Economists discuss the economic effects of tax avoidance as a consequence of the application of scarce resources to tax avoidance activities. Taxpayers alter their employment and investment choices in order to take advantages of tax avoidance activities, and in doing so, may make unproductive decisions from a special point of view.⁶⁸ One economist has argued that while the direct effects of tax avoidance on unemployment, inflation and interest rates are relatively insignificant, there may be important indirect effects of tax avoidance on inflation and unemployment. The indirect effects of tax avoidance follow from the belief by individuals that wealthier taxpayers are in a better position to avoid tax. Wage earners comprises more than 50% of all incomes in Australia. It is argued that if wage earners believe that non-wage earners are able to avoid tax, this belief will lead them to make greater demands for wage rises. If demands for wage rises are met, this will lead to higher levels of

⁶⁵ Tooma, Rachel, *supra* note 11 p. 24.

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ *Ibid* p. 25.

inflation. Governments typically respond to inflation by acting to dampen demand, which produces unemployment. It may be that unemployment will need to be kept at a high level in order to prevent the rate of inflation from rising again.⁶⁹

(d) Consequences of tax avoidance for tax avoidance

There is evidence that taxpayers engage in tax avoidance schemes believing that other taxpayers are engaged in tax avoidance schemes. This consequence of tax avoidance is particularly important to arguments in support of statutory GAARs, while proposals for the lowering of tax rates may contribute to a reduction in the extent of tax avoidance in Australia by reducing the incentive to avoid tax. Such reforms do not reduce tax avoidance by altering taxpayer's perception of the ability of other taxpayers to avoid tax. That is reducing the tax rate may not directly improve taxpayer morale.⁷⁰ "Taxpayer morale" may be understood to mean the values that individuals hold about paying their taxes. Morale is important in determining compliance behaviour. Where avoidance is perceived as being widespread, taxpayer morale may be expected to deteriorate, as taxpayers feel less inclined to pay tax while they believe that other taxpayers are actively engaged in tax avoidance schemes. This in turn leads to further tax avoidance. Indeed if socio-psychological factors are important in explaining tax avoidance, then taxpayer attitudes towards the tax system need to be taken into account in determining the appropriate methods for addressing tax avoidance.⁷¹

In a study carried out by Wallschutzky's⁷² it was found that taxpayer attitudes are more important than opportunities in determining taxpayer behaviour. It was found that taxpayers

⁶⁹ Ibid p. 26.

⁷⁰ Ibid.

⁷¹ Ibid.

⁷² Wallschutzky, I, G, "Taxpayer attitudes to Tax Avoidance and Evasion", (Research study No. 1, Australia Tax Research Foundation, 1985).

involved in aggressive tax planning are less committed to the tax system than other taxpayers and are less likely to feel remorse for avoiding their tax obligations. This suggests that increasing penalties for tax avoiders may not alone succeed in directly reducing the incidence of tax avoidance. However an effective statutory GAAR may lead taxpayers to consider that other taxpayers are not able to avoid tax. This may improve taxpayer morale and therefore reduce avoidance.⁷³ Consequently these are the considerations that force countries to put in place general anti-avoidance rules and are viewed as the positive consequences for introducing GAAR.⁷⁴

2.0.1.8 How Governments deal with tax avoidance – Enactments of GAAR.

It is for the above reasons that countries introduce general anti-avoidance rules which are meant to frustrate transactions that are contrived to avoid tax. Avoidance transactions adhere to the strict letter of the law while flouting or exploiting its policy. Statutory general anti-avoidance rules are found in many countries including a number of countries in the commonwealth a part from the United Kingdom itself, but judge made rules in the United States and United Kingdom sometimes have a similar effect.⁷⁵ Unlike tax evasion which means lying about ones income, avoidance means contriving transactions, typically but not necessarily artificial in nature, to reduce the tax that would otherwise be payable according to what would appear to be the policy of the taxing provision in question.⁷⁶ As a general rule, the law does not require people to arrange their affairs so that they may incur the greatest tax liability. When faced with two possible ways in which to organize their money, taxpayers are legitimately entitled to choose the option that require them to pay the lesser

⁷³ Tooma Rachel, *supra* note 11 p. 26.

⁷⁴ Ibid.

⁷⁵ Ibid.

⁷⁶ Prebble Rebecca, Prebble John, "Does the use of General Anti-Avoidance Rules to combat Tax Avoidance Breach principles of the Rule of Law" (Saint Louis university School of Law Center for International and comparative law critical tax conference, April 9 and 10, 2010).

amount of tax. There however comes a time where governments begin to think that taxpayers are going too far in their attempts to decrease their tax liability. It is at this time that taxpayers cease to engage in legitimate mitigation and embark on unacceptable tax avoidance.⁷⁷

Tax avoidance tends to have a number of identification features, for example artificiality, lack of business or economic reality, lack of true business risk and the exploitation of statutory loopholes, and is often accompanied with the exploitation of rules that were designed to reduce unfairness in the tax system or using existing legal structures in enterprising ways that had the legislative thought about the matter before, it would not have approval.⁷⁸

Governments therefore enact often very detailed rules in their tax legislations in order to combat avoidance. There is considerable variation in the form that general anti-avoidance rules take in different countries, but the various forms have roughly the same effect.⁷⁹

General anti-avoidance rules allow tax authorities to disregard schemes that would otherwise reduce taxes, and the transactions to which they apply are void for tax purposes. By a 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 to impose tax on the taxpayer on the basis of a reconstructed transaction.⁸⁰ An example of a typical general anti-avoidance rule in Section 99(3) of New Zealand's Income Tax Act 1976 reads:⁸¹

⁷⁷ Ibid.

⁷⁸ Ibid p.2.

⁷⁹ Ibid p.4

⁸⁰ Ibid.

⁸¹ Section 99 (3) of New Zealand Income Tax Act (NZITA) has been superseded by section BG 1, which incorporates section GB 1 and certain definitions in section YA 1.

Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void 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 preferable to, ordinary business or family dealing, - whether or not any person affected by that arrangement is a party thereto*

Despite the great difference between the legal systems and cultures of New Zealand and Germany, the corresponding German rule is very similar to New Zealand in effect:

- 1. The tax Act may not be circumvented by an abuse of possible legal arrangements. If there is such an abuse, the taxpayer shall be taxed as if he had chosen an adequate legal arrangement.*
- 2. Subsection 1 is applicable if its applicability is not excluded expressly by the law.*

Countries that have similar anti-avoidance rules have broadly similar to in form to New Zealand's and German's include Canada⁸², South Africa⁸³, Hong Kong⁸⁴ and France⁸⁵. The rule in Australia⁸⁶ was formerly similar but since 1981, the rule has been framed in more detail.⁸⁷ The United States (until recently) and United Kingdom do not have statutory general anti-avoidance rules, but they both have judicially developed anti-avoidance rules that can

⁸² Income Tax Act 1998 (Can.), s 245.

⁸³ Income Tax Act (SA.), s 103(now section 80A-L).

⁸⁴ Inland Revenue Ordinance (HK), s 61.

⁸⁵ Livre de Procedure Fiscale, article L 64.

⁸⁶ Income Tax Assessment Act 1936 (Aust) section 260.

⁸⁷ Income Tax Assessment Act 1936 (Aust), Part IV A, ss 177A-177G.

have roughly the same effect.⁸⁸ The United Kingdom common law anti-avoidance doctrines were initially promulgated by the House of Lords in *W.T Ramsay Ltd V. Inland Revenue Commissioner*.⁸⁹

The United States approach was established by the Supreme Court in *Gregory V. Helvering*.⁹⁰ In both cases, both approaches 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 the common law anti-avoidance judicial doctrines are insufficient to combat tax avoidance and should be replaced by statutory anti-avoidance rules.⁹¹ The intuitive alternative to a general anti-avoidance rule in a system of very many specific rules that detail exactly what is and is not subject to income tax. Many countries have such specific rules in at least some areas of economic activity, whether or not they have general anti-avoidance rules. The problem is that the more specific and detailed and systems rule becomes, the more ways people will find ways to circumvent them. This is because tax law is usually in two key ways.⁹²

In the first place there are very few other areas of law that people so aggressively try to avoid. Secondly by its very nature, the tax law contains a large number of potential loopholes. The result is that in the absence of general anti-avoidance rules GAAR, there is apt to be a great deal of tax avoidance that the government is apt to stop.⁹³

Tax avoidance is not a problem to governments alone; it is a problem to society as a whole. It undermines the key purpose of tax system. In the first place it undermines the principle of

⁸⁸ Prebble Rebecca, Prebble John, *supra* note 77 p.32.

⁸⁹ (1982) AC 300.

⁹⁰ (1935) 293 US 465, see also 69 F.2D 809 (2nd Circ 1934)

⁹¹ Prebble Rebecca, Prebble John, *supra* note 77 p.7.

⁹² *Ibid* pp. 17-18.

⁹³ *Ibid*.

horizontal equity which states that people in the same economic position should be taxed at the same rate. 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, meaning that people who avoid tax are not paying their fair share as measured by their wealth. In the second place tax avoidance makes it more difficult for tax systems to be economically neutral. Economic neutrality demands that people should distort the normal workings of markets as little as possible; that is, people should not make decisions for purely (or even partially) tax reasons. The existence for tax avoidance frustrates this goal.⁹⁴ It is for these reasons that government devise general anti-avoidance rules to frustrate those who are bent to contrive to avoid taxes.⁹⁵

In addition it needs to be acknowledged that other forces are also at work to counter some of the effects of avoidance. For example, lower tax rates may be associated with declining avoidance activity, and so international pressures for the reduction in tax rates since the 1980s may well have played some part in countering avoidance. Revenue authorities have also become increasingly conscious of the importance of providing incentives, or “compliance carrots”, to the great majority of taxpayers who do wish to comply with their tax obligations, rather than simply beating taxpayers with the various sticks that are available to them. This theme of cooperative compliance is mentioned but not fully developed in the paper which, by its nature, is not focused on the compliant.⁹⁶ There are however negative consequences that are cited against the introduction of general anti-avoidance rules. Since GAAR are formulated at the incident of a happening and taxpayer are caught unawares, there is a near

⁹⁴ Ibid p.18.

⁹⁵ Ibid.

⁹⁶ Evans, Chris, *supra* note 4 p. 8.

unanimity that in most jurisdictions there is uncertainty about what transactions fall inside and what falls outside general anti-avoidance rules.⁹⁷

2.0.2 Tax evasion

In contrast to tax avoidance, tax evasion is an illegal means of reducing liability which usually depend on misstating or omitting items from returns and when employed, involve liability to substantial monetary penalties or in serious cases, to criminal prosecution. Aiders and bettors are similarly liable.⁹⁸ It can be contrasted to tax avoidance as being the general term for efforts by individuals, firms, trusts and other entities to evade the payment of taxes by illegal means and usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their liability and includes in particular dishonest tax reporting such as underdeclaring income, profits or gains or overstating deductions,⁹⁹ and failing to declare assessable income, claiming expenses that were not incurred or that are not legally deductible, failing to lodge tax returns in an attempt to avoid payment of tax.

Where an employer who is required to deduct Pay As You Earn (P.A.Y.E) from an employee's remuneration fails to do so, or where he deducts less PAYE as required or deducts and fails to account for it to tax authorities, this also amounts to tax evasion.¹⁰⁰ Other examples of tax evasion among others include deliberately understating revenues or overstating expenses, fabricating invoices and making false claims to allowances.¹⁰¹ For Value Added Tax (VAT) evasion takes different forms which may include failing to register as a Value Added Tax

⁹⁷ Prebble Rebecca, Prebble John, *supra* note 77 p.8.

⁹⁸ Ibid.

⁹⁹ Wikipedia.

¹⁰⁰ Ibid.

¹⁰¹ Mo, Lai, Lan Phyllis, *supra* note 35.

registrable person when one is selling goods and services for which registration is required, charging VAT and not paying it to the tax authorities, claiming VAT input tax in returns when such input tax was not incurred, failing to file monthly returns and charging more or less VAT than at the rate that is prescribed by statute.

2.0.2.1 How governments deal with tax evasion

(a). Civil Sanctions in relation to tax evasion.

There are severe penalties usually prescribed by Income Tax Acts for tax evasion than tax avoidance. In Kenya, tax evasion is usually detected through taxpayer audit and in some cases by an informer who could be a current or former disgruntled employee, who will have known the manner in which the employer was cheating. Other informers would be an estranged spouse, a sacked former accountant, a disgruntled confidant, or just an enemy who would wish to see their target evader in trouble with tax authorities. Apart from wanting to see the evader in trouble, many jurisdictions provide for an informers reward scheme where the informer would give information to tax authorities in confidence. Informers usually give information about a taxpayer, for example a secret account that is maintained and unknown to tax authorities, the sets of secret accounting books maintained and where they are hidden, and for this the informant would be rewarded. In Kenya, the reward is based on a percentage of the recovery of unassessed tax and duties as provided for under Section 5A (2) of the *Kenya Revenue Authority Act*.¹⁰²

¹⁰² Section 5A (2) of the Kenya Revenue Authority Act provides for the reward in the case of information leading to the identification of unassessed duties or taxes, one per cent of the duties or taxes so identified or one hundred thousand shillings, whichever is the less; and in the case of information leading to the recovery of unassessed duties or taxes, three per centum of the taxes or duties so recovered or one million shillings, whichever is the less.

Civil penalties for tax evasion penalties are severe; for example in Kenya, civil penalties imposed by the tax authorities for ordinary evasion include a 20%¹⁰³ penalty on income tax that is paid late in addition to paying the tax that should have been paid had there been no evasion on income from business; and 25% penalties for P.A.Y.E paid late.¹⁰⁴ Both amounts also attract compounded interest at the rate of 2%¹⁰⁵ per month, imposed from the date the tax became due. Tax authorities are empowered to go backwards when raising assessments in relation to ordinary tax evasion upto a maximum of seven years¹⁰⁶, so that if a taxpayer is being audited or assessed for tax evasion in the year 2010, a tax audit and assessment can go as far back as year of income 2003. Where an evasion is attributed to fraud, tax assessments are not restricted to seven years backwards and can go as far back as the tax authority may determine or as far back as 1937 when income tax was introduced in East Africa since there is no limitation period in cases of fraud.¹⁰⁷ In addition, the penalties that are imposed are very severe so that in addition to the 20% late payment additional tax (for business) or 25% (for P.A.Y.E), another maximum penalty of upto 200%¹⁰⁸ of the evaded tax may be imposed. Interest at the rate of 2% per month like that for ordinary evasion continuous to accrue from the due date that the tax would have been paid had there been no fraud.

(b). Criminal sanctions in relation to tax evasion.

In addition to civil sanctions, criminal penalties are also prescribed for tax evasion. Under the Kenyan Income Tax Act, where no other penalty is specifically provided for in relation to an evasion offence, a fine not exceeding Sh. 100,000 or imprisonment for a term not

¹⁰³ Section 72D of KITA.

¹⁰⁴ Section 37 (2) (c) of KITA.

¹⁰⁵ Section 94 imposes compounded interest at the rate of 2% per month on tax that remains unpaid from the due date and on the penalties imposed, provided the interest charged shall not exceed 100% of the principal amounts owing.

¹⁰⁶ Section 79 (1) of KITA.

¹⁰⁷ Section 79 (1) (a) of KITA.

¹⁰⁸ Section 72A of KITA.

exceeding six months or both may be imposed.¹⁰⁹ A person who without reasonable cause makes incorrect returns omitting or understating his income or makes an incorrect statement in a return or gives incorrect information is guilty of an offence and liable to prosecution.¹¹⁰ Similarly a person who fraudulently makes false claims of a refund with intent to evade tax by making a return and omitting from it or understating any income, or prepares or maintains or authorizes the preparation or maintenance of false books of account or other record or falsifies, or authorizes,¹¹¹ are equally of an offence. The promoters and authorized tax agents are also liable to be penalized¹¹² for negligence or disregard of the law that results from the failure, omission, claim, statement or deduction that gives rise to the penalties imposed on their client. The weakness with these provisions is administrative - there are few taxpayers who are subjected to tax audits, a problem attributable to the KRA staff ratio to number of taxpayers. Another problem is that there are no reports and very rarely do the Kenyan tax authorities prosecute taxpayers who are evading tax with impunity. It is the authors' submission that the problem is understandable, many Kenya's would land in jail.

2.0.3 Conclusion

Most taxpayers would want to minimize the amount of tax they are liable to pay and they can do this by way of either tax avoidance or tax evasion. However there are severe penalties for minimizing tax liability through tax evasion if discovered than avoidance since in the latter case, penalties are non-existent in majority of jurisdictions. For this reason, many taxpayers have the incentive to minimize their taxes through tax avoidance which involves creating tax avoidance schemes than through tax evasion where if caught the penalties are severe. In order

¹⁰⁹ Section 107 of KITA.

¹¹⁰ Section 109 of KITA.

¹¹¹ Ibid.

¹¹² Section 72B of KITA

to stop these schemes, governments will usually put in place general anti-avoidance rules (GAAR) to counter the avoidance schemes.

CHAPTER THREE

ANTI AVOIDANCE MEASURES IN KENYA – CURRENT POSITION

3.1.0. Kenya's Income Tax Legal Framework

3.1.1 Introduction

The Kenya Income Tax Act 1973¹¹³ (KITA) herein referred to as “the Act” is the legislation for taxing income. In general, the Act brings to charge the income of any person whether resident or non-resident which was derived or accrued in Kenya¹¹⁴. What is income is a question of fact: it is constituted of gains or profits from a business or employment; rents, premiums, dividends, interest, royalties, pensions or any other periodical payment¹¹⁵. Other than the general anti-avoidance provisions (GAAP) dealt with at 3.1.2 below here are some few selected provisions in the Kenya Income Tax Act.

There are special provisions that govern the taxation of certain incomes, for example the income of insurance companies¹¹⁶, ship-owner, charterer or air transport companies¹¹⁷, and SACCO's¹¹⁸. These are among the taxpayers with special taxation provisions.

The current corporate rate is 30% for resident companies and 37¹/₂ for non- resident companies¹¹⁹. Individual rate is progressive upto a maximum of 30%¹²⁰. Kenya also recently introduced a tax known as “turnover tax”¹²¹.

¹¹³Kenya Income Tax Act, Chapter 470 Laws of Kenya.

¹¹⁴Section 3 (1) of the Kenya Income Tax Act.

¹¹⁵Section 3 (2) of the Kenya Income Tax Act.

¹¹⁶Section 19 of the Kenya Income Tax Act.

¹¹⁷Section 9 of the Kenya Income Tax Act.

¹¹⁸Section 19A of the Kenya Income Tax Act

¹¹⁹Third Schedule to the Kenya Income Tax Act.

¹²⁰ Ibid

¹²¹ Turnover tax introduced in 2006 is provided for under section 12C of the Kenya Income Tax Act and applies to taxpayers whose turnover is below Sh. 5,000,000 in a tax year, taxed at the rate of 3% of the turnover. Incorporated taxpayers or taxpayers who earn rent income, professionals and consultants are not subject to turnover tax, but fall in the normal tax regime.

Partnerships are not taxed since their income is distributed and taxed on partners who are taxed individually.

Where a resident person makes a payment to a non-resident person the payer is required to deduct withholding tax at the appropriate withholding tax rates¹²². The payments for which withholding tax are required to be applied include payments in respect of management and professional fees, interest, dividend, premiums and rents¹²³. There are also certain payments which are also subject to withholding tax requirements when a resident person makes payments to another resident person¹²⁴

Deductible business expenses are allowed against gross income to arrive at taxable income¹²⁵. Where the expenses exceed the gross income, the loss is carried forward to the next year of income to be offset against that year's profits from the same source, and is not offset against the taxpayers other sources of income¹²⁶. Where there has been a transfer of corporate assets and liabilities, the purchaser can acquire the unabsorbed losses which can be offset against the profits made in future.

Capital gains tax is not operational in Kenya currently, having been introduced in 1974 and suspended in 1985 although the provisions still remain in the statutes¹²⁷.

¹²² Section 35 (1) of the Kenya Income Tax Act.

¹²³ Ibid

¹²⁴ Section 35 (3) of the Kenya Income Tax Act

¹²⁵ Allowable business expenses are provided for under section 15. These are revenue expenses "wholly and exclusively incurred in the production of the income". Capital expenses may be deductible if they have been specifically allowed by section 15.

¹²⁶ This is provided for under Section 15 (7) of the Kenya Income Tax Act. This subsection was introduced when it had become apparent that "hobby" farmers were offsetting their "sham" losses against their employment income ending up in refunds.

¹²⁷ Capital gains, chargeable under section 3(2) (f) arose in circumstances that are described under the 8th schedule to the Act and sought to charge gains arising from the sale of property and investment shares. It was introduced in 1974 and suspended in 1985 although the provisions are still in our tax law.

Kenya does not have general anti-avoidance rules (GAAR). What it has are general anti-avoidance provisions contained at sections 23 and 24 of the Income Tax Act. In addition Kenya has a few specific anti-avoidance rules (SAAR) scattered within the Act which deal with specific issues.¹²⁸

3.1.2 GENERAL ANTI-AVOIDANCE PROVISIONS (GAAP).

Sections 23 and 24 of the Kenya Income Tax Act are the sections in the Act that deal with general tax anti-avoidance.

3.1.2.1 Section 23 – Transactions designed to avoid Tax

The marginal note at Section 23 of the Kenya Income Tax Act is titled “Transactions designed to avoid liability to tax.”

The Section is a general anti-avoidance provision which provides:

23. (1) Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be affected by the transaction.

