

ARTICLES

DOES CROATIA NEED A GENERAL ANTI-AVOIDANCE RULE? RECOMMENDED CHANGES TO CROATIA'S CURRENT LEGISLATIVE FRAMEWORK

Rebecca PREBBLE
Faculty of Law
Victoria University of Wellington, New Zealand
Institute of Public Finance, Zagreb

Review article*
UDC 336.2.04
JEL H32

Abstract

This paper considers whether Croatia would benefit from the introduction of a general anti-avoidance rule into its tax system. The paper gives an overview of what tax avoidance is and differentiates the concept from the related concepts of tax evasion and fraud. The paper then describes how general anti-avoidance rules work. The paper gives an overview of Croatia's tax system, including the measures the country already has to combat tax avoidance, and concludes that a general anti-avoidance rule is necessary. The paper draws on the experiences of countries with legal systems similar to that of Croatia to suggest the form that a Croatian general anti-avoidance rule should take.

Key words: tax, tax avoidance, tax evasion, shams, Croatia, abuse of rights, general anti-avoidance rule, Constitution.

1 Introduction

Tax avoidance is a problem for all modern tax systems. Wherever there are tax laws, it seems that people will find ways of manipulating the rules to reduce their tax liability. In order to combat tax avoidance, many countries have general anti-avoidance rules that allow their tax authorities to disregard arrangements that have the purpose and effect of avoidance of tax. General anti-avoidance rules allow tax authorities to collect the amount of tax that would have been payable but for the existence of an avoidance arrangement. General anti-avoidance rules therefore allow governments to collect a considerable amount of tax that would otherwise be lost.

* *Received:* December 15, 2004.
Accepted: November 11, 2005.

Croatia currently lacks a general anti-avoidance rule, although it does have a number of specific anti-avoidance provisions. This paper considers whether the Croatian tax system would benefit from a general anti-avoidance rule, and looks at what form that general anti-avoidance rule ought to take. The paper first defines tax avoidance, and explains how tax avoidance is distinct from tax evasion and sham transactions. The next section of the paper gives a brief overview of the Croatian tax system in its current state and identifies areas where avoidance is possible.

The paper examines the various specific anti-avoidance provisions that Croatia already has and concludes that Croatia's current tax structure is insufficient to combat many instances of tax avoidance. This paper therefore examines various general anti-avoidance rules that have been adopted by other countries, particularly countries that have similar legal systems to that of Croatia. What features of other countries' general anti-avoidance rules could Croatia adopt, and what pitfalls could be avoided? Is there any constitutional barrier to Croatia's adopting a general anti-avoidance rule? The paper concludes that Croatia would indeed benefit from a general anti-avoidance rule and suggests the form that a Croatian general anti-avoidance rule might take.

2 Tax Avoidance

2.1 What Is Tax Avoidance?

Before any thoughts of introducing anti-avoidance legislation into Croatia can be entertained, it is necessary to establish what tax avoidance actually is. As a starting point, it might be said that tax avoidance is "any lawful behaviour designed to avoid tax," (RA McLeod, 2000) but this definition does not begin to address the many difficulties that people face when trying to determine exactly what constitutes tax avoidance.

The core obstacle to finding a good definition of tax avoidance is that almost all governments acknowledge the right of citizens to arrange their money in such a way so as to incur a lower tax liability than they would if their money was arranged in some alternative way. Taxpayers have no duty to pay the highest possible amount of tax. Furthermore, it could be said that company directors have a positive duty to their shareholders to minimise that company's tax. However, there comes a point at which the arrangements that taxpayers construct to reduce their tax liability become so contrived and artificial that they cross the border that separates acceptable tax mitigation from unacceptable tax avoidance.

Tax avoidance transactions tend to have at least one of a number of features that make them identifiable. Formal legality, the abuse of statutory loopholes, artificiality, and minimal economic purpose (other than the reduction of tax) are recurring features of schemes that are seen as instances of tax avoidance (Orow, 2000:18). The following section of this paper attempts to capture the concept of tax avoidance by giving examples of various types of arrangements that have been held to be tax avoidance in the past and that tend to display some of these features. The examples also demonstrate the effect of general anti-avoidance rules, because they show that tax avoidance schemes are far easier to attack when the tax authorities have a general anti-avoidance rule at their disposal.

The Croatian system of exemptions provides many opportunities for *legal* tax minimisation that would not be caught by a general anti-avoidance rule. For example, a self-employed individual might invest in Vukovar purely for tax reasons, and yet would still have the government's approval. While most tax avoidance schemes go against the purpose of the legislation involved, investment in Vukovar is precisely the behaviour the legislation encourages. The existence of tax incentives and also a general anti-avoidance rule within a single system is a paradoxical situation that many jurisdictions nevertheless manage to cope with. The paradox arises because general anti-avoidance rules are intended to catch behaviour that is motivated by purely tax reasons, and yet at the same time the government has sanctioned *some* kinds of purely tax-motivated behaviour. In practice, it is of course relatively easy to identify which kinds of purely tax-motivated behaviour have been pre-approved by the government and to which general anti-avoidance rules should therefore not apply, but it makes the task of finding a theoretical justification for general anti-avoidance rules more difficult.

