GENERAL ANTI-AVOIDANCE THE O'FLYNN CONSTRUCTION DECISION

The recent Supreme Court decision in the case of O'Flynn Construction is likely to influence non-commercially driven tax planning. **Olivia Waldron** explains the background to the case, analyses the decision and looks at its likely impact.

The Supreme Court delivered its decision in the O'Flynn Construction general anti-avoidance case on 14 December 2011.[1] The decision upheld by a 3 to 2 majority the earlier High Court decision which had found in favour of the Revenue Com-missioners. The majority decision was delivered by O'Donnell, J. with the dissenting judgment delivered by McKechnie, J.

This case is of significance as it is the first Supreme Court decision pertaining to Ireland's general anti-avoidance tax rules introduced in s.86 Finance Act 1989 (s.86), now s.811, Taxes Consolidation Act, 1997 (s.811). This article outlines the background to the case, analyses the decision and opines on the likely impact of the decision on tax planning going forward.

BACKGROUND

The transaction at the heart of this case was entered into by the appellants, O'Flynn Construction Ltd (OFCL) and its shareholders John O'Flynn and Michael O'Flynn, in December 1991 and January 1992.

OFCL was an Irish construction company with reserves which, if distributed, would have given rise to an income tax liability for shareholders. Mitchelstown Export Company Limited (Mitchelstown) was a company that engaged in export activities that qualified for Export Sales Relief (ESR). Export relieved reserves could be distributed, directly or indirectly, to individual shareholders without triggering personal income tax, although this exemption was being phased out with effect from 29 January 1992. Mitchelstown, which was not in a position to distribute its export relieved reserves to its own shareholders, entered into a series of transactions which involved the effective sale of its reserves to OFCL which used its own reserves to fund a dividend through Mitchelstown to its shareholders.

The tax benefit arising from this transaction was challenged by Revenue under the general anti-avoidance provisions contained in s.86.

GENERAL ANTI-AVOIDANCE PROVISIONS

General anti-avoidance provisions are overriding provisions which enable the Revenue Commissioners to withdraw a tax benefit from a taxpayer to which he/she would otherwise be entitled in cases where they believe the benefit is achieved as part of a 'tax avoidance transaction'.

Both Canada and Australia have general anti-avoidance rules (GAAR) in their legislation. The Supreme Court of Canada delivered its most recent decision in the Copthorne case on 16 December 2011, which found in favour of the Canadian Revenue.[2] Case law on Canadian GAAR was referred to in the O'Flynn judgment but was distinguished given the differences between the respective tax provisions.

By their nature general anti-avoidance measures create uncertainty and it was hoped that this decision would provide a general road-map for interpretation of the provisions going forward. Unfortunately, however, as other aspects of the provisions were not argued at the Supreme Court, the case only dealt comprehensively with one particular aspect of s.86 so uncertainty will in the main prevail, which is not helpful.

The provisions of s.86 can apply where a transaction is undertaken which gives rise to a tax advantage where the transaction was not undertaken primarily for purposes other than to give rise to a tax advantage. In forming the opinion that a transaction is a tax-avoiding transaction, the Revenue are to have regard to "(a) the results of the transaction, (b) its use as a means of achieving those results, and (c) any other means by which the results or any part of the results could have been achieved" (s86(2)).

In addition, two specific situations are outlined in s.86(3) where the Revenue is not to treat a transaction as a tax-avoidance transaction. The first is where the transaction was undertaken with a view to the realisation of profits in the course of the person's business and not primarily to give rise to a tax advantage. The second, outlined in s86(3)(b), forms the basis for the key point of contention between the parties in the O'Flynn case. It applies where the Revenue Commissioners are satisfied that:

> *"the transaction was undertaken or arranged for the purpose of obtaining the benefit of any relief, allowance or other abatement provided by any provision of the Acts and that transaction would not result directly or indirectly in a misuse of the provision or an abuse of the provision having regard to the purposes for which it was provided"*

The appellants argued that there had been no abuse of the ESR provisions having regard for the purposes for which they were provided. Revenue disagreed.

> "BY THEIR NATURE, GENERAL ANTI-AVOIDANCE MEASURES CREATE UNCERTAINTY AND IT WAS HOPED THAT THIS DECISION WOULD PROVIDE A GENERAL ROAD-MAP FOR INTERPRETATION OF THE PROVISIONS GOING FORWARD."

THE DECISION

As noted at the outset, the decision found in favour of the Revenue Commissioners. In particular, the specific scheme whereby OFCL reserves were used to fund a tax-free distribution to its shareholders through Mitchelstown was found to be a misuse or abuse of ESR provisions.