(2) Without prejudice to the generality of the powers conferred by subsection (1), those powers shall extend –

¹²⁸ A few of them are discussed in this thesis at 3.1.3 below.

to the charging of tax of persons who, but for the adjustments, would not be charged to the same extent;

to the charging of a greater amount of tax than would be charged but for the adjustments.

(3) A direction of the Commissioner under this section shall specify the transaction or transactions giving rise to the direction and the adjustments as respects liability to tax which the Commissioner considers appropriate.

This is a general provision which gives the Commissioner power to form an opinion that the main purpose or one of the main purposes for which a transaction was effected was the avoidance of tax and if he forms such an opinion, he can direct adjustments to be made to counteract the avoidance or reduction of the tax.

As it can be read, the provision is too general and unlike countries which have rules on how such an opinion can be formed there are no rules or guidelines to guide the Commissioner on how to form the opinion or the basis of forming such an opinion. Whereas the section provides that if he determines it to be *just and reasonable*, the Commissioner may direct that such adjustments be made...there are no parameters within which the Commissioner's determination of "just and reasonable" can be arrived at.

This can be contrasted with countries which have GAAR : For example countries like Australia, where general anti-avoidance rules have been promulgated under Part IVA of the Australian Income Tax Assessment Act, an opinion is not just formed at the whim of the Commissioner. There are factors which have been legislated which must be satisfied before an opinion can be formed that a transaction had been effected for purposes of tax avoidance, and include a determination on whether there was a scheme, and if a tax advantage was obtained from the creation of such a scheme, having regard to the overall practical financial

consequences of the scheme and whether the same outcomes (other than the tax advantage) could be achieved in a more straight forward, ordinary or convenient way than the way in which they were achieved by the scheme. In arriving at the determination there are eight factors to be considered which have also been legislated.¹²⁹

- a) the manner in which the scheme was entered into or carried out;
- b) the form and substance of the scheme;
- c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- d) the result achieved by the scheme under the income tax law if there are no anti-avoidance rules;
- e) any change in the financial position of the relevant taxpayer that has resulted, will result or may reasonably be expected to result from the scheme;
- f) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer that has resulted, will result or may reasonably be expected to result from the scheme;
- g) any other consequences for the relevant taxpayer, or for any person referred to in matter (f) above of the scheme having been entered into or carried out; and
- h) The nature of any connection (whether business, family or other nature) between the relevant taxpayer and any person referred to in matter (g) above.

The rules spelt out under Part VIA of the Australian Income Tax Assessment Act (AITAA) are almost similar to those promulgated under the tax legislation of other jurisdictions with general anti-avoidance rules (GAAR).¹³⁰ From the Australian example it can be seen that in forming an opinion, the tax authority is not merely concerned with what a participant thought

¹²⁹ These factors are listed at section 177D of Part IVA of the Australian Income Tax Assessment Act 1936.

¹³⁰ Notable countries with GAAR are South Africa, Australia, Canada, Newzealand, France, and the Dutch. The latter two are not discussed in this thesis.

or intended. It is concerned with an objective conclusion to be rendered about the purpose of the relevant person and is determined only after considering the eight specified matters.¹³¹

Under Section 23 (3) of the Kenyan Income Tax, it is provided that the taxpayer shall be informed of the transactions that gave rise to the direction; however, as indicated above there is no objective criteria, specified in the law to give guidance to the Commissioner on how he can form an opinion as regards to the direction he can give under Section 23 (1).

3.1.2.2 Section 24 – Avoidance of Tax.

This is another general anti-avoidance provision (GAAP) in the Kenya Income Tax Act. The marginal note at the section reads, “Avoidance of Tax.”

This Section provides:

24. (1) Where the Commissioner is of the opinion that a company has not distributed to its shareholders as dividends within a reasonable period, not exceeding twelve months,

after the end of its accounting period that part of its income for that period which could be so distributed without prejudice to the requirements of the company's business, he may direct that part of the income of the company shall be treated for the purposes of this Act as having been distributed as a dividend to the shareholders in accordance with their respective interests and shall be deemed to have been paid on a date twelve months after the end of that accounting period.

¹³¹ Discussed in detail in chapter 4.

(2) *The Commissioner may direct that a charge be made upon a company in respect of adjustments to the liability of a shareholder as a result of a direction under subsection (1):*

Provided that –

- i. if a charge is made, the company shall be entitled to recover from the shareholder the amount of tax attributable to the adjustment made in respect of that shareholder; and*
- ii. Where an adjustment is made this section relating to the distributable profits of a company and those profits are subsequently distributed, the proportionate share therein of a shareholder shall be excluded in computing the total income of that shareholder.*

(3) (Deleted by 8 of 1978, s.9)

(4) A company may at any time before making a distribution to the dividend to its shareholders inquire of the Commissioner whether the distribution would be regarded by him as sufficient for the purposes of subsection (1), and the Commissioner, after calling on the company for any information that he may reasonably require, shall advise the company whether or not he proposes to take action under this section.

(5) Where under this section of the income of a company is treated as having been distributed and divided to its shareholders and in consequence thereof, another company is treated as having received a dividend, then for the purpose of applying the provisions of subsection (1) to the other company, the dividend which it is treated as having received shall be deemed to be part of the income of the other company available for distribution by the other company to its shareholders as dividends.

There are various reasons why companies may decide not to distribute dividends to shareholders, and these reasons may include a decision to put aside money for expanding or replacing an almost obsolete plant. If the company decides not to distribute dividends, it may not be doing so for the reason that it wants to avoid paying withholding taxes on dividends payable to shareholders, but for economic, expedient and for *bona fide* reasons.

3.1.2.3 History of the existence of Sections 23 and 24 in our tax statutes and their applicability.

3.1.2.3.1. Under the Kenya Income Tax Act (KITA) - 1973

These two provisions have existed in our tax statute since the coming into operation of the Kenya Income Tax Act on 1st January 1974 when Kenya, Uganda and Tanganyika went separate ways, and when each country enacted its own and separate tax statutes. Prior to that the three East African community countries tax regime had been governed by one tax statute, the East African Income Tax (Management) Act 1970 and prior Acts in which similar provisions existed. Income Tax was first introduced in Kenya in 1937 by the Colonial administration and extended to Uganda and Tanzania in 1939.

3.1.2.3.2 Under the East African Income Tax (Management) Act of 1970 (EAIT (M) A-1970)

The common income tax statute was the East African Tax Management Act of 1952 which was proclaimed by the East African High Commission applicable in the three East African partner States. The 1952 Act was repealed and replaced by the East African Tax Management Act No. 10 of 1958 which was in turn replaced by the more comprehensive East African Income Tax (Management) Act of 1970. It is on record that the East African Community was on decline in the 1970's and ultimately broke up in 1977 which explains why each country

went its separate way earlier in the enactment of its own tax statutes on 1st January 1974. Prior to the breakup of the community similar general anti-avoidance provisions (Similar to Section 23 and 24 of the ITA) existed in the Acts. Despite the long history of existence for decades in the statutes, there have been no rules that guide the Commissioner on what criteria he or she should use to form an opinion under section 23 or to determine that dividends should be distributed or that dividends can be distributed without prejudice to the requirements of the company's business, under section 24.

3.1.2.4 Interview with 4 big firms of accountants/ Tax practitioners in Kenya on application of Section 23 and 24.

The researcher contacted interviews with the big four accounting firms in Kenya, viz Price Waterhouse Coopers (PWC), Deloitte and Touche, KPMG and Ernst and Young. A further interview was contacted with M/s P.G. Wahome and Company and Wahome Consulting Services, a middle firm of tax practitioners. The Researcher spoke to some senior tax partners and staff in the accounting firms enquiring how often the provisions at Section 23 and 24 of the Income Tax Act have been invoked by KRA to their clients and the resultant tax arising from the directions.

All the interviewees stated that throughout the existence of their firms in Kenya, Section 23 provisions have never been invoked by the Commissioner. Partners in two of the firms conceded that although there could be tax avoidance in Kenya, that Section has never been invoked and attributed this to the fact that KRA may not have unearthed such schemes, and that in any event, if such schemes had been unearthed, there has been no tribunal to hear appeals until lately when it was constituted. One of the partners was of the view that if anti-

avoidance measures were to be implemented, the law requires to be reviewed to give directions on how avoidance matters can be dealt with.

One partner in another firm did not seem to know the difference between general anti-avoidance provisions (GAAP) and GAAR. His assumption was that since transfer pricing rules have been enacted following the *Unilever* case, therefore KRA was invoking anti-avoidance provisions, and had in fact invoked them. On the directions under Section 24 i.e. distribution of dividends, a partner in a senior firm was of the view that the Section is obsolete. The last time he could remember such a direction being given was in one case, over thirty years ago when the rate of withholding tax was high and when the rate of individual taxation was also high. Now that the rate of withholding tax on dividend is low, companies will still distribute dividends with or without the Commissioner's direction under Section 24, and this can be done without prejudice to the company's business.

From the foregoing it is clear that even though many taxpayers have presumably engaged in tax avoidance schemes, no effort has been made by tax authorities to invoke Sections 23 and 24 and even if it had invoked there was no guidance on how to invoke the Sections.

3.1.2.5 Forum for appeal

3.1.2.5.1 Appeals to Income Local Committee

Under the Kenya Income Tax Act, all appeals by any taxpayer who is aggrieved by the decision of the Commissioner other than a direction given under Section 23 and 24¹³² may appeal against such a decision to the local committee appointed for the area in which the taxpayer's affairs are handled, or where he resides.¹³³ Members of the local committee are

¹³² Section 86(1) (a) of KITA.

¹³³ Section 86(1) (b) of KITA.

appointed by the Minister for Finance, and sit in Nairobi, Mombasa, Nakuru, Kisumu, Nyeri and Eldoret.¹³⁴ Matters that can be appealed against to local committee include assessments¹³⁵ made upon a taxpayer which aggrieve him, a notice given by the Commissioner requiring a taxpayer to keep records, books of accounts and to keep them in a language specified in the notice,¹³⁶ a refusal by the Commissioner to make a refund and repayment under Section 105 or 106;¹³⁷ or an apportionment of an amount or sum by the Commissioner under the Second Schedule which affects, or may affect, the liability to tax of two or more persons;¹³⁸ or a determination by the Commissioner under paragraph 32(4) of the Second Schedule;¹³⁹ or a determination by the Commissioner under paragraph 12 of the Eighth Schedule,¹⁴⁰ may appeal therefrom to a local committee. The decision made by the local committee against either party can be appealed against to the High Court only on a question of law or mixed law and fact. A further appeal lies to the Court of Appeal.¹⁴¹

3.1.2.5.2 Appeals to Income Tax Tribunal

Under Section 86 (1) (a) of the Act where a person is aggrieved by the decision of the Commissioner who has made an opinion and given a direction under section 23 and 24 and made an assessment upon him, the taxpayer may appeal against the assessment if the assessment is based upon the direction given under Section 23 and 24 not to the local committee, but to the Tribunal.¹⁴² The tribunal is provided for under Section 83 (1) of the Act which empowers the Minister by notice in the Gazette to establish a Tribunal to exercise the functions conferred by the Act.

¹³⁴ Section 82(1) of KITA.

¹³⁵ Section 86(1) (b) of KITA.

¹³⁶ Section 89(1) (a).

¹³⁷ Section 89(1) (b).

¹³⁸ Section 89(1) (c).

¹³⁹ Section 89 (1) (d).

¹⁴⁰ Section 89 (1) (e).

¹⁴¹ Section 91A of KITA.

¹⁴² Section 86 (1) (a).

Section 83 states as follows:

Section 83 (1) The minister may, by notice in the Gazette, establish a Tribunal to exercise the functions conferred upon it by this Act.

(2) The Tribunal shall consist of a chairman and not less than two and not more than four other members appointed by the Minister;

(3) A member of the Tribunal shall hold office for the period, not exceeding two years, specified in his appointment unless, prior to the expiration of that period – he resigns his office by written notification under his hand addressed to the Minister;

or the Minister; being satisfied that the member is unfit by reason of mental or physical infirmity to perform the duties of his office, or that the member has failed to attend at least three consecutive meetings of the Tribunal, revokes his appointment.

(4) The quorum for a meeting of the Tribunal shall be the chairman and two other members.

(5) The members of the Tribunal shall be entitled to receive such subsistence and travelling allowances as the Minister may determine.

(6) The members of the Tribunal shall not be personally liable for any act or default of the Tribunal done or committed in good faith in the course of exercising the powers conferred by this Act.

(7) The Minister may make rules –

(a) prescribing the manner in which an appeal shall be made to the Tribunal and the fees to be paid in respect of an appeal;

(b) prescribing the procedure to be adopted by the Tribunal in hearing an appeal and the records to be kept by the Tribunal;

(c) prescribing the manner in which the Tribunal shall be convened and the places where and the time at which sitting shall be held;

(d) prescribing a scale of costs which may be awarded by the Tribunal; and

(e) Generally for the better carrying out of the provisions of this Act relating to the Tribunal and appeals thereto.

Section 86(1) (a) of the Act, was enacted at the same time as the Act and provided for the establishment of a tribunal to which an aggrieved taxpayer could appeal against a direction of the Commissioner. Further under Legal Notice No 5 of 1974 the Income Tax (Tribunal) Rules were promulgated. Despite the provision for a tribunal and the tribunal rules, no such tribunal had been constituted or established since the enactment of the Act, until 12th April 2010 when the first tribunal was constituted vide legal Notice No. 4418 of 2010.

There are no facts to suggest that there has been no tax avoidance in Kenya to warrant Sections 23 and 24 not to be invoked by a Commissioner giving a direction under these sections. This is because tax avoidance is in the nature of man. Nor do facts exist to show that there has been no need for a tribunal. It is the author's view that the fact that a tribunal had not been constituted is because no direction has been given under Section 23 and 24 against which taxpayers can appeal to it against it. Nevertheless by recently establishing a tribunal is a recognition that avoidance exists. Under the Gazette Notice Number 4418 of 2010 and unlike local committees, there is only one tribunal for the whole country, which shall sit in Nairobi. So far the newly appointed tribunal has had no sittings.

3.1.3 SPECIFIC ANTI-AVOIDANCE RULES (SAAR) UNDER KITA

Despite the inadequacies in the general anti-avoidance provisions (GAAP) and the lack of general anti-avoidance rules (GAAR), there are some specific anti-avoidance rules (SAAR) contained in the Kenya Income Tax Act. Among the issues the SAAR deal with are thin

capitalization,¹⁴³ exchange gains and losses,¹⁴⁴ transfer pricing,¹⁴⁵ and specified sources of income¹⁴⁶ among others which are dealt with below. Unlike general anti-avoidance rules, the specific anti-avoidance rules apply to specific issues for which they are designed to frustrate. Specific anti-avoidance rules (SAAR), are aimed at particular types of transactions when such transactions are entered into for purposes of tax avoidance but not otherwise. For example most of the provisions contained in Part XVII of the U.K Income and Corporation Taxes Act (ICTA) 1970 are of this type, in particular those provisions designed to cancel a tax advantage obtained from transactions in securities.¹⁴⁷ In Kenya there are a number of specific anti-avoidance rules (SAAR).

3.1.3.1 Thin Capitalization

The rule to counter thin capitalizations is contained at Section 16 (2) (j)¹⁴⁸ of the Kenya Income Tax Act and states:

16 (2): Notwithstanding any other provision of this Act, no deduction shall be allowed in respect of:

.....

¹⁴³ Section 16 (2) (j) of KITA.

¹⁴⁴ Section 4A of KITA.

¹⁴⁵ Section 18 (3) of KITA and the Rules thereto.

¹⁴⁶ Section 15(7) of KITA.

¹⁴⁷ Easson, E.J, *supra* note 30 p. 40. In U.K, the provisions dealing with avoidance are contained at Section 703 of ICTA and are directed at avoidance transactions in securities which they seek to cancel.

¹⁴⁸ Section 16 (2) (j) was recently amended by the Kenya Finance Bill 2010 by the following words : (a) in subsection (2), by inserting the words “or an amount of deemed interest” before the words “where the company” appearing immediately after paragraph j(ii); (b) deleting subsection (3) and inserting the following new subsection- (3) for the purposes of subsection (2), the expressions- “all loans” means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium”; “deemed interest” means an amount of interest equal to the average ninety-one day Treasury Bill rate, deemed to be payable by a resident person in respect of any outstanding loan provided or secured by the non-resident, where such loans have been provided free of interest. The effect of this amendment is to provide a specific anti-avoidance rule and seal an emerging loophole where non-resident related companies would give loans but charge no interest. The amendment thus provides for deeming of interest and deem it to be included in the repayment and therefore apply non-resident withholding tax rates on the deemed interest. However this deemed interest is not allowable expense against the company’s profits.

(j) interest payments in proportion to the extent that the highest amount of all loans held by the company at any time during the year of income exceeds the greater of –

- i. three times the sum of the revenue reserves and the issued and paid up capital of all classes of shares of the company; or*
- ii. the sum of all loans acquired by the company prior to the 16th June, 1998 and still outstanding in that year;*

where the company is in the control of a non-resident person alone or together with four or fewer other persons and where the company is not a bank or a financial institution licensed under the Banking Act; and for the purposes of this paragraph “control” shall have the meaning ascribed to it in paragraph 32 (1) of the Second Schedule;

Provided that this paragraph shall also apply to loans advanced to the company by a non resident associate of the nonresident company controlling the resident company.

As a matter of introduction, Section 16 is the section in the Act that forbids or prohibits the allowance or deductibility of certain expenditure against a taxpayer’s income which is subject to tax. Where a taxpayer incurs an expenditure to earn income that expenditure is disallowed meaning that it is not deductible against his gross income to arrive at the net taxable income upon which tax is charged if it is prohibited by Section 16. Section 16 (2) (j) prohibits deduction of a fraction of the interest that arises out of thin capitalization as the rule against thin capitalization is borne out of the fact that most tax legislation allows a deduction in arriving at taxable profits of a company for interest paid whereas no deduction is allowable for dividend payments which are distributions of profits and which are not expenses of earning profits.

Companies are usually funded by a mixture of equity capital and debt capital. The return on equity is normally dividends which are paid to shareholders, whereas the return on debt is interest. Kenya's tax legislation allows a deduction of interest in arriving at profits that are taxable whereas dividends are not allowable as a business expense. The dividends that are distributed to shareholders are themselves subject to tax, initially on the basis of withholding taxes when they are paid to the shareholders and when they are received by the shareholders, the resident shareholders are required to declare them in their annual returns; whereas non-resident shareholders will not be subject to further tax as their withholding tax, at an enhanced rate is the final tax.

A company is said to be thinly capitalized when its capital is made up of much greater debt than equity. Where this happens it means that the shareholders debt exceed equity with the consequence that more interest will be allowed against its taxable profits than the amount of dividend that will be distributed to shareholders. This is an avoidance scheme since the company's profits will be reduced, and the company will pay less tax, and at the same time no tax will be paid on dividends. To counter this, section 16 (2) (j) which is a specific anti-avoidance rule prohibits the deductibility of interest in the ratio of 1:3 of the debt and equity. The test for thin capitalization is a mathematical one and is based on the ratios between the indebtedness of the company; and the issued and paid up capital plus the revenue reserves. If the indebtedness is more than three times the capital, then there is a state of thin capitalization. Indebtedness is measured at its highest point at any time during the year and not merely at the balance sheet date. Further, indebtedness includes all forms of indebtedness incurred in the production of income. It includes overdrafts, ordinary trade debt, and current accounts with related persons and of course long term loans. There is no difficulty in

determining the amount of paid capital but revenue reserves are handled with care as amounts on account of revaluation of fixed assets are excluded.

3.1.3.2 Exchange gains and losses

Another specific anti-avoidance rule deals with foreign exchanges gains and losses and is dealt with under Section 4A of the Act. The purpose of the Section is to provide a comprehensive set of rules to deal with foreign exchange gains and losses. Prior to its introduction, only exchange gains and losses relating to trading transactions were taken into account in computing gains and profits of a business. Those relative to other transactions were not taken into account. For example, if a person suffered an exchange loss upon repayment of a foreign currency loan, no deductions were available to him either directly by deduction from profits, or indirectly by wear and tear deduction under Second Schedule.

Subsection 1 of Section 4A abolished this distinction between gains and losses made in trading transactions from those made otherwise. This means that, all gains and losses whatever their character and howsoever arising are taken into account in computing business profits so long as they are incidental to the conduct of that business. The Section is also drawn in such a manner that it embraces both sides of the balance sheet. There is no difference drawn between gains and losses arising from the assets of the business from gains and losses that arise from its liabilities. The consequence of the Section is that gains and losses realized on the repayment of a foreign currency loan is deductible or taxable as the case may be. Conversely, gains and losses arising on the realization of the foreign currency asset are taken into account irrespective of the nature of the asset. For example, if a taxpayer obtains foreign currency loan and deposits the proceeds to purchase an asset for his business, then the difference between the Kenya Shilling value of the loan proceeds at the date on

which the loan was obtained and the Kenya Shilling value of the currency at the date of purchase of machinery is taken into account as trading receipt or expense as the case may be, when the gains or losses are realized. The word realization has a wide meaning. It includes any disposal, sale, exchange, repayment, redemption extinguishment or conversion to Kenya currency.

There are two situations when exchange losses may not be deducted but rather such losses are carried forward to future years. This is:-

- a) when the company is thinly capitalized;
- b) When there are unrealized (accrued) gains.