2.2 Examples of Tax Avoidance

2.2.1 Mangin Case

Mangin v CIR [1971] NZLR 591, (PC) was a New Zealand case, and was one of the earlier cases in which New Zealand's general anti-avoidance rule was applied. *Mangin* is a useful case for the purposes of illustrating features of tax avoidance. The case involved the exploitation of a legal form, the trust, and had no economic purpose other than the avoidance of tax. At the time, New Zealand's general anti-avoidance rule read:¹

Every contract, agreement, or arrangement made or entered into, whether before or after the coming into operation of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay such tax.

The taxpayer in *Mangin* was a wheat farmer, who owned a number of fields and farmed them by a system of crop rotation. That is, in any given year only one field would have wheat in it and the rest of the fields would be left empty. The farmer devised a scheme in which every year he would lease the part of his land that had wheat in it, that is, the profitable part, to a family trust. Almost all income from the farm in each year therefore went to the trust and was taxed in the hands of the trust's beneficiaries.

The trust's beneficiaries were the farmer's wife and children, who were low-rate taxpayers. As a result of the scheme, the farm's profits were taxed at a lower rate than they would have been had all the income been earned by the farmer.

The Privy Council decided that this case was one where New Zealand's general anti-avoidance rule should apply, because it was clearly one that was "devised for the sole purpose, or at least the principal purpose, or bringing it about that this taxpayer should escape liability on tax for a substantial part of the income which, without it, he would have derived."²

¹ Land and Income Tax 1954, s 108 (NZ). New Zealand's current general anti-avoidance rule is contained in the Income Tax Act 2004, ss BG 1 and GB 1.

² *Mangin v CIR [1971] NZLR 591, 598* Lord Donovan (PC).

2.2.2 Countess Fitzwilliam Case

Fitzwilliam v IRC [1993] 3 All E.R. 184 (HL) was a United Kingdom case that involved a scheme to avoid inheritance tax. The Earl Fitzwilliam died in 1979, leaving a substantial estate to a two year discretionary trust, the trustees of which had the power to appoint capital to a class of beneficiaries that included the Earl's widow, Lady Fitzwilliam, and his step-daughter, Lady Hastings. Under the governing law, distributions from this trust would be taxed as if they had been made under the Earl's will itself. The issue the trustees faced was the avoidance of capital transfer tax. Capital transferred to Lady Hastings would be subject to a rate of close to 75%. The relevant legislation provided for an exemption for transfers between spouses, so the capital could have been appointed to Lady Fitzwilliam with little trouble. However, Lady Fitzwilliam was not expected to live long, so upon her death the same problem would arise.

To avoid the death duties, the trustees and their tax advisors devised a scheme consisting of five steps. At the end of the scheme, roughly two thirds of the estate had been distributed to Lady Fitzwilliam and Lady Hastings, and neither of them seemed to be liable to inheritance tax. The economic positions of the taxpayers were almost identical before and after the scheme.

The United Kingdom has no general anti-avoidance rule. Instead, it relies on a judicially created doctrine, normally known as the *Ramsey* doctrine, to combat tax avoidance. This doctrine holds that schemes that are essentially self-cancelling in that the taxpayer's economic position is the same before and after the scheme, save for the tax advantage purportedly gained, may be disregarded for tax purposes.³ The doctrine has been developed by subsequent decisions,⁴ but at the time of *Fitzwilliam* what the tax authorities had to show was which parts of the scheme could be regarded as self-cancelling and what was the appropriate amount of tax to be paid.

The tax authorities found this task rather difficult, particularly since they could not decide whether all of the five steps in the arrangement constituted the scheme, or whether some of them had independent economic effects (Whitehouse, 1994). The case was eventually decided in the House of Lords, which found for the taxpayer. The essential reasoning of the majority was that the scheme could not be regarded as self-cancelling because, looked at individually, a number of the steps had income tax consequences that meant they could not be looked at as simply part of an encompassing scheme.

Fitzwilliam illustrates the relative inflexibility of judicially created doctrines as compared with statutory general anti-avoidance rules. If invoking a general anti-avoidance rule had been an option for the tax authorities in *Fitzwilliam*, it is likely that they would have been successful. The scheme was quite clearly designed to get around the death duties regime, and had no purpose other than that. A statutory general anti-avoidance rule would almost certainly have been able to combat the scheme, but the United Kingdom's judicial anti-avoidance doctrine was not up to the task.

³ *W T Ramsey v IRC* (1981) 53 TC 101, 185 Lord Wilberforce, see further Gammie (1997:181, 189-190).

⁴ Eg, *Furniss v Dawson* (1984) 55 TC 324.

2.2.3 Bowater Case

Bowater Property Developments Ltd [1989] AC 398 (HL) was another United Kingdom case. Bowater Property Developments Ltd, the taxpayer, was a land development company. A sister company to the taxpayer company was considering selling some land to a particular, unrelated buyer. The sale did not eventuate and the taxpayer company bought the land instead, for approximately its market value. The taxpayer company then transferred the land to five other companies in the same corporate group. The original prospective buyer subsequently decided to buy the land after all, so a sale was worked out from the five companies to the original buyer. At the time, the Development Land Tax Act 1976 provided a tax exemption for the first part of the realised development value on each individual sale.⁵ The taxpayers therefore claimed five exemptions. The tax authorities argued that since what had happened was in substance just a sale from the taxpayer to the buyer, the taxpayer should only be allowed one exemption.