While the decision is not surprising, the means through which it was reached marks a new departure in an Irish tax context.

O'Donnell, J. emphasised the need to give effect to the intention of the Oireachtas in interpreting s.86. In this regard, he placed significant emphasis on the context within which s.86 was enacted and the "significant change it effected in pre-existing law". He noted that the fact the provisions were enacted in response to the McGrath decision, which in 1988 rejected a purposive approach to the interpretation of tax statutes in the absence of legislation providing for such, was 'central' to its interpretation.[3]

Against this background O'Donnell, J. considers the meaning of the exception in s.86(3)(b) (outlined above), noting that:

> *"The statutory phrase, 'misuse…or an abuse of the provision having regard to the purposes for which it was provided' is to be read as one comprehensive indication that the object of the subsection is to ensure that reliefs and benefits are only available to transactions which can be regarded as a proper and intended use of the provision".*

In assessing the purposes for which ESR was provided O'Donnell, J. rejects an assessment of a "general purpose" such as promoting exports and manufacture, noting that this purpose "can be deployed almost rhetorically on either side of this case". Instead, the purpose is to be discerned "from the words used in their context, deploying all the aids to construction which are available". This approach requires an evaluation of whether or not the transaction falls within the intended scheme of what was enacted.

In determining whether there is misuse or abuse of a provision under ss.(3)(b), O'Donnell, J. notes that the Revenue are:

> *"…to have regard to those indicators which are identified in s.86 as going towards ascertaining the existence of a tax avoidance transaction. Those matters are the form of the transaction and its substance, whether it was undertaken for the realisation of profit in the course of business activities, carried out by any person, and finally, whether it was undertaken primarily for purposes other than to give rise to a tax advantage."*

Applying this approach, the conclusion was quickly reached that the transaction in this case was a tax-avoidance transaction as its form was highly artificial, lacked any real commercial purpose and in substance allowed OFCL to use its profits to make tax-free payments to its shareholders.

This approach avoided the Court identifying any particular purposes of the ESR provisions in the comparison of the transaction with the "intended scheme" of the provisions. In this regard, it is difficult to see how the plain words of s.86(3)(b), to determine whether there is misuse or abuse of the provision "having regard to the purposes for which it [the provision] was provided", are given effect. Instead, it seems a wider interpretation of s.86(3)(b) is required in line with the context within which s.86 was enacted by the Oireachtas. This marks a significant departure from the traditional literal approach to the interpretation of tax statutes.

The dissenting judgment takes an entirely different approach in line with the

traditional approach to interpretation. McKechnie, J. looked at the meaning of the words in s.86(3)(b) and notes as regards the misuse or abuse test that:

> "*…the section is utterly clear in this regard: such must be measured against the purposes of ESR relief and not otherwise*".

In assessing the purpose he notes that:

> "*policy must be anchored in the language used, recourse being had, where appropriate, to its context as disclosed by the statute (or relevant part thereof) as a whole.*"

After his review of the ESR provisions McKechnie, J. concludes that:

> "*the unrestricted scope and nature of the exemption, over such a period of time, was part of a deliberate policy supporting total exemption of such profits from tax: this at the corporate and individual level. In such circumstances it would seem impossible to hold that the purpose of the relief could be said to have either abused or misused in this case.*"

Both judgments refer to the strong reluctance to use extraneous materials in interpreting legislation in Ireland. Consequently no reference is made to any materials outside of the legislation in assessing the purpose of the ESR provisions.

As regards the onus of proof with regards s.86(3)(b), no reference was made to this in the majority decision although the dissenting judgment states that the onus of proof should be on the taxpayer.

CONCLUSION

While this decision is likely to be viewed as a success from a Revenue perspective, it should be noted that this decision does not prevent a person from organising their normal commercial affairs as tax efficiently as possible. In particular, s.811 can only apply where the transaction is undertaken or arranged primarily for tax reasons. Therefore, most tax planning in relation to general business decisions should not be impacted by the case.

This decision was largely confined to its facts rather than a wider principled analysis of all aspects of s.811 so further cases are likely in the future on other aspects of the provisions. In the meantime there remains a grey area as to where the line should be drawn which will present a challenge to both the Revenue and tax practitioners alike.

References:

[1] *Revenue Commissioners v O'Flynn Construction & ors* [2011] IESC 47
[2] *Copthorne Holdings Ltd v Canada* [2011] SCC 63
[3] *McGrath v McDermott* [1988] IR 258

Olivia Waldron, ACA, AITI, is a tax director with Deloitte and is a facilitator on the Institute's Chartered Tax Consultants course.