As explained above a state of thin capitalization exists when loans are preferred to equity capital in financing a company. This method of financing is common in subsidiaries of foreign companies. There is an obvious tax advantage to do so as interest costs are deductible in computing gains and profits of that subsidiary whereas if the financing was done by equity capital, then the return on that capital being a dividend would not be deductible. To discourage this form of avoidance in relation to exchange gains and losses this avoidance is countered by subsection 4A (ii) (a). This subsection *provides "that where the foreign exchange loss is realized by a company with respect to a loan from a person who alone or together with four or fewer other persons is in control of that company" that loss shall not be deducted but shall be carried forward to future years* (in which the thin capitalization rule does not apply).

The law is saying here that as long as a company is thinly capitalized and has taken a loan from a person who controls it, then the exchange loss incurred on the repayment of that loan is not deductible. That foreign exchange loss will only fall to be deducted in the following

year or failing this, the year subsequent to this in which the thin capitalization does not apply. This may go on and on until the loss is exhausted. The foreign exchange losses are deferred and not taken into account to the extent that there are unrealized foreign exchange gains. The unrealized gains are computed as if all foreign assets and liabilities of the business were disposed off or satisfied on the last day of the year of income. This provision is important in that it is a safeguard against future avoidance manipulation in timing the realization of gains with respect to foreign assets.

Further to the above, another anti-avoidance provision is contained in subsection (3). It provides for non-recognition of losses claimed if this is followed by the replacement within 60 days of that asset or liability. The provision is meant to prevent taxpayers from indulging in artificial transactions aimed at realizing sham losses. Thus foreign exchange losses specific anti-avoidance rules go hand in hand with thin capitalization specific anti-avoidance rules through, Section 16 (2) (j) which provides for the disallowance of interest in the case of foreign controlled company which is thinly capitalized – i.e. where the total indebtedness of the company exceeds three times the paid up capital plus revenue reserves.

3.1.3.3 Specified sources of Income

This is another specific anti-avoidance rule (SAAR).¹⁴⁹ The anti-avoidance rule is contained at section 15 (7) and provides that losses realized in a year of income from one source of income cannot be offset against profits from another source of income unless that source of income has been grouped together with the source of income from which the loss arises, otherwise referred to as a specified source of income. If a loss is realized from a source which is not specified, it is carried forward to the next year of or subsequent years of income and

¹⁴⁹ *supra* note 126.

will be offset only from profits that are realized from the same source of income. The specified sources of income are:-

- i. rights granted to other persons for the use or occupation of immovable property (rent from immovable property);
- ii. employment of personal services, salary, commissions or similar rewards (but excluding independent contract of service) and a self employed professional service;
- iii. employment of the gains and profits from which is wife's employment income, profession the gains or profits from which is wife's professional income and wife's self employment the gains or profits from which is wife's self employment;
- iv. agricultural, pastoral, horticultural, forestry or similar activities, not falling within (i) and (ii) above;
- v. surplus funds withdrawn or refunded to an employer in respect of registered pension or registered provident fund;
- vi. Other sources of income chargeable to tax including dividends and interest, pension charge or annuity and any amount deemed to be income under the Act or the rules made under the Act.

The purpose for the introduction of these SAAR was to counter avoidance of taxes where individuals and companies commence business of no commercial and economic value where losses would be realized and then offset them against gainful and profitable business or employment income, resulting in paying less or no taxes and in some instances even claiming a refund from the P.A.Y.E deducted from employment income, or withholding taxes deducted by a payer. This is a specific anti-avoidance rule that frustrates these kind of schemes by providing that gains or profits of a person derived from the six sources of income specifically specified are computed separately from the persons gains or profits of the persons other

specified sources and separately from any other income of that person; and where a loss is incurred from a specified source, that loss is only deducted from the gains or profits of that person from the same specified source in the following year and in subsequent years.

3.1.3.4 Other SAAR

Kenya has other specific anti-avoidance rules which as mentioned are from time to time enacted to deal with specific matters as they arise. One such SAAR which deals with transfer pricing is discussed in chapter 4. The other which is worth mentioning relates to non-cash benefits provided by employers to employees to avoid payment of tax on their cash emoluments. A value has been attached to all types of non cash benefits, which are consequently taxed.

3.1.4 Conclusion

Kenya lacks general anti-avoidance rule (GAAR) which are “catch all” provisions that can catch and can counter any type of avoidance transactions entered into by taxpayer at any time a taxpayer enters into an avoidance scheme. Instead Kenya has specific anti-avoidance rules (SAAR) which deal with specific issues and which are enacted after an event has occurred, to prevent the occurrence of an equivalent event in the future. The SAAR provisions have been compared to “smart bombs” which deal with specific situations as contrasted to GAAR which are described as “carpet bombs” or “weapons of mass destruction”¹⁵⁰ because they counter all targeted tax avoidance schemes. The general anti-avoidance provisions (GAAP) contained at Sections 23 and 24 have no accompanying GAAR to guide tax authorities on how to implement countering of tax avoidance or how to educate taxpayers on not how to fall in the trap.

¹⁵⁰ Evans, Chris, *supra* note 4 p 14.

CHAPTER FOUR

APPLICATION OF SAAR, GAAR AND ANTI-AVOIDANCE DOCTRINES IN ABSENCE OF GAAR

4.1 Introduction

In contrast to specific anti-avoidance rules (SAAR) and general anti-avoidance provisions (GAAR) both which Kenya has enacted in its Kenya Income Tax Act, many countries have enacted statutory general anti-avoidance rules (GAAR) in their tax laws which target arrangements involving a course of action that would not have likely been taken other than for the purpose of a tax advantage for the taxpayer. The arrangements must be in violation of the underlying purpose of the taxing statute in order to be within the GAAR. If the transaction is within the scope of the statutory GAAR, it is usually made void so that the tax that would have been payable but for the avoidance scheme becomes payable.

By definition SAAR accept that there will be a certain level of avoidance. This is because there must first be avoidance schemes that the legislature finds unacceptable before these schemes can be shut down by specific provisions in a tax statute.¹⁵¹ On the other hand GAAR attempt to strike down avoidance that is not understood at the time of drafting legislation; and for this reason GAAR are inevitably too broad since they are meant to be “all catch” legislation. The risk however is that GAAR are drafted so broadly that they are in terminate, one of the reasons for criticism made against statutory GAAR.

GAAR are however drafted in a manner that certain conditions must exist for a taxpayer to be caught by them and before the Commissioner can exercise his power to cancel a tax benefit

¹⁵¹As will be seen at 4.2 below transfer pricing rules (specific anti-avoidance rules) were enacted after the government lost the *Unilever* case. Similarly as seen in chapter 3, the rules on thin capitalization, the specified sources of income and the exchange gains and losses specific rules discussed were enacted to shut down the unacceptable practices after they occurred.

arising from the scheme, where it would be concluded that a person who entered into it or carried out the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit. Apart from cancelling the scheme and requiring the tax that would have been payable but for the scheme, some jurisdictions provide for mechanisms for imposing penalties and interest depending on the nature of disclosure made by the taxpayer to tax authorities. There are however a number of countries which have not adopted GAAR and rely on judicial doctrines that have evolved over the years. Among these countries are the United States of America (until recently), and United Kingdom.

This chapter is divided into 4 parts and will comprehensively review the various anti-avoidance measures undertaken in various countries for the purposes of illustration on why Kenya needs GAAR and will consider how effective they are in dealing with avoidance schemes either wholesome or piecemeal while applying statutory provisions or judicial doctrines. In particular, the chapter will discuss:-

1. with reference to Kenya, the treatment of tax avoidance schemes with particular reference to the *Unilever* case, involving a company which had been taxed based on a GAAP, which led to the enactment of SAAR.
2. the treatment of avoidance schemes in countries that have enacted statutory GAAR specifically, Australia, South Africa, New Zealand and Canada;
3. the treatment of avoidance schemes in countries without statutory GAAR specifically, United States of America which until recently did not have GAAR, and United Kingdom which rely on judicial doctrines to deal with avoidance schemes;
4. the comparison of the systems above.

4.2 KENYA – APPLICATION OF GAAP AND ENACTMENT OF SAAR – THE UNILEVER CASE.

4.2.1 Introduction

As seen in chapter 3, Kenya does not have general anti-avoidance rules (GAAR), which have been described as provisions that are drafted in a manner that they counter any form of unacceptable tax avoidance transactions that a taxpayer may enter into for the purposes of obtaining tax advantage where the transactions are within the scope of the GAAR.

On the other hand Kenya has general anti-avoidance provisions (GAAP) that are considered plain; with no supporting rules to give direction on how they would be applied, in the form of GAAP which is the subject of this thesis. However there are specific anti-avoidance rules (SAAR) which are enacted to shut down specific schemes that are found to be unacceptable. SAAR recognizes that there is some level of avoidance in specific areas and are therefore enacted to target that specific area they are enacted to shut down. Such was the case in a leading Kenyan authority on tax avoidance in the case of *Unilever Kenya Ltd*. Although the judgment in the case which concerned transfer pricing has been criticized, nevertheless it provides some guidance on specific anti-avoidance rules which were enacted after it was found that the GAAP that existed prior to the enactment of the SAAR were inadequate to apply to counter the avoidance schemes.

4.2.2 Transfer pricing

Prior to June 2006, there was a general anti-avoidance provision not supported by general anti-avoidance rules contained at Section 18 (3) of the Act which read:

Where a non-resident person carries on business with a related resident person and the course of that business is so arranged that it produces to the resident person either no profits or less than the ordinary profits which might be expected to accrue from that business if there had been no such relationship, then the gains or profits of that resident person from that business shall be deemed to be the amount that might have expected to accrue if the course of that business had been conducted by independent persons dealing at arm's length."

The Commissioner of Income Tax sought to use this general provision to assess a taxpayer, *Unilever Kenya Ltd* on basis that the taxpayer had carried on a business with a related non-resident related person and that the course of the business had been so arranged as to produce less than the ordinary profits which was expected to accrue to the taxpayer from the business if there had been no such relationship and if the business had been conducted by independent persons dealing at arm's length, and therefore the taxpayer had been caught by Section 18 (3).

4.2.2.1 Meaning of Transfer Pricing

Transfer pricing normally refers to the pricing and other conditions in place in cross-border transactions between members of a multinational group of companies. Such prices will normally influence the amount of profit each of those members recognizes, and thus the amount of tax they pay in the jurisdictions in which they operate. Because of this, countries seek to regulate how members of a multinational group of enterprises price transactions between them, since regulations are found in country transfer pricing legislation. These guidelines are invariably based on the arms length principles which is internationally recognized standard of determining the amount of income, expenses or profits to be recognized for tax purposes in relation to transactions between associated enterprises. According to arm's length principle, the pricing and other conditions between independent

enterprises should not differ from the conditions that would be made between the dependent enterprises in comparable circumstances. That is, arms length principle aims to ensure that the allocation of taxable profits or loss between the constituent members of a multinational group is not distorted by the fact that these members are related.

It must be noted that it is normal and legitimate business practices for affiliated companies to transact with each other. Transfer pricing becomes a problem only when non-arms length terms are used in such transactions and the distribution of profit between non-arms length terms are used in such transactions and the distribution of profit between affiliated companies become distorted. This is a particular problem when multinational enterprises use other transfer pricing to shift profit away from normal tax rate countries towards low-tax countries. It is for these reasons that countries enact specific anti-avoidance rules (SAAR) in their tax statutes to counteract the shifting of profits from their own jurisdiction to other countries and these rules are specific anti-avoidance rules. Kenya enacted such rules as mentioned above under Legal notice number 67 of 2006 following the decision in *Unilever Kenya Ltd V. Commissioner of Income Tax*.

4.2.2.2 The Unilever Case

Transfer pricing can be illustrated in *Unilever Kenya Ltd v. Commissioner of Income Tax*.¹⁵² The facts of the case were that *Unilever Kenya Limited, (UKL)* a company engaged in the manufacture and sale of various household goods entered into a contract with *Unilever Uganda Ltd (UUL)* whereby UKL was to manufacture goods on behalf of UUL and supply to UUL such products as UUL required based on orders issued by UUL. Both *Unilever Kenya Ltd* and *Unilever Uganda Ltd* are part of Unilever Group of Companies and are related as per

¹⁵² High Court, Income Tax Appeal No. 753 of 2003.

the definition of related persons; which defined related persons as:¹⁵³ The Section states as follows.¹⁵⁴

“ For the purposes of the subsection (3), a person is related to another, (a) either person participates directly or indirectly in the management, control or capital of the business of the other; or (b) a third person participates directly or indirectly in the management , control or capital of the business or both.”

Pursuant to the contract, UKL supplied such products to UUL during the years 1995 and 1996. In addition to supplying goods to UUL, UKL also manufactured and supplied goods to its major market, the Kenyan domestic market as well as for the export market, all who were customers not related to UKL. UKL charged lower prices to UUL than it charged the Kenyan customers and the importers who were unrelated to UKL. The Commissioner raised assessments on UKL for the years 1995 and 1996 on account of sales made to UUL. The grounds for raising the assessment were that the prices charged on UUL were lower than the prices charged on unrelated customers and that these were not arms length prices. The Commissioner had relied on the general provision under Section 18(3) of the Income Tax Act to raise the assessment on the grounds that the sale of products by UKL to UUL at a price lower than the comparable prices charged to Kenyan buyers or to outside Kenyan importers represented a transfer price hence the price difference became subject to taxation on the basis of sales at arm's length. The taxpayer was aggrieved by the decision of the Commissioner whereupon he made an appeal to the local committee where he lost and consequently made

¹⁵³ Section 18 (6) of the Kenya Income Tax.

¹⁵⁴ Section 18 (6) has since been amended by Kenya Finance Bill 2010 by the addition of the following words: (c) an individual, who participates in the management, control or capital of the business of one, is associated by marriage, consanguinity or affinity to an individuals who participates in the management, control or capital of the business of the other. Further the Finance Bill 2010 amended Section 18 (3) by deleting the words “so arranged” and substituted them with the word “such”. The effect of these two amendments is (1) to increase the scope of related persons to include related individual who participate in the business of the other (2) to provide that the intention of the parties is irrelevant – what is simply required is to be proved that a transaction led to either no profits or less than ordinary profits, irrespective of whether it was designed or not.

an appeal to the High Court. The appellant's argument was that transfer pricing is simply a reference to the price at which related parties transfer goods and services to each other. In allowing the appeal, the court held that in the absence of rules in the Income Tax Act which should give guidance on how the provisions at Section 18 (3) should be applied, OECD guidelines should apply, and in particular, guidelines on how arms length prices are to be determined. In his ruling Alnashir Visram J while dismissing the Respondents argument had this to say:

"I have noticed that the very lengthy submissions made by UKL on guidelines adopted by other countries have been ignored by the respondent on the basis that these simply do not apply to Kenya. Now these guidelines do not form the laws of the countries in question. They are simply "guidelines", guiding the world of business that is business enterprises and the taxing authorities of those countries in arriving at proper Transfer Pricing principles for the purposes of computation of income tax. I am, therefore, unable to accept the argument that in view of the alleged clear wording of section 18 (3) of the Act, no guidelines are necessary here in Kenya. That is rather simplistic, and devoid of logic. We live in what is now referred to as a "global village". We cannot overlook or sideline what has come out of the wisdom of tax payers and tax collectors in other countries. And especially because of the absence of any such guidelines in Kenya, we must look elsewhere. We must be prepared to innovate, and to apply creative solutions based on lessons and best practices available to us. That is indeed how our law will develop and our jurisprudence will be enhanced. And that is also how we shall encourage business to thrive in our country.

Therefore, I cannot ignore the time-tested experiences and best practices of others, in the argument that section 18(3) of the Act brooks of no ambiguity and it is unnecessary to look elsewhere. That would be too limiting an approach to take.”

KRA's reaction to losing the case for lack of transfer pricing rules was to amend Section 18 of the Act by introducing a new subsection 18 (8) which gave the Minister power to make rules under Section 18 to issue guidelines for the determination of the arm's length value of a transaction for purposes of this section; or specify such requirements as he may consider necessary for the better carrying out of the provisions of this section. Armed with this new power, the government then promulgated the transfer pricing specific anti-avoidance rules through Legal notice No. 67 of 2006 published under the Income Tax Act, becoming operational w.e.f. 1st July 2006. This was in realization of the fact that a general anti-avoidance provision (GAAP) under Section 18 (3) was incapable of dealing with transfer pricing. It was therefore considered that in order to adequately deal with transfer pricing(GAAP), specific anti-avoidance rules (SAAR) had to be put in place to guide both taxpayers and revenue authorities in determining whether transfer pricing arises, and the methods to be applied by related persons in determining the arms length prices of goods and services involving them.

4.2.2.3 The Rules

Under the Rules, the following terms have been defined: “arm's length price”; “comparable transactions” and ; “Controlled transaction”. As earlier said section 18 (3) of the Income Tax Act is the general anti-avoidance provision dealing with transfer pricing and its concern is with a resident person who is in the following circumstances:- (a) He is a *resident* person carrying on a business in Kenya; (b) He carries on that business *together* with a *non-resident*

person; (c) He is *related* to that non-resident; (d) The business is *arranged* in such a manner that it produces to the resident person either *no profits or lesser profits* than would have been expected to accrue to the resident person had there been no such arrangements. (e) Had the business that is conducted been between *independent* unrelated persons dealing at *arms length*, the amounts of profits accruing to the resident person would be more than that produced to him but for the reason that he is carrying on business with a related non-resident person.

Pursuant to the powers given to the Minister under Section 18 (8), the following methods contained in the Act, and which are a replica of OECD guidelines¹⁵⁵ were promulgated for purpose of determining transfer prices between related resident and non-resident persons.

(a) Cup Method

The Comparable Uncontrolled Price (CUP) method, is the first method which consist of comparing the price charged for goods, or services transferred in a comparable uncontrolled transaction. CUP Method is the most reliable method because it is direct. The only problem with it is that it may be unavailable. A tax authority may not find suitable comparables. It may not also be able to have identical conditions or circumstances that would be comparable. An enterprise selling goods in country A would for example face more challenging conditions than if it were selling a similar good in country B, the conditions would therefore be unidentical.¹⁵⁶

¹⁵⁵ Article 9 of OECD Transfer Pricing guidelines.

¹⁵⁶ OECD Centre for Tax Policy and Administration, "Auditing Multinational Enterprises, Transfer Pricing Methods", (Meeting of the Advisory group for co-operation with non-OECD Economies, Vancouver, Canada, 29th -31st March 2010. Document 9, Improving the Relevance and applicability of guidance on transfer pricing)

(b) Cost plus method

The cost plus method, is the second method which may be used more appropriately where the functions of manufacturing, retail and distribution or service provision can be benchmarked. Cost plus method is less appropriate to use where the manufacturer owns valuable intangibles.¹⁵⁷

(c) Resale price method

The resale price method, is the third method and is mostly used for a sales distribution agency, and comparisons are made between the gross profits made by our taxpayer and that made by the comparable party. Resale price is used more ideally where functions of sales and distribution can be benchmarked.¹⁵⁸

(d) Profit split method

The profit split method, is the fourth method in which comparisons are made at the level of overall profits split between the parties.

The profits that are split among related entities are compared with the profit among independent parties which are in a joint venture.¹⁵⁹

(e) Transnational net margin method (TNMM)

Transnational net margin method,¹⁶⁰ is the fifth method in which a comparison is made at the level of operating margin realized by our taxpayer and that realizable and that realizable by comparable parties. It is normally expressed as operating profit as a percentage age of turnover, costs, or other measures such as assets.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid.

¹⁶⁰ Ibid.

(f) Any other method as may be prescribed by the Commissioner from time to time, where in his opinion and in view of the nature of transactions, the arms length price cannot be determined using any of the methods contained in the above 5 guidelines.

4.2.3 Conclusion

From the foregoing it can be discerned that these transfer pricing specific anti-avoidance rules were designed to deal with a specific avoidance area, “transfer pricing”. These rules are therefore not all catching in the manner GAAR are intended, but only serve to apply to the specific concern of transfer pricing.

4.3 COUNTRIES WITH GAAR – APPLICATION OF GAAR

4.3.1 Australia

4.3.1.1 Introduction

Australia is one of the countries that has enacted GAAR.

Part IVA provides the general anti-avoidance rule (GAAR) in the Australian income Tax Assessment Act (AITAA) 1936. It gives the Commissioner power to cancel certain “defined benefits” obtained by a taxpayer in connection with a “scheme” where it is concluded objectively that one of the persons who entered into or carried out a scheme, or any part of it, did so for the dominant purpose of enabling a taxpayer to obtain a “tax benefit”.¹⁶¹ Part IVA was introduced by the Income Tax Law Amendment Bill (No. 2) 1981. While introducing the rules, the Minister distinguished between the transactions which were intended that Part IVA would apply, which were described as “blatant, artificial or contrived” and those which it would not, which were described as “ordinary” or “normal commercial” transactions.¹⁶² Prior to 1981, the operative GAAR in Australia was Section 260 of the AITAA. This predecessor

¹⁶¹ Wenk, Paul, “Application of income tax anti-avoidance rule”, (16th May 2007) accessed at <<<http://www.freehills.com.au/1979.aspx>>> on 28th July 2010.