The House of Lords found in favour of the taxpayer. Since what had occurred was indubitably a sale from five different sellers to one buyer, the five buyers were entitled to one exemption each, despite the fact that from an economic point of view the situation was exactly the same as a situation in which Bowater Ltd would have been the single seller. Like *Fitzwilliam*, *Bowater* illustrates the sort of transactions that may slip through the tax net in the absence of a general anti-avoidance rule. The United Kingdom's judicially-developed avoidance doctrine required that a scheme must consist of a pre-ordained series of transactions before it could be set aside. The transactions in *Bowater*, while their purpose was to avoid tax, were not pre-ordained in this sense, so could not be set aside.⁶ *Bowater* was clearly a situation where the taxpayer took advantage of a statutory exemption by constructing an artificial situation with no economic purpose other than the gaining of a tax exemption, yet without a general anti-avoidance rule the tax authorities were powerless to challenge it.

2.3 Avoidance, Evasion, and Shams

2.3.1 What Is a Sham?

The term "sham" typically applies to a situation where the actual intentions of the relevant parties do not match what they have recorded and, in tax avoidance situations, what they have reported to the tax authorities. For example, consider a transaction that has all the attributes of a sale except that the parties involved call it a lease. The lease contract will not be a "real" lease contract, because what it describes is in fact a sale. The contract is therefore a sham. If a tax system allows gains from leases to be taxed at a lower rate than gains from sales, a taxpayer might re-characterise their sale as a lease in order to avoid tax.

Croatia already has legislation that allows the tax authorities to combat shams.⁷ A general anti-avoidance rule is therefore not necessary in order for sham transactions to

⁵ Development Land Tax Act 1976 (UK), 12.

⁶ *IRC v Bowater Property Developments Ltd [1989] AC 398 (HL)*.

⁷ General Tax Act, Chapter II, Article 11 states "If a sham transaction conceals some other transaction, then the tax liability shall be determined on the basis of the concealed transaction." It appears however that this provision has never been invoked, as the Ministry of Finance has not published an opinion on its application.

be caught. Tax avoidance and sham transactions are different concepts that must be attacked by different weapons. A general anti-avoidance rule applies where the sham doctrine is not strong enough.

2.3.2 What Is Tax Evasion?

Tax avoidance and tax evasion are conceptually different, although the two terms are often used interchangeably by economists because they have similar economic consequences. Evasion occurs when taxpayers do not accurately report their earnings to the tax authorities. The result is that they are not taxed on the earnings that they do not report. Tax evasion transactions are typically very simple, for example, accepting a cash payment for goods or services without reporting that payment to the revenue is tax evasion.

Tax evasion takes a number of different forms in Croatia. One of the more common varieties is the underreporting of income from wages. Wages may be reported to the tax authorities as being paid at the minimum rate, but in reality employees may be receiving cash or other benefits on top of that minimum (Madžarević-Šujster, 2000). A large chunk of income therefore goes unreported and untaxed. An obvious consequence of tax evasion is the erosion of the tax base. Tax evasion also affects the government's ability to distribute the tax burden fairly: people who underreport their income may be unfairly receiving benefits that the government has intended to provide to only those who earn less than a certain amount.

These consequences of evasion are identical to those of avoidance, so economists often deal with the two concepts together. However, avoidance is not the same thing as evasion. Evasion always involves some form of concealment, but avoidance does not. People who enter into avoidance transactions disclose all the steps they have taken to the tax authorities. The reduction in tax comes from the exploitation of legal loopholes, rather than from the simple underreporting of income.

Tax avoidance is a more sophisticated activity than simple tax evasion, because it requires more knowledge of the relevant laws. Similarly, methods to combat tax avoidance must be more sophisticated than those used to combat tax evasion. To combat tax evasion, no legislative change is needed – what is required is more rigorous tax auditing procedures.⁸ In contrast, tax avoidance occurs in response to deficiencies in tax legislation. While some countries try to plug legislative loopholes as they occur,⁹ many other countries use general anti-avoidance rules instead as general catch-all provisions.

⁸ The claim that all that is required to combat tax evasion is stricter auditing is obviously simplistic. The causes of tax evasion are complex and not well understood, and there is considerable debate over the best way to address the activity, see further, (Madžarević-Šujster, 2002: 20-21). Nevertheless, it remains true that tax evasion is a problem with the implementation of and compliance with tax laws, while tax avoidance is a problem with the form of the laws themselves.

⁹ This seems to be the case with Croatia, which has a number of specific anti-avoidance provisions.

3 Tax Avoidance in Croatia

3.1 Is Avoidance a Problem?

There are a number of features of Croatia's tax system that provide opportunities for tax avoidance that are not ordinarily found in other jurisdictions. Croatia uses the tax system in order to encourage certain activities, for instance, corporations operating in regions of special national concern have reduced tax rates, as do corporations that invest sufficient amounts in the economy and that have a sufficient number of employees.¹⁰ In addition, the existence of taxpayers who pay reduced rates of tax, such as disabled war veterans, provides extra opportunities for income-splitting arrangements (---, 2004). Whether people are in fact taking advantage of these opportunities is another issue.

Tax avoidance probably occurs where there is no rule preventing it. An international tax planning website refers to Croatia as "The Insiders' Choice for Tax-Advantaged Residence and Yachting in Europe,"¹¹ due to the lack of anti-avoidance legislation. The opportunities that Croatia's tax system offers clearly have not gone unnoticed by the international community; so it would be naïve to assume that corporations are not taking advantage of these opportunities. Therefore despite the lack of solid evidence that Croatia has a tax avoidance problem, it is reasonable to suppose that tax avoidance does indeed occur in Croatia and that a Croatian general anti-avoidance rule would not be entirely superfluous.

3.2 What Measures Does Croatia Already Have?

3.2.1 Thin Capitalisation

"Thin capitalisation" is the name given to a particular type of international tax planning. Companies that need to fund parent or subsidiary companies in other jurisdictions often find it more tax-efficient to fund those subsidiaries with shareholder debt, rather than with equity. The interest on loans from shareholders is deductible in the hands of the borrowing company, while normal dividends are not. There is therefore a tax advantage for a borrowing company that pays high rates of interest on shareholder loans instead of large dividends.

Of course, the interest received by the shareholders is taxable as income, so if the borrower company and the shareholders are both in the same jurisdiction there is no loss to the tax authorities. However, in thin capitalisation schemes the shareholders are usually situated in low-rate jurisdictions, so they do not pay much tax on the interest they receive.

Croatia has legislation to prevent this kind of abuse. The interest rates of loans to companies from shareholders are compared to the rates of interest that would be available from banks in respect of similar loans. If the rates paid to shareholders are excessive, the extra interest paid is not deductible against the company's income.¹²

¹⁰ Profit Tax Act 2001, Chapter VII, Arts 13-15.

¹¹ <http://www.henleyglobal.com/Croatia2001.htm>, last accessed 2 December 2004.

¹² Profit Tax Act 2001, Chapter III, Art 6.

3.2.2 Transfer Pricing

Due to the ease with which corporations are now able to move their business activities from country to country, there is a real concern that corporations will be motivated to report their profit-making activities in countries that have relatively low tax rates for purely tax-saving reasons (Bartelsman and Beetsma, 2000). As with all forms of tax avoidance, this practice causes economic distortion and is correctly regarded as undesirable. Countries with low tax rates can end up recording higher levels of production than they are in reality receiving, because companies can artificially rearrange their affairs so that it appears that most of their profits have been made in these low-tax countries (*idem*).

Croatia's corporate tax is a tax on worldwide income, but tax credits are given in respect of taxes paid abroad.¹³ Croatia's corporate tax rate is a relatively low 20%, so Croatia is less likely to have problems with Croatian companies artificially structuring their business so that their profits are earned elsewhere. However low the rate, there are of course a number of countries that have lower ones;¹⁴ so transfer pricing is still a risk. In recognition of the possibility of transfer pricing, the Croatian tax authorities may perform tax audits on transactions between resident and non-resident branches of companies to ensure that foreign profits (and domestic losses) are not being artificially inflated for tax purposes.¹⁵ The Profit Tax Act contains a number of methods that may be used to establish that companies conduct transactions at arm's length.¹⁶

3.2.3 Hidden Profit Distributions

Businesses operating in countries with classic systems of corporate income tax, in which companies are taxed on their profits before dividends are paid to shareholders, often try to siphon off profits so that they pay less tax. Of course, this siphoning is wise only if those profits end up in the hands of members of the corporation. One common way for companies to do this is for a shareholder chief executive to pay himself a large salary, which is deductible from the company's profits, instead of a dividend, which is not. More complex schemes can involve selling shares to share traders for capital gains.¹⁷

Croatia has specific legislation to combat this practice. Hidden profit distributions, which would include a chief executive's inflated salary, are simply not deductible. It is difficult to know how effective this provision is, because determining which expenses ought to qualify as hidden profit distributions requires fairly rigorous auditing procedures. Nevertheless, Croatia theoretically does have a procedure to stop this variety of tax avoidance.

¹³ Income Tax Act 2003, Chapter VI, Art 30(4).

¹⁴ For a comparison of global corporate tax rates, see (KPMG, 2004).

¹⁵ Profit Tax Act 2001, Chapter III Art 7(7).

¹⁶ *Ibid*, Chapter III Art 6.

¹⁷ E.g., the case of *Newton v FCT* [1958] 2 All ER 759 (PC) is an example of this sort of scheme.

4 General Anti-Avoidance Rules

4.1 How Do General Anti-Avoidance Rules Work?

The theory behind having general anti-avoidance rules is that their existence allows tax authorities to tax arrangements according to their economic reality as opposed to their legal form. This theory, however, is not as simple to put into practice as it may appear, primarily because the “economic reality” that a tax avoidance arrangement conceals is often difficult to determine.

For example, New Zealand’s current general anti-avoidance rule allows the tax authorities to reconstruct transactions according to the true economic situation.¹⁸ Exactly what the power to “reconstruct” directs the tax authorities to do is a difficult question. The case law suggests that¹⁹...