¹⁶² Ibid.

to Part IVA was the much shorter Section 260 of the Act (a provision with antecedents dating to at least 1915 and probably 1895). That section provided that every contract, agreement or arrangement was absolutely void as against the Commissioner of Taxation in so far as it had, or purported to have, a certain purpose or effect. That purpose or effect was described in the section as being any one of:¹⁶³

- (a) *altering the incidence of any income tax;*
- (b) *relieving any person from liability to pay any income tax or make any return;*
- (c) *defeating, evading or avoiding any duty or liability imposed on any person by this Act; or*
- (d) *preventing the operation of this Act in any respect.*

The words of the section were said to be simple and, perhaps as a consequence, carried the risk of a broader application than intended. This, in turn, led to much criticism of the section and to various attempts to give a meaning to its terms that would give it reasonable and predictable application.¹⁶⁴ As long ago as 1921, Knox CJ in *Federal Commissioner of Taxation v. Purcell*¹⁶⁵ said of the precursor to Section 260 of the 1936 Act: “*The section, if construed literally, would extend to every transaction whether voluntary or for value which had the effect of reducing the income of any taxpayer.*”¹⁶⁶ For this reason, the judge sought to construe the section to curb it of unintended excesses. Criticism of the terms in which the anti-avoidance provisions were expressed was sometimes blunt. In *Federal Commissioner of*

¹⁶³ Weldy’s Law Books online. **Part IVA: The general anti-avoidance provisions in Australia taxation law**, (Melbourne University Law Review, Pagone G.T.), December 2003, p.2., accessed at <<<http://www.accessmylibrary.com/article-1G1-115225858/Part-via-general-anti.html>>>. On 4th August 2010.

¹⁶⁴ Ibid.

¹⁶⁵ (1920-1921) 29 CLR 464.

¹⁶⁶ Weldy’s Law Books online, *supra*, note 164 p.1.

Taxation v Newton,¹⁶⁷ Kitto J said “Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the trouble to analyze his ideas and define his intentions with precision before putting pen to paper.” In the same case, Fullagar J¹⁶⁸ said ‘the “purposes” or “effects” which will attract its operation are stated vaguely. If we interpret it literally, it would seem to apply to cases which it is hardly conceivable that the legislature should have had in mind.’¹⁶⁹ These doubts and uncertainties bred the various limitations upon Section 260 that led ultimately to its replacement with Part IVA.¹⁷⁰

4.3.1.2 Part IVA of the Australian Income Tax Act – The GAAR

The application of Part IVA relies upon the existence of “a scheme to which Part IVA applies”. Such a scheme exists where two conditions are satisfied:¹⁷¹ This is where a taxpayer obtains *a benefit* in connection with *a scheme* and having regard to the eight specific matters, it would be concluded that one of the persons who entered into or carried out the scheme or any part of it did so for the dominant purpose of enabling a taxpayer to obtain a tax benefit in connection with the scheme (the purpose test). If there is a scheme to which Part IVA applies, the Commissioner may cancel the tax benefit or part of it,¹⁷² based on the concept of “scheme,” “tax benefit” and “purpose”:

- (a) *Scheme test*: The concept of a “scheme” is defined as including “any scheme, plan, proposal, course of action or course of conduct.”¹⁷³ The Courts have given the concept of scheme a wide meaning. (b) *Tax benefit test*: The concept of a tax benefit for purposes of Part IVA is one which would not have been or might reasonably be

¹⁶⁷ (1958) 98 CLR 1, (Newton’s Case).

¹⁶⁸ Ibid.

¹⁶⁹ Wenk, Paul, *supra* note 161 p.2.

¹⁷⁰ Ibid.

¹⁷¹ Ibid.

¹⁷² Ibid.

¹⁷³ Ibid.

expected not to have been obtained by a taxpayer in the year of income if the scheme had not been entered into or carried out. Consequently it requires a hypothesis to be constructed of the events which would have or might reasonably be expected to have transpired in the absence of the scheme.¹⁷⁴ (c) *The purpose test*: The “purpose test” involves the examination of eight specified factors to reach what the courts have decided to be an “objective” conclusion regarding the purposes of those who were party to a scheme, or part of it.

(b) The eight factors that have to be examined to arrive at a conclusion as to the purpose of the scheme are:¹⁷⁵

- i. the manner in which the scheme was entered into or carried out;
- ii. the form and substance of the scheme;
- iii. the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- iv. the result achieved but for Part IVA;
- v. any change in the financial position of the taxpayer as a result of the scheme;
- vi. any change in the financial position of any person who has who has connection (whether family or business) with the taxpayer of the scheme;
- vii. any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi); and
- viii. The nature of any connection (whether of a business, family or other nature) between relevant taxpayer and any person referred to in subparagraph (vi).

The following two cases may illustrate concepts and factors enunciated above.

¹⁷⁴ Defined at section 177A of Part IVA of AITAA.

¹⁷⁵ Section 177D Part IVA of AITAA.

4.3.1.2.1 *Federal Commissioner of Taxation v Peabody*

*Federal Commissioner of Taxation v Peabody*¹⁷⁶ was a 1994 High Court of Australia tax case concerning certain transactions made by the Peabody family business. The Australian Taxation Office (ATO) sought to apply the Part IVA general anti-avoidance rules of the Income Tax Assessment Act 1936. The facts in *Peabody* were complex.¹⁷⁷ The shares in the Pozzolanic group of companies were held by two controlling interests: 1) TEP Holdings Pty Ltd (T Co) as trustee of the Peabody; 2) Family Trust: 62%; and 3) Mr. Kleinschmidt (Mr. K) and his associates: 38%.¹⁷⁸ The beneficiaries of the trust were the taxpayer (Mrs. P) and her two children. The taxpayer and her husband (Mr. P) were the sole shareholders and directors of T Co.¹⁷⁹ Mr. P sought to purchase the interest of Mr. K to enable a public float of 50% of the group. Mr. K agreed to sell his interest, but two problems were identified. First, the sale price would have to be disclosed in the prospectus for the public float. This was problematic because the shares would probably be offered to the public at a higher price than that agreed between Mr. K and Mr. P. Second, if T Co then sold Mr. K's interest to the public within 12 months, as was intended, the transaction would be subject to considerable "capital gains tax" under Section 26 AITAA.¹⁸⁰ These problems were avoided by the Peabodys using another company, Loftway Pty Ltd (L Co), to purchase Mr. K's shares and then transforming those shares into virtually worthless "Z-class" shares. This would have the effect of making those shares held by T Co in the Pozzolanic group represent 100% of the real value of the group. The purchase was financed by the group's banker, Westpac Banking Corporation, in a manner that effected a considerable reduction in financing costs. The subsequent public float

¹⁷⁶ 94 ATC 4663.

¹⁷⁷ Cassidy Julie, "Peabody V. FCT and Part IVA" (Revenue Law Journal 1995, Volume 5, Issue 2, Article 3), p.198.

¹⁷⁸ Ibid.

¹⁷⁹ Ibid.

¹⁸⁰ Ibid.

of 50% of the shares in P Co was a great financial success.¹⁸¹ The Commissioner included \$888,005 in Mrs. P's income. This amount represented one third of the net capital gain Mrs. P would have realized if T Co had bought and then on-sold Mr. K's shares within 12 months.¹⁸²

For Part IVA to apply there must be:

- a "scheme" as defined in Section 177A(1) and (3);
- the scheme must provide the "relevant taxpayer";
- with a "tax benefit" as defined in Section 177C; and
- the person must enter into the scheme for the "sole or dominant purpose" of enabling the relevant taxpayer to
- obtain a tax benefit: Section 177D.

In relation to these elements, the dispute in *Peabody* raised, among others, five important issues:¹⁸³

- (i) the meaning of "scheme";
- (ii) did the Commissioner or the Court identify the relevant scheme;
- (iii) was it sufficient if tax avoidance tainted only a step in the scheme;
- (iv) how is a tax benefit identified under Section 177C;
- (v) how is the dominant purpose determined.

The Court considered each of these issues:-

(a) A "scheme" is defined in exceptionally broad terms in Section 177A (1):

¹⁸¹ Ibid.

¹⁸² Ibid.

¹⁸³ Ibid.

- i) 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;
- ii) any scheme, plan, proposal, action, course of action or course of conduct.

This definition is extended by Section 177A (3) to include unilateral schemes. On the basis of this the High Court required that the circumstances of the purported scheme be capable “of standing on their own without being robbed of all practical meaning.”

(b) Who identifies the Scheme?

In *Peabody*, the Commissioner identified the scheme as including everything from the purchase of Mr. K’s shares through to the public float.¹⁸⁴

However the High Court judgment contains the following suggestions: (i) the operation of Part IVA is not based upon the Commissioner exercising a discretion under Section 177F (1); (ii) a court may replace the Commissioner’s formulation of the scheme with its own scheme; (iii) the Commissioner is required to identify the scheme and provide particulars of such; and (iv) the Commissioner may rely on alternative formulations of the scheme.

The High Court held that Part IVA depends *on the factual existence of a scheme that provides the taxpayer with a tax benefit, rather than the Commissioner’s opinion as to its existence.*

(Emphasis mine). Hence the Court was not bound by the Commissioner’s formulation of the scheme and, in turn, the Commissioner might rely on any alternative scheme identified by the Court. The Court acknowledged, however, that the Commissioner was required to supply particulars of the scheme relied on as an erroneous identification might lead to the wrongful

¹⁸⁴ Ibid p.201.

exercise of the discretion conferred by Section 177F (1). Where the error goes to the mere detail of the scheme, however, this would not have such grave consequences. While the Commissioner must so identify the scheme, the High Court asserted that the Commissioner could justify an assessment on an alternative basis, which might include a narrower scheme that was part of a broader scheme.

(c) The next issue to be considered was whether a step in the scheme is tainted

While the High Court accepted that the Commissioner may identify alternative schemes, which may include a narrower scheme that is part of a wider scheme, it stressed that the narrower scheme must satisfy the above definition of a scheme. If the purported scheme fails this test "it is not possible to say that those circumstances constitute a scheme rather than part of a scheme". In turn, that part of the scheme may not be isolated from the overall scheme.¹⁸⁵

The High Court rejected the Commissioner's suggestion that Sections 177D and 177A (5) enabled Part IVA to "cover not only a scheme, but any part of a scheme". While Sections 177A (5) and 177D ensure that the dominant purpose under Section 177D may be that held by a person who carries out only part of the scheme, it does not "enable part of a scheme to be regarded as a scheme on its own".

(d) How a benefit is identified under Section 177C.

As noted above, before a scheme may be held to be subject to Part IVA it must provide the relevant taxpayer with a "tax benefit". Section 177C defines "tax benefit" in terms of an amount not included in the relevant taxpayer's assessable income where that amount would or might reasonably be expected to have been included in the taxpayer's income, or the

¹⁸⁵ Ibid p.206.

allowance of a deduction which would or might not have been allowable, but for the scheme.¹⁸⁶ At the Federal Court, the Full Court of the Federal Court had required a greater degree of probability that the income would have been derived, or the deduction not obtained, by the taxpayer but for the scheme. Hill J declared that Section 177C (1) (a) required a "reasonable expectation" in the sense of a reasonable "supposition or hypothesis" that the taxpayer would otherwise derive the income. He stressed that a reasonable expectation was more than a "mere possibility". It requires a "reasonable probability".¹⁸⁷ The High Court agreed with Hill J that a "reasonable expectation requires more than a possibility." It involves a prediction of what may have occurred if the scheme had not been entered into and the "predication must be sufficiently reliable for it to be regarded as reasonable". Applying this test to the facts before it, the High Court agreed with Hill J that it could not reasonably be expected that T Co would purchase Mr. K's shares. First, T Co faced considerable difficulties in financing the purchase of Mr. K's shares. Second, as T Co was a trustee company, it was "far from clear that it could have established any entitlement to a rebate in respect of dividends paid on" Mr. K's shares and this rebate entitlement constituted an integral part of the financing arrangement. Even if T Co was able to avoid this difficulty by purchasing Mr. K's shares beneficially, Mrs. P would not be presently entitled to any of the profits arising from the on-sale of the shares.¹⁸⁸ The only reasonable expectation was, therefore, that L Co would make the profit and there was no reasonable expectation that this would flow to T Co and, in turn, to Mrs. P. While the Commissioner tried to establish that even if L Co was the purchaser Mrs. P might nevertheless have obtained a tax benefit, the Court believed this had not been proven "as a matter of reasonable expectation".¹⁸⁹

¹⁸⁶ Ibid p.210.

¹⁸⁷ Ibid p.211.

¹⁸⁸ Ibid p.212.

¹⁸⁹ Ibid p.213.

(e) Determination of the dominant purpose.

The final issue to be considered was how the dominant purpose underlying the scheme is determined as noted above, Part IVA only applies where, having regard to the eight factors listed in Section 177D(b), it would be concluded that person entered into or carried out a scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit: Section 177D.

The Federal Court held that an adverse finding need not be attributable to each of the eight factors; Hill J believed that particular factors should not be considered in isolation. Rather, regard must be had "to each and every one of the matters referred to in Section 177D (b)" and the relevant purpose should be evaluated by examining those factors for and against the taxpayer.¹⁹⁰ Hill J declared that these eight factors provided an exhaustive list of matters relevant to determining the dominant purpose. Hence this was to occur solely through an objective application of these factors without reference to "the actual subjective purpose of any relevant person". Most importantly, Hill J rejected a suggestion that the predication test was inapplicable to Part IVA. He examined the explanatory memorandum and concluded that Part IVA was intended "to restore the law to what it was thought to be after the decision of the Privy Council in *Newton v Federal Commissioner of Taxation*."¹⁹¹ Hill J concluded his judgment by echoing the sentiments underlying the predication test, assuring 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. Part IVA is no more applicable to such a case than was its predecessor, Section 260."¹⁹² On these facts, Hill J accepted that the scheme as a whole was entered into by Mr. P with a dominant

¹⁹⁰ Ibid p.216.

¹⁹¹ (1958) 98 CLR, 1.

¹⁹² Cassidy Julie, *supra* note 177 p.216.

commercial purpose of acquiring Mr. K's shares and floating the company, and this was confirmed by the High Court.

4.3.1.2.2 *Federal Commissioner of Taxation v. Spotless Services Ltd*

The case of *Federal Commissioner of Taxation v. Spotless Services Ltd*¹⁹³ concerned Part IVA of the Income Tax Assessment act 1936. As indicated, for Part IVA to apply there must be a "scheme" as defined.¹⁹⁴ Which provides the relevant taxpayer with a "tax benefit" as also defined.¹⁹⁵ The person must enter into the scheme for the "sole dominant purpose" of enabling the relevant taxpayer to obtain a "tax benefit" (Section 177D).¹⁹⁶ It is only when these elements are satisfied that the Commissioner may cancel any tax benefit arising from the arrangement.¹⁹⁷ In this case, it is only the last element that was the subject of the appeal to the High Court.

Under Part IVA only applies where, having regard to the eight factors listed at Section 177D, it would be concluded that a person entered into or carried out the scheme for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. The Court cited *Peabody V Federal Commissioner of Taxation*¹⁹⁸ (1993) where it had been held that, the Commissioner must have regard to each and every one of the matters referred to in S. 177D (b) when ascertaining the dominant purpose underlying the scheme. Further, the dominant purpose is to be determined on an objective basis, having regard solely to the factors detailed in 177D (b). Hence strictly, no reference should be made to the subjective motives of the taxpayer.

¹⁹³ (1996) 186 CLR 404.

¹⁹⁴ Sub. Section 177A (1) and (3).

¹⁹⁵ Section 177C.

¹⁹⁶ Section 177D.

¹⁹⁷ Section 177F.

¹⁹⁸ 94 ATC 4663.

In this case of *Spotless* the facts were that the public float of Spotless Services Ltd left the taxpayer companies, Spotless Services Ltd and Spotless Finance Pty Ltd with surplus funds, namely \$40 million to invest in a suitable short term investment vehicle. An investment adviser provided them with an Information Memorandum concerning investing with a bank in the Cook Islands, European Pacific Banking Co Ltd ('EPBCL'). This Memorandum detailed a series of steps that had to be undertaken if the taxpayers wished to invest with EPBCL:

- EPBCL would approach the taxpayers, suggesting they deposit funds with EPBCL;
- the taxpayers would open an account with the Midland Bank in Singapore and another account with EPBCL's parent company, European Pacific Banking Co ('EPBC'), in the Cook Islands;
- the taxpayer would appoint an attorney in the Cook Islands with power to draw funds or cheques upon their EPBC account;
- the taxpayers' funds would be deposited in the Midland Bank account;
- the Midland Bank would then be instructed to transfer such funds to the EPBC account;
- the deposit in the account with EPBC and any subsequent deposit with EPBCL would be secured by a letter of credit issued by the Midland Bank;
- the taxpayers' attorney in the Cook Islands would then draw a cheque on the EPBC account in favour of EPBCL;
- EPBCL would issue a certificate of deposit to the attorney;
- On the maturity of the investment, the attorney would surrender the certificate of deposit and receive back the principal and interest (at a rate 4.5% less than the Australian bank bill buying rate) less Cook Islands' withholding tax at the rate of 5%.

A legal opinion supplied with the Information Memorandum stated that the interest would be exempt from Australian taxation under Section 23(q) AITAA¹⁹⁹ as the steps outlined above would ensure that the source of the interest was the Cook Islands and hence outside Australia. The taxpayer received a telexed offer from EPBCL for the investment of their funds in the manner outlined. The taxpayer companies negotiated a higher rate of interest than that offered by EPBCL (approximately 4% below the Australian bank bill buying rate) and invested the \$40m. Arrangements were made for the deposit of the \$40m for EPBC with Midland for the issue of the letter of credit. They sent one of their officers, Mr. Levy, to Cook Islands as attorney with authority to draw a cheque for \$40m from the EPBC account, deposit the cheque with EPBCL and receive the certificate of deposit. On maturity, and the surrender of the certificate of deposit, the principal (\$40m) and interest (\$2.96m), less withholding tax, were repaid in Australia.

The taxpayer companies claimed in their taxation returns that the interest was exempt from Australian tax under section 23(q) AITAA. The Commissioner issued assessments on the basis that (i) the interest was Australian sourced or (ii) Part IVA applied and rendered the interest assessable. The taxpayers objected and appealed to the Federal Court from the Commissioner's refusal to allow their objections. At the first instance the Court held in the taxpayers' favour. It found that the source of the interest was the Cook Islands, not Australia, and that Part IVA did not apply. In relation to the latter point, Lockhart J believed the Commissioner's formulation of the relevant scheme was too narrow as it excluded integral parts of the whole arrangement and thus did not satisfy section 177A. In light of this conclusion his judgment contains little discussion of the other elements of Part IVA, in particular, the taxpayers' dominant purpose in entering into the arrangement.

¹⁹⁹ This Section exempts foreign source income that is taxed in the source country.

On appeal, a majority of the Court dismissed the Commissioner's appeal. All members of the Court agreed with Lockhart J that the source of the interest was the Cook Islands. The division in the Court stemmed from the application of Part IVA. Both Cooper and Beaumont JJ believed there was a scheme as defined in section 177A and that the taxpayers had obtained a tax benefit, as defined in section 177C, as a consequence of the scheme through the non-inclusion of the interest in their assessable income. They disagreed, however, as to the dominant purpose underlying the arrangement. Beaumont J found that the dominant purpose of the taxpayers in entering into the arrangement was to obtain this tax benefit, thereby satisfying section 177D.

4.3.2 South Africa

4.3.2.1 Introduction – *The old South Africa GAAR.*

South Africa GAAR is contained at Section 80A-L of the South African Income Tax Act. The GAAR was enacted following the repeal of the old GAAR at Section 103 (1) of the South African Income Tax Act (SAITA) which was found to have some weaknesses.²⁰⁰ The old GAAR provided that the Commissioner could only apply Section 103 (1) of the South African Income Tax Act when satisfied that the four sets of conditions existed.²⁰¹

- a) a transaction, operation or scheme had existed;
- b) the transaction, specific or scheme had resulted in the operation, reduction or postponement of a tax liability levied in terms of the Income Tax Act;
- c) the abnormality requirement must be present having regard to its circumstances either in relation to a manner not normally employed for *bona fide* business purposes other than obtaining a tax benefit, or it created abnormal rights and obligations; and

²⁰⁰ Louw, Petrus, Daniel, "The new GAAR – a comprehensive discourse on this statute," (Cape Town, April 2005) p.9.

²⁰¹ Ibid.

- d) The transaction, operation or scheme must have been entered into solely or mainly to obtain a tax benefit.

Such tax benefit would incorporate “any avoidance, postponement or reduction of liability for payment of any tax, duty, or levy imposed by this Act or any other law administered by this act or by any other law administered by the Commissioner.”²⁰² Once established, Section 103 (4) of the South African ITA would place the onus on the taxpayer to prove that the sole or main purpose of the transaction was other than to avoid tax.²⁰³ The old GAAR was criticized by South Africa Revenue Services (SARS) for being an ineffective deterrent. In addition SARS held that where a transaction was normally employed for *bona fide* purposes, such particular form of transaction was usually “hijacked” and widely used for tax avoidance, and that such transactions had the potential of gaining commercial acceptability, citing plausible *bona fide* business purposes and to such extent, their utilization may become “normal” and every one would do it in defense.²⁰⁴ It has been suggested that following the judgment in *Conhage* case²⁰⁵ where the court held that where a dual purpose exist for entering into a transaction, SARS could not attack under Section 103 (1) if the main reason for entering into such a transaction was business and commercially oriented. The Court had reiterated that although Section 103 (1) was designed to enable the Commissioner to deal with tax avoidance schemes in an effective manner, it could only operate in the circumstances stipulated in the provisions of South Africa Income Tax Act.²⁰⁶

²⁰² Ibid, p.10.