... [The general anti-avoidance rule] gives the Commissioner a wide re-constructive power. He “may” have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, but the Commissioner is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.

That is, a general anti-avoidance rule giving reconstructive powers in effect allows the tax authorities a very broad discretion to look at a series of transactions and determine the amount of tax that ought to be paid. The tax authorities are not limited to taxing the situation that would have obtained had the tax avoidance arrangement not been entered into. There are clear advantages in including a reconstructive provision in a general anti-avoidance rule, because such provisions make it more likely that the amount that is finally taxed will be the amount that the taxpayer has actually gained, from an economic point of view.

The exact status of general anti-avoidance rules in relation to other tax laws is difficult to describe. A general anti-avoidance rule is not a superior law, because there are transactions that do not seem to be, strictly speaking, tax avoidance ones, but that the general anti-avoidance rule nevertheless cannot touch. That is, there are transactions that avoid tax but that in doing so fall squarely within the legislature’s intent, for example, transactions that benefit from preferential tax treatment that the government has decided to allow. General anti-avoidance rules cannot touch such transactions because other laws specifically allow them. That is, there are transactions that manage successfully to avoid tax while nevertheless falling squarely within the intent of the law, such as, for example, transactions that benefit from preferential tax treatment that the government has for other reasons decided to allow.

On the other hand, general anti-avoidance rules can attack some transactions notwithstanding that the transactions might comply with the letter of the law. In fact, by definition all transactions caught by general anti-avoidance rules comply with the law, strictly

¹⁸ Income Tax Act (NZ) 2004, s GB 1.

¹⁹ *Miller v CIR* (1998) NZTC 13, 961, 13, 980 Blanchard J (CA).

interpreted. The transactions that general anti-avoidance rules catch are those that comply with the law, but comply in a way that the legislature never intended to allow. Possibly the best way to describe the status of a general anti-avoidance rule is as neither superior nor inferior, but as filling in gaps in the legislation.

4.2 General Anti-Avoidance Rules in Civil Law Jurisdictions

4.2.1 Relationship with *Fraus Legis* Doctrine

In most civil law countries²⁰, general anti-avoidance rules are linked in some degree to the civil law doctrine of *fraus legis* (fraud of law), also known as abuse of rights. The doctrine holds that rights granted by law may not be abused, that is, they may not be used for a purpose other than that for which they were granted.

The relationship between *fraus legis* and tax avoidance is clear: tax avoidance is the exploitation of legal rules in order to minimise tax. Tax avoidance is by definition an unintended use of legal rights.

Common law countries do not recognise the *fraus legis* doctrine,²¹ so common law general anti-avoidance rules tend to be framed without reference to the concept. The intention to avoid tax is usually the most relevant factor, rather than the exploitation of a legal rule. In contrast, general anti-avoidance rules in civil law countries tend to refer to concepts such as “abuse of tax law.”

On the whole, civil law general anti-avoidance rules are triggered by transactions that have little or no business purpose other than tax avoidance, that are unusual compared to normal business activities, and that lack economic reality. Although these factors do not feature in the wording of general anti-avoidance rules, they are nevertheless how we may identify situations to which general anti-avoidance rules will apply. The following sections of this paper describe the general anti-avoidance rules that Hungary, Germany, and the Netherlands use.

Croatian law does not contain many embodiments of *fraus legis*.²² However, unfamiliarity with the concept might be an advantage. Countries that are too attached to the traditional *fraus legis* doctrine often find it difficult to understand the slightly different way in which a general anti-avoidance rule must work in order to be most effective.

4.2.2 Hungary

Hungary is the only country in Central and Eastern Europe to have a general anti-avoidance rule (Foldes, 2000a, 558-559). For the wording of its general anti-avoidance rule, Hungary borrowed considerably from German legislation. The Hungarian approach to tax avoidance basically has two prongs: a substance-over-form doctrine that is very

²⁰ A table showing a selection of countries in both common and civil law jurisdictions is appended to this paper.

²¹ This statement is true in general, although it has been suggested that many of the United States' judicial doctrines, including those used to combat tax avoidance, are in fact applications of *fraus legis*, if not explicitly so, see Perillo (1995).

²² Two Croatian legal provisions could be viewed as applications of the concept: the Croatian Sham Doctrine in the General Tax Act, Chapter II, Article 11, and a similar provision in Article 66 of the Obligations Act.

like Croatia's, and an anti-abuse-of-law provision that can attack tax avoidance schemes that the substance-over-form doctrine cannot reach.

Section 1(7) of the Hungarian Tax Administration Act states that contracts, transactions and similar acts are to be classified according to their true nature. This rule allows the tax authorities to look at the legal substance of a transaction instead of its legal form.²³ This provision is effective in combating tax avoidance only where the contract or transaction between the parties does not in fact match the legal classification that the parties have given to the contract or transaction (Foldes, 2000b, 558, 562). The Hungarian Supreme Court has held that contracts and transactions may not be classified as artificial and therefore ineffective for tax purposes if they still represent the actual will of the parties, in spite of the fact that they have been entered into purely to gain a tax advantage. In this sense, the substance-over-form doctrine allows tax authorities to tax legal substance over legal form, but does not allow the authorities to tax economic substance over legal substance.

This narrow construction of the doctrine is ineffective against many forms of tax avoidance because in many situations the legal form of a transaction will accurately represent the intention of the parties, yet the transaction's sole purpose will be to avoid tax. However, in 1999, Hungary introduced a general anti-avoidance rule into its tax law. Hungary's general anti-avoidance rule states that rights must be used properly in tax matters.²⁴ The links with the *fraus legis* doctrine are clear. The proper interpretation of this general anti-avoidance rule seems to be that contracts or transactions that have the purpose of avoiding tax law are not proper uses of rights (Deak, 2003:334). To invoke the doctrine, the tax authorities must prove that a transaction has no genuine business purpose other than the avoidance of tax.

The Hungarian general anti-avoidance rule has not been used so far. The Hungarian authorities are possibly still unsure of exactly how the general anti-avoidance rule works, or possibly the authorities have found the task of showing that a transaction has *no* business purpose too onerous (Foldes, 2000b).

4.2.3 The Netherlands

The Netherlands has a judicially created general anti-avoidance rule that is an application of the *fraus legis* doctrine. According to case law, transactions caught by the doctrine are those that have the sole or main purpose of frustrating taxation, and are in conflict with the meaning or purpose of the relevant tax rule. This doctrine is for all practical purposes the only weapon the tax authorities have against tax avoidance, although Netherlands tax law has a number of specific anti-avoidance provisions too. Interestingly, Netherlands tax law does in fact have a general anti-abuse provision that applies to income and corporate tax,²⁵ but since 1987, following a decision of the Under-Minister

²³ That is, s 1(7) is a simple sham doctrine.

²⁴ S 1(7) Tax Administration Act (Hungary).

²⁵ General Law on Taxation (Netherlands) Art 31.

of Finance, that provision has not been used (Arts, 1999) Nevertheless, the judicially created doctrine appears to have much the same effect.

4.3 Problems General Anti-Avoidance Rules Can Cause

4.3.1 Interpretation

A problem that a number of jurisdictions face when applying their general anti-avoidance rule is the question of how exactly the general anti-avoidance rule should be interpreted. The problem often stems from confusion over the relationship between a general anti-avoidance rule and the *fraus legis* rules contained in the general law of the country. Should general anti-avoidance rules operate in the same way as *fraus legis* rules, or should they operate in ways peculiar to tax law?

The Austrian experience illustrates this problem. Austria's tax legislation has a general anti-avoidance rule, but there is controversy over whether the general anti-avoidance rule ought to be applied in a manner similar to that in which anti-abuse provisions in other areas of legislation are applied, or whether the anti-abuse provision in the tax law has its own special rules of interpretation. This question is not entirely academic. If the former interpretation is to be preferred, then the most relevant consideration in avoidance cases is whether a particular arrangement is in accordance with the intention of the legislation. Alternatively, if the latter interpretation is correct, the more important factors are whether the arrangement is unusual in the light of its economic background and whether the taxpayer has a tax avoidance motive (Gassner, 1999).

Possibly because of this confusion over its proper interpretation, the Austrian anti-avoidance rule is not as effective as it might be. Compared to the German anti-avoidance rule, with which the Austrian rule shares a number of characteristics, the Austrian rule is fairly weak. Many types of arrangement that have been caught by the German rule have been let stand by the Austrian courts. The Austrian experience is a caution against the enactment of a rule whose exact meaning is unclear.

Furthermore, it is important not only to be clear about the correct interpretation of one's general anti-avoidance rule, but also to choose the most effective interpretation about which to be clear. It seems that the best approach is to state firmly that a general anti-avoidance rule is *not* supposed to be applied in the same way as other *fraus legis* doctrines. Countries such as France, where the general anti-avoidance rule is considered to be a simple extension of that doctrine, tend to find that their general anti-avoidance rules are not as flexible as they might be (Plagnet, 1999:101). To have a truly effective general anti-avoidance rule, it seems that it is necessary first to be clear about what it means, and secondly to make sure that it means the most effective thing.

4.3.2 Conflict with the Principle of Legality

Some civil law jurisdictions have found that their courts are unwilling to give general anti-avoidance rules their widest (and most effective against tax avoidance) interpretation, because of a perceived conflict with the rule of law, also known as the principle of legality. The principle of legality is the principle that administrations must act

according to the law. It is arguable that the terms of general anti-avoidance rules are so vague that when governments invoke general anti-avoidance rules they are not *really* acting according to the law (Cooper, 1997). Many countries simply ignore this possible conflict and apply their general anti-avoidance rules anyway, but occasionally, and particularly in countries where the principle of legality is included in that country's constitution, this perceived conflict inhibits the operation of general anti-avoidance rules.

This possible conflict could be a problem for Croatia if it were to enact a general anti-avoidance rule. Article 19 of Croatia's Constitution says: "Individual decisions of administrative agencies and other bodies vested with public authority shall be grounded on law." The principle of legality is therefore a key part of Croatian law, and in theory laws should be interpreted to comply with this principle as far as possible.