²⁰³ Ibid.

²⁰⁴ Ibid.

²⁰⁵ C.I.R v. Conhage (Pty) Ltd (Formerly TYcon (Pty) Ltd, 19988 (4) SA 1149 (SCA), 1999 173, 1999 (12) JTLR 337

²⁰⁶ Louw, Petrus, Daniel, *supra* note 200 p.17.

4.3.2.2. The new South Africa GAAR

Consequence upon this, the new GAAR was enacted and is contained in Section 80A to 80L inserted by Section 34 (1) of Act 20 of 2006 and applies to any arrangement (or any steps therein or parts thereof) entered into on or after November 2, 2006. Conversely, the old GAAR would apply to a transaction, operation or scheme entered into before 2nd November 2006. This means that the old GAAR does not apply to instances where part of a transactions, operation or scheme was entered into before 2nd November 2006 which contained steps or parts of such arrangement concluded after that date.²⁰⁷

4.3.2.2.1. Definitions and new components in South Africa GAAR.

The new GAAR introduced a series of new definitions set out in Section 80L that defined the concepts “arrangements,” “avoidance arrangement”, “impermissible avoidance arrangement,” “party”, “tax”, “tax avoidance”. The new GAAR represents a restructuring of the now repealed Section 103 (1), and while retaining certain conceptual components of Section 103 (1), it introduces a number of new components which include:

- a) The “Commercial substance” test that will be measured against a number of non-exclusive indicators.²⁰⁸
- b) The misuse or abuse of the provision within the SITA.²⁰⁹
- c) Widening the Commissioners remedies and making them less vague.²¹⁰
- d) The ability to apply the provisions of the new GAAR to individual steps within a larger scheme and to present the Commissioner with an option whereby he could

²⁰⁷ Ibid.

²⁰⁸ Section 80A (a)(ii)-taking into account Section 80C of SAITA.

²⁰⁹ Section 80A (i)(ii) of SAITA.

²¹⁰ Section 80B of SAITA.

apply the new GAAR in the alternative for or in addition to any other basis of raising an assessment.²¹¹

- e) Introducing a “connected persons” test and the concept of accommodation or tax indifferent parties;²¹² and
- f) Introducing the notice provisions and affording the taxpayer the reasons why the GAAR provisions should not be applied.

The new South Africa GAAR therefore requires three elements to be present.²¹³

- An “avoidance arrangement” must be present.
- The “sole or main purpose” of such avoidance arrangement must have been to obtain a “tax benefit”.
- In addition to obtaining a tax benefit, one of the tainted elements must be present, which are – the “abnormality” element, or “lack in commercial substance” element or “misuse or abuse” of the provisions of the Act “element.”

4.3.2.2.2. *Avoidance arrangement*

Section 80 L has defined an “arrangement” as any transaction, operation, scheme, agreement or undertaking (whether enforceable or not) including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property. Should such arrangement result in a “tax benefit”, such arrangement would constitute an “avoidance arrangement.”²¹⁴ It appears that the expansion of the word “arrangement” in the definition is useful in the sense that on the part of the Commissioner and the taxpayer, it draws the need to identify precisely the transaction, operation or scheme, to which the steps or parts of a scheme the

²¹¹ Section 80I of SITA.

²¹² Section 80E of SITA.

²¹³ Louw, Petrus, David, *supra* note 200 p.22.

²¹⁴ *Ibid.*

Commissioner has applied the GAAR. Moreover the arrangement need not be in writing. It could be a verbal understanding or agreement.

4.3.2.2.3. Sole or main purpose test

As in Section 177D of Part IVA of the Australian ITAA discussed above, the sole or dominant purpose to which GAAR refers, the South African GAAR section provides that the “scheme” must have been entered into for purpose of obtaining a tax benefit - the test is applied by having regard to the manner in which the scheme was implemented, the consequential effects of such schemes, and the connection between the parties.²¹⁵ The position with South Africa GAAR is also similar to Canadian GAAR Section 245 (3) discussed below, which provides for the transaction to have been reasonably “considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax advantage.”²¹⁶

4.3.2.2.4 Tax benefit

The term “tax benefit” is not only a requirement for an “arrangement” to be deemed an “avoidance arrangement”, but also arises in the preamble to Section 80A. Moreover, for the new GAAR to be invoked, an arrangement must result in a tax benefit, and, the main purpose of such arrangement must be to obtain a tax benefit.²¹⁷ Section 80L defines “tax” to include ‘any tax, levy or duty imposed by this Act or any other law administered by the Commissioner’.²¹⁸ A “tax benefit” includes any ‘avoidance, postponement or reduction of any liability for tax’. The avoidance, postponement, or reduction of a tax liability for any of the

²¹⁵ Ibid.

²¹⁶ Ibid.

²¹⁷ Ibid p.22.

²¹⁸ Other taxes administered by the Commissioner include Estate Duty under the Estate Duty Act, Value-added tax under the Value-Added Tax Act, stamp duty under the Stamp Duties Act, marketable securities tax under the under the Uncertified Securities Tax Act, customs and excise duties under the Customs and Excise Act, and skills development levies under the Skills Development Levies Act.

taxes, levies, or duties, would constitute a tax benefit, and, could trigger the new GAAR in relation to income tax provided that a tax benefit in relation to income tax exists as well.²¹⁹ In determining the existence of a tax benefit, no defined tests exist. In *ITC 1625*, the judgment held that a possible test to apply in determining such existence was whether the taxpayer would have suffered tax but for the transaction;²²⁰

The onus would rest on the Commissioner to show that a tax benefit has arisen as a result of an arrangement. Hence, the presence of the so called “but-for” test should be for him to establish, and the nature of an alternative position in order to quantify the tax benefit must be sufficiently clear in his mind.²²¹ In terms of section 82 of the ITA the burden of proof in all disputes is placed on the taxpayer. However, the judgment in the *Conhage*²²² case held that Section 82 does not apply to Section 103 (1). Moreover, it was incumbent on the Commissioner to establish the facts upon which he had invoked the old GAAR, subject only to the proviso that as soon as the tax avoidance effect of the transaction was proved, the onus shifted to the taxpayer to prove the main purpose was not tax avoidance.²²³ By contrast, there is equivalent wording in the new GAAR indicating that Section 82 does not apply to it, and should the courts follow such approach, the onus will rest on the taxpayer to prove that at least one of the requirements for the application of the GARR is missing.

4.3.2.2.5. Presumption of purpose

Section 80G (1) provides that once SARS has established the existence of an “avoidance arrangement”, the presumption is created that the sole or main purpose of the avoidance arrangement was to obtain such tax benefit unless the taxpayer can prove to the contrary. As

²¹⁹ Louw, Petrus, Daniel, *supra* note 200 p.18.

²²⁰ 59 SATC 383.

²²¹ Louw, Petrus, Daniel, *supra* note 200 p.19.

²²² *supra* note 209.

²²³ Louw, Petrus, Daniel, *supra* note 200 p.21.

regards such purpose, Lord Devlin said the following in *Chandler v Director of Public Prosecutions*.²²⁴ “a purpose must exist in the mind. It cannot exist somewhere else.” Such presumption, and its consequential rebuttal, could arise in relation to the entire arrangement, or, in respect of any part or any step thereof. Where, for instance an arrangement has a main business purpose, and a subsidiary step thereof was inserted for tax efficiency, such subsidiary step would fail this test, and would then be considered under the “tainted element” tests.

Notwithstanding the above, and the “choice principle” summarized by the *IRC v Duke of Westminster*,²²⁵ the new presumption contained in section 80G places a heavy burden of proof on the taxpayer. The judgment in *Ovenstone v SIR*²²⁶ held that in determining a sole or main purpose, the time of implementation of such arrangement must be looked to in determining the purpose, but had held true in a subjective test. The taxpayer must now not only provide compelling reasons for entering into such arrangements, but must possibly satisfy a court that reasonably considered in light of the relevant facts and circumstances’, the sole or main purpose was other than a tax benefit.²²⁷

4.3.2.2.6. Requirements of “tainted elements”

There is also a requirement that onus as to proving the existence of the “tainted elements” falls upon SARS, but that SARS will be assisted in discharging such onus to the extent that they would be able to point to the indicators contained in section 80C to 80E that the onus of proof that tax avoidance was not the sole or main purpose falls on the taxpayer, but SARS must establish the prevalence of the “tainted elements”, for the successful application of

²²⁴ (1962) AER 142 (HL).

²²⁵ 1936, 19 TC 490.

²²⁶ 1980 (2) SA 721 (A), 42 SATC 55, 1980 Taxpayer 166.

²²⁷ Louw, Petrus Daniel, *supra* note 200 p.25.

section 80A.²²⁸ Part II A defines an “impermissible avoidance arrangement” as any avoidance arrangement described in Section 80A has four requirements to determine whether an arrangement is an impermissible or tax arrangement:²²⁹

1. An avoidance arrangement (as defined) is entered into or carried out;
2. It results into a tax benefit;
3. Any one of the following tainted elements is present;
 - abnormality regarding means, manner, rights or obligations;
 - lacks commercial substance (as defined) in whole or in part;
 - creation of non-arm’s length and obligations and lacks statutory purpose; and
 - Misuse or abuse of any provisions of the Act (including Part II A).
4. The main or sole purpose is to avoid tax.

4.2.3 New Zealand

4.3.3.1 Introduction

Section BG 1²³⁰ of the New Zealand Income Tax Act 2007 deals with general anti-avoidance rules. New Zealand and Australia are both common law jurisdictions with general anti-avoidance rules (GAAR), but there are interesting differences in how the courts of each jurisdiction have interpreted and applied the rules.²³¹ New Zealand’s general anti-avoidance rule states that a tax avoidance arrangement is void as against the Commissioner of Inland Revenue and section BG 1(2) allows the Commissioner to counter the tax advantage obtained by a taxpayer from a tax avoidance arrangement. “Arrangement” is defined broadly in

²²⁸ Ibid.

²²⁹ Ibid p.26.

²³⁰ Under New Zealand Income Tax Act, Sections are numbered A1, A2, AA1, and BC1 – in that manner and BG1 are the sections that deal with anti-avoidance measures.

²³¹ Prebble John, Prebble Zoe, “Comparing the General Anti-Avoidance Rule of Income Tax with the Civil Law doctrine of Abuse of Law”, (New Zealand, Bulletin for International Taxation, April 2008) p. 7. Electronic copy available at <<<http://ssrn.com/abstract=1605483>>>.

Section YA 1 as “an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect”.²³²

Tax avoidance includes directly or indirectly altering the incidence of any income tax or relieving or reducing any income tax liability (Section YA 1). A tax avoidance arrangement is an arrangement that directly or indirectly has tax avoidance as its purpose or effect or has tax avoidance as one of its purposes or effects, which purpose or effect is not merely incidental (Section YA 1).²³³

4.3.3.2. Interpretation of Section BG 1

A literal interpretation of New Zealand’s legislation would suggest that an individual who, for instance, claims a rebate in respect of a charitable donation is avoiding tax. It is clear that Parliament cannot have intended the rebate claim to be avoidance; rather, Parliament intended to encourage charitable donations.²³⁴ If interpreted literally, the general anti-avoidance rule does not distinguish between acceptable tax mitigation and unacceptable tax avoidance. In light of this consideration, the courts have developed a range of methods for reading down the literal effects of the rule.²³⁵

Generally speaking, if there are two different ways to carry out a transaction and one of them involves paying less tax and if the lower-taxed arrangement is chosen, it will not be struck down for that reason alone as explained by Lord Diplock in *Europa Oil (NZ) Limited v. Commissioner of Inland Revenue (No. 2)*.²³⁶

²³² Ibid.

²³³ Ibid.

²³⁴ Ibid p.8.

²³⁵ Ibid.

²³⁶ (1976) 1 WLR 464, 475 Lord Diplock (Pc).

4.3.3.2.1 Form and substance: the basis of two dichotomies

Formerly, the courts assessed whether an arrangement had a tax avoidance purpose on the basis of its legal form, that is, by looking chiefly at the legal rights and obligations established by the arrangement. For example, in *Europa Oil (NZ) Limited*,²³⁷ Lord Diplock, citing *Inland Revenue Commissioners v. Duke of Westminster*²³⁸, said that “taxation by end result, or by economic equivalence, is not what the anti-avoidance section achieves”, and he suggested that one must look at the legal rights and obligations that arise under the arrangement, not at its economic consequences. This has the effect of reading down the literal effects of Sec. BG 1, which, interpreted literally, is more concerned with matters of substance than of form. Modern cases, however, generally treat Sec. BG 1, in large effect, as a “substance over form” provision.²³⁹

4.3.3.2.2 Legal form and legal substance

The concepts of form and substance give rise to two dichotomies. The first dichotomy is between legal form and legal substance. When analyzing an arrangement, one can look at its legal form, that is, the legal label given to the arrangement. But alternatively, one can look at its legal substance, that is, the true legal rights and obligations created by the arrangement. Legal form and legal substance can diverge. For instance, in *Ensign Tankers (Leasing) Limited v. Stokes (HM Inspector of Tax)*²⁴⁰, the House of Lords held that a non-recourse loan was, in legal substance, a partnership.²⁴¹

²³⁷ Ibid.

²³⁸ (1976) 1WLR.

²³⁹ Prebble John, Prebble Zoe, *supra* note 231, p.8. The authors have given examples of *Commissioner of Inland Revenue v. Challenge Corporation Limited* (1986) 8 NZTC 5,001 (CA); and *Accent Management Ltd v. Commissioner of Inland Revenue* (2007) BCL 728 (CA). But see *Peterson v. Commissioner of Inland Revenue* (2006) 3 NZLR 433 (PC).

²⁴⁰ (1992) BTC 110 (HL).

²⁴¹ Prebble John, Prebble Zoe, *supra* note 231, p.8.

4.3.3.2.3 *Legal substance and economic substance*

The second dichotomy is between legal substance and economic substance. Legal substance is the element common to both dichotomies. The legal substance of an arrangement is its impact on the taxpayer's legal rights and obligations. Economic substance, on the other hand, concerns the economic effect of an arrangement. The case of *Commissioner of Inland Revenue v. Wattie*²⁴², although not an avoidance case, demonstrates this dichotomy.²⁴³

The issue was whether a lease inducement paid to the taxpayer was taxable. The legal substance of the payment was that it was a premium paid by the landlord to attract the tenant; such a premium is not taxable. The economic substance of the payment, however, was that it was a rent subsidy, which is taxable. The Privy Council followed the legal substance and held that the payment was a premium and therefore not taxable.²⁴⁴

4.3.3.2.4 *The "tax avoidance purpose" test*

A second method adopted by the New Zealand courts to read down the literal effects of the general anti-avoidance rule is to look at the purpose or effect of the arrangement. To constitute tax avoidance, an arrangement must have a tax avoidance purpose or effect that is more than merely incidental.²⁴⁵ The pursuit of a valid commercial objective that incidentally results in a reduction in tax liability is not tax avoidance. The tax avoidance purpose test is objective.²⁴⁶ The test is whether the parties to the transaction would have entered into it even in the absence of a tax advantage. If the parties to the transaction would have entered into it even in the absence of the tax advantage, it does not have a tax avoidance purpose. The operation of the tax avoidance purpose test is illustrated by *Case V20* decided by the Taxation

²⁴² (1998) 18 NZTC 13,991 (PC).

²⁴³ Prebble John, Prebble Zoe, *supra* note 231, p.8.

²⁴⁴ *Ibid* p.9.

²⁴⁵ *Ibid*.

²⁴⁶ *Commissioner of Inland Revenue v. Challenge Corporation Limited*.

Review Authority.²⁴⁷ There, a dentist left a partnership and established a trading trust structure whereby he was employed by the trust. There was a minor tax saving in the 1995 income year. Judge Barber held that there was no tax avoidance because the tax advantage was merely incidental to the transaction's commercially valid chief objectives to protect assets and limit liability.²⁴⁸

Nevertheless, the magnitude of the tax advantages attributable to a scheme has been held to be relevant to the tax avoidance purpose test. In *Case W33*,²⁴⁹ the Taxation Review Authority dealt with the same dentist in the 1996 income year, during which there was a larger tax saving. The larger tax saving influenced Judge Barber to hold that the tax avoidance in that year was more than merely incidental.²⁵⁰ Although *Cases V20* and *W33* concerned the same arrangement and the same taxpayer, Judge Barber held that the arrangement in the second case had a tax avoidance purpose.²⁵¹

4.3.3.2.5 Scheme and purpose of the Income Tax Act 2007

In determining whether a transaction has a tax avoidance purpose, a third method used by the courts to read down the literal effects of Sec. BG 1 is to refer to the scheme and purpose of the Income Tax Act 2007. Arrangements that are within the scheme and purpose of the Act do not constitute tax avoidance. For instance, using a loss-attributing qualifying company (i.e. a company that is transparent for certain tax purposes) to attribute losses to shareholders is within the scheme of the Act and the intention of Parliament. However, conduct such as

²⁴⁷ (2002) 20 NZTC 10,233 (TRA).

²⁴⁸ Prebble John, Prebble Zoe, *supra* note 231, p.9.

²⁴⁹ (2004) 21 NZTC 11,321 (TRA).

²⁵⁰ Prebble John, Prebble Zoe, *supra* note 231, p.9.

²⁵¹ *Ibid* p.9.

inserting a related entity into a transaction in order to create artificial deductions is outside of the scheme of the Act and constitutes tax avoidance.²⁵²

4.3.3.2.6 Uncertainty and general anti-avoidance rules

The courts have developed methods to read down the literal effects of Sec. BG 1. In doing so, they have gone some way towards setting out the dividing line between acceptable tax mitigation and unacceptable tax avoidance. In spite of these efforts, however, the scope of New Zealand's general anti-avoidance rule remains uncertain.²⁵³ This uncertainty is not necessarily a negative feature of the general anti-avoidance rule. A degree of uncertainty is necessary for a general anti-avoidance rule to operate as intended. If such a rule tried to define tax avoidance with absolute certainty, tax avoiders would soon find new strategies that fell outside the definition. Concrete rules are the most open to avoidance; thus, a general anti-avoidance rule must indeed be general if it is to "catch tax" all avoidance arrangements and have deterrent value. With generality comes uncertainty.²⁵⁴

4.3.4 Canada

4.3.4.1 Introduction

Canada too has general anti-avoidance rules (GAAR) which are contained at Section 245 of the Canadian Income Tax Act (CITA). This Section is supplemented by many "specific" anti-avoidance rules that are intended to discourage particular types of transactions from being undertaken. Unlike SAAR, the GAAR are general rules which are intended to apply where there are offensive transactions which the specific rules do not "catch" The Canadian GAAR are elaborate and comprehensive rules and provide that where a transaction is an "avoidance

²⁵² Ibid p.10.

²⁵³ A taxpayer v. Commissioner of Inland Revenue (1997) 18 NZTC 13,350 Tipping J (CA).

²⁵⁴ Prebble John, Prebble Zoe, *supra* note 231, p.12.

transaction” the consequences to the person shall be determined as is reasonable in order to deny a tax benefit that for the section would result from that transaction.

An avoidance transaction is one which results in a tax benefit, unless the transaction may reasonably be considered to have been primarily undertaken for *bona fide* purposes other than to obtain a tax benefit.²⁵⁵ A “tax benefit” is any reduction, avoidance, or even deferral of tax, among other things.²⁵⁶ Tax benefit means the amount of income, taxable income...tax or other amount payable by or refundable to the person...or any amount that is relevant for the purpose of computing that amount. The adjustment to tax consequences will be what is reasonable in the circumstances and may take the form of inclusion in income, a denial of a deduction, a denial of a tax credit, a recharacterization of the nature of payment or simply ignoring the application of a particular section of the Act.²⁵⁷ Although the Canadian Income Tax Act (CITA) defines the terms “tax benefit”, “avoidance transaction”, and “series of transactions”, it is up to the courts to decide if these requirements are satisfied in the context of specific transactions and whether an avoidance transaction results in a misuse or abuse within the meaning of the statutory rule. In its unanimous decisions in *Canada Trustco Mortgage Company v. Canada*²⁵⁸ and *Mathew v. Canada*,²⁵⁹ the Supreme Court of Canada considered each of these issues and provided important guidance on the interpretation and application of the GAAR.²⁶⁰

²⁵⁵ Section 245 (3) of the Canadian Income Tax Act 1988.

²⁵⁶ Section 245 (1) of the Canadian Income Tax Act 1988.

²⁵⁷ Section 245 (5) of the Canadian Income Tax Act 1988.

²⁵⁸ (2005) 2 S.C.R 601.

²⁵⁹ (2005) 2 S.C.R 643.

²⁶⁰ Duff, David, G, “The Supreme Court of Canada and the General Anti-Avoidance Rule: Canada Trustco and Mathew.” (Faculty of Law, University of Toronto Bulletin, February 2006), available at <<<http://sssrn.com/abstract=1142962>>>.

The schemes and arrangements in the above cases were just too complex but a few facts of two of the cases are given and the decisions of the courts as well.

4.3.4.2 Canada Trustco v. Canada

In *Canada Trustco*, the taxpayer was a large diversified financial institution holding a portfolio of loans and leases to government agencies and large companies and carrying on business as a mortgage lender. In order to obtain additional Capital Cost Allowance (CCA) deductions to shelter leasing income that it anticipated, it entered into several transactions with other parties, which were prearranged and completed on 17 December 1996.