The problem with general anti-avoidance rules is that they seek to combat an activity that is almost impossible to define. It is difficult to specify in advance to which transactions a general anti-avoidance rule will eventually apply. When authorities invoke general anti-avoidance rules, they are doing so on the basis of a general principle that general anti-avoidance rules set out, not because the attacked transaction corresponds exactly to some transaction outlawed by legislation. People might argue that invoking general anti-avoidance rules under such vague authority is not acting according to law at all. If judges agree with such arguments, general anti-avoidance rules quickly lose their effectiveness.²⁶

It is important not to overstate the danger of a Croatian general anti-avoidance rule being weakened by constitutional conflict. After all, most countries seem to operate their general anti-avoidance rules without any qualms. For example, Switzerland has a constitutional provision that is broadly equivalent in meaning to Croatia's Article 19, which states: "The state's activities shall be based on and limited by the Rule of Law"²⁷ Nevertheless, Switzerland manages to combat tax avoidance adequately with a judicially-developed anti-avoidance doctrine. Such a doctrine theoretically is even more constitutionally troublesome than a statutory general anti-avoidance rule, because judicial doctrines are even less predictable than statutory general anti-avoidance rules.

The Swiss experience shows that constitutional conflicts are not the necessary accompaniments of general anti-avoidance rules. Or rather, while such conflicts may exist in theory, they have no visible symptoms as long as the courts do not trouble themselves with them. While it is possible that the Croatian courts would take objection to the vagueness of a general anti-avoidance rule and therefore restrict its application, there are no indications that Croatia's judiciary would take such a hard-line approach. It is unlikely that a general anti-avoidance rule would cause constitutional problems for Croatia.

²⁶ This phenomenon is not confined to civil law countries. For a considerable period of time, the Australian general anti-avoidance rule was almost completely ineffective because of the reluctance of the Australian Chief Justice, Sir Garfield Barwick, to apply it, see Lehman (1983).

²⁷ Federal Constitution of Switzerland, Art 5(1).

5 Difficulties with a Croatian General Anti-Avoidance Rule

5.1 Would a General Anti-Avoidance Rule Have any Practical Effect?

A further problem with Croatia's potential enactment of a general anti-avoidance rule is that it is quite likely that a new general anti-avoidance rule would not actually be applied for quite some time. Hungary has had its general anti-avoidance rule since 1999, yet the tax authorities have not invoked it so far (Foldes, 2000b). It is likely that Croatia would have a similar experience. Croatia has seen much reform of its tax system in recent years,²⁸ and the tax authorities are still getting used to the new laws. The fact that the tax authorities still have not decided on the proper interpretations of the sham doctrine and the economic reality doctrine shows that Croatia has yet to navigate fully its existing tax laws. Moreover, the Croatian tax administration has more pressing items on its agenda, such as tax evasion, than learning about new laws.

Nevertheless, even when general anti-avoidance rules are not used, they have a considerable deterrent effect. The Hungarian experience demonstrates this effect: companies often submit requests Ministry of Finance for an advance ruling on whether the general anti-avoidance rule will be applied to various arrangements, even though the general anti-avoidance rule has never been invoked (Foldes, 2000a 2005b).

The threat that the general anti-avoidance rule will one day be used is a sufficient deterrent to all but the most audacious tax planners. If the hypothesis that much of Croatian tax avoidance occurs because the activity is entirely risk-free is correct, then a great deal of tax avoidance will simply cease on the introduction of a general anti-avoidance rule. Even a general anti-avoidance rule that is never invoked can therefore prevent tax avoidance.

5.2 What Form Should It Take?

There is no reason in theory why Croatia should not simply lift a general anti-avoidance rule word for word from another jurisdiction. There are two main advantages of this approach: first, it eliminates the need for any in-depth legislative drafting. The Croatian legislature is already overburdened, and there is no need to redo the work that other jurisdictions have already done. Secondly, if Croatia adopts the exact wording of another jurisdiction, the Croatian courts will have a wealth of case law from that jurisdiction to help them apply this new legislation.

Which jurisdictions should Croatia emulate? The obvious contenders are Germany and countries that have followed the German model, such as Hungary. Like Hungary, Croatia has based much of its tax law on the German system, so it would seem sensible for Croatia to continue with this pattern. What Croatia should have, then, is a provision in its tax law that states, like the German provision, that possible legal arrangements are not to be abused. This provision should be located in Croatia's Gen-

²⁸ Most notably, Croatia introduced a consumption-based tax for the period of 1994-2000, see further Zdroj (2003:239).

eral Tax Act, where Croatia's anti-sham doctrine and other provisions applying to all taxes can be found.

Croatia's general anti-avoidance rule ought to contain the further statement that where taxpayers abuse possible legal arrangements to gain a tax advantage, the tax authorities may reconstruct the transactions involved according to the true economic situation, and determine the appropriate amount of tax. Reconstructive provisions such as this one are extremely useful for tax authorities.

This simple wording ought to be sufficient for Croatia's general anti-avoidance rule: while general anti-avoidance rules can be complicated to apply, they tend to be very economically worded in order to ensure their flexibility. A prudent step would be for the Ministry of Finance to publish an opinion on the correct application of the new law, detailing the kinds of transactions that the general anti-avoidance rule would catch, and explaining what the results would be.