1. First, the taxpayer borrowed Canadian Dollars (CAD) 97.35 million from the Royal Bank of Canada (RBC).
2. Second, the taxpayer used these borrowed funds and CAD 22.65 million of its own money to purchase a number of trailers from a US company called Transamerica Leasing Inc. (TLI) at a fair market value of CAD 120 million.
3. Third, the taxpayer leased these trailers to a Jersey company called Maple Assets Investments Limited (MAIL) under an agreement whereby MAIL could purchase the trailers.
4. Fourth, MAIL subleased the trailers back to TLI on terms that were essentially identical to those in the head lease.
5. Fifth, TLI transferred CAD 116.4 million to MAIL in prepayment of its obligations under the sublease.
6. Sixth, MAIL deposited CAD 97.35 million of these prepaid funds with RBC for the purpose of making lease payments to the taxpayer and used the remainder to purchase a Government of Ontario bond maturing on 1 December 2005 at CAD 33.5 million, which it pledged to the taxpayer as security for its purchase option under the lease.

7. Finally, the taxpayer assigned all the lease payments owing from MAIL to RBC, which agreed to apply the assigned payments against the installments of interest and principal owing under its loan to the taxpayer and to limit its recourse in respect of the loan to these payments.

The Minister (or Commissioner) disallowed the CCA deductions on the grounds that the taxpayer had either failed to acquire title to the trailers or was subject to the GAAR. The Crown abandoned the first of these arguments before the hearing at trial and proceeded solely on the basis that the GAAR applied to disallow the CCA deductions, arguing that:

1. the taxpayer obtained a “tax benefit” in the form of a tax deferral resulting from the CCA deductions;
2. the transactions constituted a “pre-ordained series” that was “entered into primarily for the purpose of obtaining the tax benefit and sheltering other income”; and
3. The arrangement resulted in a misuse or abuse of the CCA regime because the taxpayer did not incur any “true cost” to acquire the trailers and a misuse or abuse of the exempt property exception to the specified leasing property rules because the sale-leaseback transactions did not provide financing for the lessee “to acquire assets for operational purposes”.

(a) Decision in Canada Trustco v. Canada

The case went all the way from the Tax court, to the Federal Court of Appeal upto the Supreme Court of Canada. In dismissing the Crown’s arguments, the Court relied on textual,

contextual, purposive and consequential considerations to favour the taxpayer's interpretation of the relevant statutory provisions.²⁶¹

1. Textually, the CCA provisions refer only to the cost of depreciable property "in the well-established legal sense of the amount paid to acquire the assets", not amounts at "economic risk".
2. Contextually, the conclusion that "cost of depreciable property" generally means the amount paid for the property is supported by other CITA provisions that make adjustments to the cost of this property in specific circumstances. Furthermore, the Court stated that the Tax Court judge held that the purpose of the CCA provisions "as applied to sale-leaseback transactions" is "to permit deduction of CCA based on the cost of the assets acquired".
3. Finally, to "rewrite" the CCA provisions to interpret cost to mean amounts economically at risk "would be to invite inconsistent results" which would "vary with the degree of risk in each case" and "offend the goal of the Act to provide sufficient certainty and predictability to permit taxpayers to intelligently order their affairs".

4.3.4.3 *Mathew v. Canada*

In *Mathew*, the taxpayers were individual and corporate investors who acquired interests in a partnership called SRMP Realty and Mortgage Partnership (SRMP), which had itself acquired a 99% interest in another partnership called STIL II Partnership (STIL II), to which Standard Trust Company (Standard) had transferred various mortgages whose value was substantially less than their original cost. As Standard was insolvent and had no income

²⁶¹ Duff David, G. Prof, *supra* note 260 p.68.

against which the accrued losses could be deducted if realized, the company's liquidator devised a plan whereby:

1. Standard would incorporate a wholly-owned subsidiary;
2. Standard and the subsidiary would form a partnership;
3. Standard would transfer its mortgage portfolio to this nonarm's length partnership, relying on the stop-loss rule in ITA, Section 18(13) as it read at the time to preserve the accrued losses in the hands of the partnership; and
4. Standard would sell its partnership interest to arm's length investors who could use the losses to shelter other income when they were realized by the partnership and flowed through to the partners.

Pursuant to this plan, Standard carried out the first three transactions in October 1992 and the fourth in May 1993. Standard incorporated a wholly-owned subsidiary on 21 October 1992, entered into a partnership agreement with the subsidiary to create STIL II on 23 October 1992, and transferred various mortgages to STIL II in exchange for a 99% partnership interest on the same day, and sold the 99% interest to an arm's length company called OSFC Holdings Ltd. (OSFC) on 31 May 1993.

In July 1993, OSFC sold its 99% partnership interest to SRMP, whose units were acquired by the taxpayers. At the end of its fiscal year on 30 September 1993, STIL II reported a net loss of CAD 52,674,376 resulting from the sale of some mortgages and a write-down of its remaining inventory of mortgages.

For its fiscal year ending on 31 October 1993, SRMP reported a net loss of CAD 52,384,474, most of which was attributable to its share of the STIL II losses. These losses were allocated among the members of SRMP and deducted in computing their incomes in 1993 and 1994. Diagram 2 shows the transactions in *Mathew*.

The Minister disallowed these deductions on the basis that the transactions were caught by the GAAR. At trial, the Crown argued that the various transactions comprised a series of transactions that resulted in a tax benefit in the form of the deductions claimed by the taxpayers, that the primary purpose of SRMP's acquisition of the 99% partnership interest in STIL II and the taxpayers' acquisition of the units of SRMP was to obtain the tax benefit, and that the transactions resulted in a misuse of CITA, Section 18(13) as it then read and an abuse of the CITA scheme according to which income is computed separately for each taxpayer and the transfer of losses is generally prohibited.

(b) Decision in *Mathew v. Canada*.

As in *Canada Trustco*, the key point at issue in the appeal to the Supreme Court of Canada in *Mathew* was whether the transactions resulted in a misuse or abuse under CITA, Section 245(4). More specifically, the Court asked whether permitting the taxpayers to deduct the partnership losses would "frustrate the object, spirit or purpose" of the specific CITA provisions that give rise to the tax benefit, namely, the stop-loss rule in Section 18(13) and the flow-through rule for partnership income and losses in Section 96(1). Consistent with the "two-part inquiry" that it affirmed in *Canada Trustco*, the Court first interpreted these provisions to determine their object, spirit and purpose and then considered the transactions themselves to determine whether they defeat or frustrate these purposes.²⁶² With respect to

²⁶² Ibid p.69.

the interpretation of Sections. 18(13) and 96(1), the Court employed the “unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer” that it affirmed in *Canada Trustco*. Textually, “it is clear that the preservation of the loss under s. 18(13) is for the benefit of a person or partnership who does not deal at arm’s length with the transferor”. On the other hand, the text of the partnership provisions in ITA, Section 96 contain “no restrictions on loss sharing between partners, except for foreign partnerships under section 96(8)”. Nonetheless, the Court continued, a broader contextual analysis of other CITA provisions supports the opinion of the Federal Court of Appeal in *Canada Trustco* that “the general policy of the *Canadian Income Tax Act* is to prohibit the transfer of losses between taxpayers, subject to specific exceptions”. At the same time, “it cannot be automatically inferred from the general policy against the transfer of losses between taxpayers” that the taxpayers cannot deduct the losses that they obtained through the combined operation of CITA, Sections. 18(13) and 96(1). Finally, however, the Court resolved the issue through a purposive analysis of these provisions, explaining that the purpose of the stop-loss rule in section. 18(13) is to deny the loss to the transferor “because it originated and remains in the transferor’s control before and after the transfer”, while the purpose of the loss-sharing rule in section. 96(1) is “to promote an organizational structure that allows partners to carry on a business in common, in a non-arm’s length relationship”. As a result, the Court concluded that “the combined effect of section 18(13) and the partnership provisions do not allow taxpayers to preserve and transfer unrealized losses to arm’s length parties”.²⁶³

Having determined the object, spirit and purpose of the provisions on which the taxpayers relied in order to obtain the tax benefit, the Court had no difficulty in concluding that the

²⁶³ Ibid p.70.

series of transactions resulted in abusive tax avoidance under CITA, Section 245(4).²⁶⁴ As a result, the Court concluded that the taxpayers' appeal should be dismissed.

4.3.4.4. *The Court's Approach to Tax avoidance and the GAAR*

The Court's general approach to tax avoidance and the GAAR began, like many Supreme Court of Canada tax decisions, by affirming the long-standing principle from the *Duke of Westminster*²⁶⁵ case that taxpayers may "manage their affairs" to minimize the tax payable. Turning to the GAAR itself, the Court began by stating that the application of this rule "involves three steps":²⁶⁶ The first step is to determine whether there is a "tax benefit" arising from a "transaction" under section 245(1) and (2). The second step is to determine whether the transaction is an avoidance transaction under section 245(3), in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit". The third step is to determine whether the avoidance transaction is abusive under section 245(4). Observing that all three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit; the Court examined each in turn.

4.3.4.4.1 *Tax benefit*

In both cases, whose decisions were given almost at the same time, the Court stated, that "it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement". Where a taxpayer claims a deduction, however, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. More generally, whether a tax benefit exists is a factual determination, initially by the Minister and on review by the courts, usually the Tax Court. As such, the Court explained:²⁶⁷

²⁶⁴ Ibid.

²⁶⁵ (1936) 19 T.C. 490.

²⁶⁶ Duff David, G. Prof, *supra* note 260 p.62.

²⁶⁷ Ibid p.63.

... the burden of proof is the same as in any tax proceeding where the taxpayer disputes the Minister's assessment and its underlying assumptions of facts. The initial obligation is on the taxpayer to "refute" or challenge the Minister's factual assumptions by contesting the existence of a tax benefit...

In addition, the Court concluded that where the Tax Court determines that there is a tax benefit based on a proper construction of the CITA and findings supported by the evidence, "appellate tribunals should not interfere, absent a palpable and overriding error".

4.3.4.4.2 Avoidance transaction

On examining this aspect, the Court noted that "the function of this requirement is to remove from the ambit of the GAAR transactions or series of transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose consequently addressing the concept of "series of transactions" and the non-tax purpose test.

4.3.4.4.3 Misuse or abuse

On misuse or abuse, the Court in *Trustco* observed that Section 245 (4) raises three central issues which need analysis:

1. the distinction, if any, between a misuse of specific provisions and an abuse of the provisions of the CITA read as a whole;
2. the process for determining whether a transaction is abusive; and
3. the burden of proof for this inquiry.

After its analysis the Court concluded that GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear so that if the existence of abusive tax

avoidance is unclear, the benefit of the doubt goes to the taxpayer. GAAR will only apply a tax benefit where it may reasonably be considered that the transaction were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively.

4.4 COUNTRIES WITHOUT GAAR – APPLICATION OF ANTI-AVOIDANCE JUDICIAL DOCTRINES

4.4.1 United States of America (USA)

4.4.1.1 Introduction

The United States is one of the two jurisdictions discussed in this thesis which combats tax avoidance without having a general anti-avoidance rule (GAAR) or an abuse of law doctrine. From the earliest days of the federal income tax law, the United States courts have felt free to scrutinize a transaction, regardless of its literal compliance with the tax statute, in order to ensure that it had substance and complied not only with the language of the statute but also with its spirit.²⁶⁸

The Sixteenth Amendment authorizing income tax was ratified by the states in 1916. As early as 1935, the Supreme Court, in its landmark decision of *Helvering v. Gregory*,²⁶⁹ applied a judicial *sham* or business purpose doctrine to a transaction for which the taxpayer sought tax-free treatment, even though the transaction complied with the literal text of the 1924 Revenue Act. Emphasizing the legislative purpose of the Act, the Court ruled that the transaction was

²⁶⁸ Prebble John, Prebble Zoe, *supra* note 231, p.27.

²⁶⁹ 69 F.2d 809 (2d Cir. 1934). This is an often cited case decided by U.S Supreme Court. It was based on two legal principles: business purpose doctrine and the substance over form purpose. The business purpose doctrine is essentially that where a transaction has no substantial business other than the avoidance of tax, the tax law will disregard the transaction. The doctrine of substance over form is that a taxpayer is bound by the economic substance of a transaction, where the economic substance varies from its legal form.

invalid for tax purposes notwithstanding compliance with the literal text of the statute.²⁷⁰

Thus, early on, without delay, the courts felt it their duty to ensure that the application of a tax statute required that the *substance* of a transaction, not its *form*, be followed. In doing this, they attempted to ascertain the legislative purpose of the statute and to ensure that the transaction complied with both its text and purpose. The courts invoked various judicially created doctrines, all emanating from the same concern but employing different verbiage in their description and application, to safeguard against transactions elevating form over substance.²⁷¹

As the courts confronted more avoidance cases, they refined and developed further doctrines and sub-doctrines. The *sham* doctrine originally meant all things to all people; it now comprises shorthand phraseology for any number of judicial safeguards – the doctrines of substance over form, step transactions, economic substance, and business purpose.²⁷² These judicial safeguards were soon recognized by most tax practitioners as something they should consider in structuring transactions. Taxpayers and their counsel learned to integrate the common law surrounding the tax law into their tax planning, lest their efforts be undercut and thwarted by these judicial safeguards.²⁷³ After fully signaling the availability of these doctrines and their potential application, the courts experienced a period of relative tranquility regarding the interpretation and application of these judicial doctrines. Practitioners tended to shy away from transactions that might test the boundaries between acceptable tax mitigation and unacceptable tax avoidance.²⁷⁴

²⁷⁰ Prebble John, Prebble Zoe, *supra* note 231 p. 27.

²⁷¹ Ibid.

²⁷² Ibid p.28.

²⁷³ Ibid.

²⁷⁴ Ibid.

4.4.1.2 What did American Courts consider?

First, the court had to find that the taxpayer subjectively had a non-tax purpose for the transaction, and second, there must be an objective showing of a realistic possibility of a pre-tax profit. However, the application and interpretation of this standard were uncertain. The economic substance test has increasingly been endorsed by the lower courts, but this recent formulation of economic substance has not been considered by the Supreme Court. As a consequence, there has been no uniform definition of “economic substance”. It is uncertain whether the test is exclusive or is to be combined with other factors and whether it is disjunctive or conjunctive. The answers given by the courts have varied.²⁷⁵ The confusion continues, with the Circuit Courts of Appeal differing in their formulation and application of the test.²⁷⁶ The first case on whether the anti-avoidance judicial safeguards apply to tax products was *ACM Partnership v. Commissioner*,²⁷⁷ in which the government prevailed. While acknowledging its tax-motivated structuring, the taxpayer sought to justify the tax consequences by reference to other considerations. The efforts were unsuccessful in large measure because the court concluded that the structures were shams, lacking both a business purpose and sufficient economic substance.²⁷⁸

Notwithstanding the government’s success in the ACM type cases, in the great majority of the other cases involving tax products, the taxpayers’ successes have been dramatic, both in number and in the extreme nature of the product’s design. Taxpayer victories include *IES Industries, Inc v. United States*,²⁷⁹ *United Parcel Service of America Inc v. Commissioner*,²⁸⁰

²⁷⁵ Ibid.

²⁷⁶ Ibid p. 29.

²⁷⁷ 157 F. 3d 231 237 (3rd Cir 1998).

²⁷⁸ Prebble John, Prebble Zoe, *supra* note 231 p. 29.

²⁷⁹ 253 F.3d 350 (8th Cir. 2001).

²⁸⁰ 254 F.3d 1014 (11th Cir. 2001).

Black & Decker Corporation v. United States,²⁸¹ *Compaq Computer Corp v. Commissioner*,²⁸² *TIFD III-E v. United States*,²⁸³ and *Coltec Industries Inc v. United States*.²⁸⁴ The *Compaq* decision is worth discussing here.

4.4.1.3 The *Compaq* case

The facts in *Compaq*, in brief, involved the taxpayer's purchase of the stock of a Dutch corporation on which a dividend had been declared. The stock was sold almost immediately, i.e. within one hour, back to the original seller after *Compaq* had become the owner of record. As noted by the Fifth Circuit Court of Appeal, the purchase price was about USD 888 million, reflecting a net dividend of about USD 19 million. The sales price an hour later was about USD 868 million: the purchase price less the net dividend payable to *Compaq*. The transaction costs, the net out-of-pocket costs of participating in the tax-saving device, totaled USD 1.5 million. The transaction produced an overall loss, of which most rational taxpayers would stay clear. However, the motivation for *Compaq*'s participation was the foreign tax credit generated by the 15% withholding tax. The dividend of almost USD 22 million was taxable in the United States; the loss of about USD 19 million on the sale sheltered the related gains from *Compaq*'s other transactions; and the transaction costs were deducted, resulting in additional tax to the United States of about USD 500,000 given *Compaq*'s tax rate of 33%. The overall costs before taking the foreign tax credit into account exceeded USD 2 million (i.e. the transaction costs plus increased tax liability). Nevertheless, as the transaction generated an additional foreign tax credit of over USD 3 million, it produced an overall benefit of about USD 1 million. The investment of pre-tax USD 1.5 million resulted in an

²⁸¹ 88. 436 F.3d 431 (4th Cir. 2006).

²⁸² 277 F.3d 778 (5th Cir. 2001).

²⁸³ 342 F.Supp 2d 94 (D Conn 2004).

²⁸⁴ 91. 62 Fed Cl 716 (2004).

after-tax gain of USD 1 million, which was accomplished in an hour and possessed minimal market risk.

The Tax Court concluded that the transaction lacked both a business purpose and pre-tax profit potential. Nevertheless, the Fifth Circuit faulted the Tax Court's analysis on the basis that it focused on the net, rather than gross, dividend. The Fifth Circuit concluded instead that there was a pre-tax profit of about USD 1.5 million. It further emphasized the taxpayer's lack of control over the market, the possibility, although not a probability, of price fluctuations, and the risk that the dividend might not actually be paid. Accordingly, the Fifth Circuit upheld the transaction.

Repeated proposals to legislate meaning of "economic substance".

Interestingly, even with regard to the heart of the judicially created and contoured safeguard doctrines, there have been repeated proposals to legislate the meaning of "economic substance". While not addressed by the United States House of Representatives, the Senate amended a tax bill in May 2006 in order to provide "Clarification of the economic substance doctrine", given the lack of uniformity in its application. The amendment was dropped in the Conference Agreement. This effort reflects Congress's growing concern with these problems and a willingness to intervene. Judicial safeguards are moving sideways to the legislature and receiving greater attention, not only regarding the definition of such safeguards but increasingly regarding legislation preventing future taxpayer victories on transactions previously allowed by the courts. Simultaneously, the judiciary has become more restrained in applying such safeguards, viewing such matters as no longer within its province.²⁸⁵

²⁸⁵ Prebble John, Prebble Zoe, supra note 231, p. 32.

One could therefore comfortably conclude that United States was tending to shift to the legislative side to provide appropriate safeguard by statute, rather than continue reliance on Courts where such terms like economic substance have not been defined.

4.4.1.4 America enacts GAAR

On 30th March 2010, President Barack Obama signed Section 7701 (0) of the Internal Revenue Code 1986, the United States of America first statutory general anti-avoidance rule, or (GAAR).²⁸⁶ This is a major development in Americas' tax enforcement policy. There appears to be two main reasons that delayed the introduction of GAAR in the U.S. 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 Internal Revenue Service (IRS) was generally able to get by with various forms of economic substance doctrine, but since 2000 IRS has found it increasingly ineffective as seen in *Compaq case*. Secondly, Americans had always considered GAAR as breaching the rule of law.²⁸⁷

Nevertheless, on the face of it the U.S. section 7701 (0) is different from GAAR as we know them. It claims to codify, but instead of codifying, it incorporates judge made law by reference. It does this by applying to “any transaction” to which “economic substance doctrine” is relevant.”²⁸⁸ Section 7701 (0) (5) (A) defines the “economic substance doctrine” as the doctrine that applies to a transaction that “does not have economic substance or (that) lacks a business purpose.” As we know standard GAAR tells the Commissioner that an avoidance transaction is void against him and authorizes him to reconstruct the transaction

²⁸⁶ Prebble John, “Prebble welcomes the US Treasury and IRS to the ranks of GAAR – empowered fiscs”, (John Prebble, Victoria University of Wellington, writes exclusively for Tax Prof Blog). Accessed at <<<http://taxprof.typepad.com/files/prebbleus-gaar-for-txpfblog.pdf>>>. On 8th September 210.

²⁸⁷ Ibid

²⁸⁸ Ibid p.2.

and to tax that notional reconstruction, similarly, the economic substance tells the Commissioner to disregard the parties' legal transactions and instead tax the economic substance that lies behind those transactions.²⁸⁹ Section 7701 (0) (1) contains rules that sharpen the focus of the GAAR. 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 benefit. The relative benefits rule was presumably intended to reverse the result in a case like *Compaq Computer Corp v. Commissioner*.²⁹⁰

Just as the economic substance rule has waxed and waned in the hands of American judges, section 7701 (0) is a true weapon that will prove a powerful weapon in the hands of the Commissioner, and will operate much as GAAR in other common law countries.²⁹¹ The signing of section 7701 (0) is a clear indication that tax jurisdictions are abandoning the judicial doctrinal GAAR for statutory GAAR

4.4.2 United Kingdom (U.K)

4.4.2.1. Introduction

The United Kingdom (like the U.S, until recently) lacks a general anti-avoidance rule. Both countries have relied to a large extent on their judiciary to interpret the statutory provisions in question and to determine whether a transaction constitutes tax avoidance.²⁹² Currently two legislative techniques are employed in the United Kingdom to combat and control tax avoidance. The first is to enact specific legislation and the second is to enact targeted anti-avoidance provisions, also known as "mini general anti-avoidance rules," aimed at deterring

²⁸⁹ Ibid

²⁹⁰ Ibid p.3.

²⁹¹ Ibid p.4.

²⁹² Prebble John, Prebble Zoe, *supra* note 231, p.32.

and countering avoidance in a specific area of the tax system.²⁹³ As mentioned, U.K does not have GAAR but the U.K Courts have developed their own approach namely the sham doctrine.²⁹⁴

4.4.2.2. *Sham doctrine*

According to the *sham* doctrine the Courts will not recognize a transaction that is a sham and will instead impose a tax according to the substance of the transaction. A sham transaction is one in which the parties to the transaction intended to create different rights and obligations from those appearing in the relevant documents and to give a false impression of those rights and obligation.²⁹⁵ The fact that a transaction is uncommercial or artificial does not necessarily mean that it is a sham. The approach to United Kingdom's courts to taxing uncommercial or artificial tax arrangements has evolved over time.²⁹⁶

For many years their approach was permissive of any arrangement that fitted within the language of the legislation even if not within the spirit. The prevailing doctrine was laid down by Lord Tomlin in *IRC v Duke of Westminster*²⁹⁷ where he said:

Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of ingenuity, he cannot be compelled to pay an increased tax.

²⁹³ Ibid.

²⁹⁴ Ibid p.33.

²⁹⁵ Ibid p.34.

²⁹⁶ Ibid.

²⁹⁷ (1936) A.C. 1 (HC).

This permissive approach, sometimes known as “form over substance” survived until the 1980’s when the Courts, confronted by new and sophisticated tax avoidance devices, developed a new approach that was more restrictive of tax avoidance.

But even before the *Duke of Westminster*,²⁹⁸ the Courts were often reluctant to deviate from a strict interpretation of the tax legislation while not necessarily condoning or approving of tax avoidance, or a number of occasions ruled in favour of the taxpayer’s attempts to minimize his liability.²⁹⁹

In *Ayrshire Pullman & Ritchie v. CIR*³⁰⁰ Lord Clyde remarked:-

No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayers’ pockets. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by Revenue.

The standard set in *Duke of Westminster*, coupled with high tax rates in the 1970s encouraged taxpayers to create complex schemes of tax avoidance, many of which were commercially artificial and carried very little financial risk. The problem with *Westminster*, in which payments were made by a taxpayer to domestic employees in the form of deeds of

²⁹⁸ Ibid.

²⁹⁹ Mc Laughlin Mark, “The Ramsay Principle” (Tax Journal), accessed at <<http://www.taxationweb.co.uk/tax-articles/general/the-ramsay-principle>>> on 17 August 2010.

³⁰⁰ (1929) 14T.C. 754.

covenant, but which the House of Lords refused to disregard the legal character (form) of the deeds merely because the same result (substance) could be brought about in another form, was of limited application, since it contained a single tax avoidance step.³⁰¹ The Courts had now to devise new means to deal with pre-arranged avoidance schemes containing a number of steps. In *IRC v Plummer*³⁰² Lord Wilberforce commented that a scheme carried out with “utmost military provision” entitled and required the Court to look at the plan as a whole. In this case, the question was a “circular annuity” plan in which clarity made a capital payment to the taxpayer in consideration of his covenant to make annual payments of income over five years. The House of Lords held the scheme was valid, although subsequent circular annuity failed on the basis of the *Ramsay* principle that was to follow.

It is important to illustrate the UK judicial doctrine by citing some important cases.

4.4.2.3 The Ramsay case

The case of *W.T. Ramsay v. IRC*³⁰³ otherwise referred to as the “*Ramsay* case” or “*Ramsay* principle”, is a celebrated case on tax avoidance and this thesis will not be complete without mentioning it. The tax avoidance scheme under consideration in *Ramsay* was "ready-made", but the approach adopted in this and subsequent cases have significant repercussions for tax planning generally.

In *Ramsay*, the taxpayer company wished to shelter a capital gain. It therefore made two separate loans to a newly-acquired subsidiary company, from funds made available by a finance house. Both loans carried interest. However, the taxpayer company subsequently

³⁰¹ Mc Laughlin Mark, *supra* note 299.

³⁰² (1979) STC 793.

³⁰³ ((1981)) STC 174).

reduced the interest on the first loan to nil, while interest on the second loan was doubled.

The second loan was then sold to another company at a capital profit.

The first loan was repaid at par and an equivalent capital loss was incurred in respect of the sale of shares in the subsidiary to another company. The taxpayer company sought relief for the capital loss, but contended that the capital profit was exempt from tax as a debt on a security. The House of Lords, whilst accepting that none of the steps involved represented a 'sham', considered the scheme as a whole and held that it should be treated as a nullity for tax purposes.

In his judgment, Lord Wilberforce stated that it was not a requirement, under the *Duke of Westminster* or any other doctrine, to consider individually each separate step in a composite transaction intended to be carried through as a whole. His Lordship described the following characteristics of 'circular' schemes of tax avoidance:

First - it is a clear and stated intention that, once started, the scheme shall proceed through the various steps to the end (whether there be a contractual obligation, or merely an expectation with no likelihood in practice that it will not proceed);³⁰⁴

Second - the taxpayer does not have to use his own funds and at the end of the scheme the taxpayer's financial position is unchanged (except for the payment of fees and expenses to the scheme promoter);³⁰⁵

Third - the whole and only purpose of the scheme was the avoidance of tax.

³⁰⁴ Mc Laughlin Mark, *supra* note 299.

³⁰⁵ *Ibid.*

The *Ramsay* list of tax avoidance characteristics and circumstances was modified in subsequent House of Lords decisions. In *IRC v Burmah Oil Co Ltd*,³⁰⁶ where the House of Lords held that the *Ramsay* principle applied to a scheme devised by the taxpayer's advisers, involving the taxpayer's own funds. Lord Diplock considered that, in order for the *Ramsay* principle to apply, there must be:³⁰⁷ 1) a series of transactions; which are 2) pre-ordained; and 3) Into which there are inserted steps that have no commercial purpose apart from tax avoidance. The *Ramsay principle* had hitherto been confined to tax avoidance in the form of artificial schemes containing steps that were, in effect, self-cancelling. However, in *Furniss v Dawson*, the House of Lords applied the *Ramsay* approach to a scheme of tax deferral as opposed to avoidance, which was not circular or self-cancelling.³⁰⁸

4.4.2.4 *Furniss v. Dawson*

In *Furniss v Dawson*,³⁰⁹ the taxpayers wished to sell their family company shares to an independent purchaser. As part of a pre-arranged plan to defer their capital gains tax liability, the taxpayers exchanged their shares in that company for shares in a newly-formed investment company (Greenjacket) incorporated in the Isle of Man. On the same day, Greenjacket sold the family company shares at the previously negotiated price. The taxpayers sought to rely on a capital gains tax exemption in respect of the company amalgamation, and a no gain no loss disposal of the family company shares by Greenjacket. The High Court and Court of Appeal ruled that the *Ramsay* principle applied only where steps forming part of the scheme were self-cancelling. They considered that it did not allow the share exchange and

³⁰⁶ ((1982) STC 30).

³⁰⁷ Mc Laughlin Mark, *supra* note 299.

³⁰⁸ Ibid.

³⁰⁹ ((1984) STC 153).

sale agreements to be disturbed as steps in the scheme, because they had an enduring legal effect.

The case proceeded to the House of Lords, where it was held that steps inserted in a preordained series of transactions with no commercial purpose other than tax avoidance should be disregarded for tax purposes, notwithstanding that the inserted step (i.e. the introduction of Greenjacket) had a business effect. Per Lord Brightman "*that inserted step had no business purpose apart from the deferment of tax, although it had a business effect. If the sale had taken place in 1964 before capital gains tax was introduced, there would have been no Greenjacket*".

The approach of the Lords to 'linear' tax avoidance in *Furniss v Dawson* marked a significant extension of the Ramsay principle, which hitherto had been founded upon "circular" or self-cancelling schemes.³¹⁰ There then followed a period of a generally restrictive interpretation of the law, but recently these have been signs of a more interventionist approach in *Commissioner of Inland Revenue v. McGuckian*³¹¹ especially with the most recent decision in *Macniven v. Westmoreland Investments Ltd*³¹², it is clear that the House of Lords has again sought to curtail its power to deal with tax avoidance schemes.³¹³

4.4.2.5 Commissioner of Inland Revenue v. McGuckian

The facts in McGuckian were that at all times Mr. McGuckian and his wife had been resident and domiciled in the United Kingdom. In the early 1970s they each owned 500 £1 shares in Ballinamore, the entire issued share capital of the company. Over the years, Ballinamore

³¹⁰ Mc Laughlin Mark, *supra* note 299 p.2.

³¹¹ (1997) STC 908.

³¹² (2001) 2 W.L.R 377.

³¹³ Graham Virgo, "The Tax Avoidance Rollercoaster: Yet another New approach", (The Cambridge Law journal Vol. 60 No. 2 Jul., 2001) pg 259-261.

made profits and had built up reserves which were available to be distributed as dividends. Acting on the advice of Mr. Taylor a well known English solicitor and a tax consultant, a number of steps were devised in 1976 and 1977 whereby the shares in Ballinamore previously owned by Mr. and Mrs. McGuckian were transferred to the trustee of a settlement. The trustee of the settlement was a Guernsey company, Shurltrust Ltd. The beneficiaries of that settlement were Mr. and Mrs. McGuckian and the income was payable to Mrs. McGuckian.

In November 1979 Ballinamore had income available for distribution by way of dividend amounting to £400,055. On 23 November 1979 Shurltrust (the trustee which owned the Ballinamore shares) assigned to Mallardchoice Ltd. ("Mallardchoice") the right to any dividend payable by Ballinamore in 1979. Mallardchoice was a United Kingdom company associated with the tax consultant, Mr. Taylor.

The consideration for the assignment was expressed to be £396,054, which represented 99% of the dividend in fact paid by Ballinamore. On 27 November 1979 Ballinamore declared a dividend of £400,055 on the shares held by Shurltrust. Ballinamore gave a cheque for that amount to a Dublin solicitor for Mallardchoice. The solicitor paid the cheque into his client account out of which he then paid 99 per cent of that sum (i.e. £396,054) to Shurltrust. The solicitor then paid the balance of one per cent (less his own fee of £200) to an agent for Mallardchoice.

While the Inland Revenue tried to unravel what had happened, Mr. Taylor took every step to obfuscate what had transpired and obstructed the revenue in discovering the true facts. Nevertheless the Revenue issued an assessment on Mr. McGuckian on £ 400,055 for the

years 1979-1980, under chapter III Part XVII of the Income and Corporation Taxes Act 1970 (ICTA 1970). At that time the Revenue had not discovered the existence of the settlement.

Mr. McGuckian appealed against the assessment. The appeal came before the special commissioner, Mr. O'Brien, before whom the Crown contended, first, that the transactions between Shurltrust and Mallardchoice were a sham and, secondly, that there was a liability to tax under the Act of 1970, section 470. The revenue did not argue before the special commissioner that the principle stated in *W. T. Ramsay Ltd. v. Inland Revenue Commissioners* applied. The special commissioner held that the transactions were not a sham and that, since the notice of assessment stated that the tax liability arose under section 478, he could not uphold it under section 470.

In the Court of Appeal the Crown contended that although the transactions were not a sham they fell to be disregarded under the *Ramsay* principle. The Crown further argued that the special commissioner should have upheld the assessment under section 470 and that, even if the special commissioner did not have the power so to do, the Court of Appeal had the necessary power to remit the case to him with a direction that he should uphold an assessment under section 470.

The Inland Revenue then appealed to the House of Lords against the dismissal for their claim based on the *Ramsay principle*. In the House of Lords, their Lordships held that in their judgment this case turned on the exact scope of the *Ramsay principle*.

To their Lordships, the case fell squarely within the classic requirements for the application of that principle as stated by Lord Brightman in *Furniss v. Dawson*³¹⁴

"First, there must be a pre-ordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end . . . Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax--not 'no business effect.' If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied."

In the present case, since the *Ramsay principle* was not invoked before the special commissioner there is no express finding on those issues of fact. However, there can be no doubt the only possible conclusion on the facts is that the requirements are satisfied. No business purpose for the assignment of the dividend rights to Mallardchoice has been suggested. Given the genesis of the composite transaction in the mind of the tax consultant, Mr. Taylor, the only possible inference is that the assignment was inserted for the sole purpose of gaining a tax advantage.

The approach pioneered in *Ramsay* and subsequently developed in later decisions is an approach to construction, viz. that in construing tax legislation, the statutory provisions are to be applied to the substance of the transaction, disregarding artificial steps in the composite transaction or series of transactions inserted only for the purpose of seeking to obtain a tax

³¹⁴ (1984) A.C. 474, 527D-E.

advantage. The question is not what was the effect of the insertion of the artificial steps but what its purpose was. Having identified the artificial steps inserted with that purpose and disregarded them, and then what is left is to apply the statutory language of the taxing Act to the transaction carried through stripped of its artificial steps. It is irrelevant to consider whether or not the disregarded artificial steps would have been effective to achieve the tax saving purpose for which they were designed.³¹⁵ For these reasons, the House of Lords allowed the appeal and upheld the assessment in the sum of £396,054 being the amount received by the shareholder, Shurltrust.

Other important cases where U.K Courts have applied judicial doctrines include *Inland Revenue Commissioner v. Scottish Provident Institution*³¹⁶ and *Barclays Mercantile Business Finance (BMBF) v. HM Inspector of Taxes*³¹⁷, among others.

4.5 Illustration by use of a case

A useful case can help to illustrate that although Courts may arrive at different decisions on the same facts when they apply common law judicial doctrines by sticking to the legal principles in the absence of GAAR, while where GAAR exists, the Courts are bound to go strictly by the rules contained in the GAAR. In such cases they will arrive at a different decision from that arrived at by Courts which base their decisions on judicial doctrines in cases with same facts, as illustrated in the case below.

Bowater Property Development Ltd v Inland Revenue Commissioner.

In *Bowater Property Development Ltd v. Inland Revenue Commissioner*,³¹⁸ the case involved

³¹⁵Mc Laughlin Mark, *supra* note 299 p.3.

³¹⁶(2005) STC 1 at 15.

³¹⁷(2007) STC 1 at 14.

³¹⁸(1989) A.C 398 (HL).

the Development Land tax in the United Kingdom, a kind of capital gains tax that applied to land sales if the development value component of the sale of land was more than Great Britain Pound (GBP) 50,000. *Bowater* proposed to sell its land for more than GBP 250,000 to a company called Milton Pipes Ltd, in which case *Bowater* would have to pay the Development Land Tax.³¹⁹

Instead *Bowater* segmented the property into five undivided shares. It sold one share for GBP 36,000 to each of the five sister companies in the *Bowater* Group of Companies. Land in individual shares looks like land: there were no subdivisional surveys or separate titles. The five *Bowater* companies owned the land in one title. 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.³²⁰ The five companies then sold their undivided shares to Milton Pipes for GBP 50,000 each, so that each company paid GBP 36,000 and sold for £50,000, each making a profit of GBP 14,000 well under the threshold which the development land tax was payable. Legally there were five separate sales from *Bowater* and five sales to Milton. But economically there was one sale from *Bowater* to Milton Pipes.³²¹

Different decisions could be arrived at as to whether there was tax avoidance in the above case:³²²

- a) In the United States of America, the Courts would most likely have said that the transaction of *Bowater* sales was a *sham* and that tax should be paid.
- b) Jurisdictions that follow House of Lords decisions would on the other hand say the transactions were not shams, and the sales took place according to their

³¹⁹ Prebble Rebecca, Prebble John, note 76 p.5.

³²⁰ Ibid.

³²¹ Ibid.

³²² Ibid.

documentation, having regard to the separate legal entity of each company. The House of Lords ruled that there was no tax liability.

- c) In jurisdictions where GAAR have been enacted, this would be a clear tax avoidance case, having regard to the nature of scheme, steps undertaken, purpose and the tax benefit obtained.

This example demonstrates that different decisions may be arrived at by countries without GAAR that follow judicial reasoning vis-à-vis those that may be arrived at by jurisdictions with clearly spelt out GAAR which aim at combating tax avoidance with the use of GAAR.

4.6 Conclusion

Countries that want to combat tax avoidance must enact comprehensive GAAR in their statutes which not only give broad definitions of the terms used in the rules but also give comprehensive descriptions of situations that a taxpayer must have brought himself into, before a Commissioner can make an objective opinion of the taxpayer having been involved in an avoidance scheme. There are usually tests spelt out and such tests include tests such as, “scheme test,” “tax benefit test,” “legal form and legal substance test,” “purpose test,” “tax avoidance test,” “the dominant purpose test,” “commercial purposes tests” or “steps taken test.” All these tests must be identified using these parameters set by statute before an opinion can be formed by a commissioner, that a transaction was effected for tax avoidance purposes. As seen in the preceding chapters, Kenya does not have GAAR.

For countries relying on judicial doctrines with no statutory GAAR, judicial doctrines have been developed and evolved over time and keep on evolving thus creating uncertainties among taxpayers. Consequently court decision may not be the same when either statutory

GAAR or judicial doctrines are applied on the same facts. There is however now a tendency by the U.K government a country that relied on judicial doctrines to want to shift from judicial to the legislature which should provide appropriate safeguards by statute rather than keep on evolving judicial doctrines.

With regard to United States, great uncertainty remained regarding the application of the judicial safeguards to income tax avoidance cases leading to repeated calls to legislate terms like economic substance. The taxpayer's efforts had drawn the attention of Congress, which increasingly proposed to legislate the standard for the judicial determination of economic substance. Some commentators attributed this possible shift from one branch of the government to another to the rise of textualism as the interpretive standard employed by the courts when addressing tax legislation. With the recent assent by President Barack Obama on the enactment of GAAR by signing section 7701 (0) of the Internal Revenue Code 1986, United Kingdom is the only country left among the western countries which still applies judicial doctrines, but, which is seriously grappling with the idea of introducing GAAR

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Conclusion

5.0.1 Introduction

Tax avoidance is a problem for all tax systems. In order to counter tax avoidance a number of countries both at common law and civil law (including Germany) have enacted general anti-avoidance rules (GAAR) which enable them collect revenues that would otherwise not be collected. As seen in the preceding chapters, tax avoidance, unlike tax evasion is not illegal and for that reason it is more attractive to engage in since what taxpayers stand to lose in the scheming transactions are the transaction costs incurred in formulating such arrangements. If caught however they will only pay the tax they would have paid but for the avoidance. The attraction is further encouraged by the fact that whereas they would face civil and criminal sanctions if they engaged in tax evasion, most jurisdictions do not impose such sanctions for tax avoidance.

Kenya currently lacks GAAR, although it has a number of SAAR enacted to deal with specific areas of tax avoidance. In addition to the discussed SAAR - transfer pricing, thin capitalization, foreign exchange losses and specified sources of income anti-avoidance rules, - there are several other specific anti-avoidance rules that deal with other tax matters, for example taxation of employment non-cash benefits, income of certain trusts that is deemed to be the income of the settlors, among others.

5.0.2 Problem with SAAR

The problem with SAAR is that they are enacted only when a circumstance arises that the legislature must need to curb and this is when parliament decides to enact a SAAR to close

the notable loophole when it has already taken place. Thus SAAR serve the purpose of blocking a loophole when it has been discovered that it produces a revenue leakage in that specific area which needs to be blocked by a specific rule. The danger here is that Parliament cannot be able to predict or anticipate all avoidance schemes for which it has to make specific rules to block them in advance.

5.0.3 Kenya's ineffective GAAP

The Kenya Income Tax Act also contains general anti-avoidance provisions (GAAP) at Sections 23, supposedly meant to deal with avoidance measures for all other issues other than the non distribution of dividends which is dealt with under Section 24. Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected is the avoidance or reduction of tax which could otherwise be effected by the transaction, he is empowered to give direction to counteract the avoidance. Under Section 24, the Commissioner may direct that a company should distribute dividends if he is of the opinion that such distribution may not prejudice the business of the company.

The current general anti-avoidance provisions as framed are vague and ineffective – they don't provide the Commissioner with guidelines on how to form an opinion either under Section 23 or 24 and therefore give directions. The position is comparable to the provision at Section 18 (3) on which the Commissioner relied in the case of *Unilever*. In the absence of rules to back up the general Section 18 (3) provision, the Court allowed the taxpayer's appeal by applying the universally accepted OECD rules, and disallowing the application of a general provision under Section 18 (3). It is as a consequence of this that Transfer Pricing Rules were then formulated because before then, as it were, the Commissioner was ploughing in the dark.

5.0.4 Why Kenya should Adopt GAAR

To be able to fully achieve its mandate which includes curbing tax avoidance, Kenya Revenue Authority requires to arm itself with an effective law to assist curb tax avoidance schemes. The law should come in the form of clear GAAR to back up the GAAP enunciated at Section 23 and 24 of the Income Tax Act. These rules can only come about through the enactment of comprehensive GAAR which will give clear guidelines on how the tax authority can unravel the existence of tax avoidance schemes and bring taxpayers engaged in the schemes to pay correct taxes avoided.

If promulgated, the rules will also give taxpayers some certainty so that in whatever schemes they engage in, they will be engaging in while knowing they may or may not be caught up by the rules set up under GAAR. Clear rules will also guide the Income Tax Tribunal and the Courts when deciding cases appealed against to enable them arrive at a just decision.