6 Conclusion

Croatia would benefit from a general anti-avoidance rule. While it is difficult to estimate the amount of tax avoidance occurring in Croatia (or anywhere) with any precision, tax avoidance undoubtedly occurs. When deciding what type of general anti-avoidance rule to enact and how to interpret its general anti-avoidance rule, Croatia would do well to look to the examples of similar jurisdictions for guidance. Croatia potentially could avoid a number of the problems that other countries have experienced with their general anti-avoidance rules. The enactment of a general anti-avoidance rule would be a positive step for Croatia.

Appendix

Countries That Have General Anti-Avoidance Rules and the Effectiveness of Those General Anti-Avoidance rules

Country	Type of legal system	Type of general anti-avoidance rule	Is the general anti-avoidance rule effective? ^a
Austria	civil law	statutory	no
France	civil law	statutory	no
Germany	civil law	statutory	yes
Hungary	civil law	statutory	no
New Zealand	common law	statutory	yes
Spain	civil law	statutory	no
Sweden	civil law	statutory	no
Switzerland	civil law	judicially created	yes
The Netherlands	civil law	judicially created	yes
United Kingdom	common law	judicially created	no
United States	common law	judicially created	no

^a This assessment of whether a particular general anti-avoidance rule is effective is necessarily crude. A "no" entry does not necessarily mean that the particular country's general anti-avoidance rule is of no use in frustrating tax avoidance. The table does not address the different ways in which a general anti-avoidance rule might be ineffective, nor does it consider the various reasons for a lack of effectiveness. More detailed assessments of the effectiveness of various general anti-avoidance rules are given in the main text.

LITERATURE:

—, **2004**. *The Croatian Tax System*. Zagreb: Institute of Public Finance.

Arts, J. H. M., 1999. "Netherlands" in: *European Taxation*. Amsterdam: IBFD, 105.

Bartelsman, E. J. and and Beetsma, R. M. W. J., 2000. "Why pay more? Corporate tax avoidance through transfer pricing in OECD countries". *CES Working Paper*, No 324, August.

Bundesabgabenordnung (Austria) 22.

Cooper, G. S., 1997. "Conflicts, Challenges and Choices - The Rule of Law and Anti-Avoidance Rules" in: Graeme S Cooper, ed. *Tax Avoidance and the Rule of Law*. Amsterdam: IBFD, 13-15.

Deak, D., 2003. *Hungary in International Tax Planning*. Amsterdam: IBFD.

Development Land Tax Act 1976 (UK), s 12.

Federal Constitution of Switzerland.

Foldes, G., 2000a. "General Anti-Avoidance Rules in the Tax Legislation of Hungary". *Bulletin of International Fiscal Documentation*, (3-4), 334-337.

Foldes, G., 2000b. "General Anti-Avoidance Rules in the Tax Legislation of Hungary". *Bulletin of International Fiscal Documentation*, (11), 558-562.

Furniss v Dawson (1984) 55 TC 324.

Gammie, M., 1997. "Tax Avoidance and the Rule of Law: A Perspective from the United Kingdom" in: Graeme S Cooper, ed. *Tax Avoidance and the Rule of Law*. Amsterdam: IBFD, 189-190.

Gassner, W., 1999. "Austria" in: *European Taxation*. Amsterdam: IBFD, 93-94.

General Law on Taxation (Netherlands) Art 31.

<http://www.henleyglobal.com/Croatia2001.htm>

Income Tax Act (NZ) 2004, s GB 1.

Income Tax Act 2003. Zagreb: Institute of Public Finance.

IRC v Bowater Property Developments Ltd [1989] AC 398 (HL).

KPMG, 2004. *Corporate Tax Survey – January 2004* [online]. Available from: [<http://www.in.kpmg.com>].

Land and Income Tax 1954, s 108 (NZ).

Lehman, G., 1983. *Income tax judgments of Sir Garfield Barwick: A study in the failure of the new legislation.* 9 Monash ULR 115.

Madžarević-Šujster, S., 2002. "An Estimate of Tax Evasion in Croatia" [online]. *Occasional Paper Series*, No 13. Available from: [<http://www.ijf.hr/ops/PDF/ijf-ocp13.pdf>].

Mangin v CIR [1971] NZLR 591, 598 Lord Donovan (PC).

Miller v CIR (1998) NZTC 13, 961, 13, 980 Blanchard J (CA).

Orow, N., 2000. *General Anti-Avoidance Rules: A Comparative International Analysis*. Bristol: Jordan Publishing Ltd.

Perillo, J. M., 1995. *Abuse of Rights: A Persuasive Legal Concept*. 27 Pac LJ 37.

Plagnet, B., 1999. "France" in: *European Taxation*. Amsterdam: IBFD, 101-103.

Profit Tax Act 2001. Zagreb: Institute of Public Finance.

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

Tax Administration Act (Hungary).

Whitehouse, C., 1994. *Fitzwilliam – An End to Ramsey*. PCB 71.

Zodrow, G., 2003. "Alternative forms of direct consumptions taxes: The Croatian approach". *Tax Notes International*, 32 (3), 239-251.