If GAAR were in place for example, the Commissioner would not have lost the case in Yaya Towers Ltd (*Republic v KRA Ex-parte*)³²³ on grounds of public policy since GAAR are clear - when you arrange your affairs in a certain manner calculated to avoid tax, you cannot be relieved of the tax liability on the basis that the transactions were illegal. The statutory GAAR determine a certain standard as to the situations in which one should support tax avoidance and possible creative interpretation of the law.

One common feature with some Kenyan taxpayers is their habit of forming a company for the purposes of making money and as soon as the money is made, the company is voluntarily wound up without having paid the requisite tax and another one formed immediately by the

³²³ High Court Misc. Civil Appli. 374 of 2006.

same directors. Well drafted GAAR would catch up with these kind of directors as it will enable the Commissioner lift the corporate veil to ascertain the substance of the transaction, which though it could have had commercial value, the reality is that the purpose or one of the main purposes was to use the company as a vehicle to avoid tax. Whilst in the absence of GAAR Courts would cite *Salomon v. A Salomon & Co. Ltd*³²⁴ to reject the revenue's proposition to get taxes from the directors, under GAAR these directors will not be allowed to escape.

The alternative to having statutory GAAR is to rely on judicial doctrines as practiced in United States and United Kingdom, the countries with no GAAR, upto until recently, when the U.S. adopted GAAR.

For many years now, particularly since *Ramsay v. IRC*,³²⁵ the Courts in the United Kingdom grappled with the scope and practical application of the judicial principles to be adopted when determining whether there is tax avoidance. Seventy four years ago, in 1936 in the case of *IRC v Duke Westminster*³²⁶ the judge could see nothing wrong with the *Duke* paying his staff in the form of covenants and avoid paying surcharge tax. In the words of Lord Tomlin:-

“Every man is entitled to arrange his affairs so that the tax attaching under the appropriate Act is less than it could be.”

Case law has moved from the *Westminster* jurisprudence. Several decisions given in the English Courts have in the absence of GAAR deemed schemes which are wholly artificial

³²⁴ (1897) AC 22 (HL).

³²⁵ (1981) STC 174.

³²⁶ (1936) 19 TC 490.

and pre-ordained in their outcome to be unacceptable tax avoidance schemes and have been rejected. Some of these cases have been discussed in the previous chapter. This is the doctrine behind the *Ramsay* principle. But where there is a strong commercial motivation behind a series of transactions, the Courts are likely to permit the scheme even if tax avoidance was a primary motivation factor as the decision in *Piggott v. Staines Investments Ltd.*³²⁷ The English Courts have attempted to provide some distinction between unacceptable tax avoidance and acceptable tax avoidance. Because of the existence of this grey area, a lot of uncertainty has been created in the tax system, leaving the Courts to decide.

Because of the difficulties faced by English Courts, the U.K government has been contemplating for quite a while the possibility of introducing GAAR. In a consultative paper prepared and produced by the Tax Law Review Committee, in his foreword the President of the Committee, the Rt. Honourable the Lord House of Avebury CH QC commenced by saying:³²⁸

“In its November 1997 Report on Tax avoidance the Committee concluded that a sensibly targeted anti-avoidance provision, with a considered framework and appropriate safeguards for taxpayers could have a part to play in deterring and counteracting tax avoidance. The Committee expressed a preference for such a statutory rule, if sensibly targeted, to the continued development of general anti-avoidance doctrines. The Committee has been pleased to note that the Inland Revenue has given the Committee’s 1997 Report in preparing its October 1998 consultative document on a General Anti-avoidance Rule for direct taxes.”

³²⁷ (1995) STC 114.

³²⁸ Tax Review Committee, “A general anti-avoidance rule for direct taxes, a response to the Inland Revenue’s consultative Document” (London, February 1999).

And in an Emergency Budget 2010, the U.K government announced that it will engage informally with interested parties over this summer to explore whether there is a case for developing a U.K GAAR.³²⁹

As for the U.S the general feeling had been that there was great uncertainty regarding the application of the judicial safeguards to income tax cases determination of economic substance. Some commentators attribute this possible shift from one branch of the government to another to the rise of textualism as the interpretive standard employed by the courts when addressing tax legislation.³³⁰ The fear of usurping the role of the legislative branch increasingly led the courts to apply the “plain language of the statute” in their judicial scrutiny of transactions and to look no further. This plain language approach did not allow the courts to search for the purpose of the legislation or attempt to predict how Congress would have reacted if it had actually considered the precise situation presented to the court.³³¹

On the 30th March 2010 President Barrack Obama signed Section 7701 (0) of the United States Internal Revenue Code 1986, establishing the first GAAR for United States of America. This is a clear indication that countries that have in the past relied upon judicial doctrines have realized the weakness and are turning to statutory GAAR.

5.1 Recommendation

5.1.1 Introduction

This thesis has attempted to show that general anti-avoidance rules (GAAR) are pertinent rules that should be incorporated in any income tax statute because they enable governments

³²⁹ KPMG, Emergency Budget 2010, “Announcement of a consultation on a General Anti-Avoidance Rule (GAAR)”, accessed at <<<http://www.chancellorsfinanceagenda.co.uk/EmergencyBudget2010/14883.htm>>>, on 24th July 2010.

³³⁰ Prebble John, Prebble Zoe, *supra* note 231 p 31.

³³¹ *Ibid.*

collect the amount of tax that would not have been collectable on the basis that avoidance of tax is a legal means of reducing or evading ones tax liability. Taxpayers take advantage of the fact and engage in it with the result that inroads are dug in tax revenues leading to a drain in national revenues. The thesis has illustrated how a number of countries have dealt with this avoidance problem, mainly by enacting GAAR which are provisions that are drafted in a manner that they capture any unforeasable and un-anticipated transactions that would be created with no business or commercial value, but with the sole or main purpose of tax avoidance. Countries that have not enacted GAAR rely on anti-avoidance judicial doctrines, however these countries are abandoning this dependency and moving towards enacting GAAR. Where GAAR have been enacted, elaborate rules are spelt out in the statutes on how a Commissioner would form an opinion that the main purpose for which a transaction was effected was the avoidance of tax and therefore allow him to make adjustments. In Kenya the Income Tax Act has provisions at Section 23 and 24 allowing the Commissioner to form an opinion, but no guidance is given to him on how to form such an opinion.

5.1.2 Statutory Framework

Lack of clear and elaborate rules on how the Commissioner can form an opinion that a transaction was effected with the main purpose or one of the main purposes of avoidance of tax can lead him to form an opinion haphazardly and without basis. Elaborate rules enable the Commissioner form an opinion based on the factual existence of a scheme that provides the taxpayers with a tax benefit rather than the Commissioner's own opinion as to the existence of a scheme.

This thesis is of the view that there is the need to amend the Kenya Income Tax Act by incorporating GAAR which will comprehensively give guidance to the Commissioner as to

how he can form an opinion what he may consider to be a transaction that was effected for the purpose of tax avoidance in order to combat it and counter it by the use of GAAR. The proposed amendment will apply to transactions that the Commissioner could objectively determine to be motivated by tax avoidance based on some legislated criteria. The statutory GAAR should clearly set up the standards that should establish that an avoidance scheme had been established for the purpose of avoiding or reducing liability after having regard to the nature and manner in which the scheme was created, the form and substance of the scheme, the time and length of the scheme, the change in the financial position of the taxpayer and any other consequences to the taxpayer before concluding that a taxpayer had engaged in an avoidance scheme.

This would give the Commissioner's determination a sound basis for forming an opinion vis-à-vis the current position where he has been given authority under Section 23 yet no guidance is given to him on how to form that opinion. Where the rules are clear, taxpayers too have some certainty as to what would be considered tax avoidance if the parameters are legislated on how the Commissioner would make an opinion and subject their income to adjustments.

It is further recommended that the SAAR already in place be retained to supplement the purposed GAAR since SAAR serve to curb a specific avoidance area which the SAAR has been enacted to counter, whereas GAAR are enacted to deal with any unforeseeable or unpredictable transactions that keep on evolving and emerging over time

It is accordingly recommended that the provisions at Section 23 and 24 be amended to expressly incorporate GAAR. In the alternative the sections can be amended to give the

Minister power to make rules under delegated legislation, which will contain the elements discussed above.

In order to encourage certainty among taxpayers wishing to engage in some activity which may later be considered to have been affected for the purposes of tax avoidance and therefore subject to adjustments, it is also accordingly recommended that the amendment should include a provision requiring that taxpayers wishing to enter into transactions may obtain an advance ruling from the Commissioner to the effect that their transactions would not be subject to adjustments, provided they do not deviate from the transactions on which the initial advance ruling had been given.

5.1.3 Administrative Framework

For the purposes of the sound implementation of GAAR the government will need to sensitize taxpayers and their agents through circulars that transactions that are entered into which have little or no commercial or business value but for tax avoidance shall be subject to review if they fall within the GAAR. The benefit for this sensitization is because tax avoidance is regarded as legal and many taxpayers will do anything possible to reduce or avoid liability in the belief that there is nothing illegal about it. As seen in the thesis, no taxpayer's income has been subjected to adjustments provided for under Section 23 and on the basis of this they will continue to contrive avoidance transactions, which can be cut down if they are sensitized.

But there is no point of enacting laws without competent staff to implement it. In consideration of this it is recommended that before the GAAR are implemented KRA staff should undergo intensive training in investigative skills on how to spot avoidance

transactions that fall within GAAR and in audit skills and the application of a good sense of proportion so that if they take up a case, it should be the right case and if it is realized that a case is unwarranted, they should concede and close the file. The training should be one that is geared towards making the staff focused in selecting good cases for GAAR audits, which should be centralized and done at the Large Taxpayer Office, by experienced and skilled officers.

BIBLIOGRAPHY

A. Books

Easson A.J. , *Cases and Materials in Revenue Law*, (London, Sweet and Maxwell, 1973).

Verma, Sushil Kumar, *Government Regulation of Private Entrepreneur Taxation as a technique to regulate* (Bombay, Edition 1971).

Louw Izak Daniel Petrus, *The General Anti-Avoidance Rule: A comprehensive discourse on this statute*, (15 September, 2007).

Tooma A. Rachel, *Legislating Against Tax Avoidance*, (Amsterdam, 2008).

Whiteman, P.G. , *Whiteman and Wheatcroft on Income Tax*, (London, Sweet & Maxwell, 2nd Edition, 1976) .

Wildy's Law Books Online, *Part IVA: the general anti-avoidance in Australian taxation law*, (Melbourne University Law Review). Available at <<<http://www.accessmylibrary.com/article-1G1-115225858/Part-iva-general-anti.html>>>.

B. Journals /Articles

“A General Anti-Avoidance Rule for Direct Taxes, A Response to the Inland Revenue’s Consultative Document”, (Tax Law Review Committee, February 1999).

Albinet Media & Consulting Services, “Differences between Tax Avoidance and Tax Evasion”, (1996). Available at <<<http://albinet.com/articles/offshore-company/taxes>>>.

Arnold J. Brian, “The Long, slow, Steady Demise of the General Anti-Avoidance Rule”.

“Anti-Avoidance Legislation”, (Utlandsjuristen). Available at <<<http://www.ujoffshore.com/key-services/cj-anti-avoidance-legislation.htm>>>.

“Anti-Tax Avoidance- Two Broad Approaches- Two Broad Solutions”, (Global Anti-Tax Avoidance).

Australia Government, “Part IVA: The General Anti-Avoidance Rule for Income Tax Basic Principles about How and When it Applies.” (Australian Government, Australian Taxation Office).

Australia Government, “Part IVA of the Income Tax assessment ACT 1936 Commentary on Key Issues”. Available at <<<http://www.ato.gov.au/corporate/content.asp?doc=/content/75159.htm>>>.

Brian Arnold, “A comparison of Statutory General Anti-avoidance Rules and Judicial General Anti-avoidance Doctrines as a means of controlling Tax Avoidance: Which is better? (What would John Tiley think?)”, (United Kingdom Cambridge University Press). Available at <<www.cambridge.org>>.

“Building a Better GAAR”. Available at <<http://tunein.entrepreneur.com/tradejournals/Articles/181500073_21.html>>.

Cassidy Julie, “Commentary on the judgment of the Full Court of the Federal Court of Australia,” (Deakin University (1995)). Available at <<<http://www.austlii.edu.au/au/journals/HCRev/1996/7.html>>>.

Chris Evans, “Containing Tax Avoidance: Anti-Avoidance Strategies”, (University of New South Wales Faculty of Law Research Series (UNSWLRS) 40), (December 2008)). Available at <<<http://www.austlii.edu.au/au/journals/UNSWLRS/2008/40.html>>>.

Cooklin Jonathan, “The Journey’s End? Mawson/Scottish Provident”, (Tax Journal, 13 December 2004).

Clews Geoffrey, “The “More than Merely Incidental” Test in Tax Avoidance”.

D’Ascenzo Michael, “Part IVA: Post-Hart”, (Journal of Australian Taxation).

Deloitte, “Supreme Court of Canada Releases its decision in Lipson”, (Tax Breaks Special edition, (January 12, 2008)). Available at <<[Druckversion, “Announcement of a consultation on a General Anti-Avoidance Rule \(GAAR\)”, \(KPMG Arnold J. Brian, “The Long, slow, Steady Demise of the General Anti-Avoidance Rule”.](http://www.deloitte.com/view/en_CA/ca/Services/tax/11f05a1264001210VgnVCM100000...>>>></p></div><div data-bbox=)

Duff, David, G, “The Supreme Court of Canada and the General Anti-Avoidance Rule: Canada Trustco and Mathew.” (Faculty of Law, University of Toronto Bulletin, February 2006), available at <<<http://ssrn.com/abstract=1142962>>>.

Emergency Budget 2010). <<<http://www.chancellorsfinanceagenda.co.uk/EmergencyBudget2010/14883.htm>>>.

Ernst & Young, “International Tax Review helps me in my role”, (India World Tax). Available at <<<http://www.itrworldtax.com/Guide/296/India.html>>>.

Ernst & Young, “Anti-Avoidance provisions in the Direct Tax Code Bill”, (21 August 2009). Available at <<<http://www.ey.com/publication/UAssets/EY...>>>.

Ernst & Young, “International Tax Review assists in validating, or not, the advisers we use from time to time around the world”, (Malaysia World Tax). Available at <<<http://www.itrworldtax.com/Guide/301/Malaysia.html>>>.

Fisher Philip, “Your Partner in Tax Law, Practice and Administration”, ((25 August 2005) Vol 155, Issue 4022). Available at <<<http://www.taxation.co.uk/taxation/articles/2005/08/25/3425/1936-good-year-tax>>>.

Freehills, “Application of the Income Tax Anti-Avoidance Rule”, (2007). Available at <<<http://www.freehills.com.au/1979.aspx>>>

Freedman Judith, “Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance”, ((2005) VOL. 53, No 4). Available at <<<http://denning.law.ox.ac.uk/tax/documents.com>>>.

Grauberg Tambet, “Anti-Tax-Avoidance Measures and their Compliance with Community Law”, (Juridica International XVI/2009).

“General Anti-Avoidance Rule”, (University of Liverpool). Available at <<<http://multiutils.com/dtc/dtc24.htm>>>.

“History of Tax Resistance”, (Wikipedia, the free encyclopedia). Available at <<http://en.wikipedia.org/wiki/History_of_tax_resistance>>.

International Taxation Judicial Doctrine, “General Anti-Avoidance Rules (GAAR)”. Available at <<<http://umling.tripod.com/id23.html>>>.

“House of Common Hansard Debates”, (6 May 2009). Available at <<[Kumarasingam Skanda, “Tax Avoidance and Tax Evasion Explained and Exemplified”, \(Ezine articles\). Available at <<\[KPMG, Emergency Budget 2010, “Announcement of a consultation on a General Anti-Avoidance Rule \\(GAAR\\).” On 24th July 2010. Available at <<<http://www.chancellorsfinanceagenda.co.uk/EmergencyBudget2010/14883.htm>>>.\]\(http://ezinearticles.com/?Tax-Evasion-Explained-and-Exemplified&id...>></p></div><div data-bbox=\)](http://www.Publications.parliament.uk/pa/cm200809/cmhansrd/cm090506/halltext/90506h...>>.</p></div><div data-bbox=)

Lord Browne-Wilkinson, “Judgments-Commissioners of Inland Revenue v. McGuckian” (12 June 1997).

McLaughlin Mark ATII TEP, “Ramsay Principle”, (Tax journal). Available at <<<http://www.taxationweb.co.uk/tax-articles/general/the-ramsay-principle.html>>>.

Murphy Richard, “The Battle over a General Anti-Avoidance Principle begins”, (June 24 2010). Available at <<<http://www.taxresearch.org.uk/Blog/2010/24/the-battle-over-a-general-anti-avoidance-pr...>>>

Mugalula John, “Anti-Tax Avoidance Provisions under the Income Tax Act Cap340 a Perspective analysis”. Available at <<<http://ssrn.com/abstract=1633890>>>.

“Part VI: Miscellaneous 103. Transactions, Operations or Schemes for purposes of Avoiding or Postponing Liability for or Reducing amounts of Taxes on Income,” (Income Tax Act, 1962). Available at <<http://www.acts.co.za/tax/103_transactions_operations_or_schemes_for_purposes_of_av...>>

Prebble Rebecca, “Does Croatia need a General Anti-Avoidance Rule? Recommended changes to Croatia’s current Legislatives framework”, (Victoria University of Wellington, New Zealand Institute of Public Finance, Zagreb).

Prebble John, Prebble Zoe, “ Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law,” (Bulletin for International Taxation (2008)). Pp 151-170. Available at <<http://papers.ssrn.com/sol3.cfm?_id=1605483>>.

Prebble Rebecca, Prebble John, “Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?” Available at <<http://papers.ssrn.com/so13/papers.cfm?abstract_id=1523043>>.

Prebble John and Elliffe Craig, “General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective,” (Revenue Law Journal, Vol. 19, No. 1, Article 4, (2009).) Available at <<http://papers.ssrn.com/so13/papers.cfm?abstract_id=1509693>>

Prof. David G. Duff, “The Supreme Court of Canada and the General Anti-Avoidance Rule, (Canada Trustco and Mathew)”, (February 2006). Available at <<<http://ssrn.com/abstract=1142962>>>.

Raudsepp Pritt, “Thin Capitalization Regulations and similar Tax Limitations on Leverage Buy-out, or How to Set the Limit to your Transactions”, (Sorainen (2009)).

Revenue Canada Taxation, “General Anti-Avoidance Rule Section 245 of the Income Tax Act”, (October, 1988). Available at <<<http://www.cra-arc.gc.ca/E/pub/tp/ic88-2/ic88-2-e.txt>>>.

Rook Alan, “How to Avoid the Section 703 Pitfall”, (August 7, (2006)). Available at <<<http://www.fleetstreetinvest.co.uk/economy/taxation/avoid-section-703-pitfall-00001.html>>>.

Salsman Richard, “Treasury Secretary Paul O’Neil Confuses Tax Avoidance versus Tax Evasion,” (13 September 20002). Available at <<[145](http://www.capitalismmagazine.com/politics/taxation/1856-Treasury-Secretary-Paul-O’Neil...>>.</p></div><div data-bbox=)

Shafer E. William and Simmons S. Richard, "Social Responsibility, Ethics and Tax Avoidance: A Study of Hong Kong Tax Professionals", (Department of Accountancy Lingnan University Tuen Mun, N.T. Hong Kong).

Shah Anup, "Tax Havens; Undermining Democracy-Global Issues" (July 12, (2009)). Available at <<<http://www.globalissues.org>>>.

Singapore Journal of Legal Studies, "Revisiting the General Anti-Avoidance Rule in Singapore", (2009). Available at <<<http://ssrn.com/abstract=1543664>>>.

The Globe and Mail, "General Anti Avoidance Rule – GAAR – CRA Loses Catch-All Case," (October 2005). Available at <<<http://www.can-offshore.com/tax-planning/gaar-general-anti-avoidance.com>>>.

Tax Review Committee, "A general anti-avoidance rule for direct taxes, a response to the Inland Revenue's consultative Document" (London, February 1999).

VanderWolk Jefferson, "The House of Lords and Tax Avoidance-Scottish Provident and BMBF", (April 2005).

Wenk Paul, "Australia: Application of the Income Tax anti-avoidance Rule." Available at <<http://www.ibls.com/internet_law_news_portal_view.aspx?s=sa&id=1268>>.

Weiner Nadia, "Adam Smith's Recommendations on Taxation", (Director of the Adam Smith Club of Sydney, Australia). Available at <<<http://www.progress.org/banneker/adam.html>>>

Woodhouse Chris, "Estate Planning Now", (Issue No2, February 1997).

C. Reports

House of Lords, "Judgments-Barclays Mercantile Business Finance Limited (Respondents) v. Mawson (Her Majesty's Inspector of Taxes (Appellant)", (Session 2004-05 3rd Report ((2004) UKHL 51). Available at <<<http://www.publications.parliament.uk/pa/1d200405/1dJudgmt/jd04112>>>.

Revenue Canada, "1996 May Report of the Auditor General of Canada", (May 1996 Report). Available at <<http://www.oag-bvg.gc.ca/internet/English/parl_oag_199605_11_e_5042.html>>.

D. Newspaper article

Mugo Jemimah, "Transfer Pricing Plan Changes Game for Multinationals", (Daily Nation, June 14, (2010)). Available at <<<http://www.nation.co.ke/magazines/smartcompany/Transfer%20pricing%20plan%20chang...>>>.